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Making a positive difference
for energy consumers

Darren Jones MP
Chair, Business, Energy and
Industrial Strategy Committee
House of Commons

**BY EMAIL ONLY**

Date: 09 December 2022

Dear Mr Jones,

**Response to price cap recommendation**

Thank you for providing me with the opportunity to write to you regarding the BEIS Select Committee's recommendation that *"Ofgem should update the cost benefit analysis of its proposal for a quarterly price cap, so it reflects the risk of prices increasing this January, in order for Ofgem, the Government, and Parliament to fully understand the potential impacts for vulnerable customers*".[1]

Since the Committee published its report, forward wholesale energy prices have continued to remain high and volatile. As an illustration, the wholesale gas contract for the first quarter of 2023 traded at 368.25 pence/therm on 30 November 2022, around seven times higher than the price for this contract two years ago. In addition, increasing inflation and interest rates are putting a greater pressure on the cost of living for customers.[2] In response to high energy prices, the Government introduced two major schemes, the Energy Price Guarantee (EPG) and the Energy Bills Support Scheme (EBSS), to support customers and protect the most vulnerable. We welcome the Government's action, which brings much needed support to domestic customers who will struggle to pay their energy bills this winter.

[1] BEIS Select Committee (2022), Energy pricing and the future of the energy market, Third Report of Session 2022-23, paragraph 134.
https://committees.parliament.uk/publications/23255/documents/169712/default/

[2] The Consumer Prices Index including owner-occupiers' housing costs (CPIH) inflation measure has increased from 4.9% in January 2022 to 9.6% in October 2022. Over the same period, the Bank of England base rate has increased from 0.25% to 2.25%.

The EBSS Scheme provides a £400 grant towards households' energy bills. The EPG reduces the unit cost of gas and electricity that the average household will pay. It is in place for at least 18 months (from 1 October 2022 to 31 March 2024).

The EPG level is £2,500[3] until 31 March 2023[4] and will then rise to £3,000 until March 2024 as announced by Government on 17 November. To note, the EPG does not cap the overall size of a customer's bill. Under the EPG, the price cap continues to have a role, as it drives the reference price used to determine the funding Government provides suppliers.

While we recognise the impact on public spending, these schemes mitigate concerns about the potential impact of rising prices this winter on vulnerable customers. In particular, the EPG mitigates against the risk of customers' energy bills materially increasing in January 2023, we therefore do not intend to produce a revised cost-benefit analysis at this stage. In future, if the cap again sets the prices customers pay (e.g. after the EPG), we may revisit whether to continue with quarterly cap updates as the enduring approach.

In line with the Committee's action to understand the impact of our decisions on vulnerable customers, I have described some of the ways in which we continue to carry out our duty to protect existing and future customers, particularly customers in vulnerable situations. I have included an outline of some of our work in an annex to this letter.

I hope that this letter is helpful. I would be happy to answer any questions from the Committee on the detail of this letter.

Yours sincerely,

Neil Lawrence
**Director of Retail**

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[3] The £2,500 figure is based on a household with typical gas and electricity consumption paying by direct debit. The levels of the EPG and the price cap vary depending on a number of factors, including a customer's payment type.
[4] A typical customer will pay £2,500 instead of the price cap of £3,459 (October to December 2022) and £4,279 (January to March 2023).

## Annex – Further detail on our work to protect customers

In this annex, I have set out:

- Our considerations when changing the cap methodology including customer impacts, focussing particularly on our August 2022 wholesale methodology decision.
- Other work to support customers and relevant future work.

### Considerations when changing the cap methodology

When making changes to the cap methodology, our main objective is to protect existing and future customers on default tariffs, as set out in the Domestic Gas and Electricity (Tariff Cap Act) 2018. We consider the impact of our decisions on customers using a number of tools, depending on the scale of the change.

As an example, we introduced the quarterly cap updates[5] alongside a reduction in the notice period[6] and an adjustment for backwardation costs.[7] These were significant changes to how the cap operates. We therefore considered customer impacts in a number of ways.

#### Direct and indirect impacts

Alongside analysis of the direct impact these decisions had on the cap level (and customers' bills), we also considered the indirect impact on supplier resilience and market stability. In particular, we considered the likelihood of supplier failure, consequent costs to customers and potential service disruptions. This reflects our understanding that the cost of supplier failure (whether a Special Administration Regime or Supplier of Last Resort were used) would be levied on customers' bills.

#### Distributional impact analysis

We published a distributional impact report during our May 2022 consultation that outlined the impact on customers of moving from six-monthly to quarterly cap updates.[8]

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[5] Ofgem (2022), Price cap – Decision on changes to the wholesale methodology. https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology

[6] During the notice period, we calculate and announce the cap level, and then suppliers implement this cap level and notify customers.

[7] Backwardation costs are a result of the difference between the index used to set the cap level and the way suppliers are able to purchase energy for their cap customers.

[8] Ofgem (2022), Price cap - Changes to the wholesale methodology – Distributional impacts https://www.ofgem.gov.uk/publications/price-cap-changes-wholesale-methodology-distributional-impacts

Our analysis considered the impact on different groups of customers and across the income distribution.

### Stakeholder consultation and meetings

We sought views from stakeholders through multiple consultations and numerous meetings (including group forums and bilaterals). We were able to collate a wide variety of responses and views about the changes we were proposing. For example, in a monthly call with consumer groups and charities, we presented our proposals for changes to the wholesale methodology in May 2022. This was a good opportunity for discussing our policy and receiving feedback.

### Consumer research

To better understand consumers' perspectives, we carried out qualitative research with a diverse mix of consumers across Great Britain.[9] In our research, we found that customers were concerned over the price increases in the energy market and the transition to quarterly updates. With further information on the move to quarterly updates, some consumers did see the benefits of greater supplier resilience leading to lower supplier exit costs.

After considering the evidence, we decided to implement quarterly cap updates. We considered the benefits of greater market stability (leading to a lower chance of supplier failure) and faster pass-through of wholesale price decreases outweighed the potential downsides (e.g. potential winter price changes and shorter notice of price changes).

## Other work to support consumers

We carry out a number of activities outside of the cap to support customers. I describe a number of these activities below.

### Stakeholder engagement

We continue to have bilateral engagements with consumer groups and charities on a monthly basis. These meetings provide us with insight into how decisions we make or

[9] Ofgem (2022) Consumer attitudes towards the current energy market and price cap https://www.ofgem.gov.uk/sites/default/files/2022-08/RR_Ofgem_PriceCapPanel_Report%20277%20final.pdf

changes in the energy market directly impact consumers, allowing us to consider how we shape our work to protect customers, especially vulnerable customers.

### Consumer research

We routinely conduct consumer research to understand the needs, experiences, and attitudes of all energy consumers, including vulnerable consumers, which supports our policy work.[10] For example, we conducted a multiple wave survey throughout 2022 to understand the impact of the recent rise in global gas prices and supplier failures on the experiences, attitudes, and engagement of domestic consumers in the energy market.[11]

### Consumer vulnerability policy work

In our Consumer Vulnerability Strategy 2025[12] (CVS) we identified five key areas to drive improvements for consumers in vulnerable situations. These include supporting those struggling with their bills and driving improvements in customer service for vulnerable groups. For example, we strengthened protections for prepayment meter customers who self-disconnect, self-ration and for customers who struggle with their energy bills more broadly.[13]

We are committed to evaluating and monitoring the ongoing changes in the market which impact consumers in vulnerable situations, reporting our findings through publications such as the Consumer Protection Report: Autumn 2021.[14]

### Compliance work

We hold suppliers to account for poor performance. We have recently undertaken a suite of Market Compliance Reviews, with the most recent being a deep dive into how suppliers support vulnerable customers. We have also reviewed how suppliers set Direct Debits and support customers in payment difficulty, and we also continue to act on

[10] Ofgem consumer research | Ofgem
[11] Ofgem (2022), Consumer Impacts of Markets conditions survey: Waves 1 & 2 https://www.ofgem.gov.uk/publications/consumer-impacts-markets-conditions-survey-waves-1-march-2022-2-july-2022
[12] Ofgem (2019), Consumer Vulnerability Strategy 2025 https://www.ofgem.gov.uk/system/files/docs/2020/01/consumer_vulnerability_strategy_2025.pdf
[13] Ofgem (2020), Self-disconnection and self-rationing: decision. https://www.ofgem.gov.uk/publications/self-disconnection-and-self-rationing-decision
[14] Ofgem (2021), Consumer Protection Report: Autumn 2021. https://www.ofgem.gov.uk/publications/consumer-protection-report-autumn-2021

evidence received from a range of sources, including consumer advocacy groups such as Citizens Advice. [15]

As a result of this work, we are working with suppliers to improve performance across the market and, where this does not happen rapidly enough or we have serious concerns about potential consumer detriment, we use our Enforcement powers to drive swift and significant improvements. For example, we have issued three Provisional Orders following the market compliance reviews.

**Relevant future work**

### Future cap work

Following the coming into force of the Energy Prices Act 2022, the matters we have regard to under the Domestic Gas and Electricity (Tariff Cap) Act 2018 now include 'the need to set the cap at a level that takes account of the impact of the cap on public spending', alongside the other existing matters we have regard to. That new consideration reflects the fact that, while the Government's Energy Price Guarantee is in force, the cap level affects the levels of payments by Government to energy suppliers. As part of our decision making on changes to the cap, we shall review the issues to be decided having due regard to our statutory duties, to ensure that our approach and conclusions are appropriate.

As part of our ongoing work, we continue to monitor the cap methodology to ensure it is fit for purpose. We have published a price cap Programme of Work (PoW) to provide stakeholders with a view of the workstreams we intend to prioritise over the next two to three years. Publishing our PoW provides stakeholders the reassurance that we will continue to monitor the cap methodology and ensure that it meets its purpose of protecting existing and future default tariff customers. We highlight two key workstreams in particular here: the operating cost review and the review of changes to the wholesale methodology.

As part of our review of operating costs we intend to consider the cost bases for different types of customers. For example, under the current cap methodology customers who pay by different payment methods (e.g. prepayment meter) are charged different amounts to reflect the underlying costs. We intend to consider evidence on the size of

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[15] Ofgem (2022), Ofgem seeks improvements from 12 suppliers in relation to customer direct debit setting https://www.ofgem.gov.uk/publications/ofgem-seeks-improvements-12-suppliers-relation-customer-direct-debit-setting

cost differences between payment methods, and then what the appropriate way is to recover these costs across customers within the framework to set the cap.

We intend to review the impact of our August 2022 wholesale methodology decision on customers. We also intend to consider whether quarterly updates are an appropriate enduring mechanism for the cap. To review our position, we plan to consider what further evidence on the impacts of our decision is available since our August 2022 wholesale methodology decision.

The government announced that it will work with consumer groups and industry to consider the best approach to consumer protection from April 2024, including options such as social tariffs, as part of wider retail market reforms. We will work closely with government as they consider future consumer protection.

In addition to future cap work, we will continue our ongoing consumer research, stakeholder engagement and compliance work to support customers.