

Executive Summary

1. Headroom is an essential component of the proposed Default Tariff Cap (the “Cap”). An allowance for headroom within Ofgem’s methodology for determining the Cap will be critical if Ofgem is to meet key requirements set out in the Domestic Gas and Electricity (Tariff Cap) Bill, which are that Ofgem’s methodology must:
 - set the Cap “at a level that enables holders of supply licences to compete effectively for domestic supply contracts”; and
 - maintain “incentives for domestic customers to switch to different domestic supply contracts”.
2. Given the importance of headroom in the development of the Cap, it is therefore disappointing that Working Paper 3 (WP3) is so short on detail, lacking in substantive evidence or analysis, and provides almost no indication as to Ofgem’s developing thinking or “minded-to” position on this critical issue.
3. Headroom will be critical to ensuring that effective competition operates under the cap. As such, it is essential that Ofgem presents analysis in its forthcoming policy consultation that assesses the trade-off between headroom and levels of competition in the market. To the extent that insufficient headroom reduces effective competition (either market-wide, or for specific customer segments), it will also be necessary to assess the welfare loss to consumers that will result.
4. It is particularly concerning that, in WP3, Ofgem has not set out its views on the level of consumer engagement and switching that should exist in the market with a cap on all default tariffs (i.e. the meaning of Ofgem’s obligation under the Bill to “maintain incentives for domestic customers to switch”). This is critical to the setting of an appropriate level of headroom.
5. Analysis of the available evidence suggests that a substantial price differential (i.e. significantly in excess of £100) would be required to give the majority of customers an incentive to engage in the market. We would expect analysis such as this to be reflected in Ofgem’s assessment of the appropriate level of headroom.

Rationale for headroom

6. The role of headroom is to create enough space for price dispersion in the cap, to a sufficient degree such that customers will have an incentive to consider shopping around for a better deal. In this respect, setting an appropriate allowance for headroom is a key differentiator between a retail price “cap”, and a direct price control, such as would be set for a network monopolist.
7. A price control for a network monopoly would make no allowance for headroom, given there is no ability under such a market structure for competition to deliver benefits to consumers. However, the retail market is already characterised by existing and established competition. Therefore the Cap must be designed carefully to ensure that, not only is sufficient allowance made for the recovery of efficiently incurred costs, but that the adverse effects of the cap on competition are limited.

8. Headroom is therefore separate from the profit margin that an efficient supplier would need to cover its cost of capital. Absent an allowance for headroom, Ofgem would in effect be setting a retail price control, and not a “cap” as the Bill requires.
9. Indeed, were headroom not specified, the only suppliers able to price below the Cap would be small suppliers who are currently exempt from contributing fully to social and environmental policies. These exemptions already create an uneven playing field for competition in the market, but a cap with no headroom will exacerbate this further, removing the ability of obligated suppliers to compete on price.
10. A similar effect would result were Ofgem to fail to reflect legitimate differences in costs between suppliers in the setting of the control (e.g. due to differences in customer mix between suppliers or differences in service quality).
11. In this context, it is important to recognise “effective competition” is a precondition specified in the Bill for the cap, ultimately, to be removed. If the Cap fails to include sufficient headroom to such an extent that customer engagement and switching is materially reduced, this will therefore increase the risk that direct price regulation becomes an ongoing feature of the retail market.

Determining an appropriate level for headroom

12. Ofgem cites the CMA’s prepayment price cap methodology as being a relevant precedent for the setting of the level of headroom for the Cap. However, we do not believe this to be the case given the CMA’s own logic suggests that the £30 headroom the CMA built into the price cap would not be sufficient to safeguard effective competition for a default tariff cap.¹
13. The CMA recognised that technical aspects of the existing meter infrastructure limits the ability for competition to benefit consumers in the prepayment segment of the market. In contrast, customers served with credit meters are more able to benefit from the effects of competition.
14. The CMA also specifically highlighted that more weight would need to be given to competition considerations when setting a wider default tariff cap, due to the considerably larger share of the market covered, than when setting a PPM cap. This is because the CMA considered the potential for adverse consequences on competition to be higher when a larger segment of the market is covered by the cap.
15. Instead, we believe there is clear evidence from customer surveys, empirical observation and relevant international examples that significant price dispersion is a fundamental driver of customer engagement and switching.
16. In particular we would highlight:
 - survey evidence on consumer engagement shows that price differentials below around £200 are likely to adversely affect switching behaviour and a significant portion of customers would not consider switching;

¹ £30 headroom was based on medium TDCV at the time that the PPM cap was initially set.

- evidence from Ofgem’s own Cheaper Market Offers Letter (CMOL) trial suggests that there is a considerable drop-off in customer engagement for levels of price differential below around £200;
- relevant international evidence from Australia is consistent with the requirement for headroom to ensure sufficient rates of switching; and
- the data available so far shows that the implementation of the prepay tariff cap is also consistent with this. The prepay tariff cap has reduced price differentials from around £200 to £100, with a corresponding reduction in switching.

Other comparators

17. Contrary to Ofgem’s suggestion, neither the Northern Ireland retail energy arrangements or the payday lending arrangements are appropriate comparators for the treatment of headroom in the Cap.
18. In Northern Ireland, fundamental differences in market structure and the scope of the tariff caps mean such a comparison is invalid. Specifically, Power NI has a market share of 59%, meaning the risk of this incumbent exerting market power is significant concern. In such a context, it would be inappropriate for headroom to be allowed – not least given Power NI is the only market participant subject to retail price regulation.
19. In payday lending, the FCA’s cap was never intended to act as a benchmark of efficient costs, therefore it would be meaningless to consider the extent to which it incorporates “headroom” over such costs.

Legal considerations

20. There are a number of legal aspects relating to Ofgem’s process and interpretations that we have material concerns about. In particular we are concerned about:
 - **Process issues:** we have serious concerns about the current consultation process
 - **Ofgem’s likely duties in setting any tariff cap:** headroom is not optional
 - **Timing:** whatever the Bill (or the government) says, Ofgem may not take shortcuts
 - **Sufficient enquiry:** Ofgem needs to gather enough evidence for it to make its own decisions. The current process suggests it will fall short.
21. We set out the detail of these concerns in the legal considerations annex to this response.

Response to Ofgem's Working Paper #3

Comments on the role of headroom in setting the default tariff cap

22. In section 3 of the working paper, Ofgem indicates that it has not yet decided whether headroom is required in the Cap and cites other examples of price regulation that do not include headroom. For the reasons we explain below, headroom is an essential component of the Cap, and is a direct corollary of the requirements of the draft Bill.
23. The CMA recognised this when designing the PPM tariff cap, and noted that the need for headroom would be even greater for a cap that applied to a wider proportion of the domestic customer base. By contrast, the examples that Ofgem cites of price cap regimes where there is no headroom – namely Northern Ireland and payday lending – are simply not relevant comparators in this context.
24. We explain each of these points in turn.

The critical importance of headroom

25. Headroom is an essential component of the proposed default tariff cap, since without it there would be little or no scope for effective competition in the energy retail market.
 - If the Cap were set at a level that allowed an efficient supplier to cover its costs, there would be no room for (fully obligated) suppliers to compete for business by differentiating their prices from one another. The level of the Cap in this environment would dictate not just default tariff prices, but all prices across the entire credit segment of the market, since suppliers could not afford to offer any tariffs – fixed-term or variable – at a level below the Cap.
 - A lack of price differentiation would disincentivise customers from shopping round and engaging in the market.
 - This in turn would preclude effective competition between suppliers, since without the opportunity of winning new business or the threat of losing business to rivals, competition would be fatally undermined.
26. The draft Bill requires Ofgem to conduct a review into whether conditions are in place for effective competition in 2020. If sufficient headroom is not included in the Cap, this will have negative consequences for competition across the whole domestic energy retail market. This could preclude the conditions for effective for competition being possible by 2020.
27. In practice, the amount of headroom required to support a given level price dispersion could be diminished if Ofgem were to build an allowance into the basic level of the cap for legitimate variations in suppliers' costs. For example if the basic level of the cap allowed space for suppliers to cover the costs required to provide above-average levels of service quality or differences in customer mix, then there would be space for some variation in tariffs below the basic level of the cap – thereby reducing (though not eliminating) the amount of headroom needed over-and-above this. Ofgem should

therefore consider the interplay between these various factors when determining the amount of headroom required to support the required level of price dispersion.

28. Beyond this, the only price differences in the market permitted by the cap in the absence of headroom will be attributable to suppliers who have costs below the assessed efficient level of a supplier of scale – for example if they are exempt from contributing fully to social and environmental policies. These exemptions already create an uneven playing field for competition in the market, but a cap with no headroom will exacerbate this further by removing the ability of fully obligated suppliers to compete on price.
29. For all these reasons, headroom must be included in the default tariff cap in addition to the minimum profit margin that an efficient supplier would need to make to cover its cost of capital.²
30. Given its fundamental importance, headroom should be an explicit and separately modelled component of the Cap. It should not be seen as a factor to balance out any other limitations or errors in the process of setting the Cap.

The relevance of the comparison with the PPM tariff cap

31. The CMA built an explicit headroom component into the PPM tariff cap on the basis of the concerns set out above. There would be no justification for recognising the need for headroom in the PPM cap but not for a wider default tariff cap, when the same logic applies in both cases.
32. Furthermore, in its Energy Market Investigation Final Report, the CMA emphasised that *more* weight would need to be given to competition considerations when setting a wider default tariff cap than when setting a PPM cap. This was due to more limited ability for PPM customers to engage to exploit the benefits of competition than credit meter customers and the considerably larger share of the market covered by a wider cap. The CMA reasoned that:
 - There was “currently limited competition in the segments for on-smart prepayment customers and thus the marginal impact and thus the marginal impact of any disincentivisation [of customer engagement]....may be relatively small”³
 - The potential for adverse consequences on competition are higher when a larger group is affected.⁴
 - The impact on profitability is larger (although, as noted above, we believe the impact on profitability should be considered separately).
33. This not only further strengthens the rationale for headroom to be built into any default tariff cap, but – as the CMA itself recognised – also implies that more headroom will be

² Firms that cannot sustainably cover their cost of capital will exit the market in the long run. Efficient firms being able to cover their cost of capital is a key test for Ofgem in its duty to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

³ CMA Energy Market Investigation, Final Report, para 14.402.

⁴ CMA Energy Market Investigation, Final Report, para 14.19.

needed than the £30 permitted for the PPM price cap.⁵ We return to the question of how to determine the appropriate level of headroom later in the response document.

The irrelevance of the comparisons Ofgem draws with Northern Ireland and payday lending

34. In its working paper, Ofgem points to two examples of regulated markets where headroom is not included as a component of the price caps that are in place. However, neither of the examples are suitable comparators for the proposed Cap in the GB market. We consider each of these examples in turn.

Northern Ireland is not a suitable comparator

35. Northern Ireland does not provide a suitable comparison to assess the level of headroom to include in the Cap.
36. Domestic retail gas markets in Northern Ireland are characterised by either being a monopoly or duopoly depending on location.⁶ In those areas where there is choice for customers between suppliers, competition is very limited with quarterly switching rates of 0.1% of customers.⁷
37. The retail electricity market in Northern Ireland does have multiple suppliers and domestic consumers are free to choose their supplier. However, retail price regulation in Northern Ireland does not place a cap on the price of any tariff type within the market as a whole. Retail price regulation only applies to Power NI.
38. As the former incumbent with a domestic market share of 58.7% of customers,⁸ Power NI is not only subject to price caps but it is also subject to other pricing restrictions that prevent it from competing for customers in the same way as new suppliers. Power NI is prohibited from offering discounts to separate customer groups and so cannot offer specific acquisition tariffs in the manner that other suppliers in the market can.
39. Other suppliers within the market can and do offer tariffs priced both above and below those offered by Power NI. This means that price differentials within the NI market as a whole are not constrained by the regulation of Power NI's prices.
40. This is clearly a markedly different situation to that proposed for the GB market where a single cap would apply to all suppliers and capped suppliers would still be free to price under the Cap.

⁵ £30 headroom was included in the PPM cap as sated at the medium TDCV at the time of setting the price cap. This was 3,200kWh per year for single rate electricity and 13,500kWh per year for gas. Headroom is included in the cap as a percentage. Ofgem has since updated TDCV levels and the headroom allowed at new medium TDCV is lower than £30.

⁶ <https://www.uregni.gov.uk/sites/uregni/files/media-files/2018-02-28%20Transparency%20Report%202017%20Q4%20Final.pdf>

⁷ Ibid

⁸ Ibid

Payday lending is not a suitable comparator

41. Payday loans are also entirely unsuitable as a comparison. Unlike the proposed energy price cap, the FCA designed the price cap with full acceptance that it would reduce access to payday lending for high-cost customers.
42. The payday loan cap was not a cost-based price control which was designed to improve competition and availability. On the contrary, the FCA regulated knowing many payday lenders would leave the market entirely as a result of the price cap. It was comfortable with this outcome because it found that consumers would benefit from reduced access to such loans.⁹
43. Nothing could be further from the case in relation to energy. Undermining competition in the retail energy market would be profoundly damaging to consumers. Effective competition is central to delivering customers choice in the way their energy is supplied, as it is key to encouraging innovation in a sector that is developing rapidly. Furthermore, loss of market participants (as occurred in the payday loan sector following the introduction of a cap in that sector) would undermine the Government's own policy objectives of achieving the conditions for effective competition. Overly simplistic comparisons to an entirely unrelated sector are unhelpful, not credible and potentially seriously damaging.
44. Furthermore, even leaving aside all of these points, the way in which the payday loan cap was constructed means the concept of "headroom" simply did not apply. The level of the different components of the cap were not set to align to lenders' actual costs
 - The 0.8% interest and fees per day cap was chosen in the knowledge that this would make some high-risk (and therefore high-cost) customers unprofitable to serve.
 - When setting the level of the default fee cap, the FCA explicitly stated that "the relationship with firms' costs is not the most important factor when considering the appropriate degree of protection for consumers from excessive default charges".¹⁰
 - The total cap (where total costs must not exceed 100% of the amount borrowed) was again not based directly on an analysis of lenders' costs, and was selected partially for its simplicity.
45. Given the intention of the payday lending cap was never to act as a benchmark of efficient costs, it is meaningless to consider the extent to which it incorporates "headroom" over such costs.

Comments on Ofgem's analysis plan to inform thinking on headroom

46. In section 4 of the working paper Ofgem gives an overview of the areas of analysis that it is considering undertaking to inform the level of headroom to include in the default tariff cap. The comments that we provide below set out our views on:
 - the inadequacy of some of the approaches Ofgem suggests;

⁹ <https://www.fca.org.uk/publication/policy/ps14-16.pdf> p16

¹⁰ Ibid.

- the approaches that we believe Ofgem should be adopting;
 - the readily available evidence that Ofgem should take into account; and
 - the conclusions that can be drawn from the evidence.
47. We structure our comments by addressing each of the four impact areas highlighted by Ofgem (i.e. customer bills, supplier revenue/profitability, customer engagement and supplier incentives) in turn.

Analysis: impact on customer bills

48. The approach that Ofgem has suggested to assessing the impact on customer bills is not appropriate. Ofgem has stated that it intends to adopt the methodology set out in Annex B of the Financial protections for vulnerable consumers: Technical document.¹¹ This approach would involve a purely static assessment of the impact on consumer bills that focuses only on those customers within scope of the tariff cap. In the short term this is unsatisfactory because constraining default tariffs is likely to also affect the non-default tariffs offered in the market. In the medium and longer term this is unsatisfactory because it does not account for the dynamic benefits of competition that will be lost if headroom is set too low.
49. We set out our concerns about the methodology in more detail for each time frame below.

Short-term inadequacy of the ‘Annex B’ methodology

50. The expected value of a new customer relationship is influenced by both the net margin earned on an acquisition tariff and the value of the ongoing customer relationship.
51. Some acquisition tariffs that are currently offered by other suppliers in the market would not be sustainable if the default tariff cap were too tight. These tariffs rely on the expected lifetime value of a customer relationship to the acquiring suppliers to justify very low or negative margins earned from joining customers in the first year.
52. Ofgem’s proposed methodology for assessing the impact of the default price cap on customer bills only takes into account those customers in the scope of the cap. Whilst this approach may approximate the short term bill savings for those consumers in the scope of the cap this will overstate the total bill savings in the market. This is because some of the acquisition tariffs that are currently on offer will be raised in price or removed from the market because the longer term value of a customer relationship that they rely on will have been eroded.
53. In order to sufficiently assess the impact of a default tariff price cap on bills even in a single period Ofgem should take account of the knock-on effects that the cap will have on those customers who are out of scope of the Cap.

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https://www.ofgem.gov.uk/system/files/docs/2017/10/financial_protections_for_vulnerable_consumers_-_technical_document.pdf

Medium- and long-term inadequacy of the 'Annex B' methodology

54. The static nature of the assessment that Ofgem proposes will overstate the benefits of bill savings to consumers because it does not take into account the dynamic impact that competition has on efficiency.
55. Competitive markets are crucial to delivering dynamic efficiency savings and increasing consumer choice. Competitive markets provide the right incentives for firms to continuously seek to reduce their costs and improve their product offering in order to win customers. The form of static analysis that Ofgem is proposing implicitly assumes that the difference between uncapped prices and those implied by the price cap will stay constant over a number of future periods. This is inappropriate because under a price cap, competition will be weakened and some of the dynamic efficiency benefits from competition will be lost.
56. The introduction of the price cap will lead to the loss of some competition due to the "safe haven effect" even in scenarios with significant headroom. The safe haven effect will mean that some consumers will stop looking for better energy deals because they believe themselves to be protected by the price regulation. As part of its assessment of the PPM price cap, the CMA recognised "*the risk... that some customers may feel they benefit sufficiently from the price cap such that there is no need to investigate alternative tariffs in the market.*"¹² and the possibility that customers could even "lose the habit" of switching after the price cap expired¹³. The CMA justified the risk of widespread disengagement on the grounds that there was limited competition to begin with in the non-smart PPM segment.¹⁴ Given the greater levels of competition that exist outside the non-smart PPM segment, Ofgem will need to place greater weight on these effects.
57. In addition to the safe haven effect reducing competition, if insufficient headroom is allowed this will further reduce competition and dynamic efficiency benefits. Whereas if sufficient headroom is included to maintain competition in the market then some of the dynamic efficiency benefits can still be achieved.
58. To suitably assess the impact of the price cap and the level of headroom on consumer bills over multiple years, Ofgem must include within its assessment the impact of foregone dynamic efficiencies.

Analysis: impact on supplier revenue / profitability

59. Headroom should be included within the cap to allow space for competition and should not be used to offset risks arising from inaccuracies and approximations in the design of the cap. Any such limitations must be addressed directly as part of the determination of the costs of an efficient supplier.
60. Any analysis of profitability that Ofgem conducts should be based on the level of the cap before headroom is added – and not as a part of the headroom setting exercise.
61. The specific approach that should be adopted to assess the impact of the price cap on supplier revenue and profitability will depend on the methodology that Ofgem takes to determining the costs of an efficient supplier. However, whatever the specific approach

¹² CMA Energy Market Investigation Final Report Para 14.401

¹³ CMA Energy Market Investigation Final Report Para 14.404

¹⁴ CMA Energy Market Investigation Final Report Para 14.402

taken, Ofgem must consider the different impacts the price cap has on different types of efficient suppliers. This means that differences in the composition of suppliers' customer bases must be taken into consideration.

62. In practice, this has two implications.

- Any analysis of the impact of the price cap on supplier profitability should ensure that efficient suppliers with a high proportion of customers in scope of the cap (such as those that may offer only a single tariff) are able to make sufficient profits to cover their cost of capital. A clear precedent for this is provided by the analysis that the CMA undertook to assess whether Utilita (a supplier with a high proportion of customers in scope of the PPM cap) could make a reasonable return under the PPM cap.¹⁵
- Any analysis should also ensure that suppliers who have a high proportion of customers with higher costs to serve are able to make a reasonable rate of return under the cap. Some customers, including some with vulnerable characteristics, may need additional support which increases efficient costs to serve relative to an average customer. As higher cost to serve customers are not evenly distributed between suppliers Ofgem should ensure that as part of its profitability analysis it considers the impact on profitability for those firms with higher than average efficient costs due to the characteristics of their customer bases.

Analysis: impact on consumer engagement

63. The impact on consumer engagement – together with the knock-on impact on supplier incentives – is essential to the question of the appropriate level of headroom to include in the price cap.

64. Consumer engagement is responsive to the price differentials within the market and there is a wide body of evidence to demonstrate this. Below we group our analysis of this body of evidence into three subsections – namely:

- Survey evidence on GB domestic energy customer preferences
- Evidence based on observed customer behaviour in GB
- International evidence.

65. This evidence consistently points to the following overall conclusions:

- Once price differentials fall below around £200, further reductions are likely to lead to material reductions in switching rates.
- Price differentials well in excess of £100 are needed to incentivise the majority of customers to engage in the market in a way that will support effective competition.

66. Taken collectively, this evidence clearly indicates that headroom must be set at a level that is capable of supporting market price differentials well in excess of £100. Failure to

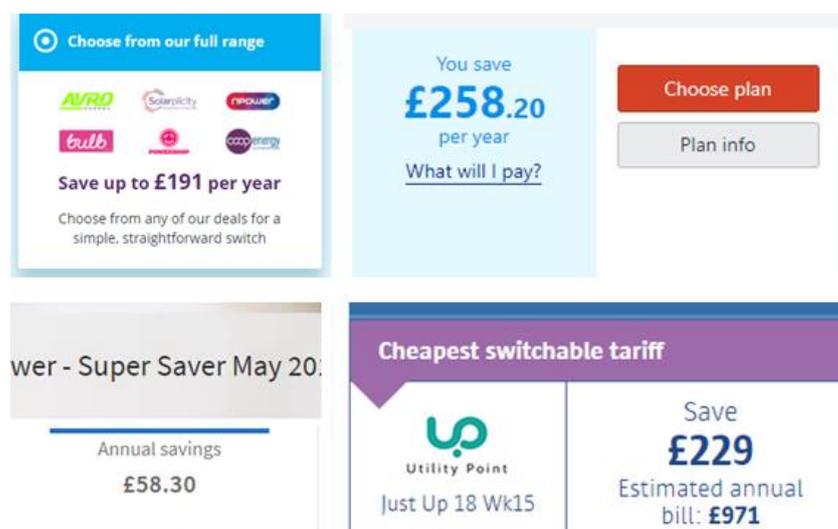
¹⁵ See CMA Energy Market Investigation Final Report 14.264

allow this level of price dispersion would lead to widespread customer disengagement and destroy the conditions necessary to support effective competition.

A. Survey evidence on GB domestic energy customer preferences

67. The most direct way to gauge the price differential required for customers to switch is to ask them directly. There is a wide body of detailed survey evidence focusing on this precise question, including surveys commissioned by both Ofgem and the CMA.
68. As indicated in the working paper, customers' stated preferences do not always align with their actual behaviour. However, as discussed in the following sections, observed behaviour is entirely consistent with the result of the surveys, and appropriately framed surveys that are consistent with actual behaviour can still provide important insights on customer decisions.
69. In 2015, as part of the Energy Market investigation, the CMA commissioned GfK NOP to conduct and analyse a survey to understand (amongst other things) the drivers of domestic customer engagement in the market. Telephone interviews were conducted with 6,999 domestic mains gas and mains electricity customers. The survey covered various aspects of consumer engagement such as the decision to search for and switch supplier, the role of price comparison websites and how behaviours vary by customer characteristics.
70. The framing of the survey (which asked customers for their minimum annual saving required in order to switch) is very similar to the language used by price comparison websites. These websites invariably express savings as an annual figure, as shown in Figure 1 below (clockwise from top-left: MoneySupermarket, uSwitch, Confused.com, and Comparethemarket.com).

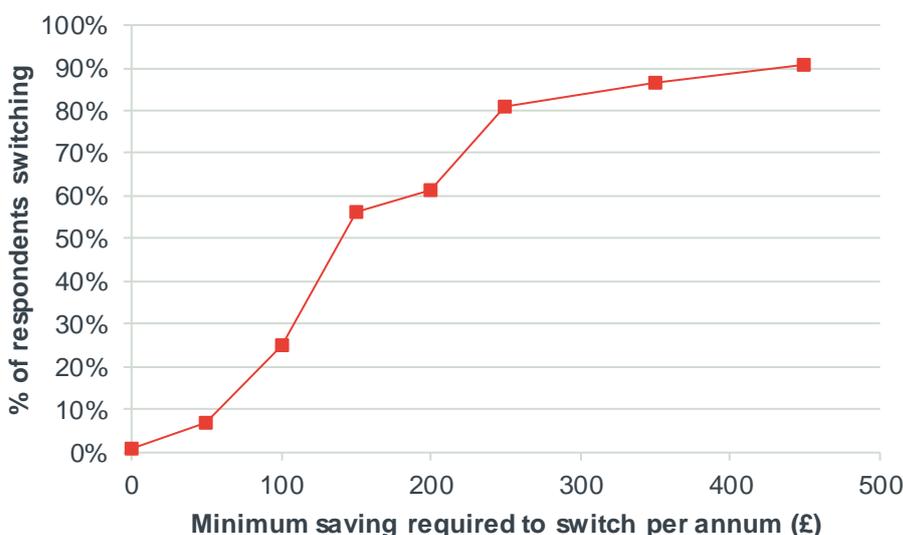
Figure 1. Examples of prompts used on price comparison websites



71. The survey confirmed that tariff price differentials were an important driver of customer engagement. Cost/tariff was the most frequently cited factor in responses to questions related to the decision to switch supplier.

72. The survey also went on to ask respondents who knew it was possible to switch (or were not sure) what minimum amount of savings required to encourage them to switch supplier.¹⁶ The mean required saving reported by survey respondents was £158 per annum.
73. We can use this evidence to plot the relationship between price differentials and customer engagement. This is shown in the graph below. The graph suggests, for example, that a price differential of approximately £100 per annum would be sufficient to incentivise 25% of customers¹⁷ to consider switching, but the remaining 75% of customers would have no incentive to do so.

Figure 2 Results from CMA survey - Minimum saving required to encourage respondents to switch energy supplier



74. The graph points to the following conclusions:
- **Once price differentials fall below around £200, further reductions are likely to lead to material reductions in customer engagement.**
 - If the price differential were to fall below about **£150**, about **half** of customers would disengage from the market.
 - If the price differential were to fall below about **£100** the **large majority** of customers would disengage from the market.
 - **Price savings well in excess of £100 are therefore required to incentivise the majority of customers to engage in the market and consider switching.**
75. Ofgem itself has also asked similar questions since 2014 as part of its customer engagement surveys. As with all the evidence we have summarised, these showed a clear relationship between price differentials and switching. However, the mean required

¹⁶ The respondents who answered this question made up 99% of the total sample.

¹⁷ Specifically, 25% of the 99% of all customers who knew (or were not sure) that it was possible to switch.

saving (£283 per annum in the 2016 survey)¹⁸ is considerably higher than the £158 reported in the CMA's survey. In contrast to the CMA's survey, these surveys appear to show considerable gains in terms of increased switching from increased price differentials as high as £400 and above.

76. In these surveys, consumers were allowed to specify a minimum saving using any time period that was intuitive to them, whether weekly, monthly or annually. In contrast, the CMA specified that the consumers had to estimate the minimum saving required on a yearly basis. We consider that this difference in framing may explain the differences in responses (expressed on a weekly or monthly basis, it is plausible that the same annual saving may appear small to consumers).
77. These surveys nonetheless add to the large body of evidence that greater price differentials lead to greater levels of switching, up to a point beyond which the effects diminish.

B. Evidence based on observed customer behaviour in GB

78. As explained in the working paper, observed consumer behaviour also provides useful evidence for the impact of price differentials on consumer engagement in the market. Customer behaviour can be considered in two respects; evidence from observing the behaviour of individual customers, and evidence from aggregate market level data. We also consider what evidence can be gleaned from the experience of the PPM cap since it came into force.

i. Customer level data

79. The CMOL trial, undertaken on behalf of Ofgem by British Gas and another supplier, demonstrates the effect of varying price differentials on customer switching.
80. ✂ It is clear that higher levels of savings lead to greater levels of switching. However, this is most pronounced for levels of savings below around £200: savings greater than £200 did not (on average) prompt further switching. This trial therefore suggests that **any reduction in price differentials below £200 would be expected to materially reduce rates of switching.**

Figure 3. Proportion of customers switching on CMOL trial, by potential saving

✂

ii. Market level data

81. It might be expected that it would be difficult to discern a relationship between price differentials and customer switching behaviour from time-series market-level switching data for a number of reasons.
- First, the propensity of consumers to switch will be affected by a wide variety of unobserved effects, which will create noise that obscures the relationship between

¹⁸ The 2017 survey did not directly ask for the minimum saving required for switching, but the responses received do still highlight how price savings are – by far – the greatest motivator of switching.

price differentials and switching. For example, as observed in analysis by KPMG,¹⁹ spikes in Google searches relating to switching are associated with government announcements or high-profile campaigns on energy prices that gain public attention. The two significant spikes in switching interest observed in September 2013 and February 2015 coincided respectively with Ed Miliband's pledge to freeze energy prices, and press coverage of the CMA's Energy Market Investigation.

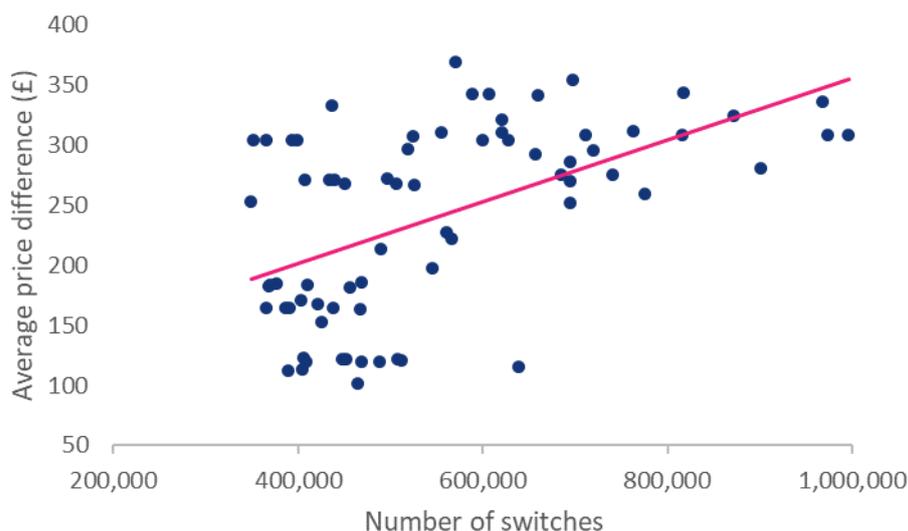
- In addition, the effect of price differentials on switching is likely to come with a delay – both due to the time taken for the switching process itself, but also because customers on fixed term contracts (which will be included within the switching data) may wait until the end of their contract to switch.
82. Despite these limitations with the data, a clear relationship between price differentials and switching is visible in monthly data at the aggregate market level.
83. Figure 4 plots price differentials since 2012 (measured in terms of the difference between the average SVT and the cheapest tariff, as reported in Ofgem's Retail Market Indicators)²⁰ against the monthly number of switches.²¹ While we have chosen 2012 as a starting point since this is when the Ofgem price data begins, we consider that this time period is appropriate since:
- It is long enough to provide significant variation in the level of the differential (which is required to detect any relationship between price spreads and switching); but
 - it avoids structural changes in the energy market from before 2012 which would lead to a bias in the results.

¹⁹ <https://home.kpmg.com/content/dam/kpmg/uk/pdf/2017/07/what-would-a-price-cap-mean-for-the-energy-market.pdf>

²⁰ These indicators are calculated on the basis of a dual fuel customer paying by direct debit, with consumption at the medium TDCV. Newer TDCVs have been applied from February 2017, and we have confirmed that the result is the same if the figures prior to this are adjusted to take this into account. The same relationship is also apparent when comparing the average SVT to the cheapest tariff "basket" measure.

²¹ BEIS Quarterly Domestic Energy Switching Statistics:
<https://www.gov.uk/government/statistical-data-sets/quarterly-domestic-energy-switching-statistics>

Figure 4. Relationship between the average price difference and actual switching behaviour (January 2012 - December 2017)



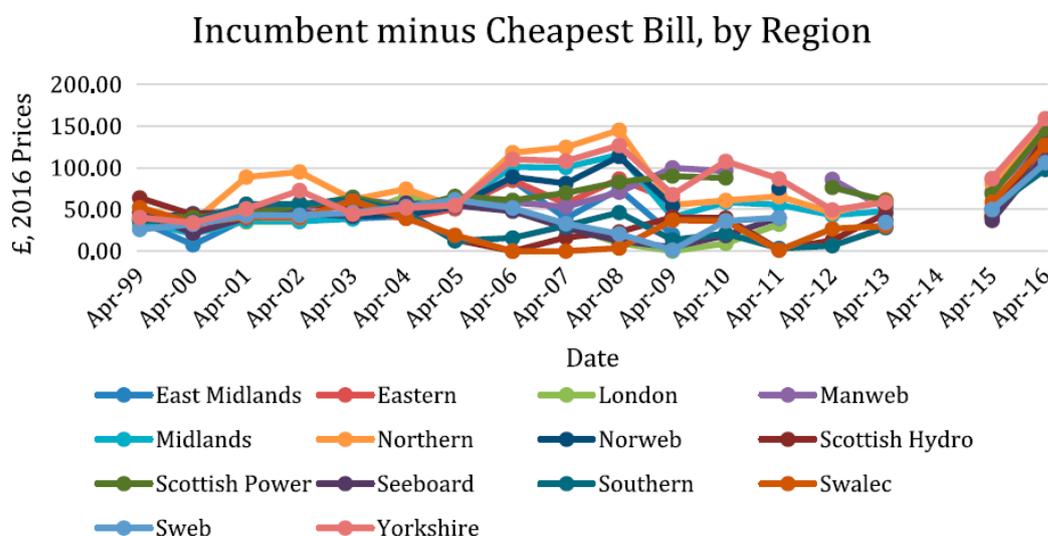
84. The relationship in the graph is positive: the greater the potential savings for consumers, the more likely they are to switch energy suppliers. The graph also suggests – like the CMOL analysis – that there is a threshold level of price differential below which customer engagement significantly worsens.
- For the 27 months with price differentials below £200, the number of switches is below 600,000 for all but one month, where it slightly exceeds it.
 - For the 45 months with price differentials above £200, the number of monthly switches covers a far wider range, up to around 1m switches per month. For price spreads of this level, even the mean monthly switches (618,511) exceeds 600,000.
85. We also note that in the data that we have analysed there are virtually no reported instances of price differentials of under £100 for the market as a whole.
86. This analysis relates to the spread between the average SVT and the cheapest available tariff. In practice, the price spreads considered by many individual customers may be lower than this (for example, the switching rates take into account switching by customers on fixed-term contracts, who would likely observe lower available price differentials). This analysis is therefore entirely consistent with the results from CMOL and the CMA survey, which suggests that **customers became increasingly less likely to switch for savings below £200.**
87. Our findings differ from the analysis by Citizens Advice²² which concludes that there is no clear relationship between savings and switching rates. We believe that this is due to the Citizens Advice analysis considering a longer time period (back as far as 2007), during which the market operated in a fundamentally different way. The conclusions presented by Citizens Advice appear to be driven by a high-switching / low-dispersion

²² Citizens Advice Written Evidence to the Domestic Gas and Electricity (Tariff Cap) Bill Committee <https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-consultation-responses/written-evidence-to-the-public-bill-committee-on-the-domestic-gas-and-electricity-tariff-cap-bill/>

cluster of months in the period between 2007 and 2012, which can be explained by shifts in how the energy retail market has operated.

- Prior to 2012, energy suppliers carried out extensive doorstep selling campaigns. Such selling practices may have driven higher volumes of switching in the absence of large price differentials (indeed, one of the criticisms made at the time was that customers were being pressured to switch despite there not being savings from doing so).
- Prior to the introduction of SLC 25A in 2009, some switching will have been driven by price differentials within regions, which national price figures will not capture. Figure 5 below, taken from a recent paper by Catherine Waddams,²³ illustrates the higher price differentials for electricity bills²⁴ within some regions for the period 2006 to 2008. By contrast, the increase in price differentials seen more recently are the result of new entrants across all regions. As new entrants have no “home” region, their prices are less likely to show regional variations. The national price spreads will therefore reflect the price spreads available within each region much more than they did in the period 2006-2008.

Figure 5. Regional price differentials for electricity bills



Source: Waddams Price (2018)

88. The CMA’s Final Report made the same observations, noting that both the implementation of SLC 25A and the decision to stop doorstep selling led to a decline in switching.²⁵

²³ Catherine Waddams Price (2018) Back to the Future? Regulating Residential Energy Markets, International Journal of the Economics of Business, 25:1, 147-155

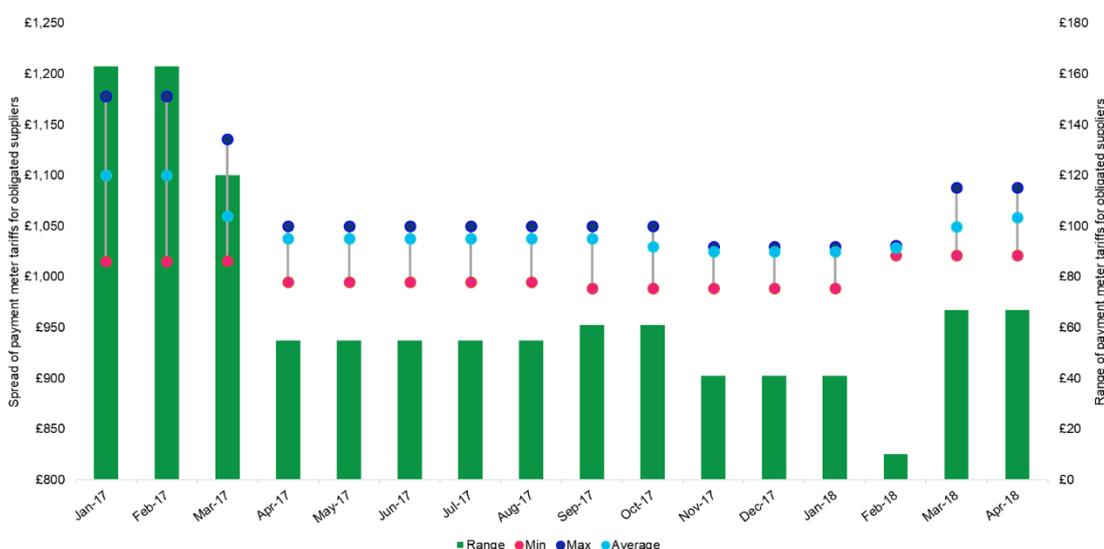
²⁴ This graph shows bills for a customer consuming 3,300kWh per year, paying by standard credit, and in 2016 prices.

²⁵ CMA Energy Market Investigation final report, para 8.142

iii. Evidence from the PPM cap

- 89. Another potential source of evidence is the prepayment tariff cap. Before the imposition of the cap, the price differentials in the PPM market were still considerably lower than those observed today in the credit market.²⁶ Despite this, the cap has significantly reduced differentials and, as a result, switching.
- 90. The graph below shows the range of available PPM tariffs for each month since January 2017, after stripping out the tariffs of suppliers who have a built-in cost advantage because they are partially or fully exempt from the social and environmental obligations that act on larger suppliers.²⁷ Since suppliers will offer tariffs for fulfilment up to 30 days in the future, the effect of the price cap appears in March 2017. Price differentials across obligated suppliers substantially fell from around £160 to less than £70.

Figure 6: Range of tariffs available to PPM customers, excluding non-obligated suppliers



- 91. Even adding back in the tariffs of non-obligated suppliers, these figures would still differ from those presented by Citizens Advice in their written evidence to the Domestic Gas and Electricity (Tariff Cap) Bill Committee.²⁸ Without further information on the source of the data used in that paper, it is difficult for us to reconcile the analysis presented there to the data available from uSwitch. However, we note that:

- Independent analysis conducted by Cornwall also indicates a fall in the PPM price differential from nearly £200 in the year to March 2017, to nearly £75 in the year to March 2018.²⁹ The monthly price differentials calculated by Cornwall are also in line

²⁶ Around £200, compared to the £315 differential between average SVT and cheapest tariff currently reported for standard credit customers in Ofgem’s February 2018 Retail Market Indicators.

²⁷ Based on uSwitch data, and calculated at the medium TDCV. We have excluded suppliers which do not provide energy to all regions, green tariffs, and tariffs which appear to exceed the cap (although doing so does not materially affect the results).

²⁸

[https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/Citizens%20Advice%20-%20Written%20evidence%20to%20Domestic%20Gas%20and%20Electricity%20\(Tariff%20Cap\)%20Bill%20Committee.pdf](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Energy%20Consultation%20responses/Citizens%20Advice%20-%20Written%20evidence%20to%20Domestic%20Gas%20and%20Electricity%20(Tariff%20Cap)%20Bill%20Committee.pdf)

²⁹ Cornwall Insight, Energy Spectrum 612, 9 April 2018

with the pattern shown above.

- Even if a supplier was offering a tariff priced lower than those reported by uSwitch, the fact that it was not visible on uSwitch suggests that it would not be apparent to a large segment of the market.
 - Despite the apparent drop in the price of the cheapest tariff in that analysis (from roughly £975 in September 2017 to £850 in October 2017), the median price appears unchanged, and extremely close to the maximum price. This suggests that the result may be being driven by an extremely small number of outliers.
92. Despite the noise inherent in market-level switching data, British Gas's own data suggests that this reduction in price differentials has already led to reduced levels of switching. ✂

Figure 7. Relative numbers of PPM and Credit customers leaving British Gas

✂

93. As shown in the graph above, rates of PPM churn appear to still be falling, and may not represent the long-run level that may result from the PPM price cap.

C. International evidence

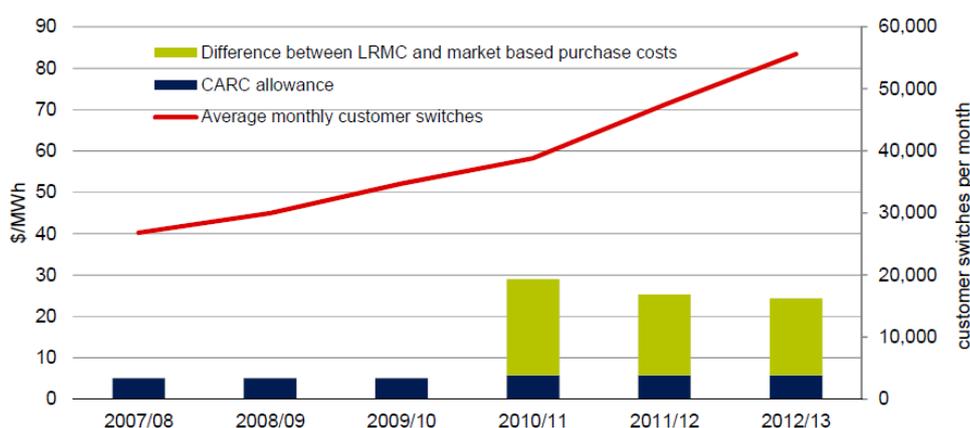
94. When considering international evidence on the impact of price caps on consumer engagement it is necessary to be mindful of the differences in circumstances between the example used and the proposed default tariff cap in GB.
95. The application of a price control to a sector which is already competitive (as opposed to natural monopolies, or sectors undergoing the process of liberalisation) is unusual. There are therefore few precedents to draw upon. For example, as stated above, the price control for Northern Ireland energy retail is not comparable, since, it only applies to the incumbent.
96. Below we consider the case of retail price controls in Australia and the evidence and lessons that Ofgem can take from their experiences.
97. A number of states in Australia used retail price controls as part of the move towards fully competitive markets. Although the different circumstances mean direct comparisons cannot be made to GB, the experience of the states' regulators in imposing different levels of headroom demonstrates the way in which switching is driven by price differentials, and can be affected detrimentally by price controls with low levels of headroom.
98. Most state regulators in Australia set (or, in the case of states which have now fully liberalised, formerly set) a price allowance which can be split into a retail operating cost (ROC) component, and a customer acquisition and retention cost (CARC) component. While the ROC allowance is set to reflect the efficient costs of operating an electricity retail business, the CARC is set to reflect the efficient costs incurred by new entrants of attracting and securing a customer base. This component is headroom above the level of efficient costs, and reflects the costs of facilitating competition.
99. The existence of multiple levels of headroom across different Australian states enabled the Australian Energy Market Commission to judge the effect of headroom levels on

competition. In its 2013 Advice on best practice retail price methodology, based on a comparison of regulatory regimes between states, it stated:

“Practical experience in Australia has shown that those markets that have included some form of headroom have developed competition, while those that do not have headroom have not.”³⁰

100. Similar evidence can be seen from the experience of different Australian states through time. For example, as part of its determination for 2013 – 2016, IPART (the regulator in New South Wales) carried out a “top-down” exercise where it compared historic levels of competitive activity (measured in terms of switching volumes) to the margin of the regulated tariff margin above efficient costs (IPART judged this margin to have increased from approximately \$5/MWh in the 2007 determination period to between \$24 and \$29 in the 2010 determination period). A summary of the analysis is shown, in Figure 8, showing the headroom (the element of allowed margins above efficient cost) over time, alongside switching levels. IPART concluded that it *“...suggests there is a clear relationship between these incentives and the level of competition in the market.”³¹*

Figure 8. Relationship between the margin above efficient costs and switching in New South Wales



Source: IPART (2013)

101. The varying experiences in Australia therefore demonstrate the way in which lower levels of headroom are associated with lower levels of switching and can detrimentally impact competition.

Analysis: impact on supplier incentives

102. Together with the impact on customer engagement, the impact on supplier incentives is critical to the question of the appropriate level of headroom to include in the price cap.
103. The introduction of a default tariff cap with too little headroom to support customer engagement will have a material impact on the incentives of suppliers in the market including the incentive to remain in the market and compete for customers. It will also

³⁰ <https://www.aemc.gov.au/sites/default/files/content/c03a2033-192c-440a-a83b-75f92644212c/Final-Report.pdf> p74

³¹ IPART (2013), Review of regulated retail prices and charges for electricity p113

disincentivise further market entry. This is because widespread customer disengagement will make it hard to compete effectively for new business.

104. There is already evidence available of price caps and the threat of price caps having an effect in the GB market. Below we highlight the relevant recent evidence on the impact of price caps on energy suppliers and then set out how Ofgem should assess the impact of the decision on headroom on suppliers' incentives in the energy market.

Recent market evidence for the impact of a price cap on supplier incentives

105. Recent market exit by two challenger suppliers illustrates the impact that an inappropriately tight cap with too little headroom can have on supplier engagement.
106. Toto Energy decided to exit the PPM market by transferring all its PPM customers to Utilita to focus on market segments without price regulation. Shortly after Toto announced its exit of the PPM market segment Flow Energy announced that it intended to exit the retail energy market entirely through a sale of the business to Co-op Energy that valued the equity holdings at zero.
107. In its statement to the market Flowgroup PLC specifically cited price caps and the likely reduction in price differentials and customer switching as one of the reasons it was deciding to sell out.³² In the same statement Flowgroup PLC also revealed that *"it had taken a view that the Group should maintain a total number of customer fuel accounts of just under 250,000, a level above which regulatory payments by Flow Energy would increase significantly."*
108. Finally, whilst Ofgem assert that *"early analysis of suppliers who supply primarily PPM customers show that they are continuing to grow at a similar rate to prior to the PPM cap"*³³ this is not borne out by the available evidence. In their recent publication, Cornwall Insight review the PPM cap one year on from implementation. In this they highlight that the four specialist PPM suppliers (Utilita, Economy Energy, Spark and E Gas and Power) have continued to grow but at a rate that is 25% less than in the period before the PPM cap introduction.³⁴

How Ofgem should assess impacts on supplier incentives.

109. In order to maintain incentives for suppliers to participate and compete in the market, it is vital that Ofgem allows sufficient headroom to encourage consumer switching. As set out in the previous section the price differential that we consider to be consistent with maintaining consumer switching incentives is around £200.
110. Ofgem should carefully assess the level of price differentials in the market that it expects a given level of headroom to be able to support. Depending on the pricing behaviour of suppliers and the space that Ofgem leaves for variation in service quality below the basic level of the cap, market differentials of £200 may be sustainable with headroom of less than £200.

³² <http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/FLOW/13598218.html>

³³ Ofgem, Working paper ~3: approach to headroom. Para 4.14

³⁴ Cornwall Insight, Energy Spectrum 612, 9 April 2018

Annex: legal considerations

111. This Annex deals with legal points arising specifically in relation to working paper 3 (WP3). It should be read in conjunction with the other submissions Centrica has made to Ofgem including ~~3~~. In this Annex, we deal particularly with the following issues:

- **Process issues:** we have serious concerns about the current consultation process
- **Ofgem's likely duties in setting any tariff cap:** headroom is not optional
- **Timing:** whatever the Bill (or the government) says, Ofgem may not take shortcuts
- **Sufficient enquiry:** Ofgem needs to gather enough evidence for it to make its own decisions. The current process suggests it will fall short.

Process Issues

112. The time allowed for responses to WP3 was extremely short and the response period overlapped with that for working papers 2, 4 and 5. The issues covered by WP3 are important and we have not been able to do them full justice in the time available. We also note that the working paper itself was very short and does not analyse the issues in any depth.

113. This is not a favourable environment for regulatory decision-making. It flies in the face of regulatory best practice. It is likely to lead to decisions which are flawed.

114. A later formal policy consultation, as mooted in paragraph 1.1 of the WP, will not fix this, as by that stage policy avenues explored earlier on may well be closed off and Ofgem's decision largely formed. Having decided to consult at this stage, Ofgem must ensure that the consultation is a proper one, in conformity with the requirements of fairness as developed in the case-law.³⁵ As Ofgem will be aware, it must consult when its proposals are still at a formative stage; must include sufficient reasons for its proposals to allow those consulted to give intelligent consideration and an intelligent response; adequate time must be given for this purpose; and Ofgem must take conscientious account of the responses received from stakeholders.³⁶

Ofgem's likely duties in setting any tariff cap

115. Ofgem sets out four matters it must have regard to when setting the default tariff cap, which are derived from the Bill currently before Parliament:

- The need to create incentives for suppliers to improve their efficiency;
- The need to enable effective competition between suppliers;
- The need to maintain incentives for domestic customers to switch;
- The need to ensure that efficient suppliers can finance their supply activities.

116. Ofgem also emphasises that the design of the approach to headroom should consider

³⁵ See *R. (Easyjet Airline Co Ltd) v Civil Aviation Authority* [2008] EWCA Civ 755.

³⁶ See *R. v. North and East Devon H.A., ex p. Coughlan* [2001] QB 213 (CA), per Lord Woolf MR, giving judgment for the Court, at [108].

- The fact that the cap needs to be introduced “as soon as practicable”.
 - The intended (time limited) lifespan of the cap
117. As noted in the main body of the response, allowing headroom is an effective requirement of the Bill. The Bill requires 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 supply contracts”; and
 - “the need to maintain incentives for domestic customers to switch to different domestic supply contracts”.
118. It is therefore incumbent on Ofgem to set out its views on the level of consumer engagement and switching that it believes should exist in the market with a cap on all default tariffs (i.e. the meaning of Ofgem’s obligation under the Bill to “maintain incentives for domestic customers to switch”), and then to determine the level of headroom that is required to deliver that outcome.
119. We are therefore concerned to find that Ofgem believes it is optional to include sufficient headroom for competition (e.g. “We are considering whether headroom is necessary to support the legislative framework”).
120. It is also clear that the obligation on Ofgem to “maintain” incentives for switching means that Ofgem is under an obligation to ensure that those incentives do not fall to levels below the status quo. Ofgem has not provided any evidence to demonstrate that it will be able to meet this obligation.
121. Ofgem makes a further error when it notes that:
- “It could also be argued that in designing the cap to meet the Bill objectives our regard for competition and switching should be focussed on fixed tariffs, and that therefore the default tariff cap should be set at the lowest possible level that does not unduly impact competition in fixed tariffs” (WP3, para 3.6).*
122. In fact, the legal duty on Ofgem is to have regard to enabling “holders of supply licences to compete effectively for domestic supply contracts” – i.e. domestic supply contracts generally. Further, whilst clause 1(6) of the Bill (and the Bill more generally) focus on customers that are on default tariffs, it is important to bear in mind that Ofgem’s principal objective is to protect the interests of existing and future consumers, as a whole³⁷ - which will include considering the switching incentives of customers on both default and fixed tariffs. Ofgem cannot simply ignore a significant part of the market (given the proportion of customers on SVTs) and still purport to be complying with its duties.
123. In summary, Ofgem cannot proceed as if any decision to allow an appropriate level of headroom on supplying SVT customers is simply a “concession” to suppliers.

³⁷ Electricity Act 1989 section 3A / Gas Act 1986 section 4AA.

Timing issues

124. We are also concerned about the implications of Ofgem's comments about timescales:

125. The need for the cap to be introduced "as soon as practicable" does not give Ofgem an excuse to cut corners in terms of thoroughgoing evidence gathering and analysis:

- Setting an inappropriately low level of headroom could severely damage competition across the whole domestic retail market. This would contravene Ofgem's statutory obligations.
- In this context, "as soon as practicable" is a direction to Ofgem to devote sufficient resources to ensuring it undertakes a meaningful and rigorous consultation and decision-making process. It does not imply (as Ofgem seems to suggest) that either the *process* or the *substantive decision* Ofgem must reach on the design of the cap may be any less rigorous or informed than they would otherwise need to be.

126. WP3 raises a separate concern. Ofgem appears to imply that it is not just the text of the Bill, *but also Government's political expectations*, which should influence the design of the cap:

"When introducing the Bill, the Government stated that it intends Ofgem to be able to set the tariff cap by the end of this year. We must therefore design it in a way which is proportionate and that allows us to implement it quickly" (WP3, para 2.2).

127. This is legally wrong and concerning for two reasons. First, the Government's "expectations" when introducing a Bill to Parliament are not law, and have no role to play in Ofgem determining its legal duties and the considerations it should have regard to when designing the price cap. Secondly, Ofgem is required as a matter of EU law to act as an independent regulatory authority and as a matter of public administrative law not to act beholden to any third party including the Government. It is anathema to these requirements for Ofgem to make a decision about the price cap design, influenced by political considerations which find no place in the law. Ofgem may not act on a "political expectation" that a control should be in place by the end of this year. This would be a breach of the Natural Gas and the Electricity Directives. We expect Ofgem to publicly correct this position in writing at the next opportunity.

Ofgem's duty to undertake sufficient enquiry

128. The area of headroom is an incredibly important issue in terms of practical impacts on competition and the importance given to it in the bill.

129. The WP3 gives little indication that Ofgem has begun to gather evidence yet and indeed, Ofgem appears to complain that "we have received little evidence in this area to date" (WP3, para 4.4) and that "suppliers did not provide supporting evidence" (WP3, para 4.14). As Ofgem will be aware, it is under the 'duty of sufficient inquiry' which requires it to take reasonable steps to acquaint itself with relevant material – and that is particularly

the case where the Bill raises related issues (such as competition and incentives to switch) as mandatory considerations. At paragraph 3.5 of WP3, Ofgem sets out that:

“Without headroom, it could be argued that suppliers would still compete with each other. Suppliers with lower operating costs could offer lower prices in order to attract engaged consumers. This switching would incentivise more costly suppliers to reduce their costs in order to maintain their customer base. In its investigation, the CMA estimated that a substantial proportion of consumer detriment was attributable to operating costs that were higher than necessary, rather than ‘excess’ profits”

130. We are concerned with Ofgem’s reliance on this view, given that the CMA provided no real evidence to support its view; and – in any event – decided against imposing a price cap in the way proposed by the Bill. Given the importance of this issue, it is not sufficient for Ofgem to merely rely on the CMA’s conclusions on this. The Tameside Duty³⁸, as set out by Lord Diplock, explains that:

“the question for the court is, did the [decision-maker] ask himself the right question and take reasonable steps to acquaint himself with the relevant information to enable him to answer it correctly?”

131. A failure by Ofgem to acquaint itself with the relevant information so as to enable itself to answer the question would leave itself open to a claim for breach of this common law duty.
132. We note, in this respect, that Ofgem is separately requesting information from suppliers. However, we are concerned about how Ofgem could credibly and meaningfully consult on this issue in May if it is only starting to consider evidence gathering and analysis. As Ofgem will be aware, the public law requirements for consultation require that stakeholders are given adequate information about Ofgem’s proposals, the evidence base to support the proposals, and its underlying reasoning, to respond in an intelligent and informed way. We are concerned that WP3 illustrates that a substantial amount of further work is required of Ofgem before a legally sound consultation can take place.
133. We would question whether the “basic understanding” of the impact of the price cap on supplier incentives, referred to in Ofgem’s analysis plan, would enable Ofgem to be confident that it was maintaining incentives for domestic customers to switch, as required by the Bill.
134. More generally: it will clearly not be possible for Ofgem to fulfil its duties under the Bill – whatever they are, if and when the Bill becomes law – if it has not properly understood the facts. It will clearly not be enough, for example, to make references to suppositions made by the CMA. Ofgem must gather whatever evidence is necessary for it to make its own decisions.

³⁸ Secretary of State for Education and Science v Tameside Metropolitan Borough Council [1977] AC 1014, paragraph 1065B