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Dear Jemma,

**SSE response to Ofgem Working Paper 2: Market Basket**

Thank you for the opportunity to comment on Ofgem's second working paper regarding the market basket approach as an option for the default tariff cap.

As previously indicated, SSE welcomes engagement with Ofgem on this topic and remains committed to being constructive and supportive of measures that seek to improve outcomes for consumers within the energy market.

We do reiterate our position that competition within the market will be the best route to delivering positive and sustainable outcomes for customers. SSE believes the market basket approach would be the least positive of the options under consideration in these terms.

Our concerns with the market basket approach have been outlined to Ofgem previously. We expand on our concerns in 2 sections:

- **Annex 1:** SSE analysis of the poor correlation between a market basket and the cost of supply; and
- **Annex 2:** Design issues that SSE believe exist with a market basket approach.

Our analysis of historic data and our perspective on design issues lead us to the conclusion that a market basket approach to setting or updating a default tariff cap should be discounted as being a viable approach. We would be happy to discuss our analysis with Ofgem if helpful.

In response to the inclusion of an Expected Milestone Plan, we have included our views on areas where the consultation process should be enhanced. These are set out in **Annex 3**, and focus on:



- (a) Our strong view that a cost-based approach to setting and updating a default tariff cap is the only reliable way to ensure that the four policy objectives handed-down by Government can be effectively balanced.
- (b) The need for explanation of Ofgem’s thinking in relation to the Critical Success Factors that will be measured when considering the future removal of a price cap, and consultation on this topic.

SSE is therefore strongly of the view that the market basket approach is not an appropriate method for setting the initial level of the default tariff cap. Nor is it suitable as an ongoing method of monitoring the efficient and sustainable operating costs of suppliers. We elaborate more on our concerns within Annex 1 and 2.

Please do not hesitate to get in touch should you wish to discuss any of the points raised within this response in more detail.

Yours sincerely,

Abiye Martyns-Yellowe  
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## **Annex 1: SSE analysis of the poor correlation between a market basket and the cost of energy.**

SSE has investigated the relationship between fuel costs and potential market basket approaches, to understand the extent to which this approach to a default tariff cap might be viable. The outcome of our analysis is that we believe such an approach has many risks, is unreliable depending on competitor behaviour and market conditions, and accordingly that the market basket approach should not be further progressed.

Clearly, fuel costs are only one part of the bill, and other costs should ideally be factored in to increase the sophistication of the analysis, not least the increasing level of policy costs over time (for those suppliers of sufficient scale). However, this analysis would take more time to prepare, and would need to be shared on a commercially confidential basis with Ofgem. We would be prepared to develop such analysis if helpful to Ofgem's further consideration of a default tariff cap.

We believe that for Ofgem to build confidence in the potential viability of a market basket approach, a suitably strong correlation coefficient should be achieved for historic data; in addition, Ofgem should be able to determine with confidence that the introduction of the cap would not in itself change the likely forward correlation substantially. SSE has analysed two correlations:

1. The correlation coefficient between daily movements in energy costs and prices; and
2. The linear fit across a scatter plot of prices vs costs.

Our analysis is based on publicly available data on tariffs available in market over time (sourced from uSwitch) and fuel cost prices (as available in the wholesale market for the month, quarter and season ahead at each time-point<sup>1</sup>).

The findings of our analysis demonstrate that:

### **(a) A market basket has not been strongly or consistently correlated to the cost of energy.**

For a market basket approach to be viable it needs to track the cost of energy supply. In the period analysed this is not the case, as shown in the chart below, which explores the potential outcomes under an approach based on (i) the whole of market, (ii) excluding the top 5 tariffs, and (iii) excluding very small suppliers<sup>2</sup>. This produced correlation coefficients

<sup>1</sup> Wholesale Market Prices used are the closing mid-price as published by ICIS Heren in their Daily Electricity and Gas reports. The Forward 12-month average is constructed from the 'Tradable Products' published by ICIS Heren. For example, the 12-month price on 10<sup>th</sup> Apr is average of [May price] + [June price] + [3x Q3 price] + [6x Winter18 price] + [1x Summer19 price]

<sup>2</sup> A proxy has been used for very small suppliers, of those suppliers that could not be fulfilled on uSwitch

of 0.59, 0.57, and 0.58 respectively – all of which are clearly insufficient to build confidence in using them as an approach to setting or adjusting the default tariff cap.



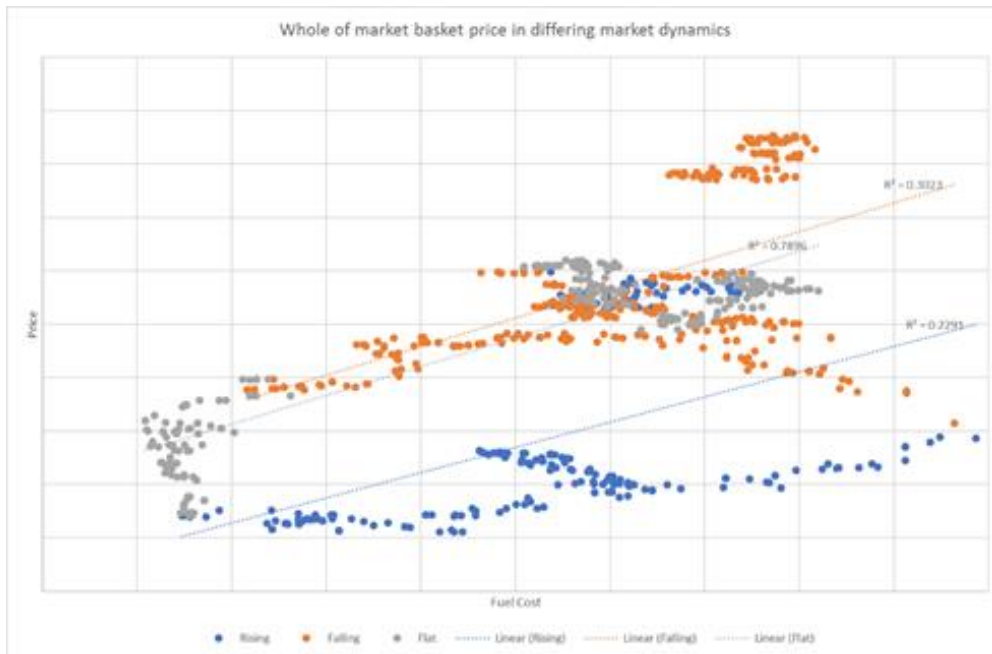
**(b) The correlation is weakest during a rising market.**

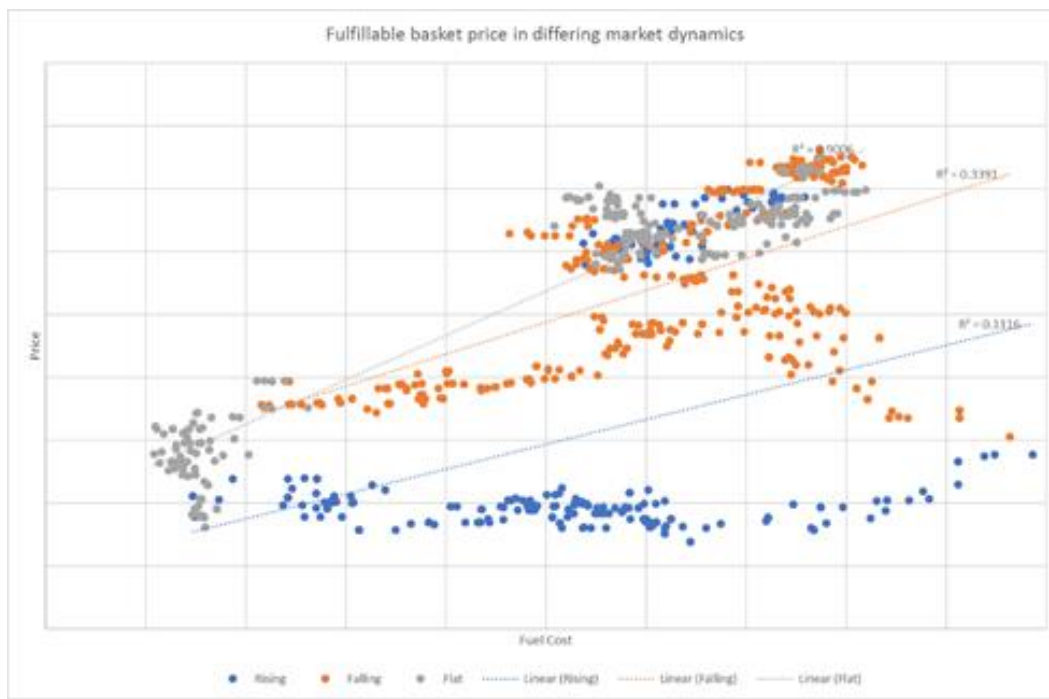
It is important that a market basket should continue to index well to fuel costs in a rising, flat or falling market; otherwise a real risk exists that efficient operators become unable to finance their activities under certain market conditions. Our analysis suggests that the correlation is weakest during periods when fuel costs are rising; as shown below.

Correlation to Fuel Cost	All	Rising	Falling	Flat
All Whole of Market	0.59	0.48	0.55	0.89
All Excluding 5 Cheapest Tariffs	0.58	0.48	0.53	0.88
All Fulfillable	0.58	0.33	0.58	0.95

While there is a strong correlation during periods of flat costs, there is poor correlation in either rising or falling periods, which dominate the timeline covered in the analysis. This is also illustrated by the R-sq values for trendlines shown on the three charts below. Further investigation of flat periods could be undertaken to understand the drivers for two clear

groupings on the charts which may be related to non-fuel costs as discussed at the beginning of Annex 1.





**(c) It does not appear to be possible to improve adequately the correlation by adjusting the market basket.**

A range of basket compositions (all consisting of multiple tariffs) was tested covering:

- Fixed tariffs, Variable tariffs, all tariff types.
- Tariffs ranked one to five, one to 10, one to 20, one to 40, five to 15, five to 25, five to 50.
- Including one tariff from each supplier, or all tariffs from each supplier.
- Including or excluding very small suppliers.

On analysing these basket types, it became clear that there are distinct differences when viewed as variable or fixed groups (with a combined group generally dominated by the volume of fixed tariffs within it). As such two views of the five basket types with highest correlation across the whole period are shown in the tables below.

Fixed / All Correlation to Fuel Cost	All	Rising	Falling	Flat
5-15 Fixed Tariffs, All Suppliers	0.69	0.50	0.75	0.89
5-25 All Tariffs, All Suppliers	0.68	0.55	0.75	0.87
1-20 All Tariffs, All Suppliers	0.66	0.54	0.72	0.85
Cheapest Fixed Tariff, Excl Very Small Suppliers	0.65	0.46	0.61	0.93
1-10 All Tariffs, All Suppliers	0.64	0.46	0.71	0.87

Variable Tariff Correlation to Fuel Cost	All	Rising	Falling	Flat
1-5 Variable Tariffs, All Suppliers	0.47	0.57	0.50	0.47
Cheapest Variable Tariff from Each Supplier	0.39	0.36	0.35	0.67
Cheapest Variable Tariff Excl Very Small Suppliers	0.35	0.17	0.21	0.94
1-10 Variable Tariffs, All Suppliers	0.33	0.34	0.38	0.15
1-20 Variable Tariffs, All Suppliers	0.24	0.13	0.33	-0.19

In each case, (1) the quality of overall indexation is not sufficiently strong to form the basis of a default tariff cap, (2) the variability across the period provides low confidence that the market basket approach would be resilient to changes in market dynamics (particularly when underlying fuel costs are rising).

**(d) The market basket approach would have performed extremely poorly if re-priced every six months.**

The issues noted in (c) above, are further exacerbated when considered over 6-month time horizons; which Ofgem has indicated is the intended repricing cycle for the default tariff cap. The tables below demonstrate that not only does a poor correlation exist in many periods, but that the cap would have indexed down during periods when fuel costs were rising. Clearly this would not be viable in practice.

Fixed / All Correlation to Fuel Cost	Summer 15	Winter 15	Summer 16	Winter 16	Summer 17	Winter 17
5-15 Fixed Tariffs, All Suppliers	0.94	0.93	0.67	-0.47	-0.69	0.49
5-25 All Tariffs, All Suppliers	0.94	0.94	0.70	-0.46	-0.71	0.79
1-20 All Tariffs, All Suppliers	0.95	0.93	0.69	-0.50	-0.72	0.64
Cheapest Fixed Tariff, Excl V Small Suppliers	0.86	0.90	0.73	-0.48	-0.75	-0.04
1-10 All Tariffs, All Suppliers	0.95	0.92	0.52	-0.51	-0.80	0.73

Variable Tariff Correlation to Fuel Cost	Summer 15	Winter 15	Summer 16	Winter 16	Summer 17	Winter 17
1-5 Variable Tariffs, All Suppliers	0.89	0.93	-0.09	-0.33	-0.78	0.58
Cheapest Variable Tariff from Each Supplier	0.90	0.91	-0.38	-0.45	0.60	-0.55
Cheapest Variable Excl V Small Suppliers	0.92	-0.24	-0.82	-0.52	-0.59	-0.53
1-10 Variable Tariffs, All Suppliers	0.89	0.89	-0.40	-0.29	-0.76	0.66
1-20 Variable Tariffs, All Suppliers	0.89	0.89	-0.68	-0.28	-0.60	0.60

SSE would be happy to share further or discuss our analysis into the historic performance of market baskets. We note that Ofgem will need to consider how the market basket might



perform in the future (not just the past); which will require substantial analysis, and would in any case be highly uncertain in nature.



## **Annex 2: Design issues that SSE believe exist with a market basket approach**

### **1 SSE considers the market basket approach could have severe unintended consequences and should not be progressed any further.**

- (i) Specifically, SSE is concerned that the cheapest tariff or tariffs in the market at a certain point in time may not be reflective of efficient and sustainable operating costs for a large customer base. For example, the cheapest tariff might be a deep discount short term offer with a capped customer base, targeted specifically at smart meter customers. How Ofgem would calibrate the cap around such highly variable and potentially unsustainable market offers, while ensuring suppliers have sufficient headroom to compete for this large customer group, is not clear.
- (ii) Since the market basket approach, as intended, does not track any costs, the risk is too high that it is open to influence by the decisions of individual competitors. We believe that significant risk exists that movements in the price cap do not bear close relation to movements in underlying costs. This is because the basket of tariffs in the market at a certain point in time may not be reflective of efficient and sustainable operating costs for a supplier serving all customer types.

### **2 Setting the initial benchmark**

We note Ofgem's emerging view that a market basket is not a suitable approach towards setting an initial benchmark (paragraph 1.9 of the working paper). SSE strongly supports the conclusion that Ofgem has at this stage reached. We see the following issues:

- (i) The market basket would only reflect the price at which a small group of competitors believe it is economically rational to invest in acquiring a customer (based on their own assumptions about retention, pricing in subsequent years, and the full costs and risks associated with supply).
- (ii) The market basket might be distorted by decisions of competitors looking to build scale quickly, who may decide to price below cost for a period. Given the well-documented low barriers to entry in the GB energy supply market and the evidence of recent years, it is likely that there will always be a group of suppliers in this category at any given time, with suppliers who have exited the market due to being unsustainable, or who have achieved the scale they were seeking and subsequently adapted their pricing strategy, being replaced at the lower end of the market by other new entrants looking to invest in building scale. This pattern also suggests that lower costs in the market basket could not sustainably be applied across the

whole of the market and therefore are not an appropriate basis on which to set a market-wide price cap.

- (iii) Some competitors benefit from exemptions for policy costs which distorts the market basket. In the short term, there has not yet been any indication that the Department for Business, Energy & Industrial Strategy intends to remove the small supplier exemption, and current proposals on the ECO taper exacerbate the market distortion on larger suppliers.
- (iv) Many tariffs are not universally available, are targeted at niche customer groups, have restrictive conditions, offer additional benefits, include termination fees, or have varying durations. This would be an uncertain foundation as the basis for setting any cap.
- (v) The market basket would comprise suppliers of varying maturity and business performance. The premise of a market basket is that the best prices are offered by businesses that are sustainable (and so would allow an efficient operator to finance its activities). It is unclear how Ofgem would ensure this were the case.

Whilst some of the issues listed above could be adjusted for through detailed design consideration (which result in moving further from a market basket approach as noted by Ofgem at paragraph 3.26 of the working paper), we believe the risks of poor correlation to the true costs of supply are high.

We believe that it is important to note the breadth of the default tariff cap, which will directly apply to all customers on SVT and those on other Default Tariffs, and is additionally likely to shape indirectly the reference price for all fixed term contracts. Accordingly, it would only be appropriate to set the initial benchmark through an extensive examination of cost-based data. We note that Ofgem has instigated an RFI which would allow this exercise to be completed.

### **3 Updating the cap over time**

SSE believes that it would be ineffective to use a market basket to update the cap over time. We note Ofgem draws a distinction between setting the initial cap level and updating it over time, however we believe the same logic applies to the poor correlation of market prices and true costs of supply in both cases. We see the following issues:

- (i) Historic data shows a poor correlation between market basket prices and movements in actual costs, as demonstrated in Annex 1.
- (ii) As rightly noted by Ofgem (paragraph 2.13 of the working paper), changing tariff components of the market basket over time would make it impossible

to construct an informed hedging strategy that allows suppliers to track movements in the market basket for their energy requirements.

- (iii) The diversity of hedging strategies across suppliers and tariffs in the market basket will produce ever-changing ‘winners’ (those suppliers with the best price) across time as wholesale prices fluctuate and cycle through a series of ups and downs. It would not be practical or possible to construct a single consistent hedging strategy under a market basket default tariff cap which could replicate this feature of the market.
- (iv) Potential exists for the actions of suppliers to influence market basket outcomes – irrespective of whether their decisions are commercially rational or not.
- (v) A potential disincentive would be created for suppliers to offer discounted prices which might influence movements in the cap.
- (vi) The price movements of any market basket designed now would be shaped by pricing decisions of competitors responding to a post-cap set of market dynamics. This fundamental change in context makes it impossible for Ofgem to forecast how the cap might track relative to true underlying costs, as well as how the cap might perform for consumers, going forwards.
- (vii) It is likely the administrative burden of the market basket would be high (with daily data feeds required, as noted in paragraph 5.8 of the working paper).

#### **4 Balancing the four policy objectives**

Given the issues outlined we do not believe it would be possible to design a market basket capable of delivering against the four policy objectives:

- Objective a: The need to create incentives for holders of supply licences to improve their efficiency
- Objective b: The need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts
- Objective c: The need to maintain incentives for domestic customers to switch to different domestic supply contracts
- Objective d: The need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

In the draft bill, Ofgem is under an obligation to exercise its functions with due regard to these objectives. We would draw Ofgem’s attention to the following issues:

- (i) Uncertainties in potential market basket movements and the absence of an implied hedging strategy are likely to lead to energy procurement inefficiencies, **(contrary to Objective a)**. Ofgem refers to the practicalities of forward hedging in paragraph 2.13 of the Working Paper identifying the possible differences in hedging strategies for standard variable tariff customers and fixed tariff customers. This, coupled with the intended six-monthly review of the cap, will make it an impossible task to hedge the supply volumes in a manner that reflects the cost movements in the basket.
- (ii) The market basket has clear potential to inhibit competitors from offering tariffs that might influence market basket movements **(contrary to Objective b)**. This gives rise to the knock-on potential of reducing levels of switching in the market-place **(contrary to Objective c)**. Ofgem recently published information<sup>3</sup> noting that over one in five energy consumers are with small and medium sized suppliers as a record number of customers switched to get a better deal last year. If competition is inhibited because of the cap, this removes an incentive to switch.
- (iii) Given the absence of a cost-based approach to price setting or price movements, it is entirely unclear how Ofgem could determine through the market basket approach that holders of supply licences who operate efficiently would be able to finance activities authorised by the licence **(Objective d)**.

It is SSE's view that if there is a risk to any of the objectives being met due to any shortcomings with the proposed method in setting the default tariff cap, that method should be conclusively removed as an option, as it cannot reasonably be reconciled with Ofgem's proposed statutory duty.

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<sup>3</sup> <https://www.ofgem.gov.uk/publications-and-updates/record-number-customers-small-and-medium-sized-suppliers>

## **Annex 3: Expected milestone plan and implied consultation scope**

### **1 Milestone plan and consultation scope**

We appreciate the transparency provided by Ofgem in outlining its current view of the milestone plan.

SSE believes the milestone plan as outlined is incomplete and that three additional working papers should be constructed to explore the following topics:

#### **Proposed Topic: Updated competitive reference price**

We propose that Ofgem should issue a working paper focused on Option 3 in Figure 2 of working paper #1. We see potential to address the flaws in the CMA benchmark to reach a position where it becomes workable to expand use of this approach for the default tariff cap.

SSE has already discussed with Ofgem the issues we see with benchmarking, metering cost indexation, and reducing energy demand causing policy cost inflation which is then unevenly applied across suppliers; which we believe should be consulted upon more broadly.

#### **Proposed Topic: Bottom up cost assessment**

SSE sees greatest potential in adoption of a bottom up cost assessment approach to both setting the default tariff cap and adjusting it over time; and would advocate that Ofgem should issue a working paper focused on Option 4 in Figure 2 and Option b in Figure 3 of working paper #1 (together, Option 4b).

Our view is that Ofgem should not be seeking to 'set prices' in the market, but rather to ensure that all prices charged are 'fair' and are 'not excessive'. By employing Option 4b, we believe Ofgem could create the conditions for competition to continue beneath the level of a default tariff cap. We believe therefore it is important for Ofgem to consult specifically on how Option 4b might work in practice.

#### **Proposed Topic: Critical success factors**

We believe it is important to determine the 'market conditions' that would lead to a decision to remove the Cap from market, and to design a process for transparent reporting of these Critical Success Factors. SSE believes Ofgem should set out its thinking around this topic and invite consultation.