

To: all stakeholders

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Price Cap – Programme of Work: Update

Background and context

The default tariff cap ('the cap') was introduced via the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act) on 1 January 2019. Our primary consideration, when exercising our price cap functions under the Act (eg setting and implementing the cap), is the protection of existing and future customers who pay standard variable and default rates. In setting the cap, we must have regard to a number of factors,¹ such as the need to create incentives for holders of supply licences to improve their efficiency, the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence, and the need to set the cap at a level that takes account of the impact of the cap on public spending.²

Since we introduced the cap, we have continued to monitor the cap methodology and made changes as appropriate. The 'Price cap - Programme of Work' (PoW), originally published on 25 November 2022, provides visibility of the areas of the cap methodology we intend to review over the next two to three years.³ It also gives reassurance that we will continue to monitor the cap methodology to improve resilience to market uncertainty, alongside other changes required to ensure customer protection.

¹ Default Gas and Electricity (Tariff Cap) Act 2018

<https://www.legislation.gov.uk/ukpga/2018/21/contents/enacted/data.htm>

² Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6)(e) as inserted by Schedule 3 to the Energy Prices Act 2022. In performing the duty under section 1(6)(e) we must have regard to any information provided by the Secretary of State, or any guidance given by the Secretary of State on this matter (section 1(6A)).

³ Ofgem (2022), Price Cap – Programme of work <https://www.ofgem.gov.uk/publications/price-cap-programme-work>

In this letter, we set out the following:

- Actions that are being taken to protect current and future consumers;
- A summary of responses we received to our original PoW;
- Decisions we have taken on reprioritising price cap workstreams; and
- An updated list of price cap workstreams we intend to prioritise over the next two to three years, in light of the current cap methodology, market conditions and organisational objectives.

This letter builds upon our recently published Forward Work Programme for 2023/24, which sets out how we will deliver effective consumer price protection, which continues to evolve to meet the needs of consumers in a changing market.⁴ Should there be future policy changes which lead to material and systematic change in efficient costs, we will build any resulting work into our plan.

Current and future consumer protection

Current market conditions have highlighted the continued importance of focussing on the most vulnerable customers and, as part of our objective to ensure customers are treated fairly,⁵ we think it is appropriate to focus on the costs in the cap allocated to customers on different payment methods, including prepayment meter (PPM) customers. Beyond the cap, we have already taken action in regard to PPM customers through a voluntary suspension of forced installations of prepayment meters, launching a market compliance review of prepayment warrant installations,⁶ and setting out our regulatory expectations on supporting customers in payment difficulty.⁷

The government also recognises the importance of consumer protection, and in response to the continued impact of high energy prices and cost of living pressures, has decided to maintain the £2,500 Energy Price Guarantee (EPG) support level until June 2023.⁸ In addition, later this year, the Department for Energy, Security and Net Zero (DESNZ) intends to consult on the best way to ensure future consumer protection. We welcome both these announcements and will work closely with the government to deliver consumer protection measures and ensure good outcomes for customers. As well as this,

⁴ Ofgem (2023), 2023/24 Forward Work Programme <https://www.ofgem.gov.uk/publications/202324-forward-work-programme>

⁵ Ofgem (2019), Licence guide: Standards of Conduct <https://www.ofgem.gov.uk/publications/licence-guide-standards-conduct>

⁶ Ofgem (2023), PPM Press release <https://www.ofgem.gov.uk/publications/energy-regulator-outlines-next-steps-forced-prepayment-meter-ppm-installations>

⁷ Ofgem (2022), Regulatory expectations on supporting customers in payment difficulty <https://www.ofgem.gov.uk/publications/regulatory-expectations-supporting-customers-payment-difficulty>

⁸ HM Treasury (2023), Spring Budget 2023 <https://www.gov.uk/government/publications/spring-budget-2023>

we have also considered how the changes we are making align with potential future price protection options that may be explored.

In addition, as announced at Spring Budget, Ofgem will work with government to explore bringing PPM charges into line with comparable direct debit customer charges.

Responses to the PoW

We received a total of ten written responses to our PoW published in November 2022, as well as verbal feedback through an online workshop with consumer groups and charities. Overall, we received a positive response from stakeholders, who welcomed the publication of the PoW and the opportunity to comment on the workstreams within it. A summary of responses can be found at Appendix 2.

In setting out our PoW, we prioritised workstreams based on a number of factors, such as the urgency of changes and their potential impact on the cap level, the impact on default tariff customers, changes in market conditions, dependencies between workstreams and availability of information.

As mentioned in our original publication, the PoW is subject to further change to ensure we remain flexible and responsive to future challenges in the market and changes in Ofgem's priorities. This PoW update is intended to help stakeholders understand the changes in workstreams to the cap resulting from consideration of their feedback and changes in market conditions.

Reprioritisation of workstreams

Reflecting current market conditions and stakeholder feedback, we have revised the order of priority of workstreams set out in the near-medium term priority table (Table A1.1).

We have taken the following reprioritisation decisions:

- Prioritise reviews of operating costs, levelisation of payment method cost differentials and debt-related costs
- Deprioritise and delay the additional wholesale allowances review
- Delay the Earnings Before Interest and Tax (EBIT) statutory consultation

Levelisation of payment method cost differentials

The sharp increase in energy prices led to an increase in the cost differences between payment methods. There is currently a greater spotlight on these differences in the context of the cost-of-living crisis, with a risk that vulnerable customers are being disproportionately affected.

We have launched a workstream looking at levelisation of the cost differences between customers on different payment methods, to investigate whether there would be benefits to customers paying a more equal price for their energy, regardless of the payment method. The main focus will be to explore whether we should levelise payment method costs, as well as exploring options for reducing the cost difference between direct debit and PPM customers, as these customers are more likely to be in vulnerable circumstances. We will also give regard to customers who pay by standard credit and are more likely to incur debt, as well as consider how any change could work within the overall cap.

As part of this work, we will consider the customer and distributional impacts of any levelisation proposals and explore mechanisms for delivering such outcomes. We intend to publish a call for evidence at the end of April 2023.

Debt-related costs

The majority of the cap allowance for debt-related costs is calculated as a percentage of the other cap costs. This means it scales with the cap level and consumption. The allowance is significantly greater now for a typical customer than it was several years ago, as we have seen a sharp increase in wholesale costs. However, several changes since April 2022 (the gas price crisis, government interventions such as the EPG, and wider market changes) mean this allowance may have deviated from the debt costs that an efficient nominal supplier would be incurring.

Through the debt-related costs workstream, we are seeking to identify whether there was a material and systematic deviation between costs and allowances in 2022/23. We also intend to explore the impact in 2023/24 of ongoing market changes, eg the use of prepayment meters as one of the mechanisms suppliers use to collect debt. We will consult on adjusting the allowance in the cap for efficient debt related costs and adjust that allowance if, following the conclusion of the consultation process, we think it is necessary.

To support this, we published a call for input on 18 April 2023,⁹ in which we are seeking views from stakeholders. We are aiming for any adjustment to the cap, if we think it necessary, to be in place for the October 2023 cap. We are also committed to reviewing alternatives to the cap for efficient recovery of debt related costs.

⁹ Ofgem (2023), Price cap – Call for Input on the allowance for debt-related costs
<https://www.ofgem.gov.uk/publications/price-cap-call-input-allowance-debt-related-costs>

This workstream is important for ensuring the cap reasonably reflects efficient costs of a notional supplier, and it promotes resilience and stability in the current market conditions.

Operating cost review

We have decided to prioritise the operating cost review. This includes the operating cost baseline, payment method uplift and smart metering net cost change (SMNCC) allowance. Many of these allowances are based on 2017 or older cost data, which have since seen a number of significant changes in the market.

We see the review of operating cost as a priority, given the interdependencies with debt-related costs and levelisation of payment method cost differentials. The review will provide an opportunity to consider how the cap functions for different types of customers (eg payment methods, smart and non-smart meters). We also consider that an updated view of operating cost related allowances will be beneficial to a number of future protection options. We intend to publish a call for input in May 2023.

Additional wholesale allowances

In our original PoW, we stated that the programme was subject to further change, to ensure we remain flexible and responsive to future challenges in the market and changes in Ofgem's priorities. We have decided to pause work on additional wholesale allowances.

In February (2023), we launched a call for input on the additional wholesale allowances review, seeking views on whether the review is appropriate, and if so, what the scope of the review should be.¹⁰ Overall, respondents expressed support for the review but there were some mixed views on when the review should start. There was particular concern around costs that may have been incurred over this winter. In addition, general themes included the impacts of low liquidity, weather risks, high bid-offer spreads, backwardation under recovery and demand destruction.

We thank stakeholders for their early engagement on this review and recognise the importance of this work. However, we have decided to pause this workstream, including sending the request for information. The decision to delay provides a number of benefits; allowing more time to collect data once the winter period has passed and enabling us to wait for more certainty on price protection post April 2024, which will reduce the risk of unused work. In addition, we are aware of the multitude of

¹⁰ Ofgem (2023), Call for Input on Additional Wholesale Allowances Review
<https://www.ofgem.gov.uk/publications/price-cap-call-input-additional-wholesale-allowances-review>

workstreams that are currently live; a delay to this work will allow stakeholders to focus on the reprioritised workstreams and enable us to suitably allocate our resources.

We recognise stakeholder concerns on potential additional wholesale costs incurred this winter and therefore will consider whether a short-term review of costs incurred over winter 22/23 is appropriate to launch this summer. We are also aware of the growing concern regarding Economy 7 (E7) and multi-rate meter customers. Should we proceed with the short-term review, we will include considering the treatment of customers with multi-rate meters. Additionally, we have made clear to suppliers their regulatory obligations under the standard licence conditions in the treatment of E7 and multi-rate meters and ensuring these tariffs are appropriate for customers. Where we have evidence of detriment arising from supplier non-compliance, we will take action.

In future, should we proceed with the long-term review of the additional wholesale allowances, we may combine it with our planned review of the August 2022 decision to move to quarterly updates and introduce backwardation costs beyond a deadband in the price cap.

EBIT allowance

There will be a short delay to the EBIT allowance review, following the initial consultation launch in November 2022.¹¹ We have deferred the publication of the statutory consultation, allowing us time to further develop our analysis in certain areas related to the review. We are aiming for a Winter 2023/24 delivery period. We welcome the responses received to this consultation and the overall support for this review.

Next Steps

We thank stakeholders for the time they have taken to engage with our PoW and recognise the value of stakeholders' views on the work that we should prioritise for the cap. We have published an updated PoW in Appendix 1 and look forward to future engagement through the workstreams outlined in tables A1.1 and A1.2.

Yours faithfully,

Dan Norton

Deputy Director, Price Protection

¹¹ Ofgem (2022), Further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance <https://www.ofgem.gov.uk/publications/further-consultation-amending-methodology-setting-earnings-interest-and-tax-ebit-allowance>

Appendix 1 – Updated Programme of Work – Workstream tables

Table A1.1: List of near-term and medium-term workstream priorities

The anticipated delivery period sets out when we expect the workstream to be implemented.

Workstream	Description	Anticipated delivery period
COVID-19 true up	Reconciliation of final additional debt related costs due to COVID-19.	Spring 23 – Delivery completed
Balancing Service use of System Charge (BSUoS)	Consideration of whether to amend the default tariff cap to reflect potential changes to the connection and use of system code (CUSC) proposed by CMP361 or a similar modification.	Spring 23 – Delivery completed
SMNCC - Review of the current process	Reconsideration of the process by which non-pass-through SMNCC values are reviewed and updated. We also consider changes to SMNCC modelling to reflect the removal of a fixed price cap end date.	Spring 23 – Delivery completed
Reflecting the planned ECO+ scheme in the cap	Consultation on our approach to reflecting the government’s planned expansion of the Energy Company Obligation (ECO) Scheme, ECO+, in the default tariff cap.	Spring 23 – Delivery completed
SMNCC – Model update	Update of the non-pass through SMNCC allowances for credit and prepayment meters in the default tariff cap and extension of functionality to 2030.	Summer 23
Price Cap Derogations	Introduction of annual compliance checks for suppliers with derogated renewable tariffs from the default tariff cap.	Summer 23
Debt-related costs	Review of the debt-related costs allowance, in light of current energy price volatility, government intervention and other factors.	Winter 23/24
Price Cap Extension consultation	Update of supply licence conditions and dates in cap models to reflect removal of the 2023 end date for the price cap (as legislated for in the Energy Prices Act 2022).	Winter 23/24
Earnings before Interest and Tax (EBIT) Allowance Review	Review of the current methodology to ensure the allowance continues to be appropriate in light of a range of market conditions.	Winter 23/24
Short-term review of additional wholesale costs	Consideration of whether there have been additional wholesale costs incurred over winter 22/23 that are materially and systematically different to the allowances. As part of this work, we will also consider cost offsets where appropriate.	Winter 23/24

Workstream	Description	Anticipated delivery period
Levelisation of payment method cost differentials	Exploration of whether we should levelise, and the feasibility of levelising payment method cost differentials and the methods through which this could be delivered, with implementation from April 2024.	Summer 24
Operating cost review	Re-benchmarking of operating costs across payment methods. Payment method uplift, SMNCC and bad debt all fall into operating costs. We intend to consider the approach to all these components as part of this workstream to ensure the allowance reflects the efficient costs of a nominal supplier. We may also consider differences in costs incurred by groups of default tariff customers (eg customers on different payment methods and differences in smart/non-smart costs) in so far as we are able to within the cap framework.	Winter 24/25
Review of the wholesale cost allowance	Review of the policy to move to quarterly cap updates, reduce the notice period and the approach to backwardation (eg recovery period). We will also review the enduring additional wholesale allowances that form part of the wholesale methodology. This includes shaping, imbalance, transaction costs and uncertainty.	Winter 24/25

Table A1.2: List of long-term workstreams

Workstream	Description
Price Cap Green Tariffs Policy	A review of whether a minimum level of renewable energy supply should be required within the default tariff cap mechanism, and ensure suppliers provide this to consumers.
Network Costs	A review of the remaining elements of network costs. This follows changes to the BSUoS costs. We plan to consider whether any further changes are required.
Policy Costs	A review of the policy cost component contained in Annex 4 of the price cap to consider whether the calculation of policy costs is still appropriate and whether there are any further costs to add or remove.
Headroom allowance	A review of the headroom component. The Headroom allowance captures the residual net uncertainty across the cap methodology. Therefore, we consider that if we review headroom, it should follow considering changes to the other cap components.

Appendix 2 – Summary of responses to the PoW published in November 2022

Type and number of respondents

We received a total of ten written responses to our original PoW published in November 2022: three consumer groups, four suppliers, one industry body and one private business. Where appropriate, these responses have been shared with relevant workstreams. Where respondents have provided us with a non-confidential version of their response, this has been published on our website.¹²

We also hosted an online workshop with consumer groups, which enabled stakeholders that did not provide written feedback, the opportunity to express their views on our PoW verbally. This was attended by ten consumer groups and charities, and we provide a summary of these responses further on in this appendix.

In addition, some respondents fed PoW-related views into the Forward Work Plan consultation.¹³ Respondents emphasised the importance of joining-up with the Department for Energy, Security and Net Zero (DESNZ) on their strategic review of retail energy. Our intention is to work with DESNZ on bill support arrangements and on addressing the significant and growing uplift for standard credit over direct debit charges.

We have taken all views on board and, as with the written feedback, will use this feedback to assist in our policy making and planning.

Overview of written responses

Overall, we received a positive response from stakeholders who provided written feedback. They welcomed the publication of the PoW and the opportunity to comment on the workstreams within it.

There were no specific comments made by stakeholders on six of the 12 workstreams in the near-medium term workstream table (table A2.1), and a couple of stakeholders mentioned one long-term workstream table (table A2.2). The main issues stakeholders raised were the timings and priority levels of the workstreams listed in the near-term table.

¹² Ofgem (2022), Price cap – Programme of Work <https://www.ofgem.gov.uk/publications/price-cap-programme-work>

¹³ Ofgem (2023), Forward Work Programme 2023/2024 <https://www.ofgem.gov.uk/publications/consultation-ofgems-draft-forward-work-programme-202324>

The EBIT allowance review, operating cost review and debt-related costs workstreams were mentioned most by respondents. In addition, some stakeholders suggested the addition of a workstream covering the treatment of multi-rate meter customers.

EBIT allowance

Three stakeholders commented on the EBIT allowance review. One welcomed the review, its timing, and the priority and scope proposed. Other respondents were concerned that the EBIT allowance review would only make marginal differences to cost recovery and that it would not do enough to restore confidence in the retail energy market.

Operating cost review

Three respondents provided feedback regarding the operating cost review workstream. All were supportive of the review but believed it should be placed as a higher priority workstream, with an earlier delivery period. Two respondents specified a delivery date – one stated the review should be completed by Winter 2024/25, the other stated it should be brought forward to Summer 2023. Some stakeholders suggested additional items to be included in the operating cost review, such as the inclusion of smart metering costs, and the inclusion of non-discretionary costs faced by suppliers.

Debt-related costs

Three stakeholders highlighted the debt-related costs workstream. Stakeholders emphasised the need for an earlier delivery period and a higher priority of the workstream to help stabilise the sector. One stakeholder suggested that an earlier delivery date could allow for the introduction of temporary measures before more robust data on debt becomes available. Another stakeholder raised concerns that debt-related costs led to significant differentials between payment methods, and that this review should be expanded to consider what can be done to levelise the price cap for different payment methods.

Additional workstream suggestions

Several stakeholders suggested two additional workstreams they believed should be included in the PoW; one that considers the treatment of multi rate tariff customers and another that includes consideration of Contracts for Difference costs and allowances.

The majority of new suggestions related to issues already covered by ongoing workstreams – we will incorporate these views in to existing workstreams and welcome further stakeholder comments on these, as consultations are published.

Some stakeholders mentioned areas where Ofgem should work alongside DESNZ. We will continue to work closely with the DESNZ as part of our ongoing work plan.

Overview of Consumer group workshop responses

Overall, attendees were positive towards the publication of the PoW. Attendees were thankful for the workshop and the opportunity to view and comment on the price cap work programme.

Responses to near-medium term workstream priorities

In general, stakeholders supported the workstreams identified for delivery in the near-medium term.

Of those who had specific comments, respondents encouraged earlier delivery periods for the operating cost review and the review of August 2022 changes to the cap methodology. Stakeholders also identified the need for a focus on differentials between payment methods, as well as the importance of reflecting regional differences in pricing.

Some stakeholders also highlighted DESNZ's work on social tariffs and the importance of understanding this work's interaction through price cap workstreams.

Responses to long term workstream priorities

Overall, stakeholders had few comments on the workstreams identified for delivery in the long term. Of the ten workshop attendees, one stakeholder suggested an earlier delivery period for the review of Headroom Allowance.

Additional workshop comments

One stakeholder suggested the need for Ofgem to do more to improve the debate on what the future of regulation in the energy sector looks like. They stated that the understanding of the purpose of the cap has become unclear.

Another stakeholder also raised an interest on what can be done within the price cap for fuels other than electricity and gas. The same stakeholder also raised an interest in measures to support consumers who are commercially supplied.