

The retail energy default tariff cap - overview

Joe Perkins, Chief Economist



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The Act What outcomes did Ofgem have to consider?

The Problem: A two-tier market: higher prices of less engaged consumers

Our Approach: How did we set the cap?

The Cap: What is the potential impact of the cap?

Removing the Cap: How will we assess when the cap could be removed?

What's next? How do we intend to transform the market for life after the cap?

In July 2018, Parliament passed the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act).

Figure: Section 1(6) of the Act

The objective: Protect existing and future customers who pay standard variable and default rates.

Other matters: In protecting default tariff customers, we must have regard to the following matters:

- A. the need to create incentives for holders of supply licences to improve their efficiency
- B. the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts
- C. the need to maintain incentives for domestic customers to switch to different domestic supply contracts and
- D. the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

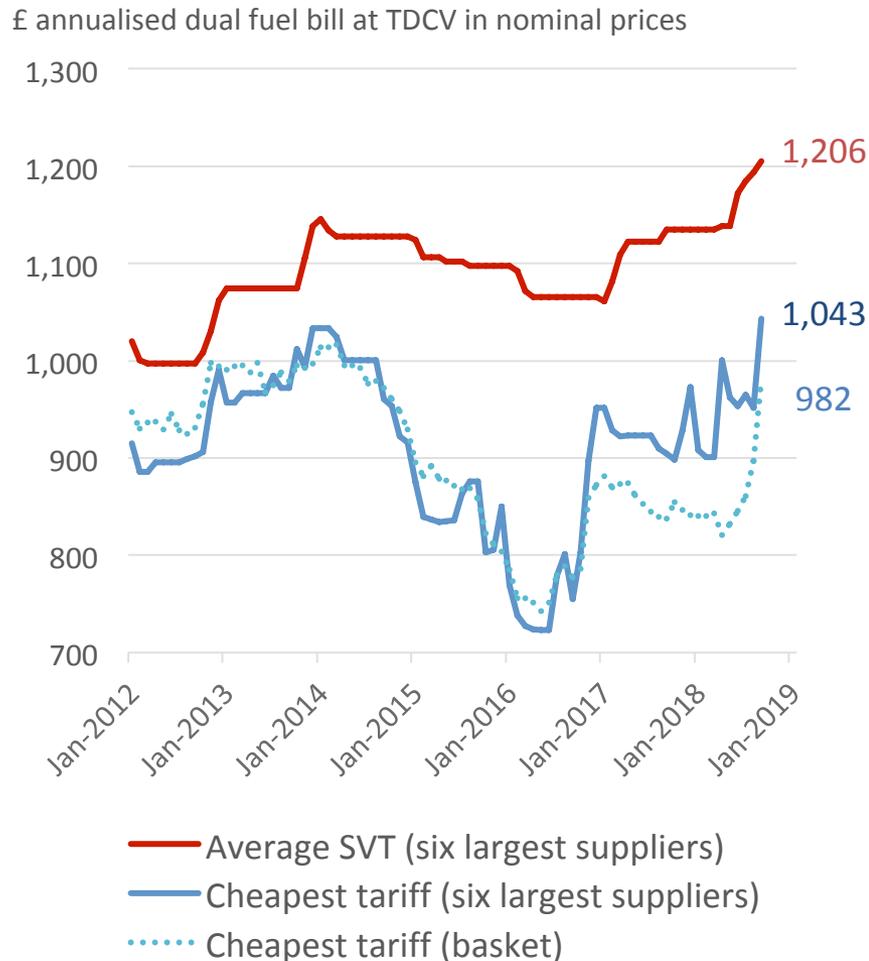
What outcomes did we have to consider?

- **The objective** is protecting default tariff customers.
- **Other matters** are, in principle, desirable – but it is not required that all are ‘achieved’

Other requirements

- **Timing:** Introduce “as soon as practicable”
- **Frequency:** The cap level should be updated no less than every six months
- **Duration:** A temporary cap. Cannot be extended beyond 2023
- **Removal:** review the conditions for competition which, among other things, considers the extent to which progress has been made in installing smart meters

Less-engaged customers pay considerably more than engaged customers



A two-tier market: higher prices of less engaged consumers

- SVT higher than FTs:
 - 2012: c.£70-100 higher
 - 2018: c. £220-320 higher

Why is there a two tier market?

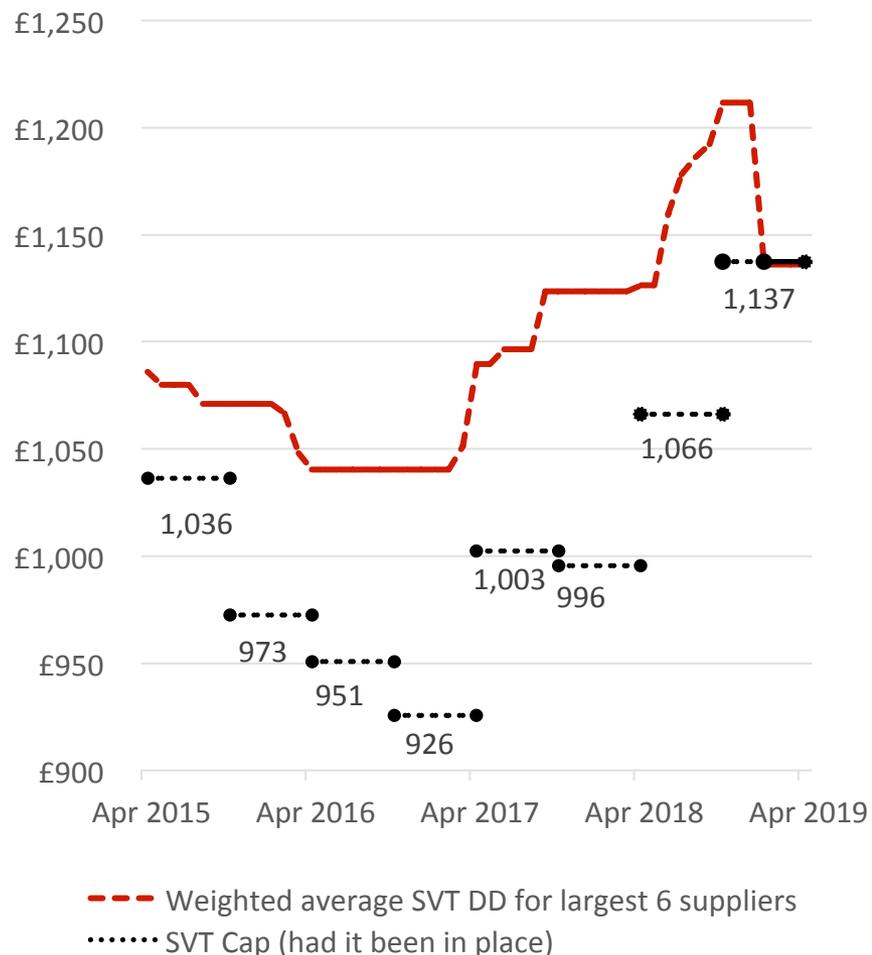
- **Consumer behaviour:** some engaged, some less
- **Increased competition:** over 70 suppliers
- **Financial incentives to switch:** new entrants tend to be cheap, reducing prices for FTs

We estimated the allowances for each cost component using a range of analyses

	Direct Debit	Standard Credit	Bottom-up assessment using:
Wholesale	447	447	Forward prices for wholesale contracts.
Policy	137	137	Administrators' forecasts for scheme costs
Network	258	258	Changing statements for the network costs
Operating costs, including smart costs	198	198	Benchmarked 2017 operating costs for 10 large suppliers Additional component for net change in smart costs
Payment method uplift	12	88	Benchmarked 2017 additional costs to serve standard credit
EBIT	20	22	CMA assessment of normal rate of return
VAT	54	58	
“Efficient” Benchmark	1,125	1,208	
Headroom – ‘top up’	12	13	consideration of risk and uncertainty not already allowed for in our benchmark assessments
Cap level in period 1	1,137	1,221	

Since April 2015, the cap would have reduced average SVTs by around £100 per year

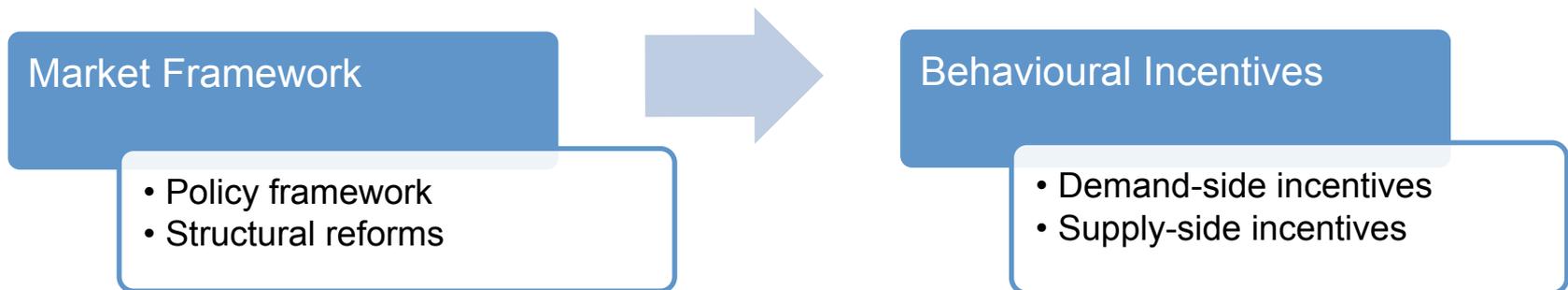
Direct debit annualised dual fuel bill (£ nominal)
For customers with typical consumption



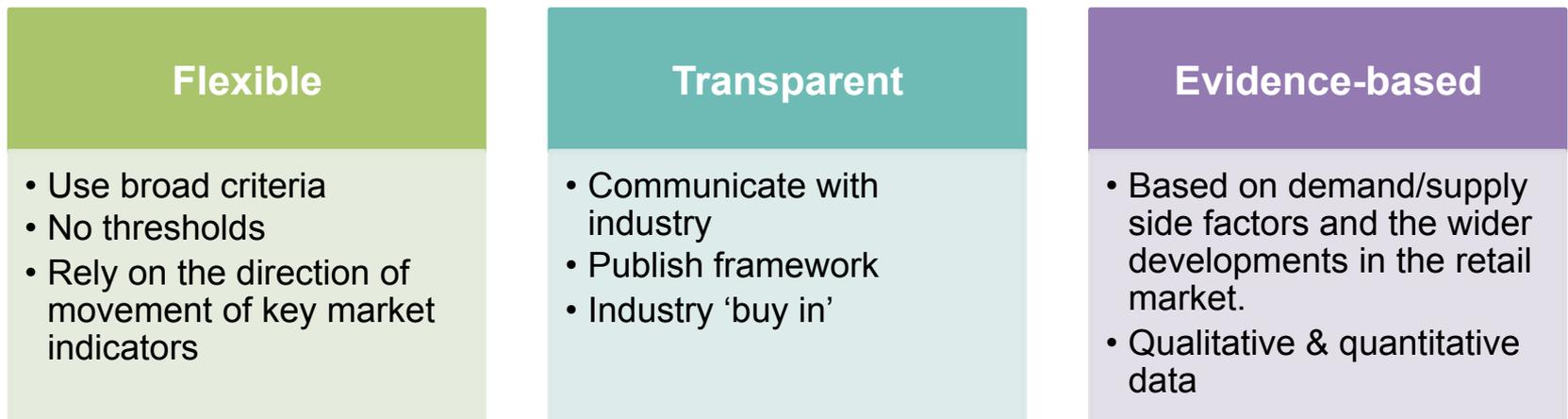
- **Over 11 million customers protected.**
 - In 2017, 98% of SVT customers would have paid less.
 - On average, the cap would have reduced SVTs by around £100 per year.
- The **absolute cap level changes.**
 - We update the cap level every 6 months, in line with trends in costs.
 - Fairly close trend between (historical) cap and (historical) SVT prices.
- **A bottom-up analysis of efficient costs.**
 - We split the bill into separate cost components, and estimated the efficient cost level for each component.
 - We update each component in line with exogenous cost data and indices (such as CPIH)

We will review “whether **conditions** are in place for effective competition for domestic supply contracts” (the Act)

We need to assess the conditions for effective competition, not the outcomes
This review should take into account



The framework should have certain characteristics:

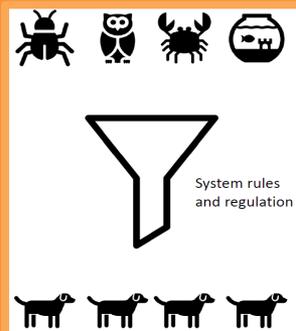


Currently, protection is in place for the majority of consumers...
...Market transformation seeks to strengthen the majority's ability to engage in the future

Consumers	Current state	
<p>Fixed Tariff customers (engaged)</p>	<p>Competitive market</p>	<p>c. 40% of consumers</p>
<p>Default tariff customers (less engaged)</p>	<p>Default tariff cap</p>	<p>c. 45% of consumers</p>
<p>Prepayment meter customers (without an interoperable smart meter)</p>	<p>PPM cap</p>	<p>c. 15% of consumers</p>

- The current energy retail market arrangements have been in place since the market was fully opened to competition 20 years ago.
- The energy system, technology, and our understanding of consumer behaviours have changed significantly over the last 20 years
- We are setting out to ensure the design of the energy retail market is fit for the future and puts consumers first.
- The review will mainly focus on the following areas:

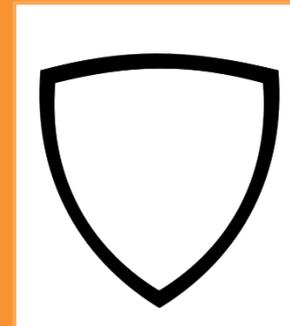
Removing barriers to innovation



Increasing value for consumers



Ensuring consumers are protected





Next Steps

- Policy papers and stakeholder engagement in early 2019 on analytical approach and options development
- Consultation document in summer 2019 setting out findings and recommendations
- Government plans to legislate in a subsequent session of this parliament if necessary

Futuresupply@ofgem.gov.uk

- In setting the default tariff cap, Parliament required us to protect existing and future consumers on default tariffs, while having regard to competition, switching, financeability and improving efficiency.
- We believe that the cap as we have set it provides substantial protection to energy consumers, and should ensure that consumers have confidence that their energy prices are reasonable over the period of the cap.
- The cap is explicitly time-limited. We are working – along with BEIS and others – on how the energy market might evolve to ensure that the problems we have seen do not recur once the cap is lifted.