Introduction

A price cap on default tariffs has been in place since 1 January 2019. Default tariffs are those that a customer has not actively chosen. Around three quarters of households, 22 million, are now covered by the cap. This figure has rapidly increased from 15 million in August 2021, as there have been no cheaper fixed deals on offer during that period.

The price cap is currently set at £1,277/year for the typical household but is expected to increase sharply to around £2,000 when it is next revised (on 7 February, to take effect from 1 April to 30 September). Early forecasts suggest that the cap for the Winter 2022/23 period may be higher still, and that the cap may remain high during the Summer 2023 period too.

We have proposed a range of measures to help consumers who are struggling with their energy bills, which are summarised here. This briefing note focuses on current Ofgem proposals for short or long term reform to the price cap.

Issues with the price cap

The price cap has been blamed by some for many energy suppliers failing in recent months. We do not think that it was the primary cause of these failures as many suppliers lacked the financial resilience to get through the level of volatility we have seen, with or without a price cap. Many were lightly capitalised, often with few signs of external funding and an apparent dependence on credit balances to provide their working capital. Few were profitable or had any reasonable prospect of becoming so, and a failure to hedge properly left some very exposed when high wholesale prices arrived in Autumn 2021.

But the crisis has highlighted that the price cap was not designed with the expectation that it could ever be the cheapest deal on the market. That it has become so has created a volume risk for suppliers. Suppliers are serving more default tariff customers than they expected to, but cannot purchase energy for those customers at the historical prices that are used to set the price cap. It has also been suggested that there is a risk that once cheaper deals become available again that suppliers may see large losses as consumers switch away from default tariffs, leaving suppliers with expensive hedges they no longer need. It is very hard to quantify how material that risk is.

Ofgem has set out a range of short term and longer term interventions to try and address these risks.

Possible short term interventions

Ofgem has consulted on three possible time-limited emergency interventions that it could put in place for this April's price cap.

The three proposals are:

1. To require suppliers to make all their tariffs available to existing customers; and/or
2. Introducing exit fees on default tariffs; or

3. Introducing a market stabilisation charge under which if a customer changes supplier their new supplier would have to pay compensation to their old one.

All three proposals are motivated by a desire to reduce the risk that suppliers face big losses if there is a big boom in switching once cheaper deals become available again, although it is very hard to gauge how material that risk is. Ofgem is worried that a large, rapid switch away from default tariffs could undermine the financial stability of the sector as suppliers might have to take large losses relating to the wholesale positions that they hedged for those customers.

We support Ofgem's proposal to require that suppliers make all their tariffs available to existing customers. We think it should be considered as a permanent intervention, not simply a temporary one. We don't agree that it would discourage switching and think that opening up the potential for more internal switching options could improve choice and outcomes for consumers. Internal switching options are likely to be particularly valuable at a time when many consumers have recently been burnt by the experience of switching suppliers to one who failed. This proposal may also help vulnerable customers who face structural barriers to switching externally.

We oppose the introduction of exit fees. They would discourage switching, particularly among lower income customers. At a time when bills are hitting record levels, it is important that customers aren't discouraged from shopping around.

We do not support the introduction of a market stabilisation charge either, although we think it is preferable to the introduction of exit fees if Ofgem wished to pursue one of those two options. Market stabilisation charges would be likely to reduce the benefits of switching. However they may be less of a deterrent to switching than exit fees as they would not be seen upfront by the consumer.

For a more detailed exploration of our views on these proposals, please see our consultation response.

Ofgem is due to make a decision on whether or not to introduce one of these short term measures on 4 February. Its consultation suggested it would prefer to avoid implementing any of them if possible. There is currently little indication that fixed deals will undercut the price cap any time soon, which may reduce the pressure to take any of these ideas further.

Possible longer term interventions

Ofgem has also consulted on a range of longer term interventions to reform the price cap.

Its three proposals are:

1. Allowing it to adjust the price cap if necessitated by extreme circumstances (described as 'Enhanced Status Quo'); or
2. Setting the price cap quarterly (rather than every six months); or
3. Introducing fixed term default tariffs with exit fees

We do not support its proposal to allow it to reset the price cap in extreme circumstances. The criteria that would trigger a reset are not clear and are likely to be very hard to define. It also appears likely that any trigger would only take place after suppliers have already hedged their position for the affected price cap period. Suppliers won't be able to change those past decisions and this approach creates a risk of windfall gains and losses.

We support the proposal to set the price cap quarterly. This may result in consumers seeing slightly more volatile prices, and there may be additional costs associated with more frequently updating tariffs. However it should reduce the systemic risk associated with delays in the price cap reflecting current wholesale market conditions. Given that consumers ultimately pay for that systemic risk, for example through footing the bill for failed suppliers, we think that there is a reasonable case that the benefits will outweigh the costs.

We do not support the introduction of fixed term default tariffs with exit fees. The introduction of exit fees for default tariffs would discourage switching. Consumers may see it as unfair that they pay a different price to their neighbour simply because their fixed terms start on different dates, or that they face default charges on default tariffs when these are not always charged on fixed deals..

For a more detailed exploration of our views on these proposals, please see our consultation response.

Ofgem has indicated that any longer term reforms to the price cap might take effect from October 2022, with further consultation to develop these reforms taking place in the spring or summer.