

Title: Draft Domestic Gas and Electricity (Tariff Cap) Bill IA No: XXX RPC Reference No: XXX Lead department or agency: Department for Business, Energy and Industrial Strategy Other departments or agencies:	Impact Assessment (IA)			
	Date: 29/11/2017			
	Stage: Consultation			
	Source of intervention: Domestic			
	Type of measure: Primary legislation			
Contact for enquiries: retailenergy@beis.gov.uk				
Summary: Intervention and Options				RPC Opinion: Awaiting Scrutiny

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
TBC	TBC	TBC	TBC	TBC

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

The Competition and Markets Authority (CMA) found that domestic customers are paying 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 for people with prepayment meters (PPM), and Ofgem published a consultation paper on extending the cap to recipients of the Warm Home Discount. As a result, without Government intervention less active customers not eligible for these caps will continue to lose out before the benefits of new measures to improve energy market competition take effect. This is of particular concern because energy is an essential service which makes up a significant portion of household budgets, more so for those on lower incomes. Moreover, households on the lowest incomes are more likely to be disengaged, and therefore more likely to lose out from uncompetitive pricing. Many will not be covered by the existing and proposed caps. The Government is therefore intervening because it is inequitable that 11 million households, many of whom are vulnerable, are unprotected and on poor value tariffs.

What are the policy objectives and the intended effects?

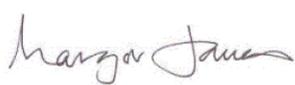
The objective of this intervention is to protect domestic energy customers from unjustifiably high prices until the conditions for effective competition are in place. The intended effect would be to temporarily cap the retail energy prices faced by household customers on Standard Variable Tariffs (SVTs) and default tariffs (excluding PPM and Green Tariffs) 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 standard variable 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. Other options, including narrowing the coverage of the tariff cap to a subset of SVT customers have been ruled out for not appropriately addressing the policy objective (further discussion in evidence base). Responsibility for developing the methodology for the cap and setting its level falls to Ofgem.

Will the policy be reviewed? TBC. If applicable, set review date:TBC				
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: TBC	Non-traded: TBC

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: 29.11.17

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: TBC	High: TBC	Best Estimate: TBC

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

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

The policy proposals build on an extensive evidence base compiled by the CMA. Ofgem will develop and consult on the detail of the methodology for setting any 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 costs and benefits.

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. This could lead to potential loss of market share by larger companies who generally have more customers on higher cost SVTs and default tariffs and loss of profit for suppliers whose business model is based on generating profit from consumers on SVTs. Customers may decide not to switch as they believe they are protected. However, in designing the cap, Ofgem is required to to minimise this potential risk.

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

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 until the conditions for effective competition are in place, reducing the detriment these customers face. There may also be an overall increase in trust in the market if customers feel that they are unlikely to be on a poor value deal. Lower revenues could drive efficiency improvements among suppliers. Unless they reduce their costs (eg 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%
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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 their methodology for setting the level.

BUSINESS ASSESSMENT (Option B)

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

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. 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.
4. Differences between typical energy tariffs offered to people who actively switch and customers of larger companies who do not switch exceeded an average of £350 per annum in February 2016 and have typically been well above £225 a year since then (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 SVTs and default tariffs, and whilst switching rates are increasing, the annual household switching rate was still only 17% in June 2017.¹ 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.²
5. 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 who are particularly badly served in the market at present. This temporary protection came into effect in April 2017 and has seen tariffs cut significantly for many prepayment meter

¹ Source: [Ofgem](#) State of the Market Report, page 6.

² 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>.

customers. The minority CMA view was that such protection should be extended to a broader group.

6. The CMA's report should be seen in the context of the roll out of smart meters, which offers 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). All of this should make choosing and transferring to the right deal simpler and quicker.
7. But these developments – the roll out of smart meters, accompanying system changes³ 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.
8. The Government has therefore carefully considered further actions. This Impact Assessment presents a largely qualitative discussion of the costs and benefits of introducing a tariff cap for all customers on standard variable and default tariffs.
9. The qualitative nature of the analysis reflects the fact that: a) the CMA have 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 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

10. 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.
11. 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.
12. 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

13. 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

³ For example midata and same day switching

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.

14. The differences are stark. Ofgem’s most recent published data in October 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 £245 to £339.

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

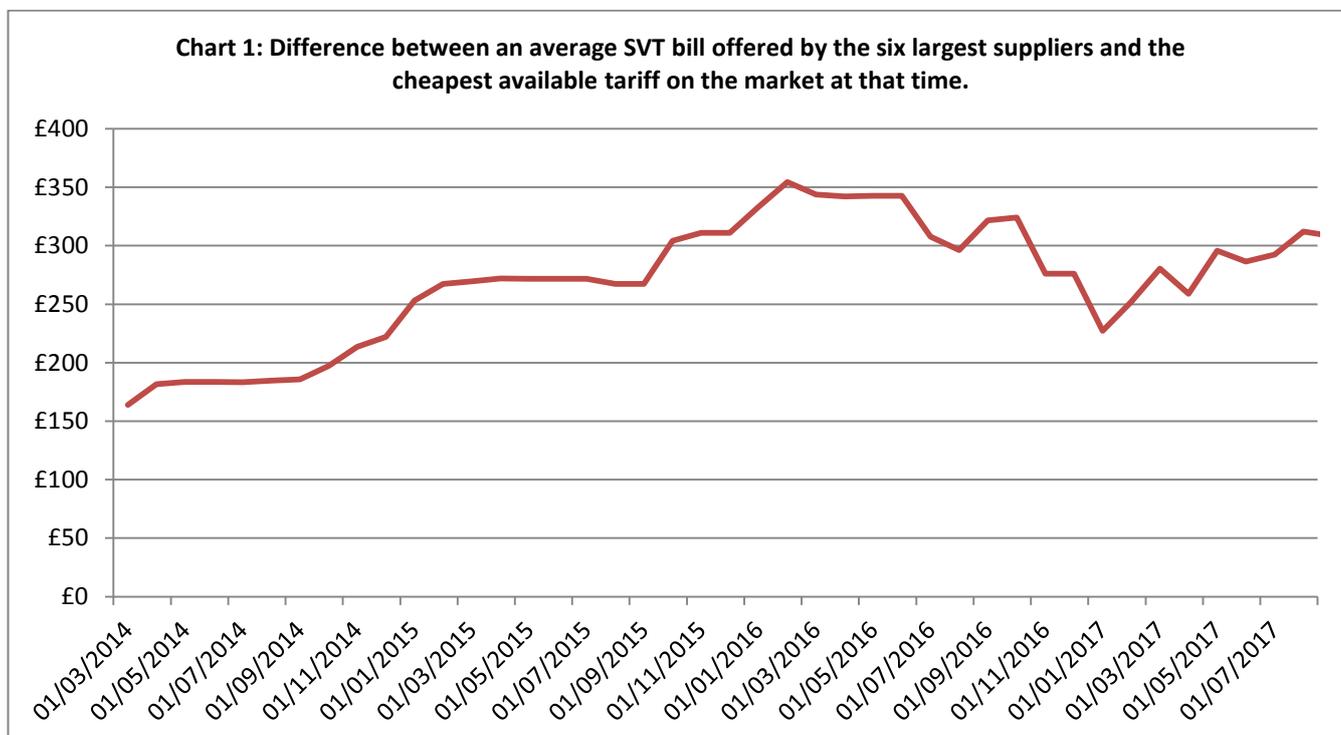
Supplier	No. non-prepayment customer accounts on standard variable tariffs (SVTs)	% customer base on SVTs	Average annual cost of a SVT	Difference between a supplier’s SVT and its cheapest tariff	Difference between a supplier’s SVT and the cheapest tariffs available on the market
British Gas	4,847,737	69%	£1,072	£36	£245
SSE	2,497,297	72%	£1,121	£249	£294
E.ON	2,248,613	68%	£1,133	£192	£306
EDF	1,557,526	54%	£1,142	£171	£315
Scottish Power	1,034,426	39%	£1,147	£174	£320
RWE npower	1,246,569	51%	£1,166	£231	£339
First Utility	155,129	18%	£1,132	£205	£305
OVO	148,294	30%	£1,097	£155	£270
Utility Warehouse	248,859	54%	£1,098	£81	£271
Coop	92,296	31%	£1,158	£299	£331

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

15. 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 standard variable tariff.

16. 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.



Source: Ofgem (2017) 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

17. 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 17% in June 2017. The majority of households remain on poor value SVTs and default tariffs. Data from Ofgem shows that around 37% of all customers of the largest 6 suppliers have been on an SVT for more than 3 years⁴ and 58% of all households have only switched supplier once or not at all⁵.

18. 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.⁶

Section 3: Rationale for Intervention

19. Energy makes up a significant portion of household budgets, especially for households from lower socio-economic groups. For the poorest households, almost ten per cent (9.3%) of their total expenditure is spent on gas and electricity compared to just 2.6% of total expenditure for the richest households.⁷ Poorer households are therefore disproportionately impacted by higher energy costs.

⁴ Source: Ofgem Data Portal and BEIS calculations based on non-prepayment meter customers

⁵ Source: State of the Market Report, page 6

⁶ Source: CMA energy market investigation, Final Report (2016): <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>, p.22.

⁷ ONS (2017) Table A6 Detailed household expenditure by gross income decile group, available at: <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/datasets/detailedhouseholdexpenditurebygrossincomedecilegroupuktablea6>

20. Moreover, insofar as lack of switching is a strong indicator of households being on SVTs,⁸ 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 £36,000.⁹
21. 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 standard variable tariffs 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.
22. Since the CMA report was published, Ofgem have implemented a price cap for PPM customers as well as recently consulting on implementing a cap for recipients of the Warm Home Discount. However, these caps only cover 5.5 million households (not all of whom will necessarily be on an SVT as the PPM cap covers all PPM tariffs). Only a sub-set of vulnerable people are covered by a cap; a group accepted as fluid and difficult to define. In addition, the existing PPM cap and proposed cap still leaves at least 11 million households unprotected, and subject to tariffs that the CMA determined were above the level that would be set in a truly competitive market.
23. 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 draft legislation 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.

Section 4: Policy objective

24. The Government’s objective is to protect domestic energy customers from unjustifiably high prices until the conditions for effective competition are in place. The draft 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. Customers who have elected to receive their electricity through a Green Tariff will also be exempt, as such tariffs are typically more expensive but the 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

⁸ 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.

⁹ 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

25. 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 has remained between 34 and 41% since it began in 2014¹⁰). 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

26. The CMA considered a wide range of remedies to address the problems with the retail energy market which were extensively consulted on.¹¹ These include a set of measures designed to promote greater competition over time,¹² and some temporary protection for 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, are well underway. However, time is needed before the full benefits of these actions can be felt for all households. Moreover, while Ofgem have recently published a consultation on extending 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

27. 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 6 of the largest suppliers have increased their SVTs 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.

28. The Government is proposing taking forward the CMA Panel's minority recommendation to extend the temporary protection for PPM customers to all customers on SVTs. 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 (eg 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

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

A. Do Nothing

¹⁰ Engagement has increased from 34% in 2014 to 41% in 2017

¹¹ See https://assets.publishing.service.gov.uk/media/559aac8eed915d1592000023/EMI_Remedies_Notice_-_Final.pdf pp. 45 - 51

¹² 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.

- B. A temporary tariff cap for all customers on SVTs and any other default tariffs (excluding Green Tariffs and customers benefiting from the PPM cap).

A. Do Nothing

30. This option would rely on the current market framework and the interventions already planned to increase competition in the market. This includes the PPM cap, Ofgem's proposed 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.
31. 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 £245-£339 per year more compared to the cheapest tariffs on the market.

B. Introduce a temporary tariff cap

32. The intention of future primary legislation would be as follows:

- To enable and mandate Ofgem to introduce a temporary tariff cap for all customers on standard variable and default tariffs (excluding Green Tariffs and customers benefiting from the PPM cap).
- 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, based on a recommendation from Ofgem, opt to extend the cap one year at a time up to 2023.

33. The draft 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 will be required to have regard to the need to:

- protect SVT and default tariff customers from unjustifiably high prices
- create incentives for suppliers to improve their efficiency
- set the cap at a level that enables competition to continue
- maintain customers' incentives to switch tariffs
- ensure efficient suppliers are able to finance their activities.

34. The proposed cap will not apply to customers that are covered by the existing PPM cap, nor will it 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 PPM meters who have a smart meter installed and therefore cease to be covered by the PPM cap. The draft legislation does not exclude customers in receipt of the Warm Home Discount who would benefit from Ofgem's proposed extension of the PPM cap, as we would expect this cap to fall away once the wider cap is implemented.

35. The Government has considered implementing both a relative price cap and an absolute price cap. A relative price cap would set a pre-determined percentage above the cheapest deal that a supplier's SVT or default tariffs could be set at. A relative cap would not require

suppliers to reduce their SVTs. Larger energy suppliers with large proportions of customers on SVTs earn a significant profit from disengaged customers. They are likely to preserve that by removing their cheapest deals rather than by reducing their SVTs – leaving the smaller suppliers to compete in this space, but under reduced competitive pressure from the six largest energy suppliers. This could lead to prices increasing overall, and would not necessarily offer everyone on an SVT the protection the cap is intended to provide.

36. In contrast, an absolute cap 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.

Section 6: Costs and Benefits of each Option

Option A: Do Nothing scenario

37. 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% customers¹³ 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.

38. 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.¹⁴ Ofgem has said that some of these increases are difficult to justify.

39. On October 11th, Ofgem published a consultation paper on extending the PPM price cap to cover an additional 1 million households, those on SVTs in receipt of Warm Home Discount rebates. In addition, three of the six largest suppliers (British Gas, E.On and Scottish Power) 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. The Government views these changes, particularly the steps toward the reduction in use of SVTs, as positive steps but does not believe that they will reduce the identified detriment by an amount significant enough to mean that a price cap is no longer required. For instance, for some suppliers who have announced these measures, it is not yet clear that the measures proposed to move existing SVT customers onto fixed will be effective – or how quickly this will deliver the step change the Government is seeking. Finally, SSE and nPower have recently announced that they plan on merging their retail supply businesses, which would see a degree of concentration at the top of the market.

40. While a number of additional new measures are being implemented to improve competition in the market, the CMA acknowledge 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 that proposed for Warm Home Discount customers will continue to pay above the competitively efficient level. Many

¹³ State of the Market Report, page 9

¹⁴ Press releases from the six largest energy suppliers.

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

41. The Government intends to introduce the Bill as soon as Parliamentary time permits - the date the price cap comes into effect will depend on the timing of the passage of the Bill. The level of the cap is 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.

Direct Impacts

42. 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 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.¹⁵ 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.

43. Energy suppliers will face a reduction in their SVT revenues. 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 6 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 to maintain profitability – the CMA suggested that there was a material degree of inefficiency in current prices.¹⁶

44. These impacts therefore represent a transfer from energy suppliers to customers on higher price 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 risk tying the regulator’s hands. As a result, this Impact Assessment does not present monetary estimates of direct cost and benefits, but this analysis should be provided by Ofgem during their preparatory work.

45. 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 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.
- 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

¹⁵ 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.

¹⁶ Source CMA energy market investigation, Final Report (2016), p. 47. Available online at:

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

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

46. 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

47. The draft 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.

48. The impacts on suppliers' incentives to compete are hard to predict. Possible impacts include:

- reduced scope for any suppliers to use higher revenues from poor value SVTs to undercut competitors in the non-standard tariff market;
- 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 draft legislation is to maintain the incentives for customers to switch and suppliers to compete.

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

49. 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

50. There are currently more than 50 small and intermediate sized suppliers (ie all suppliers excluding the Big 6) with different interests and business models and the overall impacts on them of the proposal will differ depending on the business model of the individual supplier. 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.

51. If, contrary to the intent of the draft 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 significant 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

52. 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.

53. 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 Conduct,¹⁷ that are part of Ofgem's regulatory regime, should mitigate that risk – as should competition. Other mitigations include the customer complaint handling data collected by Ofgem, the Ombudsman and Citizens Advice which is well publicised.

54. 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.

55. 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

¹⁷ <https://epr.ofgem.gov.uk/Content/Documents/Electricity Supply Standard Licence Conditions Consolidated - Current Version.pdf>.

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

56. 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),¹⁸ 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)

57. There are now over 60 energy suppliers in the domestic retail energy market, up from 13 in 2010, with around 18 suppliers¹⁹ classified as either a small business²⁰ or micro-business²¹ as of October 2017.
58. 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 some offer relatively competitive SVTs. It would not be fair to have the customers of some suppliers protected and others not.
59. In practice we expect this measure to impact smaller suppliers less as, in general, they have built their customer bases from active switchers (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. However, if there are smaller suppliers that have built their business model around loyal customers defaulting onto more expensive deals then this measure will directly impact them. Evidence shows that the price of an average SVT with the six largest energy firms is over £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 suppliers.
60. 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

61. 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

¹⁸ 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.

¹⁹ Evidence obtained by the consultancy Cornwall Insight.

²⁰ A business with between 9 and 49 employees (FTE).

²¹ A business with less than 10 employees (FTE).

employment only), pregnancy and maternity, race, religion or belief, sex and sexual orientation.²²

62. 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.²³
63. 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

64. This regulatory policy change may or may not score against the business impact target and would depend on how / when any requirement on Ofgem is implemented.

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

65. This Impact Assessment is based on the proposal that there will be a requirement on Ofgem through legislation to introduce a supply licence condition. The rationale for the draft legislation is underpinned by an extensive evidence base compiled and tested by the CMA. Ofgem will consider and consult on the detailed methodology for setting the tariff cap. Their work will include evidence on the impact different methodologies for a cap would have. Government does not want to prejudge or appear to prejudge the work of Ofgem on this issue. As a result, this Impact Assessment does not present quantified estimates of cost and benefits.

Family Test

66. 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. .

²² <https://www.gov.uk/discrimination-your-rights/types-of-discrimination>

²³ CMA final report p.33