ofgem

Working paper #5: Updated competitive reference price

This is the fifth of our working papers on the design of a default tariff cap. This paper discusses our options to recalculate a price benchmark.

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1. Executive summary

1.1. The Domestic Gas and Electricity (Tariff Cap) Bill proposes to create a new duty on Ofgem to design and implement a price cap for domestic customers on a Standard Variable Tariff or other default tariff (the 'default tariff cap'). This document is part of the series of working papers[1] that we are issuing to explain how our thinking on the design of the default tariff cap is evolving as we gather views and evidence. These papers will be followed in May by a formal policy consultation summarising our overall thinking.

1.2. In this working paper we discuss one method for estimating what is an efficient level of costs to set the initial level of the cap. This method uses average price data with adjustments – which we term a 'reference price' approach.

1.3. In our first working paper,[2] we explained the four approaches we are considering for setting the initial level of the cap. These were: a basket of market tariffs (option 1), the existing safeguard tariff method (option 2), an updated competitive reference price (option 3), and a bottom-up cost assessment (option 4).

1.4. Two approaches (options 2 and 3) use 'reference price' methods. These start with average price data, and then make adjustments where necessary to ensure comparability. In our December 2017 consultation on providing financial protection to more vulnerable consumers we discussed option 2, the existing safeguard tariff method. We are continuing to develop that approach, including considering whether or not changes would be required to meet the objectives in the Bill. This paper focuses on option 3: the **updated competitive reference price** method for **setting the initial level of the cap**. We are seeking comments on all aspects of this option. In this paper, we do not explore the other options for setting the initial level of the cap, or how the initial level of the cap is updated over time.

1.5. We are considering the relative merits of each 'reference price' approach. At a high level, an advantage of option 3 compared to option 2 is that it gives us more flexibility to adapt and update the approach (e.g. by selecting different, or more, suppliers, and using new input data). However, this flexibility could introduce more uncertainty about whether the resulting benchmark would be a robust and reliable comparator. In contrast, stakeholders have had more time to assess and understand the existing

[1] For our approach to working papers, see: Ofgem (2018), Update on our plans for retail energy price caps, p3. https://www.ofgem.gov.uk/publications-and-updates/update-our-plans-retail-energy-price-caps
[2] Ofgem (2018), Working paper #1: setting the default tariff cap, p7. https://www.ofgem.gov.uk/system/files/docs/2018/03/working_paper_1_-_design_issues_-_for_publication.pdf

safeguard tariff (option 2), as have we. That experience allows us to identify and consider ways it could be refined to suit this larger and different customer segment.

1.6. A key part of the design for updated competitive reference price is deciding which suppliers to include in an updated benchmark. We would want to select suppliers whose average prices reflect the competitive segment of the market, helping to estimate what the efficient cost of supply is. In practice this means selecting suppliers with high levels of consumer engagement, and who have the lowest prices which are reflective of efficient costs of supply.

1.7. We would also want the reference prices selected to be relevant comparators for the market as a whole. They should therefore reflect the costs of an efficient supplier, and their level should not be driven by atypical features of the benchmark supplier's business model. Issues could arise if a supplier's prices do not cover its costs, or if its efficient costs are atypically high or low. We could do this by excluding suppliers from the reference price, or adjusting their prices after selection.

1.8. We will also need to consider the robustness of our benchmark: both when making the design choices above, and when finalising the benchmark (e.g. when selecting the number of suppliers to include). Once we have selected suppliers, we will also need to consider how they should be weighted to construct the benchmark.

1.9. We welcome your views to retailpriceregulation@ofgem.gov.uk by **3 May** on the relative merits of the two reference price options, and on the high-level choices for selecting suppliers and price data for an updated benchmark.

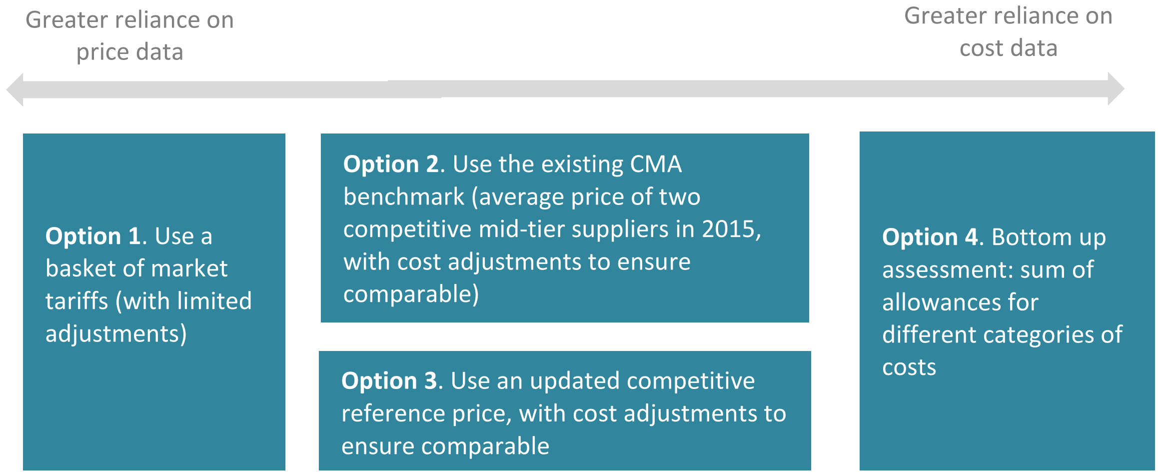
2. Context

Reference price approaches

2.1. In our first working paper, we set out the four options we are considering for setting the initial level of the cap.[3] These are shown in Figure 1 below, which is repeated from the first working paper. In working paper 1 we discussed the bottom-up cost assessment approach (option 4), and in working paper 2,[4] we discussed the basket of market tariffs approach (option 1).

[3] Ofgem (2018), Working paper #1: setting the default tariff cap, p7. https://www.ofgem.gov.uk/system/files/docs/2018/03/working_paper_1_-_design_issues_-_for_publication.pdf
[4] Ofgem (2018), Working paper #2: market basket. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-working-paper-market-basket

FIGURE 1: **Options for estimating what is an efficient level of costs to set the initial level of the cap**



2.2. The two remaining options are both 'reference price' methods. In each case, these start with average price data, and then make adjustments where necessary to ensure comparability.[5] The focus of this paper is the updated competitive reference price (option 3). We discussed the existing safeguard tariff method (option 2) in our December 2017 consultation on providing financial protection to more vulnerable consumers. We do not repeat the discussion in this paper, but we do provide a high-level comparison between the reference price methods as context. (We have already received comments on option 2, for example in response to the December 2017 consultation).

2.3. The advantage of the **existing safeguard tariff** is that stakeholders have had experience to assess and understand it, as have we. Although it could be applied in its current form, we are considering whether there are methodological changes which could ensure that the benchmark is suitable for a larger and different segment, and aligned with the statutory framework set out in the Bill. For example, we are considering whether or not we should make changes in relation to issues such as: the benchmark at nil consumption, the treatment of smart costs, and levels of online account management.

2.4. Alternatively, we could calculate an **updated competitive reference price**. This would follow the same broad methodology used to establish the existing safeguard tariff. However, this particular model would allow us to collect more recent input data, consider the process for selecting which suppliers to include, and review the adjustments made. This flexibility could potentially help us ensure that the benchmark better reflects an efficient level of costs. For example, using more recent input data might improve accuracy, if indexation was unable to update an older benchmark precisely in line with changes in costs. We would also be able to consider similar methodological changes as for the existing safeguard tariff. However, this approach would be subject to more uncertainty, as it would be a new benchmark.

2.5. We welcome any views on the relative merits of these approaches. The remainder of this paper seeks views on how we could calculate an **updated competitive reference price**, if we were to do so.

[5] This is different to a market basket approach, which would not include adjustments based on the individual suppliers in the basket.

Approach taken by the CMA

2.6. We provided a high-level description of the methodology used by the Competition and Markets Authority (CMA) for the current safeguard tariff for prepayment meters in our December 2017 consultation on providing financial protection to more vulnerable consumers.[6] Here, we highlight specific points on the CMA's approach which are relevant to the issues in this paper.

2.7. The source of the CMA's price data for setting the prepayment safeguard tariff[7] was the average direct debit prices of two suppliers on a particular day, weighted by the respective number of accounts within each of those suppliers. The prices were those charged to each supplier's customer base, rather than simply those available for sale on that day.

2.8. In relation to its choice of suppliers for its competitive benchmark, the CMA's position was to focus on "suppliers whose average price best reflects the prices paid by active customers as we expect those customers to be on competitively priced tariffs".[8]

2.9. The CMA made adjustments to the prices of its benchmark suppliers. As well as reflecting the prices charged to active consumers, the CMA said that its principles for the competitive benchmark were that it should:

- "be reflective of the costs of an energy supplier which has reached an efficient scale (ie a large supplier) and which is in a steady state (ie the supplier that is neither growing or shrinking rapidly)"; and

- "generate revenue which is consistent with a normal return".[9]

2.10. Under either of the reference price models, we would be building on the approach taken by the CMA, considering whether any changes are proportionate.

3. High-level criteria for including suppliers in updated benchmark

3.1. We have not decided which option to use to set the initial level of the cap. As noted above, this paper seeks views on how we could calculate an **updated competitive reference price**, if we were to do so. Our current objective for developing a recalculated price benchmark would be to select suppliers who are pricing competitively, and who would be relevant as market-wide comparators (after feasible adjustments). We would also take into account the robustness of the benchmark.

3.2. We briefly discuss the rationale for each of these elements in the following sections, and set out proposed high-level criteria. The main purpose of this working paper is to gather feedback on these high-level criteria. However, as context, we also provide some initial thoughts on some of the options for how these criteria could be implemented in practice.

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[6] Ofgem (2017), Providing financial protection to more vulnerable consumers, appendix D. https://www.ofgem.gov.uk/system/files/docs/2017/12/providing_financial_protection_to_more_vulnerable_consumers_0.pdf
[7] At typical consumption. The benchmark at nil consumption was calculated in a different way.
[8] CMA (2016), Energy Market Investigation – final report, paragraph 10.20. https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf
[9] CMA (2016), Energy Market Investigation – final report, paragraph 10.27. https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf

4. Pricing competitively

4.1. The first element of our current objective is selecting suppliers who are pricing competitively. If we were using a price benchmark, we would be doing this as a way of estimating an efficient level of costs. Suppliers with more competitive prices may be more likely to represent an efficient level of costs, because competition will drive suppliers to cut their prices until these reach the efficient level of costs.

4.2. One of our criteria could be a supplier's **level of customer engagement**. We want to use suppliers who are a reasonable proxy for the prices that would be seen in a competitive market. We would therefore want to limit the extent to which the prices charged to less engaged consumers are used in the benchmark, as these prices would be less likely to have been driven to an efficient level through competition. In response to the first working paper, one stakeholder told us that we should recall the CMA's finding of significant inefficiency for certain suppliers, which would be reflected in their costs.

4.3. Customers who have selected a fixed-term tariff are showing that they are engaged. As such, one option could therefore be to only include fixed-term tariffs in an updated benchmark. However, suppliers may not always price fixed-term tariffs to allow them to make a normal rate of return, and it would be difficult to apply a specific adjustment to these tariffs to address this.

4.4. Another option is to only include suppliers with a high proportion of customers on fixed-term tariffs. This would provide one measure of how many customers are engaged (although we recognise that some smaller suppliers may compete using variable tariffs, and so it is possible for an engaged customer to select a variable tariff). Alternatively, or in addition, we could look at the proportion of a supplier's customers who have been on an SVT for more than three years, and include suppliers where this only represents a small fraction of their customer base. We would be able to measure the proportion of a supplier's customers on different types of tariffs using data we already hold.

4.5. We would also likely want to look for a supplier or suppliers with **low prices**. This would be applied after excluding suppliers or making adjustments (under the other criteria); at this point, we would select the remaining supplier or suppliers with the lowest average adjusted prices. This would help to ensure that the benchmark was as close as possible to the efficient level of costs. We can look at observations of prices using the data collected through our proposed Request for Information (RFI) for tariff data.[10]

5. Relevance as a market-wide comparator (after feasible adjustments)

5.1. The second element of our objective is selecting suppliers who are relevant as a market-wide comparator (after feasible adjustments). We would want to develop a benchmark that is cost-reflective for an efficient supplier, and not driven by atypical features of the benchmark supplier's business model.

5.2. There could be several reasons why prices might not be cost-reflective. First, **a supplier's prices might not cover its costs**. For example, a supplier seeking to grow its customer base quickly may set low prices for a limited time to attract customers. Second, **a supplier may have efficient costs that are atypically low**. For example, if a supplier has a distinctive business model, its customer base might not be representative of the market as a whole. Third, **a supplier might have costs that are inefficiently high**.

[10] See section 6 for more information.

5.3. In some cases, it may be possible to make adjustments to suppliers' prices to make them more relevant as a market-wide comparator. However, where this is not possible, we may decide to exclude suppliers from the benchmark. Adjustments and exclusions are therefore two different tools for tackling the same issues. We recognise that stakeholders' views on the appropriateness of a price benchmark will partly depend on the adjustments we make – this was noted by one respondent to the first working paper.

5.4. In the remainder of this section, we run through each of the main cost categories, and provide initial thoughts on a potential approach to adjustments or exclusions. This draws on previous comments from stakeholders about potential issues with a reference price approach. However, the fact that we discuss possible adjustments and exclusions in certain areas does not mean that we have decided that they are necessary – we may conclude that no adjustments or exclusions are required.

5.5. Stakeholders have raised some concerns about **wholesale** costs, such as purchasing decisions which turn out to be fortuitous, suppliers having differing costs to engage in the market, and concerns that suppliers purchase energy for different tariffs at different times. While we are considering these points (particularly the last), at this stage we have not identified a compelling reason why we would want to make adjustments or exclusions for wholesale costs under an updated reference price approach.

5.6. Were we to adjust prices to remove the impact of differences in wholesale costs, we would first need to extract a supplier's own wholesale costs (preferably as forecast at the time of pricing, or as actually incurred). We would then need to develop and include a view of wholesale costs based on market data, and potentially include an allowance for other costs (e.g. transaction costs). These steps could be challenging. If we concluded that concerns around wholesale costs in the model were justified, we might want to consider whether an alternative model would be more appropriate.

5.7. Suppliers have different regional distributions of customers, and therefore incur different **network** charges. Our current view is that we would treat network charges in the same way as the prepayment safeguard tariff methodology. We would subtract these charges (as set out in network companies' charging statements) from suppliers' tariffs, based on their own regional distributions of customers. This would give a benchmark which was comparable across the country. We would then add back the relevant charges for a particular region when setting the cap level.

5.8. We could adjust to remove the impact of differences in **environmental and social obligations** between suppliers of different sizes, to reflect that some suppliers do not face all obligations. We could replace the actual costs of suppliers with those of suppliers who are fully-obligated (as under the prepayment safeguard tariff methodology). Another option would be to replace the actual costs with an estimate based on another source, such as scheme administration data. Alternatively, instead of replacing all costs, we could add an uplift for those specific schemes which vary between suppliers of different sizes.

5.9. For **operational costs**, we might use exclusions, adjustments or a mixture of the two. For example, we might want to consider excluding suppliers who have niche business models. Some suppliers may have particular business models which may make it difficult to look at them on a like-for-like basis (e.g. a supplier with a high proportion of products bundling energy supply with other services). Where a supplier has a distinctive business model, it could potentially be argued that their customer base might also be significantly different to the market as a whole, in a way which was difficult to control for using adjustments. In response to the first working paper, some stakeholders said that we should look to include suppliers with a customer base that was representative. This would need to be a case-by-case assessment on a largely qualitative basis.

5.10. Another potential consideration would be whether suppliers have reached an efficient scale. However, we may not need to exclude suppliers directly on this basis. If suppliers are less efficient because they have not reached scale, then (all other things being equal) this might lead to them having higher prices. Selecting the suppliers with the lowest prices might therefore also help to exclude suppliers who are less efficient.

5.11. There may be other requirements which do not apply to all suppliers (e.g. the costs of pre-privatisation pension schemes). We would need to consider whether they were material, and whether it is proportionate and feasible to adjust for them.

5.12. Suppliers will be earning different **Earnings Before Interest and Tax (EBIT) margins**. We could make an adjustment for this by using accounting information from suppliers to calculate a supplier's current EBIT margin, and then increasing or reducing a supplier's prices to deliver the EBIT margin reflecting a normal rate of return. This would follow the same approach as the prepayment safeguard tariff methodology. This could address the concerns from some respondents to working paper 1 that some suppliers may be loss-making.

5.13. If we set the benchmark based on direct debit tariffs only, we might not need to adjust the benchmark itself to take into account different **payment methods**. Rather, we could apply a separate payment method uplift outside the benchmark when calculating the cap level. This was the approach used under the prepayment safeguard tariff methodology.

6. Assembling a benchmark

Robustness

6.1. We will consider robustness throughout the process. However, we will need to consider how reliable our results will be, taking into account factors like the comparability and quality of data, and the number of suppliers included in the benchmark.

6.2. For example, the number of suppliers included in the benchmark could be one way of influencing its robustness, although we would also need to bear in mind that changing the number of suppliers in the benchmark would also affect how close the benchmark was to an efficient level of costs (where there were differences in how competitively these companies were pricing).

6.3. Choosing the number of suppliers would be a question of balancing different considerations. On the one hand, including a larger number of suppliers would mean that each individual supplier would represent a smaller proportion of the benchmark. This might increase confidence that the benchmark was representative, and reduce the impact of any decisions about supplier-specific adjustments. On the other hand, including a smaller number of suppliers would allow us to focus on understanding the data for the candidate suppliers and considering any factors which may require adjustments. We might therefore gain greater confidence in the data.

6.4. Our decision on the number of suppliers to include would also depend on how many suppliers were left after exclusions discussed in the previous sections. This would determine the maximum number of suppliers we could include.

6.5. Excluding outliers could be another way to influence the robustness of the benchmark. For example, in the market basket working paper (working paper 2), we considered excluding the very cheapest tariffs to remove outliers. Outliers might be less of a concern in the case of an updated competitive reference price, as we would be able to apply adjustments, but in theory it would be possible to take a similar approach.

Tariffs

6.6. Our analysis of data from our proposed RFI will allow us to calculate suppliers' average prices. As part of this, we may need to make decisions about whether to exclude specific tariffs: either for practical reasons (e.g. data quality), or because they are otherwise difficult to include in this analysis (e.g. tariffs with non-standard structures). The CMA took into account factors like this when deciding which tariffs to exclude from its analysis – such as excluding tariffs where suppliers provided incomplete or corrupt data.[11] At this stage, we intend to take a similar approach to the CMA when deciding which tariffs to cover when calculating average prices.

Weighting

6.7. Once we have selected which suppliers to include, there is also a question of how to weight them to construct the benchmark.

6.8. One option would be to take a simple average, where each supplier included would have the same weight. Another option would be to weight each supplier by its number of customers.

6.9. The latter approach could have potential advantages if we thought that there were residual concerns about the comparability of suppliers (even after any adjustments and exclusions). In this case, it could be argued that suppliers who represent a greater proportion of the market could be more relevant as market-wide comparators, and therefore should have a higher weight. However, given the range of sizes of suppliers in the market, there could be a risk that this approach might lead one supplier to dominate the benchmark calculation.[12] Using a simple average would help to address this, and could be a more straightforward approach.

Interaction with data gathering

6.10. We need additional tariff data to help us calculate an updated competitive reference price (but not if we were to use the existing safeguard tariff method). Given our overall timescales, we are progressing this in parallel with this working paper. We issued a draft RFI for comment on 13 April 2018. We intend to issue the final RFI before the end of April.

6.11. This means that we will be issuing the RFI before the deadline for comments on this working paper. However, we would like to emphasise that we will consider responses to this working paper and gather further information if required.

6.12. We have not decided which suppliers to include in any recalculated price benchmark. However, for reasons of practicality, we are planning to restrict our initial RFI to suppliers with over 50,000 electricity customers. If you are a supplier with fewer customers and wish to provide this information voluntarily, please get in touch with us.

[11] CMA (2016), Energy Market Investigation – final report. Appendix 10.2, paragraphs 12-14. https://assets.publishing.service.gov.uk/media/576bcc6ded915d3cfd0000bf/appendix-10-2-benchmark-analysis-of-domestic-energy-bills-fr.pdf
CMA (2016), Energy Market Investigation – final report. Appendix 9.2, paragraph 5. https://assets.publishing.service.gov.uk/media/576bcbca40f0b66bda0000b0/appendix-9-2-analysis-of-the-potential-gains-from-switching-fr.pdf
[12] This would depend on the relative sizes of the suppliers included in the benchmark.

7. Next steps

7.1. This working paper explains a high level how we could approach designing an **updated competitive reference price** benchmark, were we to adopt this option.

7.2. We welcome feedback on this working paper by **3 May 2018**. Please e-mail any submissions to: retailpriceregulation@ofgem.gov.uk. We will consider any feedback and summarise this in our policy consultation.

7.3. The working papers published today are the last ones we intend to publish before the policy consultation in late May. That document will summarise (and provide stakeholders an opportunity to comment on) our current position on the overall approach to setting the cap – including areas which have not been the subject of a working paper. We are grateful to those who have taken the time to respond to our working papers to date.