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Default Tariff Cap: Policy Consultation

Appendix 1 - Market Basket

Consultation - supplementary appendix

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Overview:

The energy market works well for consumers who shop around. Suppliers compete for these engaged consumers, offering low prices to gain or retain their custom.

But the retail energy market is not working for consumers who remain on their supplier's default tariff. Our work, and the Competition and Markets Authority's investigation, has shown there is little competitive constraint on the prices suppliers charge these consumers. As a result, they are paying more than they should be.

To address this problem, Government has introduced legislation into Parliament which would require Ofgem to design and put in place a temporary cap on all standard variable tariffs and fixed-term default tariffs. We anticipate that Parliament will approve the Domestic Gas and Electricity (Tariff Cap) Bill in the summer, and the default tariff cap will come into force at the end of 2018.

We are now consulting on how we might design and implement the default tariff cap. This supplementary appendix to the main consultation document sets out our proposals in relation to the use of a market basket to set or update the benchmark. This document is aimed at those who want an in-depth understanding of our proposals. Stakeholders wanting a more accessible overview should refer to the main consultation document.

Associated documents

Policy consultation for Default Tariff Cap – Overview
https://ofgem.gov.uk/system/files/docs/2018/05/default_tariff_cap_-_policy_consultation_-_overview.pdf

Links to supplementary appendices

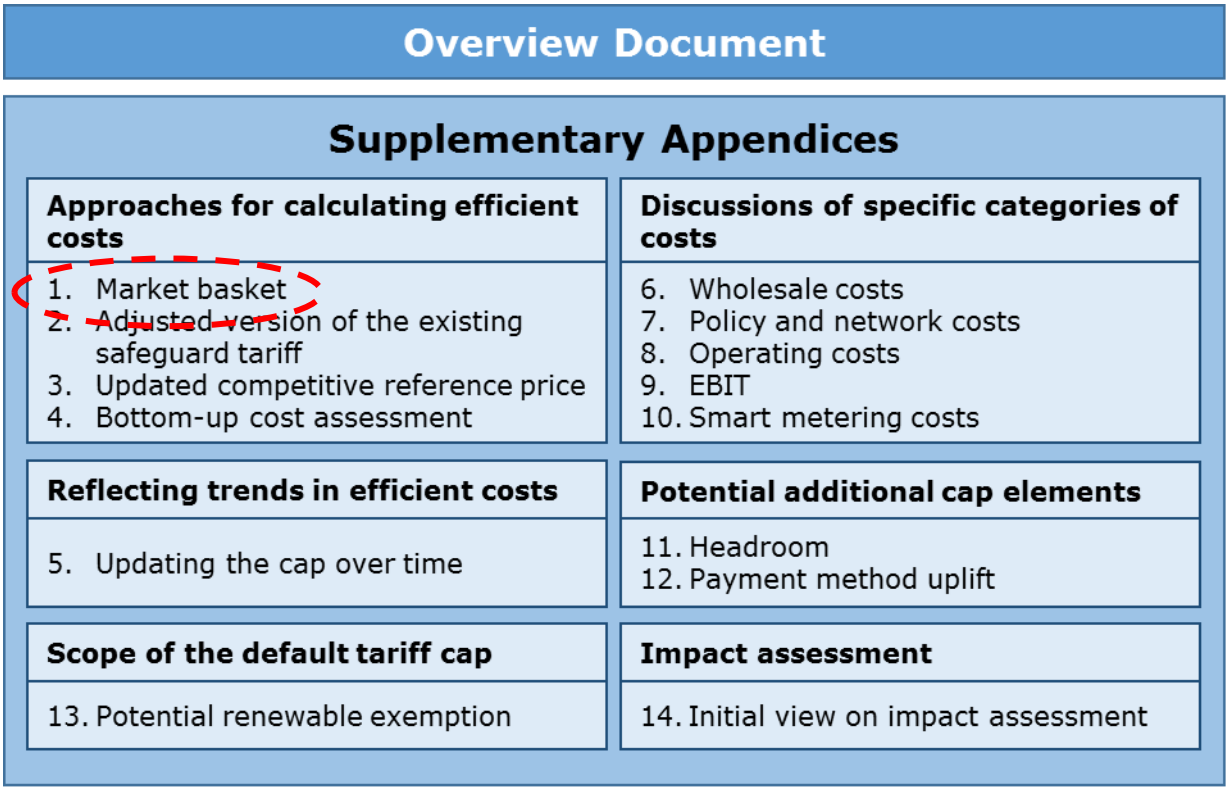
- Appendix 1 - Market basket: https://ofgem.gov.uk/system/files/docs/2018/05/appendix_1_-_market_basket.pdf
- Appendix 2 - Adjusted version of the existing safeguard tariff https://ofgem.gov.uk/system/files/docs/2018/05/appendix_2_-_adjusted_version_of_the_existing_safeguard_tariff.pdf
- Appendix 3 – Updated competitive reference price https://ofgem.gov.uk/system/files/docs/2018/05/appendix_3_-_updated_competitive_reference_price.pdf
- Appendix 4 – Bottom-up cost assessment https://ofgem.gov.uk/system/files/docs/2018/05/appendix_4_-_bottom-up_cost_assessment.pdf
- Appendix 5 – Updating the cap over time https://ofgem.gov.uk/system/files/docs/2018/05/appendix_5_-_updating_the_cap_over_time.pdf
- Appendix 6 – Wholesale costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_6_-_wholesale_costs.pdf
- Appendix 7 – Policy and network costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_7_-_policy_and_network_costs.pdf
- Appendix 8 – Operating costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_8_-_operating_costs.pdf
- Appendix 9 – EBIT https://ofgem.gov.uk/system/files/docs/2018/05/appendix_9_-_EBIT.pdf
- Appendix 10 – Smart metering costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_10_-_smart_metering_costs.pdf
- Appendix 11 – Headroom https://ofgem.gov.uk/system/files/docs/2018/05/appendix_11_-_headroom.pdf
- Appendix 12 – Payment method uplift https://ofgem.gov.uk/system/files/docs/2018/05/appendix_12_-_payment_method_uplift.pdf
- Appendix 13 – Renewable tariff exemption https://ofgem.gov.uk/system/files/docs/2018/05/appendix_13_-_renewable_tariff_exemption.pdf
- Appendix 14 – Initial view on impact assessment https://ofgem.gov.uk/system/files/docs/2018/05/appendix_14_-_initial_view_on_impact_assessment.pdf

Document map

This supplementary appendix to the main overview document sets out our proposals for the use of a market basket to set or update the benchmark.

Figure 1 below provides a map of the default tariff cap documents published as part of this consultation.

Figure 1: Default tariff cap – policy consultation document map



Links to these documents can be found in the 'Associated documents' section of this document

Contents

1. Overview

1.1. A market basket would use information on market prices to set and/or update the default tariff cap. It would use the prices of a selection of competitive tariffs, with some minimum criteria for inclusion. In theory, it is a very simple approach: by referencing the initial level to a set of competitive tariffs, no further adjustments would be required.

1.2. Our analysis has highlighted that a market basket would suffer from significant limitations. There are four reasons why the most competitive tariffs may not reflect the long-run costs of an efficient supplier – either initially or over time. First, market prices depend on suppliers' pricing strategies, and the degree and nature of competition in the market, not just their underlying costs. Second, different suppliers may face different costs. Third, when updating over time, basing the cap on market prices could affect suppliers' incentives to price keenly in the competitive segment. Fourth, when updating over time, there is a risk that due to the nature of competition within the market, a market basket tracks trends in competition as well as the underlying cost of supply.

1.3. We outlined these views and supporting analysis in working paper 2 on the market basket approach, and sought industry views on this[1]. We received 14 responses to the working paper, which we have taken into account in developing our thinking. The majority of respondents supported our view that a market basket would not be a suitable way of setting the initial benchmark. They consider that the same design challenges also exist for using a market basket to update the cap over time, and therefore consider that a market basket would not be a suitable way of updating the cap over time.

1.4. This document does not repeat the detailed analysis included in the working paper. We have summarised the working paper analysis, and explained our further thinking on the use of a market basket to update the level of the cap.

1.5. We do not believe that a market basket would be a suitable method of setting the initial cap or updating the cap over time. **We are therefore not minded to consider this approach further**.

QA1.1: Do you agree that we should not further consider the use of a market basket to set the initial level of the cap? We set out our reasoning in Chapter 3.

QA1.2: Do you agree that we should not further consider the use of a market basket to update the cap over time? We set out our reasoning in Chapter 4.

[1] Working paper 2 – The market basket approach: https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-working-paper-market-basket

2. Challenges with a market basket approach

In this chapter, we highlight the major challenges with a market basket approach. We consider that the cheapest tariffs may be loss-making, different suppliers may face different costs, and that suppliers may seek to influence the basket through the tariffs they offer.

Cheapest tariffs

2.1. We consider the cheapest tariffs in the market to more likely be representative of the long-run costs of an efficient supplier. This is because the market is split into two tiers, whereby consumers who change tariff or supplier benefit from competition and get good deals, while consumers who do not shop around pay considerably more.

2.2. However, there are potentially a number of reasons why the cheapest tariffs in the market might not reflect the long-run costs of an efficient supplier:

- The cheapest tariffs in the market could be priced above or below the long-run costs of an efficient supplier because of the nature of competition in the market. A number of suppliers have told us that they consider the cheapest tariffs to be priced below cost, to acquire new business.

- Different suppliers might have different underlying cost bases, which could be reflected in the prices they charge.

Different supplier costs

2.3. Currently, it is often smaller suppliers (or suppliers with new business models) who offer the cheapest tariffs in the market. A number of larger suppliers highlighted that smaller suppliers do not have the same regulatory costs or obligations to participate in certain social and environmental schemes. The two relevant schemes are the Energy Company Obligation (ECO) and the Warm Home Discount (WHD). Suppliers are only obligated to participate in these schemes once they exceed 250,000 customers, and the costs are not socialised across all suppliers.[2]

2.4. In our working paper, we noted that this could be addressed via an adjustment to account for the difference in policy costs faced by different suppliers. We

[2] For full detail on these schemes, see Appendix 7 on policy and network costs.

suggested that this adjustment could follow a similar methodology to that used in the construction of the Supplier Cost Index (SCI).[3] However, a supplier noted it may be more appropriate to use data on the ECO and WHD schemes provided by the department of Business, Energy and Industrial Strategy (BEIS) in constructing an adjustment. We also note that smaller suppliers may also face higher costs in other aspects due to their size, and could be more efficient (compared to larger suppliers) at managing some costs (for example if new entrants are able to make more use of new technology).

2.5. Suppliers have different business models which might also have different costs. A number of suppliers noted that some suppliers might have a cost base which cannot be generalised to the market as a whole (for example, if a supplier focussed on niche products or services). Even if a supplier's prices covered its own costs, they might not reflect the long-run costs of an efficient supplier in general. A number of suppliers, in response to our second working paper, agreed that there could be a number of reasons causing different suppliers to have different costs.

Supplier behaviour

2.6. Once the price cap is in place, over time a market basket could affect suppliers' pricing behaviour in the competitive segment in order to influence the next update of the cap level. This incentive could (over time) affect the extent to which market prices reflect the long-run costs of an efficient supplier. Whether a supplier adopted this strategy would partly depend on how confidently it could predict the basket and whether it thought it had the ability to affect the level of the basket. A supplier's incentives would also depend on its customer base – a supplier with a high proportion of customers on default tariffs (and therefore subject to the cap) may be more incentivised to influence the value of the basket upwards than a supplier with more engaged customers on fixed contracts.

2.7. Some of these issues could be mitigated through the design of a market basket, by determining which suppliers and tariffs should be included. However, the more adjustments we make to the basket, the closer we move to creating a benchmark rather than using market information. Moreover, due to the nature of competition, there would still be significant uncertainty about the extent to which the tariffs in the market basket would actually represent the long-run costs of an efficient supplier.

[3] Ofgem (2017) Supplier Cost Index – Methodology
https://www.ofgem.gov.uk/system/files/docs/2017/03/supplier_cost_index_-_methodology_v1.1_0.pdf

3. Using the market basket to set the initial level of the cap

In this chapter, we summarise analysis used to help us consider the practical implications of the choice of market basket design parameters on setting the initial level of the cap. We are concerned that in order for a basket to be representative of the long run costs of an efficient supplier, a considerable number of basket parameters, eligibility criteria or adjustments may need to be applied; detracting from the attractive simplicity of a market basket.

Overview

3.1. We are concerned that it may not be possible to design a basket to ensure that it reflects the long-run costs incurred by an efficient supplier, due to the uncertainty about the extent to which the cheapest tariffs in the market are loss-making. Further, we are concerned that due to the nature of competition in the market, there may be no clear relationship between efficient costs and tariff prices.[4] These uncertainties could lead to either setting the cap too high (failing to deliver adequate protection for affected customers) or too low (failing to ensure that efficient suppliers can finance their activities, and affecting the incentives of customers to switch).

3.2. Therefore, at this stage, **we do not consider that a market basket would be a suitable way of setting the initial benchmark**.

Summary of analysis

3.3. In working paper 2 on the market basket approach, we set out our analysis to help us consider the practical implications of the choice of market basket design parameters. This was illustrative analysis, which we used to help us think through the issues. Our analysis was based on market data on tariffs available as at 1 January 2018. The four baskets we examined had different combinations of tariff type (fixed tariffs with a term between 10 and 14 months, or variable tariffs). The baskets contained ten tariffs, with one entry per supplier, excluding suppliers with fewer than 50,000 customers, and excluding the cheapest five tariffs. All prices were direct debit, dual fuel, single rate and GB averages.

3.4. We note that we did not look at an exhaustive set of parameters as part of this illustrative analysis. A number of suppliers have suggested additional basket

[4] While the adjusted version of the existing safeguard tariff and the updated competitive reference price use tariff prices as a starting point, these methodologies can also include adjustments (eg to ensure that a supplier is making a normal rate of return).

parameters; these are highlighted under chapter 6 'responses to stakeholder feedback'.

3.5. Our analysis highlighted that fixed rate tariff baskets were significantly cheaper than baskets based on variable rate tariffs. There could be various reasons why this might be the case, but in part this might reflect the degree to which fixed rate tariffs are marketed at more engaged consumers. Setting the basket based on fixed tariffs might reduce the risk of including the effects of consumer disengagement on the prices of variable tariffs, and might therefore be more reflective of the long-run costs of an efficient supplier. However, a supplier said that fixed tariffs may not represent a true cost of supply. Excluding the loss-making tariffs or expanding the basket to include a greater number of tariffs might minimise this risk.

3.6. Our analysis also indicated that cheapest tariffs in the market may be loss-leaders, highly restricted in availability, or both. We proposed several options to mitigate this risk including excluding the cheapest five tariffs, excluding tariffs from suppliers below a minimum size (50,000 customers), only including fixed rate tariffs available to all (i.e. excluding regional and smart tariffs), and limiting the basket to one tariff per supplier. A number of suppliers agreed that tariffs that are not universally available would skew the basket and should therefore be excluded, while suppliers said that suppliers are only obligated to participate in the ECO and WHD schemes once they exceed 250,000 customers, and so suppliers with fewer than 250,000 customers should be excluded. As noted above in paragraph 2.4 we consider an adjustment to account for the difference in policy costs faced by different suppliers could account for this.

3.7. Whilst suppliers agreed that in theory some design parameters could minimise the impact of some of the challenges with a market basket, a supplier noted that despite this, there is no guarantee that the parameters would ensure a cost-reflective benchmark. In particular, a supplier noted that it may not be possible to exclude loss-making tariffs via basket parameters due to differing supplier costs; it would only be possible to identify loss-making tariffs accurately by assessing each individual supplier's costs via a bottom up cost assessment.

3.8. There is a wider risk that due to the volatility of prices, the basket at any point in time may not be reflective of the long-run costs of an efficient supplier. In theory, tariff prices should relate to the underlying costs of supply. A supplier provided analysis demonstrating a poor correlation between tariff prices and wholesale costs, which constitute a significant portion of the costs of supply. Their analysis showed that the correlation worsened when wholesale costs were rising or falling. In relation to this analysis, we note that the analysis focussed on short term correlations and may therefore not be particularly applicable to updating the cap, which is likely to be on a six-monthly basis. Another supplier noted that wholesale costs are impacted by supplier hedging policies and therefore would vary between suppliers – this could explain the poor correlation.

3.9. One supplier stated that due to the dynamic nature of price setting, there may be no link between an efficient level of costs and tariff prices. Therefore, the risk that

a basket does not reflect the costs incurred by an efficient supplier exists even if loss-making tariffs are excluded.

3.10. A number of suppliers have said that for a basket to work, it would need a significant number of adjustments, which would make the basket more like a benchmark. One supplier said that it therefore disagreed that a market basket would be simple.

3.11. We consider that a market basket in its simplest form could be relatively straightforward. However, there is a risk that such a basket may not reflect efficient costs of supply and may therefore require eligibility criteria or adjustments. In order for a basket to be representative of the long run costs of an efficient supplier, a considerable number of basket parameters, eligibility criteria or adjustments may need to be applied. We are concerned that making accurate judgements about whether certain tariffs should be excluded from the market basket would require an understanding of the complexities of pricing strategies and the growing number of tariff offerings. This would detract from the attractive simplicity of a market basket. There would be significant increases in the analytical requirements and administrative complexity.

4. Using the market basket to update the cap

In this chapter, we summarise analysis used to help us consider the practical implications of the choice of market basket design parameters on using a market basket index to update the cap over time. Our analysis indicates that different basket designs are strongly correlated with each other. We are concerned that a market basket index may not only track the underlying cost of supply over time, but may also track trends in market competition, or supplier pricing behaviour, over time.

Overview

4.1. At this stage, **we do not consider that an index based on a market basket would be a suitable way of updating the cap over time** for a number of reasons.

- There is a risk that the introduction of the price cap may change supplier pricing behaviour in the competitive segment of the market and therefore significantly alter the prices of tariffs that make up a market basket.
- We consider that although the impact of suppliers influencing the basket can be reduced through the design of the basket, the risk of suppliers gaming the index is inherent in a market basket approach.
- We are concerned that an index based on market prices to update the level of the cap over time may not only track the underlying cost of supply over time, but may also track trends in market competition, or supplier pricing behaviour, over time.

Summary of analysis

4.2. If the market basket was only used to update the price cap over time (ie as an index), it might suffer from fewer limitations.[5] It may be possible to design a basket that reflects changes in underlying cost drivers, whilst reducing the risk that suppliers are able to influence the basket.

[5] We would calculate the value of the market basket in the base period (ie at the point the initial benchmark was set), and define this as the starting index value. As we recalculated the market basket over time, the value of the index would change. To update the cap, we would multiply the initial benchmark by the changing index value.

4.3. We discuss the risks of the introduction of the price cap changing supplier pricing behaviour and suppliers influencing the basket under 'key judgements', paragraphs 5.1 to 5.6 and 5.7 to 5.13 respectively.

4.4. In theory, market prices should be driven by trends in the underlying costs. However, cost indices which are external to suppliers (ie they cannot be affected by any individual supplier) will inevitably be an approximation of the trends in the costs that suppliers actually incur. Looking at prices might reduce the reliance on these approximations. However, any observations of market prices might also incorporate non-cost trends, such as trends in suppliers' pricing behaviour.

4.5. In our second working paper on the market basket approach, we said that we would conduct analysis to assess the use of a market basket index to update the cap over time. We have carried out this high-level analysis to look at different market baskets, including those intended to reduce the potential for suppliers to influence the value of the basket through their pricing behaviour. Our analysis was based on market data on tariffs available on a single day each month from February 2016 to February 2018. We included only tariffs available to everyone (i.e. excluding regional and smart tariffs), and all prices were direct debit, dual fuel, single rate, GB averages. We trialled various basket designs, and measured their correlation (coefficient of determination, r^2) with each other in order to determine the extent to which design choices influence the trends captured by the basket.

4.6. **Basket size**. Our analysis found that a basket of the cheapest ten tariffs (one tariff per supplier) had near perfect correlation ($r^2 = 0.98$) with a basket of the cheapest 20 tariffs (one tariff per supplier), and a close to perfect correlation ($r^2 = 0.94$) with a basket of the cheapest tariff of each supplier. This indicates that the size of the basket does not have a significant impact on its trend over time, and that a basket could be broadened to minimise its susceptibility to supplier influence. Having said this, the index values at the end of the two years analysed are still several percentage points apart, and so the size of the basket remains a relevant parameter that could potentially affect the level of the cap over time.

4.7. **Excluding loss-making tariffs**. We excluded the cheapest five, or 15% of tariffs from various baskets as a proxy for the exclusion of at least some loss-making tariffs. Our analysis found that the exclusion of the cheapest tariffs has minimal impact on the trend of the basket for baskets of all sizes. A basket of ten tariffs, 20 tariffs and a dynamic basket of the cheapest tariff of each supplier were trialled, and the average correlation of baskets, including the cheapest tariffs with those excluding the cheapest tariffs, was $r^2 = 0.97$. This indicates that loss making tariffs do not have a significant impact on the basket's trend over time. However, it may be that the cheapest five or 15% of tariffs do not represent all loss-making tariffs. A supplier noted that identifying loss-making tariffs accurately would require a supplier-specific bottom up cost assessment. Further, excluding tariffs from the basket may increase its susceptibility to supplier influence.

4.8. **Tariff type**. We were concerned that a basket of fixed tariffs of varying length would represent a number of different hedging strategies, to which suppliers would be unable to match. To test the impact of this, we designed a basket based on fixed

tariffs of varying length, and of fixed tariffs with a term between 10 and 14 months. Our analysis found that the baskets had near perfect correlation ($r^2 = 0.97$). We expect tariffs of a similar term to follow a similar hedging strategy, so our analysis suggests that the impact of a hedging strategy on the market basket index may be small compared to other market forces influencing pricing.

4.9. **Supplier size**. To test whether or not the number of customers a supplier has influences the trend in prices over time, we designed two baskets. One including tariffs from suppliers with more than 250,000 customers only, and the other including tariffs from suppliers with fewer than 250,000 customers only. Our analysis found that the baskets had reasonable correlation ($r^2 = 0.80$). One possible explanation for why this correlation is slightly less strong (than for some of the baskets discussed above) is that the trends in cost of supply over time differ slightly for large and small suppliers. This could mean that we would need to adjust a market basket index for supply costs not borne by all suppliers. We consider an adjustment to account for the difference in policy costs faced by different suppliers could help to account for this. If any further adjustments were required, this would detract from the simplicity of a market basket, which is one of its advantages. However, another possible explanation would be differences in pricing behaviour between large and small suppliers. Further, limiting the basket to suppliers of a certain size may increase its susceptibility to supplier influence.

4.10. A supplier noted that ex-incumbent suppliers tend to have large numbers of high cost to serve legacy customers, who do not want to engage online and prefer to pay on demand: it said that new entrants to the market have been able to cherry pick those customers willing to manage their accounts electronically and pay by direct debit. The baskets analysed here contain a mix of online and paper tariffs, provided the basket continually has such a tariff mix, it is unlikely to have a significant impact on the trend of the basket over time.

4.11. In order to evaluate whether or not a market basket index will track the trend in the long-run efficient cost of supply, we have compared three market basket indexes with a reference index built upon the SCI.[6] The SCI tracks direct costs only. Large suppliers reported that operating costs account for 17% of bills in their 2016 Consolidated Segmental Statements.[7] We have created an index combining the SCI, weighted at 83%, representing the change in direct costs, and the Consumer Price Index (CPI)[8], weighted at 17% as a proxy for the change in operating costs.[9] The three market basket indexes vary in size of supplier allowed. Basket 1 includes all suppliers, basket 2 includes suppliers with less than 250,000 customers only, and

[6] Ofgem Supplier Cost Index: https://www.ofgem.gov.uk/data-portal/supplier-cost-index-fuel-type-gb
[7] This is an average across large suppliers. We note that this will not take into account any more recent changes in operating costs as a percentage of total costs, but we would not expect this to have a significant effect on this high-level analysis.
[8] Consumer Price Index data comes from the Office for National Statistics: www.ons.gov.uk
[9] As we are only indexing operating costs with CPI, this implies that we are indexing the EBIT and VAT bill components using the SCI. This is an approximation.

basket 3 includes customers with more than 250,000 customers only.[10] The results of this analysis can be seen in Figure A.1 below. All three baskets have reasonable correlation (r^2) with the reference index, with basket 2 having the strongest (basket 1 = 0.70, basket 2 = 0.74, basket 3 = 0.69).

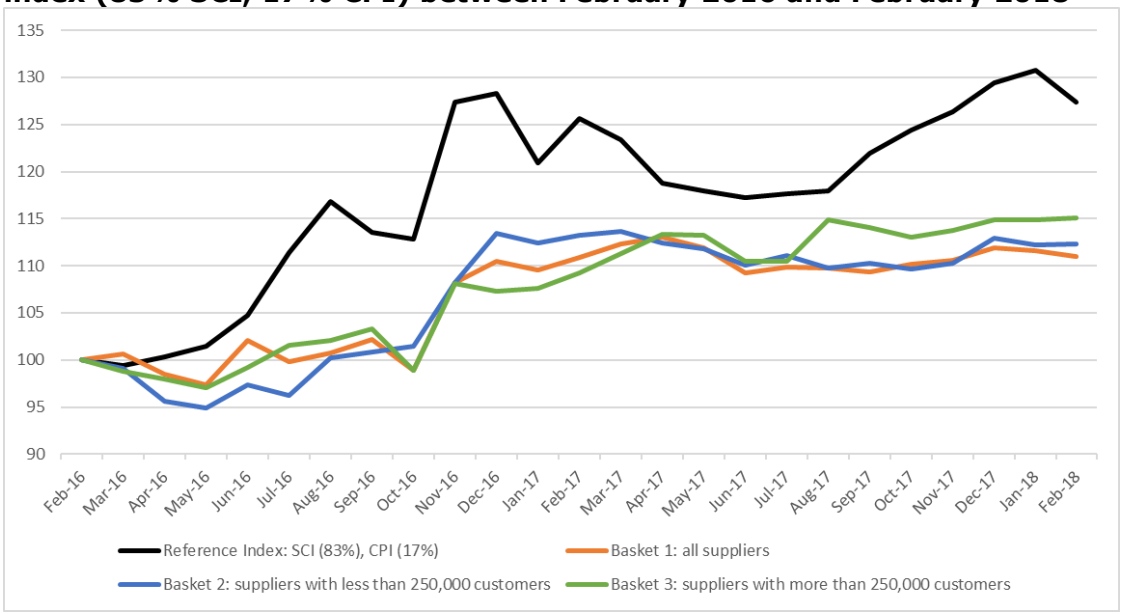
4.12. Our analysis indicates that different basket designs are strongly correlated with each other. This could mean that a larger basket would track trends as well as a smaller basket limited to the cheapest tariffs available, and may be less susceptible to supplier influence.

4.13. However, we are sceptical that the result support using a market basket approach. Despite the correlation with the reference index, it can be seen that the three basket indexes are more than 12 percentage points away from the reference index over the two-year period. This undermines the usefulness of a market basket index as a method of updating the cap over time. Comparing the basket indexes to a reference index based on the SCI indicates that a market basket index may not be tracking trends in the underlying cost of supply alone; it may also be tracking trends in competition within the market.

4.14. We consider that designing a market basket to update the cap over time may be simpler than that to set the initial cap, as different basket designs are strongly correlated with each other. However, there is a significant risk that due to the nature of competition within the market, the trend of a market basket index does not relate to the trends in the underlying costs of supply alone, and therefore is an unsuitable method for updating the cap over time.

[10] The baskets include only tariffs available to everyone (i.e. excluding regional and smart tariffs), one tariff (cheapest) per supplier (excluding the cheapest and most expensive 15% of tariffs, and all prices were direct debit, dual fuel, single rate, GB averages.

Figure A1.1: A range of market basket indexes compared to a reference index (83% SCI, 17% CPI) between February 2016 and February 2018



Source: Ofgem analysis

5. Key judgements

In this chapter, we outline a number of issues associated with the use of a market basket. First, the introduction of the price cap may significantly change the structure of the retail market, and impact the pricing of competitive tariffs for period of time beyond the introduction of the price cap. This may undermine the use of a market basket index to update the cap over time. Second, we consider the incentive for suppliers to influence the basket to be inherent in a market basket approach, undermining its use for both setting the initial level of the cap and updating the cap over time.

Issue 1: Introduction of the price cap influencing tariff prices

Issue

5.1. The introduction of the price cap is a significant change to the structure of the retail market, which could potentially influence supplier pricing behaviour. For example, some suppliers may price some of their fixed tariffs at lower than sustainable cost in the expectation that some customers will subsequently roll onto high-priced default tariffs. Since the cap would reduce the price of the default tariffs, these suppliers may increase the price of their fixed tariffs (depending on the level of the cap, and the proportion of their customers on default tariffs).

5.2. The price of tariffs in the basket may therefore change, leading to a one-off increase in prices, which would not be driven by an increase in costs. This may alter the trend of a market basket for a period of time beyond the introduction of the price cap.

Our minded-to position

5.3. We consider this a potentially significant issue that cannot be mitigated by basket design. This is a significant factor in determining our view that a market basket is not a suitable method of updating the cap over time.

Rationale and analysis

5.4. The introduction of a price cap may have knock-on effects on the pricing of fixed products in the competitive segment of the market. For example, if the introduction of the price cap decreases the lifetime value of acquiring a customer, this could cause an increase in fixed tariff prices and thus a one-off jump in the price of the basket. This may also alter the trend of a basket for a period of time beyond the introduction of the price cap, thereby undermining its ability to be used as a proxy for the trends in the long-run costs of an efficient supplier.

5.5. There is also a risk that the price cap may also change the nature of competition within the market in a way in which we have not considered, which would also undermine the ability of a market basket to track the trends in the long-run costs of an efficient supplier.

5.6. Should the price cap influence the nature of competition or prices within the competitive segment of the market, any trends demonstrated by a market basket based on historical prices may not hold for future prices. Therefore any design choices made now to ensure the basket better captures the long-run costs of an efficient supplier may not have the desired effect once the cap has been implemented.

Issue 2: Supplier ability to game or influence the market basket

Issue

5.7. The use of a market basket to update the cap over time could influence suppliers' pricing behaviour in the competitive segment in order to affect the next update of the cap level. Suppliers could price tariffs that meet the criteria to be included in the market basket in order to increase or decrease the price of the basket.

Options considered

5.8. We consider that a supplier would only adopt this strategy if it had confidence that it could affect the level of the basket. Expanding the basket to include a larger number of tariffs would minimise the influence of any single tariff. There are a number of ways in which a basket could be expanded by placing fewer restrictions on eligible tariffs, for example: by including multiple tariffs per supplier (as opposed to the cheapest tariff per supplier), by including small suppliers, or by increasing the number of entries permitted in the basket.

Our minded-to position

5.9. We consider that the incentive for suppliers to influence the basket to be inherent in a market basket. However, it may be possible to mitigate the impact of the influence of any single tariff by expanding the number of tariffs in the basket. Such a basket may require an adjustment, to account for the differing trends in policy costs between large suppliers (with more than 250,000 customers) and small and medium suppliers (with less than 250,000 customers).

Rationale and analysis

5.10. Including multiple tariffs per supplier would increase the ability of suppliers whose tariffs are eligible for the basket to influence the basket.

5.11. Increasing the number of suppliers in the basket would result in a basket including tariffs further from the cheapest tariffs available. As mentioned earlier, we consider the cheapest tariffs in the market to be more likely to be representative of the long-run costs of an efficient supplier. However, our analysis showed that increasing the number of tariffs in a basket does not significantly influence the trend of its index. This indicates that expanding the basket to include a greater number of tariffs could mitigate against the risk of suppliers influencing the basket.

5.12. Our analysis also demonstrated that the trend of a basket made up of large suppliers (with more than 250,000 customers) differs somewhat from that of a basket made up of small and medium suppliers (with fewer than 250,000 customers). Expanding a basket to contain suppliers of all sizes may result in an index that is not representative of the trends in cost for any suppliers. However, it may be possible to apply an adjustment to account for the difference in policy costs faced by different suppliers. Restricting the basket to suppliers of a certain size will reduce the number of tariffs eligible, and hence increase the influence of any one tariff.

5.13. Due to the potentially significant impact of the price cap on the market, we consider the incentive for suppliers to influence the basket to be inherent in a market basket.

6. Responses to stakeholder feedback

This chapter summarises the key stakeholder feedback we have received from responses to working paper 2 on the market basket approach which we have not covered in the previous sections.

6.1. A number of suppliers raised concerns that a range of hedging strategies of tariffs in a basket would result in significant risk to suppliers not being able to match the assumed hedging profile used to create or update the cap. In working paper 2, we noted that the cheapest fixed tariffs may be of varying term lengths and may have different associated hedging strategies. In paragraph 1.31 we outline our analysis, limiting a basket to tariffs to fixed tariffs of a particular length or range of lengths to mitigate this risk. We expect tariffs of a similar term to follow a similar hedging strategy, so our analysis suggests that the impact of a hedging strategy on the market basket index may be small compared to other market forces influencing pricing.

6.2. A number of suppliers stated that they consider the administrative burden of using a market basket to update the cap over time to be high. This is due to the significant number of tariffs in the market and requirement for daily data feeds and analysis. One supplier also noted that we may need to make a number of ad-hoc adjustments and tariff de-selections to maintain the basket, and stated that these would need to be transparent. We agree that a market basket with a large number of parameters may result in significant administrative burden.

6.3. A number of suppliers stated that they agreed with basket parameters such as only including tariffs available in all regions, but noted that we should also exclude or adjust for bundled tariffs (e.g. those that include central heating cover) as there is a potential for cross-subsidisation, and tariffs with exit fees. While such steps may be possible, we have not progressed these further given that we are not minded to proceed with this model.

6.4. A number of suppliers noted that there may be issues with poor customer service or satisfaction. One supplier said that the cheapest tariffs may be associated with poor customer service. Another supplier said that tariffs from suppliers with poor customer service should be excluded from a basket. While such steps may be possible, we have not progressed these further given that we are not minded to proceed with this model.

6.5. A supplier raised a concern that a changing basket (i.e. one containing only the cheapest tariffs at that point in time) would follow a level lower than any supplier could achieve over the medium term. It considered the cheapest tariffs at any point in time are likely to be from suppliers whose hedging strategies are delivering the lowest wholesale costs at that point in the economic cycle, and are therefore not representative of long run average costs. We note that expanding the basket to contain a greater number of suppliers (one tariff per supplier) could minimise any risk in this area, if it existed.

7. Consultation response and questions

We want to hear from anyone interested in this document. Send your response to the person or team named at the top of the front page.

We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can. The full list of consultation questions is available in Chapter 7 in the main consultation document.

Unless you mark your response confidential, we'll publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

Chapter 1 – Overview

Question A1.1: Do you agree that we should not further consider the use of a market basket to set the initial level of the cap? We set out our reasoning in Chapter 3.
Question A1.2: Do you agree that we should not further consider the use of a market basket to update the cap over time? We set out our reasoning in Chapter 4.