

Written evidence submitted by Citizens Advice (DGEB12)

Domestic Gas and Electricity (Tariff Cap) Bill Committee

1. About Citizens Advice

1.1 Citizens Advice has statutory responsibilities under the Consumers, Estate Agents and Redress Act 2007 to represent consumers' interests in the energy sector.

2. Executive summary

2.1 We support the introduction of a price cap on all default tariffs.

2.2 The form of the price cap should be absolute, not relative. An absolute cap would provide more certainty that all default tariff prices would be constrained, with less chance of unintended consequences than a relative cap.

3. Submission

The need for a price cap

3.1 The Competition and Market Authority's (CMA) recent investigation of the energy market found that consumers were paying an average of £1.4 billion a year more than they would under an effectively functioning market. This situation was deteriorating year on year.¹ Just over half of this figure, £750 million, related to inefficiency with the remainder relating to excess profits.

3.2 It found that the Big 6 energy suppliers 'enjoy a position of unilateral market power over their inactive customer base and have the ability to exploit such a position through pricing their standard variable tariffs materially above a level that can be justified by cost differences from their non-standard tariffs.'²

3.3 This position of power comes at a significant cost to consumers. The average Big 6 default tariff is more than £300 a year more expensive than the cheapest tariffs on the market. This premium has broadened markedly over time, increasing the detriment of disengaged consumers. Most consumers are disengaged. 56% of consumers told the CMA that they had never switched, did not know if it was possible, or did not know if they had done so.³ Ofgem estimates that 58% of consumers have never switched, or have only switched once.⁴

¹ The headline £1.4bn figure was the average of the four years 2012-2015 inclusive. By 2015, the annual detriment had reached £2bn.

² Paragraph 156, 'Energy market investigation: final report,' CMA, June 2016. <https://tinyurl.com/j3ye89l>

³ 'Appendix 9.1 CMA domestic customer survey results,' CMA, June 2016. <https://tinyurl.com/gr9vw5v>

⁴ 'State of the energy market 2017,' Ofgem, October 2017. <https://tinyurl.com/y6udhws9>

3.4 Vulnerable consumers are particularly badly affected. The elderly, the disabled, those on low incomes, renters, those in rural areas, the unemployed and those who left education early, are all less likely to switch than the average.⁵ Those in the lowest income deciles spend a much higher proportion of their income on energy than those in the highest income deciles.⁶

3.5 Our advice to consumers has always been to regularly shop around for a better tariff to reduce their cost of energy. That will remain the case even in a world of price caps, as the best deals on the market should continue to be much cheaper than the capped default tariffs. But, in recognition of how entrenched consumer disengagement is in this market, we think it is necessary for the prices of default tariffs to be capped to mitigate the detriment that those consumers - the majority of households - are facing.

Impact of the cap on customer engagement and switching

3.6 We used to have regulated retail energy prices in Great Britain and still have them in Northern Ireland, and can learn from these experiences. We can also use data to explore the extent to which switching rates may change if the spread of deals on the market is more constrained as a result of a price cap.

Before and after price caps in Great Britain

3.7 In Great Britain, a consumer's right to switch energy supplier was phased in on a region-by-region basis between 1996 and 1999. The former incumbents were initially subject to retail price caps, reflecting that they were starting from a position of 100% market share. The cap on electricity direct debit prices was removed in April 2000, and the remaining price caps were removed in April 2002. The department for Business, Energy and Industrial Strategy's (BEIS) records of switching rates only go back as far as January 2003, but we can find evidence of earlier switching rates in two National Audit Office (NAO) reports, 'Giving domestic customers a choice of electricity supplier,' (January 2001)⁷ and 'Giving customers a choice - the introduction of competition into the domestic gas market,' (May 1999).⁸

3.8 Both of these reports reflect favourably on the level of switching being experienced under price caps. The electricity report reflects that 'by June 2000, 6.5m customers, one in four, had exercised their choice to change their electricity supplier, and every month 400,000 customers were changing electricity supplier.' The gas report reflects that 'since the introduction of competition began in April 1996 over four million customers have changed supplier - more than 20 per cent of all customers.' The NAO does not convert

⁵ See both the CMA domestic customer survey and Ofgem's 2017 State of the Market report. Links in prior footnotes.

⁶ In 2015, energy accounted for 9.7% of total household expenditure for those in the bottom income decile but only 2.9% for those in the top income decile. 'Energy spend as a % of total household expenditure,' Ofgem.

<https://tinyurl.com/y96cfjpy>

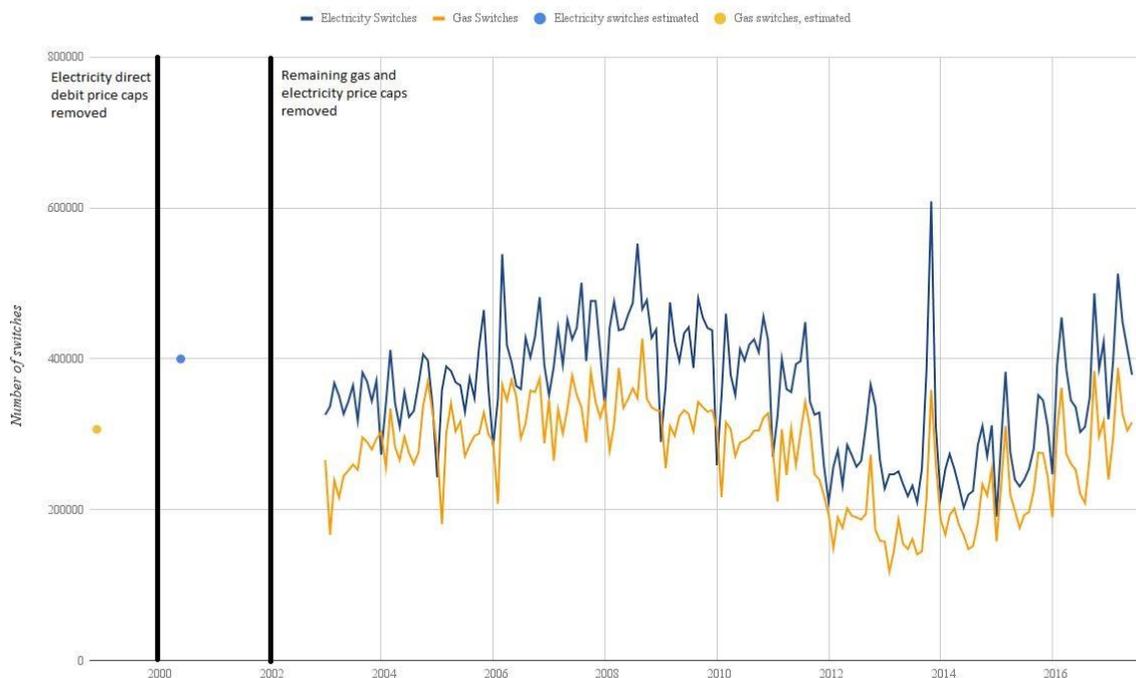
⁷ 'Giving domestic customers a choice of electricity supplier,' NAO, January 2001. <http://tinyurl.com/z6yush3>

⁸ 'Giving customers a choice - the introduction of competition into the domestic gas market,' NAO, May 1999. <http://tinyurl.com/j667o2n>

this to a monthly figure, but if we assume a flat switching rate in the period after market opening in April 1996 to the 4 million households who had switched by January 1999, after weighting to account of the regional phasing in of the right to switch, we can infer a national switching rate of about 300,000 customers per month.

3.9 According to BEIS data, in the average number of GB households who switched each month in the last 12 months for which data is currently available (October 2016 - September 2017 inclusive) was around 420,000 households for electricity, and around 330,000 for gas.⁹ So current switching rates, and those that existed during the period where GB retail energy prices were capped, are very similar. Figure 1 shows the GB switching rates for the period 1999-2017, including two data points reflecting the NAO's pre 2003 findings.

Figure 1 - Monthly domestic switching rates for electricity & gas, 1999 - 2017



Northern Ireland

3.10 In Northern Ireland, the electricity supply market is dominated by the former monopoly, Power NI. Power NI retains a 61% market share, and is required to comply with an absolute price cap by the Utility Regulator for Northern Ireland (UREGNI). This cap determines the 'maximum price [...] that domestic consumers of Power NI could pay for their electricity'¹⁰ and is subject to periodic revision to reflect movements in underlying costs.

3.11 UREGNI allows for Power NI to make a 2.2% profit margin under the cap. This is

⁹ 'Quarterly domestic energy switching statistics,' BEIS, 21 December 2017. <http://tinyurl.com/o2ux9mb>

¹⁰ 'Supply price controls and regulated tariffs,' UREGNI, November 2017. <http://tinyurl.com/yaavbkba>

higher than the 1.25% that the CMA considered would be a reasonable for an energy supplier in its 2014-16 (GB) Energy Market Investigation,¹¹ but is considerably lower than the average 4.5% margin that the Big 6 made in 2016 in Great Britain.¹² It should be noted that the 4.5% GB figure aggregates lower margin acquisition tariffs and higher margin SVTs and will therefore under-report the average profitability of GB SVTs.¹³

3.12 In the last full year for which data is available for both, 2016, the domestic switching rate for electricity in both Northern Ireland and Great Britain was identical at 15.8%.¹⁴ Partial data for 2017 suggests the electricity switching rate for that year may turn out to be higher in Great Britain than in Northern Ireland, but only by a couple of percent.¹⁵

3.13 Electricity consumers in Northern Ireland enjoy lower prices than in Great Britain, with the Consumer Council for Northern Ireland reporting in October 2017 that the average prepayment meter consumer pays 12% less, £484/year compared to £542/year at the same consumption level.¹⁶

Price spreads within GB over time

3.14 One of the arguments that has been used against price caps is that constraining the amount that a consumer can save from shopping around would discourage switching. Because consumers have had the right to switch for many years, and the amount they could save has varied considerably over that period, we can explore the relationship between achievable savings and switching rates.

3.15 Figure 2 shows the relationship between the monthly switching rate (horizontal axis) and the spread of deals on the market (vertical axis) over the last decade. The spread is defined as the price difference between the average Big 6 SVT and the cheapest fix¹⁷ being offered by any of the largest ten suppliers (the Big 6 plus Ovo, First Utility, Co-operative Energy and Utility Warehouse) at average consumption levels. Each data point is taken on the first Monday of the calendar month. The number of switches is taken from BEIS' records of monthly electricity and gas switches.

¹¹ See paragraph 10.29, 'Energy Market Investigation: Final Report,' CMA, June 2016. <http://tinyurl.com/j3ye89l>

¹² 'State of the energy market 2017,' Ofgem, 31 October 2017. <http://tinyurl.com/y6udhws9>

¹³ In its 'State of the energy market 2017' report (ibid), Ofgem notes that in 2016, after deducting direct costs, a higher proportion of SVT revenue (26%) than fixed tariff revenue (14%) was left to cover the Big 6 suppliers' operating costs.

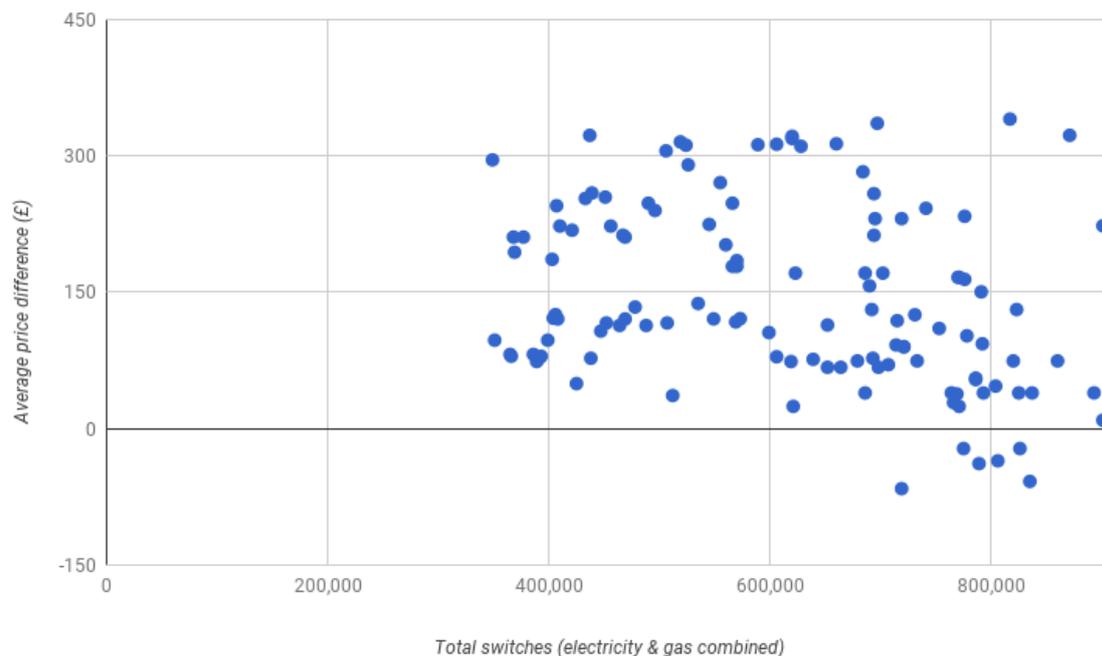
¹⁴ See Table 10: Electricity market switching activity in 'Retail Market Monitoring: quarterly transparency report,' UREGNI, February 2017. <http://tinyurl.com/yaym6l47>

¹⁵ At the time of writing, the last four quarters for which electricity switching data is available for both Northern Ireland and Great Britain are Q4 2016 - Q3 2017 inclusive. It shows a 15.5% switching rate in NI and an 18% switching rate in GB. The source of the NI figure is its utility regulator, UREGNI. The source of the GB figure is BEIS.

¹⁶ 'NI household electricity market,' infographic published by the Consumer Council for Northern Ireland, 19 October 2017.

¹⁷ Long term fixes (those lasting for over 2 years) and exclusive deals that were not available to all consumers are excluded.

Figure 2 - the poor relationship between the amount that a consumer could save by switching and the actual switching rate, April 2007 - June 2017 inclusive.



3.16 Intuitively, one might perhaps expect to see the data points clustering around an implicit line of best fit running diagonally upwards from the point where the axes meet to the top right corner, eg indicating that the more people can save, the more they switch. In fact, no such relationship exists - there have been periods where high switching rates coincided with high savings or low switching rates coincided with low savings - but there have also been periods where high switching rates coincided with low savings or low switching rates coincided with high savings. There are even a number of months with a negative price spread, relating to the gas price bubble of 2008, where cheap fixes traded at a premium to default tariffs, when higher than normal levels of switching were manifest.¹⁸

3.17 No line of best fit is included in Figure 2 because it would be misleading to include one. The r-squared value of this data is 0.086, eg that there is no statistically meaningful relationship between the switching rate and the price spread.

3.18 For the avoidance of doubt, it is not our contention that it would be prudent to constrain the spread of deals on the market to zero; this would remove all price incentives to switch. However, we think the data demonstrates that switching rates could still be healthy with a much lower spread than we currently see.

Impact of legislation on market participants

3.19 It is unlikely that a price cap would materially impact on either networks or generation asset owners. Network revenues are guaranteed through periodic price

¹⁸ The six months with a negative spread were February 2008 to July 2008 inclusive.

controls signed off by the regulator, Ofgem, and we would expect it to treat these as a cost pass through item when the price cap is set and revised. In the generation sector, most participants receive at least some of their revenue through Government backed subsidies such as contracts for difference, Renewable Obligation Certificates or the capacity mechanism and there is no proposal that any of those instruments will change as a result of the Bill. The remainder of their revenue will be made through the wholesale market and the sale of balancing and other system services and, again, there is no proposal within the Bill that would change how these function or constrain the prices that generators can offer. The price cap will need to be periodically updated to reflect the evolution of wholesale prices, but should neither inflate nor deflate them.

3.20 Within the supplier community the picture is far more mixed. Implicitly, the reactions of market participants to the prospect of a price cap may reveal those who consider themselves to be winners or losers from such a proposal. There is no appetite for a broad price cap amongst the Big 6, with several highly publicly critical of the Bill. But among smaller and medium size suppliers, there is much more support. The majority of suppliers who responded to the BEIS Select Committee's pre-legislative scrutiny of the Bill supported the introduction of some form of price cap.

3.21 One market analyst, Lazarus Partnership Limited, explains the divergent views between the large incumbents and their smaller challengers thus:

'It is unusual for companies to argue for Government intervention to cap the prices they can charge customers, but on our analysis the Challengers are acting rationally. The Challengers generally have different business models to the Incumbents, models which are based on customer engagement. Their customer bases are far more likely to switch than those of the Incumbents and as such they cannot replicate the Incumbents' strategy of profiting from disengagement. In addition, the Incumbents' profitable disengaged customer base allows them to discount to win new customers, which hurts the Challengers. We expect the price cap to be the catalyst for major change in the domestic retail sector, with the Challengers' market share growth likely to accelerate...'¹⁹

3.22 Lazarus suggest that there are four core arguments why a price cap could reduce competition, but that there are weaknesses with each.

3.23 The first is the proposition that it is unfair to compare the large suppliers default prices with the cheapest deals in the market, because it would be financially unsustainable for challenger firms to continue to offer those cheap deals. If true, it might follow that setting a price cap significantly below the current default tariffs of the Big 6 would jeopardise the financial viability of the retail supply sector. While noting that many suppliers have not been in the sector for long enough to judge their financial strength, Lazarus notes that four of the five largest challenger suppliers were profitable in either their most recent half yearly results, or their most recent yearly results. We additionally note that the prepayment meter (PPM) price cap, which the wider default tariff price cap may well be based on, was based on the CMA's analysis of the cost base of two mid tier suppliers (Ovo and First Utility) and designed to allow a supplier with a

¹⁹ 'Watt Matters - the curious case of caps and challengers,' Lazarus Partnership Limited, 2 November 2017.

similar cost base to be profitable. We further note that the support for a price cap from many challenger suppliers would be illogical if they considered it would threaten their businesses.

3.24 The second is that price caps will cause a bunching of tariffs, as those above the cap come down and those below rise towards it - an averaging towards the middle. But though some bunching has occurred since the introduction of the PPM price cap, this has generally been the result of expensive tariffs falling to the cap, rather than cheap tariffs being pulled. Far from causing inflation, *'on a dual fuel basis the movement [of prices] has been unequivocally down.'* Our own analysis (see Figure 3 in the section, 'Absolute cap') is consistent with that observation.

3.25 Thirdly, it is argued that the bunching effect will limit choice and deter switching. Lazarus notes that switching rates in Northern Ireland are similar to those in Great Britain, despite the former being subject to price caps. It suggests that concerns on limiting choice are valid, but also notes that the correlation between price and non-price factors in customer selection may be weaker than one might expect. For example, that while a consumer might in theory be willing to pay more for a higher quality service, that customer service is poorly correlated with price. Indeed, some of the suppliers with the highest customer service ratings are also amongst the cheapest. We make our own observations on the switching rate in Northern Ireland, and on the [lack of] correlation between price spreads and the switching rate in Great Britain, earlier in this submission.

3.26 Finally, it is argued that removing or reducing the profit from default tariffs will mean that suppliers are not able to offer a discount, leading to the loss of cheap deals on the market. But small and medium size suppliers typically have a far smaller proportion of their customers on default tariffs, and very few customers who have been on a default tariff with them for the long term. So the business models of challengers to the Big 6 do not appear to be predicated on using default tariffs to cross-subsidise cheap deals.

3.27 In the round, we think it is clear that the introduction of a price cap would have a disruptive effect on the domestic retail market, but not in a uniform way. The constraint on default tariff prices would disrupt the business model of the Big 6, reducing their ability to cross-subsidise their acquisition deals and forcing them to find efficiency savings. But smaller and mid-tier suppliers, whose business models are not based on customer inertia, may benefit from a removal or reduction in the ability of the Big 6 to heavily cross-subsidise their acquisition deals at the expense of their sticky customers, thereby reducing barriers to entry.

Absolute cap

3.28 We think that the form of the price cap should be absolute, not relative. An absolute cap would guarantee bill reductions in a way that a relative price cap could not. A relative price cap runs the risk of encouraging large incumbents to exit the acquisition market in order to maintain high default tariff prices, which would neither help switchers nor those stuck on poor value default tariffs.

3.29 An absolute price cap can be regarded as a 'price to beat'. Under this approach, the

regulator, Ofgem, would set, and periodically revise, a benchmark of the efficient cost to serve a typical customer based on its analysis of the underlying costs of the sector. This benchmark would allow an efficient supplier to make a reasonable profit.

3.30 This approach is essentially the one that the CMA adopted when setting its PPM price cap, where its model sought to benchmark the costs of two mid tier suppliers that it considered to be efficient and financially sustainable (profitable), and challenges other suppliers to match or beat that level of efficiency.

3.31 With a price to beat, all suppliers would remain under a continuous incentive to increase their efficiency. The more an efficient supplier can beat the benchmark, the greater its potential profitability. Less efficient suppliers will also be able to profit if they can start to beat the benchmark, or can reduce their losses if they can reduce the extent by which their costs exceed the benchmark.

3.32 These efficiency incentives are important because the CMA found that more than half of the excess that consumers were paying over what it would expect from a well functioning market, £750 million of the £1.4 billion/year of detriment, related to inefficiency.²⁰ At the moment, because disengagement is so widespread, the incumbent suppliers can pass through those inefficiency costs to their sticky customers because they know they are unlikely to leave them. That unhealthy dynamic would change.

3.33 The methodology which Ofgem would apply in setting an absolute cap has not yet been developed, so some caution should be exercised in forecasting how it might affect default tariff prices. However, some analysts have extrapolated what the level of the cap might be if the existing PPM price cap methodology were simply adjusted to reflect the different costs to serve other types of customers. These models have tended to suggest that if the price cap were in place today, the average annual default tariff bill of a consumer with a Big 6 supplier might be around £100 lower.²¹

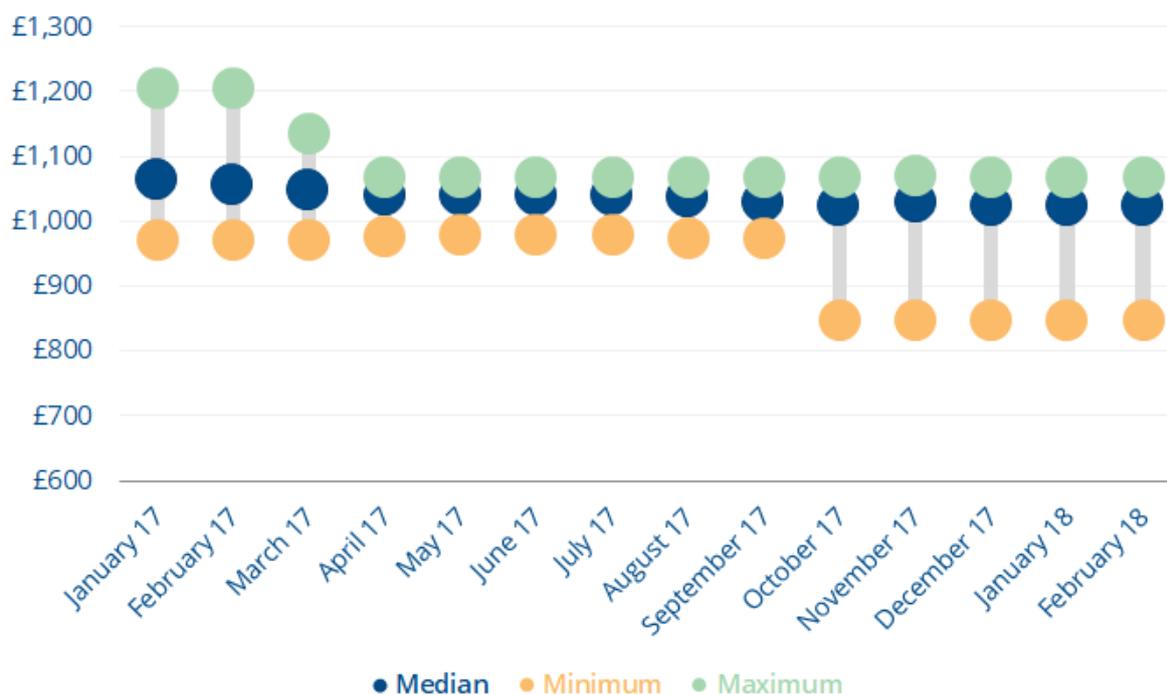
3.34 We would expect a price cap to narrow the spread of prices on the market as suppliers' ability to financially exploit sticky customers would be removed. But we do not think it should cause the cheapest deals on the market to be pulled. This is because most market leading deals are offered by smaller suppliers who have few or no default tariff customers and who will continue to need to offer keen prices in order to grow.

3.35 In the case of the PPM cap, our experience to date is that while the level of the the most expensive tariffs has reduced to comply with the introduction of the cap, that it has not caused inflation in the cheapest tariffs. After an initial compression of the price spread, we are starting to see it recover to its previous levels. This can be seen in Figure 3 below.

²⁰ 'Modernising the energy market,' CMA, 24 June 2016. <http://tinyurl.com/gurp54o>

²¹ 'A red rag to a bull: price rises and the potential for further regulatory intervention,' Cornwall Insight, 25 April 2017. <http://tinyurl.com/ybu85u7c>

Figure 3 - The spread of prepayment meter tariffs on the market since January 2017, both before and after the introduction of the price cap in April that year.²²



3.36 We recognise that there is some support for an alternative model of a relative price cap. Under this approach, the spread between a supplier’s default tariff and its cheapest tariff would be subject to a limit, which could be defined either as a % or as a figure in £s. A figure of 6% has been frequently cited.²³

3.37 The relative price cap approach is seen by some as having particular benefits in terms of its simplicity, because unlike an absolute cap it would not require the creation of a benchmark of the efficient costs of supply, which could be difficult given the information asymmetries between Ofgem and suppliers. It could also reduce the risk of supplier failure, because every supplier would be able to set their tariffs at a level that would allow them to cover their costs. That would not be guaranteed under an absolute price cap, where a very inefficient supplier could find that even if it priced at the cap it might be selling its default tariff(s) at a loss.

3.38 While recognising those merits, we think a relative price cap would come with a significant risk of unintended consequences, not least of which is that it might, ironically, reduce competitive pressure rather than increase it.

3.39 A relative price cap would force suppliers to choose between raising their acquisition prices, reducing their default tariff prices, or both. Supporters of a relative cap tend to argue that it will be the second of those things - that it would be

²² National average figures used, based on a dual fuel consumer using the Ofgem standard definition of medium consumptions. Based on figures taken on the first working Monday of each month. Dual fuel, not including Economy 7 consumers.

²³ ‘Balancing fairness and competition in the retail energy market,’ Cornwall Insight, April 2017. <http://tinyurl.com/yded4c78>

unsustainable for the incumbents to exit the acquisition market and that therefore they would reduce their default tariff prices. We think it is more likely to be the first of those three things - because the cost of acquiring new customers would become so prohibitively expensive that it would make more sense for the incumbents to slowly run down their book of customers.

3.40 There is strong evidence that if forced to choose between defending (profit) margin and defending market share the largest suppliers will choose the former - because it is a choice they are already making. In 2009, the Big 6 suppliers had a domestic retail market share of 99%, which had eroded to 85% by the end of 2016.²⁴ Yet over the same period, their average domestic retail profit margin quintupled from 0.89% to 4.48%²⁵ (for context, the CMA thought that 1.25% would be a reasonable margin for an efficient supplier to make).²⁶ The best buy tables are consistently dominated by small suppliers. A choice is clearly being made that the largest suppliers are not willing to forego the revenue necessary to lead the acquisition market even if a consequence of exiting that space is steadily eroding market share.

3.41 That underlying behaviour of defending margin rather than market share is likely to be reinforced by a relative cap. To explain why this is, it is informative to consider the likely interaction of four drivers:

1. The scale of the incumbent suppliers' default tariff portfolio (very large)
2. The numbers of new customers that acquisition campaigns could deliver (very much smaller)
3. The price spread between acquisition deals and default tariffs (usually very wide); and
4. The relative profitability of the incumbents acquisition deals and their default tariffs (the former on average lose money, the latter on average are profitable)

3.42 Figure 4 shows the breakdown of the Big 6 suppliers customer base between those who are on SVTs and those who are not. In most cases, more than half their customers are on SVT. In all cases, the number of SVT accounts exceeds one million.²⁷

²⁴ 'Electricity supply market shares by company (domestic),' Ofgem. <https://tinyurl.com/y8ywd7wa>

²⁵ 'Pre-tax domestic supply margins of large suppliers, combined gas and electricity,' Ofgem. <https://tinyurl.com/y8ywd7wa>

²⁶ 'Energy market investigation, final report,' CMA, June 2016. <https://tinyurl.com/j3ye89l>

²⁷ Similarly, the CMA found that in 2013 SVTs accounted for between 60 and 80% of the domestic revenue of these firms. 'Appendix 10.2: Retail energy supply profit margin analysis,' CMA, 2016. <https://tinyurl.com/yaaln4hz>

Figure 4 - Number of non-prepayment domestic supplier accounts, SVT and other, for the 6 largest suppliers, August 2017.²⁸

Supplier	Standard variable tariff	Other tariff	% on SVT
British Gas	4,847,737	2,194,058	69%
SSE	2,497,297	980,789	72%
E.ON	2,248,613	1,066,033	68%
EDF	1,557,526	1,337,547	54%
Scottish Power	1,034,426	1,601,458	39%
RWE npower	1,246,569	1,187,757	51%

3.43 These figures are extremely large when compared to the numbers of consumers who may be picked up in by any supplier in an individual marketing campaign. Figures for such campaigns are rarely published because they are commercially sensitive, but the influential moneysavingexpert ('MSE') website claimed in 2016 to have run the largest collective switch in UK history, with 135,000 customers switching.²⁹ More recent collective switches by MSE have been limited to 50,000 customers.³⁰ In 2013, the Department for Energy and Climate Change (DECC) spent £5 million funding 27 local authority collective switching campaigns that, in aggregate, resulted in 21,641 households changing supplier, an average of less than 1,000 switches per campaign.³¹ Anecdotally, our understanding from suppliers is that a short campaign, based on offering a deal at or near the top of the best buy tables for several weeks, would be considered very successful if it attracted a figure in the low tens of thousands.

3.44 Figure 5 shows the current spread between the Big 6 suppliers SVT and their cheapest acquisition deals. On average the spread is about 13.5%, or £134. In order to hold their current average acquisition price under a 6% relative price cap, they would need to reduce their SVTs by, on average, £74. This revenue would need to be foregone for each and every SVT customer they have - millions - in order to continue to offer acquisition deals that may only attract tens of thousands of new customers.

²⁸ 'Number of non-prepayment domestic customer accounts by supplier: standard variable, fixed and other tariffs,' Ofgem. <http://tinyurl.com/y8ywd7wa>

²⁹ 'A UK record 135,000 people switched energy in the MSE collective switch 4,' Moneysavingexpert, 23 February 2016. <http://tinyurl.com/y7pmy5ud>

³⁰ 'MSE Big Energy Switch event 7,' Moneysavingexpert, 26 April 2017. <http://tinyurl.com/yar8uuge>

³¹ 'Helping customers switch: collective switching and beyond,' DECC, 2013. <http://tinyurl.com/ooxuc9y>

Figure 5 - The SVT and cheapest deals offered by the Big 6, the price spread between them, and the cheapest deal on the market offered by any supplier, January 2018.³²

Supplier	Average annual SVT (£)	Cheapest annual tariff (£)	Price spread (%)	Cheapest deal on market from any supplier (£)
British Gas	1,101	998	10%	814
SSE	1,121	1,029	9%	
E.ON	1,133	926	22%	
EDF	1,142	1,028	11%	
Scottish Power	1,147	994	15%	
RWE npower	1,166	1,032	13%	

3.45 Meanwhile, Ofgem analysis suggests that Big 6 default tariffs are, on average, profitable while their acquisition deals are not. In its October 2017 State of the Market report³³ it noted that:

“The six largest suppliers, on average, made £54 of profit per dual fuel customer in 2016. But, on average, prices offered to the typical SVT consumer are now around £180 more than those offered to the typical fixed tariff consumer.

[...]

We estimate that if SVT prices were reduced so that they provided the same gross profit margin as fixed tariffs, then suppliers would have made a 6% loss, unless suppliers could significantly reduce their operating costs.”

3.46 In the round, these factors suggest that under a 6% relative price cap, the incumbent suppliers could generally only hold the line on current acquisition deal pricing by making their entire portfolios loss making. Because of this, we are concerned that a logical response from the Big 6 to the introduction of a relative price cap would not be to reduce default tariff prices but to exit the acquisition market to concentrate on maintaining their default tariff margins. This would reduce competitive pressure in the acquisition section of the market and would not help their default tariff consumers at all.

³² ‘Average tariff prices by supplier: Standard variable vs cheapest available tariffs (GB)’, Ofgem, January 2018. <http://tinyurl.com/y8ywd7wa>

³³ ‘State of the energy market 2017’, Ofgem, October 2017. <http://tinyurl.com/y6udhws9>

Factors included in the determination of the cap

3.47 The cap should include all the factors that determine a suppliers cost to serve its customers. These can be broadly bundled into five categories: wholesale costs, network costs, policy costs, indirect costs (e.g. a supplier's internal costs) and VAT.

3.48 The existing PPM price cap provides a reasonable model which could possibly be adopted, simply adjusted to reflect the differing cost of supplying a direct debit or standard credit customer. Under the PPM cap, the benchmark is updated every six months to reflect changes in wholesale costs, network costs and policy costs. The wholesale costs are based on an index of wholesale market prices, the policy costs are based on forecasts of environmental levy costs made by the Office for Budget Responsibility, the network charges are based on the networks published charges, and indirect costs are updated in line with CPI inflation. The model allows for an efficient supplier to make a reasonable profit margin if its costs are in line with this benchmark.

3.49 The PPM model also includes £30/year headroom (for a dual fuel customer) on top of the calculated benchmark of efficient costs. The intention of the headroom was to provide for a spread of prices on the market, such that there continued to be available savings and therefore incentives to switch. This came against a backdrop where the underlying spread of deals available to PPM was very narrow. The starting point when looking at a price cap for direct debit and standard credit customers is rather different, as there is a wider price spread with many acquisition deals currently much cheaper than the likely level of any cap. The case for including headroom when setting the level of this new price cap therefore appears weaker than it did when setting the PPM cap, and Ofgem may wish to consider whether headroom is still needed, or should be set at a lower level, when developing its methodology.

3.50 Our discussions with suppliers suggest that a number of larger market participants dispute how cost reflective the PPM price cap methodology is, though we also note that none chose to appeal its imposition by the CMA. In its parallel work to prepare for the introduction of this broader price cap, it may be prudent and appropriate for Ofgem to revisit the CMA's analysis of the indirect costs of supply to ensure that it can be fully confident it remains valid and will withstand any legal challenge.

March 2018