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## CONFIDENTIAL

Dear Dan

### Future Price Protection Discussion Paper<sup>1</sup>

Centrica very much welcomes the opportunity to respond to this important discussion paper. Ofgem's consultation is timely given DESNZ's recent call for evidence on the future of default tariffs in the context of Market-wide Half Hourly Settlement (MHHS)<sup>2</sup> and Ofgem's own call for input consultation on debt and affordability.<sup>3</sup>

Centrica's purpose is energising a greener, fairer future. As such, we support continued price protection for customers on default tariffs to provide confidence that pricing is fair in relation to underlying costs. But we also strongly agree with Ofgem that a cost reflective price cap is not and cannot be a mechanism to ensure affordability. Targeted help for those who need it, funded via progressive taxation rather than levies on bill payers, is already a pressing issue and will become ever more important in the context of energy transition.

We agree with Ofgem that retaining a flat, universal and stringent cap is increasingly unsustainable, and that some appropriate and considered reform is necessary; in short, the price cap needs to evolve to support a just and fair transition.

Taking each of the three dimensions Ofgem considers in turn:

- **Universal price protection through the default tariff cap should continue – but on a simplified basis.** We think price protection should continue to apply to all customers on default tariffs to provide confidence that prices remain fair in relation to

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<sup>1</sup> [Future Price Protection Discussion Paper | Ofgem](#)

<sup>2</sup> [Default energy tariffs for households: call for evidence - GOV.UK \(www.gov.uk\)](#)

<sup>3</sup> [Affordability and debt in the domestic retail market – a Call for Input | Ofgem](#)

underlying costs. We also think price protection should aim for simplification to help customers better understand and engage with the relationship between how they use energy and how much they pay for it. In particular, we advocate phasing out standing charges on default tariffs and ending the current postcode lottery of regional price differentials.<sup>4</sup>

- **Ofgem should not mandate a Time of Use cap in the near term.** We favour incremental and progressive change to enable consumers to adopt flexible tariffs of their own volition. There may come a time when default tariffs based on Time of Use (ToU) need to become the norm rather than the exception, but we don't believe immediate radical change is necessary or appropriate. Rather, we would suggest short term focus should be on simplifying the price cap as described above. In the initial stages of MHHS we expect there will be strong market incentives to encourage customers who can adopt flexible tariffs that reward load shifting to do so while protecting other customers from uncertain price impacts they cannot effectively respond to. However, the cap must enable suppliers to recover efficiently incurred costs and provide sufficient competitive headroom to enable suppliers to incentivise those customers with the ability to flex consumption to make financial savings by adopting non-default ToU tariffs
- **Ofgem's current approach to 'stringency' requires review.** We support the principle of a cost-reflective 'bottom-up' cap. But the level at which the cap is set must reflect the real costs and risks suppliers face and allow scope for competition, innovation and differentiation on non-default tariffs. This requires i) a fresh look at the approach to benchmarking the presumed level of efficient cost for individual cap components; ii) a review of what constitutes an appropriate allowance for risk and uncertainty, and; iii) reconsideration of the need for competitive headroom. It does not mean switching to a relative price cap or a margin cap [REDACTED]  
[REDACTED] As Ofgem notes, a relative cap or market basket cap risks creating perverse incentives and opportunities for gaming while a margin cap would risk undermining much needed investment.

This response should be read in conjunction with our recent response to DESNZ's parallel consultation on future default tariffs, which we enclose for reference. We have responded to individual consultation questions in the accompanying appendix to this response. As strong supporters of continuing price protection for all customers on default tariffs in conjunction with separate targeted intervention to address affordability, we look forward to continued engagement with Ofgem as its thinking on future price protection develops.

Don Wilson  
**Retail Market Design and Policy**

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<sup>4</sup> We continue to seek to ensure that wholesale electricity market reforms are complementary to – and at least compatible with – the retail electricity market. As part of the Review of Electricity Market Arrangements (REMA), DESNZ is continuing to consider zonal wholesale pricing which will further increase price differences consumers pay and make the market more complicated for consumers to navigate

<sup>5</sup> [REDACTED]

<sup>6</sup> [REDACTED]

## Appendix: consultation questions

### *Evaluating the cap today*

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

Ofgem suggests the cap has succeeded in:

- Incentivising efficiency gains;
- Protecting disengaged customers from price exploitation, and;
- Protecting consumers without stifling competition for engaged customers.

On the other hand, Ofgem accepts that the gas crisis has exposed limitations and challenges associated with the cap methodology in the following areas:

- 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 growing levels of bad debt.

We recognise the challenges Ofgem describes (some of which are a consequence of the current approach to stringency rather than bottom-up design) but have a more nuanced view regarding claimed successes.

Ofgem's assertion that the cap has incentivised efficiency requires qualification. Firstly, it is not the case that suppliers lack incentives to operate efficiently in the absence of the cap. Competition provides incentives to improve efficiency irrespective of any price cap. Secondly, even if forced cost reductions in indirect/operating costs may be due in part to a stringent price cap they cannot be assumed to be synonymous with increased efficiency. The fact that aggregate supplier profitability has been negative since 2019<sup>7</sup> not only suggests a lack of 'price exploitation' but also points strongly to an unduly low 'efficient' benchmark.

We agree that the cap may have benefited disengaged customers in the short term despite the fact that the differential between average SVT and average fixed tariffs did not initially narrow. In part, this reflects the presence of suppliers pursuing unsustainable business models (as Ofgem correctly notes). Structural timing issues impacting wholesale costs under the cap compared to fixed term contracts also cast doubt on the simple 'loyalty penalty' narrative and the utility of price differentials as a performance indicator. Differentials widened when wholesale prices were in decline, but that position dramatically reversed in the face of steeply rising and high wholesale prices subsequently.

Ofgem notes that *"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"*. In the event, other factors (unsustainable business models and declining wholesale costs) prolonged saving opportunities from switching in the early days of the cap. Competition was not completely stifled though it may nevertheless have been dampened (this is wholly unsurprising given that the logical corollary of a reduced 'loyalty penalty' measured by price differentials is reduced incentive for customers to switch).

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<sup>7</sup> Figure 3 presents latest Ofgem data up to 2021

We agree that the precise impacts of overlapping market interventions since the energy crisis began to bite are hard to disentangle. However, we would caution against viewing such interventions only through a lens of dampening short term price competition without also considering the longer-term consumer interest in market stability. Service competition is also increasingly important following a period prior to the cap's introduction where a narrow focus on price competition underplayed the importance of non-price competition and differentiation.

### *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?*

We agree that the cap faces some challenges and needs to evolve. We also strongly agree with Ofgem that the cap is not designed to be a mechanism for tackling affordability, which requires other targeted interventions.

We think price protection should remain in place for customers on default tariffs to provide consumer confidence that prices provide a fair reflection of underlying costs. We do not think it is necessary or appropriate to move immediately to a time of use price cap with the advent of MHHS. However, we see two key reforms as necessary to enable consumers to understand the value of flexibility and maximise the system benefits to all customers.

- First, **Ofgem should simplify the price cap by phasing out standing charges on the default tariff and removing unwarranted regional differentials which result in a postcode lottery.** This requires a fresh look at network charges as well as the detailed design of the cap itself. Simplification along these lines will help consumers engage by linking energy costs more clearly to consumption – a necessary precursor to engaging with more sophisticated time of use tariffs.<sup>8</sup>
- Second, **Ofgem needs to revisit the 'stringency' of the cap without abandoning the 'bottom-up' approach to calibration.** Ofgem is right to recognise that suppliers will face additional risks as a result of MHHS and need to be able to respond by incentivising customers with flexible loads to adopt appropriate time of use tariffs. If the cap is set at a level which leaves insufficient headroom to offer material savings to customers who use energy flexibly, system costs will increase which will ultimately result in higher prices. An appropriately calibrated cap which recognises additional risks while allowing suppliers to innovate and encourage customers to adopt flexible, competitive tariffs, offers the best prospect of incentivising flexibility while still providing backstop protection for customers who cannot easily respond to granular time of use price signals.<sup>9</sup>

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

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<sup>8</sup> For further details please see our response to the recent call for input on standing charges.

<sup>9</sup> Ofgem's recent update to its price cap programme of work signals a review of wholesale allowances in the context of MHHS which we trust will partly address this issue, though reviews of other cap allowances including operating costs and headroom are also relevant.

We would expect suppliers to respond to MHHS by actively promoting flexible tariffs that enable and encourage customers to shift consumption towards times when power is cheap and away from times when it is expensive.

*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?*

As noted above, we would expect suppliers to promote tariffs that reward flexibility. We would expect competition to ensure that such tariffs are attractive to customers with large and flexible loads so that they take them up and manage their flexible loads accordingly. However, it is difficult at this stage to predict the precise scale and pace of uptake since this will depend on a range of external factors – including Ofgem decisions on the future price cap methodology and level.

*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?*

It is important to be clear what the objectives of the price cap are. We support continued price protection to provide consumers with confidence that default tariffs they have not actively chosen are fair in relation to underlying costs. This is not the same as guaranteeing that prices are universally affordable, especially in the midst of a cost-of-living crisis and with energy costs likely to remain above historic levels for some time.

We therefore underline the need for separate targeted support to ensure affordability for those in greatest need. Such support should be funded through progressive taxation rather than regressive levies on energy bills. We appreciate that policy decisions on such matters rest with government rather than Ofgem. Nevertheless, it is important for Ofgem to make clear to government what it can and cannot do within its specific remit as a sectoral regulator. We expect Ofgem to work with Government to underline the need for separate, targeted intervention recognising that price cap was not designed to address affordability concerns, but rather to address issues of a fair price for default customers. As Ofgem has noted in its parallel call for input on affordability “*The price cap reflects the underlying costs of supplying energy to consumers but cannot subsidise the cost of energy.*”<sup>10</sup>

*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?*

Yes, we agree that broad price protection for all customers on default tariffs should be retained while acknowledging that price cap methodology needs to evolve in the light of experience and new challenges ahead.

*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?*

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<sup>10</sup> [Affordability and debt in the domestic retail market – a Call for Input | Ofgem](#)

We agree with Ofgem that maintaining all three parameters unchanged is not sustainable i.e. some degree of reform of the cap will be necessary. We think it would be premature to mandate ToU default tariffs at this stage, although there may come a time when this is appropriate. We also think the cap should remain applicable to all customers on default tariffs to provide customers with confidence that the prices they face are fair in relation to underlying costs.

The way forward lies in reviewing the stringency of the current cap which has contributed to many of the existing challenges Ofgem discusses. As noted in response to question 1, the current (excessive) approach to stringency is not required to incentivise efficiency and innovation on the part of suppliers. On the contrary, excessive stringency risks undermining the commercial scope for suppliers to market attractive and competitively priced flexible tariffs to customers who can manage their demand flexibly, which is key to enabling all customers to benefit from energy transition while containing overall system costs. Attempting to maintain the current degree of stringency in the short term is likely to be self-defeating in the longer term under a cost-reflective price cap because overall costs will be higher.

A less stringent cap may prompt concern for the impact on vulnerable customers facing affordability challenges, but those challenges are present today and need to be addressed directly through separate targeted support. We agree with Ofgem that they simply cannot be addressed effectively through a universal cost-reflective cap.

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

As discussed in relation to question 7 above, we think Ofgem should maintain a flat<sup>11</sup> and universal cap for customers on default tariffs for the time being but review the current approach to stringency while maintaining a bottom-up cap design. As Ofgem correctly notes: “*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.*” The price cap reflects the underlying costs of supplying energy to consumers but cannot subsidise the cost of energy. Moreover, the default tariff cap is a blunt instrument that does not enable targeted support for vulnerable customers. Affordability challenges for those most in need should be addressed separately with targeted support funded through progressive taxation.

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

The best way to protect vulnerable customers facing real affordability challenges is through additional targeted support while maintaining universal price protection for customers on default tariffs that appropriately reflects the mounting costs and risks suppliers actually face (including increasing customer debt and increasing pressure on hedging costs in an illiquid wholesale market).

We see targeted support as a critical complement to universal price protection rather than a substitute for it, not least because if subsidy is required to address affordability the amount of subsidy will need to be determined relative to an appropriate cost-reflective benchmark. Decisions on eligibility for such support, together with funding, are primarily for government

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<sup>11</sup> With basic adaptations for Economy 7 and other default time of use (ToU) tariffs.

rather than suppliers to determine but we urge Ofgem to work closely with government to enable effective support for those who need it most.

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

Consumers with large and flexible loads should be encouraged to adopt tariffs which reward flexible behaviour. We think this is best done through providing scope for innovation and positive incentives for consumer uptake. Mandating time of use default tariffs in the near future risks having perverse effects e.g. holding back EV penetration, adversely impacting smart meter rollout and consent for processing half-hourly consumption data.

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

Ofgem needs to reconsider its current approach to 'stringency' without abandoning the framework of a cost-reflective bottom-up methodology.

*Wholesale cost allowances require review*

Ofgem has already recognised that MHHS will increase the costs and risks suppliers face compared with current use of industry standard shape profiles and committed to review wholesale allowances in this context.<sup>12</sup> We welcome this commitment but note that wholesale costs are not the only element of the cap methodology requiring review.

*Operating cost allowances also require review*

As we noted in response to Ofgem's recent working paper on operating costs benchmarking, Ofgem's current approach is *prima facie* inconsistent with the wider consumer protection objectives it articulates – sustainable competition, high and enhanced customer service standards, in line with new licence requirements, and financial resilience.

Ofgem should, therefore:

- Abandon the current 'stringent' benchmarking approach – based on an aggressive benchmark between lower quartile and frontier - in favour of weighted average.
- Benchmark at total operating cost rather than component level and avoid cherry picking inconsistent component benchmarks that are cumulatively unachievable by any efficient supplier.
- Identify and isolate cost elements for which a general inflation index is not appropriate – notably smart costs and industry charges – so that they can be updated separately.

*Debt and affordability need to be addressed holistically*

In relation to debt, we urge Ofgem to work closely with Government on targeted support to tackle affordability directly. Beyond that, Ofgem is right to identify underlying differences in household income as a key driver of differences in average debt that has nothing to do with

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<sup>12</sup> [Energy price cap programme of work for 2024 and 2025 | Ofgem](#)

efficiency.<sup>13</sup> In the context of levelising cost differentials between payment types, Ofgem has recognised the need for cross-industry reconciliation to minimise competitive distortion and ensure that suppliers can recover their efficiently incurred costs within the constraints of a one-size-fits-all cap. The same principle is applicable more widely to the extent that the way debt is allocated does not reflect underlying cost drivers..

#### *Headroom needs to allow for competition as well as uncertainty*

Ofgem's price cap programme of work currently lists Headroom Allowance as an 'unplanned long-term workstream'.<sup>14</sup> Ofgem suggests the review should follow that of other cost components on the basis that it is intended to address residual net uncertainty. While we accept that uncertainty can be addressed in various ways within the overall cap methodology, we also note that headroom to address residual uncertainty is conceptually distinct from competitive headroom.

When designing the cap in 2018 Ofgem rejected the need for competitive headroom arguing that this would conflict with an overriding consumer protection objective to which other statutory 'needs' (including the need to maintain incentives for domestic customers to switch to different domestic supply contracts)<sup>15</sup> were subordinate.<sup>16</sup> Ofgem's reasoning was based, in part, on the fact that the cap was temporary with a defined backstop sunset date, whereas it is now indefinite. Consequently, the need to consider the long term consumer interest becomes all the more important.

As the discussion paper notes, price differentials and switching levels initially remained high but this reflected the persistence of unsustainable business models and declining wholesale prices. The position has subsequently reversed to such an extent that the cap covers around 90 per cent of the market, and while competitive fixed tariffs are beginning to return "*the discounts available from switching are expected to remain well below pre-crisis levels*".<sup>17</sup>

Experience has shown that short-term price competition and high levels of switching do not necessarily foretell good consumer outcomes in the longer term, especially where they are based on unsustainable business practices and are not robust to normal cyclical changes in wholesale commodity cost. It does not follow, however, that competitive headroom is unimportant and can safely be disregarded.

A key part of the context for the present discussion paper is the wider need to encourage demand side flexibility to support energy transition at lowest possible costs in the long-term interests of customers as a whole. Ofgem must ensure that the level of the cap enables suppliers to recover efficiently incurred costs. But it must also ensure that the cap provides sufficient competitive headroom to enable suppliers to incentivise those customers with the ability to flex consumption to make financial savings by adopting non-default ToU tariffs.

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<sup>13</sup> Discussion paper, Figure 8

<sup>14</sup> [Energy price cap programme of work for 2024 and 2025 | Ofgem](#)

<sup>15</sup> [Domestic Gas and Electricity \(Tariff Cap\) Act 2018 \(legislation.gov.uk\)](#) Section 1(6)(c)

<sup>16</sup> [Appendix 2 - Cap level analysis and headroom \(ofgem.gov.uk\)](#)

<sup>17</sup> Discussion paper, paragraph 2.10