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Dear Price Cap team,

We are responding to your call for input paper on adapting the price cap methodology for resilience in volatile markets. This submission is non-confidential and may be published on your website.

We recognise that suppliers will be facing volume risks associated with having a higher than expected volume of their customer bases on default tariffs, as current market conditions mean that the price cap is undercutting the price of fixed term acquisition tariffs. That excess is likely to have grown over time as existing fixed term deals end and customers roll off those deals onto default tariffs. It is not clear whether this trend will end when the next price cap (for April to September 2022) is put in place, e.g. whether it will cease to be priced at a discount to acquisition deals from that point. The behaviour of consumers once cheaper deals become available is also unclear, e.g. whether there will be an explosion of switching driven by high prices and pent up demand, or more of a cautious 'wait and see' attitude driven by wariness of locking in prices that may be at a market peak, or a feeling of having been 'burnt' by previous switches to suppliers who failed.

At the same time, while there are uncertainties around future volume risks, there are reasons to believe that the cost consequences of that risk may diminish with the next revision to the price cap. It is commonly agreed that the current cap does not reflect the cost of taking on new customers on default tariffs today, as a result of the use of lagged wholesale price data not reflecting current market conditions. With the price cap likely to leap to around £1,900/year in the spring, it appears likely to have either partially or wholly caught up to reflect sustained higher wholesale prices. This will materially deflate the consequences of any inaccuracy in volume forecasting.

Of the three primary options for reform you set out, we think that only the proposal to move to quarterly revision to the cap is credible, and that there are significant issues with the other two proposals. The proposal to introduce exit fees on default tariffs is particularly problematic and is not something that should be taken further.

Option 1) Enhanced Status Quo

Under this option, you would retain the existing price cap methodology, but with an enhanced ability for Ofgem to adjust the price cap in extreme circumstances.

You have already partially consulted on this option, in your November consultation on the process for updating the default tariff cap. In our response, we suggested that there were two major deficiencies in this approach. Firstly, that the criteria you were suggesting for re-opening the cap were wholly subjective and that this would result in significant uncertainty on if, when and how the powers would be used. Secondly, that the proposals would inherently have retrospective effect, as they could only be triggered after suppliers had already made their hedging decisions for the affected period.

In this consultation, you have put forward proposals that might address the first of these concerns. You set out that *'A stronger version of [the November proposals] could potentially be introduced with criteria specified in advance (eg, a specified gap between the SVT and market prices, in either direction) that would trigger a change in the price cap level. Such a 'circuit breaker' would provide market participants with greater certainty and could potentially enable the price cap level to be changed more quickly.'* We would question whether this is a stronger proposal, as the setting of defined criteria would appear likely to constrain the use of reopening powers when compared to the less bounded predecessor proposals. But insofar as the criteria for reopeners are specific and known in advance it would appear much more likely to provide certainty to stakeholders on when these powers would be used than the predecessor proposals do. In this regard, this option is an improvement on that previous proposal.

You would still however need to define what those objective criteria are. This may be very difficult - how does one empirically define the point at which something changes from a 'normal' situation to a 'crisis'? Working out robust criteria will be very difficult and we would suggest that you commit to a subsequent review if you proceed with this proposal in order to allow them to be refined by experience.

The problem of this proposal having retrospective effect remains. Prudent suppliers are likely to have largely hedged in advance in line with the price cap methodology (indeed, this was the conclusion of the British Gas et al vs GEMA judicial review). So the majority of their volumes should already be locked in at the prices prevailing at that time. Changing the reference window within the price cap period itself will not alter those past purchases but may simply expose suppliers to a windfall gain and consumers to a windfall loss (or vice versa, depending on whether the reopener

trigger has been prompted by a rising or falling market) as they are suddenly allowed more or less money than their actual purchase costs.

Where there is more of a case for automatic reopeners is in relation to shaping costs, which are likely to be incurred in short term markets rather than hedged in advance. It is not clear what aspects of the price cap you would see as being subject to automatic reopening under this model. If you decide to take this proposal forward, we would welcome greater clarity on that point.

Finally, because you are trying to reduce volume risk, it would be important that any reopeners set under this approach take into account whether or not changes in the cap level will materially impact on incentives to switch. In and of itself, a change in the level of the price cap may not alter switching incentives provided there are still cheaper deals out there. Where the volume risk is likely to emerge is if there are no cheaper deals out there. So any reopener should consider price spreads in the retail market, and not simply wholesale price conditions.

Option 2: Quarterly cap

This is the most attractive of the three options you are consulting on.

It would expose consumers to more volatility in retail energy prices, sometimes to their benefit, sometimes to their detriment. The impact of any future crisis would be felt by households more quickly, although they would also see the end of the crisis more quickly too. It would also be likely to create some additional industry costs resulting from increased volume of customer notifications and contact points, which would be passed on to consumers. Noting that the price cap is a ceiling and not a target, there may be scope for suppliers to mitigate some of these costs by not altering default tariff pricing between quarters if the change in the level of the cap is small. More frequent adjustments may result in more costs being incurred by Ofgem, though we would hope that the relatively mechanical process of recalculating the price cap would mean these are limited. The behavioural impact on consumer switching behaviour is hard to judge. More frequent price changes could result in more nudges to switch, and there is some evidence that price change notifications have prompted engagement. Conversely, there may be some risk of 'nudge fatigue' if there is a perception that prices are continually changing. If more frequent price changes were to have the effect of smoothing out large increases or falls in prices this could reduce the incentive effect of price notifications

You have not provided any estimation of any likely impact on suppliers' cost to serve, and we think it is important that these are understood and factored into any decision on whether to go ahead with this model. But we recognise that the costs associated with the current crisis are huge, ultimately fall on consumers, and have

severely tested the financial resilience of the sector. We therefore think it is likely that the benefits of moving to more frequent recalculation of the price cap will exceed the costs.

Option 3) Fixed term default tariffs

Under this option, you propose that default tariffs would be replaced by 6 month fixed term tariffs, with exit fees of an unspecified level.

There are multiple issues with this approach, of which the biggest is the introduction of exit fees on default tariffs. Default tariffs, by definition, are ones the consumer has not chosen, and many are currently on defaults only as a result of losing a deal they had chosen and moving via the Supplier of Last Resort process. Ordinarily - absent the current crisis - they are more expensive than the deals offered to consumers who switch. Making it harder, and more expensive, for consumers who are already on the worst tariffs to switch, is not consistent with protecting their interests. It is likely to discourage switching, dulling competition and innovation in the process. These negative impacts are likely to be higher the greater the exit fee is, and this should be taken into account when setting the level of such a fee, if this proposal is taken forward.

They are also likely to be a more significant barrier to switching for households on lower incomes, who we know can already be put off switching due to the need to pay a final bill and sometimes make a payment in advance to the new supplier, and may as a result be trapped paying higher prices. While Ofgem suggests that gaining suppliers may be willing to pay the exit fee, we're concerned this is not likely to be offered to certain customers, such as those who pay by standard credit or prepayment, or who manage their accounts offline. In our recent report, Market Meltdown, we highlighted that some suppliers are already taking steps, which appear to be in breach of Ofgem rules, to avoid serving certain groups of customers.

A secondary, but potentially substantive issue with this approach is that it may be perceived by consumers to be unfair that different default tariff consumers pay different prices depending on when their fixed term default tariff starts. While this may be cost reflective, it may be hard to convince a consumer that it is fair that they are paying several hundred pounds more or less than their neighbour simply because their fixed term started on a different date, when neither of them chose that date or tariff. Similarly, some suppliers choose not to levy exit fees on their fixed term acquisition tariffs, and it would seem clearly unfair if customers on default tariffs face these fees while those on acquisition deals with the same supplier do not.

In our view, the introduction of exit fees on default tariffs would be one of the most significant interventions ever made to the GB retail energy market. Its effects could be profound. Much fuller analysis would be needed to fully assess its potential implications on consumers. This should include analysis of the potential benefit to customers on default tariffs from lower costs, and how this may vary depending on different levels of exit fee levied on these products.

Other proposals raised in the call for input

Your call for input highlights a number of other possible interventions that you are ruling out at this stage. We are in agreement that they should not be taken forward at this time.

We note from discussions with market participants that there may be some industry support for the introduction of some form of relative price cap. In the interests of transparency, it may be useful for us to briefly set out our reasoning for why we do not currently support such a model.

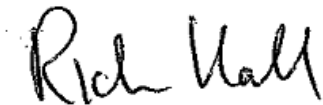
In the case of a relative price cap across suppliers there are multiple issues. Suppliers' pricing decisions would be tied to the cost base of their rivals, who may have very different costs to serve, or benefit from exemptions from policy costs that make like-for-like comparison inappropriate. The price of reference tariffs may not represent a sustainable price, noting that suppliers may price below cost in order to gain market share. There are risks of unintended consequences if suppliers with bad business models get their tariffs in the reference price basket, as others may feel compelled to try and copy their approaches given their prices are now tied together. The monthly approach considered would significantly reduce volume risk, but may result in supplier costs associated with potentially having to reprice default tariffs, notify and engage with customers to the same frequency. Monthly repricing notifications could prompt higher consumer engagement, or simply result in 'nudge fatigue' - it is very hard to tell.

In the case of a relative price cap within suppliers, in our view there are significant risks associated with the potential to inflate the cost of acquisition deals. A supplier who may have millions of ongoing customers, but who may only pick up tens of thousands of new ones with a market leading tariff, will find offering that deal extremely costly if it means they need to drag down the price of their default tariff to do so. In our view, a relative price cap is more likely to drag acquisition prices up than to drag default prices down. These risks are reduced the wider the allowed price spread is, but that may come at the cost of failing to protect consumers (e.g. if the spread is so wide that it has no meaningful effect on pricing). There are some risks that consumers with expensive suppliers may interpret a relative price capped

tariff as meaning they are not paying more than they need to, when actually significant savings might be available if they switched to a lower cost supplier.

With either model there are significant definitional challenges. These include how wide you set the cap, and what tariffs they apply to. For example, are all customers tariffs tied to each other, or is it split out into separate pots eg for different payment methods? If it is split out into different pots, is there enough competition within all of those pots to protect all customers? Is the price spread the same for all pots, and does it vary over time? One of the perceived benefits of relative price caps is that they are thought to be simple instruments, but in practice we think there are likely to be a lot of design issues that reduce that simplicity.

Yours sincerely

A handwritten signature in black ink that reads "Rich Hall". The signature is written in a cursive, slightly slanted style.

Richard Hall
Chief Energy Economist