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Dear Retail Price Regulation Team,

Working paper #5: Updated competitive reference price

Thanks for the opportunity to comment on this working paper.

Our overriding concern is that the price cap ensures the full recovery of efficient costs and sustains competition. We remain of the view that Option 4 (bottom-up assessment) would be a more robust and transparent approach for such a significant market intervention. It is essential that the baseline and indexation is based on the best and latest available data. As regards the latter, the use of third party data is most appropriate as a forward looking approach, although as set out in our response to wp#4 we have some reservations over the use of OBR forecasts and believe there are more robust alternatives.

Whilst these working papers have been a welcome means of exploring the issues, it is difficult to provide meaningful comment in the absence of any detailed analysis/modelling on which Ofgem will need to base its decisions. We assume this will be presented in the forthcoming policy consultation.

In terms of a competitive reference price, our general position on the criteria for including suppliers in the benchmark remains; that it is inappropriate and flawed to benchmark smaller or mid-tier suppliers in a growth phase (with high levels of newly acquired direct debit / online customers on heavily discounted short term tariff products and facing lower policy obligation costs) with larger suppliers (with a range of different types of customers, paying by different methods and facing the full costs of delivering the government's social and environmental obligations).

Any efficiency benchmark should include all obligations and all customer types. Essentially, it should be reflective of the long-run costs of a wide sample of suppliers operating at scale who serve the majority of Standard Variable Tariff (SVT) customer types and incur the full range of policy costs, including those costs for which there are numerous exemptions for smaller suppliers. There must be full transparency of any adjustments for comparability purposes. We reiterate that accuracy is essential for a larger/different cohort and whichever option Ofgem adopts, flaws in the current benchmark/indexation need to be addressed

It is also essential that Ofgem clarifies its position on the recovery of Smart costs under the SVT/default price cap.

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We have some specific comments on the proposed high level criteria should Ofgem decide to update the competitive reference price:

<u>Pricing competitively</u>

The implied assumption that standard variable prices being charged to less engaged customers are inefficient/uncompetitive is not universally accepted. SVT bills are comparable across a broad range of suppliers, particularly when factoring in policy cost exemptions, indicating that prices are broadly cost reflective. In our view, it would be inappropriate to unduly focus on fixed term prices or suppliers with a high proportion of customers on fixed term tariffs.

We would also caution against focussing on low prices, as Ofgem is correct to recognise that suppliers may not always price fixed-term tariffs to allow them to make a normal rate of return. Our estimate of margins indicates that the market is more competitive than 2015 (the reference point for the safeguard tariff cap). Against a backdrop of rising costs, we are seeing many suppliers price at extremely low (possibly loss making) levels, potentially as an attempt to gain market share ahead of the cap in anticipation of reduced competition. This may also apply to some SVTs. This must be recognised in any updated benchmark. If Ofgem were to re-baseline the benchmark on today’s prices, there is a risk that this would not be a sustainable basis on which to do so. Ofgem would need to undertake analysis of margins and the extent to which underlying costs are being recovered at particular price points.

There is also a risk that if the cap is based on a selection of suppliers’ forecasting / pricing, there is scope for error which could result in the under recovery of costs. This supports the need to monitor outturn costs and for a recovery mechanism to adjust the cap in subsequent charging periods.

Tariffs with exit fees would need to be excluded as 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 premia would likely be built into the unit rate, thus increasing the underlying cost of the tariff. An alternative might be to uplift the benchmark by the value of exit fees.

Only fulfillable tariffs should be included in the benchmark. If a tariff is not available for sale on one of the most popular TPI websites (and therefore paying commission for that sale), then that tariff should be excluded as not fully representative of the costs of competing in the market.

Only tariffs that are available in every GB region should be included, to avoid the benchmark being distorted by targeted pricing.

We also note that margins in the fixed market are very volatile and therefore choosing prices from a single day as per the PPM cap approach may not be representative. However, there is a trade-off as looking at prices over a longer window may help eliminate some of this volatility, but will then make it harder to index as prices will be a blend of costs from differing periods. Also note the wholesale risk below.

Relevance as a market-wide comparator

Ofgem is right to consider possible exclusions / adjustments to account for atypical costs and business models. For example, suppliers who require advance payments (with resultant working capital benefit and reduced bad debt risk).

Some suppliers and many fixed term tariffs target direct debit / online customers, whereas we believe the majority of SVT customers are offline and many pay on receipt of bill. The cap must reflect the cost to serve all customer types. If the cap is set too low this would provide an efficiency incentive to drive customers to self-serve online, whereas that may not be appropriate for a customer and suppliers must comply with Standards of Conduct.

Paragraph 5.5 refers to concerns raised about wholesale costs and that at this stage, Ofgem has not identified a compelling reason to make adjustments or exclusions for wholesale costs under an updated reference price approach. Wholesale costs have been rising and therefore prevailing costs would be higher than those implied in a revised benchmark based on historic tariffs, making it impossible for suppliers to achieve these costs. This is a substantial risk under a wider market cap. An updated benchmark should reflect the underlying wholesale costs of tariffs on sale, rather than all live tariffs in a benchmark suppliers' portfolio (noting our concerns above about current pricing/margins).

We also reiterate the need for Ofgem to review possible changes to the current index in recognition of supplier risks such as the hedge/cap mismatch and transition phase. Ideally, the forward contract and price cap delivery periods should be aligned, whether 6 or 12 months.

On weighting suppliers in the benchmark, a simple average across selected suppliers could potentially skew the benchmark price and not be reflective of costs. A weighting based on customer numbers would be more appropriate.

Generally, care will need to be taken with adjustments. Specifically, it will be very hard to adjust for profitability of tariffs (historical financial reporting will have a big lag vs forward looking tariff price setting) and operational costs (comparability of reporting and again the lag between reporting and tariff setting).

Yours sincerely,

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Regulation

Cc: Chris Harris, Head of Regulation