Making a positive difference
for energy consumers

Call for Input

Adapting the Price Cap Methodology for Resilience in Volatile Markets

1. Purpose of the document

High and volatile gas and electricity prices continue to put severe strain on energy markets. The price cap has delivered significant benefit to consumers and provides a degree of protection from this price volatility. However, the current design could result in higher costs for consumers in the longer term unless it is amended to allow suppliers to better manage risk and costs. This paper explores technical changes that could be made to the price cap methodology to ensure that it is more resilient to extreme commodity price volatility whilst continuing to protect consumers. Our goal is to protect the interests of consumers, and rebuild consumer and investor confidence in the market.

We are seeking views from stakeholders on whether change is needed, and if so, on the potential adaptations. If we decide there is a case for change, we will issue a formal policy consultation on changes to the price cap methodology in early 2022. Key questions are set out below, with instructions on how to respond.

If we decide to proceed, our aim is to have an amended price cap methodology in place by October 2022, ahead of next winter. Risks may materialise ahead of this, so we are also consulting[1] on potential interventions that could be in place from April, should they be needed.

This paper focuses on changes that can be made rapidly, within the existing legislative framework. However, we also recognise the need for wider debate on the future of energy retail markets: how best to protect consumer interests in a decade that may see continued energy price volatility, in a sector which is decarbonising at pace, and which will see increasing potential benefits from flexibility and digitalisation. We will be turning to these in the New Year, working closely with stakeholders.

[1] https://www.ofgem.gov.uk/publications/building-energy-market-resilience

2. What is the problem and what is Ofgem's planned approach

The price cap to date has delivered around £1bn in consumer benefit each year, driven cost cutting efficiency amongst incumbent suppliers, and has protected consumers from the full force of rising energy prices this winter. In the face of these sharply rising prices, poorly hedged suppliers have found themselves unable to afford to supply customers and have exited the market – Ofgem is strengthening our approach to regulating financial risks in the sector to ensure suppliers are better able to cope with such shocks in future (see separate paper[2]).

But the volatility has also hit well-hedged suppliers with hard to manage 'volume risk'. Suppliers routinely manage volume risk, but it is much more challenging at times of high price volatility: they have faced considerable costs from the unexpected increase in the number of customers on price-capped SVT tariffs; they will also face the converse risk as prices fall, with active consumers behaving rationally and shifting from SVT tariffs back to what may then be cheaper fixed tariffs at a time that will be hard to predict, and thus hard for suppliers to hedge appropriately for.

The average eight-month lag between forward wholesale prices and their recovery through the price cap, and the use of 12-month hedges helps to smooth prices for consumers, also contributes to this volume risk for suppliers.

At times of high energy price volatility, these volume risks could leave even well managed suppliers with losses, potentially amounting to significant losses across the sector. If not addressed, either by making technical changes to the price cap to reduce the risk or increasing profit allowances for suppliers to cover any additional costs, there is a risk of further supplier failures and exits, and an undermining of investor confidence to enter or invest in the retail market. This could lead to reduced competition and higher costs for consumers. We believe that tackling this issue is in consumer interests.

This Call for Input considers options for making changes to the price cap methodology within the framework of existing legislation, to ensure the price cap is more resilient in the face of volatile energy prices, and so protect consumers' longer-term interests. The options outlined in this paper are aimed at addressing this issue either through allowing emergency

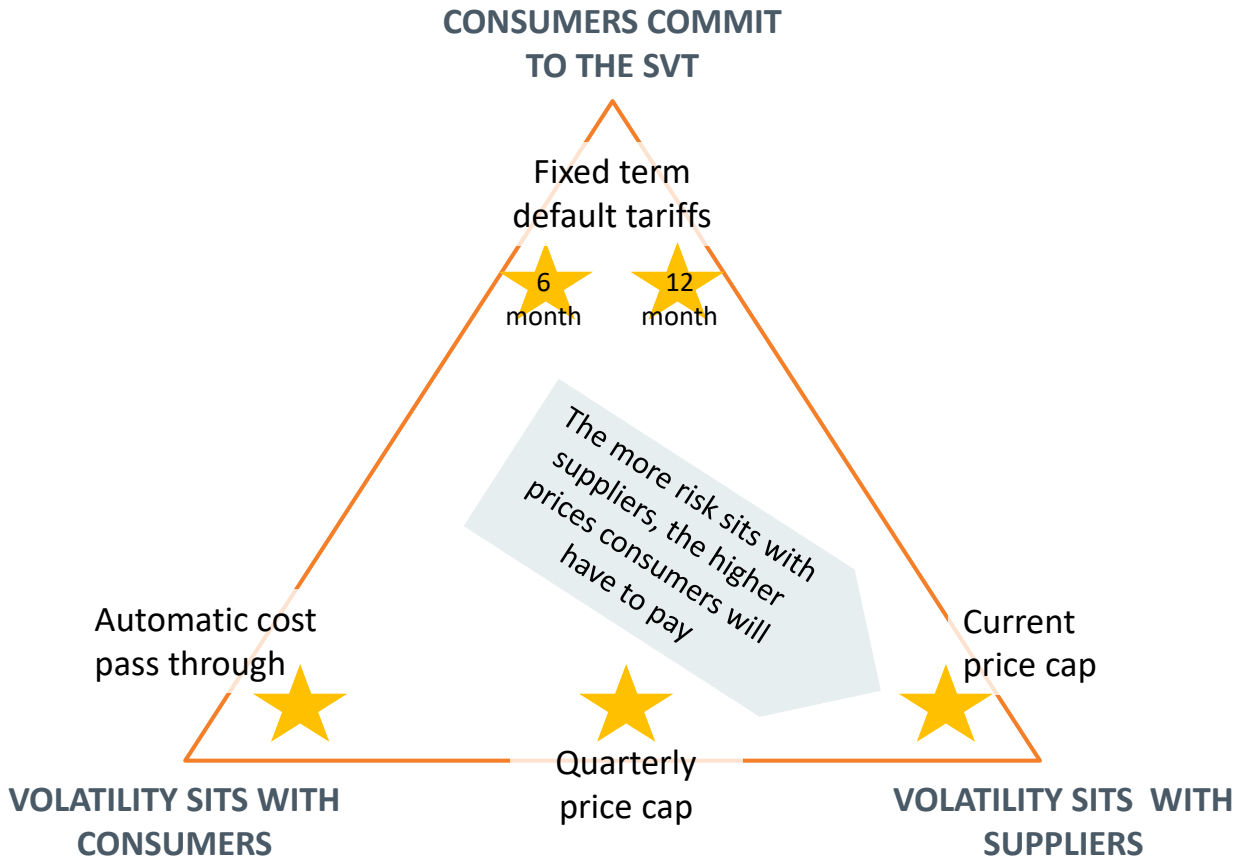
[2] https://www.ofgem.gov.uk/publications/building-energy-market-resilience

adjustments to the current price cap methodology, passing wholesale costs through to the price cap more quickly, or moving to a 'fixed mortgage' type approach that enables suppliers to better manage volume risk.

The options expose significant trade-offs, getting these wrong will result in higher costs for consumers: price volatility (and the associated volume risk) can be reduced for suppliers, but only by increasing the frequency of price changes for consumers or by limiting to a degree consumers' ability to move freely between tariff types, for example by requiring consumers to commit to staying with suppliers for a certain period of time, say 6 months or a year.

These trade-offs can be expressed as a 'trilemma' as illustrated in the diagram below:

Diagram: the price protection trilemma



We are keen to hear stakeholder views on how to solve this challenge in the interests of consumers. Specifically:

Question 1: what is your view on the nature and scale of the volume risk facing suppliers, and the case for changing the current price cap methodology?

Question 2: what is the best way to tackle this issue whilst protecting consumer interests?

Question 3: which adaptations to the price cap are preferred and why, including any additional options not set out in this paper? (Please provide an outline description of how any alternatives would work)

3. The purpose of the price cap

The goal of the price cap legislation was to tackle the excessive tariff differential seen in the market, commonly known as the loyalty penalty. The goal is spelt out in section 1(6) of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (Act) which states that Ofgem must set the cap "with a view to protecting existing and future domestic customers who pay standard variable and default rates".

The legislation gives Ofgem considerable discretion in how the price cap works in practice. In setting the cap, our primary consideration has been, and remains, the protection of existing and future consumers who pay standard variable and default rates.

Section 1(6) of the Act also outlines the criteria Ofgem must "have regard to" when setting the cap:

i. the need to create incentives for suppliers to improve their efficiency
ii. the need to set the cap at a level that enables suppliers to compete effectively for domestic supply contracts
iii. the need to maintain incentives for domestic customers to switch to different domestic supply contracts
iv. the need to ensure that suppliers who operate efficiently are able to finance activities authorised by the licence

In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Given the increased costs and risks facing suppliers, we believe even efficient suppliers may find it more challenging to finance their activities, and that modifying the price cap to reduce the risks they face is in consumers interests.

4. Potential adaptations to the price cap

In the first instance, we must consider whether there is a sufficient case for making any adjustment to the price cap methodology. One option is to do nothing.

Option 1 - Enhanced Status Quo: An alternative is to retain the existing price cap methodology, but with an enhanced ability for Ofgem to adjust the price cap in extreme circumstances. We are already consulting on a potential price cap re-opener[3] which enables Ofgem to adjust the price cap level outside of the current 6 monthly cycle. We could go further with an automatic 'circuit breaker' triggered by certain circumstances. A further change, which could potentially be applied to all three options, is to reduce somewhat the current two month gap between the observation window closing and the price cap period starting, thereby lessening the 8 month lag.

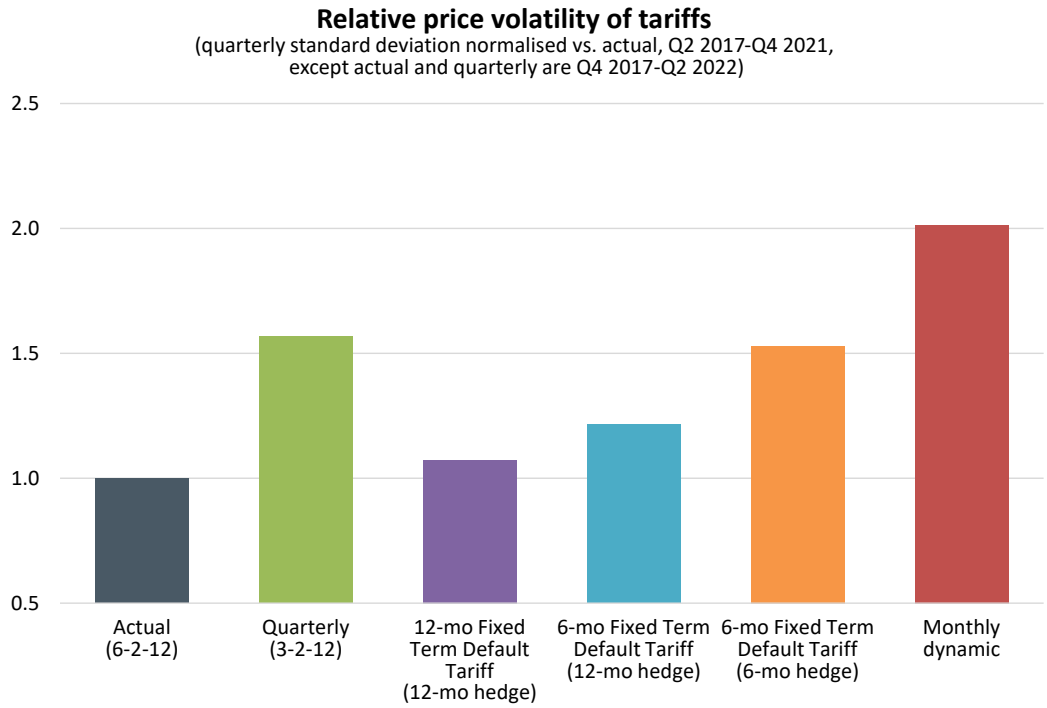
We are keen to understand stakeholder views on whether this approach would sufficiently mitigate the risks of volatile prices in the interests of energy consumers. If not, there are two potential adaptations to the price cap methodology that would help to address the issue:

Option 2 - Quarterly Updates: This option uses the existing cost-based price cap methodology, but updates the wholesale cost component every three months (instead of 6 months under the current cap), resulting in quicker pass through of wholesale costs rises and falls, thereby reducing the lag between wholesale price movements and their recovery from 8 to 5 months. The price level could be set using forward prices for three months, six months, or twelve, with different balances of price smoothing for consumers vs risk remaining with suppliers.

[3] Price Cap – Consultation on the process for updating the Default Tariff Cap methodology and setting maximum charges | Ofgem

Option 3 - Fixed Term Default Tariff: This option works in a similar way to a fixed mortgage, with a price fixed for 6 months, that is set by Ofgem each month (for consumers starting their tariff that month), and an exit fee that would potentially decline over the six months. Apart from the change to the way the way the wholesale cost element is calculated, all the other costs (such as network costs) would follow the existing calculations for the price cap. This option would protect both consumers and suppliers from price volatility. The price of the tariff could be based on either 6 or 12-month forward prices hedges. Another variation would be to have an annual fixed contract, with matching 12-month forward pricing.

All three options described above (and in more detail below) continue to provide protection from unfair pricing, but they allocate price volatility differently, and result in different levels of price smoothing for consumers (see chart below). The fixed term default tariffs, if based on 12 month hedges, offer similar levels of smoothing to the current price cap methodology. Automatic monthly pass through of wholesale prices would expose consumers to high levels of volatility, which is the main reason we do not favour this as an option. And the quarterly cap and a six month fixed term default tariff based on six month forward prices leave consumers with moderately increased levels of volatility.



They also come with individual pros and cons, for example, the fixed term default tariffs largely eliminate volume risk for supplier, keeping costs down for consumers, but achieve this by introducing an exit charge for consumers who wish to switch before the end of the fixed term, or making some other adjustment.

5. Price Cap Options in detail

Option One: Status Quo with Re-opener

What is the proposal?

Under Option One, Ofgem would retain the existing price cap methodology, but with an enhanced ability to adjust the price cap in extreme circumstances. We are consulting on a potential price cap re-opener which enables Ofgem to adjust the price cap level outside of the current 6 monthly cycle. A stronger version of this could potentially be introduced with criteria specified in advance (eg, a specified gap between the SVT and market prices, in either direction) that would trigger a change in the price cap level. Such a 'circuit breaker' would provide market participants with greater certainty and could potentially enable the price cap level to be changed more quickly.

Does it fix the volume risk for suppliers?

In times of volatile, rapidly increasing or decreasing prices, this option cuts through the average 8-month lag of wholesale prices, which is one of the primary drivers of volume risk for suppliers. However, it only reduces this lag if changes are relatively severe. There would still be periods where suppliers are exposed to unexpected/unhedged demand. Option one therefore only partially addresses the volume risk, and in a less predictable manner.

What is the consumer experience?

This enhanced status quo option would retain price smoothing for consumers, except in exceptional circumstances (such as now).

Other impacts including potential unintended consequences

It would complicate risk management and hedging strategies for suppliers, but uncertainty could be minimised by clear criteria for triggering the circuit breaker. There are also potential distributional impacts - at times of rising prices, it would result in inactive SVT consumers paying higher prices to cover the costs incurred by suppliers in supplying energy to active customers returning to the SVT. As with other cost based options for calculating the price cap,

the current price cap is relatively interventionist in that the regulator is calculates the level of efficient costs and profit allowance.

Option Two: Quarterly Cap

What is the proposal?

The Quarterly Cap involves updating the wholesale cost components of the price cap every three months using the existing price cap methodology, using the average forward prices for energy delivered in the coming 12 months starting with the price cap period to avoid seasonal variation. Instead of the current six month observation window, a three month observation window would be used. Non-wholesale costs would be updated 6-monthly, although there is the potential to also update some volatile policy costs, e.g., Contract for Difference costs, or Interim Levy Rate to the same 3-month cycle.

Does it fix the volume risk for suppliers?

This option reduces the average 8-month lag of wholesale prices, which is one of the primary drivers of volume risk for suppliers. However, it only reduces this lag to 5 months. There is still an extended period where suppliers are exposed to unexpected/unhedged demand. So, this only partially addresses the volume risk.

What is the consumer experience?

Quarterly price cap updates continue to provide price cap protection for consumers on default tariffs. It slightly reduces price smoothing for consumers with prices changing quarterly rather than half yearly. Some suppliers might continue to smooth direct debit adjustments to provide a better consumer experience. However, this cannot be done for consumers with prepay meters, or those on standard credit. Price rises may cause stress to some consumers if they happen over winter months, and more frequent price updates could be confusing to customers and/or make it more difficult to budget.

Other impacts including potential unintended consequences

Quarterly updates may decrease the chance of bill shock for consumers, with prices adjusting more frequently but in smaller jumps. Suppliers may face an increased administrative burden with more frequent price updates. As with other cost based options for calculating the price cap, the quarterly price cap is relatively interventionist in that the regulator is calculates the level of efficient costs and profit allowance. Quarterly pricing reflects current market prices slightly more quickly than the current price cap. However, it does not provide any additional

value for consumers who can provide demand flexibility, which will be essential in the future if we are to keep costs down.

Option Three: Fixed term default tariff

What is the proposal?

A fixed term default tariff would introduce 6-month contracts, which would become the default for current SVT consumers. There would be a window when each contract renews where a consumer would be able to switch away or select a different tariff. Outside of this window, exit fees would apply. The exit fee could be set at the economic cost determined at the point the customer leaves, ie diminishing over the contract period. The wholesale component would be the observed price of the 6-month hedges during the month preceding the start of that fixed term default tariff. This price would be fixed for the duration of the contract, but a new price level would be set each month for consumers joining the tariff that month. The other components could be updated on a six-monthly cycle, as now. This option could also be configured based on 12-month contracts and/or with the price cap level set using 12-month forward prices, which would deliver more price smoothing for consumers and remove the seasonal impact.

Does it fix the volume risk for suppliers?

This fixed term contract tariff significantly reduces supplier volume risk as suppliers would be able to purchase energy for customers as they take up their default tariffs with a high degree of certainty over demand levels for the coming six months.

What is the consumer experience?

The concept is similar to a fixed mortgage product. And the fixed term default tariff approach continues to protect consumers and additionally smooths prices for consumers during their contracted period. The use of 12-month hedges as sub-options (6 month fixed term with 12-month hedges and 12-month fixed term) also reduce seasonality (relative to the 6 month option) through use of annual hedges. It is unclear what impact this option will have on consumer switching: the exit fee may reduce switching within the contract period, but Ofgem would also require suppliers to remind consumers ahead of each contract renewal, and potentially require suppliers to inform consumers of any cheaper tariffs consumers could switch to – the net impact of these two factors on competition and switching is not clear. There is concern that an exit fee may prove to be a barrier to some switchers, particularly those on low incomes. It is also possible that acquiring suppliers could offer to pay exit fees.

One element of this approach would be different price cap levels depending on which month a consumer began their contract. It is not clear how consumers would respond to this, although it is already the case for fixed term contracts in the energy market and seems an accepted feature of other markets such as mortgages.

Other impacts including potential unintended consequences

There is a question as to whether supplier billing systems could adjust to this new price cap regime, although many do already offer different fixed price tariffs. As with options 1 and 2, this tariff retains the current interventionist approach with the regulator determining prices and profits. However, it does not provide any additional value for consumers who can provide demand flexibility, which will be essential in the future if we are to keep costs down. Separately, although this price protection option takes a slightly different form to the existing price cap, we consider it is compatible with the Price Cap Act, and that the price protection that it would deliver to consumers is, if anything stronger. We will continue to look at legal aspects of this proposal.

6. Other Options

We have also considered other options and proposals from stakeholders. Three of these are set out below, including the reasons why we believe that these options do not effectively tackle the issue, or could expose consumers to excessive prices or volatility. We set them out below in case stakeholders believe our assessment is wrong.

Monthly direct pass-through:

Under monthly direct pass-through, the wholesale allowance would be determined by the prices of monthly hedges during the prior month. Ofgem would calculate and publish the price level in time for suppliers to post the prices on their website and update their systems, say, 8 days before the start of the month. This option would be more reflective of the cost of energy for any given month, reducing the risk for suppliers as they do not need to forecast consumer numbers on SVTs months in advance. It would however expose consumers to significant price volatility (see graph above of Relative Price Volatility of Tariffs), with bills low in summer months, but potentially much higher when demand and (usually) energy prices peak in the winter. It could also have unintended consequences in the wholesale market, as it would likely see the removal of a significant amount of 12-month hedges demand from the market, which are used by generators for revenue certainty.

Relative Price Cap <u>across</u> the market:

A relative price cap sets the maximum default tariff at a premium over a basket of selected competitive tariffs, with choices to be made by the regulator such as the number of tariffs in the basket, their type, and whether the basket should be the cheapest tariffs or average tariffs. The level of the relative price cap would likely be set every month based on the tariff basket the previous month. With this market-based approach, there would be no cost-based calculation of the price cap. This price cap approach should significantly reduce volume risk for suppliers, as the price cap would react quickly to changes in market prices. The price cap level would change monthly, potentially making budgeting more challenging, particularly for consumers on pre-payment meters. A major challenge with the relative price cap is the difficulty in setting an appropriate premium for the price cap. Set it too high, and consumers may face price exploitation, set it too low, and suppliers would be unable to make a profit. In addition, there is scope for suppliers to manipulate a relative price cap, either changing their tariffs to boost the price cap level or, potentially, setting aggressively low tariff levels to bring the cap down and force out other suppliers.

Relative price cap <u>within</u> suppliers:

A relative price cap within suppliers involves setting a maximum price difference between a supplier's cheapest tariff and their most expensive tariff. Having a relative price cap by supplier would result in different default level tariffs by supplier, with some disengaged customers paying significantly more than others depending on the supplier they are with and the supplier's commercial decisions. As such, we do not believe it is in line with the price cap legislation. In addition, we believe it does not guarantee fair pricing: suppliers would be able to influence their cap level through their pricing of fixed tariffs to a greater extent than is possible by setting a basket that incorporates tariffs from across the market.

7. Welcoming Stakeholder Views

While this is not a formal consultation, we are keen for stakeholders to provide us with views to help shape our thinking. We welcome views in particular on the following questions:

Question 1: what is your view on the nature and scale of the volume risk facing suppliers, and the case for changing the current price cap methodology?

Question 2: what is the best way to tackle this issue whilst protecting consumer interests?

Question 3: which adaptations to the price cap are preferred and why, including any additional options not set out in this paper? (Please provide an outline description of how any alternatives would work)

How to respond to the Call for Input paper?

We ask stakeholders, should they wish to comment, **to do so as soon as possible, ideally before the 6th January and at the latest by 13th January**.
Please send your responses and any questions to the Medium-Term Price Cap Adaptation team at pricecapchanges@Ofgem.gov.uk by 6 January 2022

Next steps:

We will **be publishing a policy consultation document early in the New Year**. The policy consultation will, informed by stakeholder views, propose one, or possibly two options that we believe address this issue in the way that best protects consumer interests.

This will be followed later in the year by a statutory consultation including proposed changes to licence conditions.