29 June 2018

Dear Anna Rossington

Default Tariff Cap: Policy Consultation Response

Thank you for the opportunity to come to the industry workshop earlier this month to discuss our views more openly with yourselves and other industry participants. In this letter we would like to formally outline our views to support the implementation of the Default Tariff Cap.

We understand the motivation for bringing in this cap and agree with the ambition of preventing customers paying more for their energy than they should.

We would welcome the opportunity to discuss any of our views with you further.

Yours sincerely

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Question 1: Which approach for setting a benchmark for efficient costs do you think would be most appropriate?

Our preference is for Option 4: Bottom up assessment. The safeguard tariff approach is no longer relevant to the diverse supplier environment seen today. By taking a bottom up approach, it is possible to understand the costs and risks faced by the different types of supplier and allocate a fair cost to all participants.

The uncertainties are not eliminated by using a price reference, instead it is assumed that the sample of suppliers are all equally accurate at forecasting future costs. This is unlikely to be true, which will skew the cap towards the under-recovery of costs as lower prices will tend to have more customers.

Question 2: What are you views on the issues we should consider when setting the overall level of the cap, including the level of headroom?

Ofgem have concluded that customers on default tariffs are paying more than they should, hence the level at which the overall cap is set should ensure that the majority of consumers see a meaningful reduction in price.

There needs to also be consideration for setting the level too low, as instead of motivating suppliers to reduce costs it may result in suppliers withdrawing from the sector. Whilst a level of merger and acquisition should be expected after the implementation of the cap, too rapid could cause service issues for customers being migrated from one supplier to another.

Equally, the failure of multiple suppliers could add significant costs to customer bills through the Supplier of Last Resort process.

Question 3: Do you agree with our approach to accounting for different costs, in particular additional costs of serving consumers paying by standard credit?

We agree with the approach

Question 4: Do you agree with our proposals for how we will use cost data to update the cap?

We agree with the approach. We also agree with the approach of no correction mechanism, the headroom is a better way to manage risk rather than complicated adjustments.

Question 5: Do you agree with our assessments of whether an exemption for tariffs that appear to support renewable energy is necessary and workable?

We support exemption for renewable tariffs only through specific derogation in line with the outcomes listed under paragraph 4.13.

Question 6: Do you have any views on what information we should use to assess the conditions for competition?

Another measure could be to assess the number of suppliers who price their default tariffs at or near the cap. If few suppliers price near the cap then there is sufficient competition in default tariffs to negate the further requirement of the cap to facilitate prices at their current levels. The use of a mortgage style APR, showing the customer the total cost over 5 years (for example) may drive more focus on long run cost to the consumer.

Question A1.1: Do you agree that we should not further consider the use of a market basket to set the initial level of the cap?

We agree

Question A1.2: Do you agree that we should not further consider the use of a market basket to update the cap over time?

We agree

A2.1: Do you agree with, or have views on, our approach to adjusting the CMA's methodology to make its benchmark appropriate for the default tariff cap? In particular, how we propose to address: additional standard credit costs, existing overheads and customer acquisition adjustments, and other potential adjustments to operating costs.

We support the bottom up approach, However, if implemented then we agree with the approach.

Question A2.2: Do you agree with how we propose to adjust the benchmark at nil consumption?

We disagree with the approach as suppliers pricing policy could result non-cost reflective standing charges. The bottom up approach would better reflect the true cost of zero consumption customers.

Question A2.3: Do you agree with our proposed approach for updating the level of the adjusted safeguard tariff cap?

We agree

A3.1 Do you agree with our proposed approach for an updated price reference approach? In particular, how we select price data and exclude suppliers or adjust data.

Whilst we do not support using the competitive reference price, we agree with the approach used to calculate it. The 'compliance' benchmark could be improved as it risks a drive towards minimum cost for minimal service by also including criteria relating to complaints or scores from consumer advocacy groups.

Question A3.2 Do you agree with the judgements we set out regarding consumer engagement, policy and wholesale costs, and constructing the benchmark?

We agree

Question A3.3 Do you agree that, under an updated competitive reference price approach, we should set the benchmark at nil consumption using the adjusted standing charges from the same suppliers included in the benchmark at typical consumption?

We agree

Question A3.4 Do you agree with our approach to weighting the benchmark at TDCV and nil consumption?

We agree

Question A4.1: Do you agree with our assessment of the advantages and disadvantages of a bottom-up approach to estimating an efficient level of costs?

We agree with the assessment, but the use of headroom can mitigate a lot of the disadvantages. The headroom likely requires setting slightly higher than in other mechanisms considered but this methodology should ensure that costs are appropriately weighted when considering future changes in both costs and market structure.

Question A4.2 Do you agree with our proposed approach to categorising different costs under a bottom-up cost assessment approach to setting the default tariff cap?

We agree

Question A5.1: Do you agree with our proposal to update the cap in line with trends in exogenous cost drivers?

We agree

Question A5.2: Do you agree with our proposed choice of cap and baseline periods?

We agree

Question A5.3: Do you consider that further provision is required for us to re-open aspects of the design of the cap, beyond our licence modification powers – and if so, why?

No.

Question A6.1: Do you agree with our approach to setting the wholesale allowance? In particular using 2015 for the base period of the adjusted existing safeguard tariff approach.

We agree.

Question A6.2: Do you agree with our approach to updating the wholesale allowance?

We agree

Question A6.3: Do you agree with our proposed approach to use a semi-annual cap period, compared with a 6-2-12 annual model, or shorter observation period? Please explain how the alternatives would affect you, if we were to choose those options instead.

We agree

Question A6.4: Do you agree with our approach to modelling forward contracts? In particular: that initial shaping should be based on a 70-30 spilt between baseload and peakload, and the cap will be semi-annual. If not, please provide evidence to support alternative approaches.

We agree

Question A6.5: What are your views on the necessity and size of an additional allowance for shaping and imbalance costs? Please provide evidence to support this.

We prefer making no formal allowance but considering the risk in the headroom.

Assessing an efficient level for the allowance the coming 6 months is most likely impossible. Similarly, the historic outcome for different suppliers will be a combination of efficiency, risk appetite and market access.

Question A6.6: What are your views on the necessity and size of an additional allowance for transaction costs relating to brokers and collateral?

We prefer making no formal allowance but considering the impact in the headroom.

Market access costs are comparatively small, but as they may vary significantly by supplier scale a direct allocation is inappropriate.

Question A6.7: Do you agree that our approach to updating the benchmark for the first cap period is appropriate?

We agree

Question A7.1 Do you agree with the way we propose to estimate the costs of each of the schemes for setting the baseline level of the cap?

We agree with the approach.

However, the complexity around additional allowances given to below threshold suppliers for ECO and WHD could be removed by recovering the costs of those two schemes in a similar way to FiT.

Question A7.2 Do you agree with our proposed approach to forecasting the costs of each scheme?

We agree with the approach. The risk, particularly around FiT and CfD, that needs to be factored into the size of the headroom.

Question A7.3 Do you agree with the data sources that we propose to use to forecast the expected demand base for each scheme? Do you have any alternative suggestions which would more accurately track trends in eligible demand?

We agree

Question A7.4 Do you agree with our proposal to use the existing model to estimate the network costs that suppliers incur?

We agree

Question A7.5 Do you have any views on the impact of using information on the average share of consumption that takes place in peak periods to estimate electricity transmission charges?

We accept this approximation.

Question A8.1 Do you agree with our proposed approach to estimating suppliers' operating costs (including our focus on total historical costs per customer, and estimating separate values for gas and electricity)?

We agree

Question A8.2 Should a variable component of this allowance be split out to reflect differences in bad debt costs between customers with higher and lower consumption?

We prefer the per customer approach to maintain simplicity. As the bad debt charge is being spread across DD and standard credit customers equally, there seems no reason to associate more bad debt with higher consumers who pay their bills either.

Question A8.3 Do you consider 2017 to be an appropriate period on which to base our benchmark, or are there reasons to think a longer period would be more representative?

We agree that 2017 is appropriate

Question A8.4 Do you consider that default tariff customers have higher or lower operating costs than other types of customers?

Other than prepayment, we would expect all tariffs to have a similar cost to serve.

Question A8.5 Do you agree with our proposal of where to exclude suppliers from our benchmarking analysis?

We agree

Question A8.6 Do you agree with our proposal of what to include in our definition of operating costs?

We agree

Question A8.7 Do you agree with our proposed approach to benchmarking operating costs under a bottom-up cost assessment?

We agree

Question A8.8 Which if any of the factors listed in Table A8.2 do you think we should take into account when choosing our benchmark? Do you have any suggestions for how we could estimate the materiality of the impact of any of these factors on costs?

a) We agree with the threshold of 250,000 customers to mitigate potential issues caused by company size.
b) Average acquisition costs are an appropriate inclusion, and likely represent a steady state.
c) Representing the average stage of smart rollout for all suppliers should mean that smart costs are recovered across the industry on average.
d) All pension arrangements (including Legacy) will be captured as part of the averaging, but not given special dispensation.
e) Suppliers with low costs and poor customer service ratings via consumer advocacy groups should be excluded for the benchmarking.
f) These costs can be ignored
g) We agree with an uplift for standard credit customers
h) No special dispensation for the proportion of vulnerable customers
i) No special dispensation for the proportion of online customers
j) No special dispensation for the proportion of dual fuel customers

Question A8.9 Do you agree with our proposal to use CPIH to index the allowance for operating costs within the default tariff cap?

We agree

Question A8.10 Should the default tariff cap be reduced over time to reflect an expectation of general productivity improvements – and if so – at what level should this efficiency factor be set?

We agree not to include an efficiency factor due to the short timescale expected from the cap. This can be reviewed if this situation changes.

Question A9.1: Do you agree with our proposed approach to setting the EBIT margin?

We agree

Question A9.2: Do you agree that it is acceptable to retain the WACC figure used by the CMA? If not, do you have views on the factors we would need to consider if we were updating the WACC?

We agree

Question A9.3: Do you agree that we should maintain the CMA's estimates of the capital employed by energy suppliers?

We agree

Question A9.4: Do you agree with our proposed approach to updating the EBIT margin?

We agree

Question A10.1: Do you agree with our minded-to position to include a separate smart metering index to reflect the changes in costs from the baseline (2017) to the initial year of the cap (2018)?

We agree

Question A10.2: Do you agree with our minded-to position to include an adjustment to the Reference Price (SMRPA) in the event a material difference is identified between the smart metering net costs of the suppliers making up the reference price and the model?

We agree

Question A10.3: Do you agree with our initial assessment for the Smart Metering Net Cost Change, including our inclusion and assessment of the costs of SEGB, SMICoP and DCC charges?

We agree

Question A10.4 Do you agree with the judgements we have set out regarding smart costs; in particular our choice of data and model, identification of relevant costs and benefits, and approach to variation?

We agree

Question A10.5 Do you consider that there will be any significant change in the costs or benefits of smart metering from 2017 onwards? For example, installation costs or asset costs. Please provide evidence to support your view.

No

Question A10.6 Please comment on the proposed methodology for calculating the efficient cost of rolling out a smart meter, indicating a preference with supporting rationale, on the efficiency option (average cost approach, pure frontier cost approach, lower quartile approach).

The cost to smaller suppliers is likely to be significantly higher than for the large suppliers, as such, using the frontier or lower quartile will be a difficult target for these suppliers to achieve and likely under recover the costs involved in rollout. We support using the average. This still incentivises higher cost suppliers to improve efficiency to achieve the average.

Question A10.7: Do you agree with our approach to updating smart costs? In particular, our intention to specifically index smart cost changes, based on net cost analysis (option 3), and whether any other approaches would be preferable to option 3.

We agree

Question A11.1: What are your views on headroom being a percentage? Do you think it should be applied to all cost components except for network cost? Alternatively, do you think headroom should be applied as a percentage to only controllable costs?

We agree with the headroom being set as a percentage and applied to all cost components except network costs.

Question A11.2: What are your views on whether we should change the level of headroom over time?

The headroom enables an allowance for assumption error when building up the cost base, as such it should continue to scale with cost and not be reduced over time.

Question A11.3: Bearing in mind the analysis and scenarios presented, what are your views on the appropriate level of headroom to include in the default tariff cap?

We believe that the current £30 headroom in the prepayment cap is too low. There has been a reduction in lower priced tariffs and switching as it is difficult to cover the costs of serving a prepayment customer within the allowance. A higher headroom is required for the Default Tariff Cap to mitigate the risk of errors in the assumptions used.

We prefer the headroom set close to scenario 3. Your analysis shows that this provides protection for the vast majority of customers and is very likely to maintain incentives for customers to actively engage and switch supplier.

Question A12.1: Do you agree with our proposed methodology for allocating additional costs between standard credit and direct debit customers?

We agree

Question A12.2: Do you agree with our proposed methodology for calculating the additional costs to serve and the socialisation level?

We agree

Question A13.1: Do you agree with our minded-to positions not to provide exemptions for renewable electricity or gas tariffs?

We agree

Question A13.2: What are your views on whether to provide a derogation for renewable electricity tariffs?

We support exemption for renewable tariffs only through specific derogation in line with the outcomes listed under paragraph 3.11.

Question A14.1: What is your view on the overarching approach that is proposed for conducting the impact assessment? In particular, on the scope of the assessment, and material issues that we have not referred to. Please provide details of any relevant sources of data and evidence that you think should be considered.

We agree with the approach

Question A14.2: Do you consider that suppliers will incur a change in administration costs as a result of the default tariff cap? If so, please provide estimates with supporting evidence. Please specify whether any administration costs are fixed or variable. If variable, on what basis do these costs vary? For example, on a per customer basis.

Possibly but not material on a per customer basis.

Question A14.3: Are you aware of any unintended consequences, in the form of detrimental impacts on customers that were observed as a result of the existing safeguard tariffs? If so, please provide details of these unintended consequences.

We are not.

Question A14.4: Do you have reason to believe the default tariff cap could disproportionately impact any of the nine protected characteristics under the Equality Act 2010? Please provide any supporting evidence.

We do not.

Question A14.5: Do you have any additional information or data on the impact of the implementation of the existing safeguard tariffs on switching rates that would inform this analysis?

We do not.