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13th April 2018

Dear Retail Price Regulation Team,

Working paper #2: market basket

Thanks for the opportunity to comment on this working paper.

We agree with Ofgem's preliminary view that a market basket would not be a suitable way of setting the initial benchmark. Ofgem has rightly identified significant design challenges and risks. We raised specific issues and concerns in our response to Ofgem's December consultation. Simplicity must not jeopardise the recovery of efficient costs. This lends itself to a proper analysis of suppliers' costs in order to establish a robust benchmark.

Similarly, whilst market prices should in theory reflect trends in underlying costs, we are not convinced that the risks, challenges, volatility and practicalities can be sufficiently mitigated for a market basket to be used to index the cap level.

Please find more detailed comments appended to this letter, along with a suggested desiderata for the application of any form of indexation.

It's concerning that Ofgem appears to have dropped the planned working papers on estimating companies' operating costs (including smart metering costs) and green tariff exemptions. These are important issues that merit full and transparent consideration, ahead of formal policy consultation. We would welcome clarification.

In the interests of transparency, we believe that non-confidential consultation responses should be published by Ofgem in a timely manner. This submission is not confidential.

Yours sincerely,

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Regulation

Cc: Chris Harris, Head of Regulation

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APPENDIX: npower comments on working paper #2 – market basket

- The Bill is clear in the orientation of the cap to costs rather than prices. Hence, the role of market prices can only be, in any role they have, as a proxy for costs. It does seem to us that the risks and practicalities make it unlikely that potentially 42 caps[1] could be set correctly using prices as proxies.

- The Bill is clear that the orientation of costs should be on efficient costs, but we note that no repeal of the Electricity Act 1989 and Gas Act 1986 are proposed in relation to the financing of licensable activities (the basis on which efficiency must be interpreted).

- A basket of tariffs approach could particularly undermine engagement and competition if customers think Ofgem is effectively tracking the market for them.

- For reasons acknowledged by Ofgem (e.g. supplier exemption from certain policy costs), our view is that the cheapest tariffs offered by exempt suppliers would need to be excluded for the basket to represent the costs of an efficient larger/obligated supplier, or adjusted for policy costs. The market is not a level playing field, with cross subsidies and distortions caused by policy decisions. This would make choosing an appropriate reference basket very difficult.

- We recognise that 50k accounts does correspond to the threshold for some exemptions and would therefore be a candidate level for exclusion from the basket. However, the most significant exemption threshold is 250k accounts. Suppliers with fewer than 250k customers are not subject to policy costs. Indeed, they're currently not subject to full policy costs until they reach 500k customers. We are also aware that one supplier has publicly stated that they were aiming to lose customers to avoid policy costs. On that basis, tariffs of suppliers with fewer than 250k customers should be excluded with an argument for excluding tariffs of suppliers with fewer than 500k customers.

- The extent to which Ofgem's baskets were biased towards online tariffs is unclear. Any efficiency benchmark must be reflective of the cost to serve all customer types/preferences, with the majority of SVT customers believed to be offline.

- As Ofgem's basket used GB average prices, we assume the basket design only used suppliers that supply in all regions, but this is unclear. Only tariffs that are available in every GB region should be included to avoid artificially reducing the basket in one area and thereby impacting a supplier that has a large proportion of customers in a particular area.

- We recognise that not all fixed term tariffs have a precise 12 month duration and therefore that a window either side of 12 months would be required to include enough tariffs. The wider the window the more it is affected by the seasonality of costs and a variety of factors cause a bias to prices even though the window is widened either side of 12 months. Above a 1 month window either side (i.e. tariffs between 11 and 13 months), the bias may become substantial and seasonal corrections to the tariffs would be required.

- Ofgem's basket does not appear to have excluded tariffs with exit fees. In our view, either these would need to be excluded or the effect of the fees adjusted for. The role of these fees are to reduce the risk premia associated with mid-term customer losses on fixed tariffs. Without exit fees, a risk

[1] The existing safeguard tariffs comprise different caps for gas and electricity, for different meter types, and for different regions (a total of 3 x 14 = 42 caps for a given consumption level).

premia would likely be built into the unit rate, thus increasing the underlying cost of the tariff. An alternative might be to uplift the basket of tariffs by the value of exit fees.

- We agree that tariff availability would need to be a design parameter. Only tariffs that are generally available and fulfillable on TPI websites (and therefore paying commission for that sale) should be included in a basket as more reflective of costs.

- We agree with the principle of excluding the cheapest tariffs, but an arbitrary threshold of 5 would be inherently risky for ensuring cost recovery.

- Ofgem necessarily would have to make a series of ad hoc de-selections of tariffs and tariff adjustments. Naturally this would need to be transparent. This would present Ofgem significant challenges in being free from accusations of biasing the basket upwards or downwards.

- Consideration would also need to be given to excluding cheapest tariffs of suppliers with poor customer service/satisfaction.

Phase

To make the basket less volatile an observation period would be required. However, this causes a lag between the ex-ante cost of supply and the ex-post view of this from the historical record of tariffs. This is important where the long term trend of a particular cost exceeds inflation.

Overall

The use of a basket of tariffs for indexation does, in theory, have some merit as a proxy for costs. However, to do it properly and avoid distortions would require daily machinery that would be cumbersome in the extreme for both Ofgem and suppliers. For all of the reasons identified by Ofgem and stated above, we do not support the use of a market basket for indexation.

A suggested desiderata for any form of indexation:

1. It should aim to deliver the policy intention of balancing protection and competition and sustaining the ability of efficient suppliers to finance their activities[2];
2. It shall be robust with respect to distortion by any party;
3. It should be balanced between excessive volatility and excessive smoothing;
4. It should minimise the deadweight cost to consumers of unhedgeable risk*;
5. The re-opener conditions for catering for unforeseen risks and events should be clear;
6. Sunset, rather than continuation, should be the default policy position;
7. If based on costs, no costs should be excluded or inappropriately indexed;
8. It should be as forecastable as practically possible;
9. It should be replicable and independently verifiable, albeit not revealing in public any commercially confidential information.

* To the extent that suppliers can hedge their wholesale price risk then they do not incur cost for this risk. It is not possible to perfectly hedge the wholesale price risk for the cap, but certain formulations of the cap incur less risk than others. For example, if the delivery period for the hedge is the same as the delivery period for the index then the ability to hedge is improved and hence unhedgeable risk is

[2] In keeping with Ofgem working paper #1 paras 1.2-1.3 and 3.1

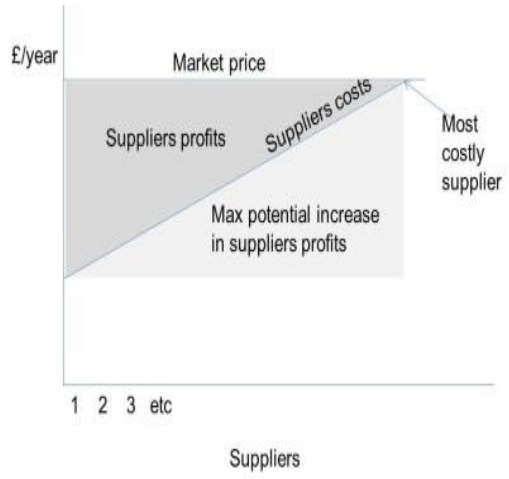
reduced. It is important to note that cost of risk is not a zero sum game. Whereas in pricing, if prices rise some gain and some lose, if risk rises, no-one gains. Higher risk increases suppliers' costs through the cost of capital. If a tariff basket is used for indexation, the more predictable this is, the lower the unhedgeable risk.

General observations on cost efficiency

Costs between suppliers have a natural dispersion amongst suppliers. For example:

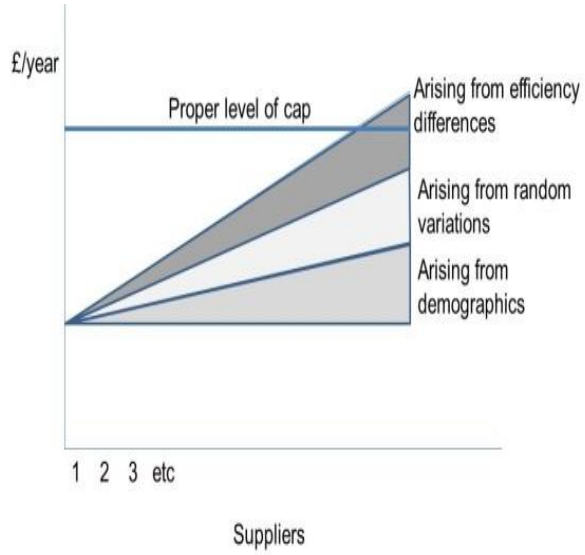
i) Wholesale costs – suppliers have different hedge strategies and this gives them different ex ante and ex post wholesale costs. The Ofgem hedge is not necessarily the most efficient hedge;
ii) Use of System costs – within each region suppliers have different biases of customers whose meter points have different UoS charges;
iii) Bad debt – Different demographics have different bad debt propensities and suppliers have different social policies for debt forgiveness;
iv) Capital – Suppliers have different ownership structures, debt/equity gearing, longevity of loans and working capital costs and requirements.

Some Ofgem and CMA narrative appear to assert that the dispersion of supplier costs flows through to cost to consumers as shown below.



The incentive to increase efficiency is readily apparent. No regulatory incentive changes this. We must assume then that the dispersion of costs arises, in addition to any efficiency differences from: i) structural differences such as arising from customer demographics, ii) random differences that affect different suppliers differently each year.

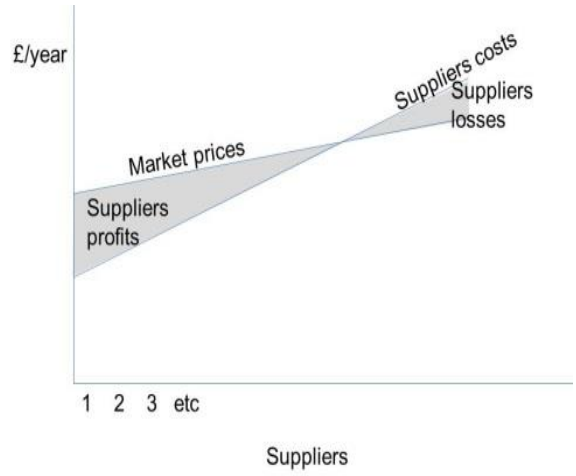
It is clear from this that efficiency explains only a portion of supplier cost differences. Supposing that Ofgem does set the price below the cost of the most costly supplier that only efficiency can be adjusted for. The level is then as shown below.



If a market basket was to be used then, what would be the most accurate proxy for this cost.

We do recognise that tariffs, in theory, provide an approximate proxy for costs, that dispersion of costs is in part related to differences of efficiency, and that **achievement of least cost by the least cost supplier is an indication of *achievable* efficiency. However, that does not mean that the other suppliers are not efficient.** The efficiency of the averagely efficient supplier is the best proxy for an efficiency benchmark.

In practice, in a normal market the least efficient suppliers have to price below cost and the more efficient suppliers price to gain, as shown below.



The price proxy is therefore quite far from the cheapest. Clearly, the most expensive tariffs are not good proxies. A broader basket would seem more appropriate. However, the administration of this would be most cumbersome, as all 42 variants of each tariff would be required each day, with various exclusions, for example: green tariffs; periods much shorter or longer than a year; those with exit fees, product bundles, etc. In addition, many suppliers with a variety of size based exemptions would have to be excluded or the exemption values added on to the tariffs. Since not all tariffs are available on Price Comparison Websites, Ofgem would need to retrieve them from suppliers each day. Highly targeted tariffs, for example single region only, would in our view need to be excluded.