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Dear Anna,

Working paper #4: approach to headroom

Please find our comments on your fourth working paper on the forthcoming default tariff price cap. This submission is entirely non-confidential and may be published on your website.

We are in broad agreement with your summary of the characteristics of existing policy costs. In particular, we agree that ECO and the RO are the only schemes where individual suppliers are likely to face materially different costs to each other, and that compliance costs for most schemes are driven by energy volumes while for the Warm Home Discount they will be driven by the number of eligible customers.

Regarding the data sources that could be used in calculating policy costs (eg those set out in Table 3), we think it is likely to be most appropriate to use a blend of these sources rather than to rely on any individual category. In the case of line items where the cost is simply passed on to suppliers by an external body rather than incurred by the supplier through its own delivery of the scheme - for example, in relation to the costs of Contracts for Difference, or the Capacity Mechanism - we think those costs can and should be sourced from the Low Carbon Contracts Company ('LCCC') or other relevant scheme administrator. We would expect the LCCC to be producing forward projections of forecast costs as well as billing for historic actuals and it may be possible to use these as the basis of indexing those items.

Where policy schemes are implemented by suppliers themselves the choice of data sources appears more difficult. As you highlight, while the OBR is independent its data comes with a significant lag time. This may limit the extent to which it can be reliably depended on as a source of contemporary cost data. In theory, this could perhaps be addressed through a rolling correction mechanism rather akin to a network price control K factor, such that any under (or over) recovery in one capped period that is revealed by later OBR data is then compensated for with a higher (or lower) allowance in a later capped period. However the temporary nature of the price cap may limit the sustainability of that approach as some corrections would likely never be made.

Reliance on supplier data may get you more up to date data, but comes with issues of comparability between suppliers and across different financial years, and also with risks that suppliers may have natural incentives to try and find methods of internal cost apportionment that inflate the book costs to increase the cap. Despite this, we think use of supplier data is most likely to give you credible estimates of delivery costs for schemes like ECO where delivery is by suppliers, not an independent administrator. In theory, where obligations can be traded the prices of these trades could be used but only if the market for those trades is liquid, and it is not clear that is currently the case for ECO.

We are sympathetic to the arguments you appear to have heard from some suppliers that the interactions between small supplier policy cost exemptions and switching behaviour may mean that some policy costs are leveraged. When the existing exemptions for small suppliers from ECO, WHD and FIT costs were introduced in 2011, hardly anyone was served by an exempt supplier. Now, around 8% of households - around one in twelve - are served by a supplier that is exempt from some policy costs. Given that rapid growth in exempt suppliers, and the likelihood that it may continue, given the effect that the exemptions have on positions in best buy tables, it seems possible that the burden on non-exempt suppliers may increase in the coming years. The inclusion of some form of scaling factor that seeks to adjust for this over time appears to be a reasonable ask to us.

We were surprised by the exclusion of smart metering policy costs from the scope of this paper. In our experience, these are currently arguably the most widely disputed policy cost. Several suppliers have attributed recent retail price movements in part to smart metering costs. Suppliers also have some discretion on the shape of their roll-out plans, resulting in likely significant divergence in ongoing costs incurred. Further, the cap itself could influence roll-out choices by encouraging (or discouraging) investment in individual capped periods. When you publish your more detailed proposals in late May, we would like to see you explain how the costs of smart roll-out will be incorporated into the cap in much more depth than you have done to date.

Yours sincerely

Richard Hall
Chief Energy Economist