

Default Tariff Cap: Policy Consultation

Appendix 14 - Initial view on impact assessment

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 intend to produce an impact assessment of the design of the default tariff cap. This supplementary appendix to the main consultation document sets out our initial views on our approach to conducting the impact assessment and the type of impacts that will be included. This document is aimed at those who want an in-depth understanding of our approach to the impact assessment and the impact of the design of the cap. Stakeholders wanting a more accessible overview of the proposals for the cap 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 initial views on the default tariff cap impact assessment.

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

Overview Document	
Supplementary Appendices	
<p>Approaches for calculating efficient costs</p> <ol style="list-style-type: none"> 1. Market basket 2. Adjusted version of the existing safeguard tariff 3. Updated competitive reference price 4. Bottom-up cost assessment 	<p>Discussions of specific categories of costs</p> <ol style="list-style-type: none"> 6. Wholesale costs 7. Policy and network costs 8. Operating costs 9. EBIT 10. Smart metering costs
<p>Reflecting trends in efficient costs</p> <ol style="list-style-type: none"> 5. Updating the cap over time 	<p>Potential additional cap elements</p> <ol style="list-style-type: none"> 11. Headroom 12. Payment method uplift
<p>Scope of the default tariff cap</p> <ol style="list-style-type: none"> 13. Potential renewable exemption 	<p>Impact assessment</p> <ol style="list-style-type: none"> 14. Initial view on impact assessment

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

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1. Introduction

We set out the context for the impact assessment and the scope of this appendix. We also seek views and input from stakeholders regarding the proposed overarching approach to the impact assessment and the nature and scale of potential impacts.

Context

1.1. In February 2018, the government introduced the Domestic Gas and Electricity (Tariff Cap) Bill (“the Bill”) to Parliament. The Bill, if enacted, places the requirement on Ofgem to design and implement a tariff cap on domestic energy Standard Variable rate tariffs¹ (SVTs) and default rate tariffs² (default tariffs).

1.2. It places an objective on Ofgem to put a price cap in place as soon as practicable and gives Ofgem a duty to design the cap in a way that protects existing and future domestic customers on SVTs and default tariffs (we refer to these collectively as default tariffs in the rest of this appendix). The Bill also sets out four matters to which Ofgem must have regard in setting the cap³:

- a) the need to create incentives for holders of supply licences to improve their efficiency;
- b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
- d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

1.3. The Bill will not apply to:

- customers on prepayment meter (PPM) tariffs, as these customers who are covered by the PPM safeguard tariff, which sets the maximum

¹ “Standard Variable rate” means a rate or amount charged for, or in relation to, the supply of gas or electricity that is not fixed for a period specified in a contract.

² “Default rate” means a rate or amount charged for, or in relation to, the supply of gas or electricity under a contract that applies if the customer under a contract fails to choose an alternative rate.

³ Domestic Gas and Electricity (Tariff Cap) Bill.

amount that suppliers can charge PPM customers per unit of energy⁴;
and

- domestic customers on non-default fixed term tariffs.

1.4. The decision to introduce a single tariff cap on default tariffs (the default tariff cap) for the Great Britain (GB) energy market follows from previous⁵ price regulation, with the PPM safeguard tariff and Warm Home Discount (WHD) safeguard tariff implemented in April 2017 and February 2018 respectively.

1.5. The default tariff cap will be put in place as a temporary measure. The Bill sets out a requirement for the default tariff cap to be in place until the end of 2020. In 2020, Ofgem will undertake a review and make a recommendation to the Secretary of State, who will decide whether to extend the cap for a further year. If extended, further annual reviews will take place in 2021 and 2022. The default tariff cap must cease to be in effect by the end of 2023.

1.6. The main consultation document provides greater detail on the market context and the rationale for the default tariff. It also provides an appraisal of the options being considered by Ofgem in the design and implementation of the default tariff cap.

Scope of this appendix

1.7. The proposals for the scope, design and level of the default tariff cap are currently in development, and potential levels of the cap have not yet been determined. Therefore, we have not undertaken an impact assessment of the default tariff cap at this stage. However, we have been undertaking work to identify and develop initial views regarding the potential impacts, both positive and negative, for different stakeholder groups that could arise from the setting of the default tariff cap.

1.8. We will publish our draft impact assessment as part of the statutory consultation on our final proposal. Our final impact assessment will be published alongside our final notice on the level of the default tariff cap.

1.9. This appendix presents our intended approach to the impact assessment, and our initial views on the potential impacts that would arise as a result of the introduction of the default tariff cap, dependent on the chosen methodology for determining the cap.

⁴ Ofgem: Safeguard tariff (or 'price cap').
<https://www.ofgem.gov.uk/gas/retail-market/market-review-and-reform/implementation-cma-remedies/safeguard-tariff-or-price-cap>

⁵ Ofgem: Safeguard tariff (or 'price cap').
<https://www.ofgem.gov.uk/electricity/retail-market/market-review-and-reform/implementation-cma-remedies/safeguard-tariff-or-price-cap>

1.10. Specifically, this appendix:

- sets out our planned overarching approach to the impact assessment, including the principles that we will follow, the scope of the impact assessment, the approach to the measurement of impacts and the sources of evidence that we will rely upon
- provides an initial overview of the potential impacts of our proposals on relevant stakeholder groups as well as the potential wider impacts
- sets out the rationale for including these impacts within the impact assessment, and, where evidence allows at this stage, presents an initial qualitative assessment of the significance of impacts and an explanation of the different stakeholder groups affected
- sets out how we will consider as part of the final impact assessment

1.11. With regard to this appendix, we are seeking views and input from stakeholders on the following question:

QA14.1: What is your view on the overarching approach that is proposed for conducting the impact assessment? In particular, on the scope of the assessment, and material issues that we have not referred to. Please provide details of any relevant sources of data and evidence that you think should be considered..

1.12. In our impact assessment we will also be drawing on responses to consultation questions included within the other appendices of this policy consultation. If you have information relating to specific impacts, please either refer to the relevant appendices for specific consultation questions, or include any relevant information as part of your response to the question above.

2. Overarching approach to conducting the impact assessment

We set out our proposed approach to conducting the impact assessment including the principles of the approach, what the impact assessment will cover, our approach to measuring impacts and the key sources of evidence we will draw upon.

Principles of the approach

2.1 We will conduct the impact assessment in accordance with the Ofgem Impact Assessment Guidance^{6,7}, and the HM Treasury Green Book.⁸

2.2 Ofgem's approach to impact assessments draws upon the principles that underpin the government's Better Regulation agenda. These principles recommend that an impact assessment should⁹:

- concisely summarise the impacts, including the qualitative and quantitative costs and benefits
- keep the process transparent
- be comparable to other assessments, without unnecessary detail or duplication
- be consistent so that impacts can be compared across proposals
- follow government best practice guidance.

2.3 In addition, the analysis of impacts included within an impact assessment should reflect the scale and materiality of the impacts (ie a proportionate approach should be adopted). As the potential impacts of the default tariff cap could be significant, we intend to undertake a detailed and in-depth impact assessment. However, we will take a proportionate approach to the assessment of individual impacts included within this. Our analysis of the individual areas of costs and benefits (impacts) associated with the proposals will be proportionate to the likely scale of those costs and benefits. We will undertake more detailed analysis where the specific area of impact is expected to be substantial.

⁶ Ofgem (2016) Impact Assessment Guidance.

⁷ We are conducting the impact assessment in accordance with the Ofgem Impact Assessment Guidance in so far as that guidance is relevant and consistent with the distinct legal framework envisaged by the draft default tariff cap legislation.

⁸ HM Treasury (2018) The Green Book: appraisal and evaluation in central government.

⁹ Ofgem (2016) Impact Assessment Guidance.

Scope of the impact assessment

2.4 Government has introduced legislation to implement a default tariff cap on SVTs and default tariffs. This policy consultation sets out the options Ofgem is considering for the design and implementation of the cap.

2.5 These options are based on analysis conducted to date and stakeholder input, including responses to the five working papers that we have published relating to the design and implementation of the default tariff cap. Based on responses to this policy consultation, as well as further evidence gathering and analysis, we will refine these options further ahead of our statutory consultation.

2.6 Our impact assessment will assess the relative impact of a refined set of policy options measured against the current baseline market position (the baseline scenario). We recognise that the baseline scenario is not a scenario that could happen, but we are using it as a way to compare the impact of our options.

2.7 The impacts set out within this appendix will form the basis for the impact assessment. These may be added to and/or refined based on responses to this consultation and based on the further analysis and evidence gathering we will be conducting for the impact assessment. The scale and nature of impacts will vary across the options for the design and implementation of the default tariff cap.

2.8 The potential areas of impact we have identified at this stage can be broadly split into four categories:

- Financial impacts on suppliers: how the design of the default tariff cap could impact suppliers in terms of prices, revenues, costs and profitability.
- Impacts on consumers: how customers may be impacted by the introduction of the chosen default tariff cap, including: customer bill impacts (both static and dynamic¹⁰); and impacts on customer engagement and switching.
- Impacts on the market and market competition: how the chosen default tariff cap could result in changes in supplier behaviour and competition within the market, including impacts on: market competition; suppliers' incentives to innovate; the supply of different tariff types and structures; and the rollout of smart meters.

¹⁰ Static impacts refer to impacts that would arise from a change in the price of default tariffs covered by the default tariff cap, and assuming all other factors, eg prices of other tariffs, levels of energy consumption, and other supplier and customer behaviour, remain constant. Dynamic impacts refer to impacts that may occur as a result of potential changes to these other factors.

- Wider impacts: how the design of the default tariff cap could have wider impacts, such as impacts on: the wholesale energy market; third party switching services; VAT receipts; government; and the environment.

2.9 We have also considered how different stakeholder groups will be impacted by the default tariff cap. We have identified a number of key stakeholder groups which could be directly or indirectly impacted by the default tariff cap design. We will undertake an Equality Impact Assessment alongside this.

2.10 These stakeholders are:

- domestic customers
- domestic retail energy suppliers
- third party switching services and supplier service providers
- generators
- government and regulators, including Ofgem, BEIS and HMRC.

2.11 It will be important not only to consider the impacts on these stakeholder groups in isolation, but also the dynamics between the impacts that affect each group of stakeholders and the net impact across all stakeholders ie how an impact on one stakeholder group may have a knock-on effect on another, or how impacts may affect different stakeholder groups in different ways. As part of this consideration we will determine the interdependencies between impacts and ensure that there is no double-counting of impacts when aggregated.

2.12 As part of considering the impacts on stakeholders listed above, the impact assessment will take account of intended impacts and, as far as possible, any potential risks, unintended consequences and wider implications of the proposals identified.

Measurement of impacts

2.13 As explained above, in line with Ofgem Impact Assessment Guidance¹¹, we will ensure that our approach to measuring the individual areas of impact is proportionate, consistent and transparent.

2.14 Where sufficient data and evidence allows, we will assess impacts quantitatively, assigning monetary values where appropriate. Our current view is that there are some areas of impact for which there is insufficient data and evidence available to allow for a proportionate and robust quantitative analysis. Where this is the case we will assess these impacts qualitatively, drawing on the evidence

¹¹ Ofgem (2016) Impact Assessment Guidance.

available, including a qualitative assessment of the potential scale, direction and distribution of impacts.

2.15 There will be a number of evidence based assumptions applied in the analysis that forms part of our assessment of impacts. Where relevant, we intend to undertake sensitivity analysis and present ranges around our expected impacts to account for the degree of uncertainty associated with these assumptions.

2.16 As noted in paragraph 2.6, we will measure the impact of a refined set of policy options against a current baseline scenario. This baseline is a scenario whereby the current safeguard tariffs remain in place until the respective end dates of both, and no other additional protections are implemented.

2.17 Once individual impacts have been identified, we will consider the total costs and benefits, and the resultant overall net impact relative to the baseline. In doing so we will consider the interdependencies between impacts in order to prevent double-counting.

2.18 To reflect how the impacts will differ dependent on the way in which we decide to design and implement the tariff cap, our measurement of impacts will assess the different scale of impacts, both quantitative and qualitative, and the stakeholders impacted, for each policy option. This will allow us to assess the relative overall net impacts of the different policy options under consideration.

2.19 We will consider the relative costs and benefits of each option overall, as well as the extent to which the option is aligned to the objective of the cap as set out in the Bill, and the matters to which Ofgem must have regard in setting the level of the cap (see paragraph 1.2). This will inform our decision regarding the preferred option.

2.20 We recognise that the decision regarding the level and design of the cap will involve trade-offs. At low levels, the cap would provide greater savings for consumers on default tariffs. It would also create strong incentives for inefficient suppliers to reduce their costs. However, it could have an impact on switching: by reducing price dispersion consumers might be less likely to frequently engage in the market and make an active choice of tariff and supplier. There are also risks that an efficient supplier, but with above-average costs due to its customer base, might not be able to cover their costs. We will consider analysis and stakeholders' responses to decide how much regard to give each matter in the Bill, and to establish what should inform our assessment of the impact we expect the cap to have on each.

2.21 The HM Treasury Green Book¹² recommends that a policy is assessed over its lifecycle. Given the uncertainty surrounding the exact end date of the default tariff cap, the impacts of the tariff cap will be assessed over two time periods: from implementation up to the end of 2020; and from implementation up to the end of

¹² HM Treasury (2018) The Green Book: Appraisal and Evaluation in Central Government.

2023. In addition, we will also look to provide qualitative assessment to consider the longer term impacts on the market, beyond the two periods above.

2.22 As per HM Treasury Green Book guidance, we will present monetised costs and benefits in real terms based on 2018 prices. As our analysis of impacts will be based on data in current market prices, we will not need to make any specific adjustment for inflation in our analysis.

2.23 Monetised impacts will be discounted using a social time preference discount rate (STPR) of 3.5%, in accordance with HM Treasury guidance.¹³

Sources of evidence

2.24 In addition to drawing on previous impact assessments, the analysis of the potential impacts of the proposals will be based on data and information gathered from a number of sources, including:

- data collected from relevant stakeholders through formal information requests
- existing energy market data held by Ofgem including data from the implementation of previous price caps
- information collected through this stakeholder consultation
- responses to the previous consultations on price protection and to our five working papers
- academic literature and international evidence
- other publicly available information.

2.25 When presenting our analysis, we will provide full details of the sources of evidence relied upon, as well as any uncertainties and assumptions on which the analysis is based.

¹³ HM Treasury (2018) The Green Book: Appraisal and Evaluation in Central Government.

3. Initial views on estimating the coverage of the default tariff cap

We set out the expected coverage of the default tariff cap, and therefore the scope of the impacts in terms of the customers affected. It also sets out the factors we will consider in estimating the scope of the impacts for the impact assessment.

Scope of the default tariff cap

3.1 In this section we have set out our initial views on the number of customers in scope of the default tariff cap and how we will estimate this as part of the impact assessment.

3.2 In paragraphs 1.1 to 1.3 of this appendix, we outlined the scope of the Bill. The number of customers in scope of the default tariff cap is dependent on:

- i) the number of customers on eligible tariffs within the domestic market at the time the default tariff cap comes into force
- ii) the number of these customers who are either exempted from the default tariff cap or already in receipt of price protections

3.3 There are approximately 13 million non-PPM customers on a default tariff.¹⁴

3.4 As part of this policy consultation we are seeking views on the possibility of providing exemptions for renewable tariffs, meaning that any default renewable tariffs eligible for exemption would not be subject to the price cap. Customers on these tariffs would therefore not be covered by the government's default tariff cap. We have not formed any conclusions as to the need for, scope of or format of any such exemption¹⁵, however based on the scope of the exclusions currently being considered, (see Appendix 13), we still expect a significant portion of the market to see protection from the default tariff cap, in excess of any previous protections.

3.5 A proportion of non-PPM customers on default tariffs are already protected and have already benefitted from reductions in their energy bills. Around 1 million¹⁶

¹⁴ As of October 2017, 57% of non-prepayment meter domestic customer accounts (approximately 13 million are on standard variable tariffs. These figures refer to data for the 10 largest suppliers and are based on the latest data submitted by suppliers.)

<https://www.ofgem.gov.uk/data-portal/retail-market-indicators#thumbchart-c7770745751913637-n114504>

¹⁵ We discuss our current approach to exemptions from the cap in Appendix 13.

¹⁶ Ofgem: Vulnerable customer safeguard tariff.

customers in receipt of the WHD are protected as part of the existing safeguard tariff. We will take into account the current protection when identifying the scope of impacts of the default tariff cap.

3.6 As part of our impact assessment we will publish analysis of the scope of customers who will be directly impacted by the introduction of the default tariff cap. These estimates will be based on the latest information available from Ofgem's tariff pricing and customer number data.

3.7 We also recognise that for the impact assessment it will also be important to take account of underlying trends in the market and changes that may occur as a result of the default tariff cap, and how these may affect the number of customers directly impacted by the introduction of the default tariff cap.

3.8 The overall number of SVT customers continues to decline¹⁷, with increasing numbers of customers switching away from SVTs to cheaper deals. We have also recently observed a number of suppliers renewing efforts to move customers away from SVTs¹⁸, with some suppliers stating that they intend to discontinue the provision of SVTs.

3.9 If these trends continue, it may result in changes to the eligible customer base in the periods ahead of, and after, implementation. Furthermore, we also recognise the potential for the default tariff cap to influence these trends. For instance, through potentially influencing the level of switching and therefore the number of customers willing to roll onto a default tariff. We consider these potential impacts in paragraphs 4.89 to 4.97.

<https://www.ofgem.gov.uk/about-us/how-we-work/working-consumers/protecting-and-empowering-consumers-vulnerable-situations/consumer-vulnerability-strategy/vulnerable-customer-safeguard-tariff>

¹⁷ Ofgem: Standard variable tariffs: Latest trends at September 2017.

<https://www.ofgem.gov.uk/publications-and-updates/standard-variable-tariffs-latest-trends-september-2017>

¹⁸ Centrica: Centrica sets out proposals to deliver a fairer and sustainable energy deal for customers.

<https://www.centrica.com/news/centrica-sets-out-proposals-deliver-fairer-and-sustainable-energy-deal-customers>

4. Initial views on the impact of the default tariff cap

We set out our initial views on the impacts of the design of the default tariff cap and how these will be considered as part of the impact assessment. These include impacts on suppliers, customers and wider impacts on the market and other stakeholders.

Overview of impacts

4.1 In this section we have set out our initial views on the impacts of the design of the default tariff cap and how these will be considered as part of the impact assessment.

4.2 We have categorised the impacts into four broad groups:

- i) Financial impacts on suppliers, including the impact on:
 - prices
 - revenues
 - costs
 - profitability

- ii) Impacts on consumers, including the impact on:
 - customer bills
 - customer behaviour and switching

- iii) Impacts on the market and market competition, including the impact on:
 - market competition
 - offering of specific tariffs and tariffs structures
 - smart meter rollout

- iv) Wider impacts affecting other stakeholder groups, including the impact on:
 - the wholesale energy market
 - third party switching services and supplier service providers
 - government
 - the environment.

4.3 We have also identified the scope of the impacts in terms of the tariffs that will be capped, and therefore the customers that will be affected by the default tariff cap.

4.4 We recognise, however, that in some areas there are interdependencies between the impacts on specific stakeholder groups and that they therefore cannot be considered in isolation. As part of the impact assessment we will consider the dynamics between these impacts in order to understand and estimate the overall net impact.

Financial impacts on suppliers

4.5 Within this section we consider the impact of the design of the default tariff cap on suppliers' prices, revenues, costs and profitability.

4.6 The financial impact of the cap on each individual supplier will depend on a number of factors, including:

- i) the level at which the default tariff cap is set
- ii) the existing prices of default tariffs at the time of the introduction of the cap (and, therefore, the extent to which prices will need to change to meet the cap)
- iii) the supplier's cost level in comparison to the level of the cap
- iv) the number of a supplier's customers that are on default tariffs, and how much energy they use
- v) dynamic changes to prices, costs and the customer base.

a) Impact on supplier pricing

Direct impact on pricing

4.7 The implementation of a default tariff cap will directly place a ceiling on the prices a supplier can set for default tariffs.

4.8 The Bill¹⁹ aims to increase protection for domestic customers on default tariffs. The principal way we are considering protection is the amount of savings to a default tariff customer, compared to current default tariff prices. The default tariff cap will

¹⁹ Domestic Gas and Electricity (Tariff Cap) Bill.

therefore be designed and implemented with the intention of reducing the average default tariff customer's cost per unit of energy, relative to what it would be without the cap.²⁰

4.9 The final level of the default tariff cap will determine the number of default tariffs priced above the cap. For tariffs above the cap, the implementation of the default tariff cap will result in a reduction in the price of these tariffs at least to the level of the cap. For suppliers with prices currently below the level of the cap, there would be no direct impact on the price of these tariffs.

Dynamic impact on pricing for default tariffs

4.10 It is possible that the default tariff cap level is used as a focal point at which prices cluster – meaning that for those suppliers with default tariffs currently priced below the cap, prices may rise to the level of the cap. This would result in a net price increase for the customers of those suppliers on default tariffs.

4.11 Evidence from the market indicates that, following the introduction of the prepayment cap²¹, there was an increase in energy prices for some PPM tariffs which were previously set below the prepayment meter cap level.

4.12 As part of our impact assessment, we will undertake quantitative analysis to understand the potential scale and subsequent impact of price clustering around the default tariff cap under a number of scenarios. Our initial thinking around the scenarios on which we could base the analysis is set out in more detail in Appendix 11. In these scenarios we will look to analyse a number of different possibilities whereby suppliers adjust the prices of their SVTs (and/or fixed term tariffs), within the boundaries of the maximum charge restriction of the default tariff cap.

Dynamic impact on pricing of non-default fixed term tariffs

4.13 It is also possible that the introduction of the default tariff cap results in a change in the pricing behaviour by suppliers for uncapped tariffs, ie non-default fixed term tariffs.

4.14 Where prices of uncapped tariffs are below the default tariff cap level, suppliers may increase prices in order to cover any costs of supplying default tariff customers that lie above the level of the cap, and therefore cannot be recovered under the default tariff cap. Costs above the level of the cap could be the result of the supplier operating inefficiently, or due to the supplier facing higher efficient costs than those used to set the cap. Even where suppliers incur costs below the level of the default

²⁰ Prices may still rise overall if costs increase by more than the reduction in prices generated by the price cap.

²¹ Based on the monitoring of prices since the implementation of the PPM safeguard tariff.

tariff cap, they may choose to change prices of uncapped tariffs to recoup any lost revenue and profits.

4.15 In addition, suppliers will likely assess the lifetime revenues from customers when deciding on their pricing strategies. Currently a proportion of fixed term tariff customers flow onto SVTs or default tariffs upon the completion of their contract. The pricing of fixed term tariffs could be run on an acquisition basis, taking into account the lifetime value of these customers. Changes to the expected value of any customer acquisitions could impact the pricing of these types of tariffs.

4.16 An increase in the price of uncapped tariffs currently below the level of the default tariff cap would reduce the price differential between default tariffs and non-default fixed term tariffs.

4.17 Such a reduction in the differential between tariffs could impact customer switching, both between suppliers and between tariffs with the same supplier. Please refer to paragraphs 4.83 to 4.93 for further detail of how this could impact consumers.

4.18 Conversely, it is possible that under certain scenarios where prices of uncapped tariffs are above the cap level, suppliers might look to decrease these prices, to avoid a negative differential between their default tariffs and fixed tariff offering. Under these potential scenarios, prices could be reduced to match the price of the suppliers' capped tariffs, or reduced below this level possibly to maintain the differential to the default tariff price.

4.19 As outlined in paragraph 4.12 above, we will assess the potential monetary impact of suppliers' pricing decisions for uncapped tariff customers under a number of different scenarios within the impact assessment. Our current views on the scenarios on which this analysis will be based are set out in more detail in Appendix 11.

b) Impact on supplier revenues

4.20 As noted in paragraph 4.9 above, it is likely that for a number of suppliers, the default tariff cap will reduce the price of default tariffs. Assuming no change to energy consumption levels among consumers, the resulting impact would be a reduction in revenues for suppliers currently offering a default tariff to customers at a price above the level of the cap.

4.21 In addition as also noted in paragraph 4.10 any suppliers who already offer a default tariff that is priced below the cap would not be required to adjust prices and, therefore, revenues would not be directly impacted. If these suppliers that have default tariffs set below the level of the cap were to maintain their existing tariff prices, there could be a marginal or zero direct impact on revenues, all other things being equal, for these suppliers.

4.22 Conversely as mentioned in paragraph 4.10, it is possible that those suppliers with default tariffs that are currently below the default tariff cap may raise their prices towards the level of the cap and thus increase revenues, all other things being equal.

4.23 However, any price changes for either default tariffs, or non-default fixed term tariff could also lead to changes in energy consumption.

4.24 It could be assumed that any reductions in price could lead to an increase in energy usage. However, the overall change, and therefore the impact on revenues, will depend on the number of customers impacted, the size and direction of any price changes, and the price elasticity of demand for these customers. For most customers, it might be expected that price elasticities are low as energy is an essential good.²² However, this may not be the case for all groups of customers. We have evidence that vulnerable customers are likely to spend a greater proportion of their disposable income on energy²³, and that in some cases they may ration their energy usage due to financial constraints.

4.25 In our impact assessment, based on the proposed level of the default tariff cap, we will present analysis on the potential impact of the default tariff cap on supplier revenues. We will also consider the impact of the default tariff cap on prices and energy consumption levels and we will consider both potential direct (static) impacts on supplier revenues, and dynamic impacts based on a number of scenarios relating to the pricing of uncapped tariffs by suppliers. We will consider the potential impact on energy consumption in the context of existing market trends in the demand for energy.

c) Impact on supplier costs

4.26 The Bill states that Ofgem must have regard to the need to ensure that suppliers who operate efficiently are able to finance activities authorised by the holding of a supply licence.²⁴ This is impacted by both the cost and availability of finance, as well as the extent to which each supplier's cost base reflects the efficient cost profile used to set the efficient level of the cap.

²² While there is a degree of variation depending on the methodological approach, a range of studies compiled by University College London imply that domestic demand for gas is inelastic, with estimates for domestic gas price elasticity in the UK ranging between -0.1 and -0.3.
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/532539/Annex_D_Gas_price_elasticities.pdf

²³ Ofgem: Providing Financial Protections for Vulnerable Customers, page 16.
https://www.ofgem.gov.uk/system/files/docs/2017/10/financial_protections_for_vulnerable_consumers_-_technical_document.pdf

²⁴ Domestic Gas and Electricity (Tariff Cap) Bill.

Impact on the availability of finance

4.27 As outlined in Appendix 9, we have proposed to continue to use the CMA's Return on Capital Employed (ROCE) approach to measure profitability. Under such an approach we use an estimate of the WACC. In Appendix 9 we outline our proposed approach to retain the WACC figure used by the CMA in its Energy Market Investigation (10% pre-tax nominal).

4.28 It is possible that the default tariff cap may cause uncertainty among investors and potential investors with regard to a supplier's ability to maintain or achieve profit levels, as well as cover the cost of debt and provide attractive dividends to shareholders.

4.29 As a result, suppliers may experience shifts in share prices and equity valuations and a reduction in investor ratings. This could result in suppliers facing an increased cost of capital and a higher underlying WACC, directly impacting their profitability. The design of the default tariff cap and the way in which it is implemented will impact the extent of these effects.

4.30 Any increased regulatory risk associated with the implementation of the default tariff cap will also contribute to this. We consider this further in paragraphs 4.43 to 4.47.

4.31 A reduction in share prices and equity valuations, and increased cost of capital, could make it more difficult for suppliers to raise finance for future investments. This could potentially limit future expenditure in areas such as innovation (see paragraphs 4.112 to 4.118) and business growth.

4.32 However, changes in the market mean that the value of the CMA's benchmark WACC may now be an overestimate of the current WACC. We outline the basis for this in Appendix 9. If the current average WACC is indeed below the CMA's benchmark used to set the cap, this would to some extent mitigate the risk to suppliers of an increase in the WACC as a result of the implementation of the default tariff cap.

4.33 In our impact assessment, we will qualitatively assess the direction and significance of potential wider financial impacts on suppliers in terms of changes in investor perceptions, share prices and equity values based on broker reports and other investment reports.

Impact on suppliers' market costs

4.34 As noted in the section above, uncertainty among investors and any reduction in investor ratings would be expected to lead to an increased cost of capital.

4.35 The extent to which suppliers will face an increased cost of capital is linked to the level of the cap; each supplier's level of exposure to the cap, as determined by

the factors set out in paragraph 4.6 above; as well as other factors such as the perceived regulatory risk in the market.

4.36 In addition to the cost of capital, there are other market costs faced by suppliers which may be impacted by the implementation of the default tariff cap, for example, costs associated with the purchase of energy on the wholesale market (see our discussion of the impact on the wholesale market in paragraphs 4.133 to 4.146).

4.37 The risk to suppliers of inaccuracies in setting the cap and changes to external costs may be mitigated to some extent by the proposed methodology for estimating the default tariff cap.²⁵ In setting its overall level, we will consider this risk and satisfy ourselves that this is accounted for in the efficient benchmark, or an additional amount of headroom if required.

4.38 The extent to which the default tariff cap design allows an efficient supplier to earn at least a normal level of profit, as well as cover any potential dynamic changes in these other costs, will depend on the combined level of the efficient benchmark and headroom allowance included, if at all (see Appendix 11).

4.39 Furthermore, the temporary nature of the default tariff cap may mitigate the extent of the risk of higher external costs to an extent.²⁶

4.40 As well as possible direct impacts on the costs of suppliers from the implementation of the default tariff cap, it might be expected that the proposals would alter the incentives of suppliers to influence their own internal costs. For inefficient suppliers with operating costs above the level of the cap, the implementation of the cap may incentivise the supplier to seek efficiency savings in order to remain profit-making and avoid exit from the market.

4.41 Our impact assessment will assess the materiality of the impact of the default tariff cap on supplier financeability, considering the potential impacts on suppliers' cost of capital, wholesale costs and EBIT levels under different quantitative scenarios based on the design of the default tariff cap.

4.42 In addition, we will look to qualitatively assess the incentive effect on supplier efficiency, including dynamic impacts on efficiency resulting from changes to the market structure.

²⁵ Ofgem (2017) Providing financial protection to more vulnerable consumers.

²⁶ Domestic Gas and Electricity (Tariff Cap) Bill.

Increased regulatory risk

4.43 Regulatory risk refers to the risk associated with a change in laws and regulations, such as the introduction of a default tariff cap, that may materially impact a business, sector or market.

4.44 The design of the default tariff cap could impact the perceived regulatory risk in the energy sector for two reasons. First, the implementation of a default tariff cap which is reviewed and updated, at a minimum, every six months creates uncertainty regarding the revised level of the cap at each review point. Second, implementation of price protections may change the perceived risk of further or ongoing protections in the future.

4.45 Linked to the section above on the availability of finance, any increase in the perceived regulatory risk of the market could result in investors seeking higher rates of return. This could increase costs for suppliers, and could also deter new entry and/or constrain investment.²⁷

4.46 These impacts can be mitigated to some extent by Ofgem developing a clear and transparent methodology for setting the default tariff cap and a clear timeline and process for review.

4.47 We will consider theoretical and empirical evidence relating to these potential impacts in order to identify the direction and significance of these impacts as part of our impact assessment. We will specifically consider the extent to which these impacts are dependent on the design and level of the default tariff cap, and therefore would vary across options. These considerations will form part of our assessment of the impact on supplier costs.

Impact on supplier administration costs

4.48 The design of the default tariff cap could impact the existing administration costs for suppliers for a number of reasons, detailed below.

4.49 When a supplier increases prices, or when there is a disadvantageous change to the terms of a supplier's tariff, a supplier is obligated under the Supply Licence Conditions (SLCs) to provide notice to all customers who will be impacted by the change.²⁸ The default tariff cap will result in a change in the terms of supply for many current default tariff customers, to which suppliers are obligated to provide notice. This will create administration costs for suppliers, for example in terms of the

²⁷ CMA (2016) Energy Market Investigation, Final Report.

²⁸ Please refer to SLC 23: Notification of Domestic Supply Contract terms.

cost of sending out physical letters to customers with paper billing, to notify them of each change.

4.50 In addition, in response to the existing safeguard tariff consultation it was argued by some suppliers, that the introduction of the default tariff cap would result in a higher volume of calls from customers wanting to understand the changes to their tariff. Some suppliers suggested that they would have to hire additional staff or increase the hours of their call centre employees to respond to this, creating additional costs.

4.51 Additional administration costs also may be incurred as a result of changes to prices in suppliers' billing systems and on their websites.

4.52 These administration costs will be incurred by suppliers with every change in the default tariff cap level. The Bill requires Ofgem to review the default tariff cap at least every six months. Therefore, suppliers can expect to go through these processes at least twice a year, and potentially more frequently depending on the cap duration adopted. In addition, it is possible that suppliers will incur additional compliance and monitoring costs associated with the default tariff cap.

4.53 However, we note that suppliers already have a tendency to update the prices of SVTs twice a year, to reflect changes in the demand and supply of energy in the winter and summer months.²⁹ Therefore, the administration costs incurred by suppliers may not be additional to the costs that suppliers incur at present, in the absence of a default tariff cap.

4.54 We will estimate the expected level of administration costs that may be incurred as a result of the default tariff cap. We will analyse supplier estimates for these administration costs and any additional person hours that may be required.

QA14.2: Do you consider that suppliers will incur a change in administration costs as a result of the default tariff cap? If so, please provide estimates with supporting evidence. Please specify whether any administration costs are fixed or variable. If variable, on what basis do these costs vary? For example, on a per customer basis.

d) Impact on supplier profitability

4.55 The potential impact on revenues and costs, as set out in the preceding sections, means we could expect the default tariff cap to impact the profitability of some suppliers in the market. For the reasons set out above, we would expect there to be a negative impact on suppliers' profitability for the majority of the market.

4.56 However, where suppliers are currently operating inefficiently (ie where their costs are above the efficient cost level we determine), we consider that the

²⁹ CMA (2016) Energy market investigation – final report.

introduction of the default tariff cap could incentivise suppliers to increase efficiency in order to cut costs and improve or maintain profit margins.

4.57 The Bill states that, in setting the default tariff cap, Ofgem must have regard to the need to create incentives for holders of supply licences to improve their efficiency.³⁰ Having regard to the consideration about efficiency, we are aiming to set the cap at a level at which it is possible for suppliers to achieve normal profits³¹ if they operate efficiently.

4.58 Nonetheless, as part of the impact assessment we will consider the potential impact in terms of loss of profit, and any knock on effects, on inefficient suppliers.

4.59 Within this policy consultation, in setting the efficient level of the default tariff cap we have proposed to base the EBIT margins on those estimated by the CMA of 1.25% or 1.9%.³² The rationale for this proposal is set out in Appendix 9.

4.60 In the impact assessment we will consider the factors affecting the potential EBIT margins of suppliers as well as quantitatively analyse how different levels of the cap, or the cap design, could impact the EBIT margins for suppliers.

Impacts on consumers

4.61 The proposed legislation would give Ofgem a duty to design the default tariff cap in a way that protects existing and future domestic customers on default tariffs. In complying with that duty, Ofgem must have regard to the need to maintain incentives for domestic customers to switch to different domestic supply contracts.³³

4.62 In this section we have set out our initial views on the impacts the design of the default tariff cap could have on consumers and how we intend to assess these in our impact assessment.

4.63 These impacts include the impact on customer bill impacts and the impact on customer behaviour and switching. The extent of these impacts on customers will primarily depend on:

- i) the initial level of the cap;

³⁰ Domestic Gas and Electricity (Tariff Cap) Bill.

³¹ Achieve a normal level of profit, defined in economic theory as the level of profit required for a business to remain in the market.

³² The CMA estimated that a normal EBIT margin of 1.25% for suppliers that use intermediaries to manage their wholesale trading activities and 1.9% for suppliers who do not use intermediaries.

³³ Domestic Gas and Electricity (Tariff Cap) Bill.

- ii) the number of customers on tariffs covered by the default tariff cap (see paragraphs 3.1 to 3.9);
- iii) current energy consumption levels among default tariff customers;
- iv) changes to supplier pricing behaviour following the implementation of the default tariff cap (see paragraphs 4.7 to 4.19); and
- v) changes to non-price based behaviour by suppliers following the implementation of the default tariff cap (see paragraphs 4.98 to 4.132).

a) Customer bill impact

Customer bill impact for eligible customers from default tariff cap

4.64 As outlined in paragraph 3.4, Ofgem expects the proposals for the default tariff cap will extend protections to cover a significant portion of the market.

4.65 In a static scenario, in which suppliers do not respond with possible price changes other than to directly comply with the default tariff cap, it could be expected that where the default tariff cap is set below the current price level for a portion of the market, customers on these tariffs would see bill reductions.

4.66 The level of any direct (static) savings for individual customers under the cap will be dependent on:

- i) the level of the default tariff cap;
- ii) individual customer consumption profiles, as any unit cost savings would vary linearly with consumption levels; and
- iii) current default tariff prices for individual customers.

4.67 As outlined in the executive summary of this policy consultation, the underlying methodology for determining the efficient cap level is still being designed (including any headroom). This will directly impact the extent of net customer bill impacts.

4.68 We expect to be able to provide estimates of these savings in the impact assessment using an indicative revenue impact model and the predicted cap maximum charges. Within the impact assessment we will quantitatively assess the potential static customer savings for those customers under the default tariff cap.

This analysis will follow a similar methodology to that undertaken within the savings assessment of the safeguard tariff.³⁴

Distributional effects of the default tariff cap

4.69 As per the Ofgem Impact Assessment Guidance, we will consider the distributional effects relevant to the design of the default tariff cap.

4.70 Within this we will consider the relative impact of the design of the default tariff cap on lower consumption groups. Savings for customers will to some degree depend on their individual consumption levels. For instance, a lower average rate of consumption among customers compared to the average Typical Domestic Consumption Values (TDCV) would result in customers benefitting from smaller savings compared to the average customer covered by the default tariff cap.

4.71 We have received responses to previous consultations³⁵ highlighting that the consumption profiles of certain customer groups who could be considered vulnerable, such as those within lower income brackets, differ to those of the average population.

4.72 It is possible that compared to the average levels of savings, vulnerable customers would see lower savings on average, due to their lower consumption levels. However, when considered as a proportion of income these savings could be more significant for vulnerable consumers. We will consider this possibility within the impact assessment.

Dynamic price impacts on customers from supplier price response

4.73 As outlined above in paragraphs 4.13 to 4.19 there is a possibility that suppliers change prices for customers on uncapped tariffs in response to the default tariff cap implementation.

4.74 We are currently undertaking scenario modelling to better understand the range of possible scenarios stemming from different supplier responses. As outlined in Appendix 11, we are seeking input from suppliers to better understand the assumptions underlying these different scenarios, to refine our understanding of the range of outcomes which are likely to occur.

4.75 At one extreme, suppliers could seek to achieve neutral overall net losses (customer savings) across their entire customer base. At the other extreme,

³⁴ Ofgem: Financial protections for vulnerable consumers. Annex B: Methodology for calculating impact on consumer bills and supplier revenues. https://www.ofgem.gov.uk/system/files/docs/2017/10/financial_protections_for_vulnerable_consumers_-_technical_document.pdf

³⁵ Ideal Economics: The case for a cap on the standing charge in energy bills. Page 8. <https://www.ofgem.gov.uk/ofgem-publications/131243#>

suppliers may look to absorb total revenue impacts. In this scenario suppliers would not look to mitigate revenue decreases by responding to the implementation of the default tariff cap with price increases on other tariffs. The outcome in this instance would be the same as in that of the static scenario considered above.

4.76 Where along this spectrum the supplier response lies will depend on a number of factors, also discussed in Appendix 11, such as the size of the supplier, the supplier's cost base and the profile of customers.

4.77 As outlined in Appendix 11, we do not think it will be possible to pinpoint a most likely outcome, due to the significant uncertainties involved. However, further refinement of these possible scenarios will allow for greater understanding of the range of possible impacts.

4.78 We will look to refine our scenario analysis within the impact assessment. Where possible we will look to quantify the impacts of a range of possible outcomes.

Unintended consequences of the cap structure on customer savings

4.79 Under SLC 22A, suppliers' tariffs must consist of both a standing charge (daily charge) and unit rate (consumption based charge).³⁶ Mirroring this, we are proposing that the level of the cap will increase in proportion to consumption, and include a fixed component.

4.80 Depending on the approach we take to setting these elements of the cap, we are aware that for a limited number of customers the structure of the cap could lead to price increases. This could be an issue for low consumption customers on tariffs with low or no standing charges. Whilst the unit rate for these customers under the cap may be lower than their existing unit rate, the introduction of a standing charge (to offset the reduction in the unit rate) on these tariffs could mean that low consumption customers on these tariffs are worse off. This issue was raised as part of the consultation responses to our consultation on extending financial protections to more vulnerable customers.³⁷

4.81 The existing safeguard tariff licence condition provides for a derogation and rebate process for such tariffs. This process allows for consumers to receive rebates instead of being transferred to a compliant tariff which subsequently leads them to pay more. As outlined in the overview document we propose to use this arrangement for the default tariff cap.

³⁶ Though suppliers are permitted to set the standing charge at zero.

³⁷ Ofgem: Decision letter WHD Safeguard Tariff, pages 9.
https://www.ofgem.gov.uk/system/files/docs/2017/12/decision_letter_whd_safeguard_tariff_-_final.pdf

4.82 We plan to consider this issue qualitatively within the impact assessment, drawing on responses to this consultation and evidence from previous price caps, to better understand the potential scale of this issue.

QA14.3: Are you aware of any unintended consequences, in the form of detrimental impacts on customers that were observed as a result of the existing safeguard tariffs? If so, please provide details of these unintended consequences.

QA14.4: Do you have reason to believe the default tariff cap could disproportionately impact any of the nine protected characteristics under the Equality Act 2010? Please provide any supporting evidence.

b) Customer behaviour and engagement

4.83 The Bill states that Ofgem must have regard to the need to maintain incentives for domestic customers to switch to different domestic supply contracts.³⁸

4.84 However, customer engagement in the energy market goes wider than the issue of switching suppliers. In its energy market investigation final report³⁹, the CMA identifies three measures of customer activity and engagement: choice of tariff; choice of payment method; and choice of supplier. Furthermore, customers may make an informed choice about one or more of these, without switching supplier.

4.85 Given this, we would expect the number of customers engaged in the market to be greater than the number that switch supplier in any given time period. Nonetheless, switching by customers in the energy market is a key indicator of customer engagement; the CMA uses information on switching in its monitoring and reporting of customer engagement levels and trends.⁴⁰ We therefore consider that changes in switching rates could be considered a reasonable indicator of changes in overall customer engagement in the market.

4.86 Engagement in the market is continuing to improve with a record number of customers now switching to small and medium suppliers.⁴¹ An active customer base is a crucial component of a well-functioning market, promoting competition and innovation while ensuring customers get the best available deals.⁴²

4.87 We are, therefore, mindful of any negative impacts that the choice of design or implementation of the default tariff cap could have on customer behaviour and engagement. Price intervention has the potential to impact customer behaviour in a

³⁸ Domestic Gas and Electricity (Tariff Cap) Bill.

³⁹ CMA (2016) Energy market investigation – final report.

⁴⁰ Ibid.

⁴¹ Ofgem: Record number of customers with small and medium sized suppliers.

<https://www.ofgem.gov.uk/publications-and-updates/record-number-customers-small-and-medium-sized-suppliers>

⁴² Ofgem: State of the Market 2017, page 20.

https://www.ofgem.gov.uk/system/files/docs/2017/10/state_of_the_market_report_2017_web_1.pdf

number of ways, altering how they interact with the market and the benefits available to them from doing so.

4.88 One of the reasons that customer engagement is important, is that it is likely to drive more switching between suppliers, in the interests of consumers. We later discuss (see paragraphs 4.100 to 4.118) the potential impact of the default tariff cap on competition, and note that any negative impact on competition may have a negative impact on consumers (and vice versa).

Customer engagement, price differentials and switching

4.89 A key driver of switching in the market is the price differential between tariffs. As discussed within Appendix 11, we have identified a number of evidence sources which suggest a positive relationship between customer switching and the estimated savings available to them. Price differentials - the difference between the market's cheapest deals and highest prices - provide an incentive for customers to engage in the market. Subsequently, any changes to price dispersion within the market could influence levels of switching.

4.90 As discussed above in paragraphs 4.7 to 4.9 in a static environment, the default tariff cap could directly reduce the size of the pricing differential between capped tariffs and uncapped tariffs, due to the default tariff cap's maximum charge restriction. As outlined in paragraphs 4.10 to 4.19, in a dynamic environment, potential supplier-led changes to other tariff prices (such as an increase in the price of cheaper fixed deals), or capped tariffs that fall below the cap level, could further compress differentials. We will therefore also consider how changes from these could impact switching, and the potential outcomes of this.

4.91 For example, while previously disengaged customers (ie those currently on default tariffs) may see a reduction in their tariff under the cap, there may be previously engaged customers (ie currently on fixed tariffs) who may become less engaged due to a reduction in the price differential between the fixed and default tariffs. They may therefore, end up paying more under the cap if they roll onto a default tariff and are no longer incentivised to switch.

4.92 The default tariff cap will be more extensive than any current price protection. Due to this, and the considerations we set out above, it could be expected that the impact on switching will be greater than that seen as a result of previous price protections.

4.93 However, due to the uncertainties which exist in relation to potential changes in price dispersion under different scenarios, we do not consider it will be possible in our impact assessment to provide a quantitative estimate of the impact of the default tariff cap on overall levels of switching. Based on evidence we have observed to date, we consider that a positive relationship between price dispersions and switching exists. We will consider this relationship further as part of our impact assessment, based on evidence from the existing safeguard tariffs, and international evidence.

QA14.5: Do you have any additional information or data on the impact of the implementation of the existing safeguard tariffs on switching rates that would inform this analysis?

4.94 Within the impact assessment, we will consider how changes to price differentials might impact different segments of the consumer market (both engaged and disengaged customers). High switching rates overall are not necessarily an indicator of customer engagement across all segments of consumers, for example many of the same bargain hunters could make up a larger proportion of switching.

Other impacts on customer engagement

4.95 There are also non-priced based effects which could lead to changes in the likelihood of customers to engage. For instance a number of responses to Ofgem's previous publications on price protections and views put forward during the CMA's energy market investigation have highlighted the safe haven effect.⁴³ This relates to a scenario in which customers perceive a regulated market as sufficient protection, leading to a reduction in the likelihood to switch regardless of price differentials.

4.96 Conversely, an increased awareness of the energy market and increased trust in the sector stemming from implementation of price protections could work to increase customer awareness and subsequent levels of engagement.

4.97 We will look to assess these impacts as part of our impact assessment. We intend to conduct research using customer panels to better understand how different drivers interact and lead to changes in switching levels. Overall, it is our initial view that the impact on customer switching will depend on the interaction of the factors we have considered above.

Impacts on the domestic energy retail market and market competition

4.98 In this section we have set out our initial views on the impacts the default tariff cap could have on the market and how we intend to assess these in our impact assessment.

4.99 These impacts include the impact on competition, the offering of different tariff types and structures and the impact on the smart meter rollout.

a) Impact on competition

4.100 The Bill states that Ofgem must have regard to "the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic

⁴³ CMA (2016) Energy market investigation – final report.

supply contracts”.⁴⁴ In setting the level of the cap, consideration will therefore be given to the potential relative impact of tariff design options on competition.

4.101 Within our State of the Energy Market 2017 report⁴⁵, we set out what we consider to be the features of a competitive retail energy market. We consider a competitive energy market should:

- be easy to enter and exit
- incentivise sustained rivalry between suppliers in the supply of innovative products and services
- allow energy users to access, assess and act on offers in the market
- reward suppliers who can best meet customer needs with larger market shares

4.102 The level of the default tariff cap could have potential impacts on supplier competition within the GB energy market, including impacts on: market entry and exit; the incentive for suppliers to compete on prices; and the incentive to innovate. We provide an initial assessment of each of these below.

Impact on market entry and exit

4.103 As noted above, as part of our assessment of the financial impact on suppliers, there is potential for the default tariff cap to impact both supplier revenues and supplier costs, thus impacting profitability.

4.104 The default tariff cap will be designed with regard to “the need to ensure that holders of supplier licences who operate efficiently are able to finance activities authorised by the license”. The methodology for setting the cap will therefore be designed such that suppliers which operate efficiently, and which face a composition of costs in line with those used to set the default tariff cap, can achieve normal profit (albeit this profit level may be below current levels of profitability).

4.105 However, for those suppliers that are operating inefficiently or that are operating efficiently but face higher costs than those used to set the cap, for example due to the profile of their customers⁴⁶, the implementation of the default tariff cap may result in them not being able to make normal profit. Over time if these

⁴⁴ Domestic Gas and Electricity (Tariff Cap) Bill.

⁴⁵ Ofgem (2017) State of the energy market: 2017 report.

⁴⁶ The cost of servicing varies across customers. For example, on average, customers that pay by standard credit are more costly to service than direct debit customers. And customers that manage their account purely online are cheaper to service than those that request paper billing and/or are more likely to require telephone support.

companies were unable to improve their cost efficiency or evolve their customer base, it would be expected that this would lead to their exit from the market.

4.106 In addition, the introduction of the default tariff cap in the market, and the higher level of regulation in the GB retail energy market, could discourage potential market entry, for example due to potentially lower switching rates, and reduced potential for price differentiation.

4.107 However, over recent years the market has attracted a considerable number of entrants. For example, between June 2016 and June 2017 the total number of domestic energy suppliers increased by 16.⁴⁷ There are likely to still be opportunities for market entry when the default tariff cap is implemented, particularly for firms that are able to achieve costs below the level of the cap.

4.108 Some of these factors may have an impact on competition, for example if higher barriers discourage competitive entry, or if providers competing for particular niche customer groups exit, due to the cap not reflecting their particular cost structures.

Impact on price competition

4.109 The introduction of the default tariff cap could be expected to impact suppliers' ability to compete on price within the market. Depending on the level of the efficient benchmark, inclusion of headroom within the cap design could allow for greater price competition, albeit limited, dependent on the size of headroom designated by Ofgem.

4.110 If the design of the default tariff cap also has the effect of reducing customer engagement as discussed in paragraphs 4.83 to 4.97, then this might further reduce competition. This impact might be more pronounced if the default tariff cap not only impacted on the engagement of customers on default tariffs, but also on customers who subscribe to non-default fixed tariffs.

4.111 We will undertake a qualitative assessment of the impact the default tariff cap could have on suppliers' incentives to compete on price as part of the impact assessment. This will be based on our analysis of the potential impact of the cap on prices, revenues and profits. We will consider how the default tariff cap may influence price competition for both default tariffs, and non-default fixed term tariffs.

⁴⁷ Ofgem (2017) State of the energy market: 2017 report.

Impact on non-price competition and innovation

4.112 The implementation of the default tariff cap could also impact the extent to which suppliers compete on other factors, such as quality of service or innovation in tariff offerings.

4.113 Innovation in the energy sector relates to both improved product and service quality and enhanced process effectiveness.⁴⁸

4.114 A reduction in suppliers' revenues and profitability could constrain the ability of suppliers to reinvest to fund innovation and improvements in customer experience. In addition, the potential impact on profitability may encourage suppliers to cut costs. These factors could lead to a lower levels of customer service and less innovative customer service and tariff offerings.

4.115 In line with this, suppliers that employ business models that result in a higher cost base, for example with a greater focus on quality service or geared towards a higher cost customer base, may not be able to operate these same business models when the default tariff cap is in place as it may not be possible to recoup all these costs through prices. Therefore, it is possible that the implementation of the default tariff cap could impact the introduction and adoption of specific business models, and could cause those currently operating under these models to change practices or exit the market.

4.116 Furthermore, if the price cap leads to customers being less engaged generally (ie not just on price), then just as with competition on prices discussed above (see paragraphs 4.109 to 4.111), suppliers may face weaker incentives to also compete on non-price factors. A counterargument could be made that competition may become more focussed on quality eg levels of customer service and innovative product offerings, though this may depend on the degree to which customers can be engaged and compare suppliers on these bases. In this scenario, proposals could lead to increased investment and innovation, and the potential adoption of more innovative business models as suppliers seek to draw in customers based on non-price based factors.

4.117 In addition, as outlined in Appendix 8, we have also not seen any evidence to suggest that better customer service is in fact related to higher costs. In some cases, the opposite could be the case: eg higher operating costs may be related to problems with billing systems, which may result in worse service levels.

⁴⁸ BIS (2014) Innovation Plan. See: Innovation Plan 2014:
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/293635/bis-14-p188-innovation-report-2014-revised.pdf

4.118 In the impact assessment, we will assess, in qualitative terms, the potential impact the default tariff cap is likely to have on non-price competition and suppliers' incentive and ability to innovate.

b) Impact on tariff types and structures

4.119 The default tariff cap could also have an impact on the number and range of different tariff types and structures offered by suppliers.

4.120 It is possible that the introduction of the default tariff cap could have a specific impact on the supply of default renewable tariffs which provide additional benefits to the environment above and beyond what current subsidies are delivering.⁴⁹

4.121 Where suppliers face higher costs in the supply of renewable tariffs, the implementation of the default tariff cap could restrict the supply of these tariffs. This would be the case if suppliers are not able to recoup these higher costs within the cap limit due to the efficient costs for renewable tariff providers being higher than the efficient costs used to set the level of the cap.

4.122 However, the Bill states that an exemption from the default tariff cap may be made for default tariffs which appear to Ofgem to support the production of gas, or the generation of electricity, from renewable sources, ie renewable tariffs, where customers have chosen to be on the tariff. Within this policy consultation, we have presented a number of options through which any exemption for renewable tariffs could be implemented.

4.123 The extent to which the default tariff cap is likely to impact the supply of renewable tariffs, and thus the suppliers who provide them and the customers in receipt of these tariffs, will depend on the costs associated with the provision of renewable tariffs and the coverage of any exemption for renewable tariffs.

4.124 We will assess these impacts within our impact assessment. If an exemption is implemented, we will look to assess the impact of the exemption and the options for the design and implementation of the exemption.

4.125 As part of the impact assessment we will also qualitatively assess the potential impact on the supply of other tariff types and structures, based on evidence from academic studies and international case studies of tariff caps.

⁴⁹ Ofgem (2008) Ofgem clears up green tariff confusion. Press release.

c) Impact on the smart meter rollout

4.126 The Bill states that as part of Ofgem's review of the default tariff cap, Ofgem must consider the extent to which progress has been made in installing smart meters for use by domestic customers.⁵⁰

4.127 The government requires energy suppliers to take all reasonable steps to install smart meters in every one of their customers' premises by 2020. The scheme is supplier-led, meaning that it is at an individual supplier's discretion to determine how they will complete the roll-out by 2020. However, suppliers are bound by the government's target of having smart meters as the standard by the end of 2020.

4.128 The cost of smart meter rollout will be considered as part of the setting of the efficient operating costs. However, as noted in paragraph 4.20, it can be expected that the cap will reduce the revenue gained by suppliers from customers on higher priced default tariffs. It is possible that, in an attempt to reduce costs and thus maintain or increase profit, suppliers decrease investment, including smart meter rollout expenditure. However, it is possible that the proposals could present additional challenges, which in line with their licence conditions, suppliers must take all reasonable steps to overcome, for example, the propensity for customers to seek out and accept the installation of smart meters in their home could differ under a default tariff cap, compared to the counterfactual. We will undertake a qualitative assessment of the impact on smart meter rollout as part of our impact assessment.

4.129 However, it is possible that proposals could present additional challenges, which in line with their licence conditions, suppliers must take all reasonable steps to overcome, for example, the propensity for customers to seek out and accept the installation of smart meters in their home could differ under a default tariff cap, compared to the counterfactual. We will undertake a qualitative assessment of the impact on smart meter rollout as part of our impact assessment.

Wider impacts

4.130 In this section we have set out our provisional views on the potential wider impacts the default tariff cap could have on other stakeholder groups, and how we intend to assess these in our impact assessment.

4.131 The potential wider impacts we have considered may be split into the following categories:

- impact on the wholesale energy market;
- impact on third party switching services;

⁵⁰ Domestic Gas and Electricity (Tariff Cap) Bill.

- impact on government; and
- impact on the environment.

4.132 It should be noted that these impacts are not standalone, and should be considered in the wider context of the supplier and consumer impacts we have identified above. In our impact assessment we will consider the dynamics between stakeholder groups, in order to understand and assess the overall impact of the introduction of the default tariff cap.

a) Impact on the wholesale energy market

Impact on supplier hedging strategies and the cost of purchasing wholesale energy

4.133 The design of the default tariff cap could change the way in which suppliers hedge energy prices. Some suppliers have already indicated that they would move towards the wholesale buying strategy used to assess wholesale costs. This could reduce the risk of having costs that vary greatly from the wholesale costs reflected in the default tariff cap design.

4.134 At present, the majority of energy suppliers hedge energy prices by purchasing energy in advance. Suppliers will forecast the amount of energy they require in advance and purchase it accordingly.

4.135 However, dependent on how the cap is set and the frequency of updates, suppliers may choose to reduce their hedging activities until they know the approach for assessing wholesale costs and the allowance for these costs.

4.136 They may hedge in accordance with the strategy assumed under the tariff cap, potentially discouraging suppliers from trading products which deliver energy beyond the period assessed for the purpose of wholesale costs (ie beyond 12 months). This could have wider impacts on factors such as wholesale market liquidity, reference pricing and price signalling. Ultimately if these factors were materially negative, they could impact the ability of suppliers (particularly smaller ones) to access parts of the market and compete, possibly leading to market exit. It could also increase the costs of transactions more broadly, and especially for later dated contracts.

4.137 Furthermore, forecasting is subject to errors. If suppliers inaccurately forecast the amount of energy they require, they may incur additional costs as a result. For example, an underestimate of demand could result in a need to purchase the shortfall of energy on the market – which tends to be at a higher price. Whilst the level of the cap is not expected to influence forecasting costs themselves, the extent to which these costs are accounted for in the setting of the efficient level of the cap depends on the methodology employed. The implementation of the cap could therefore limit the extent to which suppliers are able to recover these costs.

4.138 However, there are a number of steps that suppliers can take to forecast more robustly. Examples of these include investing in modelling and analytical tools to assess potential demand, rolling out smart meters or buying flexible generation contracts. The implementation of the cap may therefore encourage investment in such tools and therefore lead to an overall improvement in forecasting accuracy.

4.139 Furthermore, the cap will be updated at least twice a year, reflecting the way suppliers tend to price at present⁵¹, so we consider that these are factors that suppliers already manage. In addition, a forward understanding of the calculation process for setting the wholesale cost stack in advance could be seen to focus suppliers, incentivising them to seek lower wholesale costs through their individual hedging strategies.

4.140 In addition, the wholesale energy market is subject to external shocks that may result in changes in energy prices or changes in energy usage, eg weather events. These shocks can create additional, unforeseen costs to energy suppliers which will not be able to be passed on to customers immediately under a tariff cap.

4.141 In our impact assessment we will qualitatively assess the potential impact the default tariff cap could have on the wholesale market, considering impacts on supplier hedging strategies, wholesale market liquidity and functioning, as well as the ability for suppliers to manage unforeseen wholesale costs.

Impact on price volatility

4.142 Wholesale prices change over time and we are consulting on how wholesale prices will be set and updated under the cap.

4.143 There is the potential for wholesale prices to change considerably between default tariff cap periods. Wholesale costs are the single largest cost area that feeds into an overall customer bill, making up between 36.30% and 37.88% of a customer's bill⁵², depending on fuel type.⁵³ Large changes in wholesale costs from one cap period to another, could result in more significant price volatility in bills from one cap period to the next.

4.144 The extent to which this impact could occur will depend partly on the length of a tariff cap period. A shorter period is likely to create less volatility, whilst a longer cap period could result in more volatility.

⁵¹ CMA (2016) Energy market investigation – final report.

⁵² Ofgem, Understand your gas and electricity bills.

<https://www.ofgem.gov.uk/consumers/household-gas-and-electricity-guide/understand-your-gas-and-electricity-bills>

⁵³ Wholesale costs make up 36.30% of an electricity bill, 39.42% of a gas bill and 37.88% of a dual fuel bill.

4.145 This impact was previously considered in the impact assessment for the existing safeguard tariff. We considered this impact to be marginal as suppliers do not currently change SVT prices frequently.⁵⁴ In addition, the current energy market is already subject to price volatility driven by the wholesale market. Therefore, any impact may not add to the price volatility that is already experienced.

4.146 In the impact assessment, we will qualitatively assess the potential for there to be price volatility under the default tariff cap, and how this may impact customer energy bills.

b) Impact on third party switching services

4.147 As set out in paragraph 4.89 above, the default tariff cap could reduce the savings available to customers from switching tariff and/or suppliers. This could impact both customers on default tariffs, and customers impacted by any dynamic indirect price changes to uncapped tariffs and the changes in wider price dispersions.

4.148 It is, therefore, possible that following the implementation of the default tariff cap, as outlined in paragraph 4.90, fewer customers may look switch their energy tariff and/or supplier. Subsequently, there may be indirect impacts on other areas of the market linked to customer switching, namely third party switching services.

4.149 A lower level of switching would have the knock-on effect of reducing the number of comparisons and switches orchestrated through these third party switching services.

4.150 Many of these switching service providers receive a commission when a customer switches through them. Reduced use of these services could therefore result in decreased revenues for these companies.

4.151 The scale of these impacts will depend on a number of factors already discussed above, primarily:

- i) the impact of proposals on price dispersions
- ii) how changes in price dispersions and other behavioural factors impact the number of customers switching, particularly those customers on a default tariff
- iii) the tendency for those impacted customers to have otherwise relied on the use of third party switching services.

⁵⁴ Ofgem (2017) Financial protections for vulnerable customers.

4.152 We are aware that a significant number of all switches rely on the use of comparison services.⁵⁵ Therefore, it could be that any impacts on switching would lead to impacts on the use and subsequent revenues of these organisations.

4.153 In addition, it is possible that implementation of the default tariff cap could influence supplier service providers. We are aware that a number of, often smaller, entrant suppliers use the provision of third party outsourcing services, which, for instance, provide off the shelf billing and customer relationship management systems.

4.154 As we note in paragraphs 4.103 to 4.108, the market has attracted a considerable number of entrants over recent years. However, the impact of the default tariff cap on supplier operations could influence the levels of market entry and/or exit. Therefore, it is possible that any changes in the number of smaller suppliers within the market could impact the tendency to seek outsourcing services from third parties.

4.155 Within the impact assessment we plan to further assess the direct impacts of proposals on these third party organisations. Expanding on the scenario assessments we will be undertaking, we will look to analyse how changes in market prices, switching and market entry/exit could impact these third party services.

c) Impact on the government

4.156 The default tariff cap could impact the government through two routes: through changes to VAT receipts and through changes to government administration costs.

4.157 As set out in paragraph 4.65 above, it is possible that the default tariff cap will lead to a reduction in customer bills for those currently on a default tariff due to a decrease in the price per unit of energy. A proportion of this reduction per unit of energy will reflect a decrease in the VAT which customers pay on their energy bills. This reduction in VAT would represent a reduction in VAT receipts for HMRC.

4.158 However, dynamic impacts over the longer term are likely to lead to many of these savings going back into the economy. These indirect spending changes could come from a number of avenues, including:

- dynamic price changes (potential increases) for uncapped tariffs;
- increased energy consumption for some customers; and

⁵⁵ Ofgem: Press release.
<https://www.ofgem.gov.uk/publications-and-updates/comparison-sites-now-main-way-savvy-shoppers-switch>

- increased expenditure in other areas of the UK economy, from an increased disposable income for customers covered by the default tariff cap.

4.159 In our impact assessment, we plan to assess how the relationship between changes in price dispersions, price elasticities and consumption might impact overall VAT receipts.

4.160 There will also be a cost specifically to Ofgem, in the development, implementation and monitoring of the default tariff cap. Ofgem will incur costs in the development and implementation of the default tariff cap. Further costs will also be incurred on an ongoing basis as a result of updating and monitoring of the cap.

4.161 We do not expect these costs to be material in the context of the overall impact of the default price cap. However, they will generate a resource burden on government. We will, therefore, look to estimate the monetary cost to the government as a result of the implementation of the default tariff cap in our impact assessment.

d) Impact on the environment

4.162 There may be a wider impact on the environment as a result of the implementation of the default tariff cap.

4.163 In paragraphs 4.119 to 4.123 above we have set out the possibility of a reduction in the offering of renewable tariffs by suppliers due to the introduction of the default tariff cap. We will consider the potential impact of this, if any, on renewable generation.

4.164 As noted in paragraph 4.23, it is possible that the default tariff cap could lead to an increase in consumption. Although we would expect any impact on individual customer consumption to be small, the aggregate impact on the environment could be significant. We will consider the expected impact on the environment as part of our impact assessment.

5. 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 of 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 1 - Introduction

Question A14.1: What is your view on the overarching approach that is proposed for conducting the impact assessment? In particular, on the scope of the assessment, and material issues that we have not referred to. Please provide details of any relevant sources of data and evidence that you think should be considered.

Chapter 4 - Initial views on the impact of the default tariff cap

Question A14.2: Do you consider that suppliers will incur a change in administration costs as a result of the default tariff cap? If so, please provide estimates with supporting evidence. Please specify whether any administration costs are fixed or variable. If variable, on what basis do these costs vary? For example, on a per customer basis.

Question A14.3: Are you aware of any unintended consequences, in the form of detrimental impacts on customers that were observed as a result of the existing safeguard tariffs? If so, please provide details of these unintended consequences.

Question A14.4: Do you have reason to believe the default tariff cap could disproportionately impact any of the nine protected characteristics under the Equality Act 2010? Please provide any supporting evidence.

Question A14.5: Do you have any additional information or data on the impact of the implementation of the existing safeguard tariffs on switching rates that would inform this analysis?