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Dear Anna,

Working paper #2: market basket

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

We have previously commented on a number of design issues associated with the market basket approach in our 26 March 2018 response to your first working paper and our 9 February 2018 response to your consultation on broadening price protection for vulnerable consumers, and this response should be read in conjunction with those submissions.

As we have noted in previous submissions, the basket approach has attractions in theory as it would remove some of the information asymmetries, and might remove some of the efficiency assumptions, that are inherent in the alternative of a cost data led approach. It might also be regarded as less intrusive and lighter touch to rely on data self disclosed by the market (i.e. prices) than on cost data disclosed through regulatory information requests.

However, those theoretical advantages could be rapidly eroded by the very significant difficulties in reaching robust and objective criteria on what to include and exclude from the basket and adjusting for policy costs. That process of 'normalising' the basket could result in a process just as intrusive as a cost data led approach, and with no greater chance of reaching the 'right' answer.

We agree with your headline recommendation that a market basket would not be an appropriate way of setting the initial benchmark. The analysis presented in your paper does not suggest that you are close to having a workable model for a market basket approach, or give us confidence that you could close the gap to do so in the few remaining months you have to develop the price cap methodology.

In particular, the working paper highlights just how arbitrary and potentially poorly evidenced some of the policy choices you would have to make are. For example, you, quite reasonably, suggest that you may wish to exclude a certain number of outlier tariffs to avoid the risk that they are priced below long-run costs and will result in an unrepresentative basket. But you do not explain how you have reached the suggested figure of five being excluded - why not ten, or two, or some other number? You also do not set out whether this figure might vary over time, why, what might trigger a review, and so on. Similarly, you present alternative options of including all tariffs, or only including one year fixes to try and create a representative index - but do not explain why other fixes are considered to be unrepresentative. Likewise, while the proposition that deals from the very smallest suppliers are excluded from the basket is reasonable, you set out no logic as to why the exclusion threshold should be suppliers who have 50,000 customers or more, as opposed to any other number.

In short, in every area where you have made an assumption on what should be included or excluded from the basket there are alternative plausible assumptions that could be made. The thought process of why thresholds are set where they are is not adequately explained. As a result, the strawman methodology is very subjective, and may struggle to withstand challenge.

It is also not clear how well the design assumptions could withstand the passage of time. The price cap could last for as little as two years, or as many as five, under the draft legislation. Five years is a long time in energy policy and market development. For a market basket approach to be sustainable, it would need to flex to reflect the evolution in the retail market. It is unclear that the strawman model contains this flexibility. Given the absence of objectivity in most of the initial assumptions, it is also not clear what might trigger revisions to one or several of its criteria.

We retain the view that the outturn prices of the basket would need to be adjusted to reflect policy cost exemptions, as the best buy tables are typically dominated by suppliers who do not face full policy costs.

You note that it could be possible to use a different approach to set the initial level of the price cap, but then use a market basket approach as an inflation/deflation index that is used in its periodic revision. We think this approach has similar advantages and disadvantages to whether to use the market basket for the initial index - that it has superficial attractions in terms of sounding simple, but that this simplicity may rapidly be eroded when the design decisions of what is or is not included in the index, and why, are developed. In practice, other indexes are available - such as the Supplier Cost Index maintained by Ofgem, or the Cornwall Insight Index of Domestic Energy Supply Costs. We do not have a view at this time on a preferred index that should be used in periodic refreshes, however would wish to reiterate the point that some allowance would need to be made for policy cost movements in any indexation.

Yours sincerely

Rich Hall

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