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Default Tariff Cap: Policy Consultation Appendix 11 - Headroom

Consultation - supplementary appendix

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Overview:

The energy market works well for consumers who shop around. Suppliers compete for these engaged consumers, offering low prices to gain or retain their custom.

But the retail energy market is not working for consumers who remain on their supplier's default tariff. Our work, and the Competition and Markets Authority's investigation, has shown there is little competitive constraint on the prices suppliers charge these consumers. As a result, they are paying more than they should be.

To address this problem, Government has introduced legislation into Parliament which would require Ofgem to design and put in place a temporary cap on all standard variable tariffs and fixed-term default tariffs. We anticipate that Parliament will approve the Domestic Gas and Electricity (Tariff Cap) Bill in the summer, and the default tariff cap will come into force at the end of 2018.

We are now consulting on how we might design and implement the default tariff cap. This supplementary appendix to the main consultation document sets out our proposals in relation to headroom. This document is aimed at those who want an in-depth understanding of our proposals. Stakeholders wanting a more accessible overview should refer to the main consultation document.

Associated documents

Policy consultation for Default Tariff Cap – Overview
https://ofgem.gov.uk/system/files/docs/2018/05/default_tariff_cap_-_policy_consultation_-_overview.pdf

Links to supplementary appendices

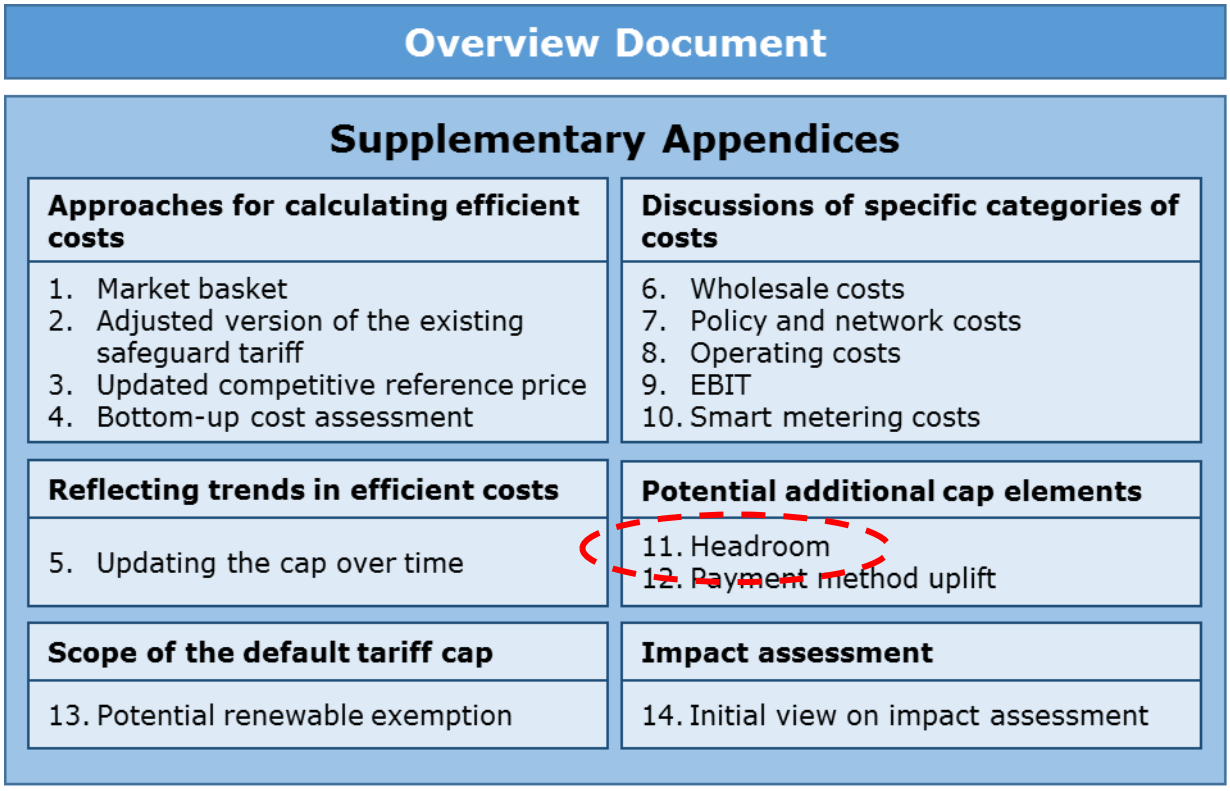
- Appendix 1 - Market basket: https://ofgem.gov.uk/system/files/docs/2018/05/appendix_1_-_market_basket.pdf
- Appendix 2 - Adjusted version of the existing safeguard tariff https://ofgem.gov.uk/system/files/docs/2018/05/appendix_2_-_adjusted_version_of_the_existing_safeguard_tariff.pdf
- Appendix 3 – Updated competitive reference price https://ofgem.gov.uk/system/files/docs/2018/05/appendix_3_-_updated_competitive_reference_price.pdf
- Appendix 4 – Bottom-up cost assessment https://ofgem.gov.uk/system/files/docs/2018/05/appendix_4_-_bottom-up_cost_assessment.pdf
- Appendix 5 – Updating the cap over time https://ofgem.gov.uk/system/files/docs/2018/05/appendix_5_-_updating_the_cap_over_time.pdf
- Appendix 6 – Wholesale costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_6_-_wholesale_costs.pdf
- Appendix 7 – Policy and network costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_7_-_policy_and_network_costs.pdf
- Appendix 8 – Operating costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_8_-_operating_costs.pdf
- Appendix 9 – EBIT https://ofgem.gov.uk/system/files/docs/2018/05/appendix_9_-_EBIT.pdf
- Appendix 10 – Smart metering costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_10_-_smart_metering_costs.pdf
- Appendix 11 – Headroom https://ofgem.gov.uk/system/files/docs/2018/05/appendix_11_-_headroom.pdf
- Appendix 12 – Payment method uplift https://ofgem.gov.uk/system/files/docs/2018/05/appendix_12_-_payment_method_uplift.pdf
- Appendix 13 – Renewable tariff exemption https://ofgem.gov.uk/system/files/docs/2018/05/appendix_13_-_renewable_tariff_exemption.pdf
- Appendix 14 – Initial view on impact assessment https://ofgem.gov.uk/system/files/docs/2018/05/appendix_14_-_initial_view_on_impact_assessment.pdf

Document map

This supplementary appendix to the main overview document set out our proposals for headroom.

Figure 1 below provides a map of the default tariff cap documents published as part of this consultation.

Figure 1: Default tariff cap – policy consultation document map



Links to these documents can be found in the 'Associated documents' section of this document

Contents

1. Overview

This chapter provides an overview of the content of this document. Although we emphasise some specific points to invite stakeholder views, we welcome feedback on any points discussed in this appendix.

Overview

1.1. In this appendix we discuss our proposed approach to setting an appropriate level of headroom; the level between the efficient level of costs[1] and the level of the cap. We will make our decision on the level of headroom in the cap in conjunction with our decision on the efficient level of costs benchmark.

1.2. Including a level of headroom might be desirable to account for uncertainty that has not already been allowed for when estimating the efficient level of costs. For instance, when:

- addressing the intrinsic uncertainty involved in estimating an efficient level of costs;
- allowing efficient suppliers to manage volatile pass-through costs, particularly when purchasing energy; and
- helping with cost variation, because some efficient suppliers have costs that are higher or lower than average for reasons outside of their control (eg due to differences in their customer base).

1.3. Different levels of headroom will have an impact on how the cap provides consumer protection, which is the main objective of the Domestic Gas and Electricity (Tariff Cap) Bill ("the Bill"). It will also affect how the cap balances the impact on the different matters we must have regard to that are set out in the Bill. For example headroom levels will affect suppliers' incentives to improve their efficiency, incentives to compete, engaged consumers' incentives to switch, and efficient suppliers' ability to finance their activities.

1.4. While headroom should encourage a range of price and service offerings in the market, there is a risk that some of the benefits of headroom could be offset by suppliers converging their prices at the maximum level allowed by the tariff cap. However, the number of suppliers currently offering tariffs, combined with the potential for entry, and the likelihood that suppliers will have different strategies to attract new customers should mean suppliers will continue to compete for currently

[1] The different methods for establishing the efficient costs are set out in Appendices 1, 2, 3 and 4.

engaged customers and offer a range of tariffs, reducing the risk that suppliers simply price to the cap.

1.5. In the rest of this document we first explore the format of headroom. We then set out the criteria and the analysis that we will use when considering what is an appropriate level of headroom. To illustrate and to test the potential impact of headroom we then discuss four illustrative headroom scenarios, based on a range around the CMA's prepayment meter cap headroom of around £30 for dual fuel accounts. The illustrative scenarios in this document should not be seen as the "options" for headroom, ie we could choose any value for headroom, but consider that the scenarios here provide practical lower and upper limits.

1.6. As described in the main document, our decisions on headroom and the efficient benchmark are interdependent and need to be taken together so all the issues can be considered in the round. As we undertake such a process we will update our modelling to help inform our decision.

2. Our proposed approach

Our views on how headroom could be applied to the cap. We set out our current views on whether it should be:

- A percentage or absolute amount
- A fixed or adjusted level

How could headroom be applied in the cap?

Percentage versus absolute

2.1. The Competition and Markets Authority (CMA) looked at whether the format of headroom in the prepayment cap should be an absolute figure across all levels of consumption or a percentage figure fixed for the life of the price cap. It decided that the headroom level should be set as a percentage figure fixed over the life of the tariff.[2] This percentage is applied to all elements of costs except the network allowance,[3] and means that the absolute value of headroom varies over time according to indexation movements.

2.2. The CMA decided upon a level of headroom in absolute (£) terms for the typical consumer for both electricity and gas, then converted this into percentage terms. Using a percentage allows headroom to scale with consumption and reduces the risk that the level of the cap is unduly high for low consumption customers or relatively low for high consumption customers.[4]

2.3. A fixed headroom approach would result in headroom being a higher proportion of customers' bills that consume less. The consumption trends in the State of the Market Report show that low-income households tend to consume less than households with higher incomes,[5] making a percentage approach seem more appropriate, given that an absolute approach could lead to relatively higher costs for low-income consumers.

2.4. If the headroom level were set based on an absolute figure, consideration will need to be given to how the initial level could be indexed, and updated based on a headroom specific index. We are not currently aware of an objective index that would be appropriate to update an absolute figure. Also, to the extent that headroom plays a role to capture any uncertainty in costs, then it makes sense for it to increase

[2] CMA (2016), Energy Market Investigation Final Report, paragraph 14.127.
[3] CMA (2016) Energy Market Investigation Final Report, paragraph 14.128.
[4] CMA (2016) Energy Market Investigation Final Report, paragraph 14.125.
[5] Ofgem (2017) State of the Market, https://www.ofgem.gov.uk/system/files/docs/2017/10/state_of_the_market_report_2017_web_1.pdf

when costs rise and decrease when costs fall. These issues are addressed with a percentage approach to headroom.

2.5. In the CMA methodology, the headroom percentage is applied to all the elements of cost except the network allowances. We think it is appropriate to exclude network costs since they vary regionally and are known with a reasonable degree of precision. Applying a percentage uplift to network costs would lead to greater headroom in regions with high network costs. This would mean consumers living in higher cost network areas paying more headroom, which would be an unintended consequence.

2.6. We welcome views on whether we should set headroom as a percentage of only controllable costs instead. However, this approach would exclude costs that are uncertain and fluctuate, such as wholesale costs. As set out in paragraph 1.2, one potential rationale for headroom is to allow efficient suppliers to manage volatile pass-through costs.

Position

2.7. We are minded to set headroom as a percentage because it enables the headroom proportion to vary with consumption, and the headroom to vary over time with other costs. In order to initially calibrate the cap we will propose a level of headroom in absolute terms then this will be set in percentage terms.

2.8. At this time our view is that headroom should be a percentage that applies to all elements of costs except the network allowance, given these costs are known and unlikely to vary in the six month price control period.

QA11.1 What are your views on headroom being a percentage? Do you think it should be applied to all cost components except for network cost? Alternatively, do you think headroom should be applied as a percentage to only controllable costs?

Should the level of headroom change over time?

2.9. The CMA applies the same level of headroom (as a percentage) for the life of the prepayment meter cap. Some stakeholders have suggested we consider whether to use a fixed percentage like the CMA or whether we should adjust the percentage over time, because it may take time for suppliers to achieve efficiencies in their operations or that it should be reduced as suppliers realise efficiencies which should be passed to consumers through lower prices. Some respondents to our working paper on headroom suggested mechanisms for how we might adjust the headroom level over time.

2.10. The CMA estimated that suppliers' actual costs are higher than the efficient level, implying that a cap set at the efficient benchmark would require inefficient

suppliers to cut their costs or make losses.[6] Some stakeholders have suggested that we could set a higher initial level of headroom and then decrease it until it reaches a target level, to allow time for suppliers to realise efficiencies.

2.11. Notwithstanding that the potential for restrictions on suppliers' tariffs has been well trailed, certain suppliers have argued that because of rules preventing them from changing the terms of existing fixed price contracts, they have limited levers available to them to respond to the introduction of the cap and ensure a continued ability to finance their activities. An approach where headroom changed over time could provide some mitigation, were this to be considered a significant issue. However, since the cap is temporary there would need to be a strong case to support a transitional period as this could delay and reduce the savings to consumers. We also note that the Bill requires us to give regard only to efficient suppliers' ability to finance their activities, rather than suppliers in general.

2.12. We have not proposed reducing the level of headroom over time, either to further encourage suppliers to improve their efficiency, or to allow inefficient suppliers time to adjust. However, we remain open to this possibility and will consider it when finalising how to set the cap in a way that best supports the Bill. We will continue to consider and analyse this issue, given the appropriateness of any adjustments over time will be dependent on our decision on the efficient benchmark methodology, the overall level of the cap, and consideration we need to have towards the objective and matters we have to have regard to in the Bill.

QA11.2 What are your views on whether we should change the level of headroom over time?

[6] CMA (2016), Energy Market Investigation Final Report, paragraph 10.100

3. Setting the level of headroom

How we will consider the impact of headroom in the context of the objective and matters we must have regard to set out in the Bill. It also describes the evidence and analysis that we are proposing to use when considering what is an appropriate level of headroom

Context

3.1. We have reviewed available evidence and performed initial analysis to build on our understanding of the implications of varying levels of headroom and the trade-offs that are required. We intend to conduct further analysis in advance of reaching a final decision, and consider stakeholders' feedback. As we stated earlier, we will make our decision on headroom in conjunction with our decision on the efficient cost benchmark. In this chapter, we describe the evidence we are considering, our initial analysis and the further analysis we intend to perform.

3.2. Analytically, there are direct and indirect impacts on both consumers and suppliers from the cap level (combining the efficient benchmark and headroom). Directly, the default tariff cap reduces bills for consumers in the scope of the cap and correspondingly reduces revenues for suppliers. Indirectly, the impacts depend on how suppliers and consumers respond.

3.3. Academic and industry literature on consumer behaviour emphasises a two-stage decision process:

- Whether consumers search for a new energy supplier or tariff (see, for example, Armstrong, Vickers and Zhou, 2009). This may be due to an expectation of financial gains, or some other trigger.
- If they have searched, whether the net benefit is sufficient for them to switch. This includes the financial gains from switching, but also other factors such as the time value of the switching process.

3.4. Most suppliers are commercial businesses aiming to maximise profits. In the short-term, they may undertake a range of strategies aimed at either - or both - of increasing their market share and customer profitability.

3.5. We set out in paragraph 1.2 above reasons why headroom might be desirable. We are considering the impact of headroom, in the context of the factors set out in the Bill. We intend to conduct further analysis before reaching our final decision on the level of headroom. We will summarise our further work in the Statutory Consultation.

Protecting existing and future SVT customers: considerations and evidence we intend to draw on in reaching a final decision

3.6. As set out in the Bill, the objective for the default tariff cap is to provide protection to existing and future Standard Variable Tariff (SVT) and default[7] customers. One way in which we are considering protection is the amount of savings to a default customer, compared to current default prices. A lower cap would suggest higher savings. However, as noted in the working paper on headroom, protection also requires consideration of dynamic efficiency (innovating and reducing costs over time) and is broader than immediate financial savings.[8]

3.7. Stakeholders have raised concerns about whether a low cap in the near term could damage protection for consumers in the long term. If switching rates reduce during or after the temporary default tariff cap period, suppliers may have less incentive to innovate or improve service for customers, and so reduce costs. This could increase prices or lower service levels for customers in the future. We intend to consider these issues further before making our final decision.

3.8. As the level of headroom increases, the direct impact on current default customer bills reduces. From a default customer perspective, the impact of the default tariff cap depends on the current price of the tariff they are on, their consumption, and the level of the cap.

3.9. We have used Ofgem data, and data provided by suppliers in response to information requests, to analyse how typical SVT and default customer bills may change for suppliers in response to a default tariff cap with varying levels of headroom. We have also analysed changes in revenue and how SVT and default customer bills may change for suppliers, using supplier level mean consumption data where available.

3.10. As we have not decided which efficient cost benchmark methodology to use or the resulting level of efficient cost, our analysis to date has focused on the impacts of four illustrative headroom level scenarios, based on a range around the CMA's prepayment meter cap headroom of around £30 for dual fuel accounts. Stakeholders should not take these scenarios as the only options for the final level of the cap. They have been constructed as theoretical example cases that enable us to consider the impact of different levels of headroom and as such the overall cap level, on the various matters to which we must have regard for as set out in the Bill. The summary results are presented in Chapter 4.

[7] References hereafter to default tariff customers refer to both SVT and default tariff customers.
[8] https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-working-paper-3-our-thinking-including-headroom-allowance

Creating incentives for suppliers to improve their efficiency: considerations and evidence we intend to draw on in reaching a final decision

3.11. Given one of the key conclusions from the CMA's market investigation was the inefficiencies in suppliers operating in the energy market, it is important that suppliers have incentives to improve their efficiency. This provides long-term benefits to customers through improved service and reduced prices. While a temporary default tariff cap has the potential to create significant incentives on suppliers to become more efficient, in the long-run, we believe competition is the best way of creating such sustained incentives, because it puts pressure on companies to find new, efficient and better ways of doing things. Competition also encourages market participants to discover and provide the services that consumers really want. Competition creates incentives for consumers to steadily move from less efficient companies to more efficient companies.

3.12. An important consideration is how inefficient suppliers' incentives may change following the introduction of a default tariff cap with or without headroom. With zero or low headroom inefficient suppliers will need to reduce costs rapidly. Where suppliers are unable to realise efficiencies, they may exit the market and be replaced by more efficient operators. This is a normal feature of a market, but Ofgem has a role in ensuring consumers are protected when suppliers exit the market. This is because the efficient benchmark would be below their actual costs. How suppliers choose to respond to this incentive may, or may not, benefit customers. They may attempt to reduce costs through changes to their business model (for example, removing higher cost service offerings), finding cost efficiencies, or seeking to shed loss-making customers.

3.13. A key focus of our assessment is on the incentives existing suppliers and potential new entrants have to reduce costs, and to innovate to attract customers and make a profit. A higher cap increases the scope for suppliers to compete actively beneath the cap.

3.14. Competition between fixed price tariff offers currently provides the main incentive for suppliers to cut costs, in order to offer lower prices and attract new customers. It can be argued that there is a risk that a lower level of headroom (through its impact on price dispersion, switching, and the expected long-term profitability of new customers to a supplier) dulls this incentive.

3.15. It is plausible, because of the uncertainties in setting an efficient benchmark, that the lower the level of headroom, the greater the risk that as an unintended consequence efficient suppliers come under pressure to exit the market. A further consideration is that zero or low headroom levels may discourage (potentially efficient) prospective new entrants from entering the market due to the reduced profit opportunity compared to today.

3.16. An alternative view is that a lower default tariff cap may encourage suppliers to compete more actively on non-price factors, if they are unable to continue competing as strongly on price. This may include innovative products or service, and the

opportunity to move into parallel markets such as connected homes. However, others have argued that a lower cap would make it more difficult to invest in products and services to support such innovative offerings.

3.17. We intend to do further work to understand the impacts a default tariff cap with varying levels of headroom may have on efficiency.

Enable effective competition: considerations and evidence we intend to draw on in reaching a final decision

3.18. We regard effective competition as the best way to improve long-term outcomes for engaged consumers. We are required to look at conditions for effective competition when proposing whether the cap should be extended beyond 2020. The principal ways we are considering effective competition are through price dispersion, switching, and market participation. A higher cap may provide more scope for effective competition than a lower cap.

3.19. Even without headroom, suppliers who become more efficient than the efficient benchmark in the cap, or new entrants who are more efficient than incumbents, will be able to compete effectively on price. However, for the reasons set out in paragraphs 3.28 to 3.42, customers may require savings above those that can be realised purely through supplier efficiency gains against an efficient cost default tariff cap in order to switch. Headroom could provide some of this incentive to switch and enable more effective competition.

3.20. We have undertaken initial modelling of how suppliers may respond in the short term to a default tariff cap. To do this, we have used supplier level data (where available) on revenues, costs, customer numbers, prices, consumption, and tariff types. This data has been provided by suppliers through routine data collection by Ofgem and in response to specific Requests For Information (RFIs). In reality, suppliers are commercial businesses with a variety of business models and will make strategic decisions specific to their unique circumstances, which makes it difficult to make exact predictions of what might happen once a cap is introduced. As such, we are considering a wide range of scenarios, recognising that suppliers may follow a mixture of these scenarios in practice. How suppliers' pricing responds to a default tariff cap is a key determinant of future pricing dispersion, which in turn is a key determinant of consumer switching.

3.21. In all scenarios, we assume compliance with the default tariff cap for all tariffs within scope of the cap. We are considering scenarios whereby suppliers:

- may or may not choose to increase default tariffs to the level of the cap, where they are initially beneath the cap
- may or may not choose to decrease fixed price tariffs (immediately for new offers and upon contract expiry for existing customers) to the level of the cap, where they are initially above the cap

- may or may not choose to increase fixed price tariffs (immediately for new offers and upon contract expiry for existing customers) to the level of the cap, where they are initially below the cap
- may choose alternative approaches to adjusting or maintaining fixed tariffs, for example through decreasing them to maintain the difference to the SVT and default price, or by adjusting such that the supplier overall earns normal economic profits.

3.22. Qualitatively we are considering how these responses may differ in practice, for example for smaller or larger suppliers. There are practical limits to these pricing decisions, including contract timing and consumer responses. The relative plausibility of different responses also depends on the level of headroom. In practice, individual suppliers' strategies will depend on their specific circumstances.

3.23. Smaller suppliers targeting specific market segments and with policy cost exemptions may be willing to continue to offer prices below the estimate of efficient costs.[9] However, savings available will still be reduced compared to current levels. Further, there is some evidence that many consumers are less willing to switch to smaller suppliers, eg due to a lack of brand recognition. In addition, small suppliers benefiting from policy cost exemptions may grow over time if they are the main source of price dispersion in the market, and so no longer benefit from policy cost exemptions.

3.24. We are qualitatively considering the impact of headroom on potential new entrants. A default tariff cap which reduces the expected long-term lifetime value of a customer to a supplier could reduce both existing suppliers' incentives to actively acquire customers, and new entrant incentives to enter the market. We are also aware that some new entrants' business models are relatively unaffected by a default tariff cap.

3.25. We have reviewed evidence from international case studies including Australia, Northern Ireland, Spain, California, and Illinois. These have provided useful information on how price caps (which may be higher or lower due to headroom or another factor) can impact price dispersion, market entry and effective competition. As some respondents to our working paper on headroom noted, there are limitations to the comparability of these case studies to the proposed default tariff price cap in the context of the GB market. We will bear these limitations in mind when assessing the overall evidence to decide on the level of headroom.

3.26. The early evidence from the prepayment meter cap[10] suggests that whilst there has been some price convergence for the typical consumer, the cheapest offers

[9] Appendix 7 contains details of the thresholds required for suppliers to be required to contribute to each type of policy cost.
[10] For example, see the State of the Market Report, 2017. We have also reviewed the submissions companies provide to us for compliance monitoring and social obligations reporting.

available have remained relatively similar to those prior to the cap. Average bills for prepayment customers fell £60 following the introduction of the prepayment meter cap[11]. We believe that the prepayment meter cap is a good reference point, as it is well understood, includes explicit headroom, applies to the GB market, and impacts largely the same group of suppliers who will be impacted by the default tariff cap. We note the limitations to the comparability of the prepayment meter cap set out by some respondents to our working paper on headroom. These include the relative market size and consumer behaviour. We will bear these limitations in mind when assessing the overall evidence to decide on the level of headroom.

3.27. We note that many respondents to our working paper on headroom made useful suggestions for our approach to analysing effective competition. Prior to making a final decision on the level of headroom we intend to do further work to understand the potential impact of headroom on effective competition.

Maintain incentives to switch: considerations and evidence we intend to draw on in reaching a final decision

3.28. Consumer engagement is an indicator of the health of the domestic energy retail market.[12] The principal way we measure such engagement in this appendix is switching rates, though other metrics such as the proportion of customers on different tariffs are also relevant. A higher cap may enable more switching than a lower cap.

3.29. There were over 9 million electricity and gas switches in 2017.[13] Consumer decisions to engage with the market and to switch are driven by multiple factors.[14] These factors can include, for example, quality of service, brand recognition, 'pull' factors such as marketing, and preferences for tariffs with additional products and services such as a smart thermostat. As explained below, the financial savings available from switching is a key determinant of switching behaviour for many consumers.

3.30. To develop our understanding of how different levels of headroom could affect switching behaviour, we have reviewed evidence from a number of sources on the relationship between switching and price dispersion. Price dispersion captures the range of prices in the market, including tariffs that are out of scope of the default tariff cap. Price dispersion is not the same as headroom – some suppliers may offer tariffs beneath the efficient cost benchmark. We discuss our approach to date for analysing price dispersion in paragraphs 3.18 – 3.27 above.

[11] State of the Market Report, 2017, p32.
[12] See Table 2.1 in the State of the Market Report, 2017, for further characteristics of a well-functioning energy retail market.
[13] Ofgem retail market indicators.
[14] See, for example, Ofgem's Consumer Survey results for 2015, 2016 and 2017.

3.31. Data from the Cheapest Market Offer Letter (a randomised control trial conducted by Ofgem and two large suppliers) show that SVT customers who are prompted to engage with the market are more likely to switch for higher levels of saving. Using this data, it is also possible to assess how consumers may have behaved in the trial if they had started on a capped price, rather than their original SVT. In general, at low levels of headroom, savings available would be lower and the switching rate would decline. At higher levels of headroom, this impact is less marked, and so savings available and switching rates are more similar to those actually observed in the trial. The impact on switching rates could be greater if there is a price rise for cheaper offers in the market.

3.32. As an additional point, the Cheapest Market Offer Letter trial data demonstrates customers are willing to save less (in the order of £40 - £60 less) to switch internally rather than externally. This may be seen as a proxy for the perceived costs of switching externally (eg hassle, time costs, perceived risks, ending relationship with their existing supplier).

3.33. Whilst the Cheapest Market Offer Letter trial is a useful source of evidence, we recognise it has limitations. In particular, it measures only the one-month response to a particular form of prompt. It may not be possible to extrapolate from this trial, where SVT customers (who have been on SVT for at least one year) receive a prompt, to the general population of energy consumers being subject to a default tariff cap.

3.34. Data provided by a Price Comparison Website (PCW) and reviewed by Ofgem shows a strong positive relationship between customer switching and the estimated savings available to them. This relationship holds for customers who use the website, and also for customers who contact the PCW via telephone. This data also shows that customers are more likely to switch to a large or medium supplier than a small supplier for a given level of savings available. This evidence suggests that it may not be possible to rely entirely on smaller suppliers to maintain incentives to switch for those customers who are disinclined to switch to them, eg due to brand recognition preferences.

3.35. Stated preference surveys undertaken by Ofgem and the CMA have persistently shown that most consumers switch primarily to save money, and that they typically require savings of between £100 and £300 per annum to switch. Only a minority of consumers would consider switching for savings of under £50 per annum, with several surveys finding that less than 10% of customers would switch for under £50.[15] We recognise that stated preference survey results should be used with

[15] Surveys with the relevant questions in include the Retail Market Review surveys undertaken by Ofgem (2014, 2015 and 2016), the survey undertaken by the CMA as part of the Energy Market Investigation in February 2015, and Ofgem's Customer Engagement Surveys (2014, 2015).

caution, and that there are a number of reasons to believe that they may not reflect actual consumer behaviour.

3.36. The experience in other countries such as Australia[16] and Spain[17] show that switching tends to be lower in countries with 'lower' price caps compared to those with some form of headroom or no price control. Further, academic work (eg Waddams Price and Zhu (2013) in Britain) has found evidence that price dispersion and switching behaviour are related. Previous work by Ofgem, such as the supplier-level econometrics analysis supporting the 2008 Energy Supply Probe, has also demonstrated a relationship between switching and relative pricing.

3.37. It is possible that the level of headroom we set (alongside the efficient benchmark) will affect pricing in the non-default tariffs market. The interaction between default and non-default tariffs is complex, and it is possible that a lower cap leads to an overall higher average price in the market than a higher cap.

3.38. Whilst the Bill is not focussed on delivering consumer protection for customers on non-default deals, it does require us to have regard to maintaining incentives to switch. The pricing differential between fixed and default tariff prices is a driver of switching, as evidenced in the paragraphs above. Moreover, the impact of the cap on the prices of fixed tariffs can have an impact on the protection available for default tariff customers in the future. The number of customers who will become default tariff customers in the future is, in part, determined by whether they are sufficiently attracted by non-default tariffs to actively choose them over a default tariff, and that over time, the best form of protection for default customers is to engage and make active choices of supplier and tariff.

3.39. We note that some respondents to the working paper on headroom looked at the high-level relationship between switching volumes and price dispersion in GB, using data gathered by the CMA as part of the energy market investigation. In the period since 2012, there is a positive correlation between monthly switching volumes and price dispersion. The period 2007 – 2012 does not show evidence of a correlation. This may be due to other causal factors, such as the introduction of non-discrimination pricing rules in 2008, and the prevalence of doorstop selling until 2012. We are considering this as one data point among the several outlined in this chapter, which are relevant for consideration in setting the level of headroom appropriately.

3.40. Evidence on the impact of the prepayment meter cap is still emerging, and the cap has only been in place for one year. Confidential data provided to Ofgem suggests that, so far, there is some early indicative evidence that switching in the prepayment market has declined for some suppliers. This should be seen in the

[16] For example, see Australian Energy Regulator, 2017. State of the Market, May 2017, and Independent Pricing and Regulatory Tribunal, 2015, Review of the Performance and Competitiveness of the Retail Electricity Market in NSW.
[17] For example, see Federico, G., 2010. The Spanish Gas and Electricity Sector: Regulation, Markets and Environmental Policies.

context of the general (non-prepayment) increase in switching. We also recognise that there are some differences between the GB prepayment market and the wider credit meter market, such as the relative market sizes, revenue impacts and differences in consumer behaviour. These differences must be borne in mind when considering evidence on how suppliers and consumers may respond to a default tariff cap.

3.41. There are a number of other regulatory and market developments, which are likely to impact upon switching. These include the faster switching programme, CMA remedies, and continued market entry of new suppliers. These changes may offset some of the potential impact of a default tariff cap on switching behaviour.

3.42. In making our final decision on headroom, we are interested in any further sources of evidence consultation respondents may be willing to provide on the relationship between headroom levels and switching. We also intend to look further at how different sub-groups of consumers may be impacted in different ways.

Ensure efficient suppliers are financeable: considerations and evidence we intend to draw on in reaching a final decision

3.43. It is important that efficient suppliers are financeable – otherwise market participation will decline in the long run. Our principal measure is the ability of efficient suppliers to make a normal rate of return under a default tariff cap environment. A higher cap increases returns for an efficient supplier compared to a lower cap.

3.44. The efficient benchmark in the cap (ie excluding headroom) is intended to enable efficient suppliers to finance their activities and make a normal return (we are proposing to use the same approach to setting a reasonable margin as the CMA – see Appendix 9). We recognise that some suppliers may face higher costs due to factors at least partially beyond their control that are nonetheless consistent with them being efficient. Examples of this may be the proportion of their customer base receiving paper bills, the proportion of their customer base to whom they provide a single fuel, and the proportion of their customer base not using direct debit.[18] We intend to analyse the cumulative impact of these factors and consider them in the round, including whether headroom could reduce the risk that efficient suppliers, with higher than average efficient costs, are unable to finance their activities.

3.45. A further potential issue relates to the risks of the default tariff cap not exactly reflecting the actual costs an efficient supplier faces. This may result, for example, from where we use forecasts, such as for the Energy Company Obligation (ECO) or Feed in Tariffs (FITs), in reaching a view on efficient costs.[19] Similarly, real world events within a charging period (eg an atypically cold spell which increases demand

[18] Further discussion of this point is included in Appendix 8.
[19] For further details, see Appendix 5.

unexpectedly) may cause divergence between the efficient default tariff cap and actual efficient costs.

3.46. Some suppliers may provide additional services which customers value. They may provide these services efficiently, but they will be more costly than the efficient benchmark in the cap. An example of this may be above average customer services, such as rapid query resolution and local customer services. Headroom may provide some opportunity for such suppliers to continue to provide these offers in the market. We note that tariffs which are outside of the scope of the default tariff cap (ie non default fixed tariffs) can still be priced differently to those within the default tariff cap, allowing suppliers to continue offering such services.

3.47. As is currently the case, we will be monitoring customer service levels and will act swiftly and firmly with suppliers who do not perform at a level consistent with their licence conditions.

4. Headroom scenarios

We set out four potential headroom scenarios based on our initial analysis to illustrate the relative impacts of different levels of headroom

Scenario overviews

4.1. To illustrate and to test the potential impact of headroom we have developed four illustrative potential headroom level scenarios. These are based on a range around the CMA's prepayment safeguard tariff headroom level of around £30 for dual fuel accounts:

- Zero headroom (~£30 less than the prepayment meter cap headroom)
- Headroom of around 4% of costs excluding networks (~£30 Dual Fuel, consistent with the prepayment meter cap headroom)
- Headroom of 10% of costs excluding networks (~£45 above the prepayment meter cap headroom)
- Headroom of 15% of costs excluding networks (~£80 above the prepayment meter cap headroom).

4.2. The scenarios are based on the initial analysis we have undertaken to date and will be further informed by the additional analysis we have set out in Chapter 3, as well as evidence provided by stakeholders in response to this consultation or that was provided in response to the working paper on headroom that we are still considering.

4.3. For any level of headroom, there are various trade-offs between the overall objective of the Bill - the level of consumer protection - and the other matters which we need to have regard to in setting the cap, ie efficient suppliers being able to finance their activities, as well as impacts on switching, effective competition and price dispersion.

4.4. This range includes values above and below the amount of headroom the CMA included in the prepayment meter cap. We include values above the level in the prepayment meter cap, in part because the default tariff cap may involve more uncertainty, which the market would be more exposed to. For instance, the cap will affect a larger group of customers, and potentially affect fixed-tariffs as well. This affects a much greater proportion of market revenue than the prepayment meter cap. Also, variation in suppliers' efficient costs and their service offers is likely to be wider, given the larger market.

4.5. The range allows us to assess scenarios that place a greater emphasis on competition and switching. This is a matter the Bill requires us to give regard to, and it affects the type of incentives we create to improve efficiency. We have considered headroom of up to about £110 / 15% (scenario 4), which is the upper end of any

plausible range as above this point there is limited short-term protection for default consumers by way of savings off their bill.

4.6. Our final decision on the level of the cap needs to be taken in the round alongside decisions on the efficient benchmark. Levels within our range affect differently the matters in the Bill to which we must give regard. We have set out the advantages and disadvantages of each end of our range below, and welcome stakeholders' views on how we might weigh these difficult trade-offs.

4.7. We are yet to make any decisions on headroom because we need to do so alongside our decision on the efficient benchmark. However, we are focusing our considerations around the level of headroom included in the PPM cap, i.e. the first three scenarios, because of the focus on the ultimate aim of the Bill to provide protection for consumers.

4.8. The scenarios are illustrative at this stage given the impacts of different headroom levels are dependent on, and highly sensitive to, the approach taken to the efficient cost benchmark.[20] For modelling purposes, we have used the prepayment meter cap as of April 2018, adjusted for payment type (and excluding headroom), as the efficient benchmark on which to add headroom. This is purely for modelling purposes and should not be taken as an indication of policy intention. We will use the draft numbers for the efficient benchmark in the statutory consultation for modelling to support the statutory consultation, because we will have a methodology for the benchmark at that time. The illustrative scenarios in this document should not be seen as the "options" for headroom, ie we could choose any value for headroom, but consider that the scenarios here are practical lower and upper limits.

4.9. **Relationship with the efficient benchmark:** We consider that there is an important relationship between the level of headroom and the judgements that affect the level of uncertainty within the efficient benchmark. We may want to include some headroom if we felt there was uncertainty for which our efficient benchmark did not account. If however, the efficient benchmark already accounted for these sources of uncertainty, we may not require headroom to account for this uncertainty, as it would in effect, be reflected in the benchmark already. Possible factors include:

- the amount of volatility in suppliers' costs, particularly wholesale costs
- the amount of variation in suppliers' costs that are not related to efficiency (due to differences in their customer bases)
- whether we set benchmarks close to the frontier – ie cheapest – costs

[20] A £10 increase in the efficient benchmark, for example, is equivalent to a £10 increase in headroom, when the impacts of a price cap compared to current prices are being evaluated. In addition, the greater the uncertainty we consider there to be in the efficient benchmark, the greater the risk that suppliers have higher costs for reasons outside of their control.

- The inherent uncertainty in estimating Earnings Before Interest and Tax (EBIT).

4.10. Our decisions on headroom and the efficient benchmark are interdependent and need to be taken together so all the issues can be considered in the round. As we undertake such a process we will update our modelling to help inform our decision.

4.11. As a result of the interactions with the efficient cost benchmark, our analysis focuses on the relative impacts of each headroom scenario, rather than the absolute values. It is not possible to analyse the absolute impacts without a final decision on the efficient cost benchmark. It is worth noting that where explicit values have been used in this appendix in terms of the impacts of headroom, these are broadly indicative. They have been included to aid readers in reaching a reasonable understanding of the potential implications of headroom.

4.12. Using the prepayment meter cap as a base, all headroom scenarios provide savings to the majority of SVT and default tariff customers. The illustrative scenarios indicate that zero headroom would provide the greatest savings for existing SVT and default tariff customers, reducing consumer bills by around £100 more than the higher headroom scenario of 15%. Higher levels of headroom provide some level of protection, but the estimated consumer savings, and the number of customers impacted, are comparatively low. For this reason, we are focussing our considerations on a narrower range around the level of headroom in the PPM cap, but have not yet ruled out any levels of headroom.

Scenarios

Scenario 1: zero headroom (~£30 less than the prepayment meter cap headroom)

4.13. **Protection:** A zero headroom level provides the greatest short-term savings to default customers, affecting most default customers and over 0.6m more customer accounts[21] than in the 10% scenario. It reduces average default bills by around £75 dual fuel per annum more than a headroom level of 10%.

4.14. **Create incentives to improve efficiency**: Zero headroom will sharpen incentives for inefficient suppliers to reduce costs to avoid market exit, by becoming more efficient. However, these incentives could be moderated because price dispersion is likely to be limited and switching reduced (see paragraph 4.16). It could be argued this might reduce the incentives to reduce costs to attract customers. However, because a cap at this level is likely to limit the ability of inefficient suppliers to raise non-default prices, they would have to reduce costs, which should create incentives to realise efficiencies.

[21] Customer accounts are in this appendix defined as households with at least one fuel supplied. This is approximated by the number of houses with either a dual fuel account, or a single electricity account.

4.15. At zero headroom, depending on how we set the efficient benchmark, we would expect inefficient suppliers to make losses and need to reduce costs. This is important in the context of protecting consumers. It gives strong incentives for suppliers to eliminate costs and inefficiencies in their operations. We recognise this also increases the risk that suppliers cut costs quickly, by reducing quality of service and cutting corners. This factor was also identified as relevant by the CMA[22]. We would need to be vigilant and to hold suppliers to licence conditions on service quality. If inefficient suppliers do not realise efficiencies then they should be replaced by more efficient firms. Ofgem has a role in ensuring consumers are protected when suppliers exit the market.

4.16. Further, we recognise that many suppliers seek to differentiate on the basis of non-price factors such as customer service. Similarly, some suppliers target particular market segments with a particular set of characteristics. In some cases, this will add costs, even if the supplier is efficient. Zero headroom does not provide any additional allowances for such models.

4.17. **Enable effective competition**: At zero headroom, we would not expect an efficient supplier to maintain large price differences in their default and fixed tariffs over a prolonged period of time – because they could not sustainably price fixed term tariffs below the efficient level of cost. Small suppliers with policy cost exemptions, or those more efficient than our efficient benchmark, may provide some additional price dispersion.

4.18. If suppliers increased fixed price tariffs (immediately for new offers and upon contract expiry for existing customers) to fully offset the revenue decrease, typical fixed bills would need to rise by £90 more than in the 10% scenario. However, for many suppliers it may not be practically possible to increase these tariffs, eg due to consumer responses and existing contract terms.

4.19. **Maintain incentives for switching**: Our evidence set out in Chapter 3 above suggests that low (or zero) levels of price dispersion would reduce the incentives to switch. Additional price dispersion may be provided by small suppliers, of which there are more than 50, who are likely to continue to actively compete for engaged consumers. The extent to which this can support switching depends on three factors – whether consumers are willing to switch to brands they may not recognise, the continued entry to the market of new suppliers, and whether small suppliers will be able and willing to offer substantially lower prices than larger firms.

4.20. Overall, there is a high risk of price convergence, and we might expect many of the cheaper tariffs to increase toward the cap as suppliers manage the revenue impact. To give an illustration, using the prepayment meter cap (as described in paragraph 4.7), and using the evidence discussed in paragraphs 3.28 – 3.42,

[22] CMA Energy Market Investigation – Provisional decision on remedies, paragraph 7.170.

depending on how other prices changes, it is feasible that switching could reduce by 50% or more, though this range is subject to significant uncertainty.

4.21. **Efficient company financeability**: Due to circumstances beyond suppliers' control (see Chapter 3 above), some efficient suppliers will have higher than average efficient costs – they may be lossmaking in a zero headroom scenario, depending on decisions on the efficient benchmark. In addition, zero headroom does not provide an allowance for uncertainty in how we set the efficient cost benchmark. For example, an unforeseen and atypical spell of cold weather could increase costs in a way not captured in the efficient benchmark. This could expose suppliers to risks in their ability to finance their activities.

4.22. We will continue to do further work on the impacts of the zero headroom scenario. We will summarise any further work we do in our statutory consultation.

Scenario 2: prepayment meter cap headroom ~4% headroom

4.23. **Protection**: A prepayment meter cap headroom scenario provides fewer savings to default customers (around £30 less dual fuel per annum) than the zero headroom scenario. We estimate that there would not be a substantial difference in the number of customer accounts directly affected by the cap than in the zero headroom scenario (around 0.1m fewer customer accounts).

4.24. **Create incentives to improve efficiency**: Headroom at this level would sharpen incentives for some inefficient suppliers to reduce costs to avoid market exit, potentially by becoming more efficient. This is important in the context of protecting consumers. It gives strong incentives for suppliers to eliminate costs and inefficiencies in their operations. We recognise this also increases the risk that suppliers cut costs quickly, by reducing quality of service and cutting corners. If inefficient suppliers do not realise efficiencies then they should be replaced by more efficient firms. Ofgem has a role in ensuring consumers are protected when suppliers exit the market.

4.25. A further consideration is that, at prepayment meter cap headroom, price dispersion is likely to be reduced with a potential knock-on impact on switching (see paragraph 4.30) compared to current levels, though the impact is less marked than the zero headroom scenario. This potential reduction in competitive pressure may dull incentives for efficient suppliers to become more efficient to lower prices and attract additional market share.

4.26. Unlike the zero headroom scenario, prepayment meter cap headroom levels may help support the continuation of different business models or the evolution of further models which are lossmaking in a zero headroom scenario (noting this depends on where the efficient benchmark is set). We estimate that the prepayment meter cap headroom level could provide £300m more revenue per annum than the zero headroom scenario, depending on how prices adjust after the cap is introduced.

4.27. **Enable effective competition**: At prepayment meter cap headroom levels, there is capacity for suppliers to offer more price dispersion than the zero headroom scenario. As efficient suppliers can make above normal levels of return from default tariff customers they may be able and willing to offer lower prices to fixed tariff customers, and to actively compete for customers.

4.28. If suppliers increased fixed price tariffs (immediately for new offers and upon contract expiry for existing customers) to fully offset the revenue decrease, typical fixed bills would need to rise by £60 more than in the 10% scenario. However, for many suppliers it may not be practically possible to increase these tariffs, eg due to consumer responses. Indeed we would expect suppliers would seek to compete on fixed price tariffs by making efficiencies to offset the impact of the cap.

4.29. Evidence from the prepayment meter cap and our initial modelling indicates that price dispersion could reduce to under £100 for larger suppliers, and potentially in the order of under £200 for smaller suppliers, depending on how suppliers respond. Some suppliers may offer very minimal price dispersion, whereas others may offer the full extent of this range of prices across their tariffs.

4.30. **Maintain incentives for switching**: There is greater price dispersion to encourage switching than the zero headroom scenario. However, this is still likely to be lower than currently observed levels of price dispersion. Additional price dispersion may be provided by small suppliers. The extent to which this can support switching depends on three factors – whether consumers are willing to switch to brands they may not recognise, the continued entry to the market of new suppliers, and whether small suppliers will be able and willing to offer substantially lower prices than larger firms.

4.31. There could be reductions in switching compared to current levels. The extent of these reductions depends on how different the final level of the cap (including both the efficient benchmark and headroom) is from current pricing levels, supplier pricing responses, as well as how consumers respond in practice to the different price signals. To give an illustration, using the prepayment meter cap (as described in paragraph 4.7), and using the evidence discussed in paragraphs 3.28 – 3.42, depending on how other prices changes, it is feasible that switching could reduce by 25% - 50%, though this range is subject to significant uncertainty.

4.32. **Efficient company financeability:** Due to circumstances beyond suppliers' control (see Chapter 3 above), some will have higher than average efficient costs. In addition, headroom provides scope for uncertainty in how we set the efficient cost benchmark. For example, an unforeseen and atypical spell of cold weather could increase costs in a way not captured in the efficient benchmark. We estimate that prepayment meter cap levels of headroom could provide an additional £300m of revenue compared to the zero headroom scenario. This revenue provides substantial scope for suppliers to mitigate these risks.

Scenario 3: 10% headroom scenario (~£45 above the prepayment meter cap headroom)

4.33. **Protection**: A 10% headroom scenario provides fewer savings to default customers (around £70 less dual fuel per annum) than the zero headroom scenario. We estimate that around 0.6m fewer customer accounts are impacted directly by the cap than in the zero headroom scenario.

4.34. **Create incentives to improve efficiency**: Compared to no cap, a 10% headroom scenario may have some – more limited - incentives for some inefficient suppliers to reduce costs to avoid market exit, potentially by becoming more efficient. As the revenue reduction is much less marked than at lower levels of headroom, this incentive is less strong than in the other scenarios. An additional factor is that, at 10% headroom, price dispersion is likely to be limited and switching reduced compared to current levels (see below), though the impact is less marked than the zero or prepayment meter cap headroom scenarios.

4.35. 10% headroom may help support the continuation of different business models by efficient suppliers with atypical costs or the evolution of further models which are lossmaking in a zero headroom scenario. We estimate that the 10% headroom level could provide £800m more revenue to the industry per annum than the zero headroom scenario, depending on how prices adjust after the cap is introduced.

4.36. **Enable effective competition**: At 10% headroom levels, there is more capacity for suppliers to offer more price dispersion than the lower headroom scenarios. As efficient suppliers can make above normal levels of return from default tariff customers they may be able and willing to offer lower prices to fixed tariff customers, and to actively compete for customers.

4.37. If suppliers increased fixed price tariffs (immediately for new offers and upon contract expiry for existing customers) to fully offset the revenue decrease, typical fixed bills would need to rise by £90 less than in the zero headroom scenario. However, for many suppliers it may not be practically possible to increase these tariffs, eg due to consumer responses. Indeed we would expect suppliers would seek to compete on fixed price tariffs and seek instead to make efficiencies to offset the impact of the cap. However, there is also a possibility that some suppliers will increase comparatively low default prices to the level of the cap.

4.38. Evidence from the prepayment meter cap and our initial modelling indicates that price dispersion could reduce to in the order of £50 - £150 for larger suppliers, and potentially remain over £200 for smaller suppliers, depending on how suppliers respond.

4.39. **Maintain incentives for switching**: There is greater price dispersion to encourage switching than the lower headroom scenarios. However this is still likely to be lower than currently observed levels of price dispersion. There is significant uncertainty, and much depends on how each supplier individually chooses to respond. Nonetheless, savings should be possible from switching, and it is expected

that that many suppliers will offer non-default tariffs under the cap. To give an illustration, using the prepayment meter cap (as described in paragraph 4.7), and using the evidence discussed in paragraphs 3.28 – 3.42, depending on how other prices changes, it is feasible that switching could reduce by 10% - 30%, though this range is subject to significant uncertainty.

4.40. **Efficient company financeability**: Due to circumstances beyond suppliers' control (see Chapter 3 above), some will have higher than average efficient costs. In addition, headroom provides scope for uncertainty in how we set the efficient cost benchmark. For example, an unforeseen and atypical spell of cold weather could increase costs in a way not captured in the efficient benchmark. We estimate that 10% headroom could provide an additional £800m of revenue compared to the zero headroom scenario. This revenue may help suppliers mitigate these risks.

Scenario 4: 15% headroom scenario (~£80 above the prepayment meter cap headroom)

4.41. **Protection**: A 15% headroom scenario provides fewer savings to default customers (around £100 less dual fuel per annum) than the zero headroom scenario. We estimate that around 4.4m fewer customer accounts are impacted directly by the cap than in the zero headroom scenario (because they already have default tariffs below the level of the cap). This is significantly less compared to the other scenarios. It is also possible that suppliers would increase the prices for some default customers to the level of the cap, reducing the overall benefits to default customers and having an unintended consequence of offering consumers less protection. It is not clear that any benefits from competition for non-default tariffs would be passed through to consumers on default tariffs – this is important given the Bill objective specifically relates to default tariff consumers.

4.42. **Create incentives to improve efficiency**: A 15% headroom scenario is likely to have fairly limited incentive for inefficient suppliers to reduce costs to avoid market exit, by becoming more efficient. This is because of the limited impact on revenue. On the other hand, at 15% headroom, price dispersion and switching may be reduced compared to current levels, but less than the other scenarios we are considering. Broadly, we expect this scenario to maintain tariffs below the cap for engaged consumers (see below). This continues to provide incentives for companies to become more efficient to compete on price for new customers.

4.43. **Enable effective competition**: At 15% headroom levels, there is more capacity for suppliers to offer more price dispersion than the lower headroom scenarios. As efficient suppliers can make above normal levels of return from default tariff customers they may be able and willing to offer lower prices to fixed tariff customers, and to actively compete for customers.

4.44. **Maintain incentives for switching**: At 15% headroom we expect there to be similar price dispersion to that currently observed in the market, and strong incentives to switch. However switching may still be lower than currently observed if price dispersion does fall.

4.45. **Efficient company financeability**: Due to circumstances beyond suppliers' control (see Chapter 3 above), some will have higher than average efficient costs. In addition, headroom provides scope for uncertainty in how we set the efficient cost benchmark. For example, an unforeseen and atypical spell of cold weather could increase costs in a way not captured in the efficient benchmark. Revenue from a 15% headroom scenario would provide substantial scope for suppliers to mitigate these risks.

4.46. As described in paragraph 4.6, we are yet to make any decisions on headroom because we need to do so alongside our decision on the efficient benchmark. However, we are focusing our considerations around the level of headroom included in the PPM cap, ie the first three scenarios, because of the focus on the ultimate aim of the Bill to provide protection for consumers.

How we intend to balance the matters to which we must have regard in reaching a final decision

4.47. We have not set out the absolute total impact on suppliers and consumers of headroom in this policy consultation. This is because it is dependent on the efficient cost benchmark, which is yet to be determined. We intend to make our final decision on headroom in tandem with our final decision on the efficient cost benchmark, taking into account their interactions.

4.48. Table A11.1 (next page) summarises the relative impacts in the three main scenarios, using an illustrative efficient cost benchmark as discussed in paragraph 4.7. These results are highly indicative, and sensitive to the level of efficient benchmark used for modelling and assumptions on both supplier and consumer responses to the default tariff.

4.49. We will have regard to all of the matters set out in the Bill in reaching our final decision alongside the objective to protect existing and future SVT and default tariff customers. We recognise that different levels of headroom lead to different impacts on each of these matters. We intend to consider all of the evidence and analysis set out above in the round as we evaluate the appropriate level of headroom to balance our objective and the matters to which we must have regard.

QA11.3 Bearing in mind the analysis and scenarios presented, what are your views on the appropriate level of headroom to include in the default tariff cap?

Table A11.1: Relative impacts of scenarios

Scenario (level of headroom at TDCV, £)	Number of customer accounts directly impacted (relative to 0% case)	Impact on typical SVT/ default customer bills (relative to 0% case)	Possible impact on supplier default/ SVT revenues (relative to 0% case)	Indicative view of resultant price dispersion (average SVT – cheap fixed)	Indicative view of impacts on switching (relative to no default tariff cap)
£30 less than the prepayment safeguard tariff headroom	0	£0	£0	Larger suppliers: £0 - £50 Smaller suppliers: £100 - £200	Over 50% reductions
Headroom equivalent to the prepayment safeguard tariff headroom	-0.1m	+£30	+£300m	Larger suppliers: £0 - £100 Smaller suppliers: £100 - £200	25% - 50% reductions
£45 more than the prepayment safeguard tariff headroom	-0.6m	+£75	+£800m	Larger suppliers: £50 - £150 Smaller suppliers: £200+	10% - 30%
£80 more than the prepayment safeguard tariff headroom	-4.4m	+£100	+£1,200m	Larger suppliers: £100 - £200 Smaller suppliers: £200+	Less than 25% reductions

Source: Ofgem analysis

5. Responses to stakeholder feedback

Summary of the responses to our working papers in relation to headroom and any additional stakeholder feedback received to date.

Overview

5.1. We issued a working paper on headroom on 9 April 2018. We have received a total of 15 responses, of which 5 are confidential. We have reviewed all responses and provide a summary of these below.

5.2. Some respondents commented on issues outside of the scope of the working paper in their responses. Where this has been the case, the points raised are addressed in the relevant appendices to this policy consultation.

Explicit headroom

5.3. There were mixed responses on the need for explicit headroom. Some respondents argued that explicit headroom is unnecessary, for an appropriately set efficient benchmark cap. Others argued that it is necessary, citing competition, incentives to switch, risks of inaccuracy and approximation, and other factors for this view. We have considered these views when reaching the views set out in Chapter 2 above.

Ofgem modelling

5.4. Several respondents made helpful suggestions regarding our approach to modelling the impact of the default tariff cap on consumer bills. This included suggestions on how the prices of tariffs outside of the scope of the cap may evolve, in response to the different incentives faced by suppliers. As set out in Chapter 3 we have undertaken modelling of a range of pricing responses to a default tariff cap. This work to date has been consistent with many of the suggestions made by respondents. As also set out in Chapter 3, we intend to do further work in this area before making our final decision.

5.5. Several respondents provided data to us, or offered to provide data. We are considering this information and how it can support our analysis and decision making.

Sources of evidence

5.6. We received mixed responses on the relevance of the prepayment meter cap as a comparator. Several respondents provided confidential information regarding their experience of the prepayment meter cap to date. As set out in Chapter 3 above, our

view is that the experience of the prepayment meter cap to date is a useful one to consider, however we recognise the practical limitations of its applicability.

5.7. Several respondents commented upon the relevance of the comparators we had suggested in other energy markets or in other sectors. Respondents most commonly referred to Australia as an appropriate comparator. We agree that there are limitations to any comparators that we could select. As discussed in Chapter 3, we have looked at the experiences of Australia, Northern Ireland, Spain, California, and Illinois. We are also considering, as suggested by some respondents, the experience in GB to date, including the introduction of non-discrimination regulations in 2008, and more recent market and consumer trends. When weighing up the evidence we will have regard to the relevance of each of these comparators to this policy consultation.

5.8. Several respondents offered views and evidence on the relationship between consumer switching and price dispersion. Most respondents argued that switching is positively related to price dispersion. Citizens Advice argued that switching and price dispersion are not strongly related based on historic GB market data. As set out in Chapter 3 above, the weight of evidence suggests that savings available is a primary driver of switching behaviour for typical consumers.

5.9. Some respondents discussed other impacts a default tariff cap may have on consumer and supplier behaviour. In particular, some respondents suggested that we consider the impact a default tariff cap may have on the dynamic efficiency of suppliers to reduce costs and innovate over time. They also suggested that consumers may see tariffs set at the default tariff cap as a 'safe haven', and so have a reduced propensity to switch. We are considering these potential impacts qualitatively as part of our final decision making.

5.10. Some respondents suggested that we consider the impact of a default tariff cap on potential new entrants. We are doing this qualitatively currently, and would welcome the views of potential new entrants on how a default tariff cap may impact their potential business.

Adjustments over time

5.11. A small number of respondents offered suggestions for how headroom could evolve over time. One suggestion was for 'triggers' that would lead to adjustments to headroom, such as a particular switching rate being reached. Another suggestion was for a glide path – two respondents suggested that if we are to adopt a transitional approach that values are set in advance to provide certainty. As set out in Chapter 2 above, we are considering further the options on setting headroom as a fixed value or whether it should adjust over time (and the mechanism by which it could be adjusted).

6. Consultation response and questions

We want to hear from anyone interested in this document. Send your response to the person or team named at the top of the front page.

We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can. The full list of consultation questions is available in Chapter 7 in the main consultation document.

Unless you mark your response confidential, we'll publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

Chapter 2 – Our proposed approach

Question A11.1: What are your views on headroom being a percentage? Do you think it should be applied to all cost components except for network cost? Alternatively, do you think headroom should be applied as a percentage to only controllable costs?

Question A11.2 What are your views on whether we should change the level of headroom over time?

Chapter 4 – Headroom scenarios

Question A11.3: Bearing in mind the analysis and scenarios presented, what are your views on the appropriate level of headroom to include in the default tariff cap?