3rd Floor North
200 Aldersgate Street
London EC1A 4HD
Tel: 03000 231 231

citizensadvice.org.uk

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Dear Neil,

We are responding to your consultation on medium term changes to the price cap methodology. This submission is non-confidential and may be published on your website.

Reducing the notice period of changes to the price cap period.

We are supportive in principle of your proposal to reduce the amount of notice given to suppliers of changes to the level of the price cap from two months to one month. This should reduce the risk to suppliers that the wholesale prices used to set the level of the cap deviate materially from those prevailing in the market. In turn, this should reduce costs to consumers, noting that they ultimately bear both the costs of capital of ongoing suppliers and the costs of failure where suppliers go bust. Given the scale of these costs, we are persuaded that the benefits of this measure would outweigh its disadvantages.

The reduction in this notice period will compress the amount of time that suppliers have to notify consumers that their prices are changing. This may have operational implications, with knock-on effects on consumer experience. For example, it may reduce the ability of suppliers to stagger notifications in order to manage demands on their call centres. It may also make it harder for households to budget, particularly when prices are rising.

It will remain important that suppliers notify consumers promptly where their prices are changing, given the potential impact on both their ability to budget and to switch to avoid the price rise. It would not be appropriate for them to only receive a few days notice. By the time your proposals are implemented, the faster switching programme should have been implemented, which should reduce the amount of time consumers need to consider switching. However there is still potential for delay to that programme, and if it has not been fully implemented this compressed timeline will be much more challenging for consumers. With a shorter lag time between changes to the level of the cap being announced by Ofgem and taking effect, there may be tension between supplier interests, which may be best served by trying to spread out notifications as much as possible to smooth out consumer contacts, and consumer interests, which may be best served by having as much notice as possible so they can plan and act accordingly. Ofgem will need to closely monitor the situation to ensure that an appropriate balance is found. If consumers are not being given adequate notice, it should step in to protect their interests.

The 'strengthened status quo' option

The strengthened status quo option has three components: the reduction in the notice period for price cap changes; the introduction of a backwardation mechanism and the possibility of in-cap reviews in exceptional circumstances. The third of these three components has already been implemented by your 4 February 2022 decision. [1] The other two components are common to several of your proposals, and we discuss those components separately in this response.

The 'quarterly price cap' option

We remain of the view that moving to a quarterly price cap is the most attractive ('least worst') of the options on the table. This is primarily because it would materially reduce the risk of supplier failures, which are ultimately paid for by consumers. It should also reduce risks associated with market participation, which also pass through to consumers.

The increase in the frequency of tariff re-pricing may result in some industry costs associated with its delivery, for example, more frequent consumer contacts and the need to generate more correspondence. Noting that the cap is a ceiling, not a target, there may be scope for suppliers to mitigate these costs by not changing prices where changes in the level of the cap between two periods are small. Similarly, Ofgem may face higher costs though we would expect these to be quite limited, as the recalculation of the cap is a well-established process that should be relatively mechanical. Ofgem should seek to quantify its costs and those of industry in its decision making process.

The impacts on consumer outcomes are hard to judge. It would result in more volatility in consumer bills (for those on price capped tariffs), which may make it harder for households to budget. In a rising wholesale market, it would result in bills rising more quickly - though it would also result in them falling more quickly in a falling market.

The impact of more frequent price notifications on consumer behaviour, once switching options re-emerge, is hard to assess. There is historic evidence that significant changes to default tariff prices tend to prompt consumer switching, but this has been during periods where prices have changed either every six months

[1] 'Decision on the process for updating the Default Tariff Cap methodology and setting maximum charges,' Ofgem, 4 February 2022.

(under the price cap) or less frequently and irregularly during the pre-price cap period. It is hard to judge whether more frequent price changes would generate more consumer engagement, or simply result in 'nudge fatigue'. If more frequent re-pricing somewhat smoothes the scale of price rises/falls between price cap periods it could reduce the incentive effect of notifications.

We think a quarterly cap may appear to be fairer to consumers than the fixed term default tariffs option, given that the latter could result in two consumers in similar circumstances facing very different prices simply because their tariffs started on different dates. We note however, that this perception has not been tested with the public. If time allows, there may be value in your commissioning research to test consumers' likely reaction to either this or the fixed term default tariffs option.

'Fixed term default tariffs' option

We welcome your removal of the proposal to include exit fees under this option. Their removal makes this option more attractive than it was previously, although we still consider the quarterly cap approach to be preferable. At the working meeting that Ofgem convened with consumer groups on 2 March 2022, it was clarified that you were looking for thoughts specifically on the 12 month contract option, and we have focused our comments on that option below. We think that this option is worse than 'do nothing' and should not be considered for implementation.

This approach would appear to largely remove the issue of backwardation, but would significantly increase volume risk compared to the status quo. With default tariffs being set for 12 months, compared to the current price cap of 6 months, there is significantly more potential for wholesale prices to deviate from the allowance made for them in fixed term contracts. In the case of a rising wholesale market that should be unproblematic for suppliers as consumers would be likely to stick with those contracts, but in the case of a falling one there is likely to be a heightened risk that suppliers would face significant - and higher than the status quo - windfall losses as a result of consumers switching away from the default tariff to cheaper deals. This option would appear to increase the risk of supplier failure, not reduce it, resulting in higher costs to consumers.

In discussions with suppliers, it appears that in some cases they may be relying on the Market Stabilisation Charge ('MSC') as the means to mitigate those risks, if this option were adopted. This view appears to be predicated on one or both of the following assumptions proving true: that any huge drop in wholesale prices will occur during the temporary life expectancy of the MSC (due to end March 2023, if Ofgem takes the option to extend it by 6 months); and/or that the MSC will be made a permanent measure.

To rely on the first of those two assumptions is a massive gamble. It is quite possible that wholesale prices will fall substantially before March 2023, but equally possible that they will not (or that they will fall in a staggered fashion over several years, partially inside and partially outside the coverage of the MSC). We would have serious concerns if the MSC were to become a permanent measure as it erodes the benefits of switching and has many of the characteristics of a tax on competition. Given the significantly increased level of volume risk inherent in them, we think the adoption of 12 month fixed term default tariffs may leave us on a slippery slope towards the permanent application of MSCs.

In addition to the significantly increased volume risk associated with 12 month default tariffs, there appear to be very difficult obstacles to its implementation, combined with a risk that consumers may perceive it to be unfair.

The unfairness issue arises because it would result in different consumers paying different prices depending on the given start date of their fixed term. Over the long run, these should even out, meaning that there is no disadvantage to being on, say, a September fix pattern rather than a March one. But in the short term, it may be hard to convince the public that it is fair that two households face very different prices simply because their fixes start on different dates - particularly if these dates are chosen for them, or appear arbitrary. If wholesale market prices were relatively stable this might not be much of an issue, as the difference between two fixes might be small. But currently they are not, and any sharp readjustment of the kind we have seen in the last few months could result in very different consumer outcomes driven by the allocation process. To put this issue in context, a 12 month fix struck in April 2021 would differ from one struck in January 2022 by around £2,000/year.

Your consultation document suggests that consumers stuck on an expensive default fix in a falling market could mitigate the detriment by switching to a cheaper deal, but this simply highlights the volume risk discussed previously. We acknowledge that the quarterly cap also comes with volume risks, but these are lesser given the much shorter duration.

A 'big bang' approach of all consumers moving onto fixed term default tariffs on the same date might remove the problem of a perceived 'calendar lottery', but does not appear likely to be practical. Feedback from suppliers, echoed in your consultation document, suggests that there may not be adequate liquidity in the wholesale markets to allow for suppliers to be hedging so much demand in such a short period. There may also be risks that it distorts the ability of generators and others to contract at other times of year.

The alternative of staggered allocation of different consumers to different start dates would appear to solve the liquidity problem but presents different difficulties. It is very hard to see how objective criteria could be developed to divide up consumers into different start dates. It also creates complicated transition issues from the current price cap as you would need to have transitional caps in place of varying durations to cover the period between the summer 2022 price cap ending and the 12 different monthly caps starting in 2023.

Other transition issues

You are considering implementing proposals this autumn. The observation window for the winter 2022/23 price cap started on 1 February, and suppliers will already be hedging their positions for that period in line with the price cap methodology.

We are worried that this means your proposals are likely to have retrospective effect, and that there may be cost implications for consumers (i.e. a need to compensate suppliers for any redundant costs) that flow from this. We would like to see Ofgem produce a fuller analysis of the impacts of transition, identifying any windfall gains or losses that may arise from this and how it will mitigate against them.

A new mechanism for managing backwardation costs

Our preferred approach here is for you to do nothing.

As you highlight in the consultation, backwardation and contango costs should broadly even out over time. You calculate a net figure of less than £1/customer resulting from all the price cap periods up to Summer 2021. While you included an additional allowance for backwardation in price cap period 8, to reflect additional costs incurred in price cap period 7, this was only £8 - despite the markets being in turmoil.

Given the limited scale of these figures - even in extreme circumstances - we are not convinced that a case has been made that a methodological adjustment is necessary.

Yours sincerely

Rich Hall

Richard Hall
Chief Energy Economist