Regulatory Policy Committee

Domestic Gas and Electricity (Tariff Cap) Bill

Department for Business, Energy and Industrial Strategy

RPC rating: Fit for purpose

Description of proposal

The Department reports that the difference between suppliers' standard variable tariffs (SVTs) and the cheapest available tariff on the market ranges from £283 to £352 per household per year, and that customers who do not switch to cheaper tariffs are more likely to be low-income households with a higher proportion of their total expenditure being spent on gas and electricity. The Department therefore argues that customers presently pay more for energy than would be the case in a truly competitive market, and that this is inequitable. Thus, it proposes to place a duty on *Ofgem* to introduce a price control (or tariff cap) to protect all domestic energy customers, regardless of need. Such a cap already exists for the most vulnerable customers, having been introduced in April 2017 for customers on pre-payment meters and extended in February 2018 for customers who receive the Warm Homes Discount.

The Department presents two options: (a) do nothing; and (b) introduce a tariff cap for all customers on standard variable and default tariffs. The Department expects that, in the long term, improvements to market conditions (such as the introduction of smart meters) will obviate the need for a cap. It does not, however, present any evidence underpinning this expectation, or set out what it might do if the introduction of smart meters does not have the expected results. The proposed cap would therefore be a temporary measure, running until the end of 2020. However, the IA explains that if conditions for effective competition are not in place by 2020, the Government could, based on a recommendation from *Ofgem*, opt to extend the cap. Any single extension would last for one year, and the cap could not be extended beyond 2023 without further legislation. The Department does not address whether the cap could in itself address the speed and extent of the transition to effective competition, nor whether its assumption that the market will function effectively in the medium term is robust, in light of early experiences of the impacts of smart meters.

Impacts of proposal

The Department expects the main impact of the proposal would be a reduction in energy expenditure for households on SVT and default tariffs. It suggests, based on

research undertaken by the Competition and Markets Authority (CMA) in 2014-16, that this reduction could affect up to 11 million households. It quotes CMA estimates that, in total, household energy customers of the six largest energy suppliers were paying on average (between 2012 and 2015) around £1.4 billion a year more than they would in a truly competitive market. Energy suppliers would face a corresponding reduction in revenue; in effect the proposal is for a transfer from energy suppliers to customers who do not switch tariffs. The IA states that, in addition to the 'big six' suppliers, there are currently more than 50 small and intermediate-sized suppliers. The impact on each supplier would vary depending on the level of their SVT tariff and the size of their SVT customer base. The Department notes that large and medium-sized suppliers would be most likely to see a reduction in revenue because these companies typically have some of the highest SVTs and a larger SVT customer base.

The Department expects there would be one-off costs to energy suppliers from familiarising themselves with the requirements, and transitional costs to *Ofgem* of developing and implementing the price cap. It does not estimate these costs, on the basis that it is not possible to do so with any degree of reliability until *Ofgem* has developed its approach to implementation in more detail.

Energy suppliers would also incur ongoing administrative costs in providing *Ofgem* with information. The Department expects that these costs would be low because many suppliers already have procedures in place to provide data to *Ofgem* to comply with the current price caps for customers with prepayment meters or in receipt of the Warm Homes discount.

The Department also describes a number of possible wider or consequential impacts/risks of the proposal. These include the following.

- A reduction in competition in the short term, as the gains from actively switching deals would decrease, weakening incentives for customers to switch. This is also likely to lead to reduced use of price comparison websites.
- Lower tariffs encouraging more use of gas and electricity.
- Suppliers aiming to reduce operating costs by reducing the quality of customer service. The Department argues that the current regulatory regime of *Ofgem* would mitigate this specific risk.
- Suppliers gaming the system in various ways, for example offering more "green" tariffs, or shifting standard variable tariffs to "green" tariffs, to take advantage of a possible exclusion of these from the cap;

- Increases to other tariffs and to non-domestic rates, as suppliers aim to recoup profits. The Department argues (but does not evidence) that competition in these segments of the market makes such increases less likely than might seem to be the case.

Quality of submission

The Department relies largely on references to the CMA's 2014-16 assessment to support its rationale for intervention. It notes that the CMA arrived at a different conclusion - a tariff cap only for the most vulnerable - based on this analysis. It then argues that for reasons of equity, it proposes to extend the cap to all households, and that this position is supported by the cross-party BEIS Select Committee. It does not, however, offer any evidence in support of this decision or address how it expects a cap to be applied equally to all consumers, regardless of their circumstances, to deliver an efficient or an equitable position.

The Department also discusses the possibility of a relative price cap, which it rejects on the grounds that it offers insufficient certainty to customers and may create perverse incentives for suppliers to set non-SVT tariffs at artificially high levels. However, it argues that these risks outweigh the potential risk of bunching around the cap but offers no evidence in support of this contention.

In general, the evidence the Department presents in support of its rationale and selected option is weak, and even confused, moving from an approach grounded in efficiency to one based in equity without a clear argument. It also does not discuss whether it believes the loss to consumers who remain on variable tariffs arise as a result of super-normal profits, or through cross-subsidisation of other customers; given that the impacts of a cap will be different in each case. The Department should clarify its position.

The Department sets out the likely costs and benefits of the measure in a structured way but largely in qualitative terms. However, it only makes reference to a single monetised estimate – for the potential size of the transfer from suppliers to customers. It also provides a relatively limited and optimistic discussion of the possible distortions resulting from price controls and does not discuss whether it believes the loss to customers remaining on standard variable tariffs is a result of super-normal profits or cross-subsidy. As a consequence, it does not consider sufficiently whether the proposed cap is more likely to create transfers between

groups of customers than from suppliers to customers or to set out clearly what the impacts are likely to be on different groups of customers .

The monetised estimate quoted is the CMA's 2014-16 assessment, where the Department notes that some elements of a price cap have been put in place since these estimates were constructed and SVTs have increased, recognises that a more up-to-date figure could be either higher or lower. However, it does not appear to have taken those changes into account in deriving the estimate it presents in the current IA. Rather, it argues that any more detailed estimate of this transfer, including an estimated lower bound or best estimate, would appear to prejudge the work of *Ofgem* in setting the cap, and might influence the regulator or set misleading market expectations; it does not, however, provide any evidence in support of this argument. This is not entirely consistent with the presentation of the status of this estimate, which it treats variably as either an upper bound or a best estimate.

The Department also argues that it cannot produce estimates of other costs (for example familiarisation and administrative costs) at this stage, as they will be highly dependent on *Ofgem's* final approach to managing the cap. At this stage, the RPC would normally expect the Department to provide at least an indicative scale for these costs, especially as they would provide a theoretical lower bound on the total costs of the measure. For the purposes of the business impact target, either the Department or *Ofgem* will need to provide a detailed, monetised assessment of all the relevant impacts, once *Ofgem* has completed its work.

The Department presents a small and micro business assessment (SaMBA), which argues that, on average, the smallest suppliers will be less affected than others as they tend to set lower SVTs but acknowledges that some small suppliers may be adversely affected, depending on the details of their business models. It argues on equity grounds that it would be inappropriate to exclude customers of small suppliers from the measure and does not discuss any other forms of mitigation.

Overall, the Department provides a reasonably clear qualitative assessment of the costs and benefits of the measure, though it tends to downplay the costs to business and emphasises the benefits to consumers. Its monetised assessments and SaMBA fall short of the standard that would normally be expected, even taking account of the dependencies on *Ofgem's* work. The absence of even an indicative scale for familiarisation and administrative costs is of particular concern to the RPC.

The RPC can only assess this Impact Assessment as fit for purpose on the understanding that (a) *Ofgem* will present specific monetary estimates of direct cost and benefits during its preparatory work and (b) the Department will publish (or ensure that *Ofgem* publishes) a clear estimate of the costs and benefits once the level of the cap is known, regardless of the eventual business impact target status of the measure. The RPC has received assurances from both the Department and *Ofgem* that it will do so.

The RPC is also pleased to see that *Ofgem* will review the need for a cap on an annual basis, though it is disappointed that there is no clear commitment to reassess the impacts of the measure as part of this review. In particular, *Ofgem* should consider whether the loss to consumers who remain on fixed tariffs to arise as a result of super-normal profits, or of cross-subsidisation of other customers, and should assess the impacts of the measure in that light. The RPC also notes that, on the basis of the evidence presented, this measure would, as a new price control, have been a qualifying regulatory provision under the rules for the business impact target for the 2015-17 Parliament.

Departmental assessment

Classification	To be confirmed once BIT scope for this Parliament has been agreed
Equivalent annual net direct cost to business (EANDCB)	Not applicable
Business impact target score	Not applicable
Business net present value	Not applicable
Overall net present value	Not applicable

RPC assessment

Classification	Under the framework rules for the 2015-17 parliament: qualifying regulatory provision (IN)
Small and micro business assessment	Sufficient
RPC rating	Fit for purpose

Anthony Browne, Chair