Energy UK

The voice of the energy industry

Default Tariff Cap Policy Consultation Energy UK response

25 June 2018

Introduction

Energy UK is the trade association for the GB energy industry with a membership of over 100 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership covers over 90% of both UK power generation and the energy supply market for UK homes. We represent the diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 27 million homes and every business in Britain. Over 730,000 people in every corner of the country rely on the sector for their jobs, with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry invests £12bn annually, delivers £88bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to HMT.

This is a high-level industry view; Energy UK's members may hold different views on particular issues raised by the consultation. As such, our consultation response will focus on the six main consultation questions, and include points from relevant appendices questions where relevant. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

Energy UK welcomes the opportunity to provide feedback on Ofgem's current thinking towards the design of the default tariff cap. However, it is unfortunate that the length of time given to respond to such an extensive consultation ultimately undermines stakeholders' abilities to respond fully and effectively. This in turn limits the usefulness of the consultation process for both Ofgem and stakeholders. While we recognise that the Bill will require Ofgem to impose the cap "as soon as practicable", Energy UK does not believe that this requires the independent regulator to undermine the robustness of its tariff cap design process to the detriment of market competition.

As Energy UK has noted in our working paper responses, the accuracy of the level of any cap becomes increasingly important the wider the group of customers it impacts. Given the significance of the cap for the domestic supply market and the volume of households it will impact, it is vital that the efficient costs benchmark is robustly designed to ensure suppliers of all sizes, with varying customer bases, costs and business models can continue to efficiently finance their activities and operate competitively. Each option currently being considered has obstacles that Ofgem will need to overcome in order to implement an effective temporary cap that achieves the objectives of the Bill.

Energy UK has a wide range of members including larger, medium and smaller suppliers, with differing views on the proposed cap. We do not, therefore, put forward a preferred approach to benchmarking efficient costs in this response. However, we are clear that the ultimate decision needs to be transparent and have a solid evidence base. To this end, we recommend that Ofgem allow suppliers of all sizes to provide relevant data and to open data rooms, as per the Competition Markets Authority's (CMA) Energy Market Investigation, to allow stakeholders the greatest level of input and review of the data underlying Ofgem's decisions. The cost associated with the smart meter rollout is a key concern of Energy UK and Ofgem should open a specific smart data room.

The UK requires a stable and proportionate regulatory framework to attract the investment required to transform our energy system and deliver positive outcomes for consumers. Independent evidence points to the UK as unattractive relative to the rest of Europe and utilities similarly less attractive than other industries. A poorly designed price cap could adversely impact investor confidence, to the detriment of consumers through a reduction in competition.

As recommended previously in our working paper responses, Energy UK would have preferred more details on the criteria Ofgem will be using to assess conditions in the market for its annual review and recommendation for the Secretary of State from 2020. Greater clarity on this key issue may have influenced consultation responses to improve their usefulness for Ofgem and stakeholders.

The Process

Energy UK recognises the challenge of Ofgem's task in designing and implementing this cap and we welcome the opportunities to feed-in to Ofgem's design process to date through the five working papers, industry stakeholder events and this policy consultation. However, Energy UK has a number of concerns that revolve around the process currently being undertaken by Ofgem to design the cap.

Energy UK believes that the restricted timeline Ofgem has imposed on the default tariff cap's design and implementation process, which is not stated in the Bill, has undermined Ofgem's ability to fully evaluate the evidence when analysing options for the cap. Ofgem should be transparent about the evidence base for their future decisions on the cap design, and should implement data rooms, as per the CMA, so that suppliers can evaluate and contribute towards the data being used. The short time allowed by Ofgem to respond to the five working papers and this policy consultation has also limited the effectiveness of suppliers' engagement, with suppliers of all sizes facing increased staffing pressure to be able to engage with the various regulatory developments of which the tariff cap is only one.

The likely obligation to introduce the cap "as soon as practicable after the Bill is passed" does not negate the need for a thorough and rigorous design process to avoid any detriment to competition and consumers. The "as soon as practicable" provision in 1(1) of the Bill in no way suggests that Ofgem can compromise due process and accuracy of the cap construction for the sake of speed.

With a statutory consultation planned for August, Energy UK is concerned that there is a risk that Ofgem's self-imposed time restraints could undermine the robustness of the analysis being undertaken and we would not want to see the politically driven deadline for the cap's implementation unduly limit engagement with industry stakeholders to the detriment of the measure's effectiveness. Given the length and detail of the consultation questions being asked by Ofgem, Energy UK is also concerned that the political desire for a Winter 2018 implementation will limit the extent to which Ofgem are able to take into account responses effectively. The effects of these time restraints is evident in some areas of the consultation whereby Ofgem are seeking comments on analysis it is still yet to undertake.

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

Energy UK does not hold a view towards the most appropriate approach for setting a benchmark for efficient costs, and we expect our members to answer this question in more detail.

The consultation notes that each potential approach has pros and cons that Ofgem will consider and ultimately make a judgement as to which will be used. Whichever approach Ofgem ultimately decides upon must be based on thorough analysis of all available data. Ofgem needs to fully understand suppliers' costs, recognising that in a competitive market with suppliers of all sizes and varying customer bases, with different costs to serve, there will inevitably a range of costs and business models. While Ofgem recognises this in the consultation document, to be able to effectively assess these differences Energy UK believes that all suppliers should have the opportunity to provide Ofgem with relevant data on which it will base its decisions.

Currently, only suppliers with over 250,000 customers have received RFIs requesting data. To ensure that the smallest suppliers are not over-encumbered by extensive request, we would welcome Ofgem allowing suppliers under 250,000 customer accounts to voluntarily respond to relevant RFIs. Energy UK notes that the Government has recently announced that the threshold for Warm Home Discount scheme will be lowered to 150,000 customer accounts during the life of the cap and believe that this should be considered within Ofgem's analysis of costs. Energy UK would also welcome Ofgem instigating an open data room, as per the CMA's approach, so that stakeholders can evaluate the evidence base for Ofgem's decisions.

The robustness of the approach that Ofgem decides upon is crucial for the conditions for effective competition being successfully put in place. As such, Ofgem could consider running analysis through more than one model to ensure the ultimate level is as robust as possible and any unforeseen errors can be better found and addressed.

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

Energy UK believes that Ofgem's final decision on the inclusion and level of a headroom element in the overall level of the cap needs to fully account for two issues. Firstly, Ofgem must consider the risks of errors that could be made within the cap design that could be alleviated by a headroom element being incorporated. It is vital that the imposition of the default tariff cap does not restrict suppliers' ability to recover efficiently incurred costs and make a reasonable return. Whether Ofgem decides to include "cost" headroom in the cap or not it should keep the market under continuous review to ensure that any detrimental distortions caused by the market intervention can be addressed as soon as possible.

Secondly, Ofgem need to consider how they intend to maintain incentives for consumers to switch, as per clause 1(6)(c) of the Bill. Ofgem has previously stated that *"customer engagement and switching are key to achieving good outcomes in the market as a whole".*[1]

[1] State of the Energy Market, 2017 Report, Ofgem. p.23

However, Ofgem appears to believe that consumer engagement is likely to be reduced by the imposition of a cap. As noted in our response to Work Paper #3, Energy UK believes that if Ofgem are of the view that engagement and switching will form part of the criteria of a competitive market then they need to design the cap to ensure that damage to consumer engagement is limited as much as possible. This could be aided by the inclusion of a headroom component.[2] We note that the CMA viewed headroom as a necessity in the PPM price cap to ensure competition was not damaged:

> *"Potentially more significant are the distortions to competition that could arise from the application of the cap, but we have again chosen aspects of the design to minimise these –notably, by building in headroom to allow competition below the level of the cap"*[3]

Providing headroom to allow for competition could be a more important consideration for the default cap than the PPM cap, not least because of the different rationales for the caps and far greater number of customers that will be in scope. In the PPM segment, the CMA imposed the cap because of technical barriers to these consumers accessing the competitive market which do not exist for credit customers covered by the default cap.

As noted in the consultation, Ofgem are undertaking separate work to boost consumer engagement such as the implementation of the CMA database remedy and a move towards principles-based regulation. Energy UK would, therefore, urge Ofgem to ensure that the imposition of this temporary price cap does not unduly inhibit the progress on consumer engagement that these other work streams seek to achieve.

We note that Ofgem has found that 91% of consumers who switch are motivated by price,[4] and that the CMA found the mean saving required for consumers to switch was £158 per annum.[5]

In addition, Ofgem could look at evidence that emerged from the energy price controls that were in place in New South Wales (NSW), Australia, until 2013-14 which supports the case for headroom to maintain incentives to switch. The example illustrates how price controls can reduce price dispersion and weaken competition – and conversely, how relaxing the price control can allow competition to flourish.[6] While the regulator (IPART) acknowledged challenges in determining the precise relationship between incentives and switching, it noted the experience of Victoria, Australia before energy market deregulation where higher margins occurred alongside increasing retail market competition. Conversely, in Queensland, Australia, lower incentives in regulated prices occurred alongside relatively lower levels of customer switching.[7] Ultimately the regulator concluded:

> *"[W]e consider it reasonable to conclude that the incentives included in regulated prices will significantly influence the level of competitive activity. The evidence suggests that as the incentives in regulated retail prices increase, so does the level of competitive behaviour by retailers and market participation by customers."*[8]

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[2] One Energy UK member, Octopus Energy, has indicated that it does not agree with the necessity to include headroom in the design of the cap.

[3] Energy Market Investigation, Summary of Final Report, CMA, p.60

[4] State of the Energy Market, 2017 Report, Ofgem. p.24

[5] [5] Energy Market Investigation, A report for the CMA by GfK NOP, p,75

[6] "*Review of Regulated Retail Prices and Charges for Electricity*", Independent Pricing and Regulatory Tribunal of New South Wales (IPART) (2013): p. 114 (table 9.2).

[7] *Ibid*, p.114

[8] *Ibid,* p.114

In IPART's latest review of the electricity market in December 2017, its third since the deregulation of the markets in 2013-14, competition in the NSW market had continued to increase with the regulator's key indicators of competition all improving: the number of suppliers has risen from 15 to 26; the market share of smaller suppliers has doubled from 7% to 14%; the number of consumers on default tariffs has dropped from 37% to 23% and the proportion of customers switching in the last 12 months rising from 23% to 31%.[9] Energy UK believes that Ofgem should, therefore, look to take into account international examples when making its judgement in the context of the overall aim of the Bill to allow a more competitive market to be put in place.

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

Network Costs

Energy UK agrees with Ofgem's proposed approach to accounting for network costs.

Wholesale Costs

Energy UK is concerned that the proposed 6-2-12 semi-annual approach cannot be matched up with suppliers' risks. While Ofgem acknowledges this mismatch in its consultation, it has not addressed in detail how they would account for or overcome the cost implications this may have for suppliers. Energy UK expects members to individually comment in detail on Ofgem's proposals for accounting for wholesale costs in the level of the cap.

Energy UK would welcome clarity from Ofgem as to how it anticipates accounting for wholesale market shocks, for example the extreme weather recently faced from the "Beast from the East".

Smart Metering Costs

Progress of the smart meter installation programme is the key consideration on the face of the Bill when reviewing whether conditions for effective competition are in place to enable removal of the cap. It would be wrong if the cap undermines the roll out of smart meters by not allowing the full recovery of costs reasonably incurred. Investment in smart (and energy efficiency) is essential in ensuring that the UK doesn't continue to be a place of relatively high domestic consumption, regardless of price, to the detriment of customers.

Energy UK welcomes the decision to separately index the costs incurred as a result of the smart metering rollout, having highlighted it as a key concern of suppliers throughout the working paper responses. As it is such an important issue for suppliers, Energy UK would urge Ofgem to open a specific smart data room so that suppliers of all sizes can input the necessary data into Ofgem's ongoing analysis and review the evidence base being used by Ofgem in its decision making process.

Energy UK is also concerned about the timings of the cap updates being out of sync with certain cost changes, causing periods where suppliers' efficient cost recovery could be impacted. If any charges or costs are updated in-year then this would cause them to lag behind the cap's 6 monthly update windows. Without a correction process being proposed by Ofgem in this consultation, clarity would be welcome over how it anticipates such lags in cost assessments will be dealt with under the cap.

[9] "*Retail Energy Market Monitoring 2017*", IPART (2017)

Payment Method Uplift

Energy UK welcomes Ofgem's acknowledgement that suppliers face legitimate, differing costs based on the payment method of their customers. Energy UK believes that a general principle of cost-reflectivity should apply to the tariff cap. However, we expect Energy UK members to respond individually to the proposal to implement different caps based on payment methods.

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

Energy UK agrees with Ofgem's mined-to position on updating the cap in reference to trends in exogenous cost drivers ever six months. In particular, the transparency of such a process is welcome so that suppliers are able to plan accordingly (as far as possible, not counting more volatile costs).

Separate but related to re-assessment options is the ability of errors in the cap to be rectified. We would welcome clarity from Ofgem on their thinking regarding any process or option that could be available for identifying, highlighting or rectifying any errors made in either the initial setting of the cap or any subsequent changes as a result of re-assessment. Errors or unintended consequences of market interventions are not rare and the constrained timeline of the cap's design and implementation could expose the eventual level to flaws. Such an error-correction process could also account for any unforeseen events that distort the market, and to which suppliers' options are restricted by the cap; for example, another 'Beast from the East' scenario placing a spike in energy use and wholesale costs. To be clear, Energy UK does not have a position on whether there should be automatic error correction in the cap, or whether Ofgem can review the cap if it deems necessary as and when and consult with interested parties in the normal way.

Energy UK has concerns regarding how Ofgem's proposed update model will account for costs changing in-between periods. As mentioned in the response to Question 3, DCC charges are updated quarterly, out of step with Ofgem's planned updates of twice a year. Without an error-correction process outside of the cap updates, clarity would be welcome on how Ofgem plans to address lag from the update periods which could lead to suppliers being unable to recover efficient costs until the next scheduled cap update.

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

Energy UK has some concerns regarding Ofgem's minded-to position of not including specific exemptions for "green tariffs" but allowing for suppliers to apply for a derogation for green electricity tariffs only. Although this could be a workable solution from a practical point of view, it provides no certainty to renewable generators that they will be able to continue to access such a competitive PPA market. The consultation state that new renewable technology has access to other revenue streams and explicitly points to the Capacity Market; however, Energy UK would note that this is currently not the case for all renewables. Overall, Energy UK believes that limiting routes to market for renewables does not seem to align with wider clean growth ambitions.

If Ofgem were to pursue exemption by derogation, however, then Energy UK has a number of concerns that Ofgem should address. The derogation process could be off-putting to suppliers and stifle innovative green tariffs being offered to consumers. Ofgem should avoid, as best as possible, the cap constraining market choices. The derogation process needs to be accompanied by clear guidance and governance from Ofgem so that the application and decision processes are transparent. This guidance should include clear and transparent criteria that needs to be met by suppliers for a derogation to be granted for a tariff.

Energy UK is also concerned that there are no indicative timelines for the derogation process. Given the speed at which Ofgem is seeking to implement the cap, we would welcome clarification on the intended timescales for the derogation process and decisions. This is especially important for the first period of the cap so that suppliers that are currently offering green tariffs can be assured that their application will be dealt with, and a derogation granted before the cap is first implemented. Clarity is also needed on the expected length of derogations and whether Ofgem will require suppliers to reapply for the same tariff during the lifetime of the cap.

Energy UK also has significant concerns that Ofgem is minded not to allow suppliers of green gas tariffs to also apply for a derogation. This risks significantly undermining a young industry, which is an essential part of the journey to decarbonising the supply of heat in the UK.

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

Energy UK recognises that any market intervention, especially one as large as a price control mechanism, will ultimately distort the market. This creates a challenge for Ofgem in measuring competition while the cap is in place, as is highlighted in the policy consultation. While we do not underestimate the task, Energy UK is concerned about the lack of coherence and detail that Ofgem has so far put forward on their views towards which criteria the success of the cap will be judged against.

Energy UK believes that any assessment criteria needs to be multi-faceted to take account of any distortions in the market that the cap's imposition might create. Switching is currently used a proxy for competition in the energy market, and Energy UK would expect switching figures to be used as part of Ofgem's assessment given the various work streams currently being undertaken by Ofgem to improve engagement and switching. However, as Ofgem states in its consultation, there is a risk that switching rates are depressed by the imposition of the cap. Switching is also not the be-all and end-all of competition in the energy market, as there needs to be recognition that consumer can be well-engaged with the market but actively choose to not switch.

A key concern around this area is the political dimensions of any assessment. Ultimately, it will be down to the Secretary of State to make a decision about lifting or keeping the cap. While the industry and stakeholders recognise the importance of the projects highlighted in the consultation, such as the faster switching program and the CMA database remedy, Energy UK is concerned that political realities may override Ofgem's recommendation if its assessment is not clear-cut and robust. As such, any criteria that Ofgem uses to assess the conditions for competition in the market need to be robust and transparent to ensure confidence in Ofgem's final recommendations.

If you would like to discuss the above or any other related matters, please contact me directly on 020 7747 2931 or at steve.kirkwood@energy-uk.org.uk.