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Dear Jemma,

WORKING PAPER #2: MARKET BASKET

Thank you for the opportunity to respond to the second working paper on the use of a market basket to set the initial level of the default tariff cap and to update it over time. Whilst we remain of the view that the default tariff cap will not be in consumers' interests, we are committed to working with Ofgem on its implementation, aiming to preserve effective competition so far as possible.

Use of a market basket to set the initial level of the default tariff cap

We have previously set out our concerns about the use of a market basket to set the initial level of the default tariff cap (in our response to Ofgem's December consultation and to Ofgem's first working paper) – notably the susceptibility to gaming, the risk of volatility, the difficulty in specifying *ex ante* the design of the basket and the fact that this approach has never been tried before in the UK. We therefore agree with Ofgem's view that it is unlikely that the market basket would be an appropriate way to set the initial benchmark.

Use of a market basket to update the level of the default tariff cap over time

Ofgem suggests that it might be possible to use a method other than the market basket for setting the initial level of the cap, but use an index based on the market basket to update the level of the cap over time. Ofgem suggests that it might be easier to design the market basket if it was to be used in this way, so that it is still reflective of underlying cost drivers but suppliers are less able to influence it.

We consider that while using a market basket just to update the cap (rather than setting its initial level) could address some of the concerns about this technique, significant other drawbacks remain. In particular:

- A wider price cap on default tariffs is a significant change to the structure of the retail market, and the relationship between the market basket and the efficient level of prices may change on its implementation. This could invalidate the use of a market basket for updating the cap, at least until the new structure had settled.
- In our experience energy supply markets do not always behave 'rationally' – they can exhibit variability that is not obviously due to underlying cost changes and may not even be easily attributable to suppliers' marketing strategies. Basing the

updates to the price cap on a market basket would expose suppliers to unacceptable risk that changes in the basket might not reflect changes in cost.

- We think Ofgem has underestimated the difficulty of specifying in advance the criteria for selecting tariffs to go into the market basket in a way that is robust. As we have pointed out in previous submissions, many tariffs are subject to some limitations of availability (whether by channel, region, or time periods) and the rules for selecting tariffs would need to cater for this in a way that avoids gaming.
- Suppliers need the indexation to be based on an assumed hedging profile so they can match their forward purchasing to the assumed profile and minimise their hedging risk. An index based on the market basket would deny suppliers this opportunity and significantly increase their risk exposure for no obvious gain. As we noted in our response to Ofgem's working paper #1 it may be helpful to further consider such hedging issues in an industry workshop.
- Ofgem is right to highlight the risk of circularity, whereby the tariffs used to make up the basket are themselves influenced by the level of the cap.

For these reasons we do not believe that the market basket approach would be appropriate for the purpose of updating the level of the cap.

Ofgem's updated timetable and planned working papers

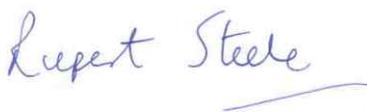
Working paper #2 also sets out Ofgem's updated timetable for future working papers and consultations over the coming months to support the design of the cap. This is helpful. The timetable sets out a further two working papers (on 'approach to headroom' and 'costs that could be adjusted periodically') prior to a full policy consultation on Ofgem's design thinking to date.

In the open letter of 6 March, Ofgem stated that the planned working papers would also cover the approach to estimating companies' own costs, including smart costs, and views on any exemptions to support the production of renewable gas and electricity. It would be helpful to understand how Ofgem will consider these points within this revised timetable if not in specific working papers.

In particular, we have previously highlighted to Ofgem the need to fully consider the costs of the smart programme in its assessment of the level of price cap. While the programme will ultimately deliver consumer benefits, little consideration was given to smart costs by the CMA in relation to the existing prepayment price cap, and since then costs have been increasing rapidly with supplier benefits arising more slowly than expected. We have already provided Ofgem with further detail of our assessment of the programme costs, however we think it is essential that Ofgem undertakes a full assessment of such costs across all suppliers to inform the price cap process.

Should you have any questions on this response, please do not hesitate to contact me.

Yours sincerely,



Rupert Steele
Director of Regulation