utilita
life with power

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By email

Dear Anna,

Re: Working Paper #2: market basket

Thank you for the opportunity to comment on the working paper. The timeline was short for responses, but we agree that it is helpful for Ofgem to share its evolving thinking in this area through the route of working papers.

Utilita is primarily a smart prepayment supplier, and has carefully considered the paper in the context of our experience under the CMA prepayment charge restriction (PPM Cap). This is relevant to the working paper and the development of the tariff cap and both the PPM cap and the CMA process for implementation offer valuable insights and lessons to be learned.

We have a number of concerns about using a market basket approach as set out in the paper. We support the initial analysis that Ofgem has carried out which identifies that the lowest tariffs in the market may be loss-leaders, highly restricted in availability or both. This further indicates, as recognised that they carry a high risk of skewing the basket, or allowing a small number of suppliers to wield undue influence over the level of the basket.

However, we do not agree that removing a selection of the cheapest tariffs addresses the issue. The number of suppliers in the market is high, and even applying a parameter of one tariff per supplier, leaves a wide range.

We believe the assumption that the remaining tariffs after excluding the 5 cheapest are an accurate representation of all efficient supplier costs and margins is flawed:

- The majority of these tariffs will be loss leaders where suppliers seek volume; and
- The approach is open to manipulation of suppliers targeting these positions on price comparison websites

In addition, the approach may be extremely administratively onerous. Ofgem, has noted the data gathering requirements (possibly daily) which might be imposed on suppliers. This will have significant costs for both data gathering and data processing. It is also unclear how such frequent data points would be translated into the operation of a cap, where Ofgem is required to review the level six monthly. It will also be important not to underestimate the consequential supplier cost issues of overlaying such requirements on top of the PPM cap.

We also note that suppliers vary widely in their approach, and that is a valuable attribute in driving competition. Using a market basket, which is relatively tightly confined, even allowing for the exclusion of outliers, will not address such variation.

Differences in costs are not common to all suppliers or even groups of suppliers. Hedging policies will vary, as will the burden associated with Government policy costs, such as ECO and the Warm Home Discount. The approach means it will be impossible to match the implied hedging strategies of the tariffs used in the basket, and it will therefore become impossible for suppliers to manage basis risk. Ofgem notes an adjustment could be made, but the consequence was unclear on how this would interact with cap setting to produce an equitable cap. Metering costs are also not accounted for, an issue which was not addressed under the PPM cap where the tariffs used to set the cap did not include smart metering costs.

We do not support the approach of using a basket as an index into another method. We believe this produces unnecessary complexity. The only real benefit of a market basket approach would be its relative simplicity, but to use in another method would only introduce further complexity to that method, and the benefits are not demonstrated in the paper. If this basket index is given significant weight it will still result in a misrepresentation of long run costs.

The analysis of the four different baskets, A-D, evidences that even basic variations in approach is likely to produce substantial differences in price points. Although this was not showing price differentiation for individual suppliers, this market trend (as set out specifically in section 3.12 which discusses the point between fixed and variable tariffs) would be unlikely exist if marked price differentiation between suppliers' most expensive and cheapest tariffs did not exist.

In general, from the methodologies discussed in other working papers we would prefer to see a bottom-up, cost plus approach with additional headroom to support competition above an efficient supplier's costs.

As we have stated previously, we do not support the application of a price cap to all suppliers' tariffs. The issue in the market is one of historic and current issues within Big Six pricing policies which has led to customers on the Big Six' SVTs paying more, while significantly cheaper acquisition tariffs are available.

The simple solution to the issue would be to apply a relative cap within the Big Six tariffs, preventing this practice, while allowing the rest of the market to compete actively and freely for customers.

We hope these comments have been helpful and would be happy to discuss any points in more detail.

Yours sincerely,

By email

Alison Russell
Director of Policy and Regulatory Affairs