

Discussion Paper

Future of domestic price protection

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This discussion paper sets out the successes and challenges of the default tariff price cap ('the cap') and how the cap will need to evolve to respond to future energy market changes. It sets out a broad spectrum of options for evolving consumer price protection and seeks input from stakeholders on whether reform is needed and if so what kind of reform will work best for consumers. This is part of our work to open the discussion around price protection in the future retail market - including our publications on standing charges, affordability & debt, and the Ban on Acquisition-only Tariffs. We would like views from people with an interest in domestic energy pricing. We particularly welcome responses from consumer groups and charities, suppliers and investors. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose of the discussion and how you can get involved. Once the response period is closed, we will consider all responses. We want to be transparent. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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Foreword

Energy markets are changing. In future, we can expect to see growth in flexible technologies and expansion of green energy. These changes will result in new and different ways for households to use and pay for their energy. We will also see continued progress towards our net zero goals. This will mean cheaper and more secure energy, but the transition will also require investment.

Against this backdrop – and our first responsibility to protect consumers – it is important Ofgem looks at all areas of pricing regulation. Since its introduction in 2019, the price cap has played an important role in ensuring fair prices for customers. But the way we regulate must evolve to keep pace with changes to the structure of the energy market, as reflected in the Government’s recent Call for Evidence seeking views on making standard default energy tariffs more flexible.

The future of pricing in the retail energy markets needs to be looked at in the round. This includes looking at the structure of billing, the needs of those who are struggling or are particularly vulnerable, and how we protect those customers who are not actively engaged in the market. This discussion paper should therefore be seen in conjunction with our wider work and recent calls for input on affordability, standing charges and the Ban on Acquisition-only Tariffs. Bringing these elements together in a coherent way will be essential to building a form of pricing regulation which delivers for energy consumers in the future.

Tim Jarvis

Director General Markets

Executive Summary

The price cap has worked well in maximising consumer protection and driving down supplier costs, but it needs to evolve as the retail market changes.

The default tariff price cap ('the cap') ensures that households pay a fair price for their electricity and gas by limiting the amount that a supplier can charge on default tariffs. The cap was legislated by Parliament in 2018 to tackle an estimated £1.4bn of annual consumer detriment resulting from operational inefficiencies and the overcharging of disengaged customers (often referred to as the 'loyalty penalty'). Prior to the crisis, around half of households were on the cap. It is now around 90% but starting to reduce.

The cap maximises consumer protection by ensuring there is a strong efficiency incentive on energy suppliers' costs. This means it is set with reference to a **stringent** efficiency benchmark. The cap is applied **universally**, meaning all consumers¹ on the cap pay the same unit rate for energy regardless of household circumstances or consumption patterns. It is based on the tariff structure that prevailed at the time of its implementation, consisting of a standing charge and **flat**² unit rate (ie a single unit rate that does not vary throughout the day).

The current approach to the cap has largely succeeded in addressing the loyalty penalty and in driving incumbent suppliers to improve efficiency and we explore how the cap has effectively achieved this in Chapter 1 of this paper. But as we reflect on lessons from recent significant market volatility and look to a future where the retail market will need to be considerably more dynamic, it is clear that the cap in its current form has some limitations and reform is needed to ensure it can continue to protect consumers as the retail market evolves. Chapter 2 of this paper sets out some of the limitations the cap has faced in responding to market volatility.

As electricity prices become more dynamic, price protection will need to play a big part in ensuring the transition to a flexible, net zero energy system that works for all consumers.

The price of wholesale electricity is not static throughout the day – it changes as supply and demand conditions change. When demand is high or supply low, the price of electricity increases. As our energy system changes and we transition to net zero, flexible technologies such as electric vehicles (EVs) will offer new ways for households to tailor the way they use and pay for their electricity. Flexibility in how we use (and store)

¹ for a given region and payment method

² With basic adaptations for Economy 7 and other default time of use (TOU) tariffs

electricity is the most cost-efficient way to manage peaks in demand and troughs in supply and is a critical part of ensuring the lowest possible cost net zero energy system.

The introduction of Market-wide Half-Hourly Settlement (MHHS) from 2025 will enable this flexibility by exposing suppliers to the true costs of their customer's electricity consumption patterns. Importantly, the resulting shifts in electricity consumption will reduce overall system costs, bringing down bills for all. This will mean that customers with a higher proportion of their consumption during more expensive (peak) periods will become more expensive to serve, and those with lower peak consumption, less expensive. However, the electricity unit rate under the current flat cap does not reflect these changes in cost during the day. We need to encourage consumers to flex their electricity use where possible, but we also need to consider how to protect consumers who are unable to engage. In Chapters 3 and 4 of this paper we explore the trade-offs in whether or not the cap should reflect these price changes to consumers and if so, how.

It will be challenging to maintain a flat, universal and stringent price cap as the retail market becomes more diverse; we need to explore the role of price protection in this more dynamic retail market.

Customers able to flex their demand³ will have an incentive to move to a time of use (ToU) tariff, reducing their bills. On the other hand, customers with high-cost patterns of consumption will have an incentive to stay on (or move to) the flat default tariff which protects them from the high costs of their consumption patterns. Over time, this could lead to a selection effect where price cap customers are increasingly customers with a higher cost to serve.

It will become increasingly challenging for Ofgem to set a stringent, universal and flat cap that works for the whole market as the costs faced by suppliers are becoming increasingly differentiated. To enable a notional supplier to recover its efficient costs for default tariff customers, Ofgem may have to increase the level of the cap. We risk customers that are facing the greatest affordability challenges, and those who are least able to benefit from flexibility, paying higher prices⁴ and suppliers' success being driven as much by cap decisions as by their commercial decisions. Without some form of price protection, we risk seeing a return of price exploitation of inactive customers, and it's important that we make sure that we have the right system of price protection in place to fit the changing energy market. In Chapters 3 and 4 we explore the challenges posed by a more diverse market and potential options for cap reform in this context.

³ or those with inherently low-cost patterns of consumption

⁴ Even if the system costs as a whole are improved by the participation of customers that can flex demand

We set out in this paper alternative approaches that might address some of these concerns, enabling continued price protection as the retail market changes. There are no perfect options, but choices exist as to what extent the cap should be:

- **flat** single rate pricing as now, or time-of-use, or a combination, eg time of use price cap for customers who charge an EV at home,
- **universal**, applying to all default tariff customers or targeted to a sub-set, such as those in vulnerable situations or on prepayment meters,
- **stringent** as currently calculated based on a notional efficient supplier or market determined, eg relative price cap, or a principles based approach.

The options presented are illustrative rather than exhaustive and could be implemented independently or combined and applied to different groups of customers. Different approaches could be taken to gas and electricity bills, as the benefits of flexibility do not apply to gas supply and demand in the same way as they do to electricity.

We are yet to form a view of the appropriate approach. At this early stage, our goal is to stimulate debate and explore a range of options to inform our thinking. Some of these options could be implemented under the existing statutory framework, while others may require legislative change.

This work forms part of a wider package of activity to explore pricing and price protection in the retail energy market and we will consider responses alongside our wider activity on affordability & debt, standing charges and the Ban on Acquisition-only Tariffs (BAT). We have worked together with the Department for Energy Security and Net Zero (DESNZ) on this discussion paper and their Call for Evidence⁵ (CFE) to explore how default tariffs may evolve to best protect customer interests in a world of more flexible electricity pricing.

⁵ DESNZ (2024), Default energy tariffs for households: call for evidence <https://www.gov.uk/government/calls-for-evidence/default-energy-tariffs-for-households-call-for-evidence>

Overview of this document

What are we considering?

In this discussion paper, we consider the successes and challenges of the default tariff price cap in the current market. We also describe the increasing diversity of the market and increased role of time of use tariffs under Market-wide Half-Hourly Settlement (MHHS) that may further challenge the cap.

We describe and provide a high level assessment of several alternative approaches to price protection that we may consider in the future, to address the challenges discussed.

The document is structured as follows:

- **Chapter 1: Context** sets out the history of the cap, the legislative context it operates within and describes the current retail market.
- **Chapter 2: Evaluating the cap today** evaluates the successes and challenges of the cap in the context of the gas crisis and the current market.
- **Chapter 3: Evaluating the current cap for the future** provides an overview of upcoming market changes and describes how they may further challenge the cap.
- **Chapter 4: Options for evolving price protection for the future** provides high level descriptions of a range of alternate price protection options.
- **Next steps and related publications** touches on next steps for this workstream and describes interlinkages with DESNZ's CFE on default tariff arrangements and our call for inputs on affordability and standing charges.
- **Annex 1** introduces reviews under section 9 of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (DTCA)
- **Annex 2** provides an overview of approaches to price protection adopted by other countries.
- **Annex 3** provides a summary of all questions asked in this discussion paper.
- **Annex 4** provides a privacy note.
- **Annex 5** provides a glossary of key terms used in this discussion paper.

How to respond

We want to hear from anyone with views on this topic. Please respond via the webform included on the web page associated with this document, or send your response to the email address listed on this document's front page by 10 May 2024.

We've asked for your feedback on each of the questions throughout. Please respond to each one as fully as you can.

We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

We will be working closely with DESNZ and will consult further as our thinking develops. We therefore anticipate that responses to our respective publications to be shared. If there is a particular reason a response should not be shared, consultees should indicate so in their response.

General feedback

We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this discussion. We'd also like to get your answers to these questions:

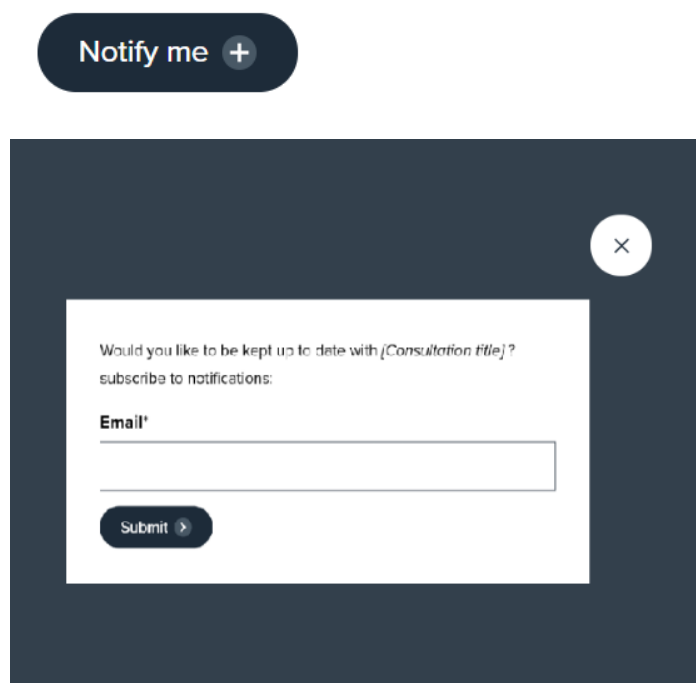
1. Do you have any comments about the overall process?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to stakeholders@ofgem.gov.uk

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You can track the progress from upcoming to decision status using the 'notify me' function on a consultation page when published on our website.

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Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

Upcoming > **Open** > **Closed** (awaiting decision) > **Closed** (with decision)

1. Context

Chapter summary

The cap was introduced in 2019 to address concerns that households on default tariffs were being charged more for their energy than would be the case in a truly competitive market, leading to excess supplier profits and insufficient incentives for greater supplier efficiency. In this chapter we set out the history and legislative context for the cap and also the interlinkages between price protection and affordability issues.

- 1.1 The default tariff cap (the cap) came into effect on 1 January 2019 under the Domestic Electricity and Gas (Tariff Cap) Act 2018 (DTCA). As the primary form of price protection for domestic consumers, the cap ensures that households on default tariffs pay a fair price for their energy, based on the efficient costs of supplying that energy.

Information Box 1: What is a default tariff?

Tariffs are what suppliers charge their customers for gas and electricity. A 'default' or 'standard variable' tariff (SVT) is a basic energy tariff, which will usually apply if you have not actively chosen a tariff, including when moving into a new home or when an actively chosen fixed-term contract ends. Throughout this document we use the term 'default tariff' to refer to default and standard variable tariffs collectively.

- 1.2 The cap was introduced following several years of political and regulatory concern that households on default tariffs were paying excessive prices for gas and electricity – with the Competition and Markets Authority (CMA) finding that “the customer detriment associated with high prices was about £1.4 billion a year on average for the period 2012 to 2015”.⁶ The excessive pricing was attributed to two main factors: suppliers passing through inefficient high operating costs, and a 'loyalty penalty' whereby customers that do not actively choose a tariff pay high default tariff prices.

Evolution of the cap

- 1.3 Initially, the cap was designed as a temporary intervention. Under the DTCA as first introduced, the cap conditions were to apply from 2019 – 2020 with the

⁶ CMA (2016), Energy market investigation
<https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

option for Secretary of State to extend annually thereafter (up to the end of 2023).

- 1.4 This extension was informed by Ofgem producing an annual assessment of the Conditions for Effective Competition (CFEC).⁷ This assessment measured the extent to which competitive and structural changes were in place to ensure fair pricing for consumers and mitigate the harms the DTCA was intended to address. Our assessment suggests that, without some form of price protection, price exploitation of inactive consumers would likely return.

Information Box 2: Legislative Context

Ofgem must set the cap under the Domestic Electricity and Gas (Tariff Cap) Act 2018 (DTCA) with a view to protecting existing and future domestic customers who pay default tariffs, and in setting the cap, must have regard to the following matters (set out in section 1(6) of the DTCA) —

- the need to create incentives for suppliers to improve their efficiency,
- the need to set the cap at a level that enables suppliers to compete effectively for domestic supply contracts,
- the need to maintain incentives for domestic customers to switch to different supply contracts,
- the need to ensure suppliers who operate efficiently are able to finance their licensed activities, and
- (since October 2022) the need to set the cap at a level that takes account of the impact of the cap on public spending.

- 1.5 The objectives of the DTCA led to design choices to maximise customer protection and efficiency incentives, resulting in a 'stringent' cap. The definition of default customers widened the eligibility to more 'universal' protection compared to the targeted protection afforded by the preceding safeguard tariff.⁸ The structure of the cap was based on the prevailing market at the time of its introduction with effective standing charge and 'flat' unit rate elements.⁹
- 1.6 Through the Energy Prices Act 2022, amendments were made to the DTCA so that the cap could act as the reference price for the Energy Prices Guarantee (EPG). The requirement for annual review and the sunset clause were removed. The cap is now a permanent market feature until such a time that the Secretary

⁷ Ofgem (2019), Framework on conditions for effective competition in domestic supply contracts <https://www.ofgem.gov.uk/publications/framework-conditions-effective-competition-domestic-supply-contracts>

⁸ Ofgem (2017), Background on prepayment meter safeguard tariff, <https://www.ofgem.gov.uk/publications/background-prepayment-meter-safeguard-tariff>

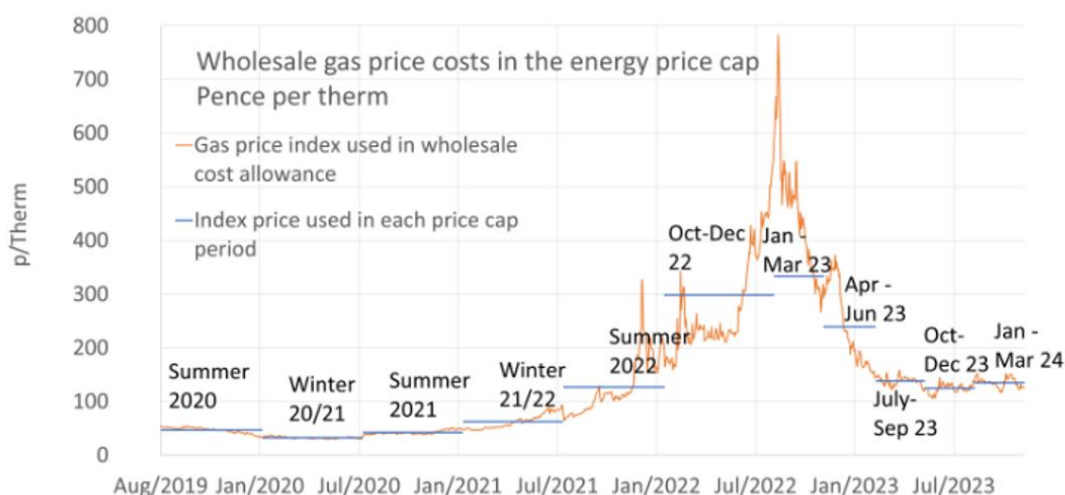
⁹ Ofgem does not set an explicit cap on unit rate and standing charge, rather the cap is set at two consumption values: nil and benchmark. Suppliers have freedom to choose their own standing charge and unit rates as long as the overall tariff is compliant at the consumption values.

of State provides notice that it should end, ie it is the government’s decision whether and when to remove the cap.

- 1.7 The amended section 9 of the DTCA also requires Ofgem to conduct reviews, at intervals we consider appropriate, into supplier pricing practices and whether there are categories of domestic customers for whom protection against excessive pricing should be provided. If, following a review, Ofgem concludes that protection should be provided, it must take such steps as it considers appropriate steps using its powers under the Gas Act 1986 and the Electricity Act 1989.
- 1.8 **The cap is not a mechanism for tackling affordability:** it can ensure fair pricing, but reflects underlying costs of energy, so when energy prices rise, the cap level also rises. From August 2021, wholesale energy prices became extremely volatile in response to global events (see Information Box 3). This had two key impacts, i) the cap rose to unprecedented levels to reflect the volatility in wholesale markets, and ii) the cap became the only tariff available to most domestic householders.

Information Box 3: the cap during the gas crisis

Figure 1: Wholesale gas prices in the cap



Source: Ofgem Analysis

Wholesale markets have experienced record high prices and unprecedented volatility over the past few years, on the back of the Covid-19 pandemic in 2020, Russia’s invasion of Ukraine in February 2022 and Europe’s subsequent shift away from Russian gas.

Wholesale gas and electricity prices have fallen and started to stabilise since the beginning of 2023 but remain higher compared to historical norms.

1.9 As wholesale energy prices rose and the market became increasingly volatile, and with price support offered by the government's EPG, suppliers were no longer able to offer competitive fixed deals below the EPG to consumers. This meant that as fixed tariffs expired, with no other offers available, households increasingly defaulted onto default tariffs. Some households also moved onto default tariffs as a result of being transferred to a new supplier when their existing supplier failed. The number of customers on default tariffs has grown substantially to represent roughly 90% of households in January 2024, up from around half of households at the time of the cap's introduction.

Links to affordability

- 1.10 The cap can ensure that households on a default tariff pay a fair price for their energy, but it cannot tackle the problem of energy affordability for low-income or vulnerable consumers. Addressing affordability issues requires alternative interventions such as the Warm Home Discount (WHD), a social tariff (or other targeted support), and/or temporary interventions at times of high prices such as the Energy Bills Support Scheme (EBSS). Earlier this month, Ofgem published 'Affordability and debt in the domestic retail market – call for input'¹⁰ to consider what more can be done to tackle issues around affordability and debt especially for those in vulnerable circumstances.
- 1.11 Nevertheless, aspects of future price protection, in particular how costs are distributed to vulnerable customers, do have interlinkages with affordability issues. It may be that price protection might need to be implemented alongside an affordability intervention. For example, switching the cap to time of use (ToU) might necessitate targeted bill support for vulnerable customers with high or unavoidable peak consumption.
- 1.12 Equally, the approach to price protection might reduce the magnitude of or need for additional affordability interventions, for example, a well targeted price protection regime might reduce the quantum of price support needed for low-income households by acting as a reference price to benchmark the fair energy costs for this group of consumers.

¹⁰ Ofgem, (2024), Affordability and debt in the domestic retail market - call for input <https://www.ofgem.gov.uk/publications/affordability-and-debt-domestic-retail-market-call-input>

2. Evaluating the cap today

Chapter summary

The cap is designed to ensure that households on a default tariff pay a fair price for their energy. Immediately following its introduction, the cap appeared effective: default tariff customers saved on their bills and suppliers invested to improve efficiency, but the last few years, particularly during the gas crisis, have demonstrated some limitations of the cap. As a result, we have made changes to the cap to make it more responsive to market conditions, but issues remain.

Question

Q1. Do you have any reflections on our list of the cap's successes and challenges?

Successes of the cap

- 2.1 Since its introduction in 2019, the cap has been the primary form of price protection for domestic consumers, ensuring that households on a default tariff pay a fair price for their energy.
- 2.2 The cap has:
- incentivised efficiency gains,
 - protected disengaged customers from price exploitation, and
 - protected consumers without stifling competition for engaged customers.

We discuss each of the above points in turn below.

Improved efficiency

- 2.3 When suppliers were free to set their own default tariffs, they could recover inefficient costs from relatively high tariffs for disengaged customers, reducing the pressure to improve efficiency. From 2019 to 2021 large supplier indirect / operating costs fell by 11%¹¹ as the cap gave stronger incentives to improve efficiency, for example, through one-off investments or process changes – most notably, several suppliers updated their IT systems. We are separately working

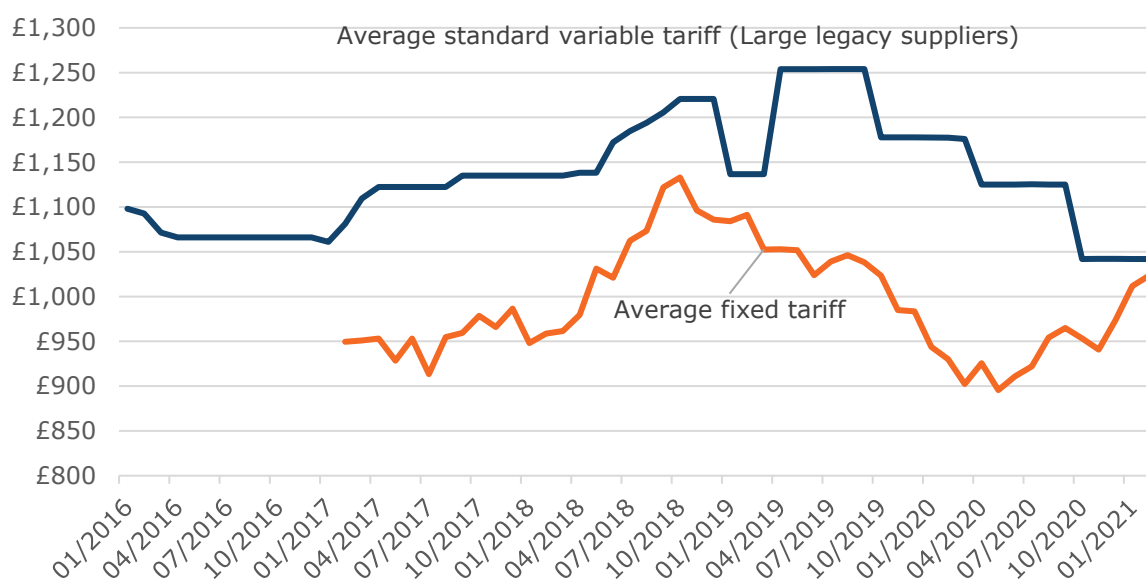
¹¹ Ofgem (2022), Outcome of 2022 review into whether conditions are in place for effective competition in domestic supply contracts, Paragraph 3.22, 2021 data for some large suppliers
<https://www.ofgem.gov.uk/publications/outcome-2022-review-whether-conditions-are-place-effective-competition-domestic-supply-contracts>

on a new framework to benchmark supplier operating costs to better understand achieved and potential efficiency savings.¹²

Protected disengaged consumers

- 2.4 The cap protected disengaged customers, ie those that do not switch supplier and therefore do not shop around for the best deals, from higher prices: upon introduction of the cap, default tariff prices fell.
- 2.5 The Competitions & Markets Authority define the loyalty penalty as a situation “where businesses charge higher prices to customers that stay with them, than they do to new customers or those that negotiate. It is a form of price discrimination”.¹³ The level of differential between inactive and switching tariffs did not initially narrow after the cap was introduced (see Figure 2), but that was probably due to the presence of suppliers pursuing unsustainable business models, which reduced prices in the competitive part of the market.

Figure 2: SVT (default) vs Fixed Tariff price per typical customer trend in pre-cap and early cap years



Source: Ofgem analysis¹⁴

¹² Ofgem (2023), Price cap programme of work <https://www.ofgem.gov.uk/publications/price-cap-programme-work-update>

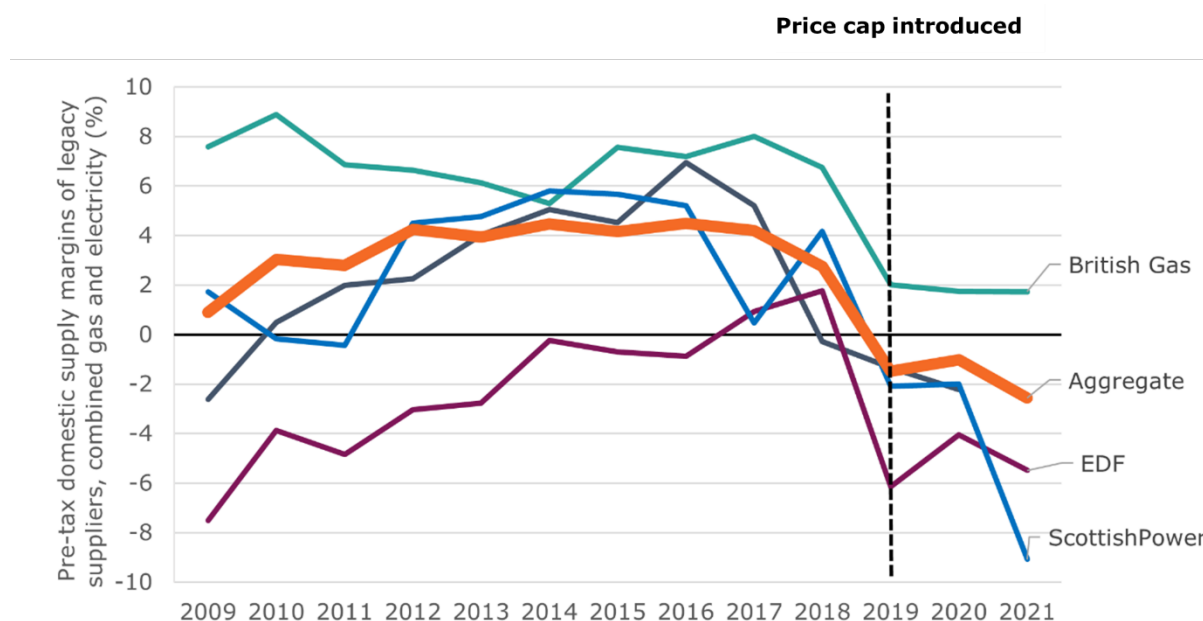
¹³ Competition & Markets Authority (2018), Tackling the loyalty penalty (Glossary)

https://assets.publishing.service.gov.uk/media/5c194d4940f0b60c22fb8e9b/Annexes_and_glossary.pdf

¹⁴ Ofgem (2024), Retail price comparison by company and tariff type <https://www.ofgem.gov.uk/retail-market-indicators> These prices are based on typical domestic consumption values for a medium consumer, which was 11,500 kWh/year for gas and 2,700 kWh/year for electricity as of October 2023. The tariffs are for dual fuel, direct debit customers.

2.6 The price cap clearly depressed default tariffs below the level they would otherwise have been, evidenced most clearly by suppliers collectively turning from profit to loss when the price cap was introduced (see Figure 3).

Figure 3: Pre-tax domestic supply margins of large legacy suppliers, combined gas and electricity



Source: Ofgem analysis¹⁵

Did not stifle competition for engaged customers

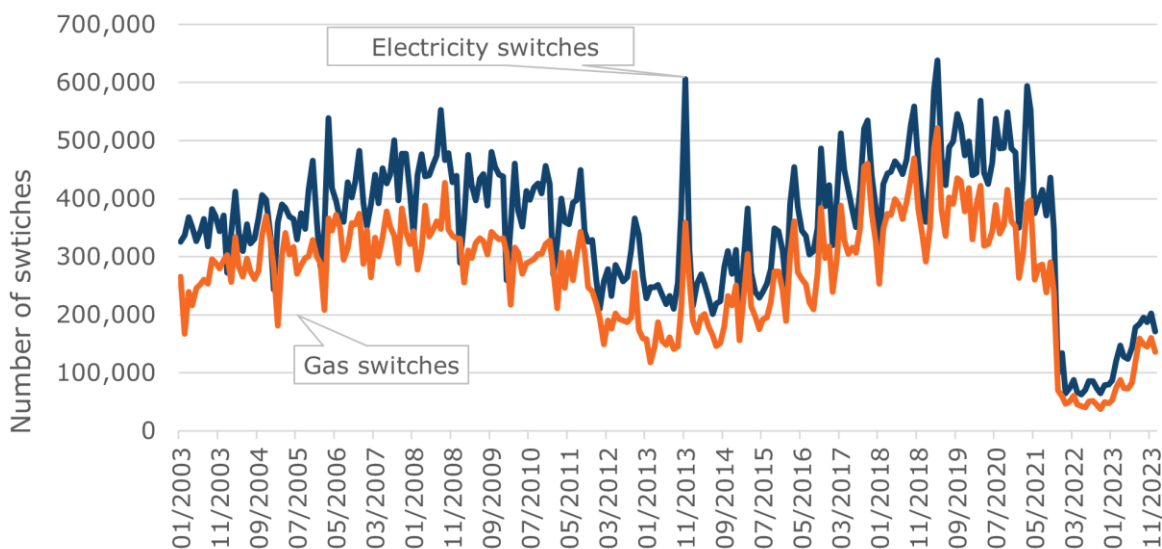
2.7 It would be expected that a cap would result in a reduced level of intensity of competition, as it was expected to reduce the savings from switching. Before its introduction, there was a concern that prices would cluster around the cap and consumers would therefore become more disengaged.

2.8 Instead, as set out above, price differentials remained high, which helped consumer engagement to reach record levels¹⁶ (see Figure 4 below), and incumbents' market share continued to fall (see Figure 5 below).

¹⁵ Ofgem (2024), Pre-tax domestic supply margins of large legacy suppliers, combined gas and electricity <https://www.ofgem.gov.uk/retail-market-indicators> - data displayed is the latest available (2021)

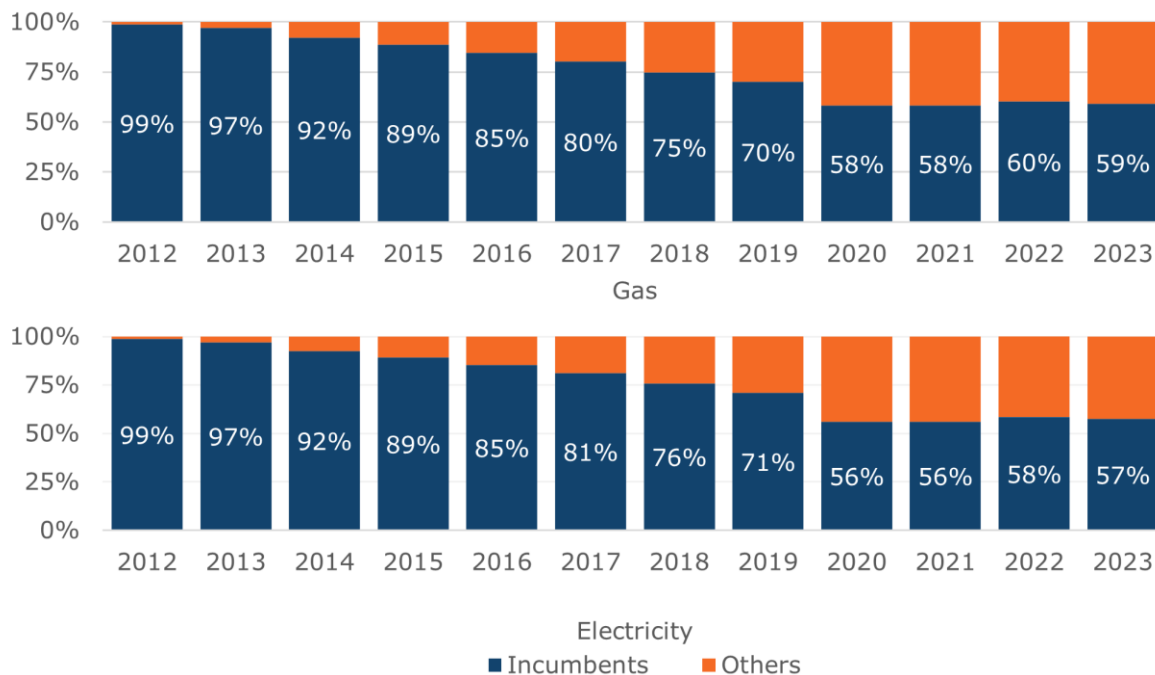
¹⁶ The trend growth in supplier switches is partially due to repeat switchers, and even pre-crisis there remained significant barriers to engagement for many consumers resulting in almost 40% of consumers still not engaging with the energy market in 2021. Ofgem (2021), Consumer Survey 2021 <https://www.ofgem.gov.uk/publications/consumer-survey-2021>

Figure 4: Number of switches in the energy market by fuel type



Source: Ofgem analysis¹⁷

Figure 5: Gas and electricity domestic retail market shares by supplier group



Source: Ofgem analysis¹⁸

¹⁷ Ofgem (2024), Number of domestic customers switching supplier by fuel type (GB) <https://www.ofgem.gov.uk/retail-market-indicators>

¹⁸ Ofgem (2024), Gas, Electricity supply market shares by company: Domestic (GB) <https://www.ofgem.gov.uk/retail-market-indicators>. Supplier market shares were aggregated based on type, ie incumbent or other.

- 2.9 When the gas crisis hit, the increasing consumer engagement and falling market concentration that we saw from 2012 to 2020 went sharply into reverse. The rapid rise in energy prices and high levels of uncertainty meant that fixed price tariffs ceased to be competitive versus the cap and the government's EPG and were unavailable for several months. As a result, most customers that were on fixed tariffs reverted to default tariffs, and the majority of those customers are still on default tariffs today.
- 2.10 As the market has stabilised, competitive fixed tariffs have started to return and switching rates are rising. In the current market, with enhanced financial stability requirements in place,¹⁹ the discounts available from switching are expected to remain well below pre-crisis levels, which could leave switching levels below historical levels (although there is likely to be pent-up demand for better deals).
- 2.11 Current levels of switching may also be lower due to our temporary interventions to stabilise the retail market during the crisis: the Market Stabilisation Charge (MSC) (the temporary requirement for domestic suppliers who acquire domestic customers to pay a charge to the losing supplier when wholesale prices fall below the wholesale price cap index), which will end in March 2024,²⁰ and the BAT (the supplier requirement preventing new, often lower "acquisition" style tariffs being offered to new customers only), which has been extended for up to another 12 months.

Challenges of the current cap

- 2.12 The gas crisis exposed certain limitations and challenges associated with the cap methodology. We set these out below, in three categories:
- Additional costs and risks, which exist as side effects of the cap design.
 - Impacts on competition, innovation and service levels over time as a result of the existence and design of the cap.
 - The growing challenge of applying the cap to a more diverse market especially when considering the growing bad debt levels.

¹⁹ Ofgem (2023), Decision on Strengthening Financial Resilience <http://www.ofgem.gov.uk/publications/decision-strengthening-financial-resilience> and Ofgem (2023), Decision on introducing a minimum capital requirement and ringfencing customer credit balances by direction www.ofgem.gov.uk/publications/decision-introducing-minimum-capital-requirement-and-ringfencing-customer-credit-balances-direction

²⁰ Ofgem (2024), Future of Market Stabilisation Charge after March 2024 www.ofgem.gov.uk/publications/future-market-stabilisation-charge-after-march-2024

Costs and risks of the cap

2.13 While the cap has generally protected disengaged consumers from price exploitation (as set out in the previous chapter), it led to additional costs for consumers during a period of volatile energy prices.

Supplier failure

2.14 Initially, following its introduction, the cap level was set every six months, with a two-month lag between the end of the observation period and the start of the cap. When the gas crisis started in late 2021,²¹ with gas prices rising to record levels in 2022, this meant a delay to wholesale energy price increases being passed through to consumers and ultimately being reflected in supplier revenues. Some suppliers were exposed to volatile energy prices because they had not hedged enough wholesale energy to meet their customers' demand.

2.15 This effect was compounded by the fact that millions of customers on fixed tariffs were unable to find new fixed tariffs that were competitive when their contracts came to an end, so rolled onto their supplier's default tariff. This 'volume risk' meant suppliers had to meet higher than expected demand at high prices, and at the time, the cap prevented them from increasing their tariffs to cover these costs.^{22,23}

2.16 The combination of these effects contributed to major losses in the sector and over 30 suppliers exiting the market, with significant exit costs to be recovered from all consumers. Since then, we have taken several steps to reduce the cost and likelihood of supplier failure. Most notably: we introduced new financial resilience requirements for suppliers, quickly reformed the cap, moving to quarterly updates with a 5-week notice period and introduced the MSC and the BAT to stabilise the market and ensure suppliers were incentivised to hedge fully. This, alongside other measures, has significantly reduced the risks of supplier failure. But a degree of volume risk remains for suppliers, which requires them to hold more capital and thus increases costs for consumers.

²¹ Energy prices started rising in 2021, due to various global factors highlighted in our: Ofgem (2021), [https://www.ofgem.gov.uk/sites/default/files/2021-08/Default tariff cap letter for 1 October 2021.pdf](https://www.ofgem.gov.uk/sites/default/files/2021-08/Default%20tariff%20cap%20letter%20for%201%20October%202021.pdf)

²² In February 2022 we decided to include an allowance for unexpected SVT demand costs incurred in cap period seven to offset this. We also introduced a range of targeted mechanisms to mitigate the risk of unexpected changes in SVT demand from April 2022. See: Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap <https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap> and Ofgem (2022), Price cap - Decision on changes to the wholesale methodology <https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology>

²³ This can affect both suppliers who had not hedged enough and through suppliers unexpectedly having additional customers to buy energy for at short notice.

2.17 In summary, although the cap was not the main driver of supplier failures, the frequency of its updates and its nature as a measure targeting all customers that end up on default tariffs contributed to the resilience challenges faced by suppliers and costs for consumers.

Greater price volatility for consumers

2.18 The move to a quarterly cap and the introduction of the backwardation allowance²⁴ was essential to stabilise the market in the face of price volatility, but these changes have reduced the smoothing impact of the cap, as it now moves more frequently in response to changes in wholesale energy prices.

2.19 The cap delivered smoother²⁵ prices for consumers than the sharp peaks in the gas and electricity wholesale markets. But prior to the cap, many suppliers hedged for longer periods, often 1-2 years ahead. Such hedging strategies would have enabled those suppliers to cushion the impact of the crisis for their customers. When the cap was introduced, it provided a strong incentive for responsible suppliers to hedge in line with the cap methodology, initially 6-8 months ahead of demand, now 4-5 months ahead. As such, some price cap customers experienced less price smoothing during the crisis than they might otherwise have done.

2.20 It must be noted, however, that substantial long-term hedging is not a perfect solution as it is challenging to ensure that long-term hedging is compatible with more engaged customers that may move on and off a default tariff. Furthermore, in the event of falling energy prices, customers may be disadvantaged by long-term hedges.

Effect on wholesale market liquidity

2.21 Domestic suppliers have an incentive to follow the cap indexation methodology, and therefore to have similar hedging patterns.²⁶ Such concentration of demand for certain hedging products could drive up prices for these products in wholesale markets. In a fluid, liquid market, this effect is likely to be limited due to active traders and market makers, but during times of market stress, such activity may be limited. It is possible that at the height of the crisis when wholesale markets

²⁴ Ofgem (2022), Price cap - Decision on changes to the wholesale methodology

<https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology>

²⁶ Ofgem (2023), Power Market Liquidity – Call for Input <https://www.ofgem.gov.uk/publications/call-input-power-market-liquidity>

were exceptionally tight, this collective behaviour may have led to higher prices, which were then reflected in the level of the cap.

Practical challenges of operating the cap

- 2.22 In line with the legislation, we set a cap for all suppliers and, having regard to the various statutory factors, do so at a level that is in line with the recovery of notionally efficient costs. That has been challenging to do during the crisis, when the costs facing suppliers have been changing quickly and unpredictably.
- 2.23 Over this period, we have made frequent changes to the cap calculations – both one-off adjustments and ongoing methodology changes. This has partly been a consequence of the shocks impacting the retail market. However, it is also a consequence of our decision to set a stringent cap, which delivers a low cost for consumers and strong incentive for supplier efficiency but means we have considered it necessary to intervene rapidly to change the cap if costs rise, to allow suppliers to recover notional efficient costs. Indeed, most adjustments to the cap methodology have resulted in increases in the cap level, reflecting a succession of additional costs that suppliers have faced.
- 2.24 Importantly, the cap does not respond automatically to exogenous shocks, but rather relies on adjustments by Ofgem which by necessity often happen with a significant lag. This increases the risks facing suppliers and the amount of capital they may have to hold.
- 2.25 Cap setting decisions are particularly challenging when costs affect different suppliers in different ways: enabling recovery of average costs could deliver windfall gains to some suppliers while locking in losses for others. This is one of the limitations of a universal cap. This issue will become even more challenging as the retail market becomes more diverse as set out below and in Chapter 3.

Impacts on competition, innovation and service levels

- 2.26 As discussed above, since its implementation, the cap has operated alongside the competitive segment of the market. In considering the performance of the cap, it is important to consider whether it is having an adverse effect on consumers, by reducing the incentives on suppliers to offer more competitive tariffs, or to offer better services to consumers through improved efficiency and innovation.
- 2.27 Under the DTCA we have to consider “the need to set the price cap at a level that enables suppliers to compete effectively for domestic supply contracts”. A reduced gap between default and competitive tariffs reduces the financial

incentive to switch, but a number of factors may limit the impact of the cap on competition:

- Price certainty: many customers value the price certainty of fixed tariffs, which operate only in the competitive market.
- Non-price competition: those suppliers that have grown and maintained market share have tended to have better quality of service and / or offer other non-price benefits to consumers.
- Alternative tariffs: while they represent a small part of the market at present, there is a growing number of suppliers offering, and customers choosing, ToU tariffs, or tariffs tied to particular usages, such as electric vehicles (EVs).

2.28 The overall effect of the cap on competition will depend on the relative importance to customers of the price of energy versus non price factors such as more innovative tariffs and service levels (see below). As such, while the cap may dampen competition in the short-term, the medium-term effect on dynamic innovation-led competition is less clear.

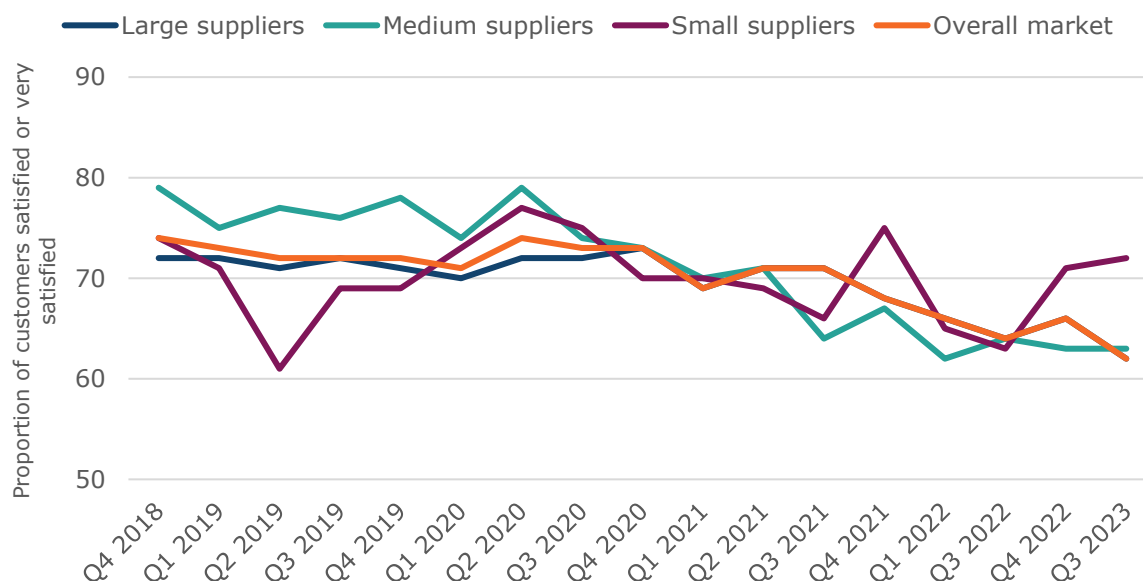
Effect on service levels

2.29 During this period, we have seen extensive supplier failures and losses, sharp price rises, and a cost-of-living crisis, which all put pressure on service levels. We have intervened robustly, conducting reviews of billing, ease of contactability, and debt pathways, introducing new rules to drive up standards and fining suppliers with the worst performance. It is therefore hard to link trends in customer standards and satisfaction directly with the cap. Nevertheless, as might be expected during a period of such instability, customer satisfaction and service levels have on the whole declined.

2.30 Data we have collected as part of regular monitoring from our joint Consumer Perceptions in the Energy Market survey with Citizens Advice shows overall domestic consumer satisfaction with customer service from their energy supplier decreased from 74% in Q4 2018 to 62% in Q3 2023.²⁷ Figure 6 below shows how different categories of supplier types have performed on this measure. Medium-sized suppliers saw the largest fall in customer service satisfaction, followed by large suppliers, while small suppliers saw the smallest decrease.

²⁷ Ofgem (2024), Energy Consumer Satisfaction Survey: August to September 2023
<https://www.ofgem.gov.uk/publications/energy-consumer-satisfaction-survey-august-september-2023>

Figure 6: Percentage of domestic consumers satisfied or very satisfied with overall customer service



Source: Ofgem and Citizens Advice Consumer Perceptions of the Energy Market survey Q4 2022²⁸

- 2.31 We conduct market compliance reviews on customer service which have highlighted service issues such as long call waiting times and difficulties faced by consumers when contacting suppliers.²⁹ Between Q4 2018 and Q3 2023, of those consumers who had recently contacted their supplier, the percentage of consumers who reported that it was very easy or fairly easy to contact their supplier gradually dropped from 61% to 51%, as seen in Figure 7. In parallel, those who reported it as very difficult or fairly difficult almost doubled from 11% to 19% (though this may also at least partially be on account of a surge in customers contacting suppliers around general affordability concerns).³⁰
- 2.32 One hypothesis is that the tight level of the price cap is constraining the ability of suppliers to invest in better service standards. It must however be noted that suppliers have a responsibility to meet their license obligations, and should be

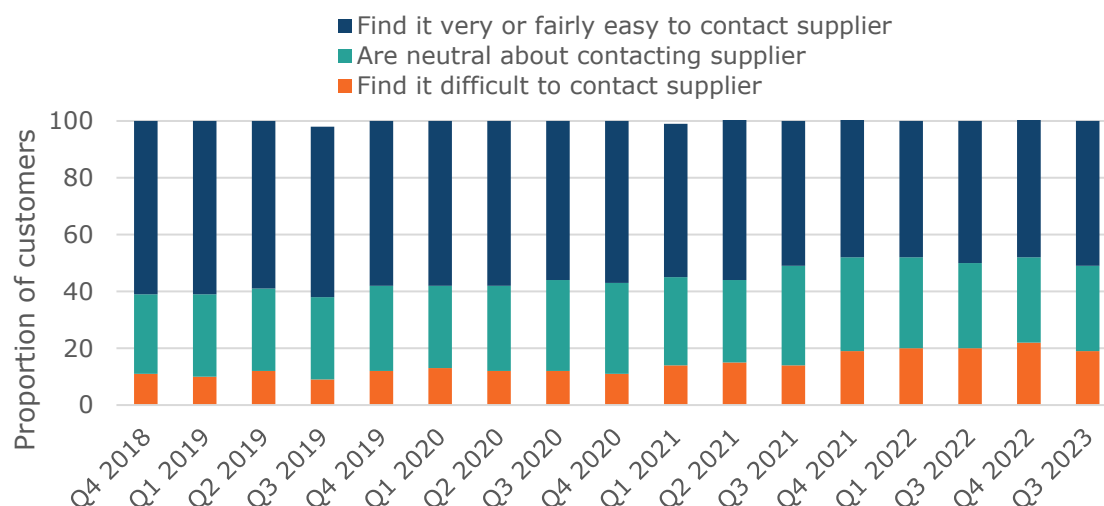
²⁸ Ofgem (2023), Customer service data. <https://www.ofgem.gov.uk/energy-data-and-research/data-portal/customer-service-data> The figures in the chart are split by supplier size groups – large, medium, and small. From Q3 2020 the following classification applies: the category 'large' refers to those suppliers whose market share exceeds 5% in at least one fuel, 'medium' is for those exceeding 1% in at least one fuel but remaining below 5% in both fuels and 'small' for suppliers with market share below 1% in both fuels. Suppliers may move across different supplier types in different periods depending on their classification in that period. The survey was not run in certain periods and data are not available, namely Q2 2022 and Q1 and Q2 2023. From Q4 2020, the trend for large suppliers mirrors the overall customer satisfaction trend.

²⁹ Ofgem (2023), Ofgem review reveals that customer service standards of suppliers must improve <https://www.ofgem.gov.uk/publications/ofgem-review-reveals-customer-service-standards-energy-suppliers-must-improve>

³⁰ Ofgem (2023), Consumer Perceptions of the Energy Market Q4 2022 <https://www.ofgem.gov.uk/publications/consumer-perceptions-energy-market-q4-2022>

competing to win customers from each other, including through better service standards. Furthermore, there is no guarantee that any additional allowances in the price cap would be spent on increasing customer service levels.

Figure 7: Customer’s ease of contacting energy suppliers



Source: Ofgem analysis³¹

Applying the Cap to a more diverse electricity market

- 2.33 Customers in the retail market present a wide range of demographic, financial and consumption characteristics. The evolution of the market in recent years has resulted in diversity between the customer bases of different suppliers. This diversification could become amplified with the growing range of consumption behaviours, for example, on the uptake of low-carbon technologies. This could lead to some suppliers having higher cost to serve customers than other suppliers, posing challenges for a stringent, one-size-fits-all cap.
- 2.34 This has always been a challenge with a stringent cap, but the rise in debt levels and the coming of MHHS could make it increasingly challenging to retain a stringent, universal and flat cap, as outlined in Chapter 3.

The impact of customer base on debt-related and wholesale costs

- 2.35 Initial Ofgem analysis suggests there is a positive correlation between suppliers having a greater proportion of lower-income customers and the average level of debt and arrears per customer, as depicted in Figure 8. This is not a surprising

³¹ Ofgem (2023), Customer satisfaction: Ease of contacting supplier (GB), Q3 2023 included for reference. Data is not available for some quarters up till then. <https://www.ofgem.gov.uk/energy-data-and-research/data-portal/customer-service-data>

finding, although there are clearly other factors at play, including suppliers' business models and their debt management practices.

Figure 8: Relationship between debt, arrears and income



Source: Ofgem analysis³²

- 2.36 The cap includes allowances for bad debt, but evidence suggests these have not been sufficient to cover the rising levels of debt in the sector. As a result, we have introduced a temporary uplift to the price cap from April 2024 cap.³³ However, this adjustment is universal, so does not account for the significant differences in debt levels between suppliers.
- 2.37 Furthermore, the debt-related cost allowance currently follows a complex calculation methodology and is accounted for in multiple components of the cap. This necessarily involves a degree of estimation. The result is an intricate process to generate a bad debt allowance reflective of a 'notional supplier'. With growing supplier and customer diversity, this complexity represents an ever-increasing challenge to effective operation of the price cap.

³² Ofgem (2024), Supplier Debt Analysis February 2024. This chart represents data from an anonymised sample of suppliers currently active in the market.

³³ Ofgem (2024), Energy price cap: additional debt costs review decision <https://www.ofgem.gov.uk/publications/energy-price-cap-additional-debt-costs-review-decision>

3. Evaluating the current cap for the future

Chapter summary

The coming years will see growing diversity of household electricity consumption. The introduction of Market-wide Half-Hourly Settlement (MHHS) will bring significant consumer benefits, but it will also add a further challenge to operating a stringent, flat, universal cap. There is a significant risk that customers with low-cost consumption patterns move to time of use tariffs, leaving higher cost customers on the cap, potentially leading to a higher cost cap.

Questions

- Q2. Do you believe that the growing diversity of electricity consumption patterns will make it challenging to retain a flat, universal and stringent price cap? How quickly do you think this will materialise and with what impacts? What evidence can you provide to support your view?
- Q3. What plans do suppliers have to launch ToU tariffs and to incentivise customers to shift their electricity consumption once MHHS is implemented?
- Q4. How quickly and at what scale do you expect customers, especially those with large flexible loads such as EV and solar/battery users, to take up ToU tariffs once MHHS is implemented?
- Q5. In addition to the factors set out in this chapter, are there any other important changes that might affect the ability of the current default tariff cap to achieve its objectives?

- 3.1 The previous chapter outlines existing challenges to the cap, including the high and differential levels of consumer debt currently in the sector. In the coming years we are expecting to see growing diversity of household electricity consumption patterns. When paired with MHHS this could present challenges to maintaining a stringent, flat, universal cap.
- 3.2 The recent DESNZ CFE outlines the potential benefits of MHHS for both suppliers and consumers as well as the effects on the cap and how existing tariffs may need to be altered. We set out our views below.

Growing diversity in electricity consumption

- 3.3 With increased offerings of EVs, heat pumps and alternative sources of energy (eg solar panels), the retail electricity market is growing more diverse. Combined with the introduction of MHHS, which will expose suppliers to the half-hourly

costs of their customers' electricity consumption (instead of typical consumption profiles), this is likely to drive significant differences in the consumption costs of different customers.

- 3.4 In addition, the growing role of renewable generation in GB and our neighbours is likely to lead to higher variability in wholesale electricity prices, as they become increasingly determined by weather patterns.
- 3.5 These developments (customer diversity, MHHS and renewables dominated generation) will give suppliers an increasing incentive to offer ToU tariffs to their customers, and an incentive for customers to adopt such tariffs if they have low-cost consumption patterns or are able to shift their demand. Such flexibility in consumption will enable a lower cost system for everyone (see Box 4).

Information Box 4: Rollout of MHHS

Market-wide Half-Hourly Settlement (MHHS), which is being rolled out over 18 months from spring 2025, is a critical part of ensuring the lowest possible cost transition to net zero. It will enable much greater flexibility in how and when we use electricity, with consumption set to increase significantly in the coming years as we change the way we heat our homes and power our cars. MHHS will do this by incentivising suppliers to offer customers ToU tariffs which charge customers according to when they use electricity. ToU tariffs reward customers with lower bills for shifting their electricity use, for example when charging their EVs, to times when demand is low or when renewable generation is high because it's windy or the sun is shining. This will help us make the best use of our renewable resources and, by reducing peak demand on the system, reduce the amount of new generation and network infrastructure we need to build to meet it. The resulting reduction in system costs (estimated at £10bn a year by 2050³⁴) will reduce electricity bills for everyone.

Static and dynamic Time of Use tariffs

- 3.6 There are two types of ToU tariffs: static and dynamic. Static ToU tariffs have fixed rates, but those rates differ between time-bands with typically higher unit rates during peak hours. Such tariffs, such as Economy 7 (E7) and Economy 10 have been in the market for decades, are relatively simple, and are used by millions of customers. These tariffs help customers to reduce their bills by avoiding consuming electricity during peak periods, while also reducing suppliers' wholesale costs.

³⁴ A £6-10bn annual saving in high DSR scenarios in 2050 versus costs of ~£66-72bn (2012 prices), Table 1. DESNZ (2021), Electricity System Flexibility Modelling https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1003787/smart-systems-appendix-i-electricity-system-flexibility-modelling.pdf

- 3.7 Dynamic ToU tariffs have electricity prices that are linked to the wholesale market. As such, they often vary by half-hour, and are likely to be unpredictable. However, by aligning with wholesale markets, they enable consumers, and the energy system more generally, to benefit by increasing consumption when cheap electricity is plentiful and curbing demand when it is not. Smart devices, such as smart charging EV, make it easy for customers to shift their consumption automatically to take advantage of these price movements.

Information Box 5: Treatment of static ToU tariffs in the cap today

For multi-rate tariffs, Ofgem does not set a limit on the individual time-based unit rates. Rather it gives suppliers discretion over how to set their rates, so long as they can evidence that the overall tariff structure is compliant with the cap given their consumer base's expected demand profile.

For E7 tariffs, Ofgem defines the consumption profile as the average consumption pattern of E7 customers (58% peak: 42% off-peak). This is across all customers so an individual supplier's consumer base might have a different consumption profile.³⁵

- 3.8 As the wholesale market moves from one where prices peak quite predictably at the same time each day (eg, winter peak early evenings) to one determined by less predictable weather patterns, the benefits of dynamic ToU tariffs may start to outweigh those of static ToU tariffs.

Increasing customer diversity will impact the cap

- 3.9 The cap provides a single price across the market. As electricity consumption patterns becomes increasingly diverse, maintaining a flat cap becomes more challenging.
- 3.10 There is a risk that, similar to the incidence of debt (see previous chapter), the consumption patterns of consumers vary significantly between suppliers. We do not have any evidence at this point to suggest this is the case. But if it were, it would make it more challenging to set the cap at a stringent level without causing a supplier exit, potentially leaving a large number of high cost to serve customers that are unprofitable for other suppliers to take on.
- 3.11 A potentially more significant challenge to the cap is that customers with lower cost consumption patterns and/or with the ability to shift their electricity demand, will have a strong incentive to leave the cap and adopt ToU tariffs. Similarly, customers with higher cost consumption patterns will have an

³⁵ Some consumer groups have raised concerns that the freedom suppliers have in setting their day and night rates may result in consumer detriment
https://www.sustainabilityfirst.org.uk/images/2023/02/06/glen_dimplex_report_economy_7_Jan23.pdf

incentive to stay on, or move to, the flat cap. For example, an EV owner who does not wish to smart charge their vehicle and prefers to charge during peak times would face high costs if they were on a ToU tariff, so would likely shelter on the cap where they would impose significant costs on their supplier. Most examples are unlikely to be this extreme (and EV owners tend to be more engaged in their energy consumption given the potential savings on offer).

- 3.12 However, over time, this effect could lead to the higher-than-average cost to serve customers congregating under the cap. To enable suppliers to recover efficient costs of supplying these customers, Ofgem would likely increase the level of the cap or face supplier exits as they are unable to recover the costs of serving their cap customers. Although this is not the objective of the cap, we may have to regard suppliers' abilities to recover efficient costs for market stability purposes.

Impact of MHHS on cap methodology

- 3.13 Any change in the structure of the cap away from a single rate cap would require a change in the methodology by which we currently assess efficient electricity wholesale costs.
- 3.14 In particular, when setting the wholesale allowance, we currently make an assumption around the shape of domestic demand using industry standard 'profiles'. We use a 30:70 mixture of peak and baseload electricity contracts into our price observations and apply a percentage uplift of 4.16% to account for the cost of shaping quarterly contracts into half-hourly shape. This uplift does not vary by the period being shaped and is set for these standard demand profiles.
- 3.15 To accommodate MHHS in the cap it is likely both elements of the wholesale methodology would need to be reviewed and changed. Such changes would be a prerequisite to deliver some of the options for reform discussed in this document, including multiple bottom-up caps based on different consumption profiles and a static ToU cap.
- 3.16 Without prejudicing how the cap develops we consider it prudent to start considering the detail of the technical changes needed to deliver wholesale allowances which could accommodate the impact of MHHS.
- 3.17 In addition, the methodology and data behind elements of the wholesale allowances in the cap have not been reviewed or updated since being initially set in 2018. We therefore intend to conduct a review of a wholesale allowance

methodology more broadly. The outline scope of this review is set out in an update to the Price Cap Programme of Work published alongside this document.

Other Considerations

Review of Electricity Market Arrangements

- 3.18 The UK government launched the Review of Electricity Market Arrangements (REMA) programme in April 2022³⁶ which aims to identify and implement reforms to GB electricity markets to drive the efficient operation of a secure and low carbon electricity system. For example, Ofgem supported the government in assessing locational wholesale pricing for Great Britain and found that improving the accuracy and effectiveness of locational signals can produce material benefits for consumers.³⁷
- 3.19 The government's recent update on REMA³⁸ includes zonal pricing (wholesale prices set regionally) as an option for further consideration. The cap is currently set regionally on fixed distribution charges, but under zonal pricing, the methodology used to calculate wholesale costs within the cap would require some changes. We will continue to work with government in support of the REMA programme.

³⁶ GOV.UK (2023), Review of electricity market arrangements
<https://www.gov.uk/government/consultations/review-of-electricity-market-arrangements>

³⁷ Ofgem (2023), Assessment of locational wholesale pricing for Great Britain
<https://www.ofgem.gov.uk/publications/assessment-locational-wholesale-pricing-great-britain>

³⁸ DESNZ (2024), Review of Electricity Market Arrangements (REMA): technical research supporting consultation, <https://www.gov.uk/government/publications/review-of-electricity-market-arrangements-rem-technical-research-supporting-consultation>

4. Options for evolving price protection for the future

Chapter summary

Ofgem believes that removing all price protection risks a return to price exploitation of inactive consumers, but as the market changes, it is likely to be increasingly challenging to retain a price cap that is flat, universal and stringent. Here we present a non-exhaustive list of alternative approaches to provide price protection that could help to address the challenges identified in previous chapters. These could be implemented independently or in combination. Ofgem does not have a preferred option. We welcome views from stakeholders.

Questions

- Q6. Do you agree that we need to retain some form of price protection in the retail market?
- Q7. Do you have views on which of the three key parameters – the cap being flat, universal and stringent - should be relaxed when considering future price protection options?
- Q8. What are your views on options discussed? Do you have any preferred options or combination of options?
- Q9. In particular, which options or combination of options do you think would best protect vulnerable customers?
- Q10. How should consumers with large flexible loads, mainly EV and solar/ battery users, be treated with regards to future price protection?
- Q11. Are there any additional options that we haven't, but should be considering?

- 4.1 Our starting premise is that, if price protection was removed completely, we would likely see a return to price exploitation of inactive customers, as existed before the cap. The question in this paper is not whether price protection is needed, but what is the best way to deliver it in a changing retail market.
- 4.2 In this chapter, we explore potential alternative approaches to the stringent, flat and universal cap currently employed. We do not have a preferred option. The purpose of this discussion paper is to stimulate debate on whether there is a case for changing the current cap and whether there are alternatives that will better protect consumers.
- 4.3 The discussion primarily applies to electricity bills as the growing diversity of consumption is not an issue in gas. A different, likely simpler, approach could be taken to gas bills.

The challenge of maintaining a flat, stringent and universal cap

4.4 The preceding chapters described the benefits consumers have realised from the cap as well as the challenges that are placing strain on the current cap approach. Some of these challenges could, and in some cases already are, being fully or partially addressed by existing interventions:

- **Lack of flexibility and resilience to market shocks:** we are strengthening suppliers' financial resilience by introducing a minimum capital requirement, an enhanced Financial Responsibility Principle, ringfencing of Renewables Obligations and Ofgem's ability to direct ringfencing of customer credit balances when in the consumer interest. This is reducing much of the risk of supplier failure to customers from market volatility, although these protections do come at a cost, and that is exacerbated by the existence of the cap.
- **Downward pressure on standards that a stringent cap may be contributing to:** Ofgem is robustly monitoring and enforcing standards, and tightening them where needed, for example we introduced a moratorium on involuntary PPM installations, only allowing suppliers to begin installations after meeting strict standards. We are reviewing operating costs to check that the cap enables efficient costs to be recovered.
- **Stability risk to suppliers with high incidence of bad debt** (or other material deviations from the notional supplier): as shown in Chapter 3, debt costs are not evenly distributed between suppliers due to a complex mixture of customer service practices, accounting policies and customer characteristics. In making an initial float for higher debt costs we reflected this uncertainty in our decision to ensure the appropriate help could be offered to customers facing payment difficulties.³⁹

4.5 But we do not see any solutions to the growing customer diversity under a **flat**, **stringent** and **universal** cap. Attempting to deliver all three key parameters is likely to be increasingly challenging in a retail market with increasing customer diversity and will necessitate some trade-offs.

4.6 We could address the challenges by relaxing any one of these three parameters: you could retain a stringent and flat price cap but limit it to just part of the market such as lower income / vulnerable customers, with looser price protection

³⁹ Ofgem (2024), Price cap – Additional debt related costs review decision, <https://www.ofgem.gov.uk/publications/energy-price-cap-additional-debt-costs-review-decision>

for the rest of the market, you could manage some of the pressures of greater customer diversity by moving to a ToU price cap, which remains universal and stringent, or if these options are not feasible or desirable, a less stringent price cap based on the current design, or more market based price protection approaches may instead be necessary.

Flat

- 4.7 We describe the current cap as flat because it is based on a single unit rate. This doesn't reflect the fact that electricity changes price significantly during the day and as a result doesn't incentivise consumers who can shift their usage to cheaper times of day or enable suppliers to recover notionally efficient costs.
- 4.8 Therefore, one set of options under consideration is moving to a price cap that has a unit rate based on ToU tariffs. There are two main ways you could do this – you could set in advance a different rate for different periods of usage (static, multi rate ToU) or you could publish unit rate caps that vary based on a daily price index (dynamic, multi rate ToU).
- 4.9 Both of these options better reflect the actual costs of electricity on a half-hourly basis, introducing an incentive to shift demand from peak demands, and as a result lowering costs for all consumers. The first, static, option has the potential advantage of being simpler for consumers to understand and engage with. The latter, dynamic, option is better able to reflect actual costs, though it increases complexity for the consumer and can expose consumers to price volatility which may not be appropriate for a default tariff.
- 4.10 In either option we would need to be mindful that those customers that cannot or do not shift their demand away from peak usage times could lose out if they have high-cost consumption patterns. This is particularly a concern for some vulnerable consumers who may have higher than average consumption at peak times and/or be less able to shift their demand due to, for example, reliance on medical equipment. We are exploring mitigations to affordability issues through our CFE on affordability.

Universal

- 4.11 We describe the current cap as universal because it protects all customers on default tariffs, currently around 90% of the market. This means that as well as protecting customers that can't engage in the market and/or have household circumstances that need protection, it also protects those who choose not to engage in the market, potentially reducing the incentive for them to engage. It

also means that the same costs are charged to all consumers despite the cost to serve them becoming increasingly differentiated.

- 4.12 An alternative way of addressing these issues is to relax the universality principle, either to apply the cap to a subsection of consumers or introduce multiple caps for different subsections of consumers.
- 4.13 We could target coverage on the basis on vulnerability (for example vulnerable consumers such as those in receipt of the Warm Home Discount), exclude customers with certain time/type of use characteristics (such as those with EVs or solar and batteries) or introduce multiple cap levels for customers with different demand profiles.
- 4.14 Reducing the scope of price protection allows us to tailor support to the needs of different consumers while reducing cross subsidisation and cost recovery issues. However, defining in principle which consumers require price protection may not be straightforward, and there are likely to be limitations on which options are feasible in practice.

Stringent

- 4.15 We describe the current cap as stringent because it is calculated using a bottom-up approach based on a notional efficient supplier. This may deliver lower prices for consumers in the short term but can also lower market resilience and place more risk on suppliers. It also may become increasingly unsustainable as the costs suppliers face to serve their consumer bases become increasingly differentiated for the reasons set out in previous chapters.
- 4.16 One set of options is to reduce the stringency of the cap and move to more flexible forms of price protection. For example, instead of Ofgem trying to calculate efficient prices in a changing and increasingly complex retail market, we could use more market-based mechanisms.
- 4.17 This could be in the form of a relative cap, which could either be set relative to the market as a whole or within a particular supplier, a cap on just supplier margins, or a version of the BAT.
- 4.18 These options may result in looser price protection compared to the current cap but should be more resilient to market shocks, and more flexible, and thus better suited to an increasingly diverse retail market. They may also enable increased competition, investment and innovation.

Frameworks

4.19 In assessing how we strike the right balance between these parameters, there are a number of frameworks that we can consider. At the moment, when making decisions on the cap we must do so with a view to protecting existing and future domestic customers that pay default tariffs and must have regard to the following matters:

- the need to create incentives for suppliers to improve their efficiency,
- the need to set the cap at a level that enables suppliers to compete effectively for domestic customers,
- the need to maintain incentives for domestic customers to switch to different domestic supply contracts,
- the need to ensure that suppliers that operate efficiently are able to finance supply activities,
- the need to set the cap at a level that takes account of the impact of the cap on public spending. In this discussion paper, we are consciously not limiting ourselves to interventions possible within the current legal framework and so, while we are mindful of these important factors, also consider the existing policy frameworks available to us.

4.20 We have also established a Consumer Interest Framework⁴⁰ to ensure we are thinking holistically about consumer interests. We can apply these to the question of price protection as follows:

- **Fair prices:** consumers that need protection are protected from price exploitation. Unfair cross subsidisation is minimised. Suppliers are incentivised to operate efficiently.
- **Low-cost transition:** there are appropriate incentives for demand flexibility to help bring down bills and system costs.
- **Resilience:** ensure the system is resilient to market shocks such as the gas crisis and that the sector is investable.
- **Quality and standards:** suppliers are able to, at a minimum, meet the required service standards, helping customers engage with an increasingly complex market.

⁴⁰ Ofgem (2023), 2023/24 Forward Work Programme, <https://www.ofgem.gov.uk/publications/202324-forward-work-programme>

- 4.21 The competition framework⁴¹ also helps us to assess the impact of our policies on the market, considering the impacts on a number of indicators across:
- **Consumer engagement and empowerment:** such as price dispersion, customer satisfaction and switching rates,
 - **Market Rivalry:** such as market shares, profitability, new entrants,
 - **Structural parameters of the market:** such as interest rates, opportunity costs to exit, capital requirements, smart technology take-up.
- 4.22 Through their CFE on the future of default tariffs, DESNZ is considering what types of tariffs different groups of customers should default onto. Ultimately, the future of price protection should be coherent with the future of default tariffs, including any legislative changes which are made. At this early stage, we are therefore also mindful of the draft principles included in DESNZ's CFE:
- **Principle 1** – The market should be free to reward households for using electricity smarter,
 - **Principle 2** – Default tariffs should protect consumers from unnecessary complexity and costs,
 - **Principle 3** – Households should not be exposed to excessive costs from the inefficient use of high-consuming items by other consumers.

Options for evolving price protection

- 4.23 We do not present all potential options, rather a range of them to encourage discussion. Options could be implemented independently, or a number used in combination to meet the needs of different segments of the market. For example, EV owners could be exposed to ToU price cap (for electricity consumption) whilst other customers stay on a flat price cap, or the current stringent, flat cap could be restricted to low income/vulnerable consumers, with other consumers having looser price protection. Different approaches exist in different countries, and a few international examples are discussed in Appendix 2.
- 4.24 As we flagged in the Executive Summary, some of the options described could be implemented under the existing statutory framework, while others may require legislative change. To facilitate open discussion, we have outlined proposals

⁴¹ Ofgem (2023), A competition framework for the household retail market, <https://www.ofgem.gov.uk/publications/competition-framework-household-retail-market>

without limiting ourselves to what could be implemented under the current statutory framework.

Options that move away from a flat cap

- 4.25 As set out above, there are two potential ToU price caps – static and dynamic. It is important to note that such approaches would likely apply only to electricity and could only be applied to customers with smart meters.

Static ToU

- 4.26 A static ToU price cap would have a number of time bands, for example, there could be two weekday periods and two weekend periods with each day divided between peak and off-peak hours. A larger number of time bands is possible but would add to complexity both for customers and to administer. The tariffs for each period could be set quarterly, as per the existing cap.
- 4.27 This would be a more prescriptive approach to ToU price capping than the current application of the price cap to static ToU tariffs such as Economy 7 (see Box 5).
- 4.28 A static ToU cap would help to address the variance in costs facing suppliers after the introduction of MHHS, although not as fully as a dynamic ToU price cap.
- 4.29 ToU pricing reduces customer cross-subsidisation and creates incentives to shift demand away from predicted peak times, lowering costs for all customers. Simple time bands may help facilitate consumer engagement and reduce their exposure to the peakiest price events.

Dynamic TOU

- 4.30 A dynamic ToU price cap would likely combine non-dynamic tariff elements, calculated in the same way as the existing price cap, alongside unit rates based on market prices set a day ahead. To simplify, half-hourly periods could be grouped as per the example for static TOU above. However, dynamic rates for each period would be updated daily to reflect market prices using a published index.
- 4.31 By substantially reducing the risk of suppliers being exposed to costly consumption patterns of their customers, a dynamic ToU tariff would likely enable lower headroom and profit allowances. It could also reduce suppliers' hedging requirements and the associated costs.
- 4.32 Dynamic ToU tariffs would maximise the incentives to align household electricity demand with market conditions, delivering a more stable and low-cost energy system. However, it does mean exposing customers to wholesale price variability.

And the peak prices would not always be predictable, as they would often be determined by weather patterns. Such price signals would incentivise price cap customers to shift demand away from peak times, lowering system costs for all. However, many consumers may struggle to engage with constantly evolving pricing. The scope for more granular pricing may depend on whether automation is widespread among default tariff customers.

- 4.33 Exposing all electricity consumers to dynamic pricing may cause some issues for vulnerable and/or disengaged consumers, so this option may only be appropriate for consideration in combination with another option, such as retaining a flat price cap for low income / vulnerable consumers.
- 4.34 More generally, there could be concerns for all customers of exposing them to potentially very high wholesale peak prices at times of system stress. An absolute cap, at a very high price, could be retained to protect consumers from such extremes, but would entail additional costs for suppliers to be recovered.

Options that move away from a universal cap

Targeted cap based on vulnerability

- 4.35 The challenges of maintaining the existing flat universal price cap as customer diversity increases could be managed by restricting access to that cap to a subset of customers, for example, low income or vulnerable customers. Indeed, prior to the existing universal price cap, Ofgem introduced such a cap, the safeguard tariff for PPM and Warm Home Discount (WHD) scheme-eligible customers.
- 4.36 This option would not address energy affordability issues as, with the existing price cap, it would simply pass through costs and would not include a cross subsidy. However, it could be combined with affordability interventions.
- 4.37 Inactive customers that are not eligible for the targeted cap could be protected by looser forms of price protection, as set out below.
- 4.38 We would not envisage having significant ToU elements to such a targeted price cap, so it would not encourage flexibility for the targeted group (who could always choose ToU tariffs in the competitive market if they wished to).
- 4.39 The primary implementation issues will be defining and identifying the eligible cohort of vulnerable customers for the targeted cap. The easiest approach would be to use an existing proxy such as WHD eligibility or Priority Service Register data, but more sophisticated options (such as houses with high energy demand or poor efficiency) could deliver more effective targeting.

Bottom-Up Cap excluding customers with certain ToU or type of use products

- 4.40 A key risk with the existing price cap is that high usage customers such as EV owners who do not wish to smart charge, sit on the price cap imposing their high consumption costs on others. This could be addressed by excluding EV owners from access to a flat price cap.
- 4.41 This would also reduce the impact of MHHS as a driver of variation in suppliers' costs as suppliers will be able to recover the costs of highly inefficient customers directly. Other drivers of variances, such as varied bad debt costs, will remain.
- 4.42 Those excluded could be offered a ToU version of the price cap or left to access competitive deals in the retail market. Having characteristics such as being EV owners enables them to achieve competitive tariffs that would incentivise them to use their asset efficiently, reducing total system costs. There is a risk that this disincentivises the take up of low carbon technology and/or smart meters if consumers perceive it to be more risky as they are not able to access the price cap.
- 4.43 Identifying consumers could be challenging for suppliers but it could be done through a combination of information gathering on the type of flexible technology they have, their demand profiles (through smart meter data) or the type of tariff they are defaulting from. Careful design would be required to ensure that high consuming vulnerable customers, such as those with medical devices, are suitably protected, either by the cap or an affordability measure.

Options that move away from a stringent cap

Market Basket Cap

- 4.44 A form of relative price cap, the Market Basket Price Cap would limit default tariffs based on average tariffs in the competitive market. It is, in theory, a much simpler, more market-driven approach than the existing cap, which could benefit supplier resilience while retaining some of the strength of customer protection. Customers wouldn't need a smart meter to be protected by this cap.
- 4.45 It relies on there being a degree of competition in a segment of the market to set fair prices. It also relies on that segment being sufficiently valuable for there to be an incentive for suppliers to continue competing in this segment once it is influencing their default tariff revenues.
- 4.46 There are several related design choices to be made:

- The permitted variance from the market basket benchmark
 - Whether there are multiple baskets creating caps on different types of tariff (eg TOU)
 - Tariff eligibility for inclusion in the market basket(s) (such as contract length, tariff eligibility, when the tariff was available etc.)
 - Timelines for observation of tariff prices and application of the restriction
- 4.47 There are risks that the Market Basket Price Cap, depending on the specific design, is either ineffective in protecting consumers (if a large variance is used) and/or could create risks to supplier resilience (if a small variance is used to account for the increasingly differentiated cost to serve).
- 4.48 Designing a market basket is to some extent open to gaming, as suppliers would be able to influence the reference price through their own tariff setting. It could also be complicated by the increasing fragmentation of the market as new ToU and innovative tariffs proliferate.

Within Supplier Relative Cap

- 4.49 A Within Supplier Relative Cap would require suppliers to set their default tariff to be no higher than a permitted variance above their cheapest available tariff.
- 4.50 Ofgem would define the criteria for the lowest price tariff and the permitted variance. There could be multiple categories of tariffs and therefore multiple caps to account for different types of tariffs. Some criteria for the lowest price tariff to be considered would include: contract length, tariff eligibility and type (eg single or multi rate). The permitted variance could be an absolute value or a percentage or the lowest price tariff.
- 4.51 It has been considered as an alternative to the absolute cap since it was first debated. We, for example, sought evidence on it as part of our call for input in December 2021.⁴² This option received some support from stakeholders for its ability to allow suppliers to maintain control over their hedging strategies and to encourage innovation, while linking the tariffs faced by disengaged consumers to the cheaper tariffs brought about by competition.
- 4.52 Depending on design, it could accommodate a range of tariff types and support flexible tariffs and demand shifting. And this option supports retail market resilience as it provides suppliers with full control of pricing for all their

⁴² Ofgem (2021), Adapting the price cap methodology for resilience in volatile markets
<https://www.ofgem.gov.uk/publications/adapting-price-cap-methodology-resilience-volatile-markets>

consumers. Our primary concern with a within-supplier relative cap are the perverse incentives it may create, including the risk of gaming. It could create an economic incentive for suppliers to increase the prices in their cheaper tariffs rather than reducing the rates of their higher priced default tariffs. This effect could be especially strong for suppliers that have a more disengaged customer base, a trait that trends with vulnerability.

- 4.53 As with the market basket cap, design and implementation of this option is likely to be challenged by the reduction in the number of fixed tariffs currently offered, reducing the sample size to set a cap relative to, and increased tariff diversity, reducing tariff comparability.

Ban on Acquisition-only Tariffs

- 4.54 The Ban on Acquisition-only Tariffs (BAT) requires suppliers to offer the same tariffs to all customers (both new and existing).
- 4.55 Ofgem introduced a BAT in April at the height of the gas crisis to promote market stability. Last month, with markets stabilising, Ofgem announced its decision to remove the BAT, following an extension for up to another 12 months.⁴³ That consultation will consider the role of the BAT in the current market. Here, we consider the BAT's potential role in a future market.
- 4.56 In the absence of an absolute price cap, the BAT may reduce prices for default customers as suppliers may be less likely to charge default tariff customers a premium to subsidise below cost acquisition tariffs. Default tariff customers could, nonetheless, still be used to subsidise below cost tariffs offered to all customers on the assumption that they would be unlikely to take up the tariffs offered. In this respect, the BAT has a much weaker impact on reducing price discrimination than a relative price cap.
- 4.57 However, there are drawbacks to the BAT. Despite promoting sustainable competition, it also has a more general dampening effect on competition as it reduces customers' incentive to switch. This can have a knock-on impact on innovation as the incentive to launch innovative offerings to attract new customers is reduced.

⁴³ Ofgem (2024), Future of Market Stabilisation Charge after March 2024, <https://www.ofgem.gov.uk/publications/future-market-stabilisation-charge-after-march-2024>

4.58 The BAT could replace the current cap or supplement price protection options set out in this discussion paper. It does not necessitate consumers to have a smart meter.

Margins Cap

4.59 Different to a bottom-up cap, a margins cap would act to limit only the profits that suppliers can make. There are several ways that this could be applied:

- Considered on a per tariff basis, where suppliers would have to show evidence to Ofgem's satisfaction that they have set a tariff at a level that will not result in excessive profits. This would allow margin capping of a subsection of tariffs but would be challenging to introduce in a way that couldn't be gamed – suppliers generally don't allocate all costs on a per tariff basis so significant judgment would be required in the allocation of shared costs such as overheads.
- Considered on aggregate through ex-post review of announced profits. If a supplier exceeds the profits allowed, remediation plans and penalties would be considered. An ex-post review of total profits could be less effective at protecting consumers as the harm is identified and addressed after it has materialised. It could be challenging to provide redress to the customer that experienced the harm.

4.60 There could also be challenges in accurately identifying profits from the domestic retail business in a supplier that is part of a larger business with shared functions and transfer payments between divisions.

4.61 Whilst a margin cap would limit price exploitation, it also removes most efficiency incentives as suppliers do not have the potential of greater profit to incentivise efficiency, although they would still want to minimise costs assuming they wished to compete effectively in the competitive segment of the market.

4.62 Further, without an equivalent cap on downside risk, a margins cap could impede investment in the sector. The magnitude of this risk would depend on the level of the margin cap – a higher cap would have a far lesser impact on investment than a tight cap.

5. Next steps and related publications

- 5.1 In this discussion paper, we have set out our views around the successes and challenges of the existing cap and on the desirability and feasibility of future price protection options as MHHS is implemented. We are seeking views and evidence from stakeholders on the considerations presented and will use this to inform our thinking. The deadline for responses is 10 May 2024. Please send your response to the person or team named on this document's front page.
- 5.2 We have worked with DESNZ on this discussion paper and their CFE. This publication is designed to complement their CFE. Ofgem and DESNZ will consider responses to both papers as we continue to work closely on building a future retail energy market that works in the interests of consumers.
- 5.3 The considerations presented in this discussion paper also have interactions with other aspects around consumer price protection which we are reviewing such as the affordability and debt, and standing charges calls for input. We will consider responses to such related calls for input in the context of responses to this discussion paper and vice versa when considering next steps for these related workstreams. We will consult further as our thinking develops.
- 5.4 Related publications:
1. DESNZ Call for Evidence: [Default energy tariffs for households: call for evidence - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/default-energy-tariffs-for-households-call-for-evidence)
 2. Price cap programme of work: [Price Cap - Programme of Work: Update | Ofgem](https://www.ofgem.gov.uk/price-cap-programme-of-work-update)
 3. Affordability and debt call for input: [Affordability and debt in the domestic retail market \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/affordability-and-debt-in-the-domestic-retail-market)
 4. Standing charges call for input: [Standing charges – call for input | Ofgem](https://www.ofgem.gov.uk/standing-charges-call-for-input)
 5. BAT extension: [Future of Ban on Acquisition-only Tariffs post-March 2024 decision | Ofgem](https://www.ofgem.gov.uk/future-of-ban-on-acquisition-only-tariffs-post-march-2024-decision)

Appendices

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Appendix 1 - Review under section 9 of the DTCA

- A1.1 In conjunction with the broader discussion in this paper on future price protection, we set out in this appendix how we will approach the requirement under section 9 of the DTCA to carry out regular reviews of domestic energy pricing to determine whether there are domestic customers in need of protection.
- A1.2 Section 9 of the DTCA requires Ofgem to review domestic supplier pricing practices to determine whether certain groups of domestic customers that are, or may in the future be, on default tariffs, including vulnerable customers, are in need of protection from excessive charges or an excessive price differential when moving from a fixed price tariff.

Legislative context

- A1.3 Previously, under the DTCA, Ofgem was required to review the domestic electricity and gas supply market to assess whether conditions for effective competition (“CFEC”) were in place. Ofgem was then required to produce and publish a report on this and recommend whether or not it considered that the tariff cap conditions should be extended to have effect for the following year. The latest report⁴⁴ was published by Ofgem on 4 August 2022, which recommended that the cap should be extended to the end of 2023.
- A1.4 The Energy Prices Act 2022 repealed this requirement and amended section 9 of the DTCA to require Ofgem to conduct reviews, at intervals we consider appropriate, into pricing practices of domestic suppliers and whether there are categories of domestic customers for whom protection against excessive pricing should be provided. If, following a review, Ofgem concludes that protection should be provided, it must take the steps it considers appropriate, using its powers under the Gas Act 1986 and the Electricity Act 1989.
- A1.5 We have not yet conducted a section 9 review, and the intention is not to directly replicate the previous Conditions for Effective Competition (CfEC) review. Nevertheless, we expect that it would be informative for a section 9 review to assess the kind of measures of competition that were performed as

⁴⁴Ofgem (2022) Outcome of 2022 review into whether conditions are in place for effective competition in domestic supply contracts <https://www.ofgem.gov.uk/publications/outcome-2022-review-whether-conditions-are-in-place-effective-competition-domestic-supply-contracts>

part of the CfEC process. However, a section 9 review also includes specific questions relating to default tariffs.

- A1.6 The decision on when it is appropriate to conduct a review under section 9 of the DTCA is separate to the wider discussion on options for evolving the cap in the future, which we are seeking to stimulate through publication of this paper. Nevertheless, our current intention is to use evidence gathered from this discussion paper to inform a future review conducted in accordance with section 9 of the DTCA.

Potential issues to be covered by review

- A1.7 Ofgem is required to consider whether there are categories of customers that pay, or may in the future pay, default tariffs for whom protection against excessive charges should be provided. In doing so, Ofgem must consider whether there are customers that would suffer an excessive tariff differential when moving from a fixed rate to a default tariff and whether protection should be provided to them, including vulnerable customers. Tariff differentials are not per se detrimental to consumers, they are one way to incentivise engagement which can support a well-functioning competitive market which benefits all consumers.
- A1.8 However, in the more sustainable market we expect to see following the introduction of our financial resilience measures, tariff differentials may not in the future provide such a strong incentive for customers to engage in the market. Competition may be more closely linked to non-price considerations such as new products and services. The key question for the review to consider is whether there are circumstances where tariff differentials are “excessive” (to be defined by the review) and whether the cap mitigates it.
- A1.9 In a well-functioning market, competition should also be able to protect customers from excessive charges, and therefore the interaction of the cap with competition needs to be considered when conducting the review. To do this, we will use our Competition Framework⁴⁵, which defines the key themes of competition in the retail market, to ensure that the cap is consistently assessed against the same parameters as other interventions.
- A1.10 A review will also consider the distributional impact of supplier pricing on different categories of consumers, acknowledging that charges may cause

⁴⁵ Ofgem (2023), A competition framework for the household retail market
<https://www.ofgem.gov.uk/publications/competition-framework-household-retail-market>

disproportionate levels of detriment to some categories of consumers, especially those in vulnerable circumstances. The review would draw on related workstreams, such as the affordability and debt calls for input, as we consider these questions and if any additional protection should be provided for such customers.

Timing of review

- A1.11 We will consider when it is appropriate to conduct a review under section 9 of the DTCA, taking into account, among other factors, supplier pricing considerations mentioned above (which may in part be informed by evidence gathered from this discussion paper) and the future of the BAT. The BAT influences supplier pricing strategies by requiring suppliers to offer new and existing customers the same tariffs. This has the effect of removing from the market the cheapest “acquisition” style fixed term tariffs exclusive to new customers, thereby reducing the tariff differential with default tariffs. In February, Ofgem announced its decision to extend the BAT for another 12 months until March 2025 and to consult on shortening this extension to six months.
- A1.12 We consider however there could be benefits from conducting a review by the end of this year ahead of any changes related to the implementation of MHHS, such as the options currently being explored by DESNZ in their CFE.
- A1.13 Ahead of conducting the initial review, we plan to publish an open letter outlining the proposed approach to the review to enable stakeholders to input. We would conduct subsequent reviews at regular intervals. We would welcome any feedback in response to this consultation on the nature of the analysis that should be undertaken as part of a review under section 9 of the DTCA.

Appendix 2 – International Approaches to Price Protection

A2.1 This appendix provides some examples of price protection adopted in other countries, highlighting that price protection models can be combined and take a variety of forms. It is worth noting that while protected ToU tariffs are quite widespread, we are not aware of a within-supplier or market relative energy price cap being adopted by other countries.

France

A2.2 France has a long history of offering ToU electricity tariffs to domestic consumers, including in regulated tariffs which are contracted by around 60% of households (2023).

A2.3 Two main options are available for consumers to choose from on the regulated market:

- Most consumers are on simple ToU tariffs splitting the day between a peak period (16 hours) and off-peak period (8 hours).
- A more complex option involves critical peak pricing with the unit rate price depending on both the time of day and the day itself. Twenty-two days per year with the highest cost of supply are subject to peak pricing, with consumers notified of peak pricing events the day before.

A2.4 In the above tariffs, unit rates for energy consumed are set by the regulator but differ according to ToU. French consumers also pay standing charges, which differ depending on the amount of maximum power (in kW) contracted with their supplier – a consumer with a higher ‘capacity’ connection pays a higher standing charge.

A2.5 The French regulator also actively regulates tariffs available on the free market, including ToU tariffs. Dynamic ToU tariffs are authorised so long as the consumer’s monthly bill does not exceed twice what they would pay on a regulated tariff. Likewise, the ratio between peak and off-peak unit rates cannot exceed seven in ToU tariffs.

Spain

A2.6 Spain introduced the Voluntary Price for the Small Consumer (the Spanish acronym being PVPC) in 2014. The PVPC is a dynamic ToU tariff with unit rates changing every hour, and the price for each period is announced by the

regulator every evening for the next day. It is a regulated, electricity only tariff available for consumers to choose and currently a third of all domestic consumers have elected to join the PVPC.

- A2.7 Dynamic pricing only applies to the wholesale element of consumer bills. Other costs, mainly transport and policies, are based on static ToU tariffs with the day divided between three periods – off peak, standard and peak. Consumers also pay for a contracted power charge (in KW), which is split between two peak and off-peak periods.
- A2.8 The PVPC is uncapped, meaning that wholesale costs are fully passed on to consumers. However, high and volatile prices observed during the gas energy crisis led the Spanish regulator to amend the calculation for wholesale costs in the PVPC. From January 2024, this includes a link to both day-ahead and (less volatile) futures prices.
- A2.9 Vulnerable consumers are also eligible for a discount on the PVPC price. The standard rebate is 25% but an exceptional discount of up to 80% was introduced during the gas energy crisis and was available until 31 December 2023.

The Netherlands

- A2.10 In September 2002, the Netherlands introduced a retail price cap to reduce exposure for consumers to high energy prices. Both domestic users and small businesses are eligible.
- A2.11 The cap is set as a maximum unit rate for gas and electricity, with a separate rate for district heating. Suppliers can claim back the difference between the cap and actual supply costs, from the government.
- A2.12 However, the cap applies to specific levels of consumption: the capped unit rate is only valid for electricity consumption up to 2.9 MWh per year. For consumption above these levels, users are charged at the price agreed in their contract with their suppliers.

Appendix 3 – Summary of questions

Please provide answers to the questions below alongside any other relevant comments and evidence. Please provide as much detail as possible to support your input.

Evaluating the cap today

Q1. Do you have any reflections on our list of the cap's successes and challenges?

Evaluating the current cap for the future

Q2. Do you believe that the growing diversity of electricity consumption patterns will make it challenging to retain a flat, universal and stringent price cap? How quickly do you think this will materialise and with what impacts? What evidence can you provide to support your view?

Q3. What plans do suppliers have to launch ToU tariffs and to incentivise customers to shift their electricity consumption once MHHS is implemented?

Q4. How quickly and at what scale do you expect customers, especially those with large flexible loads such as EV and solar / battery users, to take up ToU tariffs once MHHS is implemented?

Q5. In addition to the factors set out in this chapter, are there any other important changes that might affect the ability of the current default tariff cap to achieve its objectives?

Options for evolving price protection for the future

Q6. Do you agree that we need to retain some form of price protection in the retail market?

Q7. Do you have views on which of the three key parameters – the cap being flat, universal and stringent - should be relaxed when considering future price protection options?

Q8. What are your views on options discussed? Do you have any preferred options or combination of options?

Q9. In particular, which options or combination of options do you think would best protect vulnerable customers?

Q10. How should consumers with large flexible loads, mainly EV and solar / battery users, be treated with regards to future price protection?

Q11. Are there any additional options that we haven't, but should be considering?

Appendix 4 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name, address, and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. ie a consultation.

4. With whom we will be sharing your personal data

Ofgem may share your personal data with DESNZ as part of our efforts to work together on the future of price protection

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for 6 months after the project is closed

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services

- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas (Note that this cannot be claimed if using Survey Monkey for the consultation as their servers are in the US. In that case use “the Data you provide directly will be stored by Survey Monkey on their servers in the United States. We have taken all necessary precautions to ensure that your rights in term of data protection will not be compromised by this”.

8. Your personal data will not be used for any automated decision making.

9. Your personal data will be stored in a secure government IT system. (If using a third party system such as Survey Monkey to gather the data, you will need to state clearly at which point the data will be moved from there to our internal systems.)

10. More information For more information on how Ofgem processes your data, click on the link to our “[ofgem privacy promise](#)”.

Appendix 5 – Glossary

Default tariff

The deals that consumers move onto once a contract expires or if they have yet to proactively choose a tariff including when moving into a new home or when a fixed term contract ends.

SVT – Standard variable tariff

Alternate expression for a default tariff (this paper refers to both terms collectively as a 'default tariff').

The default tariff cap ('the cap')

The maximum standing charge and unit rate a supplier can set on their default tariffs, which translates into a maximum energy bill for a given consumption level.

Market-wide Half-Hourly Settlement (MHHS)

Settlement system based on site-specific reconciliation using half-hourly meter readings. Suppliers' wholesale costs will depend on customers' actual consumption at half-hourly intervals.

Department for Energy Security and Net Zero (DESNZ)

Government department responsible for delivering security of energy supply, ensuring properly functioning energy markets, and identifying and pursuing net zero opportunities.

Single-rate pricing

When the same price for each unit of electricity is paid regardless of what time of day it is used.

Time/Type of Use (ToU) tariff

Tariffs that charge consumers different amounts per unit of electricity depending on the time of day, fluctuating due to times of lower and higher demand. There are two types: dynamic and static. Dynamic ToU follow the wholesale market, moving prices up as wholesale costs increase while static ToU refers to tariffs with 2 different rates: peak and off-peak.

Standing charge

Standing charges are a fixed daily amount that customers pay to their suppliers to cover fixed costs which include network, administration, and asset fees.

Unit rate

This is the rate charged per unit of electricity or gas a consumer uses.

Wholesale electricity prices/costs

This is the price at which suppliers buy the electricity they use to supply to end consumers. It is the largest single component of a typical consumer bill.

Energy Price Guarantee (EPG)

From 1 October 2022 up until 30 June 2023, the Energy Price Guarantee provided a support rate discount to all households with a domestic gas and/or electricity contract. This scheme supported customers during the period of the gas energy crisis.

Notional supplier

The assumed archetype for an efficient supplier for whom the cost allowances within the cap would be accurate.

Direct Debit

A payment method for energy bills whereby an automatic monthly payment is set up with the customer's bank or building society. The regular payment amount is commonly calculated using projected energy use based on historical usage.

Standard credit (SC)

A payment method for energy bills whereby a customer directly pays the appropriate amount upon receiving the gas or electricity bill.

Prepayment Meter (PPM)

A payment method for energy bills whereby the customer pays for a certain amount of energy before it is used, on a pay-as-you-go, credit basis. Credit is then deducted from the meter with use.

Debt-related costs

The costs incurred by a supplier in the face of debt and arrears accumulated by customers. This includes bad debt (revenue written off due to delinquency), debt

administration (including chasing and collecting debt), and working capital costs (to cover the cost of payment in arrears).

Network costs

These include the costs to build, maintain, and operate the gas pipes and electricity wires run by the network companies who transport energy to the customer's property.

The gas crisis

Refers to the surge in the wholesale price of natural gas in part due to reduced supply and storage in central Europe due to Russia's invasion of Ukraine in 2022.

Ban on Acquisition-only Tariffs (BAT)

The supplier requirement preventing new, often lower tariffs being offered to new customers only.

Market Stabilisation Charge (MSC)

The temporary requirement for domestic suppliers who acquire domestic customers to pay a charge to the losing supplier when wholesale prices fall below the wholesale price cap index.

Hedging

Suppliers often purchase energy in advance of deployment to customers to lock in prices, protecting themselves against potential price volatility closer to the time of delivery.

Supplier of Last Resort (SoLR)

A safety mechanism to ensure consumers' gas and electricity supplies are not disrupted as Ofgem switches these customers to a new supplier with no interruption.

Fixed term tariff

A tariff with specific terms applying to the contract conditions. Usually these lock-in a price for a fixed period, among other services.

Low-carbon technologies (LCT)

Sources of energy production that emit a small amount of greenhouse gases eg solar or wind power.

Green tariff

A tariff that is promoted primarily on the basis of its association with renewable energy sources and/or climate change mitigation.

Review of Electricity Market Arrangements (REMA)

As part of the British Energy Security Strategy, the UK government launched the REMA programme in April 2022. REMA aims to identify and implement reforms to GB electricity markets to unlock the necessary investment in, and drive efficient operation of, a secure and low carbon electricity system.

Contracts for Difference (CfD)

The CfD scheme is the government's main mechanism for supporting low-carbon electricity generation. Under the CfD scheme, renewable generators receive a fixed price for their energy. Suppliers incur costs or benefits from the CfD scheme depending on whether there is a positive or negative difference between the wholesale price and this fixed price, leading to CfD generators making or receiving payments.

Locational pricing

Under locational pricing, wholesale prices reflect the locational value of energy at different points across the network. Wholesale electricity prices would reflect the marginal cost of generating the electricity, the losses incurred in transmission, and the cost of any network congestion.

Economy 7

Economy 7 is a multi-rate electricity tariff with cheaper rates during off-peak hours and more expensive rates during peak times.

Volume effect

A dynamic whereby an increase in energy prices results in customers using less energy while suppliers have a significant energy supply due to hedging.

Backwardation

Backwardation is the situation that arises when an energy supplier pays more in wholesale costs than what it can charge customers. Backwardation costs result from the difference between the index used to set the cap level and the way suppliers are able to purchase energy for their cap customers.