



Ofgem
9 Millbank
SW1P 3GE

Contact	Paul Dawson
Phone	01793 475278
Email	paul.dawson@rwe.com

By email: retailpriceregulation@ofgem.gov.uk

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Default Tariff Cap: Response to Statutory Consultation

RWE welcomes the opportunity to respond to the statutory consultation on the default tariff cap.

Ofgem's proposed approach results in a benchmark and cap which are far too low. The cap was originally intended to provide a temporary backstop to protect consumers who are not engaged in the competitive market. However, the proposed cap goes further and will crowd out competition in the domestic sector, distort suppliers' hedging decisions and undermine suppliers' credit standing. This damage to the retail domestic market will, in turn, undermine competition and liquidity in the wider wholesale and retail markets. The longer-term costs of setting the cap too low significantly outweigh the temporary consequences of a cap which is marginally too generous. Ofgem should therefore revise the headroom to the very top of the range in setting the initial cap.

Ofgem are proposing to cap retail prices below the costs of most suppliers, which will significantly distort the wholesale and retail markets. RWE has the following specific areas of concern regarding Ofgem's methodology.

- **Flawed benchmarking.** The combination of a bottom-up approach to setting the cap with benchmarking based on the lowest quartile will significantly understate the efficient level of costs. We share Ofgem's view that they should not set a cap to enable "every supplier – even those who may be relatively inefficient - to compete". However, Ofgem's eclectic methodology appears to deliver a situation where only the most efficient supplier has any chance to compete. While Ofgem provides an allowance for uncertainty and operating costs are 15% above the cost of "frontier" suppliers, these allowances are negated by genuine differences in the underlying costs and do little to provide any headroom for a "typical" supplier over and above the most efficient supplier. As such, the cap becomes a substitute to competition rather than a complementary "backstop" protection for customers.
- **Insufficient headroom.** Setting a very low benchmark should have resulted in the provision of generous headroom to account for the underlying uncertainty and to ensure that an appropriate balance is struck between protecting customers and preserving competition. Conversely, more generous benchmarks would have justified lower headroom. Ofgem's approach of adopting a "low benchmark-low headroom" will undermine the ability of most suppliers – including relatively efficient suppliers - to finance their activities.

- **Inadequate provision for policy-driven cost changes.** A six-monthly review of the cap - or the option of modifying the license – may not sufficiently mitigate the significant impact of exogenous events on suppliers. Specifically, market participants currently face significant uncertainty surrounding the future interaction of carbon price support and EUA allowance prices in the event of a no-deal Brexit. While we share Ofgem’s caution about retrospective changes to the cap, these uncertainties further support the case to adopt a less stringent benchmark and more generous headroom.
- **A semi-annual cap distorts liquidity more than an annual cap.** Semi-annual updates of the wholesale element will focus hedging activity on “tracking the cap” and shorten the natural horizon for hedging domestic load. This will distort suppliers’ natural risk management and hedging activity and reduce wholesale market liquidity.

While lower caps result in lower bills for those customers who remain on default tariffs, this should not be at the expense of suppliers and customers who have actively engaged in the competitive market nor distort the wider wholesale market to the detriment of all customers. This balance is particularly acute given that the cap is intended to be temporary while the impact of stifling retail entry and undermining wholesale market liquidity will extend well beyond the period of the cap. In the light of its aggressive approach to cost-benchmarking, RWE would therefore urge Ofgem to increase the level of headroom to the highest level in setting the initial cap.

If you have any comments or wish to discuss the contents of this response further, then please do not hesitate to contact me.

Yours sincerely,

Paul Dawson
Head of Regulatory Affairs
RWE Supply & Trading