



Consumer Champion for the Over-50s

FAO Dan Norton, Deputy Director Price Protection, Ofgem

Over50smoney response to Programme of Work

Good afternoon Dan,

Below I present Over50smoney's request for an immediate review of the Headroom Allowance component of the Price Cap. I note that the Programme of Work does list the review of headroom allowance as a long-term workstream, whilst I see it as a positive sign that this review is on Ofgem's radar, I'd like to see it moved to the near-term list with a delivery period of Summer 23.

For clarity, my goal is to have the Headroom Allowance element completely removed from the Price Cap by October 2023.

To explain how I got to this conclusion, I'll present the request using the following points:

- My understanding of headroom allowance
- The abuse of headroom allowance
- The redundancy of headroom allowance
- Support for this request

These four points should show you that there is a strong argument against the existence of the headroom allowance.

If you have any questions about the information below, please contact me on Richard@over50smoney.com. Please feel free to share this document internally at Ofgem and externally if necessary to gather a sense of how other stakeholders feel about my proposal.

Kind regards,

Richard Winstone

Director

Over50smoney

Request to Review and Remove Headroom Allowance in Summer 2023

My Understanding of Headroom Allowance

This section is included as it may come to light that my understanding of headroom allowance isn't 100% accurate, in which case I'm happy to hear feedback to ensure my request is still reasonable.

My understanding of headroom allowance is that it was originally introduced as a measure "to enable suppliers to compete and provide an incentive for customers to shop around", as explained in Ofgem's working paper #3 <https://www.ofgem.gov.uk/publications/default-tariff-cap-working-paper-3-our-thinking-including-headroom-allowance>.

After a few consultations, Ofgem's reasoning behind headroom allowance changed, it is now used to "recognise uncertain cost pressures that are not explicitly covered by other allowances".

This allowance is calculated as 1.46% of all other costs added together except network costs, EBIT and VAT. This means, that as we've gone through an energy crisis, the amount of headroom per customer has increased significantly, moving from £12 per household in September 2021 to £53 per household in January 2023. Additionally, the number of households on SVTs has moved from around 14 million to over 25 million. Therefore, **the total headroom available in the retail energy market has gone from around £280m to over £1.3bn.**

The very definition of headroom allowance, as it exists now, means that headroom is not assigned to any specific cost, it is a generic allowance. To have over £1.3bn of expenditure for nothing specific is a clear and unnecessary waste, especially as it has been noted on numerous occasions that almost all energy suppliers use the headroom allowance as additional profit and not to cover other costs. Whilst this cost is technically being covered by the Government through the Energy Price Guarantee, it is wasting public money.

Section 1(6) of the Domestic Gas and Electricity (Tariff Cap) Act 2018 states five regards Ofgem must take into consideration when setting the cap, to which I'd say it can easily be argued that the mere existence of Headroom Allowance goes against four of those five regards, specifically:

1. the need to create incentives for holders of supply licences to improve their efficiency;
2. the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
3. the need to maintain incentives for domestic customers to switch to different domestic supply contracts; and
4. the need to set the cap at a level that takes account of the impact of the cap on public spending

Most clearly, the headroom allowance is a waste of public spending, going against the fourth point listed above.

The Abuse Of Headroom

By its original definition, headroom allowance should be used to enable switching, however there has been no switching market since August 2021, over 16 months ago.

By Ofgem's own definition, the price cap should "ensure an energy supplier can recoup its efficient costs", I strongly argue that the price cap calculation falls extremely short of promoting efficiency in an energy supplier.

Taking a real-life example, in October 2022 Octopus Energy reduced its SVT by £50 per customer. With almost 3 million customers, that is £150m per year Octopus Energy decided they didn't need. If the Price Cap was set to an efficient level then a privately owned energy supplier wouldn't feel the need to reduce their own income by £150m. At the time, the headroom allowance was only £43 per household, so Octopus Energy effectively said no to receiving the headroom allowance because it wasn't necessary for them.

If one energy supplier can be efficient enough to not need headroom allowance then all other energy suppliers must fall into one of two categories:

1. They are so inefficient that they need the headroom allowance to remain profitable
2. They are efficient enough to not need the headroom allowance, but they take the extra income to boost profits.

Regardless of which category an energy supplier falls into, they are abusing the headroom allowance. Category 1 suppliers lack motivation to improve efficiencies in order to cut costs, because they don't have to with such a large headroom allowance. Category 2 suppliers could cut their SVTs like Octopus Energy did, but private companies exist for the benefit of shareholders not customers so they're just doing their duty by charging as much as Ofgem's allows them to.

The Redundancy of Headroom Allowance

It is also important that we weigh up the changes Ofgem have implemented in 2022 against the necessity of the headroom allowance. With the energy crisis causing over 30 suppliers to collapse, it would be easy for most to argue that reducing the price cap would be detrimental to the remaining energy suppliers, but the collapses need to be viewed relative to time and the changes that have been implemented since the start of the energy crisis.

The crisis started around August 2021, the same time that Ofgem announced the Oct 21 – Mar 22 price cap figure. There was no emergency protocol in place to change the price cap as the crisis worsened between August 2021 and April 2022, which is what caused all of the 30+ energy suppliers to collapse prior to April 2022. Since then, energy suppliers have seen a huge number of supportive measures implemented which has made the market almost ideal for them.

The price cap eventually caught up with the energy crisis, and we're now seeing a reduction in wholesale costs whilst the price cap continues to increase, meaning energy suppliers are receiving far more than they are spending. On top of this, around 11 million households have moved from cheaper fixed rate tariffs to the more expensive SVTs since August 2021, giving energy suppliers more income per household than they were previously receiving.

A variety of other measures were introduced by Ofgem during 2022, all of which help energy suppliers and increase the price cap or reduce competition in the market. These include:

- Two increases in the additional wholesale cost allowance, a total of £14 extra per household
- Two backwardation cost allowances added, a total of £149 extra per household

- The implementation of a Market Stabilisation Charge (MSC) – a charge of £150 to a supplier if they take on a new customer, disincentivising suppliers from offering tariffs that allow customers to switch
- EBIT (profit) figure moving to £76 per household from £22 per household
- Headroom figure moving to £53 per household from £12 per household
- The move to 3-monthly price cap updates rather than 6-monthly updates works to the benefit of suppliers in the short-term whilst the cap is increasing, although we should see this benefit consumers when the cap starts to decrease

All of these changes, whilst designed to ensure the stability of the retail energy supply market, have increased the cost of the price cap significantly. Additionally, we're in a market where energy suppliers are incentivised to keep costs high as EBIT and Headroom are calculated as percentages of these costs, therefore it is financially better for suppliers to have higher costs so they can then charge more for profit.

With all of these additional measures in place to support energy suppliers, Headroom Allowance becomes increasingly redundant, as Octopus Energy has shown.

It's also worth noting that Ofgem also added a Ban on Acquisition-only Tariffs, which I do agree is to the benefit of consumers, primarily because it means suppliers cannot offer cheap tariffs to new customers whilst profiteering from their existing customer base. However, it does also reduce competition more, when seen alongside the MSC. If a supplier must pay £150 per new customer to the customer's old supplier, then they are unlikely to offer a cheap tariff to get new customers. If they're not looking to gain new customers, there's no reason for a supplier to create a cheap fixed rate tariff for their existing customers, because they are all on the expensive SVTs, which is more profitable for the supplier.

Support For This Request

The request for the Headroom Allowance element to be reviewed is backed by **341,712 signatures**, as of the morning of 3rd January 2023, on a petition started by Over50smoney Director, Richard Winstone. You can review the petition here: <https://www.change.org/OfgemPriceCap>.

This is 341,712 people agreeing that the headroom allowance affords energy supplier's higher profits and lower incentives to be efficient with managing their costs. At the very least, the formula for calculating headroom allowance is absurd, it should not scale with costs any more than EBIT should, and seeing as Ofgem are reviewing the EBIT formula you should also review the headroom allowance formula at the same time.

We, the signatories of the Ofgem Petition, formally request an immediate review of the headroom allowance, with any changes that result from the consultations of that review to be implemented no later than 1 October 2023. Our specific request is for Headroom Allowance to be completely removed.

With both EBIT and Headroom being reviewed, backwardation coming off of the price cap soon, wholesale costs falling and hopefully the removal or pausing of VAT on the price cap, it is an achievable goal that we can get the price cap to being below £3,000 by 1 October 2023, saving the government £billions of public money and saving households £00s on their energy bills before Winter 2023 starts.



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These changes should prompt energy suppliers to be more efficient with their costs and emulate the work being done by other, efficient energy suppliers in the market.

Thank you for taking the time to review this information and our request. For any feedback or queries, please contact Richard Winstone at richard@over50smoney.com.