

## Executive Summary

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1. As set out in our response to Working Paper 1 (WP1), we believe that competition is the best way of protecting the interests of consumers in the long term. We therefore do not believe that introducing a price cap is the right way forward. Instead we favour measures that work to enhance competition and customer engagement, such as ending "evergreen" contracts.
2. However, if Ofgem is to set a cap for default tariffs, it is essential that this allows for legitimate differences in costs, including costs to serve different customers reflecting their varying needs and preferences. A failure to do so would have serious implications for consumers, the market and risks creating financeability issues for suppliers.
3. Similarly, in setting allowances for costs, Ofgem will need to understand and accept the potential effects on consumers if the cap fails to provide for adequate recovery of costs to serve. This relates in particular to impact on quality of customer service, and future innovation.
4. For these reasons we believe that a "market basket" approach to a) setting the initial level of the cap or b) updating the cap over time would be inappropriate and risk introducing material unintended consequences. We consider that any use of the "market basket" approach would therefore be incompatible with Ofgem's obligations in setting the cap as set out in the Domestic Gas and Electricity (Tariff Cap) Bill.

### ***Setting the initial level of the cap***

5. We fully support Ofgem's view that "it is unlikely that the market basket would be an appropriate way to set the initial benchmark".<sup>1</sup>
6. Our key concern is that the "market basket" approach to setting the Default Tariff Cap would not allow an explicit assessment of the level of efficient cost necessary for a supplier to conduct its business, or reflect legitimate differences in costs across suppliers.
7. However, we also have concerns that the cheapest tariffs in the market could be priced below costs for competitive reasons, making them inappropriate for inclusion in an initial benchmark. A "market based" approach may also have unintended consequences of affecting energy suppliers' pricing decisions.
8. We do not believe it is possible to design the basket so as to mitigate these issues. Indeed, any attempt to do so, aside from only being partially effective, would be expected to introduce layers of complexity and defeat the main purpose of a market basket approach, which is simplicity.

### ***Using the market basket to update the cap over time***

9. It is difficult to be definitive about the appropriate indexation methodology to use without knowing how the initial benchmark will be set and what alternative options for indexation

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<sup>1</sup> Ofgem Working Paper #2, paragraph 4.4.

are being considered.

10. However we have significant concerns that a market basket approach may fail to track costs more accurately than alternatives and think it likely that we would reject Ofgem's proposal to use the market basket approach to update the cap over time.
11. This is because:
  - it is not clear that a price basket will be a better way of tracking costs than alternative available cost indices;
  - the practical challenges associated with specifying a price basket mean that it will not be possible to identify an acceptable approach to doing so; and
  - the introduction of the cap is likely to impact supplier pricing behaviour, resulting in a high risk of unintended consequences.

### **Consultation process**

12. Ofgem makes a number of unsubstantiated statements relating to the long-run costs of an efficient supplier in WP2. For example, Ofgem states that smaller suppliers are "more likely to represent the efficient level because... they may be more likely to be efficient with the costs they face").
13. We do not believe there is any credible or compelling evidence to substantiate these assertions, and Ofgem has failed to demonstrate that these statements are based on evidence provided in response to a consultation process which draws on the views of all relevant stakeholders. We would be extremely concerned were such views repeated by Ofgem when it considers alternative methodologies for setting the initial benchmark.
14. We believe Ofgem must undertake a substantive consultation in its own right about how it will determine what it means by the "long-run costs of an efficient supplier", given that the definition used will be absolutely central to the determination of the level of the cap, whatever methodology is used to set it.
15. Finally, given the clear headline view expressed by Ofgem – that a market basket would not be suitable for setting the initial benchmark – and the high-level nature of the consultation generally, we would expect a further consultation if Ofgem were to consider changing its position on this important issue. In Centrica's view, having reviewed the relevant case law, this would be a basic fairness requirement in circumstances such as these.

## Response to Ofgem's Working Paper #2

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### Using the market basket to set the initial level of the cap

16. It is imperative that – whatever the design of the price cap methodology – Ofgem allows for legitimate differences in costs, including costs to serve different customers reflecting their varying needs and preferences. A failure to do so would have serious implications for consumers and the retail market. Because the safeguard tariff will cover a substantial proportion of GB domestic customer base, a cap that did not allow suppliers to recover the cost of supplying these customers (including their cost of capital) risks creating serious financeability issues for energy suppliers.
17. For this reason, we welcome Ofgem's view that "it is unlikely that the market basket would be an appropriate way to set the initial benchmark".<sup>2</sup> This approach would not allow an explicit assessment of the level of efficient cost necessary for a supplier to conduct its business and it would fail to control for legitimate differences in costs across suppliers. It would also fail to control for the fact that the cheapest tariffs in the market are unsustainable acquisition tariffs, and expose suppliers to risks that could not be controlled or mitigated.

### *Design challenges with a market basket approach*

18. We broadly support Ofgem's identification of the challenges associated with the market basket approach. In particular, we agree that a market basket is unlikely to reflect the costs of an efficient supplier because:
  - The cheapest tariffs in the market could be priced below costs for competitive reasons;<sup>3</sup>
  - Suppliers' costs may differ for entirely legitimate reasons (such as differences in customer mix, service quality or social/environmental obligations); and
  - Supplier pricing behaviour could be influenced going forwards in order to try to influence the level of the cap.
19. In addition to these points, Ofgem raises the prospect that changes in composition of the basket between fixed and variable tariffs could make it challenging for suppliers to apply a hedging strategy in line with the basket. However, this challenge is not limited to changes in composition of the basket. Instead it would occur even if the constituents of the basket were stable and/or restricted to certain types of tariff (e.g. fixed only) given that suppliers would have no way of knowing what hedging strategy is informing the basket, and so no way of aligning their strategy with the approach underpinning the cap. This would expose suppliers to significant risks from the potential mismatch between the movement of their costs and the level of the cap.
20. The effect of volume on hedging is also relevant to this issue. Purchasing commodity to fulfil a fixed term tariff for relatively small volumes (tens of thousands) of customers in short term / spot markets is very different from purchasing commodity for relatively large

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<sup>2</sup> Ofgem Working Paper #2, paragraph 4.4.

<sup>3</sup> Although we note that Ofgem's description of the nature of competition fails to capture the concept of customer lifetime value.

volumes of (millions) of customers in the same market. Doing so would be expected to move the market (i.e. incur higher cost) and may even be impossible due to liquidity constraints. Were the entire market to attempt to buy commodity near spot, as may be implicit within some tariffs in the basket, it would therefore be expected to either create delivery risk for customers, or create material financial risk for suppliers.

21. Ofgem has also not taken into account an additional important challenge associated with the market basket approach. If the make up the basket were permitted to change over time (for example, in response to which tariffs were the cheapest in the market), then the cap would follow a level that is lower than any supplier could reasonably be expected to achieve over the medium term. For example, at any given point in time, the cheapest tariffs in the market are disproportionately likely to be offered by suppliers whose hedging strategy happens to be delivering the lowest wholesale costs at that point in the economic cycle. This means that the basket will track the lower envelope of wholesale costs associated with different – and mutually inconsistent – hedging strategies over the cycle as a whole.

### ***Mitigating issues through basket design***

22. We support Ofgem's conclusion that it is not possible to design the basket in such a way that all of the challenges identified with the market basket approach can be mitigated. In addition, any attempts to partially address some of the challenges will introduce layers of complexity and defeat the main purpose of a market basket approach, which is simplicity.
23. We are also pleased that Ofgem undertook an evaluation of the approach, and we broadly support the methodology it takes to do this. However, we have concerns about some of the largely arbitrary choices that Ofgem has made in respect of the design parameters listed in Table 1, such as only excluding the 5 cheapest tariffs and using a threshold of 50,000 customers at the supplier group level. If Ofgem were ever to revisit the use of the market tariff approach, we would strongly contest the use of such a baseline.
24. For the reasons discussed in the previous section (in paragraph 19), we do not consider that limiting the basket to only fixed tariffs mitigates the risks to suppliers from not being able to apply a hedging strategy in line with the basket. Further, we note that the additional challenge we raise in paragraph 20 above (relating to the basket being lower than any supplier could reasonably be expected to achieve over the medium term) cannot readily be mitigated through basket design either. In order to address the problem of tariffs tracking the "lower envelope" of wholesale (and other) costs, the tariffs that constitute the basket would need to be fixed over time. However this solution would itself give rise to other concerns given that it would create perverse incentives for suppliers to "game" the cap if they know that their tariffs will remain in the basket come what may.
25. We note that policy costs are to be picked up as part of a later Working Paper and will comment on the issues raised at that time.

### ***Requirement for a substantive consultation on the definition of "long-run costs of an efficient supplier"***

26. While we support Ofgem's conclusion that a market basket is unlikely to be appropriate for setting the initial benchmark, we are concerned by some of the statements that

Ofgem has made in this paper about how it may be defining the “long-run costs of an efficient supplier”. For example, Ofgem makes reference to smaller suppliers arguably being “more likely to represent the efficient level because while they may not face all the same costs as larger suppliers, they may be more likely to be efficient with the costs they face”.<sup>4</sup> Later it argues that fixed tariffs might “be more reflective of the costs of an efficient supplier”,<sup>5</sup> despite the fact that it also recognises that a number of these tariffs may be ‘loss-making’.<sup>6</sup> Furthermore, there is no mention by Ofgem about trying to identify tariffs that may be marketed towards customers that are less expensive to serve, nor any consideration of the lower quality of service that may be associated with some of these cheaper tariffs.<sup>7</sup>

27. We are concerned that such views may be repeated by Ofgem when it considers the alternative methodologies for setting the initial benchmark.
28. We therefore believe that Ofgem must undertake a substantive consultation in its own right about how it will determine what it means by the “long-run costs of an efficient supplier”, given that the definition used will be absolutely central to the determination of the level of the cap, whatever methodology is used to set it. There are at least two important dimensions to this: the type of company that is held to be the benchmark (for example relating to scale of operation or years of operation) and the type of customer that needs to be served. Ofgem must be clear about the assumptions that it is making, and stakeholders given the opportunity to challenge these assumptions. In particular we note that Ofgem will need to beware of unintended consequences if the resulting cap does not cover the costs of the most expensive customers to serve, considering the negative impact this would have on suppliers’ financial incentives to compete to acquire and retain such customers.

## Using the market basket to update the cap over time

29. As Ofgem observes, “the appropriate method for updating the cap level over time will depend on the approach used to set the initial benchmark”.<sup>8</sup> It is therefore not possible for us to be definitive in our views about indexation without knowing how the initial benchmark will be set or what the alternative options being considered for indexation are.
30. However, the methodology used to update the cap over time is extremely important: it must ensure that the costs and risks that suppliers face in serving customer groups protected by the cap continue to be covered, just as it must when the initial level of the cap is set. Based on what we currently know, we think that it is unlikely to be the case

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<sup>4</sup> Ofgem Working Paper #2, paragraph 2.3.

<sup>5</sup> Ofgem Working Paper #2, paragraph 2.12.

<sup>6</sup> Ofgem Working Paper #2, paragraph 5.1.

<sup>7</sup> This was illustrated by the recent report by Citizens Advice:  
<https://www.citizensadvice.org.uk/about-us/how-citizens-advice-works/media/press-releases/energy-star-rating-raises-serious-questions-for-some-smaller-firms-says-citizens-advice/>

<sup>8</sup> Ofgem Working Paper #2, paragraph 2.3.

that a market basket approach would be an appropriate methodology for updating the cap over time.

### **Prices may not track costs**

31. We are not able to say whether a price basket will be a better way of tracking costs than an alternative cost index, without knowing what cost we are trying to index and what indices we have available. However, we do know that any price index will be imperfect.
32. As Ofgem notes, this is in part because “any observations of market prices might also incorporate non-cost trends, such as suppliers’ pricing behaviour”.<sup>9</sup> As Ofgem has identified in section 2 of the working paper, there are plenty of reasons to suppose this will be the case. Furthermore, as we have identified in paragraph 20 above, there are also plenty of reasons to suppose that any price basket will track an unrealistic profile of costs, rather than the “average” costs that an efficient supplier could hope to achieve.

### **Practical challenges associated with identification of a price basket**

33. Even if a price basket could be used as a way of tracking costs in theory, the challenges associated with specifying a price basket mean that one cannot be identified in practice.
34. The chart that Ofgem presents in Figure 1 of Working Paper #2 from Octopus Energy does not establish that “the basket design does not have a significant effect on its ability to accurately track changes in efficient costs over time”.<sup>10</sup> This is because the Figure does not look at different variants of basket design. Instead it is merely showing exactly the same basket design with a different number of tariffs included. Furthermore, each additional basket includes all of the tariffs that make up the previous basket, making it entirely unsurprising that they all follow a similar trend. The basket also (as far as we are aware) has no restrictions applied to it and so will allow multiple tariffs per supplier, again making it less surprising that the trends look similar.
35. To illustrate the effect of varying the basket design, we have recreated the five variants relied on in the Octopus chart and then also included Ofgem’s own Basket A variant.<sup>11</sup> We have then created an index for each basket, based on a rolling 6 month price

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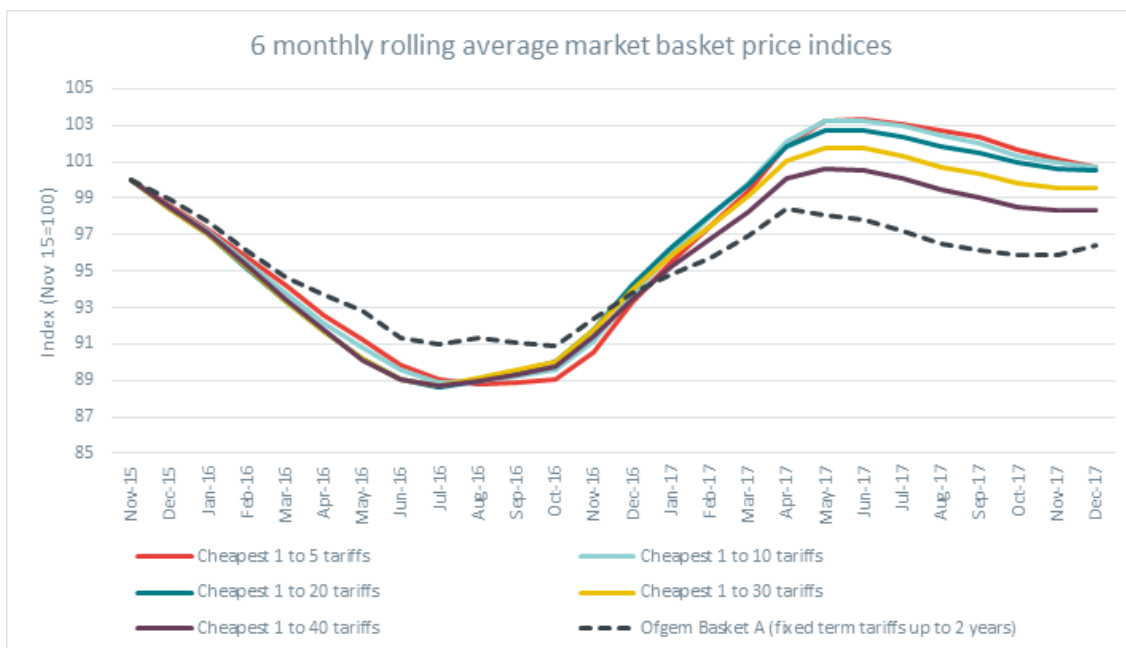
<sup>9</sup> Ofgem Working Paper #2, paragraph 5.5.

<sup>10</sup> Ofgem Working Paper #2, paragraph 5.3.

<sup>11</sup> As defined in Ofgem Working Paper #2, Table 2. This means that the basket is limited to the 6th to 15th cheapest tariffs, requires suppliers to have at least 50,000 customers, and allows only one tariff per supplier. However, for some months in the time series, particularly in the period up to April 2016, a full basket of ten tariffs was not available using Ofgem’s Basket A methodology if we were constrained only to one-year fixed tariffs. Given this, we have created the basket by looking at all fixed term tariffs of up to two years. In practice, the precise level of the price index calculated for this basket will vary depending on the specific order in which the basket restrictions described above are applied. However, irrespective of the order chosen, the historical evolution of the Basket A price index differs materially from the historical evolution of the indices based on the baskets used in the Octopus chart.



change, as an approximation of how a price basket would be used in practice to update a price cap over time.<sup>12</sup>



- 36. It is clear from this chart that basket design is likely to have a material impact on its ability to accurately track changes in efficient costs over time, with the difference in the indexation values resulting in potentially large differences in the level of the cap over time.
- 37. We have used monthly pricing data for this analysis as we do not have access to the daily pricing data used to inform Figure 1. In the event that Ofgem is to rely on the evidence provided in Figure 1, or similar analysis using a data set with daily prices, it is vital that Ofgem provides stakeholders with access to this data so that the robustness of the results can be scrutinised.

**Unintended consequences of using prices to index costs**

- 38. Finally, even if a price basket could be found that appropriately tracks costs, the introduction of the cap will impact pricing behaviour (and thus the basket) resulting in a high risk of unintended consequences given the endogeneity introduced by this approach. This risk goes beyond that acknowledged by Ofgem in this working paper. It is not just about suppliers’ ability to directly influence the value of the basket, and so cannot be mitigated by increasing the size of the cap (paragraph 5.6). Nor is it just about the inclusion of prices that are subject to the cap appearing within the basket (paragraph 5.7). The competitive dynamics will be changed by the introduction of the cap and this will impact on all prices in the market.
- 39. Indeed we are surprised that Ofgem has even proposed this methodology for consultation, given the concerns the CMA raised about this risk when it was deciding on

<sup>12</sup> We have calculated each index by first calculating the 6 month rolling average price for each basket. This is done by taking the arithmetic mean of a 6 month series up to and including the month being calculated. For example, the average price for November 2015 is the arithmetic mean of the prices from June to November 2015. Our index for each basket is based in November 2015 (November 2015 =100) and the index is created by dividing the 6 month rolling average price by the November 2015 6 month rolling average price.

the indexation methodology to be used in setting the PPM cap.<sup>13</sup> We also note that the CMA raised a number of further concerns about the use of an external reference price as an indexation methodology including:

- potential accuracy concerns as a result of the lag between the date reference tariffs were brought onto the market and the implementation of the cap informed by these tariffs – which would be particularly problematic if costs were trending upwards;
- practicality in terms of the significant, regular data required by Ofgem to calculate updated caps; and
- potential changes in the nature of competition in the reference basket which may reduce the effectiveness of the cap.<sup>14</sup>

40. For these reasons, and based on what we are currently aware of regarding how we expect this cap to be set, we do not believe that it will be appropriate to use a market basket to update the cap over time.

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<sup>13</sup> For example, see paragraphs 14.52 – 14.56 in CMA Energy Market Investigation, Final report, CMA, June 2016.

<sup>14</sup> Ibid paragraph 14.55.