

Ofgem Working Paper #3: Headroom

Energy UK response

23 April 2018

Introduction

Energy UK is the trade association for the GB energy industry with a membership of over 100 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership covers over 90% of both UK power generation and the energy supply market for UK homes. We represent the diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 27 million homes and every business in Britain. Over 730,000 people in every corner of the country rely on the sector for their jobs, with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry invests £12bn annually, delivers £88bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to HMT.

This is a high-level industry view; Energy UK's members may hold different views on particular issues raised by the working paper. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

Given the significance of the cap for the domestic supply market and the volume of households it will impact, it is vital that Ofgem undertakes a robust design process that enables the conditions for a competitive market to be in place by 2023 at the latest. To enable comprehensive views to be made by stakeholders as to the headroom component Ofgem should outline its thinking on the cap's success criteria, in particular the level of consumer switching that is required when the cap is in place. In particular, Energy UK notes that Ofgem is concerned that the cap could negatively impact upon switching rates.¹ As such, if engagement and switching is to be used as an indicator of a competitive market then action needs to be taken to ensure that this does not happen, or at least mitigate its impact – the inclusion of a headroom component could be means to achieve this.²

¹ [Dermot Nolan oral evidence to BEIS Select Committee](#), 10 January 2018, Q345

² One Energy UK member, Octopus Energy, has indicated that it does not agree with the view of Energy UK on the necessity to include headroom in the design of the cap.

We are concerned the Ofgem's view that they "*need to consider what is proportionate within the current timeframe*", as stated in the Working Paper, risks decisions being made without comprehensive and transparent review. In particular, we note that the "as soon as practicable" provision in 1(1) of the Bill does not suggest that Ofgem can risk compromising the robustness of the design process it undertakes.

The proposed analysis outlined in the Working Paper is also welcomed, although we would welcome clarity as to the timings available for stakeholders to review Ofgem's findings before policy decisions are made. Care should be taken to not put emphasis on cross-sector price control comparisons which would not have applicability to the GB domestic supply market.

The Process

The likely obligation to introduce the cap "as soon as practicable after the Bill is passed" does not negate the need for a thorough and rigorous design process to avoid any detriment to competition and consumers. The "as soon as practicable" provision in 1(1) of the Bill in no way suggests that Ofgem can compromise due process and accuracy of the cap construction for the sake of speed. Rather, it only bites on Ofgem's use of its internal resources. Energy UK has a number of concerns that revolve around the process currently being undertaken by Ofgem to design the cap.

With a policy consultation indicated for May or June, Energy UK is concerned that there is a risk that time restraints could undermine the robustness of the analysis being undertaken and we would not want to see the politically imposed deadline for the cap's implementation unduly limit engagement with industry stakeholders to the detriment of the measure's effectiveness. Indeed, when discharging its statutory duties, only Ofgem's statutory duties are relevant, and no more. Ofgem is also a regulator that is independent.

In specific regard to headroom, we are concerned that the working paper gives no detail about the expected timeline for the analysis being undertaken and what, if any, opportunities there will be for stakeholders to review the results of the work before Ofgem makes a decision based on their findings.

We would also welcome clarity as to how responses to this and other working papers will be taken into proper consideration ahead of the consultation that Ofgem has indicated could be published as early as May, and how much time will be available for Ofgem to consider stakeholder responses to the consultation itself ahead of any subsequent action. We note that with the process currently being undertaken that responses to one working paper are not being taking into account ahead of the next one, despite their inherent inter-connectivity. We are, therefore, concerned that Ofgem may not be able to give proper consideration to all responses it has received ahead of the policy consultation's publication.

As highlighted in our response to Working Paper #2 (WP2) we believe that stakeholders would benefit from greater clarity on the future work that Ofgem anticipates it will be undertaking. As per Table 3 in WP2, there had been one more working paper due ahead of the policy consultation. However, in Working Paper #3 (WP3) there appears to be more on the horizon as it states that Ofgem is "*planning to publish more working papers on different topics in April*". No detail is given about the nature of these working papers or a definitive timeline which makes it more difficult for stakeholders to manage their resources accordingly. During the process of producing this working paper response we note that Ofgem have published a further two working papers that it has indicated will be the final such papers before an expected policy consultation in late May.

Underlying these concerns is the lack of transparency on what criteria Ofgem will be judging the success of the cap. In Energy UK's response to Working Paper #1 (WP1) we asked that

Ofgem share their thinking on this as it would aid in stakeholders' responses to subsequent working papers. On this current working paper, when commenting on Ofgem's planned analysis on headroom, stakeholders are at a disadvantage as they are not able to judge the proposals against what Ofgem is hoping to achieve with the cap overall. For example, if the cap was to be judged on engagement and switching rates then the proposed analysis on this aspect would merit closer examination and overall views on the inclusion of headroom in the cap would be different.

Headroom Principle

Ofgem has previously stated that *"customer engagement and switching are key to achieving good outcomes in the market as a whole"*.³ Ofgem CEO, Dermot Nolan, gave evidence to the BEIS Select Committee stating that *"if the number of switches is high, if people seem to find it easy to switch, that is one sign of a competitive market"*.⁴ However, he also stated that the cap could reduce the number of switches, which we note could have implications for Ofgem's obligation to have regard to maintaining incentives for consumers to switch if it is not actively guarded against in the cap design.

In essence, if Ofgem are of the view that engagement and switching will form part of the criteria of a competitive market then they need to design the cap to ensure that damage to consumer engagement is avoided or at least limited. This could be aided by the inclusion of a headroom component.⁵ We note that the CMA viewed headroom as a necessity in the PPM price cap to ensure competition was not damaged:

*"Potentially more significant are the distortions to competition that could arise from the application of the cap, but we have again chosen aspects of the design to minimise these – notably, by building in headroom to allow competition below the level of the cap"*⁶

Energy UK requests the inclusion of Ofgem's current thinking on the success criteria in the expected policy consultation, if not beforehand in a separate working paper, so that full consideration can be given to the overall design.

In addition, Ofgem are undertaking separate work to boost consumer engagement such as the implementation of the CMA database remedy and a move towards principles-based regulation. Energy UK would, therefore, urge Ofgem to ensure that the imposition of this temporary price cap does not unduly inhibit the progress on consumer engagement that these other work streams seek to achieve.

Proposed analysis

Energy UK welcomes the analysis that Ofgem proposes to undertake on the four matters it must have regard to when designing the cap, having specifically asked for further work on financeability to be undertaken in our response to WP1.

The Working Paper makes reference to the PPM price cap, stating that early analysis of PPM-focused suppliers show continued growth in spite of the cap. We believe that such a general statement does not take into account certain aspects of the PPM market that are not applicable to the wider domestic retail energy market, and should be relied upon for a like-for-like comparison. For example, there are various non-price attributes in the PPM market that would

³ [State of the Energy Market, 2017 Report](#), Ofgem, p.23

⁴ [Dermot Nolan oral evidence to BEIS Select Committee](#), 10 January 2018, Q345

⁵ One Energy UK member, Octopus Energy, has indicated that it does not agree with the view of Energy UK on the necessity to include headroom in the design of the cap.

⁶ [Energy Market Investigation, Summary of Final Report](#), CMA, p.60

impact upon PPM-focused suppliers' engagement strategy such as their smart meter roll-out programmes or the availability of smart top-up options.

Other mentions are made in WP3 towards price controls in other markets that Ofgem will be taking into consideration when deciding on the inclusion of a headroom component. Energy UK believes that both of those mentioned would not be suitable for comparisons and the usefulness of such an exercise would be limited as lessons learned would not be applicable to the domestic energy market. For example, the Northern Ireland price control only impacts upon one supplier, Power NI. We also note that in setting the level of the cap, the Utility Regulator thoroughly scrutinises Power NI's proposed costs before to determine the level of profit it is allowed to make from price-regulated customers. We do not believe that this would be a useful comparison for Ofgem to draw upon.

To this end, a more instructive comparator may be an analysis of the history of the current GB market. For example, we note that 91% of consumers who switch are motivated by price,⁷ and that the CMA found the mean saving required for consumers to switch was £158 per annum.⁸

In addition, Ofgem could look at evidence that emerged from the energy price controls that were in place in New South Wales (NSW), Australia, until 2013-14 which supports the case for headroom. The example illustrates how price controls can reduce price dispersion and weaken competition – and conversely, how relaxing the price control can allow competition to flourish.⁹ In the 2007-10 price control period, the level of 'incentive' (a measure of headroom in the price cap) was relatively low and the number of customers opting for regulated as opposed to 'market' prices increased over the period. In the next price control period 2010-2013, the incentive was increased four-fold (to approximately 10% of total costs). This caused price dispersion to widen from 4-5% (in 2009/10) to 5-15% (in 2012/13), the switching rate to increase from 12% to 19% and the number of customers on regulated tariffs to fall from 65% to 40%, leading the Independent Pricing and Regulatory Tribunal (IPART) to ultimately conclude that the price control could be removed altogether.

While the regulator (IPART) acknowledged challenges in determining the precise relationship between incentives and switching, it noted the experience of Victoria, Australia before energy market deregulation where higher margins occurred alongside increasing retail market competition. Conversely, in Queensland, Australia, lower incentives in regulated prices occurred alongside relatively lower levels of customer switching.¹⁰ Ultimately the regulator concluded:

"[W]e consider it reasonable to conclude that the incentives included in regulated prices will significantly influence the level of competitive activity. The evidence suggests that as the incentives in regulated retail prices increase, so does the level of competitive behaviour by retailers and market participation by customers."¹¹

In IPART's latest review of the electricity market in December 2017, its third since the deregulation of the markets in 2013-14, competition in the NSW market had continued to increase with the regulator's key indicators of competition all improving: the number of suppliers has risen from 15 to 26; the market share of smaller suppliers has doubled from 7% to 14%; the number of consumers on default tariffs has dropped from 37% to 23% and the

⁷ [State of the Energy Market, 2017 Report](#), Ofgem. p.24

⁸ ⁸ [Energy Market Investigation, A report for the CMA by GfK NOP](#), p.75

⁹ [Review of Regulated Retail Prices and Charges for Electricity](#), Independent Pricing and Regulatory Tribunal of New South Wales (IPART) (2013): p. 114 (table 9.2).

¹⁰ *Ibid*, p.114

¹¹ *Ibid*, p.114

proportion of customers switching in the last 12 months rising from 23% to 31%.¹² Energy UK believes that Ofgem should therefore look to take into account international examples that better model the GB market and the overall aim of the Bill to allow a more competitive market to be put in place.

If you would like to discuss the above or any other related matters, please contact me directly on 020 7747 2931 or at steve.kirkwood@energy-uk.org.uk.

¹² “[Retail Energy Market Monitoring 2017](#)”, IPART (2017)