

# Consultation Response

## Reviewing the potential impact of increased wholesale volatility on the Default Tariff Cap: November 2021 policy consultation

Office of Gas and Electricity Markets (Ofgem)

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## **About this consultation**

Volatility in the wholesale energy market has led Ofgem to reconsider the additional space required within the Default Tariff Price Cap ('the Cap') to account for unexpected spikes in wholesale costs. Ofgem have put forward their preferred reform to the Cap methodology - involving a change to the existing wholesale risk allowance. This would afford additional space in the Cap value to account for increased wholesale volatility.

## **Key points and recommendations**

- Rising wholesale cost increases mean consumers are facing significant increases to their energy bills from April 2022. These increases are happening alongside the proposed changes to the Cap methodology, the impact of other policy costs, and those for dealing with failed suppliers. Ofgem must commit to working with Government to mitigate the impact of this price shock in the Spring.
- Ofgem must further consult on the precise figure proposed for the adjusted wholesale risk allowance. Whilst there are some estimates about its impact on consumer bills, there is continued uncertainty about how much these bills could rise by in April and beyond.
- Ofgem must review the cumulative impact of proposed reforms to the Price Cap, and other measures. Consumers must not unfairly shoulder the costs of reducing risks for suppliers.
- Ofgem's reviews must have greater consumer focus and avoid the sort of crisis thinking which would benefit suppliers at the expense of their customers.
- We agree with Ofgem's view that increasing the earnings before interest and taxes (EBIT) or headroom allowances would not be suitable solutions at this time.
- Suppliers have licence conditions to support customers' ability to pay. Ofgem must ensure these requirements are being met and provide transparency about how suppliers are performing.
- Ofgem should commit to consulting on the design and implementation of a social tariff, as well as work with the Government to legislate to extend the Cap beyond 2023.
- Ofgem should commit to working with the Department for Business, Energy, and Industrial Strategy (BEIS) on the design and structure of new consumer price protections.
- Ofgem and suppliers must do more to ensure that consumers understand the impact of changes to their bills. The sector must keep customers engaged throughout this crisis and beyond.

## **About Age UK**

Age UK is a national charity that works with a network of partners, including Age Scotland, Age Cymru, Age NI and local Age UKs across England, to help everyone make the most of later life, whatever their circumstances. In the UK, the Charity helps more than seven million older people each year by providing advice and support. It also researches and campaigns on the issues that matter most to older people. Its work focuses on ensuring that older people: have enough money; enjoy life and feel well; receive high quality health

and care; are comfortable, safe, and secure at home; and feel valued and able to participate.

## Response

We welcome the opportunity to respond to this consultation. The Price Cap was designed to ensure default tariff customers pay a fair price whilst ensuring suppliers can charge the efficient cost level for energy. Age UK understands the impact that surging wholesale energy costs have had on suppliers. In theory, the Price Cap was designed to ensure suppliers can effectively sustain their business model while reducing the risk of consumers paying above market rates. The Government has recognised that this protection is particularly important for those consumers who are disengaged from the market and are unlikely to switch from a longstanding default tariff<sup>1</sup>.

Our response to this consultation comprises two parts. Firstly, we have specific recommendations regarding Ofgem's preferred amendment to the Cap, via adjustments to the wholesale risk allowance. Our second recommendation is for Ofgem to champion calls for greater consumer support as an essential part of confronting the present energy crisis.

Ofgem have outlined five options for adjusting the methodology of the Default Tariff Price Cap. These options are designed to allow the Cap to better account for increased volatility in wholesale energy prices. Ofgem's 'minded-to' position is to amend the wholesale risk allowance. The wholesale risk allowance is presently fixed at 1% of the core direct fuel allowance for gas and electricity. Its purpose is to ensure the value of the Price Cap is set after accounting for a degree of variability in the wholesale energy costs paid by suppliers. The risk allowance sits alongside the headroom allowance as the two in-built mechanisms for managing market uncertainty. Beside these there is an allowance for earnings before interest and taxes (EBIT allowance) and wider costs are included within the Cap, such as policy costs and VAT.

Ofgem's proposals to amend the risk allowance should allow the Price Cap to better account for increases in wholesale prices. However, it will result in a small increase in the Cap value which will be passed onto consumers. The risk allowance is presently set at 1% of direct fuel costs. Presently, wholesale costs represent £528 of the total Price Cap value<sup>2</sup>. We therefore estimate that the wholesale risk allowance represents around £5 of the total Price Cap value.

While it may be expedient for consumers to see the wholesale risk allowance amended, Ofgem have not set out clear proposals for what this risk allowance will be increased to. We cannot comment on whether a change in the risk allowance is the best option without knowing what sort of range of increase Ofgem is proposing. Ofgem will need to propose an adjustment to the allowance and provide an impact assessment of the additional consumer cost this will entail from April onwards before we can agree or contest this change. We would welcome further consultation on the precise figure proposed for any new wholesale risk allowance as soon as possible.

However, we do agree with Ofgem's view that increasing the EBIT or headroom allowances would not be suitable solutions at this time. Increases in EBIT would not be appropriate during a consumer crisis – as this will pass greater profits onto suppliers at a time when consumers are struggling to heat their homes. Similarly, increases in the

headroom allowance would likely represent a much higher cost to consumers as this allowance accounts for a wider range of supplier expenses beyond wholesale prices.

We welcome Ofgem's commitment to mitigate any risk of Price Cap reforms conducted in the context of the present Energy Crisis from disproportionately benefiting suppliers at the expense of consumers over the longer term. Ofgem are also consulting on a range of other measures and reforms, including supplier financial 'stress tests'. We support Ofgem's commitment to review any reform put in place within 12 months of implementation. However, this review must consider the cumulative effect of recent changes, and not just the impact of separate policies.

Age UK recognises that current proposals for immediate Price Cap reforms from April are being conducted in the context of an Energy Crisis. However, we are concerned with the range of reforms being proposed and the uncertainty about their impact on consumer bills. For example, Ofgem must consider whether changes to the wholesale risk allowance are necessary on top of any wider changes, such as those in the event of 'exceptional circumstances'. A sustainable energy market is to the benefit of consumers, but they should not be left to unduly shoulder the burden of reduced risk to suppliers.

Age UK recognises the importance of an efficient competitive energy market which drives down costs, attracts investment, and promotes innovation. We agree that a Price Cap which reflects the actual costs for suppliers is important, and should reduce the risk of supplier failure, but with increasing numbers of consumers facing unaffordable bills, we need to see a wider discussion about improving consumer support. Ofgem should be pressing for changes to the retail energy market which will not only avoid suppliers going bust, but will ensure that consumers can afford to heat their homes.

New research for Age UK<sup>3</sup> found that almost half (45 per cent) of over-60s are worried about heating their home this winter. A third (33 per cent) of this age group are worried about paying their energy bills this winter, with a similar proportion (32 per cent) worried about having to reduce energy use due to financial concerns.

Around 1 in 10 (roughly 1 million) older households are already in fuel poverty<sup>4</sup>. This represents around 1.4 million older people<sup>5</sup>. The expected increase in the Cap in April will push tens of thousands more into fuel poverty. With higher heating costs<sup>6</sup>, more time spent at home and a greater propensity to live with health conditions which require more heating or energy use<sup>7</sup> - older people will require improved consumer support as part of any Price Cap reforms.

Rising wholesale cost increases mean consumers are facing significant increases to their energy bills from April 2022. These increases are happening alongside the proposed changes to the Cap methodology, the impact of other policy costs, and those for dealing with failed suppliers. Ofgem must commit to working with Government to mitigate the impact of this price shock in the Spring.

Age UK's energy campaign<sup>8</sup> has called for several short-term measures this winter, including a one off £50 payment to those eligible for the Cold Weather Payment, a doubling of the Household Support Fund and improved support for benefits take-up.

Longer term we have called on the Government to provide legislative certainty regarding the Price Cap and to reintroduce social tariffs - alongside existing support measures such as the Warm Home Discount Scheme and energy related benefits. Ofgem should commit to working with BEIS on the design and composition of a social tariff as part of its Price Cap adjustment process. It should also reinforce its commitment to the Price Cap and press the Government to legislate for its extension beyond 2023.

It is also critical that Ofgem think about the longer-term dangers facing the energy market. While wholesale energy cost volatility poses risks to the energy market consumer debt creates a potentially greater danger if left unaddressed. Even before the peak of the Energy Crisis, more than 4 million people were already behind on their household bills<sup>9</sup>. Suppliers have licence conditions to support customers' ability to pay. Ofgem must ensure these requirements are being met and provide transparency about how suppliers are performing. Going forward, Ofgem will need to work with the Government to find solutions for the impending energy debt crisis. Without addressing this issue, Ofgem's Price Cap reforms will, at best, resolve the short-term crisis for suppliers, but the scale of consumer detriment could threaten to destabilise the energy market on an even greater scale.

In addition to considering how its reforms are communicated, Ofgem must also do more to investigate how it and suppliers can act to ensure that consumers, and their representatives and advocates, best understand the impact of any changes to their bills. Energy is already a complex market and these changes, alongside the adoption of new tariffs, and the transition to Net-Zero will only serve to make it more complicated. The half of households on standard variable tariffs were effectively disengaged from the energy market, and Ofgem must do more to reduce customer inertia and ensure the long-term affordability of essential energy costs.

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<sup>1</sup> BEIS, 2021. Domestic energy retail Consultation: Opt-in switching, and testing opt-out switching. Department for Business, Energy, and Industrial Strategy. [Online]. Available at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1005304/domestic-energy-retail-condoc-opt-in-testing-opt-out-switching.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1005304/domestic-energy-retail-condoc-opt-in-testing-opt-out-switching.pdf). [Accessed 01/12/21]. Pg5.

<sup>2</sup> Ofgem, 2021. Record gas prices drive up price cap by £139: Breakdown of the Cap. Ofgem. [Online]. Available at: <https://www.ofgem.gov.uk/publications/record-gas-prices-drive-price-cap-ps139-customers-encouraged-contact-supplier-support-and-switch-better-deal-if-possible>. [Accessed 11/10/21]. Based on dual fuel direct debit customers. See 'breakdown of cap' figure.

<sup>3</sup> Online survey conducted by Opinium on behalf of Age UK between 3rd and 8th December 2021. Sample of 2,000 UK adults (18+), weighted to be nationally representative.

<sup>4</sup> Based on households where the oldest person is aged 60+. BEIS, 2021. Fuel Poverty detailed tables 2021 (2019 data). Department for Business, Energy, and Industrial Strategy. [Online]. Available at: <https://www.gov.uk/government/collections/fuel-poverty-statistics#2019-statistics>. [Accessed 07/12/21]. Table 22.

<sup>5</sup> Age UK calculation: based on BEIS statistics on the proportion of fuel poor households where the oldest person is aged 60+ and fuel poor household composition where the household consists of a couple aged 60+ (available at Department for Business, Energy, and Industrial Strategy. [Online]. Available at: <https://www.gov.uk/government/collections/fuel-poverty-statistics#2019-statistics>. [Accessed 07/12/21]. Table 20 and 22).

<sup>6</sup> BEIS, 2021. *Annual Fuel Poverty Statistics in England, 2021 (2019 data)*. Department for Business, Energy, and Industrial Strategy. [Online]. Available at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/966509/Annual\\_Fuel\\_Poverty\\_Statistics\\_LILEE\\_Report\\_2021\\_2019\\_data\\_.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966509/Annual_Fuel_Poverty_Statistics_LILEE_Report_2021_2019_data_.pdf). [Accessed 22/11/2021].

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- <sup>7</sup> BEIS, 2021. Annual Fuel Poverty Statistics in England, 2021 (2019 data). Department for Business, Energy, and Industrial Strategy. [Online]. Available at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/966509/Annual\\_Fuel\\_Poverty\\_Statistics\\_LILEE\\_Report\\_2021\\_2019\\_data.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966509/Annual_Fuel_Poverty_Statistics_LILEE_Report_2021_2019_data.pdf). [Accessed 05/08/21].
- <sup>8</sup> Age UK, 2021. The Cost of Cold Campaign. Age UK. [Online]. Available at: <https://www.ageuk.org.uk/our-impact/campaigning/the-cost-of-cold/>. [Accessed 01/12/21].
- <sup>9</sup> EFCP, 2021. Energy bills set to hit highest peak since price cap introduced. End Fuel Poverty Coalition. [Online]. Available at: <http://www.endfuelpoverty.org.uk/energy-bills-set-to-hit-highest-peak-since-price-cap-introduced/>. [Accessed 29/09/21].