

Future Price Protection Discussion Paper Response

Energy UK response

Response deadline: 10 May 2024

Scope of response

Energy UK members have differing views about the best price regulation options and will be responding individually. However, there are objectives and concerns relating to price regulation that members share which we will cover in this response.

Summary

We welcome this discussion paper and Ofgem considering the needs of customers over a longer timeframe. Many of the possible regulatory reforms discussed will not take effect quickly. In the interim, Ofgem should prioritise a price cap that is fit for purpose and progresses towards a more sustainable arrangement. We think there is important evolution possible through the planned Opex and wholesale allowance reviews.

Our members want to avoid a return to unsustainable pricing and a lack of resilience in the energy market. However, it requires a better approach to managing supplier allowances in the price cap. We think it is sensible for Ofgem to tackle first, the over-stringency of the cap, then consider further the protections required for some or all unengaged customers and those that need support. It is vital that Ofgem and the government set out their objectives for future price regulation and should not be constrained by the legacy considerations in the Default Tariff Act.

In the pursuit of a more efficient, low-carbon energy grid it is vital that price regulation and the market design more widely support good customer engagement. Ofgem's approach to price regulation should seek to move forward pragmatically given the uncertainty about how consumers might respond to new tariffs and products. We think Ofgem needs to stay alert and willing to be agile in response to emerging issues – rather than seeking to base interventions on uncertain predictions of consumer behaviour.

We think that in its current form, the price cap methodology will contribute to uncontrollable and unnecessary costs for suppliers and their customers through increased risk, opportunity cost and regulation. These can be mitigated through cautious and well-managed reform to the price cap aligned to other developments including separate, targeted support to address affordability and regulatory action to facilitate take-up of energy demand management to minimise system cost.

Energy UK welcomes the approach from DESNZ and Ofgem that seeks to modernise the price cap to anticipate Marketwide Half Hourly Settlement (MHHS). We think Ofgem should seek to ensure there

are adequate arrangements for certain customers on default arrangements to be on a static time-of-use tariff. This should build on the existing Economy 7 and Economy 10 offerings under the price cap already. However, we do not think it is in the interests of the market or customers at this stage to consider a default dynamic time-of-use product.

Energy suppliers represent the gateway between customers and the complexity of the energy system. This means they have a critical role in helping customers through the net zero transition. Given the critical role of customer choices and behaviours in ensuring we have a clean, reliable and affordable energy system, we think Ofgem's approach to retail policy must actively seek to incentivise consumer engagement with the market, including through its price regulation approach.

In practice, this requires adequately balancing fair prices for customers on default tariffs with maintaining incentives and rewards for those who engage as required by the Default Tariff Cap Act. This should involve working with the Government to give customers clear guidance that they will be rewarded for engaging with their energy and will be at risk of missing out if they do not.

We consider that retail market design simplicity and clarity will improve customers' drive to understand and engage with their energy options. On reflection, it is our view that price regulation has, likely had a positive impact on confidence that prices are fair in relation to underlying costs, which is valuable to maintain. However, the volatility of wholesale costs has exposed issues with the cap design. With the introduction of half-hourly price signals and greater variation in customers' identifiable impact on the system, alongside the continued scope for extreme fossil fuel price volatility: price regulation must tread a careful balance between price protection for disengaged consumers and the longer-term goal of ensuring a just and fair transition at least cost.

The price cap was designed to tackle issues associated with sticky' customers who did not switch supplier (otherwise known as the 'loyalty penalty' and therefore requires an assessment of the potential for this to reemerge in the current market. However, in a market where the regulator has set a standard on monitoring and defining suppliers' efficient costs, there is greater transparency for customers which in turn challenges any misconceptions about pricing.

Alongside the original objectives of the price cap, it is now more important, given the scale of the benefit for GB, that price regulation supports and does not hinder the scope for net zero benefits to the UK. Oxford Economics estimate a £165bn bonus to the UK from the most ambitious net zero pathway¹. Ofgem's duties around net zero and growth require such an approach.

Setting parameters of supplier risk

In pursuit of stringency, the inadequacy of the cap allowance has created transitory issues that have resulted in cashflow volatility for suppliers² and have arguably contributed to routine loss-making across the sector which has held back investment. This is not to say that stringency should be removed but the approach to setting allowances and the level of stringency in the cap in combination have caused issues.

Ofgem's recent controls on suppliers' financial arrangements will support resilience, yet the inadequacy of cap allowances still represents a continuing and persistent threat to suppliers' efficient financing of their licensed activities.

¹ [Energy UK \(2024\) Funding the future](#)

² [Energy UK \(2024\) Energy UK explainer: Why the price cap is allowing suppliers to recover recent losses \(Feb 2024\)](#)

Energy suppliers worked hard (and at speed) to deliver government support to customers during the height of the energy crisis, but the EPG and support payments were only able to work within the existing frameworks. The experience of the crisis demonstrated that a single cap, by itself as a reference price, was not effective as a tool to get adequate support to the customers who needed it the most. The cap helped address the immediate crisis but the debt and affordability challenges facing the sector now are arguably a result of a situation in which some customers were given support that they didn't need at the expense of others who would have benefited from more.

Two key things are required to address affordability challenges effectively – a mechanism using government data for targeting and delivering both ongoing and exceptional support and the commitment to Government funding. This is necessary because suppliers will not be able to manage an open-ended risk of fossil fuel volatility – particularly if any Government customer support used is not targeted at customers in such a way that it effectively reduces debt risk. The lack of mechanism and doubt over what will happen in future price shocks creates unnecessary challenges and costs for the sector and will exacerbate the impact when wholesale costs are volatile.

An affordability mechanism and clear scope for cost recovery are necessary to mitigate the risk created through customers' inability to pay and those unwilling to pay being subsidised by those who do. There is an open-ended risk of costs for suppliers in mitigating affordability challenges and from individual customers simply choosing not to pay their bills, which ultimately all customers end up paying for through their bills. This needs to be addressed directly to further Ofgem's stated aims to support resilience in the energy market to protect the wider energy sector and customers from the impacts of supplier failure. Otherwise, the price cap will see continual updates to account for socialised debt which then further worsens affordability.

Avoiding opportunity cost

The price cap was designed to tackle issues associated with 'sticky' customers who did not switch supplier (otherwise known as the 'loyalty penalty') and therefore requires an assessment of the potential for this to reemerge in the current market. However, in a market where the regulator has set a standard on monitoring and defining suppliers' efficient costs, there is greater transparency for customers which in turn challenges any misconceptions about pricing.

With 90% of customers on a default tariff arrangement, price competition has changed. While price differentials persisted initially due to a combination of falling wholesale prices and unsustainable business models, opportunities for customers to realise significant savings by switching have subsequently been much more limited. A key objective of price regulation and energy policy more widely should be to support engagement with energy suppliers who can provide support and help achieve ambitious net zero pathways through tailored products and services. It represents an opportunity cost for market development if the level of stringency in the price cap does not allow for competition and tariff competition.

Currently, the price cap applies across a number of tariffs, including non-default evergreen tariffs. We suggest the regulator should consider limiting the cap's application solely to default tariffs and not non-default evergreen tariffs, which would respect customers' choice to set and forget their chosen service.

While 1% of the country currently has a heat pump and 7% have electric vehicles, the electrification of heat and transport is at an early stage. However, it is growing quickly with many of our members rapidly scaling their capabilities to support the Government's objectives for decarbonisation.

Maintaining equitable access to the grid at fair costs is crucial for customer confidence in the transition. However, there is a risk that overly complex price and consumer protections could restrict the ability and incentive for customers to engage with their energy options. For example, by providing overly competitive default tariffs or by attaching support offers to particular tariff types. Where positive customer engagement is vital and able to benefit the energy system, Ofgem should anticipate a more dynamic market which means they will have to regulate less prescriptively and become more agile.

The current price cap should be updated to reflect the importance of the opportunity to develop a retail market that improves customers' effective use of energy for their needs. The implementation of MHHS, alongside price regulation should seek to support customers effective use of energy to meet their needs efficiently. This involves actively changing energy requirements and consumption patterns to reduce peak demand, thereby lowering the amount of distribution network investment required and reducing the need to pay constraints or use back-up power generation such as gas.

It could be the case that customers whose consumption is biased towards cheaper half hours (or who can shift their consumption in that way) will move to ToU tariffs following introduction of MHHS, meaning that the residue of customers remaining on a flat rate tariff will have higher average costs than before. If this is the case it may require the tariff cap to be set at a level that reflects the cost to serve a sub-set of customers (those who are on flat rate default tariffs), which will likely result in an increasing cap over time; or else the tariff cap will not be adequate to cover the efficient cost to serve of default customers, damaging market stability, investability and competition. The growing number of customers with EVs and other Low Carbon Technologies may also mean that price cap assumptions regarding Economy 7 consumption patterns may also need to be revised. Ofgem should take a cautious approach to understand if and when this dynamic occurs, and it remains important that Ofgem does not try to guess consumption patterns but uses available data to learn and respond to change.

Inevitably, the fairness and affordability of costs will appear as a singular issue to customers. A key group that are at risk of not benefiting, or perceiving they are not benefiting from the improved flexibility of the energy grid may well be low-income and vulnerable customers. The Government will need to increase support for customers to encourage the uptake of new products and services, and fund interventions in homes that facilitate energy demand reduction and control. It also requires better targeting of customers who can't engage to enable them to avoid undue costs.

Regulatory risk and burden

As the Government and the regulator rightly seek to improve energy system efficiency by passing on temporal price signals to suppliers, the risks from customers not engaging, both through legitimate barriers or through choice, will increase costs for suppliers. To the extent suppliers pass through granular price signals to consumers, it may increase the cost for customers who cannot easily respond and who may therefore require targeted support to help adapt, or to meet additional costs where this is not possible³.

Targeting support to those who most need it will make price cap costs lower and more stable. However, low costs and stability also require a commitment to facilitate active engagement with energy options. This is a careful balance of risk for Government and Ofgem in reforming price regulation.

³ Energy UK's forthcoming response to Ofgem CFI on Debt and Affordability

How the price cap was originally designed and has now evolved means that the process of coming to an exact and accurate allowance number involves complex calculations across disparate business models⁴. This is not to say that the monitoring of costs through a bottom-up methodology is wrong but that Ofgem should be seeking a better balance of accuracy and the impact of the regulatory risk and burden on market offers to customers.

We think that Ofgem needs to take a more strategic approach to ensuring adequate allowances for suppliers and should explore scope through the currently planned allowance reviews to simplify the overall price cap methodology and make it more responsive to suppliers fluctuating cost requirements. For example, setting clear triggers for automatic adjustments, defining passthrough costs and setting benchmarks that enable suppliers to drive engagement while managing risks set out above.

Another key element of reform is Ofgem's welcome commitment to simplify, rationalise and reduce the duplication of its information requests. The regulator should also ensure that it allows adequate timeframes for responses.

⁴ Mantzari (2019) [The UK Domestic Gas Electricity \(Tariff Cap\) Act: Re-regulating the Retail Energy Market](#)