Retail Market Policy
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

By email to: retailpriceregulation@ofgem.gov.uk

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Dear Sir / Madam

Default Price Cap: Third Working Paper (Approach to Headroom)

We welcome the chance to respond on Ofgem's third working paper on the market-wide default price cap ("**Default Cap**").

Our initial view on Ofgem's approach to headroom is that we agree that in principle, headroom is not needed in the context of a market-wide default cap. The nature of the cap - applicable to tariffs not chosen by customers - changes somewhat the arguments in favour of headroom. Ofgem rightly points to the argument that "regard for competition and switching should be focused on fixed tariffs" (paragraph 3.6), and the need to ensure customers can choose new fixed tariffs (from default tariffs). We agree that a "good" cap has among other things to be set so as to encourage switching (or at an absolute minimum, not making it any worst benchmarked at current SVT switching levels). We note here that in parallel, it is essential that active engagement requirements are placed on suppliers (following from the CMA's package of remedies here and Ofgem's own trials programme).

Our initial view on headroom is contingent on the following:

- The underlying cost stack being complete, including all appropriate policy costs and providing for appropriate adjustments, e.g. appropriate risk premia, and margin, howsoever the initial Default Cap is set (in this regard, we would reiterate the points made in our response to the first working paper (which referenced our comments in our response to the safeguard tariff year two)); and

- Communications and engagement measures being in place on *all* suppliers, supporting regular communications with and prompts to SVT customers (subject to appropriate data protection and privacy measures).

In terms of policy costs, for those policy costs it is hard to forecast (e.g. DCC and SoLR), this may require some form of pass-through but in any event, a specific uplift or risk premia may be justified here (as well as in relation to other elements of the bottom-up costs). Where possible, any review period could usefully align with likely policy cost reviews or forecast changes, or specific provision could be made for those expected to be outside the review windows.

Ofgem is right to consider how best to assess the impact of the Default Cap and how it is set.

The differences in the allocation of policy costs - between suppliers and between customer cohorts - plays out in the costs making up the initial cap and in the prices assessed (whether as part of the Cap-setting exercise, by benchmark or impact assessment or otherwise). This situation creates a distortion as between those suppliers within these schemes and those that are not - and their customers. The lack of obligation on smaller players effectively gives them an entry "headroom", creating a separate market (fixed tariffs and competition amongst suppliers who pay these costs and fixed or other chosen tariffs among those who do not).

A further distortion is created for those suppliers not incurring such costs and effectively funding their entry and initial growth phase through up-front payments taken prior to service start date and (potentially) poor account balance management. The lack of moral hazard on entrants here does not encourage responsible entry, and in our view is not the competition being sought for this utility market. Management of this risk could assist with addressing the SoLR risk premium referred to above.

In our view, a market-wide cap is unique, which makes it challenging to draw on other country comparisons and the behaviours of stakeholders under or be reference to any cap. Ofgem should of course consider such comparisons, and the practical experiences of the relevant markets, but it is essential that Ofgem builds the ability to track on a dynamic basis the impact of the Default Cap in the capped and uncapped market segments on an ongoing basis. The working paper highlights the modelling to be developed. It is not clear whether this can be used to assess impacts across the market on a dynamic basis but if not, we would urge Ofgem to work towards building the capability to undertake quantitative or modelling-based analysis to underpin its assessment of the impact of the Cap.

In terms of specific additional information, and to the extent this is not already being sought, Ofgem should consider:

- For newer suppliers, the approaches to market entry (and the costs), as well as the costs in the first year (including around funding, risk management, cash and liquidity, and credit management), e.g. board reports and decisions, investment and business cases, pricing and payment policies, power purchase and hedging approach and policies for all tariffs offered; and

- Any information around the price changes made by suppliers over the period of their operation (if under e.g. 18 months) or over the last 2-3 years if in the market for longer, including smaller suppliers (within their SVT tariff and any acquisition tariffs if this model is followed, or the SVT tariff only).

We look forward to working with Ofgem further on these key issues.

Yours sincerely

[not signed]

Natasha Hobday