

Executive Summary

1. This submission sets out our headline views on Ofgem’s policy consultation and should be read in conjunction with our detailed response and Legal Annex (both attached). The detailed response contains our responses to the individual consultation questions, some additional points not covered by the questions, and more commentary on the points set out in this summary. The Legal Annex contains, amongst other things, a description of what the requirements of the Bill mean for setting the cap in practice. It also sets out analysis of the substantive and procedural concerns that must be addressed if Ofgem is to specify a cap that is capable of meeting the statutory obligations in the Bill and the interests of energy consumers.
2. Our response focuses on helping Ofgem ensure it sets a default tariff cap that protects the interests of existing and future consumers. This can only be achieved by specifying a cap which meets all of the conditions set out in the Bill, and by following as transparent a process as possible to enable stakeholders to respond meaningfully. We have material concerns about whether the requirements of the Bill will be met, based on Ofgem’s current approach.
3. Whilst we welcome Ofgem’s recognition of the issues that require consideration, we have a number of important concerns:
 - Ofgem’s **process and analytical framework** is not enabling stakeholders to respond meaningfully; and
 - Ofgem has not gathered or disclosed important information regarding its treatment of **specific components of the cap**, including:
 - operating expenditure;
 - smart metering costs; and
 - the level of headroom and the impact on competition.
4. These concerns are described more fully below.

Ofgem’s process and analytical framework

5. The Bill requires that, when setting the cap, Ofgem must have regard to the need to (a) incentivise efficiency, (b) enable effective competition, (c) maintain incentives to switch and (d) enable efficient suppliers to finance their activities. These duties are not in conflict with the objective of protecting consumers. They are all essential means of protecting consumers over the long term. Put at its most simple, the need to have regard to competition, innovation and quality of customer service are all inextricably intertwined with the protection of energy consumers.
6. Accordingly, if any of the above-mentioned duties are compromised, the negative impact on consumers is likely to be substantial. As set out below, a poorly specified price cap risks compromising investment in smart meter rollout, and severely reducing levels of customer service and innovation across the sector. We have already shared some of these implications with Ofgem in our previous Working Paper responses, yet there is no indication that Ofgem has taken account of or addressed such evidence. Such an

outcome would damage customer engagement and switching and risks the duration of the cap being extended due to its own detrimental impact on competition.

7. Furthermore, a poorly designed cap may distort the incentives of energy suppliers to acquire and retain particular groups of customers, which would have detrimental implications for competition. In this regard, it is far from clear that Ofgem has turned its mind to and made sufficient enquiry into these considerations. There is therefore a real risk that Ofgem will determine incorrectly the way in which ‘protection of consumers’ should be applied when setting the level of the cap, rendering the decision unsafe.
8. There are areas where we welcome developments in Ofgem’s thinking. Notably:
 - Ofgem’s in-principle recognition that ‘protection of consumers’ should not equate to a cap level that results in the “cheapest possible prices”¹ without consideration of the impact or consequences of the cap level for consumers.
 - Ofgem’s recognition that a bespoke adjustment should be made for smart meter costs and indexed in line with expected cost movements.
 - Ofgem’s recognition that suppliers’ costs differ for reasons that are nothing to do with efficiency, such as “differences in their customer bases”².
9. However, these issues have not been developed or articulated to the necessary level of detail. A significant amount of work still needs to be done in these areas to develop appropriate cost allowances, which should then be exposed to scrutiny by external stakeholders. For Ofgem to be confident that its decision is consistent with its statutory duties, it will need both to gather and disclose more information from and to industry stakeholders. We expand on this point below and throughout our consultation response.
10. We are concerned that Ofgem has not yet quantified a proposed benchmark level for operational costs, or the level of all adjustments. We are similarly concerned about the lack of disclosure and scrutiny for calculating smart meter costs³.
11. Once Ofgem has collected all necessary cost data, it should consult on a set of fully quantified and transparent proposals, and be prepared to amend these in response to stakeholder views. The primary purpose of the next stage of Ofgem’s process - the 28-day statutory consultation - is to ensure that the licence drafting reflects the policy intent. It is not currently clear as to whether the selected methodology, relevant cost inputs and underlying reasoning would be disclosed in this statutory consultation. In any event, disclosure at this stage would be too late to mitigate the risk of errors not being identified and corrected. These issues are explored in more detail in the Legal Annex. We therefore believe Ofgem should introduce an additional step of policy consultation before then. Absent this additional policy consultation, Ofgem risks implementing the tariff cap in a way which will not have satisfied legal standards of due process.

¹ Default Tariff Cap: Policy Overview Document, para 1.6, page 11

² Default Tariff Cap: Policy Overview Document, page 8

³ Detailed in a separate letter from Tim Dewhurst to Anna Rossington on 8 June 2018.

Specific components of the cap

12. In addition to **operational** and **smart metering costs**, in this summary we highlight other key points for setting a price cap that best protects existing and future consumers, and meets the requirements of the Bill. These include:
- Ofgem must ensure that the **wholesale costs allowance** is set on a prospective basis and includes all costs, including those that have increased since 2015.
 - Ofgem should establish through more detailed analysis that the cap sets **headroom** at a level that provides sufficient price dispersion and scope for competition, consistent with satisfying the entire requirement of section 1(6) of the Bill. Analysis we have submitted to Ofgem suggests that customer engagement and switching rates are highly sensitive to levels of price dispersion.
 - The extra costs of supplying customers who pay by **standard credit** should be fully recovered from customers who pay by standard credit.
 - Ofgem should not accept the CMA's view of the level of the competitive **profit margin**.
13. We expand on these points further below.

Operational costs

14. We agree that, for all approaches, Ofgem should ensure that the operational cost allowance in the cap reflects efficiently incurred costs, taking into account legitimate differences in costs to serve between suppliers that have nothing to do with efficiency. The mix of customers served by each supplier can differ significantly, and as a result drives operational cost differences. Such differences include, but are not limited to, the additional cost to serve vulnerable customers and the lower cost to serve customers who interact online.
15. We have a disproportionate number of customers who could be considered vulnerable. We have ✕ customers on the Priority Services Register (PSR) and ✕ who receive the Warm Home Discount. These customers tend to contact us more frequently than non-vulnerable customers by making calls to call centres largely based in the UK, even when they have access to online services. On average their contact costs are around £✕ per customer higher than a comparable standard credit customer and around £✕ per customer higher than a comparable direct debit customer.
16. Customers who manage their accounts entirely online are significantly less expensive to serve than customers who opt to use suppliers' offline services, with differentials of £60 observable in the market⁴.
17. More generally, an operational cost allowance in the cap that is inconsistent with the conditions set out in the Bill could result in severe unintended consequences. For example, ✕ leading to a significant increase in abandoned calls ✕. We note Ofgem's view that current service standards should not be diminished⁵. Such standards generate a particular level of cost, which must be capable of being funded under the cap, not least because the Bill requires licensed activities to be financed under the cap.

⁴ Ovo offers a £60 discount to dual fuel customers who opt for their online-only service.

⁵ https://www.ofgem.gov.uk/system/files/docs/2018/06/180315_-_final_minutes_15_march_2018.pdf

18. If the maintenance of current service standards is indeed Ofgem's stated policy preference, then it must make the necessary enquiry into and fully appreciate the real-world consequences of the allowance for operational costs that it provides for energy consumers under the cap. Ofgem notes repeatedly at Appendix 11 of the consultation that it intends to undertake further work in respect of these issues. However there is no evidence of such work having been undertaken, nor of stakeholders such as Centrica having been contacted for their views (even though we have already provided highly relevant evidence to Ofgem).
19. By this stage⁶ we would expect Ofgem to have made specific, quantified and fully reasoned proposals for how the operational cost benchmark will be set (e.g. which suppliers, with what weightings, and therefore what level) and adjusted (e.g. which adjustments, by what amount). Specific, quantified proposals are required in order for stakeholders to understand and comment on the impact of the proposals. It is impossible for stakeholders to comment on which adjustments should be made to the benchmark unless the initial construction is understood.

Smart meter rollout costs

20. We agree with Ofgem that a bespoke adjustment should be made for smart meter costs and indexed in line with expected cost movements. Sufficient provision for smart rollout is particularly important, firstly to ensure that the smart programme progresses to conclusion and is not inadvertently slowed down, and secondly because the Bill requires that the cap is temporary, and its removal is linked to the progress of smart rollout.
21. If insufficient provision is made for smart costs, then it would have a negative impact on the rollout and the rate of installation would slow. This is an outcome that the Bill specifically seeks to avoid. In these circumstances, there is also a real risk that the duration of the cap is extended. Such an outcome would be particularly damaging for consumers, given the benefits that smart meters (and the technological advances they enable) deliver in terms of opportunities for increased engagement.
22. Where Ofgem uses cost data to calculate an allowance, stakeholders should be able to scrutinise the inputs and methodology. Only by disclosing data and calculations for scrutiny by stakeholders will Ofgem be able to ensure that any decision does not contain avoidable errors, takes full account of all relevant factors and otherwise meets the requirements of the Bill. To date, stakeholders have not been given the opportunity to scrutinise the analysis underpinning Ofgem's proposals. There is no plausible explanation for the failure to make such disclosure.
23. We have asked that Ofgem publishes (a) the qualitative inputs, (b) the model, and (c) the aggregated figures that it has used to calculate the proposed smart meter cost adjustment. Where quantitative cost data is sensitive, Ofgem should allow stakeholders' advisers to access it on a confidential basis by establishing data room arrangements such as those used by the Financial Conduct Authority (FCA) when setting the cap on

⁶ In light of Ofgem's (self-imposed) objective of implementing the price cap in December 2018. There is no legal duty, actual or prospective, that binds Ofgem to an implementation date of December 2018. The prospective duty in 1(1) to implement the cap as soon as reasonable practicable after the Bill is passed only affects how Ofgem should use the resources at its disposal; it does not give permission to set the cap less carefully. The fact that the cap is temporary also does not permit Ofgem to set the cap less carefully; it imposes a requirement to ensure that the "conditions for effective competition", including smart meter rollout, can be met when the cap is in place.

payday loans. Ofgem has refused to do so. The cursory reasoning for this refusal is apparently based on a view that stakeholders should be able to divine sufficient information from existing publicly available information. This does not seem correct to us; but even if it were correct, it is not a reason why it should not be disclosed – if anything, the contrary. If the information is readily available, Ofgem should disclose it.

24. All the relevant costs of installing smart meters should be included in the allowance to ensure that suppliers can finance their obligation. Some material costs are missing from Ofgem's current proposal. For example, additional rental agreement termination costs for conventional meters, which suppliers incur, have not been included. These are real costs that are only incurred because of the smart meter rollout, and therefore must be included. The allowance should also reflect changes in cost that will happen over the course of the rollout. For example, there should be an explicit provision for the possibility that additional marketing spend is needed to counteract a reduction in demand for smart meters that occurs as a result of the cap itself depressing engagement. The need for such an allowance is particularly compelling given that Ofgem recognises explicitly at the outset that a cap might well result in a drop-off in customer engagement.
25. In order to accurately set the smart allowance, Ofgem needs to include provision for costs that are not included in the BEIS Annual Supplier Report (ASR) process. Ofgem should issue a Request for Information (RFI) to suppliers in order to gather accurate data on those costs omitted from the ASR process.
26. The methodology for assessing the level of efficient smart meter costs needs to take account of suppliers' differing levels of rollout progress when making comparisons on a cost per customer basis. Ofgem's proposed methodology does not do this, and therefore risks understating the costs by extrapolating the per customer costs from that of a supplier which has made relatively little progress in the rollout. Further, Ofgem needs to reconcile the benchmarking methodology for operational costs used in the bottom up approach with its smart metering benchmarking.

Wholesale costs

27. The commodity index that is used to set and update the cap should be replicable by suppliers. Ofgem is currently proposing that the observation period for the initial period of the cap (December '18 – March '19) is partly historic (i.e. from April 2018). Applying retrospective assumptions in price controls creates a damaging precedent, penalises suppliers who have not already purchased commodity in line with Ofgem's assumptions and is inconsistent with established legal principles against retrospection.
28. Without prejudice to Centrica's strongly held legal view and reserving our rights on this matter, if Ofgem felt unable to avoid retrospection after performing an appropriately rigorous legal analysis of the various options, the least damaging position Ofgem could adopt would be to (a) minimise the extent to which the decision is retrospective, and to (b) maximise the opportunity for suppliers to replicate the assumed hedging strategy.
29. To achieve this, Ofgem could use a three-month observation period to set the initial cap (e.g. July to September or mid-July to mid-October), providing the 'smoothing' required while allowing suppliers to replicate it. Although suppliers would have to buy a significant amount of commodity over this period, it is possible given current market liquidity. We, as the owner of the largest supply business, believe that we can buy sufficient commodity, so other suppliers should be able to do the same.

30. Ofgem’s assumption that the wholesale provision in the PPM price cap methodology captures all relevant wholesale costs is incorrect. Ofgem is consequently incorrect in its proposal not to adjust it for the default cap. The PPM methodology would understate wholesale costs for the default cap for a number of reasons, including the fact that the market has changed since 2015 and that the scope of the default cap is broader.
31. In the table below, we list how the PPM price cap would understate wholesale costs if used for the default cap, and how to address these issues. The table includes shaping costs, and other costs. There is currently £38 of overall shaping cost included in the PPM cap (indexed to the commodity allowance – it was £44 in summer 2015⁷ but the decrease in market prices has now reduced it to £38). This shaping cost was sufficient to cover the extra wholesale costs for PPM customers in 2015, but is insufficient now. If the bottom-up methodology was used, the full costs in the second column would need to be accommodated because there would be no existing cost allowance to potentially offset them against.
32. In the appendix, we explain more fully what these costs are and how they are calculated, using external source data where possible. We are also submitting spreadsheets that show how they are calculated. Given this, we consider it would be unacceptable for Ofgem to continue to claim that insufficient evidence has been provided to show that adequate provision needs to be made for all of the costs in the table below.

Cost/issue	Shortfall per dual fuel customer in PPM cap, not including allowance of £38 for shaping costs⁸	Solution
Mismatch between index used to set the cap and used to update the cap	Unknown as OVO/FU hedging strategies in 2015 unknown. But OVO’s response to WP4 suggests in the region of £30	Use same commodity index to set and update the cap, or apply an uplift (e.g. £30)
Understatement due to curve backwardation	Around £8	Best option is to factor in the structure of the forward curve when calculating each cap. Ofgem could adjust the index construction so that the mismatch cancels out across a year (by adjusting the Winter cap up or down so that the amount under recovered in Winter matches the amount over recovered in the previous Summer). Alternatively, apply an uplift.
Underweight of demand in winter compared to summer	£6	Best option is to correct assumed level of demand across the seasons using Xoserve gas profiles and Ellexon power settlement profiles Alternatively, apply an uplift.

⁷ Calculated based on current Ofgem average TDCV, using price data from Table 14.7 of the CMA Energy Market Investigation Final Report.

⁸ At current Ofgem Medium TDCV

Cost/issue	Shortfall per dual fuel customer in PPM cap, not including allowance of £38 for shaping costs ⁸	Solution
Incorrect split between baseload and peakload	£3-£6 (electricity only)	Best option is to adjust the ratio to 50-50 Alternatively, apply an uplift.
Does not cover variances within seasons	£4	Apply an uplift
No allowance for within-month shaping for gas	£7	Apply an uplift
Imbalance	£1	Apply an uplift
Cost of trading	£0.3/customer for gas and £0.5/customer for electricity	Apply an uplift
Uplift to cover T&D losses	£11/customer for gas and £16/customer for electricity	Apply an uplift using Line Loss Factors/Transmission Loss Multipliers from Elexon and Unidentified Gas from Xoserve (c. 10% for electricity and 5% for gas)

Headroom

33. Ofgem indicated in the industry workshop on 12 June that there are two distinct purposes for headroom when setting the cap: (1) to account for differences in efficient costs and uncertainty when setting efficient costs; and (2) set above the allowance for efficient costs to maintain incentives for customers to switch and enable suppliers to compete effectively. We agree with Ofgem’s characterisation of the two types of headroom. We refer to the former as “cost headroom”, and the latter as “competitive headroom”. It will not be possible for Ofgem to set a price cap at the right level without both.
34. Cost headroom will necessarily depend on the uncertainties and variation inherent in Ofgem’s estimates of efficient costs. It is not possible for us to suggest a single “appropriate” level at this stage in the absence of knowing what decisions Ofgem intends to take elsewhere in relation to efficiently incurred costs; the extent of cost headroom will therefore critically depend upon the rigour of Ofgem’s analysis of the level of efficient costs, which needs to be undertaken in the first place.
35. Clauses 1(6)(b) and 1(6)(c) of the Bill impose a duty on Ofgem to provide competitive headroom. If there were no competitive headroom, then the main driver of price differentials and incentives to switch would be the exemption of smaller suppliers from the costs of the Energy Company Obligation (ECO) and Warm Home Discount (WHD). An efficient supplier which is fully obligated and operating in steady state would not be able to compete effectively if there were no competitive headroom.
36. Competitive headroom for the default cap will need to be higher than the headroom in the PPM cap, in part because of the different reasons for imposing each of the caps – but also because it is now apparent that the PPM cap has had a detrimental impact on competition. The CMA introduced the price cap for PPM customers because of technical limitations with PPMs which presented barriers to competition. The rationale for the

default cap is that customers are able to engage but do not. Therefore, ensuring that there are price differentials to maintain incentives for customers to engage is a much more important consideration when setting the default tariff cap than was the case for the PPM cap.

37. Ofgem should give considerable weight to sections 1(6)(b) and 1(6)(c) of the Bill. As stated at the start of this Executive Summary and in the Legal Annex, sections 1(6)(a) – 1(6)(d) of the Bill are not in conflict with protecting consumers and are essential means of protecting consumers over the long term. Acting with similar duties, the CMA chose not to implement a cap on default tariffs at any level because it unduly risked “undermining the competitive process, potentially resulting in worse outcomes for customers in the long run through a combination of reducing the incentives of suppliers to compete and reducing the incentives of customers to engage”⁹.
38. To inform Ofgem’s further analysis on this subject, we have submitted clear and consistent empirical evidence from a number of sources that once the level of price dispersion falls below £250, customer engagement and switching rates will begin to decline precipitously, which would significantly undermine the scope for effective competition. Given that sections 1(6)(a) to (d) of the Bill are intended to work together in harmony, we believe that only by setting headroom at a level that maintains customer engagement and incentives to switch can Ofgem satisfy the entire requirement of section 1(6) of the Bill.
39. It will therefore be critical that Ofgem assesses the impact of the cap level on competition, and specifically this must form a key element of the impact assessment. This analysis needs to be released and consulted upon *before* the statutory consultation, if stakeholder views are to be reflected appropriately in policy formulation.

Payment method differentials

40. The extra costs of supplying customers who pay by standard credit should be recovered from customers who pay by standard credit, consistent with well-established principles of cost causation.
41. If the extra costs of paying by standard credit are partially socialised, then it would:
 - Reduce the incentive for standard credit customers to switch to direct debit, increasing costs for all customers and disproportionately those suppliers with more standard credit customers.
 - Give a competitive advantage to those suppliers with a greater proportion of direct debit customers than the split assumes.
 - Mean that those suppliers who are efficient but have a greater proportion of standard credit customers than the split assumes cannot finance their activities.
42. Customers who pay by standard credit on FTCs may choose the socialised costs of the default tariff over more cost reflective FTC rates, again further exacerbating the problem for suppliers with a greater proportion of customers who pay by standard credit.
43. We disagree that a customer who pays on time by standard credit should cover the same bad debt costs as a direct debit customer. In a competitive market, it is expected that a group of customers that are on average more costly to serve will face higher

⁹ CMA PDR para 146.

prices. In any case, a customer who has set up a recurring direct debit will clearly be less likely to miss payments than a customer who is required to make an ad-hoc payment by cash/cheque. This lower risk should be reflected in the prices these customers pay.

44. There is nothing in the Bill that supports socialisation. Socialisation of some or part of the extra costs would go against the requirements in the Bill to incentivise efficiency, ensure suppliers can compete effectively and finance their activities. Ofgem may argue that some costs are socialised today, but this may be in part caused by Ofgem's licence condition that requires that any price differentials need to be fully justified (with the resulting regulatory risk creating a bias towards socialisation).

Profit margin

45. Ofgem should not accept the CMA's view of the level of the competitive profit margin. The CMA materially understated competitive profit margins for a number of reasons, including not recognising the requirement to hold sufficient capital to cover the peak requirement (rather than average requirement). The peak requirement includes capital to withstand short-term losses that suppliers periodically face as a result of unpredictable demand shocks that are beyond their control.
46. In both of the market investigations that it has undertaken since the Energy Market Investigation (EMI), the CMA has avoided using the return-on-capital-employed based approach that it used in the EMI for the purposes of informing its thinking about the competitive EBIT margin. We have previously calculated the additional requirement as being in excess of £✂m for a large supplier, and suggested for this and other reasons that a more reasonable range for competitive EBIT profits for an efficient supplier would be 4-6%.

Other considerations

47. The Bill requires that extension or termination of the tariff cap depends on an assessment being made regarding whether the conditions are in place for effective competition. We therefore agree with Ofgem that that the use of the term "conditions" in the Bill implies that this must be the focus of the assessment.
48. The conditions for effective competition should be realistic, targeted and proportionate. If the conditions require particular policy interventions to be undertaken, each intervention must be (a) individually justified by reference to an Impact Assessment that shows net benefits to consumers and (b) financeable under the price cap that is in place. When Ofgem considers the state of competition, as distinct from the conditions for competition, we urge it to develop a more sophisticated measure of engagement than a simplistic observation of whether or not a customer has chosen a fixed term tariff.
49. It is also critical that the price cap methodology introduced by Ofgem recognises the artificial competitive distortion created by small supplier exemptions. We urge Ofgem to press the Government to remove these distortions at the earliest opportunity. In any event, to meet Ofgem's obligation to ensure suppliers can finance their operations sustainably, the cap must be set at a level that allows fully obligated suppliers to recover these costs.

50. In terms of the methodology to choose, in principle any of the three remaining options could work, if properly set and adjusted. However, we do not believe that the updated reference price can realistically be achieved in Ofgem's self-imposed timescales. The updated reference price approach is the least developed option, and Ofgem will likely need to apply multiple adjustments to make it fit for purpose. At this stage we believe Ofgem should pause development of the updated reference price approach and focus on (a) further developing the bottom-up approach and (b) further developing corrections to the PPM approach.
51. In any case, it is vitally important that Ofgem consults on a substantive basis once its proposals have been developed into a quantitative form. If Ofgem chooses not to address the issues we raise in order to meet an unnecessarily self-imposed requirement implement a cap by December, then it will need to take a cautious approach in setting the level of the cap, otherwise it risks creating material adverse consequences for consumers and competition in the long term.
52. We hope that our points on Ofgem's approach are clear and constructive. We believe that we have demonstrated clear and objective reasons why they should be adopted in order to best protect the interests of existing and future consumers.