

Friday 4 March 2022

## **Consultation on medium term changes to the price cap methodology**

Price Cap Changes Project, Ofgem

### **Summary**

#### **1) The 'enhanced status quo' and 'quarterly price cap' options are sensible and workable solutions and should be progressed to statutory consultation phase**

We understand why Ofgem has sought to address the need to reform the price cap in the medium term. This winter has shown that the timing misalignment between historic wholesale cost inputs and the current level of the price cap needs to be improved.

The consultation document presents two reasonable and workable solutions. Both the 'enhanced status quo' and the 'quarterly price cap' options are relatively straightforward adjustments.

The enhanced status quo option recognises that Ofgem is now able to reopen an existing 6-month price cap period, and would therefore be much better able to manage a repeat of this winter's extreme volatility.

Moving to a quarterly price cap would also mitigate the fundamental misalignment gap, whilst keeping the established functionality of the existing process intact. It also maintains the existing advantage of providing clarity and foresight on precisely when the price cap is to be updated.

We would support either the 'enhanced status quo' or the 'quarterly price cap' options and regard both as simple, sensible and workable solutions that would ensure that customers are treated fairly.

#### **2) The 'price cap contracts' option must be dispensed with**

Whereas the 'enhanced status quo' and the 'quarterly price cap' options are simple and easy to implement, by contrast, the 'price cap contracts' option is unworkable for the following reasons:

- It is impossibly complex to implement
- It would force all suppliers to buy their hedges at the same time
- Given its complexity, it would not be understood by consumers
- Alarmingly, protection of volume risk is only achieved if customers are disengaged - highlighting a fundamental design flaw in the model
- It would create perverse and unfair customer outcomes
- In particular, it would negatively impact vulnerable customers who have a higher tendency to be disengaged
- It would transfer hedging risk from suppliers to customers
- The option is protectionist in nature and would stifle competition
- It would be heavily criticised by the media and politicians, and has been rejected by consumer groups

It is also being presented for consultation without being ready, with subsequent working groups having to overlay ever more complex adaptations to make the solution look feasible on paper. Moreover, analysis of the detrimental consumer impacts of the price cap contracts option has largely been glossed over in the consultation.

### **3) Perceptions that the sector is seeking protectionist intervention must be avoided**

We get the distinct impression that a case is being formed for a desired combination of regulatory interventions that would excessively protect large suppliers from their hedging risk:

- An extension of the Market Stabilisation Charge to cover next winter
- A removal of the trigger point from the Market Stabilisation Charge so that it would apply to any fall in wholesale prices
- A further adjustment to the Market Stabilisation Charge so that gaining suppliers would pay 100% of the costs
- The price cap contracts solution

The outcome of these combined interventions would have the effect of protecting the largest suppliers, at the expense of consumers, and would stifle competition. Accordingly, this scenario must be avoided.

The overall regulatory solution should aim for a backstop level of market protection from extreme market conditions. It should not provide anti-competitive protection for suppliers from the fundamental hedging and customer retention risks which they should manage as sustainable suppliers.

Accordingly, for the reasons set out above, the price cap contracts option should be disregarded and only the enhanced status quo and quarterly price cap should be taken forward to statutory consultation stage.

We have set out in the Annex below, our specific responses to questions raised in the consultation document.

## **Annex: responses to specific consultation document questions**

**Question 1:** *Are there any other costs and risks to consumers and suppliers that we should consider?*

The price cap contracts option is not only fundamentally unworkable, the analysis presented is wholly inadequate

Regarding the impacts of the price cap contracts option, the consultation document is wholly inadequate in its consideration of many key aspects. This is indicative of the option having gone to consultation before being remotely ready, requiring ongoing working groups to consider the design gaps.

It's notable, for example, that it has since been renamed as the '12 month price cap' option in acknowledgement that the term 'contracts' is confusing.

For the price cap contracts option there has been absent or insufficient analysis of:

- Customers' understanding of how it would work, understanding of how their specific tariff would be derived, and understanding of what their with-supplier and new-supplier switching options would be
- The year-on-year impact on individual customers as their tariff is recalculated annually, given that an individual's price increase could be much higher than those experienced by all consumers under the existing price cap (a quantitative distribution should be calculated, based on if price cap contracts had been in place in previous years)
- A distribution calculating the range of price differences that could occur between customer cohorts (also based on if price cap contracts had been in place in previous years)
- The impact on competition and customer switching rates, on its own and in combination with the Market Stabilisation Charge (if extended)
- How the transition from suppliers' sunk cost hedge positions to new, cohort-aligned hedge positions could work in a staggered implementation
- The impact on generators' and gas shippers' hedging requirements from the retail market changing its hedging patterns en masse
- Suppliers' operational capability and capacity to implement the solution, particularly as further complicated with a staggered implementation (there is no targeted implementation question in the consultation document)

Consideration of the likely public reaction would highlight why the price cap contracts option is untenable

Furthermore, there has been no meaningful consideration of how the price cap contracts solution would likely be received in the public domain.

The solution would not long survive scrutiny from public opinion and the media, before becoming controversial and unpopular. It would be seen to fall a long way short of the expectation of fairness that consumers, consumer groups, politicians and the media rightly expect of the price cap.

Supporters of the solution have been citing a comparison with, for example, consumers paying different rates over time for mobile phone contracts. But such a comparison clearly does not apply to a legislated and high profile price control mechanism, which is also operational at the time of a cost of living crisis.

We should instead think through how the price cap contracts solution would truly be received if implemented. When the personal finance media would start to report its impact in a rising price market, there would likely be immediate calls to abandon monthly updates in order to hold an existing rate.

In a falling price market, there would self-evidently be a clamour to move all capped energy consumers onto the latest lower rate. It would not be understood, nor readily defensible, to reason that disengaged customers, particularly the vulnerable, were meant to be 'left behind' on older and more expensive rates intentionally, as a deliberate design feature.

People would not understand how disengaged and vulnerable people could be paying for cap protected energy at a higher (potentially substantially higher) rate than the current version. They would likely demand that the protection should become a wholesale cost tracker for all when prices were falling.

**Question 2:** *To what extent would a price cap contract without exit fees leave suppliers carrying volume risk in a falling prices scenario? How significant would this risk be? How might it be mitigated?*

For the price cap contracts solution to mitigate volume risk, it relies upon customer disengagement in the falling price scenario (see question 5, below). We see no credible way to mitigate this risk given that the only means of doing so would be to disincentivise switching.

This would be a poor customer outcome, and would be contrary to the price cap legislation which states the authority must maintain incentives for domestic customers to switch.

**Question 4:** *Please provide further evidence on the impact of quarterly updates and price cap contracts on households and their finances, and how these could be mitigated.*

The quarterly price cap option has one potential disadvantage in that it guarantees a review date in mid-winter 2022/3. This could possibly be avoided with the enhanced status quo option, as a winter review would be dependent on Ofgem's change criteria. The fundamental benefit of both these options is that all customers protected by the price cap experience the same price increases and price falls, and at the same time.

We do not know the potential impact on individual customers of the price cap contracts option because the analysis has not been commissioned. What we can deduce, by considering if the solution had been in place in 2021, is that cohorts later in the year would have faced much more expensive tariffs than cohorts earlier in year. Indeed, it's easy to conceive of the later tariffs being double the price.

Similarly we have no insight into the year-on-year price increases and falls individual cohorts could experience, in either normal or tail-end scenarios. But again, considering what could have occurred if the solution had been in place in 2021, it can be deduced the earlier cohorts

would now be experiencing anniversary price increases much higher than the actual 54% increase that will apply to all in April.

A simple test is to consider the level of default tariff customers in a May 2022 cohort would face. Without the protection of historic hedging averaging, this cohort would be priced on the full force of the record high forward curves for gas and electricity being witnessed now in March. This scenario would represent an inconceivable transfer of hedging risk from suppliers to customers.

**Question 5:** *Do you think it is unfair that consumers would sometimes have higher or lower prices depending on the wholesale cost at the time their cohort starts the price cap contract? Do you think over the longer run this would even out?*

We have become increasingly concerned over recent weeks that the price cap contracts option is being considered as a credible solution when it manifestly fails the test of upholding universal and fair consumer protection.

The solution relies on discrimination towards passive customers for its model to work. We understand from the recent workshops, that if wholesale costs fall, and therefore default tariff prices for the monthly versions of the price cap contracts also fall, an existing default tariff customer could request that their supplier (or another supplier) moves them onto the latest, cheaper version of the capped tariff.

It cannot be assumed that a customer in this situation would opt to switch to a comparable or cheaper fixed tariff, which may or may not be available from either their current supplier or another supplier in the market.

If every default tariff customer requested that their supplier (or a new supplier) move them onto cheaper versions of the price cap, the price cap contracts solution would fail entirely in its main objective of aligning hedging costs with capped tariff revenues. No default customer would be paying the tariff that had been set to align with the hedges bought on their behalf i.e. for their specific cohort.

Therefore, by definition, the solution could only work if the majority of customers failed to exercise their option to track falling market prices. This means that discrimination against disengaged customers is the essential enabler of the solution, which would be a perverse and demonstrably unfair outcome for a legislated consumer protection solution.

**Question 6:** *What opportunity and impact could each proposal have on consumer engagement? And where there may be negative impacts, please provide options to address these.*

Consumers' understanding of the price cap and the protection it provides them would be compromised by the complexity of the price cap contracts solution. Engagement levels in the market would likely to fall as a result.

Suppliers and consumer organisations have worked hard since the introduction of the price cap to explain how it works in straightforward terms. It has been a challenge for the sector to explain that:

- The price cap is an absolute protection yet is still variable based on household energy consumption
- Direct Debit payments are fixed instalments made towards estimated annual consumption, rather than what consumers ‘are paying for their energy’
- Specific default tariffs are capped by other variables: fuel, region, meter type and payment type; meaning that in practice no one actually pays the average annual price cap figure quoted in the media

It would be difficult to maintain a credible level of public confidence if the sector had to additionally explain that there were in fact a further 12 price cap levels, and the cap level which the customer is protected by from the outset has been arbitrarily determined by the month in which a customer originally switched to the supplier.

**Question 8:** *Are there any challenges in transitioning to quarterly updates or the strengthened status quo? If so, please provide details.*

There are no significant challenges because the underlying tariff change and customer journey processes would be unchanged. Hence there is a gulf between the simplicity and effectiveness of these two options and the overwhelming complexity of the price cap contracts option.

In a recent discussion with Ofgem, we encountered the challenge that implementation of the price cap contracts solution would be akin simply to launching an additional 12 fixed tariffs.

In practice, managing the customer journey for the default tariff is substantially more burdensome for suppliers’ systems and customer services. The work involved to manage a rolling cycle of monthly versions of default tariffs would create an exponential operational challenge.

Fixed term contracts are easy to present and tend to run their full term. It is also relatively easy to present customers - who are engaged by definition - with their renewal options. The supply of fixed term contracts - whether a lot or a few - can also be determined by individual suppliers.

In contrast, the default tariff versions (already split for payment types and meter types) require a more intricate customer journey from the outset:

- Many of the customers will be disengaged (and are more likely to be vulnerable)
- Those that do contact their supplier are likely to be less knowledgeable about the market and their options
- Suppliers have to take extra steps when default tariff prices increase in order to manage the unilateral variation
- The ‘SLC23’ obligation to hold expired tariffs open for customers after the expiry date already tests supplier systems and processes to the limit, for what is currently only a single cohort of default tariff customers each time there is a change

To this already complex and delicate customer journey, the price cap contracts solution would overlay customers moving between tariff versions, potentially on a very frequent basis which would greatly increase complexity.

Moreover, suppliers' billing systems tend to be organised around discrete customer cohorts with uniform supply durations or change dates. They are not designed to manage subset cohorts of customers who may wish to exercise a new option to change tariff for free every month, and at various points throughout the month. This would be extremely challenging from an operational perspective.

**Question 9:** *What would the impact be if suppliers tried to buy the energy requirements for all their customers on price cap contracts in August (for 12 month contracts) or August and February (for 6 month contracts) of each year? Do stakeholders agree there would be liquidity challenges in the wholesale markets? How damaging would this be? Are there any ways to avoid this issue?*

The consultation document, and the subsequent working groups, have implicitly acknowledged that the concept of the entire retail sector hedging at the same time, in one summer month, is absurd. It would shatter the normal and continuous market process for clearing the long positions of generators and shippers, and the short positions of suppliers. This conclusion is so obvious it has been reached without Ofgem thinking it necessary to commission analysis into liquidity and price volatility.

Therefore it has already been recognised that the price cap contracts option would have to be staggered. Unfortunately, whilst staggered implementation may resolve, on paper, this flaw with the solution, it would only serve to exacerbate its overall complexity and unfairness.

**Question 10:** *If we were to implement the price cap contracts, how should we implement it - with an immediate start and single cohort on a price cap, or with a staggered start and six or twelve different cohorts?*

Ofgem has effectively accepted that the implementation of the price cap contracts option would have to be staggered to make the wholesale hedging schedule tenable.

However, no work has been done on how hedging the staggered implementation could work in practice, and how assumed hedging cost inputs could be transitioned into the price cap methodology.

Suppliers have already significantly hedged energy demand from October 2022, and at high prices. Therefore what we can call the 'sunk cost hedging path' must be inputted into the next price cap adjustment calculation.

The consultation speculates on an absurd solution for the hedging transition that would be required for the first price cap contract cohort if the launch was not staggered. This envisages all suppliers suspending new hedging until August 2023 and then returning to the wholesale market en masse to buy the October 2023 forward curve.

But what would happen with a staggered implementation? At what point would sunk cost hedging inputs be ignored in favour of the assumption that suppliers had started fresh hedging of the individual cohorts? It seems too perplexing to contemplate and hence is left as an unresolved issue in the consultation document.



**Question 11:** *What is a fair and practical way to allocate consumers to different cohorts?*

To be clear, there is no mechanism for allocating customers into cohorts which could be considered fair.

As the price cap contracts cohorts will differ in price by design, any customers initially moved to a higher price cap level will be disadvantaged compared to those who will be fortunate enough to be allocated to a lower price cap level (which is arbitrarily based on the month in which the customer joined the supplier).

Then from a practical perspective, if cohorts are determined by customer join date, these will vary significantly in terms of their volume, due to seasonal variances of both switching rates and Supplier of Last Resort events.

We also have concerns for those customers in the later cohorts, given as we understand the current proposals could mean the December 2022 cohort would be placed on an initial price cap level set for 14 consecutive months, lasting from the start in October 2022 until the end of November 2023. In a falling price scenario, a price cap level covering this period would further penalise customers who are unable to engage in the market.

**Question 13:** *(Reducing the notice period to a minimum of 28 days) Do you have any evidence or data that supports or challenges our assessment of the benefits of this? What are the practical considerations for price changes over winter and Christmas?*

We consider that implementing price changes to go live over the Christmas period would be manageable, as much of the operational processes are completed in advance of the date on which they become effective.

We do consider that Ofgem may have to be flexible when assessing whether suppliers have met the principle of providing contract change notices ‘in reasonable time for a customer to avoid the change.’

**Question 14:** *Do you have evidence or data to support a move to a shorter implementation window – such as 14 days? What are the potential risks to consumers of a shorter notice period? And what are the operational considerations?*

We do not believe that a shorter implementation period is manageable. Within the customer journey, it would not allow enough time to communicate to customers ahead of the change taking effect.

Any implementation period shorter than the proposed minimum of 28 days would also be too difficult operationally. A prominent example is the process for updating tariff rates for traditional prepayment meter customers. Prepayment Meter Infrastructure Providers must receive new tariff rates at least two weeks before they take effect.