

## **Future of domestic price protection: response to Ofgem consultation**

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### **Introductory remarks**

This Ofgem Discussion Paper (DP) is a very timely and constructive invitation to consider how the default tariff price cap will need to evolve to respond to future energy market changes. I am sympathetic to the case for change that it presents, and to the wide range of options considered.

However, in my view, the tariff cap needs to change now, to undo some of the significant damage that it has already caused and is still doing, as well as to lay the groundwork for further changes in future. For that reason, this response focuses on three main issues: 1) the nature and extent of the damage previously and presently caused by the tariff cap; 2) the need to see competition, not simply as a way of ensuring that price is equal to efficient cost, but more broadly as a rivalrous discovery process taking place over time, in which competing suppliers are able and incentivised to offer different kinds of products at different prices, in order to discover and provide the kinds of products that different customers prefer, and 3) the nature and extent of the options for reform available now, under present legislation, rather than those that require legislative change.

### **Comments on the DP's Executive Summary**

The following comments on the headline passages in the DP's Executive Summary will indicate the main arguments in this response.

***“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 DP is far too self-congratulatory on the price cap. Far from working well in maximising consumer protection and driving down supplier costs, the cap has likely driven up supplier costs and hence prices to customers. The claim that it has largely succeeded in addressing the loyalty penalty is misconceived: Parliament decided explicitly against a relative price cap, and the misplaced concern to protect allegedly “loyal” customers has reduced competition at the expense of customers generally. The cap has forced about two thirds of energy suppliers out of the market, including some of the most well-financed international energy market companies. It has also reduced diversity of tariffs to a sad fraction of its former self. The present DP analysis, like the CMA analysis and calculations before it, fails to understand and appreciate the nature of competition as a rivalrous discovery process, which (as the DP implicitly recognises) will be increasingly important in future.

***“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.”***

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Some measures are already in place to protect lower income and vulnerable customers, and these might be improved or enhanced. And some form of price cap(s) can have a role in enabling Ofgem and Government to continue to reassure customers about the retail energy market. But it is not clear that the price cap per se needs to “play a big part” in ensuring the transition mentioned. Rather, as in other competitive markets, customers are primarily protected by rivalry between suppliers, so the cap needs to ensure that that rivalry can be effective. The DP is entirely correct that the price cap in its present form has some limitations – serious limitations - and does need to evolve, not only as the retail market changes in future, but now. Not least, the cap needs to make the market more attractive to suppliers, and enable more diversity in the market, to help discover what kinds of products, prices and suppliers are attractive to customers and what kinds are not. And, in particular, to provide new kinds of products for customers that might otherwise be disadvantaged by the evolution of the market.

***“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.”***

In general, I agree. A flat, universal and stringent price cap has done enormous damage already, so is already inappropriate and against the interests of most customers. This will increasingly be the case as the retail market becomes more diverse. But rather than speculate as to what kinds of measures could or should be put in place in the event of legislative change, this submission explores how the price cap could be relaxed or modified to provide greater scope for innovation and competition under present legislation.

The following comments pick up on some detailed statements in the DP that seem to me either important or misleading, before considering possible approaches to setting the price cap in the immediate future.

## **1. DP Chapter 1 Context**

The chapter summary makes reference to the tariffs that would be charged “in a truly competitive market”. I argue below that the CMA interpretation of a competitive market, and its associated calculations, and the subsequent approach of Ofgem, are based on a static neoclassical welfare economic concept of a competitive market. This misses the significance of the innovation and discovery process over time that is integral to a successful and fully competitive market.

“As the primary form of price protection for domestic customers, the cap ensures that households on default tariffs pay a fair price for their energy”. (Para 1.1) The cap may *seem* to be the primary form of price protection for customers. In fact, however, as in any market, the primary protection is provided by competition between rival suppliers. Hence the importance of ensuring that competition can operate fully and effectively. Note that the DTCA [Domestic Tariff Cap Act] has nothing to say about “a fair price”: that is a concept (obsession?) introduced by Ofgem in more recent years, which is not obviously helpful in the present context.

The DP refers to the CMA finding that “the customer detriment associated with high prices was about £1.4bn a year on average for the period 2012 to 2015. 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.” (Para 1.2)

As I have explained elsewhere<sup>2</sup>, the CMA did not make a conventional calculation of excess profit (which was much less, at about £170m per year over 2007-14, or only about £6 on a dual fuel bill of around £1000 per year). Rather, it made a comparison with “a hypothetical construct, a ‘supplier’ that is a combination of the suppliers that we have identified as being the most competitive in the market”. But these suppliers were not directly comparable, and the CMA had to make a series of major adjustments to their prices, so the final calculation ended up as a massive guess.<sup>3</sup>

### 1.1 Evolution of the cap

“The objectives of the DTCA led to design choices to maximise customer protection and efficiency incentives, resulting in a ‘stringent’ cap.” (Para 1.5) We need to be clear that the choice of design was Ofgem’s own decision: within the provisions of the DTCA, alternative design choices could and arguably should have been made, as the DP now envisages.

“The cap is not a mechanism for tackling affordability”. (Para 1.8) This is correct, and very important. “it [the cap] can ensure fair pricing”. To repeat, the cap is not designed to implement or ensure Ofgem’s concept of fair pricing, whatever that might be. The considerations listed in the DTCA essentially seek to bring about the prices that would result from effective competition. Alternative mechanisms are available and are used for implementing subsidies from taxpayers and cross-subsidies between different types of customers (as noted in DP para 1.10). Nothing in this present consultation response is intended to preclude the use and development of such mechanisms.

“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.” (Para 1.9) This is exactly the opposite of the policy aim to increase the effectiveness of retail competition in the energy sector, and a sad commentary on the concept

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<sup>2</sup> E.g. “Competition and Price Controls in the UK Retail Energy Market”, *ACCC Network*, Issue 63, June 2017, pp 1-11; “The challenge of removing a mistaken price cap”, *Economic Affairs*, October 2021, 21(3): 391-415

<sup>3</sup> “In the event, the CMA compared actual prices of the six large suppliers with the CMA’s guess at what just two of the much smaller mid-tier suppliers would charge *if* they were not exempt from costly environmental obligations and *if* they had reached an efficient scale and *if* they were in a steady state and *if* they were not loss-making and *if* instead they were earning a normal return on capital. It was a comparison with a purely hypothetical more efficient alternative.” (“Competition and Price Controls in the UK Retail Energy Market”, p.12)

and/or implementation of the tariff cap. Hence the DP is right to identify the importance of considering alternative approaches to its calculation and implementation.

## **2. DP Chapter 2 Evaluating the cap today**

### **2.1 Successes of the cap**

The summary of Chapter 2, and para 2.1, again make the claim that “the cap is designed to ensure that households on a default tariff pay a fair price” and indeed ensures that households on a default tariff do “pay a fair price”. Again, to note that the DTCA makes no mention of a fair price.

### **2.2 Improved efficiency**

“The cap has incentivised efficiency gains”. (Para 2.2) “From 2019 to 2021 large supplier indirect/operating costs fell by 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.” (Para 2.3) It is true that a price cap could increase pressure to be more efficient – but it could also disincentivise investment or innovation to improve efficiency if the supplier considered that continued future operation would not be profitable. The calculated efficiency improvements cited in the DP were already underway when the cap was implemented and are more likely attributable to the increasing competitive pressures that existed before its implementation. So this evidence of increased efficiency does not make the case for a stringent cap.

### **2.3 Protected disengaged consumers**

“The cap has protected disengaged customers from price exploitation”. (Para 2.2) This is because “Upon introduction of the cap, default tariff prices fell.” (Para 2.4) This is not convincing: this was also a period of falling wholesale prices. In the event, wholesale costs were lower than Ofgem assumed in setting the cap. It is conceivable that, in this particular period, default tariffs clustered at the cap were *higher* than would have obtained in the absence of the cap. In which case the cap, far from protecting disengaged customers, would have made them worse off.

Later, as DP para 2.6 points out, “The price cap clearly depressed tariffs below the level they otherwise would have been, evidenced most clearly by suppliers collectively turning from profit to loss when the price cap was introduced.” There is no doubt that the serious loss-making since 2019 is attributable to the way the price cap was implemented. It is very difficult to square this with the DTCA statutory obligation to have regard to “1 (6) (b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts; ... and (d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence”.

## 2.4 Did not stifle competition for engaged customers

Para 2.2 “The cap has protected consumers without stifling competition for engaged customers”. This is simply not a tenable claim: by any measure the cap has indeed stifled competition. More specifically,

- Para 2.7 “Before its introduction there was a concern that prices would cluster around the cap and consumers would therefore become more disengaged.” But that’s precisely what eventually did happen.
- Para 2.8 “Price differentials remained high” – this was only initially, as noted, because wholesale price reductions were initially higher than Ofgem expected when it set the cap. Price differentials did not “remain high”.
- Par 2.8 “which helped consumer engagement to reach record levels”. But Fig 4 shows that consumer engagement as represented by switches between supplier had been rising steadily ever since 2013. Then they levelled out and were broadly constant for the first three or four years of the price cap, after which they plunged dramatically. So the price cap initially stunted consumer engagement then almost extinguished it.
- Para 2.8 “incumbents’ market share continued to fall”. But it didn’t. Fig 5 shows that the shares of the incumbent (Big 6) suppliers fell steadily from 99% in 2012 to 70% electricity/71% gas in 2019 (as a result of the increasing competitive pressure from new entrants). There was a sudden and significant reduction to 58/56% from 2019 to 2020. But this was a result of incumbent SSE exiting the market, which it had long indicated an intention to do. (For example, back in November 2017 it announced that it had opened talks with npower.) SSE’s decision to exit the market, and the later consequent reduction in incumbent market share, was a result of the pressure of competition before the introduction of the cap (and SSE’s failure to invest in a modern IT system). Since the introduction of the price cap, the market shares of the initial incumbents has actually increased (from 58% to 59% electricity and from 56% to 57% gas) during the price cap period.

Paras 2.9 and 2.10 belatedly acknowledge some adverse effects of the tariff cap on competition. Para 2.11 admits that

“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 [Ban on Acquisition Tariffs] 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.

So switching “may” be lower due to these extremely serious restrictions on competition??? It is embarrassing that Ofgem should have to consider, let alone implement, two such anti-

competitive restrictions. The DP does itself no favour by sticking its head in the sand and refusing to face realities.

## **2.5 DP Chapter 2 (cont'd) Challenges of the current cap**

“The gas crisis exposed certain limitations and challenges associated with the cap methodology.” (Para 2.12) It certainly did, although there would also have been problems even in the event of no gas crisis. The DP sets out three categories of limitations and challenges, which have all been observed.

### **Additional costs and risks, which exist as side effects of the cap design**

The DP gives four examples of these additional costs and risks.

- 1) **Supplier failure:** the price cap prevented suppliers from passing on the rise in wholesale gas prices. There was also a ‘volume risk’ because the cap prevented suppliers from increasing tariffs to cover the cost of additional SVT customers arising, for example, from the ending of fixed tariffs. “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.” (Para 2.16)

The adverse effects of the cap are correctly noted, but “Over 30 suppliers exiting the market” seems an underestimate. Ofgem’s tables show 70 suppliers in Q2 2018. The drop to 62 by Q4 2018 is no doubt partly attributable to suppliers’ concerns about the impending price cap, but then the reduction to 20 suppliers in Q4 2023 is surely largely attributable to the price cap itself. So, the number of suppliers driven out of the market by the price cap was more likely in the range 40 to 50. That is a reduction of 57% to 71%. In other words, the price cap reduced the number of suppliers by about two thirds.

Some of these exiting suppliers have been accused of being thinly capitalised and often unhedged ‘fly-by-night’ operators. But that is not by any means true of all of them. Rather, several of the exiting suppliers were associated with some of the most efficient and well-financed international energy companies in the world, including Engie (formerly Gaz de France), Pure Planet Energy (24% owned by BP), iSupply (owned by Vattenfall), Green Network Energy (part of the Green Network Group in Italy since 2003), Tonik Energy (backed by Mitsui), and of course most recently Shell Energy.

Nothing like this happened in other competitive energy markets, even those affected by the same spikes in wholesale prices. It is a terrible condemnation of the tariff cap and/or its implementation.

The DP does not mention the magnitude of the additional costs to consumers as a result of these supplier exits primarily caused by the unduly tight price cap. I think I have seen a figure of the order of £2.7bn.

“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, ... , and introduced the MSC and 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 customers.” (Para 2.16)

This paragraph correctly acknowledges some of the serious additional costs to customers of the price cap, which need to be set against the claimed reductions in customer prices (at the expense of suppliers). In addition, there are the serious restrictions in the competitive discovery process that the MSC and BAT represent, as touched on in the next section.

“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.” (Para 2.17)

Yes, indeed, these specific adverse effects were problematic. But surely the cap *was* the main driver of supplier failures?

- 2) **Greater price volatility for customers:** the move to a quarterly cap and the introduction of the backwardation allowance reduced the smoothing impact of the cap.

This is true, and there is an associated comment of particular importance.

“The cap delivered smoother 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.” (Para 2.19)

It is true that, as a result of the way the cap was reformulated, some customers experienced less price smoothing than they otherwise would have done. Note that this would have included many low income and otherwise vulnerable customers who set great store by predictability of future living expenses. They are now worse off insofar as the cap effectively renders their energy bills uncertain more than three months ahead, so they need to reassess their situation and perhaps their spending habits every three months instead of once a year or more.

But also, of course, some other customers experienced more price smoothing, and associated higher costs as a result of the tariff cap, than they otherwise would have chosen.

Even this understates the adverse effect of the cap on the whole competitive discovery process. A competitive market is not simply one in which price is equal to efficient cost for a

given product. Rather, it is an ongoing process of exploring what kinds of products customers want, at what kinds of prices and on what conditions. Suppliers respond to that experience by introducing or withdrawing products accordingly. So at any time, there is a constantly evolving variety of products and prices on offer. And different kinds of product appeal to different customers: there is not one single uniform solution.

This competitive discovery process is essentially what the price cap practically destroyed. Henceforth, it was not viable for suppliers to adopt or explore a hedging policy that differed from the one adopted by Ofgem in setting the price cap. Thus, the price cap replaced the competitive market discovery process by Ofgem's regulatory dictat. Henceforth, almost all customers would get what Ofgem decided was the right product, at the price that Ofgem considered appropriate. For the most part, the price cap made it too risky for suppliers to offer anything else.

- 3) Effect on wholesale market liquidity:** “Domestic suppliers have an incentive to follow the cap indexation methodology, and therefore to have similar hedging patterns. Such concentration of demand for certain hedging products could drive up prices for these products in wholesale markets.... It is possible that at the height of the crisis when wholesale markets were exceptionally tight, this collective behaviour may have led to higher prices, which were then reflected in the level of the cap.” (Para 2.21)

The nature and magnitude of such price increases caused by the cap are necessarily a matter of conjecture, but the point just made by the DP is still important: the price cap distorted and prevented the market discovery process by focusing demand on one particular set of hedging products. This was determined by regulatory decision rather than by the exploration, discovery and meeting of customer preferences in the competitive market.

- 4) Practical challenges of operating the cap:** setting a cap that reflects efficient costs “has been challenging to do during the crisis, when the costs facing suppliers have been changing quickly and unpredictably” (para 2.22) “...we have made frequent changes to the cap calculations ... [this] is also a consequence of our decision to set a stringent cap”. (Para 2.23) “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.” (Para 2.24) “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 ...” (Para 2.25)

All these practical challenges, which have costs for customers, are well observed. And note again the point just made above: the nature of these costly adjustments is no longer determined by a multitude of suppliers all trying in different ways to work out the different

arrangements that different customers would prefer. Rather, one single entity Ofgem is now trying to work out what one more or less single option would be best for customers as a whole, despite the very different natures and preferences of all these customers.

## **2.6 Impacts on competition, innovation and service levels**

Sections 2.26 – 2.28 of the DP consider whether the cap is reducing the incentive on suppliers to offer more competitive tariffs or improved efficiency and innovation. They conclude, “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.” (section 2.28) But to a greater or lesser degree, the ability and incentive of suppliers to engage in exploring non-price factors with customers surely is adversely affected by the very existence of the tariff cap.

Sections 2.29 – 2.32 consider the effect of the cap on service levels. “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.” (Section 2.29)

Here again the same point: rather than leaving competing suppliers to discover and provide what service levels different customers prefer, Ofgem is led to intervene more heavily, determining what service level should be provided by all suppliers. Evidently the aim is to increase the service levels beyond those that many suppliers have been providing, and hence presumably more costly to provide. No doubt some customers are happy to pay more for better service, but is this true of all customers? There doesn't seem much concern to allow customers to choose the price-quality combination that they prefer, or are able to afford.

## **2.7 Applying the cap to a more diverse electricity market**

“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.” (Section 2.33)

Comment: Absolutely right.

The DP continues with some discussion of price cap allowances and a recent adjustment for bad debts. It concludes,

“However, this adjustment is universal, so does not account for the significant differences in debt levels between suppliers. 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.” (section 2.37)

Comment: Again absolutely right.

To explain and emphasise the point, it is not simply that customers have different financial situations and different preferences, and that suppliers are different because they have different customer mixes and different ways of meeting these. So that any “solution” imposed by Ofgem is going to suit some customers and suppliers and not suit, or indeed adversely affect, other customers and suppliers. It is also that this is a dynamic market in which customer preferences, and the understanding and abilities of suppliers to serve them, are constantly evolving over time as part of the competitive market process. Any form of price cap, but particularly a stringent and wide-ranging one, inevitably hampers this market discovery process, and perhaps even prevents it from working.

### **3. DP Chapter 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.”

Comment: This prediction seems plausible. But cross-subsidisation of high-cost customers by low-cost customers was not one of the objectives of the DTCA, or indeed of the original Acts regulating these suppliers. If there is a concern about one particular set of vulnerable customers then surely the solution should involve explicit subsidy from other customers (e.g. via the WHD) or from Government, or enabling and encouraging suppliers to offer tariffs that suit these customers, rather than restricting the ability of suppliers to offer tariffs that other customers prefer.

“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.” (Section 3.1)

Comment: Again, absolutely right. Neither the DTCA nor the original Acts required a stringent or flat cap, so Ofgem will have to change the way it has implemented the cap. It is clear from the previous material that a stringent cap has been particularly problematic and has prevented the competitive market process from operating.

“The cap provides a single price across the market. As electricity consumption patterns becomes increasingly diverse, maintaining a flat cap becomes more challenging.” (Section 3.9)

Comment: Agreed. A flat cap becomes more unreasonable and more distorting.

“There is a risk that, similar to the incidence of debt (see previous chapter), the consumption patterns of consumers vary significantly between suppliers.” (Section 3.10)

Comment: What?? A risk that consumption patterns vary between suppliers? But that is the normal situation in any competitive market. How can the DP believe or assume that this would not be the case in the energy market?

“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.” (Section 3.12)

Comment: Has Ofgem only just realised this? The DTCA provides that Ofgem must have regard to suppliers’ ability to recover their efficient costs. So the broader the scope of the cap, the more likely that Ofgem will be faced by problems of this kind.

## **4. DP Chapter 4 Options for evolving price protection for the future**

### **4.1 General remarks**

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.”

Comment: I do not accept that removing all price protection would mean a return to exploitation of inactive customers, or indeed that inactive customers were exploited before the introduction of the price cap. In simple terms, before the cap there was an increasing number of competitors offering an increasing variety of products, not least for prepayment meter customers, there was increasing pressure to be efficient and to keep costs down, and profits were not excessive.

But I do agree that retaining a price cap that is flat, universal and stringent would be a serious mistake – both in present market conditions and more especially in the future when technological, economic and political conditions, and customer preferences are likely to evolve in significant but not always predictable ways.

I am therefore sympathetic to the exploration in Chapter 4 of various options for evolving price protection in future. For present purposes I broadly agree with the suggested difficulties and disadvantages of maintaining a flat, stringent and universal cap, and it is helpful to

explore the possible options and implications of relaxing (or moving away from) each aspect separately.

I do have some concerns about some particular suggestions. For example, as indicated earlier, the Market Stabilisation Charge and the Ban on Acquisition-only Tariffs are both anti-competitive and against the interests of customers generally, and would be inconceivable in the absence of the cap.

I accept that there is frequent concern to ensure policies that protect “disengaged” customers who don’t switch supplier. However, this would logically imply the need for similar policies to “protect” customers that continue to favour a particular pub, restaurant, corner shop, supermarket, hairdresser or for that matter football team. Surely many customers don’t change energy tariff or supplier because they are relatively content with their present ones, rather than because they are incapable of doing changing? The DP is right to point out that the costs of certain SVTs may increase over time because some other customers are switching to more advantageous TOU tariffs, thereby increasing the cost of the remaining SVT profile. But surely the answer is not to try to emulate King Canute and “stop the world” or resist the continued development of cost-reflective pricing. Surely the answer is to assist the remaining customers in considering whether to change tariff, and to encourage suppliers to develop new products and tariffs that will appeal to these customers, and if necessary to provide some explicit support from other customers or from Government.

There is also continued reference to “fair prices”, which are never explained, as if they could be the basis of policy when there is no statutory basis for them.

Finally, a comment on the Within Supplier Relative Cap.

#### **4.2 Relative price cap**

The DP makes occasional reference to a relative price cap (e.g. para 4.17), particularly as an option for moving away from a stringent cap (paras 4.49 – 4.3).

“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. 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.” (para 4.51)

There is no objection to an individual supplier self-imposing such a relative price limitation on its own products if it wishes to do so. For example, Bulb Energy’s policy was a single tariff for all its customers, and Octopus Energy and So Energy have committed to keeping their fixed and variable tariffs in line with each other. Good luck to them, and let us see whether it is viable and whether customers value such a policy.

What is the evidence on that to date? Octopus (including Bulb) has grown to 22% market share, So Energy has another 1%. Deduct the size of the various Octopus acquisitions

(including Engie, Avro, Shell totalling about 8% or more) of suppliers that had no commitment to such a policy. So the proportion of GB customers that might have signed up to the three suppliers because of their stance on relative prices might be of the order of 15% at most. However, many of their customers surely signed up for other reasons, including the attractive levels of prices, the innovative nature of Octopus tariffs and products, and the outstanding customer service that Octopus has consistently provided. This leaves at least 85% of GB customers that didn't consider this relative price policy particularly relevant, or thought other things more important, or were not aware of it, or conceivably actually opposed it.

That's fine, we can leave this to play out in the market, to discover whether other suppliers and customers are increasingly attracted to the concept, or whether other considerations gradually become more significant.

However, the proposition that Ofgem should force all suppliers to adopt such a relative price policy is a different matter. It is presented as a way of protecting disengaged customers, but in fact it is a dog-in-manger policy: if not all customers benefit from a price reduction then no customers shall benefit. It is also undermining of competition policy. If a supplier is unable to compete for a few additional customers without having to cut its price to all its existing customers, that supplier is more likely not to compete at all. Which is why such a policy would be an ideal way for leading suppliers to enforce tacit collusion in a market, at the expense of customers generally, not least various kinds of vulnerable customer.

When the DTCA was passing through Parliament, a relative price cap was actively canvassed and Parliament explicitly voted against it, by a significant margin. At a time when facilitating competition is so important, it is disappointing to see Ofgem still giving credence to a relative price cap.

## **5. A more focused discussion of options for revising the tariff cap**

### **5.1 The case for focusing discussion on options consistent with the DTCA**

The DP says of its own options, "Some of these options could be implemented under the existing statutory framework, while others may require legislative change". This might indeed "facilitate open discussion" and I have no wish to curtail that. But it would be helpful to be aware of which options could be implemented under the current statutory framework, as opposed to those options that would require some form of legislative change.

The political reality is that the DTCA is in place now and is not going to be abolished within the next year or two. Any modification to it would be argued over and uncertain, and would not be in place in the next year or two. So for the moment, Ofgem is going to continue to have to set a tariff cap, and this cap is going to have to be consistent with the conditions of the DTCA.

It also seems that the tariff cap presently has broad public acceptance. Not in the sense that the public has a view on precisely how Ofgem has set the cap, or that there is a general belief

that Ofgem has always or mostly “got it right”, or that there should be no change to the Act or the way that Ofgem sets the cap. But rather, in the sense that, if Ofgem has looked at the energy market and says that retail energy prices need to go up or down, then the public accepts that that’s what has to happen. The public feel that they don’t need to worry that energy suppliers are exploiting customers, and can focus on how best to deal with the changes that are happening. People can get on with the rest of their lives.

So what variants of the cap and what other options are consistent with the present DTCA? In particular, what kinds of regulatory policies would most promote competition as a rivalrous discovery process? That is, what kinds and levels of cap would incentivise and enable suppliers to offer not only better prices but also new and different products, that might be better suited to the market of the future – if it turns out that customers like them.

## **5.2 Flat, universal and stringent?**

In order to facilitate competition as a rivalrous discovery process, I support the DP’s proposal to move the main focus of the exploration away from a stringent cap. That aspect of the cap has probably done the most damage to the competitive market properly understood.

As regards flat pricing, the DP notes that there are static Time of Use tariffs subject to the cap.

“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.” (DP p 29)

I see no reason to insist that all or almost all tariffs be set on a flat basis, or indeed to limit the range of consumption profiles that suppliers might choose to offer. There might be practical considerations as Ofgem struggles to match the flexibility of the competitive market, but Ofgem’s use of supplier discretion is encouraging.

It is claimed that “the cap provides a single price across the market” (para 3.9), which seems difficult to understand. There is also concern that multiple prices will disadvantage some customers.

“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 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.”

Surely this should not lead Ofgem to discourage an increasing variety of tariff, or insist that all tariffs should be on a flat basis. Instead, we should encourage suppliers to develop new options for customers, particularly those customers that might otherwise be adversely affected by the spread of TOU tariffs. We should seek to attract new suppliers with new ideas into the market, and appeal to customers. And let them explore how best to interest customers in the variety of tariffs that could be available, and discover which kinds of tariff these (and other) customers most prefer.

At the same time, of course, it is for Ofgem to consider whether there is a case for supporting the resulting (smaller?) set of customers on the original tariff by making transfer payments from other customers (e.g. via the Warm Home Discount or similar schemes), or from funds from central government. So in sum there seems no case for restricting the cap to flat pricing – or, more precisely, for using the DTCA to restrict the adoption of non-flat pricing by suppliers.

Finally, as to universal, to what extent is it open to Ofgem to target the cap on a sub-set of default tariff customers, “such as those in vulnerable situations or on prepayment meters” (p 7)? Recall that the whole purpose of the DTCA was to require Ofgem to extend the previous cap to all SVT and default tariff customers. It would be useful if Ofgem could provide further information about the scope for relaxing the universal characteristic within the scope of present legislation.

## **6 Some further options for consideration: are they legal?**

Implementation of the tariff cap to date has led to considerable reduction in the variety of SVT tariffs on offer. Is this a necessary implication of a tariff cap, or could increased variety be achieved by a different approach within the present DTCA?

### **6.1 Two options not pursued**

One possibility is that some suppliers might choose to offer an SVT which is different from their default tariff (whereas at present these are regarded as the same product). A default tariff could apply in the event that the customer has not yet actively chosen a particular tariff with that supplier – for example, after a change in tenancy, or after the expiration of a chosen fixed

tariff, or if another supplier suddenly ceases service. This is common practice in the US.<sup>4</sup> I don't see an objection to it in the provisions of the DTCA. But after some consideration, it seemed unlikely that suppliers would see this as a priority.

Another possibility is that a particular supplier might wish to offer two or more SVTs – for example, one based on a long hedging policy and another based on short hedging, to appeal to different kinds of customers. But there would potentially be problems with customers switching between the two as prices evolved, so again I have not pursued that possibility.

## **6.2 Different hedging strategies for standard variable tariffs (SVTs)**

Before the price cap, different suppliers adopted different hedging strategies for their SVTs. In simple terms, the BigSix incumbents had traditionally hedged for about a year or more in advance, and they all tended to revise their tariffs about every 12 to 15 months, typically within a short time of each other. There was some competition to be the first to reduce SVTs at times of falling prices and to avoid being first to raise them, or to be last to raise them, at times of increasing prices.

As new suppliers entered the market, they adopted different and typically shorter hedging policies for their SVTs. Bulb Energy reportedly hedged for about six months in advance, some other suppliers for fewer months, some suppliers not at all. They were thus able to offer different pricing policies to customers, and it became apparent that customers themselves had different preferences. And of course some suppliers and customers fared better as wholesale prices fell then increased, some fared worse.

But with the advent of the tariff cap, implemented on a stringent basis and following the severe movements in the wholesale market, essentially all suppliers now have to hedge their SVTs on the same (3 month) basis as used by Ofgem. It would be too financially risky not to do so. The variety in the market, exploring and catering to the variety of customer preferences, has been suppressed.

So the key question I am asking is whether there is scope for setting a tariff cap that will allow different suppliers to offer SVTs with different hedging strategies.

And here is a final possibility, which I understand was proposed by one supplier as the cap was initially under consideration. The supplier's SVT would evolve over time, and different customers would be on different tariff levels, depending on the date at which they joined the SVT. Specifically, customers joining in January of a particular year would be charged at a

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<sup>4</sup> “The Commission has designated Providers of Last Resort (POLR) as a back-up electric service provider in each area of Texas open to competition. POLR service is relatively high-priced, due to the costs associated with planning and the risk of serving an uncertain number of customers with uncertain electricity loads. POLR service is a safety net for customers whose chosen REP [Retail Energy Provider] is unable to continue service. This service is intended to be temporary and used only under rare circumstances when a REP is unable to provide service, or when a customer requests POLR service.”  
(<https://www.puc.texas.gov/consumer/electricity/polr.aspx>)

price reflecting the cost of hedging for one year starting in January, and this price would obtain for these customers for the next 12 months. The price would be revised in January of the next year. Those customers joining in February would be charged at a rate reflecting the cost of hedging for one year starting in February, and so on. At any time, then, this supplier would have one SVT available to new customers, and a dozen SVTs for existing customers, that were no longer open to new customers.

### **6.3 The provisions of the DTCA**

How far would such different SVT policies be feasible within the DTCA? At various times and places, Ofgem has remarked that this or that type of default or SVT tariff would not be consistent with the DTCA, but I am not aware of any systematic exposition of the issues and constraints involved. So here are some thoughts.

For present purposes, the relevant provisions of the DTCA appear to be as follows.

#### **1. Cap on standard variable and default rates**

- (1) As soon as practicable after this Act is passed, the Gas and Electricity Markets Authority (“the Authority”) must modify the standard supply licence conditions so that they include conditions (“tariff cap conditions”) that impose a cap on all standard variable and default rates that may be charged by the holders of supply licences for the supply of gas or electricity under domestic supply contracts.

#### **2. Tariff cap conditions**

- (1) Tariff cap conditions— (a) have effect in relation to supply licences, whenever granted, and domestic supply contracts, whenever entered into; (b) must set out how the cap is to be calculated, and may make provision about assumptions required to be made in making the calculation; (c) may make provision specifying how a standard variable or default rate is to be identified; (d) may make provision requiring information to be provided by holders of supply licences to the Authority for the purposes of exercising functions relating to tariff cap conditions; (e) may confer functions on the Authority; (f) may make different provision for different areas or different cases;

- (2) But tariff cap conditions may not— (a) exempt holders of supply licences from their application, or (b) make different provision for different holders of supply licences.

In short, the tariff cap conditions must “impose a cap on all standard variable and default rates”, and “may make different provision for different areas or different cases” but may not “make different provision for different holders of supply licences”.

### **6.4 Different hedging strategies for SVTs**

Would the DTCA allow different suppliers to have different SVT caps depending on their different hedging strategies? In principle I don’t see why not. The DTCA explicitly allows different caps in different distribution areas, to reflect different distribution network costs, for example. But it also allows “different provision for different cases”.

So, for example, Ofgem could set a cap on SVTs designed for one-month hedges and another on SVTs designed for 3 month hedges and another on SVTs designed for 6 month hedges. It would be open to each supplier to decide which duration of SVT to offer.

A supplier with a one-month SVT hedge would thus have a different cap than a supplier with a six month hedge. But this would not constitute “different provision for different holders of supply licences”. Rather, it would constitute “different provision for different cases”.

Perhaps it might be argued that an SVT with a specified rate for one month is a fixed tariff rather than an SVT. But then it would not be subject to the DTCA and could not be capped under it.

There would, of course, be a higher burden on Ofgem to calculate three sets of costs, in one case at monthly intervals. And Ofgem would need to satisfy itself that each supplier’s SVT was properly categorised, so it was not misrepresenting a low-cost product as a high-tariff product. These are not unimportant considerations, but they are separate from the legal question explored here.

And there would of course be commercial considerations for each supplier to consider: how would it hedge given the uncertainty about what other suppliers might offer hence what its own customers might do. But that would have been the case before the cap too.

What about the final possibility mentioned, where a supplier proposed to reset its SVT monthly? Each customer would remain on the rate applying in the month that it joined, until that rate was reset at annual intervals. Again, I see no objection in principle under the DCTA. But I understand that Ofgem told the supplier that this would not be allowed under the DCTA. Why not?

## **8. Final remarks**

I have argued in this DP response that, although the tariff cap is claimed to have protected customers, in fact it has had an almost fatal impact on the GB competitive retail energy market and hence has adversely affected customers. The most urgent need now is to restore and encourage the competitive market discovery process. To that end, Ofgem needs to move (further) away from a flat single rate cap, away from universal pricing and most importantly away from stringent pricing. It needs to encourage suppliers to try new and different tariffs, not least as technology offers an increasing variety of options.

I have suggested that it would be sensible to focus present thinking on what is required and permissible under the present Act, rather than speculate on what might be done under a hypothetically different Act.

It seems to me that one of the main casualties of the tariff cap is the variety of hedging policies underlying supplier Standard Variable Tariffs. So a consideration of whether suppliers are able and willing to pursue different policies here would seem useful.

Ofgem must of course consider the particular situations of various classes of vulnerable customers. But there are ways of doing this, and of assisting these customers, by encouraging rather than restricting the competitive market process.

Finally, this response has at times been critical of Ofgem's previous policy with respect to the tariff cap. Whether setting the tariff cap could have been done significantly better (in the absence of foresight) is debateable. Certainly Ofgem was taken to court and lost.

The DP acknowledges some challenges of the cap. But my prime concern is that Ofgem has still not sufficiently acknowledged the disadvantages and risks of the price cap itself, particularly in a world where future wholesale cost movements are unknown but may be significant. The CMA explicitly recognised the disadvantages of a cap and recommended against it, but considered that a temporary cap for prepayment meter customers would be justified. The dissenting member Professor Cave suggested that the cap be extended to more customers but he, too, argued that it should not last more than two or three years. Parliament allowed the possibility of a slightly longer but still capped duration.

If there is a criticism of Ofgem, it is for not sufficiently alerting Ministers and the public, in a more timely and public way, to the difficulties, risks and disadvantages of the cap, and for even now overstating the benefits and understating the disadvantages of the cap. The remedy is to take active steps to relax the cap, so as to enable the competitive market process to flourish more effectively, to the advantage of customers generally.

At the same time, Ofgem needs to consider and support various classes of vulnerable customers that might initially seem to be disadvantaged by technological and market changes. It can do this by encouraging suppliers to develop other tariffs and products that might better suit these customers, as well as by enabling support from other customers and from government as deemed appropriate.