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**25 June 2018**

Dear Sir / Madam,

**Response to Ofgem's consultation on the design of the new default tariff cap**

This submission was prepared by Citizens Advice. Citizens Advice has statutory responsibilities to represent the views of electricity and gas consumers in Great Britain. This document is entirely non-confidential, and may be published on your website. If you would like to discuss any matter raised in more detail please do not hesitate to get in contact.

In summary, we:

- Support Ofgem's proposal not to further consider a basket of tariffs approach for setting the initial cap.
- Think the three other models proposed are workable, but have a preference for the Updated Competitive Reference Price model (Option 3). As an evolution of the existing PPM price cap methodology it is largely tried and tested, and the use of updated price data in its calculation should make it more reflective of current market conditions than Option 2.
- Support the adjustment of the headline prices used under Option 3 to net out the effect of any policy cost exemptions.
- Broadly support your proposals to narrow down the group of tariffs that are used to set the competitive reference price, such as the exclusion of tariffs from suppliers with large numbers of disengaged customers from this group.
  - But think the proposed exclusion for poor customer service should only cover those suppliers who have been subject to an enforcement finding, and not also include those who are under investigation.
- Support the inclusion of a normal level of profit that is based on the range suggested by the CMA's 2014-16 energy market investigation.
- Suggest that you may wish to consider including an efficiency ratchet to claw back the inefficiency found by the CMA over the course of several price cap periods rather than through a single 'big bang.' Given the uncertainty on the life expectancy of the cap, we think this should aim to claw back the detriment it found no later than the end of 2020.

- Think the case for including any headroom on competition grounds is weak. It is likely that a reasonably significant spread of deals will remain on the market even if the large incumbents price spreads narrow. There is significant evidence of high switching levels being maintained in energy markets with narrow price spreads and/or regulated prices.
- Support setting separate caps for standard credit and direct debit to reflect their different cost to serve. We agree with your arguments that payment methods are a crude proxy for vulnerability and that trying to subsidise vulnerable standard credit customers through setting the same price for both payment methods may simply disadvantage vulnerable direct debit customers. We agree that bad debt costs should be smeared over all customers and not only attributed to standard credit customers.
- Support not including an exemption for tariffs with no standing charge by default, but allowing for suppliers to seek a derogation if they wish to offer one.
- Support not including an exemption for green energy tariffs by default, but allowing for suppliers to seek a derogation if they wish to offer one.
- Support the proposal to ordinarily only update the level of the price cap once every six months.
  - But think you may wish to set out defined triggers that could necessitate an update outside that timescale.
- Note that widespread disengagement has been a long term feature of this market both here and overseas and that:
  - Ofgem will need to persuasively demonstrate that this disengagement has ended before it recommends lifting the cap;
  - The levels of inefficiency that the CMA found should be wholly removed before Ofgem recommends lifting the cap; and
  - Ofgem should develop proposals for enduring price protection for vulnerable consumers that will remain in place after the default tariffs cap expires.

We explore these positions further in the remainder of this submission, framing our comments against the six consultation questions in the overview document.

*Question 1: Which approach for setting a benchmark for efficient costs do you think would be most appropriate?*

The explanation of the pros and cons of each of the four possible methodologies is balanced and reasonable. We agree that Ofgem is right to rule out the market

basket of tariffs approach as there is a reasonably high likelihood that it would not reflect the long-run costs of an efficient supplier. For more background on our concerns with the market basket approach, please see our responses to your first and second working papers.<sup>1</sup>

### **Our preferred option is the Updated Competitive Reference Price model**

We think that any of the other three options could reasonably be used, but that Option 3, the updated competitive reference price model, appears to be the best of those options. As a variation on the existing PPM price cap methodology it has the benefits of being largely tried and tested, and of being likely to deliver material consumer savings. By using market prices to establish the initial reference price, many of the difficult and fundamentally subjective choices required by a bottom up approach could be at least partially avoided. While Option 3 has much in common with Option 2, the use of updated price data should mean that a price based on it is more reflective of current market conditions and operating obligations and is therefore more logically and legally defensible. We are aware that the use of only two, at the time relatively immature, suppliers to create the PPM cap reference price remains relatively controversial and is often used by some in the industry to criticise the legitimacy of that cap. The pool of suppliers that meet your proposed eligibility criteria for inclusion in the new benchmark is broader than that used by the CMA and should help to build confidence that a price derived from this benchmark is sound and reasonable.

The exclusions and adjustments from the benchmark that you propose appear reasonable to us.

As we have indicated in responses to previous working papers, we think that adjustments to the headline price of reference tariffs do need to be made where a supplier is exempt from the costs of the Warm Home Discount ('WHD'), Energy Company Obligation or Feed-in Tariffs, and we are pleased to see your recognition of this. Any adjustments will need to take into account that some technically exempt suppliers may voluntarily choose to offer the WHD, so in effect there are three categories of supplier (exempt, non-exempt, and exempt but partially incurring these policy costs) and not two.

Given the CMA's findings of significant inefficiency among the large incumbents, we think you are right to try and exclude tariffs from suppliers with largely disengaged customer bases. The criteria you are using to do this, of only including suppliers

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<sup>1</sup> Response to first working paper: <https://tinyurl.com/yb3375e8>. Response to second working paper: <https://tinyurl.com/y8ukhofy>

who have no more than a quarter of their customer base on long term SVT seems reasonable to us.

We also support your decision to exclude suppliers who are delivering an unacceptably poor level of customer service, in order to ensure that the benchmark should enable the delivery of a cap that sufficiently funds good customer service. We note the suggestion that this exclusion will cover suppliers where you have proposed or enforced disciplinary action for non-compliance with licence conditions. We think that you may wish to narrow this constraint to only those where you have enforced action for non-compliance. This is because not all enforcement cases will result in a finding against the relevant licensee, and it could be considered to send out inconsistent regulatory signals, or to be prejudging a case, if a participant is excluded from the reference basket when no finding has been reached against them.

We agree that the price data that is used in the benchmark should include at least the two cheapest suppliers. There may be a case for adopting a lower quartile approach that incorporates more suppliers. Including a larger number of suppliers may help to improve the robustness and defendability of the benchmark, and avoid the risk that it could be driven by a data outlier. The decision to exclude suppliers with a significant portfolio of sticky customers should form an adequate protection to allow a larger number of suppliers to form the reference price without undue concern that this price may be inefficient.

On the incorporation of a normal level of profit, we agree that the CMA's estimates of the normal rate of return should be used. Its figures were reached at the end of an exhaustive inquiry. Large suppliers had the chance to appeal its findings, and did not do so. We note your intention to use a different margin for suppliers using an intermediary to trade and one for those those are not, but are not entirely clear on how this will flow through to the cap that is set given the apparent legislative requirement to set the same cap for all suppliers. Our working assumption is that these two figures will be fed into a volume weighted adjustment to the efficient benchmark and not to differing caps for differing suppliers, but would welcome clarification on this point.

#### Option 4: the bottom-up cost approach

While we prefer Option 3, this does not mean we think the other two options are unworkable. The Option 4 approach of building a bottom up costs model looks workable to us, but it is not clear to us that it would give a more robust and accurate answer. This approach would involve the regulator making a much larger number

of assumptions of what the efficient cost of supply would be than under either Option 2 or 3. Each of those individual decisions would come with its own risk of error, and there are significant information asymmetries between the regulator and its principal data source, suppliers, that further enhance the risk of reaching the wrong answer. The bottom up approach looks particularly logistically challenging to deliver in the very limited time you have remaining. Furthermore, adopting a very different methodology to calculating this mass market default tariff cap to the one that will remain in place for PPM customers may create the risk that two are disconnected in the levels at which they are set and how they move. This could create legitimacy problems for either or both caps, even if individually they are both being correctly calculated and updated.

### Option 2: a less accurate version of Option 3

Option 2 is also workable. As the most similar option to the existing PPM price cap it would probably be the easiest to implement, the easiest to forecast and understand, and the most likely to deliver a default tariff cap that is logically consistent and in sync with the PPM price cap.

However, it is dependent on using a small number of now dated price points. This may undermine whether it can be trusted to deliver an efficient benchmark, and any inaccuracy in so doing could harm either consumers (by setting it too high) or suppliers (by setting it too low). Option 3 appears to provide a better balance of harnessing the benefits of maintaining consistency with the PPM cap while utilising a more robust, recent and larger data set.

The CMA found that, on average over the years 2012 to 2015, consumers were paying £1.4bn/year more than they would under an effectively functioning market. The situation was deteriorating over time, and reached £2bn/year in 2015. Just over half the average annual excess, £750m, related to inefficiency. Part of the function of this default tariff cap must be to try and drive out this inefficiency and not simply to allow it to be passed through to consumers. It therefore needs to be challenging for inefficient suppliers to beat the cap. At the same time, it is unrealistic to expect that all these inefficiencies can be driven out in the first price cap period and there may be supplier solvency or customer service quality issues if this is attempted.

It may therefore be appropriate to design in a mechanism that allows the steady tightening of the cap over its lifespan to drive year-on-year efficiency improvements rather than a 'big bang' one-off slashing of costs. This could be achievable through a CPI-X annual adjustment to allowable supplier costs (under options 2 to 4).

Alternatively, headroom could be deflated over time, which would be conceptually clumsier but could achieve the same net effect.

While the cap could be extended until 2023 under the draft legislation, it is only certain to be in place until 2020. We therefore think that any incremental approach to clawing back inefficiencies would need to be parameterised in such a way that the inefficiencies that the CMA found are wholly eradicated no later than the last price cap window set in 2020.

*Question 2: What are your views on the issues we should consider when setting the overall level of the cap, including the level of headroom?*

As we highlighted in our response to your third working paper on the price cap's design, the case for including any headroom at all is relatively weak. That response made the following key points:

- While incumbent supplier price spreads may narrow as they are less able to subsidise acquisition deals through default tariff revenues, there are a large number of smaller suppliers, principally competing on headline price, and who are not subsidising those prices with default tariff revenue. The need for those suppliers to remain price competitive to gain market share is likely to limit price inflation in the 'best buy' tables.
- While the level of the new cap has not yet been set, were it to be a version of the PPM cap modified for the cost to serve other payment methods this would be several hundred pounds above current best buys - and we think that consumers would still be willing to switch for several hundred pounds.
  - Switching levels during the previous period of GB retail energy price caps (1996-2002) were similar to those we see today, despite the savings typically achievable from switching being much lower (less than £100 in today's prices).
  - Switching levels peaked in 2008, when the savings typically achievable from switching were much lower than they are today.
- Statistical analysis of the linkages between price spreads and switching rates suggests that there is no statistically meaningful relationship. While there are periods where high savings coincided with high switching rates and low savings coincided with low switching rates, there have also been periods where high savings coincided with low switching rates or low savings coincided with high switching rates.

We concluded that ‘in deciding whether to include headroom, we think you would therefore need to determine the trade-off between the beneficiaries of such a move (the minority pool of switchers, who might be able to save slightly more) versus those left worse off by it (the majority pool of sticky customers, who are likely to pay slightly more). We think it is unlikely that this trade-off will be positive.’

To avoid excessive repetition, we attach that submission to this one and it should be referred to for a fuller understanding of our views.

Given energy retail price caps already exist in the UK, in Northern Ireland for customers of the former monopoly, and in Great Britain for prepayment meter customers, you may wish to analyse the price spreads and switching rates in those segments to inform your views on what level of price spread is needed to drive consumer engagement.

As noted in our answer to the previous question, Ofgem may wish to consider including an efficiency ratchet within its price cap methodology that incentivises suppliers to get steadily more efficient over time. It is possible that this could be achieved by steadily deflating any headroom allowed, if you decide that headroom is needed.

*Question 3: Do you agree with our approach to accounting for different costs, in particular additional costs of serving consumers paying by standard credit?*

Yes, we do.

As we highlighted in our response to the first working paper, we think that there is a need to set separate caps for those paying by direct debit and those paying by standard credit, to reflect their different cost to serve. While simply taking an average of the two might be simpler, there is a risk that this could end up setting a cap that is too high for one payment method and too low for the other, with potentially negative unintended consequences.

You highlight that some stakeholders have suggested that there may be benefits in applying the same cap for both payment methods because standard credit customers are more likely to be fuel poor, and that therefore there might be a social policy argument for wishing for them to be subsidised by direct debit customers, but suggest that you are not persuaded that payment method is a good proxy for fuel poverty. In particular, you highlight that fuel poor customers are actually more likely to pay by direct debit than by standard credit. This point is well made. Both

payment cohorts are very diverse and will include both affluent customers and those who are struggling to pay their bills. It is not clear that there is a strong social policy argument for pushing up direct debit bills in order to subsidise standard credit bills.

We also agree that there is no reason why all the costs of bad debt should be loaded on to standard credit customers who pay on time, rather than spread across the entirety of suppliers' customer base.

The approach proposed for allocating costs at different consumption levels appears reasonable. We note the concern that in theory it may discourage suppliers from offering tariffs with no standing charge. Few if any suppliers offer a default tariff with that characteristic. We believe the proposed approach of allowing suppliers to seek derogations were they to wish to do so could cater for this, and they would remain able to offer no standing charge tariffs as acquisition deals.

*Question 4: Do you agree with our proposals for how we will update the cap?*

Broadly, yes.

We agree with your proposal not to use a market basket of tariffs to update the cap. In our view, that approach would suffer from the same structural weaknesses as using a market basket of tariffs to set the initial cap. Principally, these are that the basket may not be representative of efficient sustainable prices, may simply reflect loss-leading acquisition deals, and is unlikely to make allowance for policy costs.

Of the other options, we prefer the use of a set of cost drivers outside suppliers control (Option C) over a period review of suppliers' realised costs (Option B). The Option B approach has multiple significant weaknesses, not least that this data is only available in arrears, making it of limited use in forecasting, and that it may not reflect efficiently incurred costs. Option C is likely to be more objective and easier for third parties to model and forecast.

We note that the draft Bill requires Ofgem to update the cap at least twice a year. You seek feedback on whether you should choose to update it more frequently than this. We think it is unlikely that more frequent updates will be necessary because most of the underlying costs are either unlikely to either move by a limited amount in any six month period or will only move on set dates. For example, the network costs component should only change at defined dates in the calendar set by Ofgem. VAT extremely rarely changes, although it is possible that this could change with



Brexit. While the cap will need to incentivise efficiency, it is unlikely that suppliers internal costs would move by a sufficiently large margin in any six month period to justify a shorter cap. Wholesale costs are more likely to be volatile than other components of the cap, but are still unlikely to be sufficiently volatile as to justify more frequent movements in the cap and suppliers could at least partially mitigate that risk if they so chose by adopting a hedging strategy that largely replicates the implied hedge in the cost index used to update the cap.

As you highlight in the consultation document, suppliers are well used to managing volatility in some costs like wholesale prices without changing default tariff prices more than twice a year (and frequently while changing them less frequently than that). They will also have built some familiarity with this frequency being applied to price capped customers given its use in the PPM price cap. There are also likely to be diseconomies associated with continuously tweaking the cap - notifying customers of any changes to their prices come with a cost. So we are supportive of your core proposal that the cap should be adjusted twice per year.

If there is a desire to maintain the option of more frequent adjustments, we suggest that Ofgem may wish to define the potential re-openers in advance in order to give all stakeholders certainty on what would prompt that change. This could be, eg, if the cost index moves more than a defined threshold away from where it was at the time the cap was last set, or if a defined trigger event (such as eg the VAT rate on energy supply changing) is met.

*Question 5: Do you agree with our assessments of whether an exemption for tariffs that appear to support renewable energy is necessary and workable?*

We agree with your proposals in this area. In particular, we strongly agree that there should not be a default exemption and that a supplier should have to apply to Ofgem for a derogation where it could demonstrate that its tariff satisfied a challenging set of criteria or outcomes.

Our reasons for holding this view is that a blanket exemption for green default tariffs would only be sustainable if there was evidence that they are inherently high cost to provide - and we see no evidence that they are. You highlight that the underlying GB generation mix is increasingly low carbon and that all consumers are paying towards decarbonising the economy. We would go farther than this, and note that many acquisition tariffs claiming to be 100% backed by renewables are priced significantly below the likely level of any default cap.

We are comfortable with your proposal that derogations could be allowed for green default tariffs where challenging defined outcomes are met.

*Question 6: Do you have any views on the what information we should use to assess the conditions for competition?*

We do not underestimate the challenges of putting a price cap in place, or the very real risk of negative unintended consequences. But we also think that some of the narrative in this section of the consultation document presents a somewhat false dichotomy of having to choose between a world with price protection but no competition, or one with competition where disengaged customers are ripped off. In practice, we think that competition and price regulation can comfortably co-exist.

There are real world examples of this, including in Great Britain. From the period where the domestic retail energy market started to open in 1996 through to 2002 there were retail price caps on the former monopolies, yet a level of switching existed that was comparable with that we see today.<sup>2</sup> In Northern Ireland, where price caps still exist, the switching rate for electricity is broadly similar to that in Great Britain.<sup>3</sup> In the Republic of Ireland, where domestic electricity prices were regulated until 2011 and domestic gas prices were regulated until 2014, switching rates have either dropped (in the case of electricity) or remained similar (gas) since their removal.<sup>4</sup> We would expect the price spread for the large incumbents to narrow as they are no longer able, or at the very least are less able, to cross-subsidise acquisition deals with over-priced default tariffs, but the sheer number of smaller suppliers now in the market is likely to act as a constraint on the extent to which the cheapest deals in the market inflate. Provided a reasonable achievable saving remains on the table, there should still be adequate incentive to switch - as explored in our earlier comments on headroom.

It will be important that consumers understand that the price cap is not a 'market best deal' or even a cheap one, and simply limits the extent to which they will overpay if they are disengaged. They will need to receive appropriate advice and messaging on the need to engage and consider switching if they want to be on the

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<sup>2</sup> See Figure 1 and the exploratory narrative on the preceding page of our response to your third working paper on headroom. <https://tinyurl.com/yc7f746x>

<sup>3</sup> The same percentage of household electricity customers, 15.8%, changed supplier in 2016 in both Northern Ireland and Great Britain. In 2017 the switching rate was a little higher in GB (18.2% versus 15% in NI). Sources: 'Quarterly domestic energy switching statistics (QEP2.7.1),' BEIS, for GB and 'Quarterly Transparency Reports, UREGNI, for NI.

<sup>4</sup> Figures 8.3, 8.9, '2016 Electricity and gas retail markets annual report,' CER, June 2017. <https://tinyurl.com/y9jif6fx>

best deal. Both our organisations will need to play a part in this, and we would be happy to work with you to develop our ideas and approach to delivering this.

You characterise 'effective competition' under the current market model as having three components: rivalry between energy suppliers who are offering differentiated tariffs and services that meet the needs of consumers; unrestrained movement of energy suppliers in and out of the market; and informed and active consumers who are able to shop around easily for better energy prices and services. While we wholly agree with the first of these three things, we think the market shows limited evidence of the third - and may always show limited evidence of it, with or without a cap - and question the focus of the second.

In terms of that second test, in our view a market should have proportionate barriers to entry and exit rather than unrestrained ones. The explosion in the number of small suppliers in the market in recent years has delivered significant benefits to some consumers in the form of greater choice and lower prices (albeit the latter has also been driven at least in part by unsustainable policy cost exemptions, which both distort competition and push those costs on to poorer customers who are less likely to switch). But it has also seen a number of suppliers who are under-prepared - either operationally, financially, or both - enter the market. Ofgem will be aware from our previous discussions that we think that market entry checks need tightening to protect consumers against these risks. Under-performance or failure of new entrants may not simply directly affect their customers but may impact on consumer confidence and engagement more broadly. For example, we are starting to see consumer advice providers adding filters to price searches to only include 'big brands' at least partially in response to consumer concerns that they may experience customer service problems with less well known ones.<sup>5</sup>

In terms of the third test, we recognise its theoretical basis but question whether it is likely that the majority of consumers will ever be active. Great Britain has one of the highest household energy switching rates in the world, with around 17% of consumers - one-in-six - changing supplier each year. Consumer awareness of the right to switch is near universal, and has been near universal for several decades.<sup>6</sup> Consumers are very frequently reminded of the benefits of engagement by a range

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<sup>5</sup> *'We know many have reservations about switching to certain firms so let's address the main worries... Worried about switching to a firm you've never heard of? We know this is the biggest switching turn-off for many, so we've a special 'Big Name Supplier' filter where we remove all bar the Big 6 + Co-op, First Utility and Ovo. To see all suppliers, just unclick the filter.'* moneysavingexpert.com weekly money saving email, 30 May 2018. <https://tinyurl.com/y8w9l84y>

<sup>6</sup> The domestic customer survey conducted by GfK for the 2014-16 CMA Energy Market Investigation found that 89% of consumers were aware of their right to switch energy supplier. <https://tinyurl.com/gr9vw5v> In 1999, a Mori poll for Ofgem's predecessor, Offer, also found that 89% of consumers were aware of their right to switch electricity supplier. <https://tinyurl.com/yaauyhtz>

of bodies, including both us and you. It is not difficult to switch suppliers, and only a very small proportion of switches experience problems. Yet despite this very high awareness and, for many consumers, very low barriers, the majority of consumers are fundamentally disengaged from the market. Ofgem's own findings are that 58% of consumers have either never switched or have only switched once.<sup>7</sup>

Because of this, we have some doubts as to whether it is realistic to think that the majority of consumers will ever fully engage with the energy market. The last two decades in Great Britain, and ongoing international experience, do not provide a strong evidential basis for thinking that they will.

This risk that high levels of disengagement are an inherent feature of the energy market, and not simply a transitory glitch that can be corrected with more behavioural nudges or time limited interventions, has led us to the view that vulnerable consumers probably need enduring protection from excessive pricing. We welcome the signals from both Dermot Nolan<sup>8</sup> and Claire Perry<sup>9</sup> that this view is shared by both Ofgem and the government. We would welcome Ofgem publishing its plans for how it will deliver enduring price protection for those consumers.

For consumers who will fall outside the scope of that protection - likely, the majority - the challenge for Ofgem in applying this third test will be in reaching a view that they would be active when the cap is removed, when historically they have not been. We would look to you to demonstrate a credible case for why their behaviour would have changed and/or why any relevant changes in technologies or product design may have modified their disinclination to engage before you remove the cap. In particular, we would look to you to build a compelling case that the market would not simply revert to current behaviours - with the majority of disengaged consumers paying a huge premium over the minority of engaged ones - before you reached a recommendation to remove the cap.

In addition, we would also look to you to provide evidence that the detriment that the CMA had found, in terms of excess profits and inefficiency, had been wholly eradicated before reaching a recommendation to remove the cap.

We trust this submission is clear, but would be happy to discuss or clarify any issue raised in more detail if that would be useful.

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<sup>7</sup> 'State of the energy market, 2017,' Ofgem, October 2017.

<sup>8</sup> Q361, BEIS Select Committee pre-legislative scrutiny of the price cap bill, 10 January 2018. <https://tinyurl.com/yal5d6n9>

<sup>9</sup> Q465, BEIS Select Committee pre-legislative scrutiny of the price cap bill, 17 January 2018. <https://tinyurl.com/ydfwnh87>

Yours sincerely

A handwritten signature in black ink that reads "Rich Hall". The signature is written in a cursive, slightly slanted style.

Richard Hall  
Chief Energy Economist