

Title: Domestic Gas and Electricity (Tariff Cap) Bill IA No: BEIS007(F)-18-ESNM RPC Reference No: RPC-4212(1)-BEIS Lead department or agency: Department for Business, Energy and Industrial Strategy Other departments or agencies:	Impact Assessment (IA)			
	Date: 26/02/2018			
	Stage: Final			
	Source of intervention: Domestic			
	Type of measure: Primary legislation			
Contact for enquiries: retailenergy@beis.gov.uk				
Summary: Intervention and Options				RPC Opinion: GREEN

Cost of Preferred (or more likely) Option				
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANDCB in 2014 prices)	One-In, Three-Out	Business Impact Target Status
N/A ¹	N/A	N/A	N/A	N/A

What is the problem under consideration? Why is government intervention necessary?

The Competition and Markets Authority (CMA) found that domestic customers were paying £1.4bn a year on average more for their energy than they would do in a truly competitive market. They put in place a package of remedies designed to improve competition, but many of these measures will take time to take effect. In the meantime, the CMA put in place price protection in the form of a safeguard tariff for over 4 million customers with prepayment meters (PPM) from April 2017, and Ofgem extended the safeguard tariff on 2 February 2018 to almost one million vulnerable customers who are recipients of the Warm Home Discount. However, without Government intervention less active customers not eligible for these tariffs will continue to lose out before the benefits of new measures take effect. This is of particular concern because energy is an essential service which makes up a significant portion of household budgets. Moreover, households on the lowest incomes are more likely to be disengaged, and therefore more likely to lose out from uncompetitive pricing. The Government is therefore intervening because it is inequitable that 11 million households, many of whom are vulnerable, remain unprotected and on poor value tariffs.

What are the policy objectives and the intended effects?

The objective of this intervention is to protect domestic energy customers from unjustifiably high prices, which have resulted in £1.4bn in annual detriment, until the conditions for effective competition are in place. The intended effect would be to temporarily cap the retail energy prices faced by household customers on Standard Variable Tariffs (SVTs) and default tariffs (excluding tariffs that are already capped and potentially Green Tariffs), thereby reducing the amount of annual detriment for these customers, while maintaining incentives for customers to switch and suppliers to compete. The policy is intended to be transitional while the CMA package of remedies takes effect and as the benefits of the smart meter roll out and other market reforms are realised.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

This Impact Assessment appraises the costs and benefits of introducing primary legislation that would place a duty on Ofgem to introduce a tariff cap to protect certain domestic energy customers. Two options are presented: (A) do nothing; and (B) a tariff cap for all customers on SVTs and default tariffs. These are considered in the context of measures already taken to drive competitive outcomes for household energy customers, as well as those for which outcomes have yet to fully take effect.

Will the policy be reviewed? N/A If applicable, set review date: N/A						
Does implementation go beyond minimum EU requirements?			N/A			
Are any of these organisations in scope?			Micro Yes	Small Yes	Medium Yes	Large Yes
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)			Traded: N/A		Non-traded: N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: 

Date: 26 February 2018

¹ Ofgem will produce the analysis to determine cost/benefits when they design the methodology for introducing the cap.

Summary: Analysis & Evidence

Policy Option B

Description: Requiring Ofgem to introduce a safeguard tariff cap to protect domestic energy customers.

FULL ECONOMIC ASSESSMENT

Price Base Year 2017	PV Base Year 2018	Time Period Years 3	Net Benefit (Present Value (PV)) (£m)		
			Low: N/A	High: N/A	Best Estimate: N/A

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	N/A ¹	N/A	N/A
High	N/A	N/A	N/A
Best Estimate	N/A	N/A	N/A

Description and scale of key monetised costs by 'main affected groups'

The policy proposals build on an extensive evidence base compiled by the CMA, including an estimated consumer detriment of £1.4bn per year. Ofgem will develop and consult on the detail of the methodology for setting the tariff cap including evidence of the impact different cap designs would have. We do not want to prejudge or appear to prejudge the work of Ofgem; therefore until the cap level and design is known, we cannot quantify the costs and benefits. However, the estimated benefit for consumers could be up to £1.4bn per year.

Other key non-monetised costs by 'main affected groups'

The primary cost would be a reduction of energy suppliers' revenues from customers on SVTs and other default tariffs which may lead to lower profitability if it is not fully offset by efficiency improvements. Potential other costs include those to customers not on SVTs and default tariffs if suppliers raise these tariffs to counteract the impact of the cap although the operation of competition in the fixed tariff market and the presence of challenger suppliers should minimise this. Customers may also decide not to switch as they believe they are protected. However, in designing the cap, Ofgem is required to minimise this potential risk.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	N/A	N/A	N/A
High	N/A	N/A	N/A
Best Estimate	N/A	N/A	N/A

Description and scale of key monetised benefits by 'main affected groups'

The policy proposals build on an extensive evidence base compiled by the CMA. Ofgem will consider and consult on the detail of the methodology for setting the tariff cap including evidence of the impact different cap designs would have. Government does not want to prejudge or appear to prejudge the work of Ofgem. As a result, this Impact Assessment does not present quantified estimates of cost and benefits.

Other key non-monetised benefits by 'main affected groups'

The key benefit of this option would be the protection of SVT and default tariff customers from unjustifiably high tariffs and a further reduction, in addition to the safeguard tariff already in place, of the £1.4bn annual consumer detriment until conditions for effective competition are in place. There may also be an increase in trust in the market if customers feel that they are unlikely to be on poor value deals. Lower revenues could drive efficiency improvements among suppliers. Unless they reduce their costs (e.g. through efficiencies), it may also reduce the ability of larger suppliers to sustain low or no profits in the competitive part of the market, leading to market share growth and greater profitability for more efficient challenger companies.

Key assumptions/sensitivities/risks Discount rate (%) 3.5%

Costs and benefits will depend on the detailed methodology Ofgem adopts to set the level of a tariff cap. This will become clear as Ofgem develop and consult on their methodology for setting the cap level.

BUSINESS ASSESSMENT (Option B)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m:
Costs: N/A	Benefits: N/A	Net: N/A	
			N/A

¹ Ofgem will produce the analysis to determine cost/benefits when they design the methodology for introducing the cap.

A FAIRER DEAL FOR ENERGY CUSTOMERS: Impact Assessment – Evidence Base

Section 1: Strategic Overview

1. The Government is committed to ensuring a well-functioning market economy as the best way to deliver prosperity and security for everyone. In order for markets to operate effectively it is crucial that customers understand them and have confidence they are working in their interest. This will enable customers to get the best deal.
2. Government recognises, however, that sometimes markets develop in ways that do not benefit a large number of customers. One market that is not working as it should for the majority of customers is the market for domestic retail energy. Customers trust well established brands and in many cases assume that loyalty is rewarded. In fact the opposite is true. Energy suppliers have for a long time operated what amounts to a two tier market, in which people who frequently change their deals do well, but loyal customers pay higher prices. Repeated attempts to improve the situation have had limited impact. The majority of people have been losing out, many of whom are vulnerable and/or on low incomes.
3. This matters because energy is an unavoidable necessity of life, which makes up a significant portion of household budgets and for which consumers have relatively inelastic price elasticity of demand (meaning consumption is relatively unresponsive to changes in prices). After a series of attempts to improve the market, the Competition and Markets Authority (CMA) undertook an extensive study between June 2014 and June 2016. Their conclusion was that the market was not operating as it should, and that on average the customers of the six largest energy suppliers were paying around £1.4bn a year more than they would in a truly competitive market over the period 2012 to 2015.
4. The CMA estimated the detriment using two approaches. The first was a 'direct' approach, which compared the average prices charged by the six largest suppliers with a competitive benchmark price based on all direct debit tariffs offered by Ovo and First Utility. The benchmark was adjusted to allow for a normal return on capital (1.25% EBIT margin) and where appropriate for differences in suppliers' size, rate of growth and the cost elements that are outside of their control. The second was an indirect approach, which involved assessing both the six largest supplier's levels of profitability (and in particular whether the return on capital employed by such suppliers exceeds their cost of capital) and the extent to which the six largest suppliers have incurred overhead costs inefficiently (i.e. whether costs are higher than the CMA estimate an efficient supplier would incur). The figure of £1.4bn is calculated using the direct approach which the CMA placed greater weight on although the indirect approach (which estimated a detriment of £1.1bn per annum between 2012 and 2014) found a similar level of detriment when compared on a like-for-like basis.
5. In its pre-legislative scrutiny report the BEIS Select Committee found no valid reason to question the £1.4bn figure.
6. Differences between typical energy tariffs offered to people who actively switch and customers of larger companies who do not switch exceeded £350 per annum in February 2016 and have typically been well above £225 a year since then and have been around £300 in the 6 months to December 2017 (see Chart 1). In the energy market as a whole, the majority of people are paying more than they would in a truly competitive market. The majority of people remain on poor value Standard Variable Tariffs (SVTs) and default tariffs,

and whilst switching rates are increasing, the annual household switching rate was still only 18% in the twelve months to September 2017², meaning that 5 out of 6 households did not switch.³ Those who can least afford it are more likely to be affected. Households with low incomes, people with low qualifications, those in the rented sector and those over 65 are more likely to lose out than others.⁴

7. The Panel that undertook the CMA's work set out a series of actions designed to improve the operation of the market, but were split on the case for putting in place additional protection while those actions were implemented. The majority CMA view was that temporary protection should be put in place for people with prepayment meters that are particularly badly served in the market at present. This temporary protection came into effect in April 2017 for around 4 million households and has seen tariffs cut significantly for many prepayment meter households, saving the average household £60 per annum. The minority CMA view was that such protection should be extended to a broader group.
8. The CMA's report should be seen in the context of the roll out of smart meters, which may be necessary for the prospect of considerable change in the retail energy market. Smart meters will allow people to access up-to-date information on their energy usage. Bills will be based on accurate readings of actual consumption and In-Home Displays offered as part of the roll-out will provide near real-time feedback to customers on what energy they are using and how much it is costing. Smart meters will also be an enabler for new initiatives to make the switching process easier and more reliable. The CMA's package itself also included measures to stimulate engagement (for example, trialling new prompts) which Ofgem are taking forward. All of this should make choosing and transferring to the right deal simpler and quicker.
9. But these developments – the roll out of smart meters, accompanying system changes⁵ and the work going on in parallel to improve the market – will take time. Meanwhile, customers are likely to continue to lose out, with a greater impact on those who are on lower incomes or vulnerable.
10. This Impact Assessment presents a largely qualitative discussion of the costs and benefits of introducing a tariff cap for all households on SVTs and default tariffs. The qualitative nature of the analysis reflects the fact that: a) the CMA has provided an exhaustive and expert analysis of the nature and the scale of the problem; and b) Ofgem will be responsible for developing the methodology and setting the level of the cap. Ofgem will consult on a proposed methodology and provide a quantitative impact assessment prior to implementation of the cap. **Were the Government to publish quantitative analysis at this stage of possible cap levels it would risk prejudicing the results of Ofgem's work to develop a suitable methodology and establish the level of the price cap.**

Section 2: Problem under consideration

11. The Government wants an economy that works for everyone. Strong competition is the best way to protect the interests of customers, drive good service, improve value and incentivise innovation. Competitive markets benefit customers by giving them more choice and lower prices. In the UK, customers enjoy strong protections and an effective customer regime to help them to get the best deal.

² <https://www.gov.uk/government/statistical-data-sets/quarterly-domestic-energy-switching-statistics>

³ Source: [Ofgem](#) State of the Market Report, page 6.

⁴ For further information on the characteristics of these customers please see CMA Energy Investigation: Final Report (2016), available online at: <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>.

⁵ For example midata and same day switching

12. In certain markets, where businesses are able to identify customers who are more active and engaged, they have a natural tendency to seek to ensure that they are offering these customers – and only these customers – a competitive price. Less active customers then end up paying more, and sometimes considerably more, for the same goods or services.
13. This is of particular concern to Government where these markets are providing essential goods and services, which are unavoidable household costs. These goods and services can form a large part of the household budgets for those on lower incomes compared with those on higher incomes.

A two-tier market

14. The retail energy market is one of the clearest examples of such a market. Despite sustained efforts to improve competition and the numbers of customers switching to get a better deal, many energy suppliers effectively operate a two-tier system, with considerably cheaper tariffs on offer for those that switch and more expensive tariffs for those people who do not. As part of their investigation, the CMA estimated that, in total, the customers of the six largest energy suppliers were paying on average around £1.4bn a year more than they would in a truly competitive market.
15. The differences are stark. Ofgem’s most recent published data in January 2018 (relating to December 2017), reproduced below, shows the difference between the cheapest tariff on the market and the poor value default tariffs of the 10 largest suppliers (as well as the difference to the supplier’s own cheapest tariff). This difference between suppliers SVTs and the cheapest available tariff on the market ranges from £283 to £352.

Table 1: ‘Standard variable’ rate tariff information for the largest 10 suppliers as at December 2017

Supplier	No. non-prepayment customer accounts on standard variable tariffs (SVTs)	% customer base on SVTs	Average annual cost of a SVT	Difference between a supplier’s SVT and its cheapest tariff	Difference between a supplier’s SVT and the cheapest tariffs available on the market
British Gas	4,430,067	68%	£1,101	£103	£287
SSE	2,394,409	71%	£1,121	£92	£307
E.ON	2,042,956	61%	£1,133	£207	£319
EDF	1,483,749	52%	£1,142	£114	£328
Scottish Power	1,010,671	40%	£1,147	£153	£333
RWE npower	1,169,925	47%	£1,166	£134	£352
First Utility	175,844	22%	£1,132	£234	£318
OVO	150,390	25%	£1,097	£97	£283
Utility Warehouse	247,309	53%	£1,125	£102	£311
Coop	124,233	35%	£1,158	£171	£344

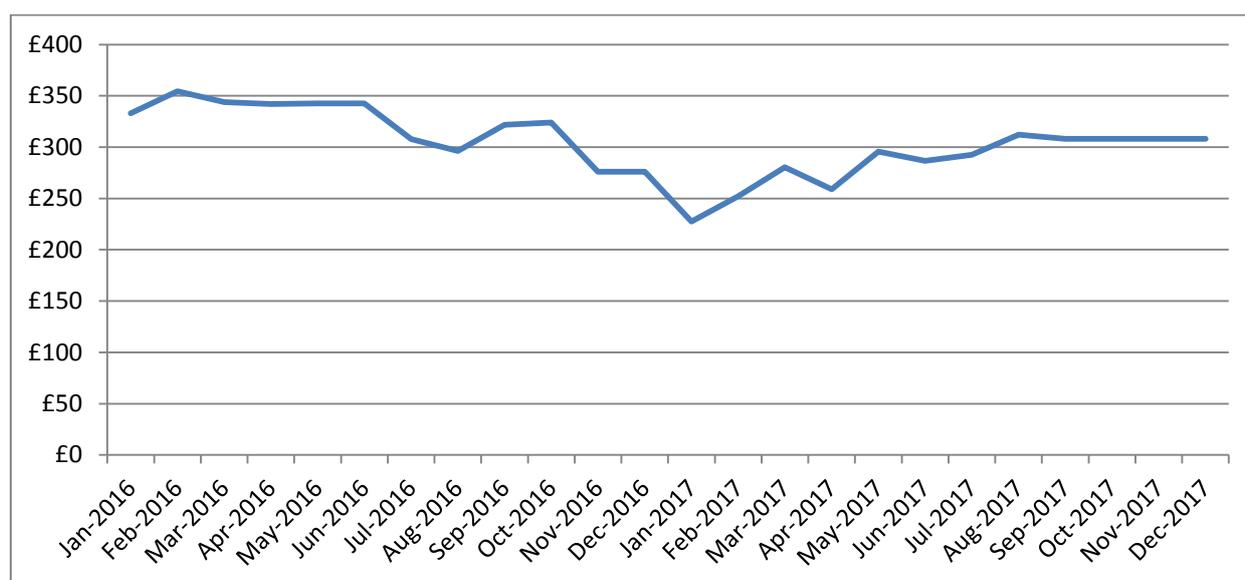
Source: Ofgem Data Portal (Retail price comparison by company and tariff type: Domestic (GB); Average tariff prices by supplier: Standard variable vs cheapest available tariffs (GB); Number of non-prepayment domestic customer accounts by supplier: Standard variable, fixed and other tariffs (GB)) For each supplier, a 'dual fuel' customer account (i.e. where a customer takes gas and electricity from the same supplier) is counted as one account, rather than two separate accounts.

A long-standing problem

16. This is not a recent feature of the market. Evidence from the CMA investigation shows that some fixed term tariffs launched by the six largest suppliers between mid-2013 and March 2016 offered as much as a £380 discount compared to their dual fuel SVTs.

17. As shown in the chart below, the difference between the average SVTs charged by the six largest suppliers to loyal customers and the cheapest dual fuel tariff has remained high, typically well above £225 per year for the last two years and has been around £300 for the six months to December 2017.

Chart 1: Difference between an average SVT bill offered by the six largest suppliers and the cheapest available tariff on the market at that time for the 24 months to December 2017



Source: Ofgem (2018) Retail market indicators, available at: <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>

A majority of people lose out, with disproportionate impact on the vulnerable

18. There remains a lack of understanding and engagement by consumers with the energy market. The people who are constantly working to make sure they are on the best deal are the minority – whilst switching rates are increasing, the annual household switching rate was still only 18% in the twelve months to September 2017⁶, meaning that 5 out of 6 households did not switch. The majority of households remain on poor value SVTs and default tariffs. Data from Ofgem shows that around 36% of all customer accounts of the

⁶ <https://www.gov.uk/government/statistical-data-sets/quarterly-domestic-energy-switching-statistics>

largest six suppliers have been on an SVT for more than 3 years⁷ and 58% of all households have only switched supplier once or not at all⁸.

19. This low level of switching can in part be explained by lack of consumer knowledge around the switching process. As part of the CMA's energy market investigation, a survey was conducted which found that 56% of household customers reported they had never switched supplier, did not know it was possible, or did not recall if they had done so.⁹

Section 3: Rationale for Intervention

20. Energy makes up a significant portion of household budgets, especially for households from lower socio-economic groups. For the poorest households, over eight per cent of their total expenditure is spent on gas and electricity compared to under three per cent of total expenditure for the richest households.¹⁰ Poorer households are therefore disproportionately impacted by higher energy costs.

21. Moreover, insofar as lack of switching is a strong indicator of households being on SVTs,¹¹ the majority who do not switch include many low income households and vulnerable people. Households with low incomes, low qualifications, those in the rented sector and those over 65 are more likely to be losing out. The CMA found that only 20% of households with incomes below £18,000 switched suppliers in the period 2013 to 2015, compared with a switching rate of 35% for households with incomes above £36,000.¹²

22. The CMA stated "that the overarching feature of weak customer response gives the suppliers a position of unilateral market power concerning their inactive customer base and that suppliers have the ability to exploit such a position through their pricing policies: through price discrimination by pricing their SVTs materially above a level that can be justified by cost differences from their non-standard tariffs." The CMA proposed a set of remedies focussed on improving customer engagement and switching in order to build a more competitive market.

23. Since the CMA report was published, Ofgem have implemented a price cap (in the form of a safeguard tariff) for around 4 million PPM households from April 2017 and extended this cap to nearly 1 million recipients of the Warm Home Discount (typically pensioners and on low incomes) on 2 February 2018. However, these caps only cover around 5 million households (not all of whom will necessarily be on an SVT as the PPM cap covers all PPM tariffs). In extending the cap to recipients of the Warm Home Discount, Ofgem acknowledged that only a sub-set of vulnerable would be covered the safeguard tariff – for example, by committing to extend its safeguard tariff to another 2 million vulnerable households in winter 2018 if wider protection is not in place by then. Thus despite the introduction and extension of the safeguard tariff, least 11 million households remain unprotected, and subject to tariffs that the CMA determined were above the level that would be set in a truly competitive market.

24. The Government's view is that the measures being undertaken to improve the market will take time to implement and become effective. Meanwhile, people may well trust well-established brands and wrongly assume that loyalty is rewarded with lower prices, when in fact the opposite is true. As a result, the Government has brought forward legislation

⁷ Source: Ofgem Data Portal and BEIS calculations based on non-prepayment meter customers

⁸ Source: State of the Market Report, page 6

⁹ Source: CMA energy market investigation, Final Report (2016): <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>, p.22.

¹⁰ ONS family spending for financial year ending 2017

¹¹ Households who have never switched will remain on their area's old incumbent energy supplier's default SVT, and households who are on fixed tariffs but do not switch at the end of their tariff default to their supplier's SVT.

¹² Source: CMA energy market investigation Final Report (2016). Available online at:

<https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>, p. 33

because it is inequitable that 11 million households, many of whom are vulnerable and/or on low incomes, are on the most expensive tariffs, in circumstances where the conditions for effective competition are not yet in place.

25. In the process of pre-legislative scrutiny, the cross-party BEIS Select Committee commented on the Government's rationale for intervention and proposed approach of a price cap and concluded that there was a strong case for introducing the Government's Bill. In its report the committee said: "We concluded that the Competition and Markets Authority's Energy Market Investigation remedies alone would not necessarily fix the problems in the market soon enough."¹³

Section 4: Policy objective

26. The Government's objective is to protect domestic energy customers from unjustifiably high prices until the conditions for effective competition are in place. The legislation will temporarily cap the retail energy prices faced by household customers in Great Britain on SVTs and default tariffs while maintaining incentives for customers to switch and suppliers to compete. Customers who benefit from the pre-payment meter cap will be excluded from this cap, and Ofgem have the ability to exempt consumers who benefit from any other cap that Ofgem may implement for vulnerable consumers. Ofgem will consult on whether to exempt from the cap customers who have elected to receive their electricity through a Green Tariff (the definition of which will fall to Ofgem to consult on and determine). While such tariffs are often more expensive customers on them have made an active choice to pay more for greener energy.

Section 5: Options considered

Previous attempts to improve the situation have had limited impact

27. Repeated attempts to improve the situation have had limited impact (e.g. switching rates remain relatively low and the level of consumer engagement reported by Ofgem in their annual consumer engagement survey is broadly unchanged since it began in 2014¹⁴). From 2008 to 2013 there was a period of repeated, but ultimately unsuccessful, interventions in ending the two-tier market in the domestic retail energy market, as Ofgem launched first an Energy Probe in 2008 and then the Retail Market Review in 2010. This latter intervention sought to improve consumer engagement by simplifying and reducing the number of tariffs on the market. Suppliers were restricted to four tariffs per fuel and restrictions were placed on the structure of tariffs, discounts and other offers. Due to the lack of success, these restrictions have been removed following a recommendation by the CMA. Ofgem also requires suppliers to provide personalised messages on bills and other communications on the savings customers can make by moving to the cheapest tariff.

New measures are being taken forward, but these will take time to take effect

28. The CMA considered a wide range of remedies to address the problems with the retail energy market which were extensively consulted on.¹⁵ These include a set of measures designed to promote greater competition over time,¹⁶ and some temporary protection for

¹³ <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

¹⁴ Engagement has increased from 34% in 2014 to 41% in 2017

¹⁵ See https://assets.publishing.service.gov.uk/media/559aac8eed915d1592000023/EMI_Remedies_Notice_-_Final.pdf pp. 45 - 51

¹⁶ These remedies included: introducing a testing regime to find better ways to prompt customers to engage in the market; developing a database of disengaged customers and removing restrictions around the number of and types of tariffs suppliers could offer.

PPM customers who they found were particularly badly served in the market. In addition, the roll-out of smart meters and associated market changes, which should transform the customer experience of the market, is well underway. However, time is needed before the full benefits of these actions can be felt for all households. Moreover, Ofgem have recently extended the PPM cap to recipients of the Warm Home Discount, which should protect a further 1 million households. This still leaves around 11 million households on SVTs and other default tariffs unprotected.

Tackling customer detriment during the transitional period

29. The CMA Panel recognised that the measures they identified would take time to take effect to address the detriment currently experienced by domestic energy customers. Given this, and the size of the detriment observed, they considered very carefully the need to intervene to address domestic customer detriment directly in this transitional period through a price cap. The CMA therefore put in place price protection for PPM customers. Since the CMA report was published, all six of the largest suppliers increased their SVTs in 2017 by around 7-10% for the average dual fuel customer. These increases come on top of tariffs that the CMA had already determined were too expensive, resulting in higher bills for those consumers who were already experiencing a significant level of detriment.
30. The Government is proposing taking forward the CMA Panel's minority recommendation to provide protection to all customers on SVTs and default tariffs. This is because it is inequitable that 11 million households, many of whom are vulnerable, are unprotected and on poor value tariffs. Limiting the cap to only a small subset of customers (e.g. those who have been on an SVT for a given period of time) would mean that a significant number of disengaged domestic energy consumers would continue to experience detriment during this transitional period. Moreover, the Government believes that it is possible to maintain incentives for customers to switch and suppliers to compete.

Final options

31. Given the reasons set out above, the two final options under consideration are:

- A. Do Nothing
- B. A temporary tariff cap for all customers on SVTs and any other default tariffs (excluding customers benefiting from the PPM cap and potentially those on Green tariffs).

A. Do Nothing

32. This option would rely on the current market framework and the interventions already planned to increase competition in the market and protect customers. This includes the PPM cap, Ofgem's cap for recipients of the Warm Home Discount and the intention announced by some of the six largest energy suppliers to move away from SVTs towards lower priced fixed default tariffs.
33. However, this option will not meet the policy objective of providing transitional protection to all customers on poor value SVTs. Based on the prices presented in Table 1, customers on SVTs provided by the 10 largest suppliers would still be paying between £283-£352 per year more compared to the cheapest tariffs on the market.

B. Introduce a temporary tariff cap

34. The intention of this primary legislation is as follows:

- To enable and mandate Ofgem to introduce a temporary tariff cap for all customers on SVTs and default tariffs (excluding customers benefiting from the PPM cap, potentially

customers benefiting from protection under any Ofgem cap for vulnerable consumers and potentially those on Green tariffs).

- Ofgem will be required to develop and consult on a methodology for developing the cap.
- a temporary tariff cap would be in place until the end of 2020, by which point the Government expects every home in the country to have been offered a smart meter, and other market improvements will be in place. However if the conditions for effective competition are not in place by 2020, the Secretary of State could, after considering to a recommendation from Ofgem, opt to extend the cap one year at a time up to 2023.

35. The legislation places a duty on Ofgem to implement an absolute cap on SVT and default tariffs. Whilst it does not introduce a cap in itself, Ofgem must implement the cap with a view to protecting existing and future domestic customers while giving regard to the need to:

- create incentives for suppliers to improve their efficiency
- set the cap at a level that enables suppliers to compete effectively
- maintain customers' incentives to switch tariffs
- ensure efficient suppliers are able to finance their activities.

36. The proposed cap will not apply to customers that are covered by the existing PPM cap, and potentially it will not apply to customers who have elected to be on a Green Tariff, as customers will have made a conscious choice to be on such tariffs and the higher costs associated with such tariffs reflect the increased energy costs faced by suppliers. The cap will apply to those currently with pre-payment meters who have a smart meter installed and therefore cease to be covered by the PPM cap. The legislation gives Ofgem the ability to exclude customers in receipt of any caps they impose that benefit vulnerable consumers.

37. The Government will require Ofgem to introduce an absolute price cap as this delivers certainty for consumers that their prices will not exceed a pre-determined level. In addition, the presence of so many small- and medium-sized suppliers in the market, many of whom compete by offering attractive fixed-term deals to win new customers (and/or have relatively low SVTs and default tariffs and a low proportion of customers on SVTs and default tariffs), should ensure that the market remains competitive and fixed tariffs do not bunch around the level of the cap.

38. The proposal for an absolute rather than relative price cap was supported by the BEIS Select Committee which found in its report "that on balance the risk associated with an absolute cap are outweighed by the greater risks associated with a relative cap and the immediate benefit to consumers on poor-value tariffs." In particular it felt that a relative cap "would create a perverse incentive for suppliers to increase their lowest prices to keep their profit levels constant."

Section 6: Costs and Benefits of each Option

Option A: Do Nothing scenario

39. In the absence of any intervention, it is likely that many customers will continue to remain on poor value tariffs and suffer detriment. Ofgem estimate that around 60% of customers¹⁷ remain on SVTs and default tariffs, and the CMA estimated that, in total, household energy customers of the six largest energy suppliers were paying on average (between 2012 and 2015) around £1.4bn a year more than they would in a truly competitive market.
40. Since the CMA's investigation there have been a number of developments in the energy market. In particular, after a winter price freeze all of the six largest suppliers increased their domestic gas and electricity SVTs in 2017. The increase for a dual fuel SVT customer was significant and varied between 6.9% and 9.8% across these suppliers.¹⁸ Ofgem has said that some of these increases are difficult to justify.
41. On 2 February, Ofgem extended the PPM price cap to cover approximately an additional 1 million households, those on SVTs in receipt of Warm Home Discount payments. In addition, some suppliers have recently announced their intention to begin phasing out their SVTs, replacing them with default tariffs that are cheaper than SVTs, with a fixed end date but no exit fee.
42. While a number of additional new measures are being implemented to improve competition in the market, the CMA acknowledges that these will take time to take effect. Under this option, it is therefore expected that the 11 million households on SVTs and default tariffs who are not currently covered by the existing protection for PPM or Warm Home Discount customers will continue to pay above the competitively efficient level. Many of these households will be low-income or vulnerable, for whom energy represents a greater proportion of total household expenditure, and who are less likely to have switched to better value tariffs.

Option B: Introduce a temporary safeguard tariff cap

43. The timing of when a cap would come into effect is dependent on the time the proposed primary legislation takes to achieve Royal Assent and the time for Ofgem to implement its delivery, but it is expected that the cap will be in place by winter 2018. The level of the cap is also uncertain, and would be for Ofgem to determine. For the purpose of this Impact Assessment it is assumed that the tariff cap would not be set at a level that is equivalent to the cheapest in the market, but would set at a level low enough to protect customers from unjustifiably high prices. The following sections assess the direct and indirect impacts that we would expect. These impacts would be expected over the period that the temporary tariff cap is in place.
44. It should be noted that Ofgem will produce their own impact assessment as part of their work to introduce a cap, and this will contain analysis of the direct and indirect impacts of the cap. They are also required to publish an annual review as to whether the market conditions still require a cap to be in place. Whilst this will not necessarily analyse the ongoing impact of the cap, it will, alongside the data already regularly collected by Ofgem and BEIS, enable analysis of the market and to the extent a robust counterfactual can be created provide some transparency over the impact of the policy as well.

Direct Impacts

45. Capping SVTs and default tariffs will lead to a reduction in total energy expenditure across households on these tariffs. The extent and distribution of these benefits will vary across

¹⁷ State of the Market Report, page 9

¹⁸ Press releases from the six largest energy suppliers and wider market commentary.

households. Households whose energy tariffs would have been higher under “do nothing”, will experience benefits from a cap associated with lower energy bills, i.e. more disposable income to spend on other goods and services, and/or warmer homes as a result of comfort-taking.¹⁹ This is likely to give rise to equity benefits especially for vulnerable and low-income households for whom energy bills are a higher proportion of household expenditure.

46. Any reduction in SVTs will reduce the level of consumer detriment present within the market. The CMA estimated that the level of detriment of customers of the six largest energy suppliers averaged £1.4bn per year over the period 2012 to 2015. The CMA also found that there was an upward trend with estimated detriment reaching almost £2bn in 2015, including almost £400 million per year for PPM customers in 2015. This implies that even after the introduction and extension of the PPM cap, consumer detriment in domestic energy market remains significant at around £1bn per year and possibly higher. The level of remaining consumer detriment represents the upper limit of the direct impact that could be expected from the cap; otherwise Ofgem will not be complying with its duty to ensure efficient businesses can continue under the cap.
47. To help ensure that the cap takes into account developments in the market as well as changes in the costs of supplying energy, the legislation requires Ofgem to review the level of the cap at least every six months.
48. It is possible to look at the impact of the PPM cap which is estimated to have reduced annual energy bills for the 4 million households it covered by an average of around £60 when it was introduced in April 2017²⁰. Moreover, tariffs remained on offer that were greater than £10 and up to around £50 below the level of the PPM cap. Whilst this is by no means indicative of the expected level of the cap or impact that it will have, it nonetheless serves as evidence that price caps can be implemented that save consumers money, reduce the level of deficit and allow price competition to continue.
49. Energy suppliers overall will face a reduction in their SVT and default tariffs revenues as a result of the cap. The large and mid-tier suppliers are most likely to see a reduction as their SVTs are typically some of the more expensive on the market and some of the largest six suppliers in particular have a larger SVT customer base. The impact on each supplier will vary depending on these two factors, the price of their SVT tariff and the size of their SVT customer base (see Table 1). The resulting impact on SVT profits will depend on the extent to which impacted suppliers choose to seek further efficiencies in their operating costs to maintain profitability. The CMA found that there was a material degree of inefficiency as well as excess profits in prices. In separate analysis of the detriment the CMA found that approximately 60% reflected profits in excess of the cost of capital and 40% reflected measured inefficiencies.
50. These impacts therefore represent a transfer from energy suppliers to customers on higher-priced SVTs. Ofgem will consider and consult on the detailed methodology for setting the tariff cap. Government does not want to prejudge or appear to prejudge the work of Ofgem because this might set market expectations at the wrong level and possibly be seen as indicating to the regulator where it believes the cap should be set. As a result, this Impact Assessment does not present specific monetary estimates of direct cost and benefits, but this analysis will be provided by Ofgem during their preparatory work.
51. In addition to these impacts there will be:
 - a direct cost to Ofgem of developing, administering and implementing the price cap. This will depend on the process and detailed methodology that Ofgem develop to

¹⁹ A rebound effect - i.e. in light of the reduced fuel bills they feel able to afford to heat their homes at their preferred level.

²⁰ Ofgem State of the Market report.

implement a tariff cap. It is currently too early in the policymaking process to estimate this as we do not know what detailed methodology Ofgem would develop. However, Ofgem are responsible for and have implemented the PPM price cap and the extension to a further 1 million vulnerable customers.

- costs to domestic retail energy suppliers to provide Ofgem with certain information, to familiarise themselves with the policy, and to comply with the cap. However, these costs are, on average, expected to be low in comparison to suppliers' overall operating cost base, in part because many suppliers will have already put procedures in place to ensure compliance for the PPM price cap and because they already have to provide Ofgem with significant amounts of data.

Indirect Impacts

52. At this stage it is not possible to quantify the indirect costs and benefits of this potential intervention as the final impacts will depend on the detailed methodology that Ofgem develop for the tariff cap as well as the level of the cap. Therefore it is particularly important to identify and assess qualitatively the likely impacts of introducing a temporary tariff cap. The potential impacts considered below are:

- impacts on competition,
- impacts on domestic fixed tariffs and non-domestic contracts,
- impacts on small suppliers,
- impacts on the wider market, and
- impacts on energy demand.

a) Impact on competition

53. The legislation is intended to ensure that customers on SVTs and other default tariffs are not charged unjustifiably high prices until the conditions for effective competition are in place. If a temporary tariff cap were set at too low a level then customers may decide not to switch as a result of being protected – the potential benefits from switching will have reduced. However, in many cases, the highest cost SVTs are being paid by disengaged customers who have either never switched or not switched for some time, and (notwithstanding ongoing measures to increase engagement) have a low likelihood of switching for the duration of the period under consideration. Engaged customers are expected to continue switching, as gains from switching should remain, though the size of these gains will depend on the level of the cap set by Ofgem and from the reaction to the cap from suppliers. In developing the detailed methodology for setting the level of a cap, Ofgem is required to have regard to the need to enable effective competition to continue, and to maintain incentives to switch.

54. The possible impacts on suppliers' incentives to compete include:

- reduced scope for any suppliers to use higher revenues from poor value SVTs to undercut competitors in the non-standard tariff market;
- an incentive to engage customers so that they reduce the number of their customers on SVT or default tariffs;
- an incentive to offer green SVT or green default tariffs;
- a decrease in competition as customers may choose not to engage if the gains from switching are decreased, and/or if they perceive that they are being protected by the Government and hence on a fair tariff; and

- a negative impact on Price Comparison Websites if there is a smaller pool of switchers, although the intention of the legislation is to maintain the incentives for customers to switch and suppliers to compete.

b) Impact on domestic fixed tariffs and non-domestic contracts

55. In adjusting to an SVT price cap suppliers may decide to adjust the pricing structure of their other tariffs. This is difficult to anticipate but possible impacts include:

- the impact on the price levels of domestic fixed tariff products on offer in the competitive part of the market. The reduction in revenues from SVTs may mean that some suppliers, especially those with large numbers of customers on SVTs, may seek to raise the prices of these products. However, the presence of challenger suppliers, some of whom have a relatively small number of customers on SVTs and therefore will not see their revenues impacted to the same extent, should ensure that there are still competitive fixed tariffs for customers to switch to;
- higher non-domestic contract prices as suppliers look to recoup a reduction in revenues from SVTs. Again, the forces of competition in most of the non-domestic market should be sufficient to mitigate this in the most part, especially given the presence in the non-domestic market of firms who will not be impacted by the domestic tariff cap.

c) Impact on small and intermediate sized suppliers

56. There are currently more than 50 small- and intermediate-sized suppliers (i.e. all suppliers excluding the six largest) with different interests and business models and the overall impacts on them of the proposal are hard to predict. A small supplier that operates a business model which relies on charging a higher SVT to customers once they reach the end of their fixed term contract will be more affected than a small supplier which focuses on offering good value tariffs to all their customers.

57. If, contrary to the intent of the legislation, this measure discourages switching, then this might negatively affect the pool of switchers for smaller growing suppliers to compete for. On the other hand, if this meant that larger suppliers were less likely to offer big discounts on non-standard tariffs, then it could increase the pool of switchers away from larger companies and potentially lead to market share growth for smaller suppliers.

d) Impact on the wider market

58. Depending on the methodology for determining the tariff cap, and particularly how the cap is adjusted to take into account changes in supply costs, there could be an impact on how suppliers buy energy in wholesale markets. For example, if the cap were set with reference to wholesale energy costs, then the way in which this cost was calculated could encourage suppliers to try to replicate the same cost profile in their own purchasing of energy to reduce their risk exposure to differences in their underlying costs and those used to set the cap. This could impact liquidity in different parts of the wholesale market. For the parts of the market where liquidity decreases, this could reduce price transparency for independent companies, reducing the scope for developing innovative tariffs. The overall market impact is uncertain. We expect that wholesale market effects will be considered as part of Ofgem's consultation on the more detailed methodology for setting the cap.

59. Suppliers may react to any reduction in revenues as a result of this measure by changing their approach to their own costs. For example, they could reduce their controllable operating costs or their investment plans. There is also a risk that suppliers might choose to reduce the quality of customer service. However, licence conditions and the Standards of

Conduct²¹ that are part of Ofgem's regulatory regime, should mitigate that risk. Other mitigations include the customer complaint handling data collected by Ofgem the Ombudsman and Citizens Advice which is well publicised.

60. The tariff cap could also result in an increase in the perception of regulatory risk either in this industry or in similar utilities. This might result in investors requiring a higher return to provide capital. This risk is likely to be mitigated by Ofgem developing a clear and transparent methodology for setting the cap and the fact that the cap will be a temporary measure.

61. There is a risk that a supplier could choose to exit the market as a result of this measure. However, as well as considering the impact on competition and switching, Ofgem will need to take into account the need to ensure that an efficient supplier is able to finance activities authorised by the licence.

e) Impact on energy demand

62. If a cap results in lower tariffs, then this could encourage more use of gas and electricity. This would have a direct benefit for those using more energy but would also have an impact on carbon emissions. Any impact on demand or carbon emissions would be dependent on the price elasticity of demand (which is generally quite inelastic in the domestic energy market),²² as well as the level of the cap and, as such, if appropriate, it will be assessed by Ofgem.

Section 8: Small and micro business assessment (SaMBA)

63. There are now over 60 energy suppliers in the domestic retail energy market, up from 13 in 2010, with around 18 suppliers²³ classified as either a small business²⁴ or microbusiness²⁵ as of October 2017. Of these, only ten suppliers currently have a customer base in excess of 250,000 and those suppliers outside the six largest supply a total of around 20% of the dual fuel market.

64. To ensure equal treatment, the Government's approach is to apply the tariff cap to all domestic energy suppliers. The rationale for this is to protect customers from being charged poor value tariffs until the conditions for effective competition are in place. Customers with suppliers that are small or microbusinesses can be on high-priced SVTs, though many offer relatively competitive SVTs. It would not be fair to have the customers of some suppliers protected and others not.

65. In practice we expect this measure to impact smaller suppliers proportionately less as, in general, they have built their customer bases from engaged consumers by offering more competitive tariffs (as their customers will at some point have switched away from one of the former incumbent larger suppliers). Some also have a large proportion of their customer base on fixed-term tariffs, so the impact of a cap on SVTs and default tariffs will be less. Many of the smaller suppliers offer Green SVT or Green default Tariffs which may be exempted from the cap, and some small suppliers offer exclusively Green Tariffs. In addition, evidence shows that the price of an average SVT with the six largest energy firms is around

²¹ https://epr.ofgem.gov.uk/Content/Documents/Electricity_Supply_Standard_Licence_Conditions_Consolidated_-_Current_Version.pdf.

²² While there is a degree of variation depending on the analysis, a range of studies compiled by University College London, show estimates for domestic gas price elasticity in the UK ranging between -0.1 and -0.3. Source: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/532539/Annex_D_Gas_price_elasticities.pdf.

²³ Evidence obtained by the consultancy Cornwall Insight.

²⁴ A business with between 9 and 49 employees (FTE).

²⁵ A business with less than 10 employees (FTE).

£100 more than the average SVT of all other firms in the market, indicating that these firms will, on average, be impacted less than the largest six suppliers²⁶.

66. If there are smaller suppliers that have built their business model around loyal customers defaulting onto more expensive deals then this measure will have a more significant impact on them.
67. The administrative cost of complying with the primary legislation is expected to be relatively small in comparison to total operating costs.

Section 9: Equality assessment

68. The Department for Business, Energy and Industrial Strategy (BEIS) is required to comply with the public sector duty (PSED) set out in the Equality Act 2010 (“the Act”). The PSED requires the Minister to have due regard to the need to advance equality of opportunity, eliminate discrimination and foster good relations between those with and without certain protected characteristics. This due regard is taken to eliminate unlawful discrimination and to tackle prejudice and promote understanding. The characteristics that are protected by the Equality Act 2010 are: age, disability, gender reassignment, marriage or civil partnership (in employment only), pregnancy and maternity, race, religion or belief, sex and sexual orientation.²⁷
69. As part of their energy market investigation the CMA conducted a survey to better understand the characteristics of disengaged customers in the domestic retail energy market. The results suggested that disengaged customers were more likely to be those on low incomes, those who have low qualifications, are living in rented accommodation or who are above 65 years of age.²⁸
70. The CMA analysis suggests that introducing a tariff cap for all SVT customers should disproportionality benefit the elderly. There will also be positive impacts on customers on SVTs from the other protected groups from this measure.

Section 10: Business Impact Target

71. This regulatory policy change may or may not score against the business impact target as the rules for this Parliament have not yet been agreed.

Section 11: Rationale and evidence that justify the level of analysis used in the Impact Assessment

72. This Impact Assessment is based on the legislation introducing requirement on Ofgem to introduce a supply licence condition that will cap SVTs and other default tariffs. The rationale for the legislation is underpinned by extensive evidence base originally compiled and tested by the CMA and has been scrutinised by the BEIS Select Committee. Ofgem will consider and consult on the detailed methodology for setting the tariff cap. Their work will include evidence on the impacts a cap would have. Government does not want to prejudge or

²⁶ <https://www.ofgem.gov.uk/data-portal/retail-price-comparison-company-and-tariff-type-domestic-gb>

²⁷ <https://www.gov.uk/discrimination-your-rights/types-of-discrimination>

²⁸ CMA final report p.33

appear to prejudge the work of Ofgem on this issue. As a result, this Impact Assessment does not present specific quantified estimates of cost and benefits.

Family Test

73. We expect this measure will benefit families that are on SVTs or other default tariffs, many of whom are low-income. It will reduce the energy costs of these families and/or help them afford to heat their homes more adequately. In this respect the policy could have potential benefits for family formation and families going through key transitions.