ofgem

# Working paper #3: approach to headroom

In February 2018, the Government introduced the Domestic Gas and Electricity (tariff cap) Bill, creating a new duty for Ofgem to design and implement a price cap for customers on default tariffs. This paper discusses our thinking on including a headroom allowance.

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| Date | 9th April 2018 |
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## Contents



## 1. Executive summary

1.1. The Domestic Gas and Electricity (Tariff cap) Bill, creates a new duty on Ofgem to design and implement a price cap for domestic customers on an SVT or other default tariff (the "default tariff cap").[1] This document is part of the series of working papers[2] that we are issuing to explain how our thinking on the design of the default tariff cap is evolving as we gather views and evidence. We will follow these papers with a formal policy consultation, summarising our overall thinking, in May.

1.2. This paper discusses our thinking on headroom, an amount above the efficient level of costs, which could be used to enable competition to co-exist with the cap. We welcome feedback on our initial thinking and the analysis we are planning to undertake.

1.3. When developing our approach we will take stakeholder feedback on previous consultations, and on the safeguard tariffs already in place in the energy markets, into account.

1.4. We invite comments and further engagement on the thinking and analysis proposed in this paper. We are specifically interested in views on:

- alternative sources of evidence or analysis we should consider;
- our approach to assessing the impact on consumer bills and on revenues and profitability, and in particular the best way to assess the impact on the smaller suppliers; and
- additional data that could be useful in looking at the impact of price differentials on switching.

1.5. Please submit these no later than **23rd April** to our mailbox: retailpriceregulation@ofgem.gov.uk.

[1] Domestic Gas and Electricity (Tariff Cap) Bill
[2] We have published a previous working paper on the overarching design questions relating to how the level of the cap will be set, and a working paper on the market basket approach.

## 2. Legislative framework

2.1. The proposed legislation gives Ofgem a duty to design the cap in a way that protects existing and future domestic customers on SVT and default rates. It also sets out four "matters" Ofgem must have regard to:

a) The need to create incentives for holders of supply licences to improve their efficiency;

b) The need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;

c) The need to maintain incentives for domestic customers to switch to different 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.

2.2. The Bill also requires us to introduce the cap "as soon as practicable" after the Act has passed. When introducing the Bill, the Government stated that it intends Ofgem to be able to set the tariff cap by the end of this year. We must therefore design it in a way which is proportionate and that allows us to implement it quickly. Our approach to headroom and any analysis must take this into consideration.

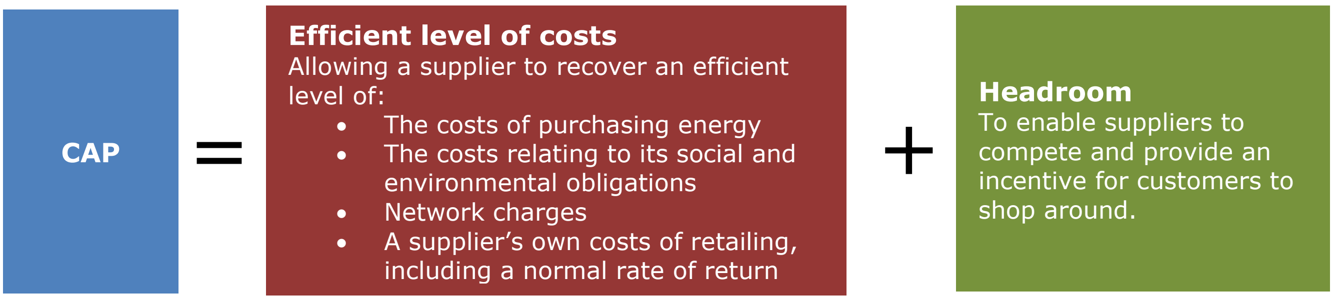
2.3. Under the legislation, the cap will be time limited: in 2020, we must review whether the conditions are in place for effective competition, and publish a report, including a recommendation on whether the cap should be extended or not. The Secretary of State would then decide whether to remove the cap. If the cap is not removed, we would carry out further reviews in 2021 and 2022. If the cap is extended after each of our reviews, it will cease to have effect at the end of 2023. This means the cap should be designed in a way that reflects its intended (time limited) lifespan, and again, we need to consider this in our thinking on headroom.

## 3. The role of headroom in setting the default tariff cap

### The components of the default tariff cap

3.1. The default tariff cap could include two components: an allowance to reflect an efficient level of costs, and an allowance for "headroom" (see Figure 1).

**Figure 1**: **Components of the default tariff cap**




3.2. The allowance for an efficient level of costs is required to ensure efficient suppliers can finance their businesses. By including within this allowance only those costs that would be incurred by an efficient supplier, suppliers should continue to have an incentive to reduce their costs to an efficient level. We discuss the approach to estimating what is an efficient level of costs in our first working paper.

3.3. Headroom would then be an increment between the efficient benchmark and the level of the default tariff cap to enable suppliers to compete, and provide an incentive for customers to shop around.

3.4. We are considering whether headroom is necessary to support the legislative framework. There are other regulated markets and sectors that do not include an allowance for headroom (for example the Northern Ireland retail price controls or any explicit reference in the payday lending price cap). Concerns have been raised that headroom could reduce protection for disengaged consumers, because suppliers could set their default tariffs at the level of the cap to maximise their margin, as there would be little risk of them losing customers by doing so.

3.5. Without headroom, it could be argued that suppliers would still compete with each other. Suppliers with lower operating costs could offer lower prices in order to attract engaged consumers. This switching would incentivise more costly suppliers to reduce their costs in order to maintain their customer base. In its investigation, the CMA estimated that a substantial proportion of consumer detriment was attributable to operating costs that were higher than necessary, rather than 'excess' profits.

3.6. It could also be argued that in designing the cap to meet the Bill objectives our regard for competition and switching should be focussed on fixed tariffs, and that therefore the default tariff cap should be set at the lowest possible level that does not unduly impact competition in fixed tariffs. Suppliers would still be able to differentiate and innovate by encouraging consumers to actively choose new fixed tariffs (rather than stay on default tariffs).

## 4. Our analysis plan to inform our thinking on headroom

4.1. In this section, we give an overview of the areas of analysis that we are considering undertaking; both qualitative and quantitative. In considering whether headroom is appropriate for the default tariff cap, and if so, what level, we will consider what impact a higher or lower default tariff cap might have on:

a) Customer bills (ie the extent of protection offered by the cap)

b) Supplier revenues and profitability (taking into account different service propositions and cost structures)

c) Consumer incentives to engage in the market (in particular the incentive for customers to switch)

d) Supplier incentives on efficiency

4.2. The proportion of the market affected by the default tariff cap is likely to be a key consideration in setting any headroom level. We will need to consider the interaction of any headroom component and the efficient level of costs.

4.3. The table below summarises the approaches we are currently considering, followed by a description of the analysis we are exploring to inform each of the impacts.

**Table 1: Overview of analysis**

| Impact Area | Purpose | Proposed analysis |
|---|---|---|
| **Impact on consumer bills** | To consider consumer detriment and the level of consumer protection provided. | Modelling the impact on typical consumer bills of different levels of headroom, relative to current prices |
| **Impact on revenue/profitability** | This will inform our assessment on the ability of efficient suppliers being able to finance activities. | Modelling the impact of different levels of headroom on supplier revenue and profitability. |
| **Impact on consumer engagement** | To provide an understanding on how much consumers say they require to switch suppliers and engage in the market. | Reviewing how much customers say they need to switch and perceptions of a price cap. Also, looking at the general relationship between price dispersion and switching. |
| **Impact on supplier incentives** | To provide a basic understanding of how suppliers might behave under the default tariff cap. This will inform our position on both efficiency over time and enabling effective competition. | Qualitative scenario analysis of a range of incentive effects and the impact on pricing incentives. |

4.4. *We are interested in views on the approach and analysis we are intending to undertake. We welcome early engagement from stakeholders on any analysis or sources of evidence that would better inform our thinking on headroom and note that we have received little evidence in this area to date.*

## a) Impact on Bills

4.5. In order to understand the extent of protection offered by the tariff cap we will look at understanding how bills for typical consumers change under various tariff levels, relative to current prices.

4.6. In Annex B of the technical document[3] we published alongside our October consultation for the warm home discount safeguard, we set out our methodology for calculating the impact on consumer bills of the safeguard tariff. We intend to follow a similar methodology to assess the impact of the default tariff cap, making appropriate adjustments such as updating customer account information and supplier specific average annual consumption per customer.

4.7. We have recently sent out a Request for Information (RFI) and some of the data should help improve our approach to modelling the impact on bills. We are planning to extend the analysis to include more mid-tier suppliers, which should provide a view on customer bills across over 90% of the market. Information from the recent RFI will help us in making the adjustments mentioned in 4.6 above.

## b) Impact on revenues and profitability

4.8. We will need to consider the impacts the default tariff cap will have on the ability of efficient suppliers to finance activities.

4.9. Annex B in the December technical document also included our methodology for calculating the impact on consumer revenues and profitability of the safeguard tariff. As mentioned in paragraph 4.6 we intend to follow a similar methodology to assess the impact under the default tariff cap, making appropriate adjustments to the

[3] Annex B: methodology for calculating impact on consumer bills and supplier revenues.

customer accounts and average annual consumption per customer. We are also planning to look at the impacts on mid-tier suppliers.

4.10. We acknowledge that business plans of new small suppliers might focus on growth and acquisition, so we are currently considering the most proportionate way to engage and look at the impact on smaller suppliers.

4.11. One potential method of engaging small suppliers would be to focus on those suppliers that have a large differential between their default tariff and their cheapest fixed tariff. We could also consider selecting small suppliers of varying sizes to act as representation of that supplier size segment.

*4.12. We welcome views from stakeholders on our approach to assessing the impact on consumer bills and on revenues and profitability. We are interested in suggestions on the best way to assess the impact on the smaller suppliers.*

## c) Consumer incentives to engage

4.13. In order to assess the incentives for domestic customers to switch to different domestic supply contracts we are looking at the impacts of the prepayment tariff cap. We will also look at consumer research on both switching and consumers perceptions of price caps.

*Prepayment (PPM) tariff cap methodology*

4.14. The prepayment safeguard tariff came into force on 1 April 2017. In response to our December consultation one supplier argued that the amount of headroom provided for in the prepayment methodology was insufficient and that this was reducing competition. A number of suppliers of all sizes stated that the implementation of the prepayment price cap had led to a reduction in switching rates. However, these suppliers did not provide supporting evidence . Most switching data does not differentiate by meter type, but early analysis of suppliers who supply primarily PPM customers show that they are continuing to grow at a similar rate to prior to the PPM cap. This is indicative that there is still a reasonable amount of switching going on in the PPM market. We welcome evidence on switching levels in the PPM market.

4.15. We are looking at the impacts of the prepayment safeguard and will consider these when considering headroom for the default tariff cap. We will also be looking at the examples from other countries and sectors that could inform our thinking.

*Impact on the incentive to switch supply contract*

4.16. Price differentials provide some of the necessary incentives for consumers to engage in the market. In response to our December consultation a respondent suggested that we should conduct research on the relationship between price and consumers' action to engage.

4.17. We are looking at a range of historic studies[4] to get an overview of what consumers say they need to switch. However, many of the existing studies are stated preference, where a consumer is simply asked a question in relation to how much "would they" switch for, and this does not always match actual behaviour observed.

4.18. We are looking at including results from trials and studies that are based on actual observed consumer behaviour. We are also considering studies that are intended to

[4] These will include a number of sources, for example the CMA research to support The Energy Market Investigation.

reveal consumer's preferences to complement the stated preference studies and trial results.

4.19. To explore consumer perspectives of the price cap we will look at the feasibility of qualitative research with consumers, potentially using the Ofgem Consumer Panel. These types of forums are more appropriate for exploring some of the more in-depth issues around the perceived "safeguarding effect", when a price cap creates a disincentive to engage in the market because consumers feel they are being protected and receiving a fair price under the regulated tariff.

*4.20. We welcome views or suggestions of alternative sources of evidence. Due to the requirement of legislation to introduce the cap as soon as practicable we need to consider what is proportionate within the current timeframe. We welcome engagement from price comparison websites and other stakeholders who might provide additional data that could be useful in looking at the impact of price differentials on switching.*

### d) Impact on supplier incentives

4.21. To inform our position on both efficiency over time and enabling effective competition we intend to undertake some qualitative analysis on how suppliers might behave under the default tariff cap.

4.22. This is likely to involve qualitative scenario based analysis, considering the different behaviours and incentives you would expect to observe when a price cap is introduced into a market.

4.23. As discussed previously, we also intend to undertake some simple analysis on the different impacts the default tariff cap could have on the wider market. This is likely to be a combination of qualitative scenario analysis together with some analysis of current default and fixed prices.

4.24. We will also analyse the price dispersion in the prepayment market before and after the cap. Also checking the extent to which suppliers' prices are below the cap and how that compares to the level of headroom in the prepayment safeguard design.

## 5. Next steps

5.1. We are planning to publish more working papers on different topics in April and these will be followed by a formal policy consultation, summarising our overall thinking.

5.2. We welcome comments on all of the proposed approaches and analysis set out in this paper. We are specifically interested in views on:

- alternative sources of evidence or analysis we should consider;
- our approach to assessing the impact on consumer bills and on revenues and profitability, and in particular the best way to assess the impact on the smaller suppliers; and
- additional data that could be useful in looking at the impact of price differentials on switching.

5.3. We are looking to receive views and comments by **23rd April**. Please submit directly to our mailbox: retailpriceregulation@ofgem.gov.uk.