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Dear Neil,

We are writing in response to your consultation on reviewing the potential impact of increased wholesale volatility on the default tariff cap. This submission is non-confidential and may be published on your website.

Just over half of households are on default tariffs. These consumers have seen the level of the price cap increase by 23% in the last year, to an average of £1,277/year. They face the grim prospect of huge increases in the price cap in the spring. It is estimated that the level of the price cap may increase by a further £400-520, based on an unchanged methodology.[1] Ofgem's decision to bring forward some SoLR recovery costs to 2022 will aggravate the affordability picture. Wholesale prices remain stubbornly high and it appears possible that the level of the cap will remain at extreme levels for more than one period.

This will put massive pressure on household bills, and cause real pain to millions on low incomes. While the increase in wholesale prices are outside Ofgem's control, its decisions on how to structure the cap are not, and given its principal duty to protect consumers' interests it must do all it can to try and mitigate their exposure to costs. We therefore expect the evidential threshold that would need to be met before further costs are added to people's bills at this time should be very, very high. Given the level of public interest in this matter, and the potential adverse consequences on affordability, we think it is important that you are as transparent as possible about this evidence when explaining your final decision. If commercial confidentiality proves a barrier, we encourage you to publish anonymised data or data ranges to allow for adequate scrutiny.

We recognise, and agree with your suggestion that suppliers may be facing higher than anticipated costs at this time in two areas, relating to shaping and imbalance costs and unanticipated levels of customers on SVT tariffs. However, while these are higher than anticipated at this time, they may not be in future - and this is crucial, because your proposals can only have effect from a future price cap period. Because the wholesale risk allowance is set at a fixed percentage of the core direct fuel allowance, it will currently not be reflecting short term high wholesale prices, as

[1] 'Market meltdown,' Citizens Advice, December 2021.

the wholesale price was much lower in the observation window used to set the core direct allowance. However that will not be the case when the cap is next reset, given how high forward prices have been.

Given the way the cap is configured the wholesale risk allowance will always lag current prices, but it could do so in either direction (eg be too high, instead of too low) as you acknowledge in the consultation. Even without modification to the price cap methodology, the cash value of the wholesale risk allowance will increase significantly in the next price cap period given its mechanical linkage to the core direct fuel allowance.

We also note that consolidation in the market should reduce the relative volume of shaping and imbalance costs incurred in supply, as larger market participants are better able to balance their positions.[2]

We recognise the likelihood that the number of consumers on default tariffs will steadily inflate over time, for as long as it remains the case that the cap is undercutting the price of fixed term acquisition deals. As you note, suppliers have had some opportunity to anticipate this, given legacy suppliers fixed term deals have been higher than their default tariff deals since May 2021.

We are conscious of concerns that suppliers may lock in expensive hedges for default tariff consumers only to see them leave in huge numbers when fixed deals start to undercut the price cap again. This is plausible, but it is speculative and may or may not happen. Our past analysis has suggested that achievable savings and the switching rate are poorly correlated.[3] Consumers are likely to have less choice due to the reduction in the number of suppliers, and those suppliers that remain are likely to be characterised by greater financial prudence which may deter an all out price war. Consumer confidence in switching, particularly to lesser known brands, may be adversely affected by the current crisis in the market,[4] their own experiences with failed suppliers, or the potential confusion caused by changing public messaging on whether they should switch or not. Conversely, the incentives to switch may be strong due to record bills, and to pent up demand that could not be met when no deals were available.

[2] In its energy market investigation, the CMA noted that 'Some small suppliers rely, even under current rules, to a much greater extent on cash-out than do the larger firms.'
[3] Figure 2, 'Written evidence to the Domestic Gas and Electricity (Tariff Cap) Bill Committee from Citizens Advice,' 12 March 2018.
[4] Recent polling conducted for Citizens Advice found that 40% of people who've heard about supplier failures are less likely to switch supplier in future as a result. Yonder Data Solutions interviewed 2,019 GB adults, online, between the 26th and 28th of November 2021. Data were weighted to be demographically representative of all GB adults aged 18+.

So we simply cannot say with certainty how big this risk of stranded hedge costs is. But what we can say with certainty is that increasing the price cap will cause consumers pain. You should be mindful of this certain pain that a price rise will cause when taking a judgement on whether it is worth insuring against a speculative risk that may or may not materialise.

Given this is the case, we welcome that you appear to be taking a relatively cautious approach in estimating suppliers' exposure to unhedged costs, and propose using a figure taken from efficient suppliers rather than an industry average.

We are in strong agreement with your proposal to also include the likely drop in suppliers CfD costs in any overall adjustment you make. As you highlight, CfD liabilities are inversely correlated to market prices and it is right that any reduction in these costs is clawed back for consumers. That would be the case at any time, but is acutely necessary now given other inflationary pressures.

We agree that any adjustment should be temporary, although we would prefer its duration to be more definitively constrained and to a shorter period. You propose that you 'would endeavour to review this decision no later than 12 months after its implementation.' This appears to imply that the allowance could be in place for at least 3 price cap periods, given that there would need to be time for the consideration of the results of the review and a decision before the allowance could be changed. 'Endeavour' falls short of a firm commitment. As previously highlighted, the need for an additional allowance is speculative, and its introduction could not be coming at a worse time for consumers given the prospect that at least the next two price cap periods may see an extremely high cap set. We think you should commit to conducting an earlier review of the need for any uplift - it is imperative that consumers do not pay any additional costs for any longer than absolutely necessary.

Finally, while this consultation does not contain proposals to change the observation window it does suggest that you may wish to look at amending it to take into account nearer to real time wholesale prices in the coming months. We think it is reasonable to be posing that question, but you should be mindful that there are risks that this may expose consumers to more volatile prices. As hard hit as consumers will be by the sharp increase in the cap this winter, it would have been much worse for them if they had been exposed to anything resembling spot prices.

Yours sincerely

Richard Hall
Chief Energy Economist