



What would a price cap mean for the energy market?

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Theresa May formed a minority Conservative Government, following the election held on 8 June. One of the key commitments in the Conservative Manifesto was to introduce a “safeguard tariff cap [on energy bills] that will protect customers who do not switch against abusive price rises”.

The Queen’s Speech on 21 June confirmed that the Government would bring forward “measures to help tackle unfair practices in the energy market to help reduce energy bills.” The Government also signalled that it was still considering the best way to achieve this. Greg Clark wrote to Ofgem on 21 June to ask what other measures they could take, which might avoid the need for new legislation.

As the Government considers its options, this paper considers the potential implications of a price cap for the way the UK energy market works. Any re-regulation of the retail energy sector would represent a fundamental shift away from the post-privatisation belief in competition and markets as the best way to protect consumers. Any such change would have widespread implications and raises some major questions that Boards in the energy sector would need to consider.

Questions for the board to consider:







-  How would we sustain our existing strategy and targets for earnings and customer numbers?
-  How would we realistically offer competitive tariffs where prices are regulated?
-  How would this change open up new opportunities to differentiate ourselves? Or would we sell up and exit the UK retail market?
-  How would we diversify our offering into other parts of the value chain or customer base?
-  Would continued investment in improving our customer experience offer the same returns if there is price regulation?
-  How would we fund innovation in new services/products?



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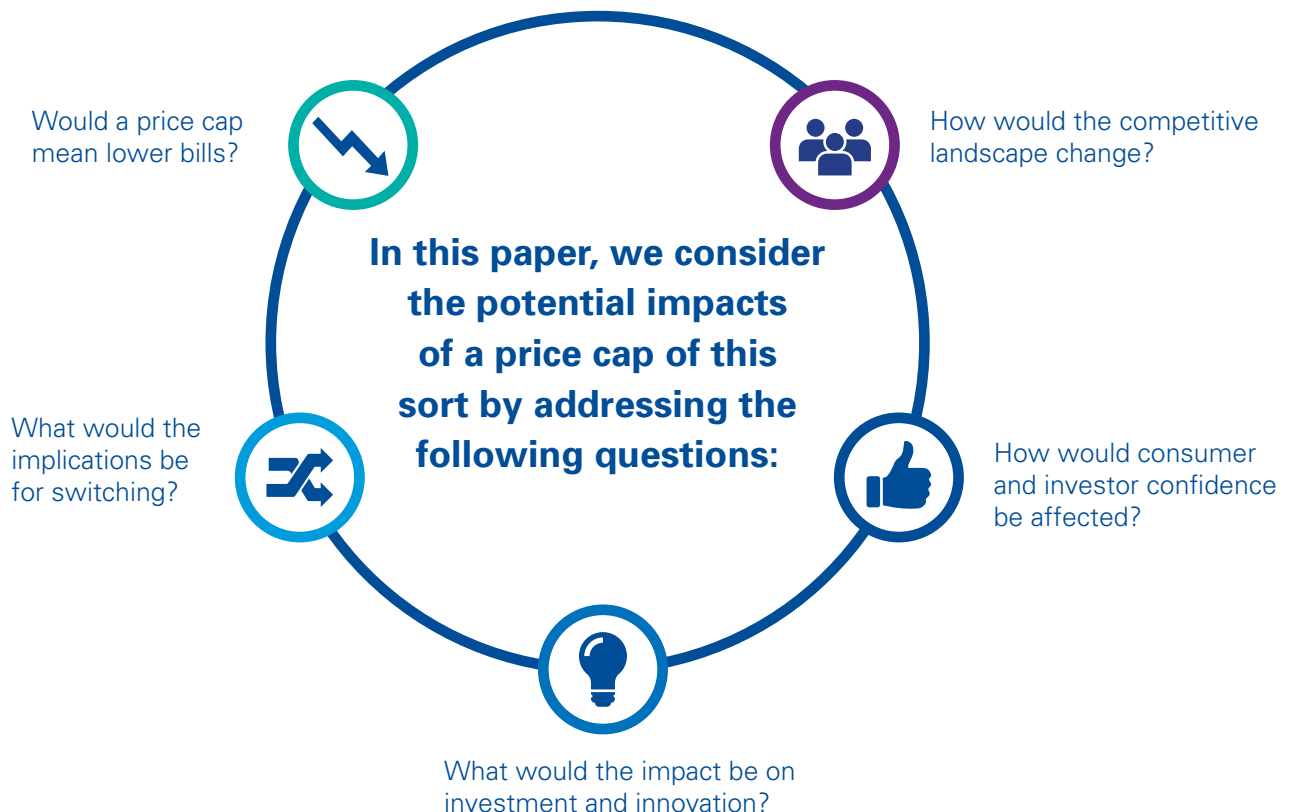
The design of the price cap

The impacts of any price cap would depend on its design, scope and the level at which it is set. There are precious few details available yet on what the Government's plans are on any of these aspects.

Some companies, along with Citizens Advice¹, have argued for extending the price cap that was introduced for Prepayment (PPM) customers (as recommended by the Competition and Markets Authority (CMA)) to other vulnerable groups, such as those on the Warm Home Discount (WHD), rather than market wide regulation. However, for the purpose of this report, we have assumed that the cap would apply to those on Standard Variable Tariffs (SVTs) and would seek to deliver a material reduction in bills for those customers. This is in line with Martin Cave's view (in his dissenting opinion in the CMA report last year) as well as briefings from government sources before the Election, that the cap would deliver the equivalent of 'up to £100 off energy bills for 17 million households'².

It seems likely that Ofgem would be asked to set the safeguard tariff cap and to revise it periodically – perhaps every six months. There would probably need to be primary legislation for a policy change of this magnitude, making it unlikely that it will be in place before the second half of 2018 at the earliest. Under EU law, any price regulation is supposed to be temporary, so the Government would look to time-limit the intervention. This was the case with the price cap for PPM customers, which is tied to the completion of the smart meter rollout in 2020³.

Several providers, including British Gas, have argued that a cap along these lines will reduce competition, as well as hitting investment and innovation in the sector⁴. Others, such as Ovo and Utility Warehouse, have argued in favour of a cap, saying that it will help vulnerable and disadvantaged customers⁵.



¹ Price cap must go ahead, insists Citizens Advice, Utility Week, 2017

² Energy bills: £100 cap plan defended by Theresa May, BBC News, 2017

³ Energy market investigation, CMA, June 2016

⁴ British Gas owner warns Tory energy price cap could push up prices, The Guardian, 2017

⁵ Energy minnows back call for price cap to protect customers, The Times, 2017

Summary of main findings

With the proviso that all impacts depend on the final design of any cap, our provisional findings are summarised below:



Consumer bills

We have already seen a narrowing of the differential between SVTs and the best fixed price deals in the market, from around £300 pa a year ago (when the CMA report was published) to around £150 pa in April 2017⁶. This may be (in part) due to anticipation of the price cap being introduced.



Switching

Reduced differentials will probably lessen the incentive to move to another supplier, so switching rates may fall over time (although there may be some short-term uptick caused by the political and media attention on energy bills).



Consumer confidence

The cap could potentially improve consumer trust in the market, given the Government-backed nature of the safeguard tariff.



Share prices

The share prices of the UK-listed larger suppliers have been hit by the announcement of the cap.



Competitive landscape

This has not stopped other suppliers entering the retail market, including during the period since the policy announcements were made.



Investment and innovation

If profits are reduced, there may be an impact on investment and innovation in the sector.

⁶ Ofgem's Retail price comparison by company and tariff type.

Would a price cap mean lower bills?

The price differential between customers on SVTs and those on fixed tariffs, as illustrated in Figure 1, was one factor that led to the proposed cap. More than 60 percent of customers are on SVTs and more than half (56 percent) have never switched supplier. It is these customers, seen as disengaged and missing out on the most competitive tariffs, whom the proposed price cap seeks to protect.

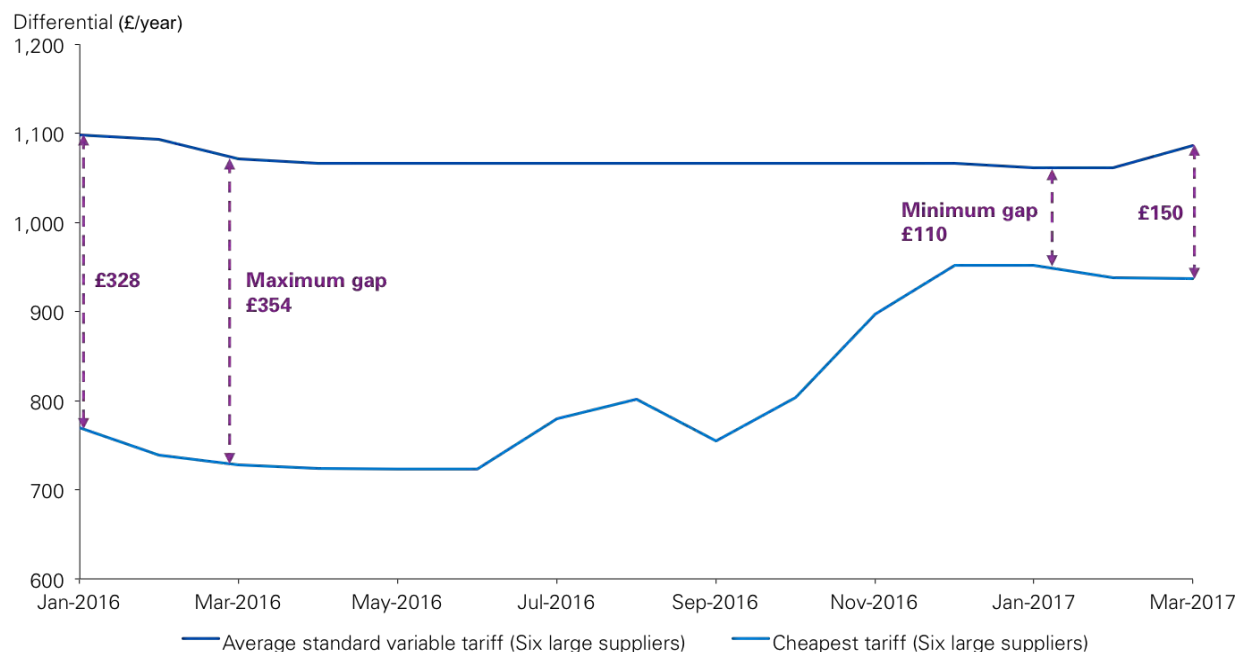
Even before the regulated tariff was proposed, however, there is evidence that the gap between SVTs and fixed-price tariffs was already narrowing, and not by reducing SVTs but by increasing average fixed-price tariffs. Between early 2016 and April 2017, the gap reduced from more than £300 to less than £150, as illustrated in Figure 2.

Figure 1: Average tariff prices by type and supplier (March '16-17)



Source: KPMG analysis based on Ofgem's retail price comparison data, 2017.

Figure 2: Recent changes in retail price



Source: Ofgem's retail price comparison data, 2017

If further narrowing of the gap is achieved by fixed price tariffs rising, then the benefits to loyal customers could be offset by the opportunity costs to those most engaged with the market. As MoneySuperMarket energy expert Stephen Murray puts it: "A price cap, whether relative or actual, will lead to many of the best deals disappearing, prices finding a higher level and a growing market of disengaged customer"⁷.

As the differential is eroded, all suppliers could find it harder to attract new customers through cheap fixed price deals on low margins. Alternatively, the cap could prompt a 'race to the bottom' as suppliers opt to compromise on service and innovation and cut costs in order to undercut competitors on price. While this might prove to be good for affordability, investment in customer service and premium products could suffer in a contest to provide the cheapest possible deals.

However, if the Government's proposed price cap is linked to market fundamentals, like the cap on Pre-Payment Meters (PPMs), it could reduce the benefits of hedging and forward procurement of energy (i.e. impact the liquidity and depth in the wholesale market). This could result in greater, not reduced, volatility for customers who value price stability. On the other hand, it would offer customers greater transparency of the wholesale market changes impacting their bills, and ensure that if wholesale prices were to fall, they would be reflected in their bills more quickly. In 2016, many of the Big Six were criticized by Ofgem and campaign groups for not reducing prices and passing on steep falls in wholesale gas costs faster.

It is worth noting that a wholesale tracked price cap could provide small suppliers with a ceiling on their overall costs. This could potentially increase the products offered by trading companies and allow for innovation in the trading businesses, with such wholesale price index-linked products allowing for more competition. However, consideration also needs to be given to the impact that the price cap can have on the credit rating of the Big Six, as this could have a knock-on effect on the ability of independent power producers (IPPs) to contract into financeable power purchase agreements (PPAs) with suppliers. IPPs such as renewable generators, seek long-term contracts with a counterparty, whose credit quality meets equity and debt investors' requirements, with Big Six suppliers historically playing a significant role in the PPA market. If the credit rating of the Big Six is negatively impacted, the policy could have potential unintended consequence of altering the competition in the PPA market and the ability of IPPs to finance new investment.

Over time, market dynamics – number of suppliers, the availability of alternative tariffs, increased or reduced differentiation between suppliers – will each have a bearing on the savings that can be achieved from a price cap. As each of these factors can change in several ways in response to a price cap, it is difficult to predict whether a cap alone can truly guarantee customer savings in the medium term.

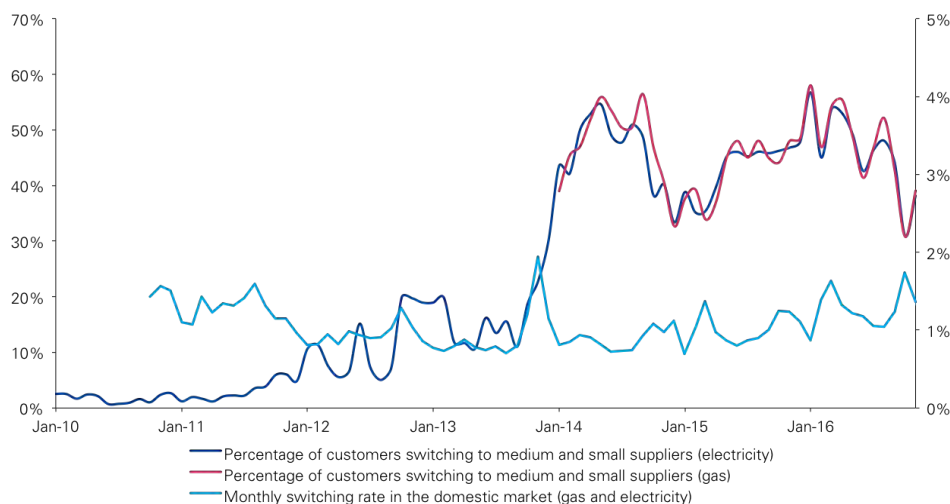
⁷ Energy price cap plans under fire, Utility Week, 2017

What would the implications be for switching?

Around one percent of the retail customer base switches supplier every month in the GB market⁸. Although only a minority of customers switch frequently, customers who do switch are moving away from the Big Six to small and medium-sized challengers (see Figure 3.) The level of consumer switching is an important benchmark used by Ofgem to determine whether the energy market exhibits effective competitive behaviour⁹.

Low switching rates have at times been interpreted as an indication of apathy, vulnerability or lack of engagement. However, KPMG Nunwood's Customer Experience Excellence methodology associates customer loyalty – rather than changing provider – with customer satisfaction¹⁰. So, low switching rates could in fact be an indication of customer satisfaction, as opposed to lack of engagement or dissatisfaction. In a similar vein, not all non-switchers are vulnerable customers, as has been implied in some of the recent commentary.

Figure 3: Proportion of customers switching to small and medium sized suppliers



Source: Ofgem's Number of domestic customers switching supplier by fuel type, 2016

2016 represented a five year high for switching, with rates increasing by nearly a million over the previous year and almost 4.5 million people changing electricity supplier in 2016 (Figure 4). More recently, Energy UK also reported that more than 500,000 switches took place for two consecutive months (April and May 2017) for the first time¹¹.

4.5m

people changed electricity
supplier in 2016

⁸ Retail energy markets in 2016, Ofgem, 2016

⁹ Retail energy markets in 2016, Ofgem, 2016

¹⁰ Making memories, UK Customer experience excellence analysis, KPMG Nunwood, 2016

¹¹ 2016: A record year for consumers switching, Energy UK, 2017 and Switching up 14 per cent on last year, Energy UK, 2017

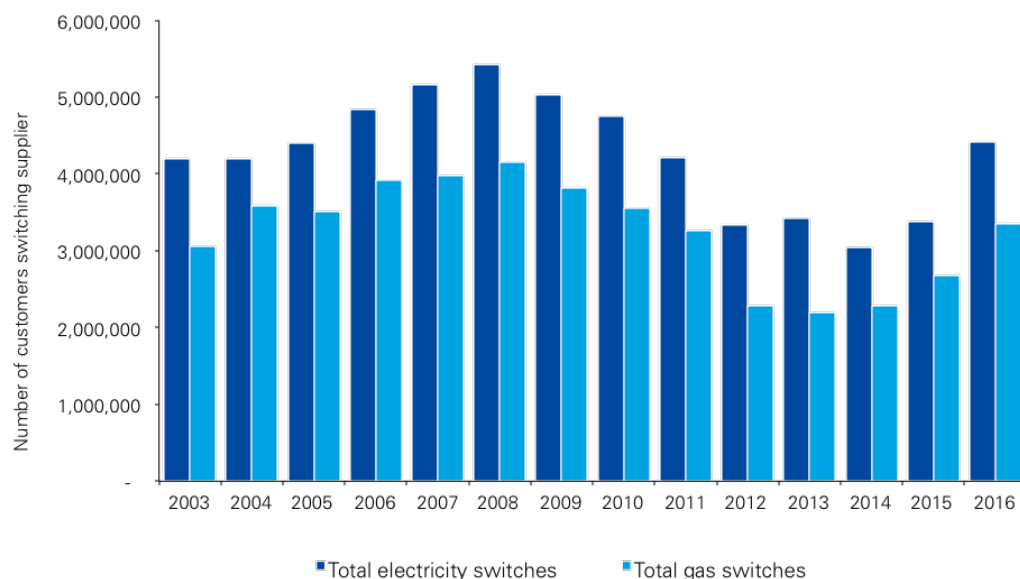
If SVT and fixed tariffs do converge, and prices become less differentiated, then there is likely to be reduced incentive to switch. Prices may converge to the regulated price set by the cap. This could erode the historical financial benefits of switching, which are typically promoted by price comparison websites, leaving suppliers fighting harder for an ever shrinking group of customers motivated to change regularly.

Another reason that switching might reduce include the fact that customers might perceive the cap as a Government-regulated price and, presuming a fair deal, choose not to explore alternative suppliers.

While some smaller suppliers clearly see the price cap as an opportunity to gain market share from the larger suppliers, these smaller suppliers may seek to focus on particular market segments to differentiate their offering, as has been the trend in recent years.

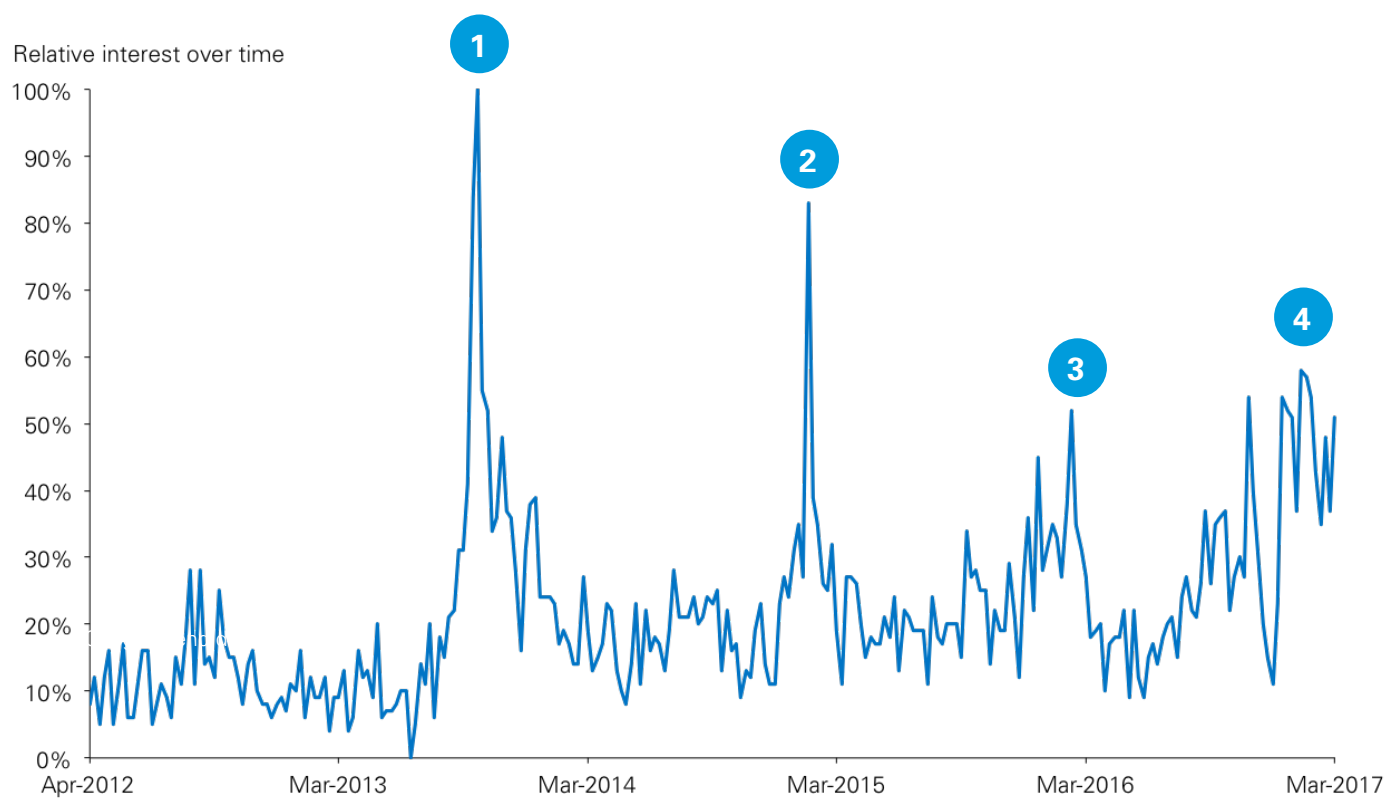
We may also see an increase in switching in the short term due to increased political and media attention. As figure 5 shows, this has often been the case when energy prices and bills have been the focus of attention.

Figure 4: Number of domestic customers switching supplier by fuel type



Source: Ofgem's Number of domestic customers switching supplier by fuel type, 2016

Figure 5: Google Trends - Key words “Switch energy supplier” (United Kingdom)



Source: Google Trends data, 2016

- 1** Ed Miliband pledged a 20-month freeze in energy prices while some of the Big Six announced winter price rises. Source: <http://www.bbc.co.uk/news/business-24607242>
- 2** The CMA released an update on the energy market investigation on SVT prices and switching. Source: <http://www.bbc.co.uk/news/business-31512878>
- 3** The CMA released a provisional decision on remedies. Source: <https://www.gov.uk/cma-cases/energy-market-investigation>
- 4** Energy price rises. Source: <https://www.theguardian.com/business/2017/mar/13/how-to-beat-uk-energy-price-rises-reduce-bills-switch-capping>

Experience from other markets on switching

The experience of other countries, which have some price or tariff regulation, offers a useful point of reference but no definitive conclusions, on what may happen to switching rates in the UK.

For example, in France between 2007 and 2015, when France initially moved away from fully nationalised pricing to the introduction of some market pricing, the trend for switching away from the incumbent providers moved from zero to 12%, which is broadly consistent with overall switching rates in the UK. In this case, market rather than regulated pricing acted as a clear stimulus to switching.

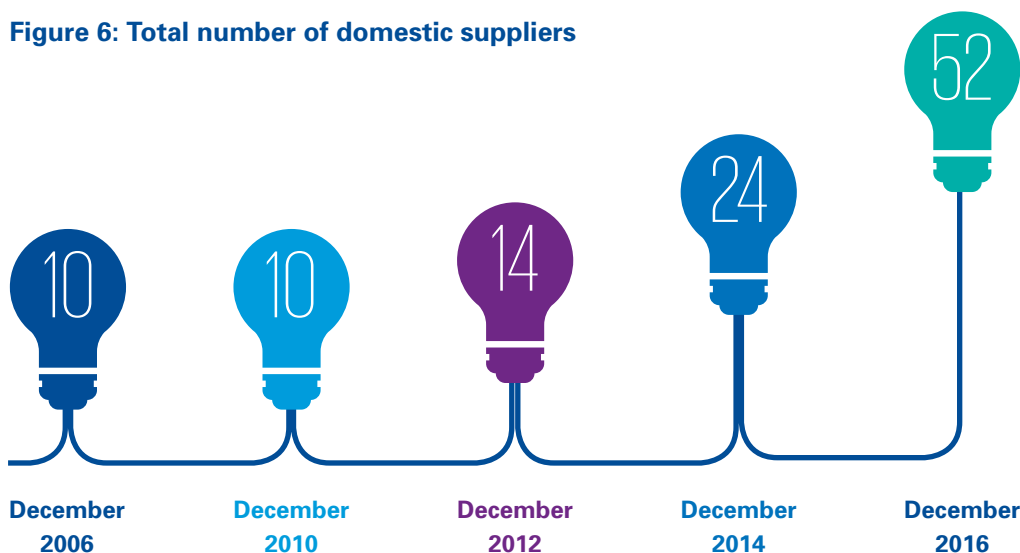
Similarly, Spain moved from a regulated tariff to a market based solution in 2009. The PVPC regulation, enables consumers to choose from a government set voluntary price for smaller consumers (up to 10KW connection) which includes an ex-post application of actual market prices on individual hourly consumption, or a fixed price tariff offered by the last resort supplier. This has resulted in increased switching rates and significant percentages of consumers moving away from the PVPC to the market. (For further details, see Annex).



How would the competitive landscape change?

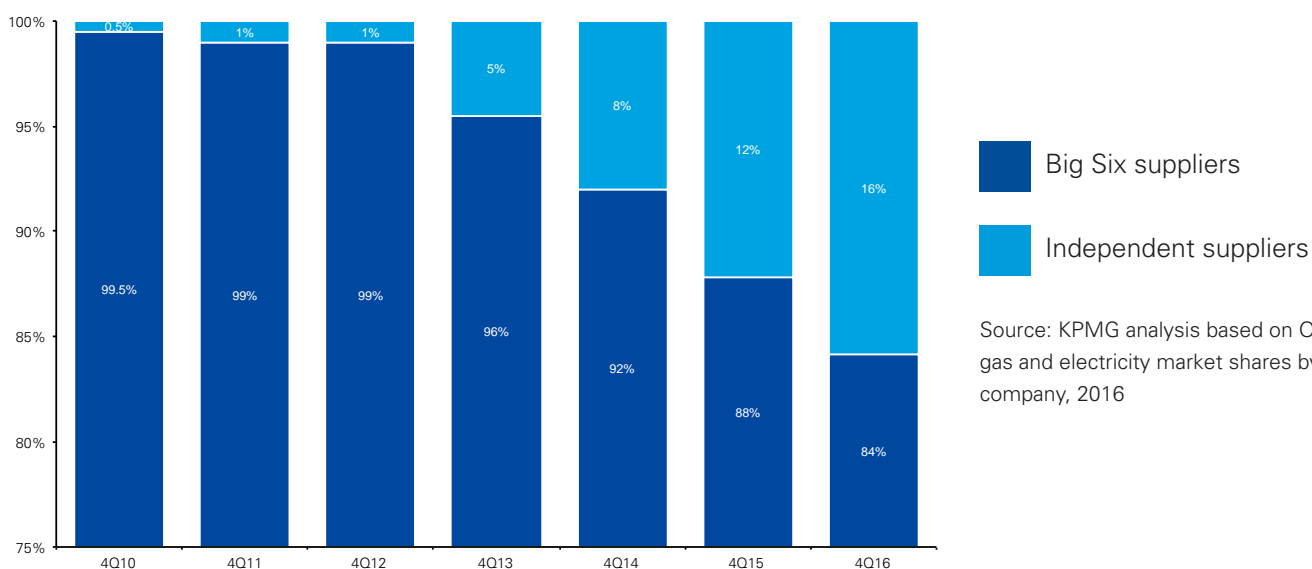
The number of energy retail suppliers active in the UK market has never been greater, growing from 14 domestic suppliers in 2011, to 52 by late 2016 (see Figure 6)¹². Over the past three years, challenger energy firms have grown their share of the market from 2 percent to 16 percent (See Figure 7).

Figure 6: Total number of domestic suppliers



Source: Ofgem's Number of active domestic suppliers, 2016

Figure 7: Market share



Source: KPMG analysis based on Ofgem's gas and electricity market shares by company, 2016

¹² Retail market indicators, Ofgem, 2017

Domestic retail energy suppliers have become increasingly differentiated over time. Customers have more options than ever before when selecting an energy supplier, in which choices based on price, service, environmental or “ethical” preferences are facilitated by comparison websites and slicker switching processes. A number of the smaller suppliers have welcomed the price cap, reflecting their optimism about their ability to continue to attract customers from the bigger suppliers.

Opening or exit for Big Six?

The price cap is likely to present some very tough decisions for the Big Six, all of which have at least half of their customer base on SVTs¹³.

Already experiencing falls in customer numbers, companies may find that measures such as this cap, which affect the number and/or profitability of their core SVT customers, make it harder than ever to recover their customer losses.

A number of Big Six firms have argued that the cap will damage profitability and reduce incentives for suppliers to compete in the market. Margin erosion resulting from capping SVTs may make it even harder for them to compete with challenger suppliers, which typically benefit from lower policy cost obligations and none of the costly burdens associated with legacy IT systems.

With their retail businesses under threat, it is always possible that some of the Big Six could look to exit the UK domestic energy retail market to focus on other countries, non-domestic supply or other activities in their value chains.

Fewer new entrants?

Although a tariff cap may slow the speed and number of new market entrants, providers and potential investors are still expressing interest both publicly and privately. For example, Engie continued with its previously announced plan to enter

the UK domestic supply market¹⁴. Undeterred by the promise of a cap, it stated that it would avoid switching customers to SVTs and instead automatically switch customers to its best deal at the end of their initial term. Similarly, Vattenfall confirmed their entry to the domestic retail market with the purchase of ISupplyEnergy on 20 June¹⁵. Newcomer ‘People’s Energy’ announced on the day after the Conservatives pledged to introduce a price cap, that it will launch in August 2017, saying it will return 75% of its profits to customers¹⁶.

Digital-only, single-tariff Pure Planet energy recently entered the market, and will offer customers energy at wholesale prices plus a fee, ensuring their prices mirror wholesale market changes¹⁷.

Each seems confident that if the retail market cap applies to SVTs, as seems likely, it will not undermine their business model.

¹⁴ Engie enters UK domestic energy market, FT, 2017

¹⁵ Vattenfall to enter UK consumer energy market, FT, 2017

¹⁶ Energy firm promising 75% of profits to customers wins Ofgem license, Business-reporter, 2017

¹⁷ Digital energy supplier offers clean energy at wholesale cost, Clean-energy-news, 2017

How would consumer and investor confidence be affected?

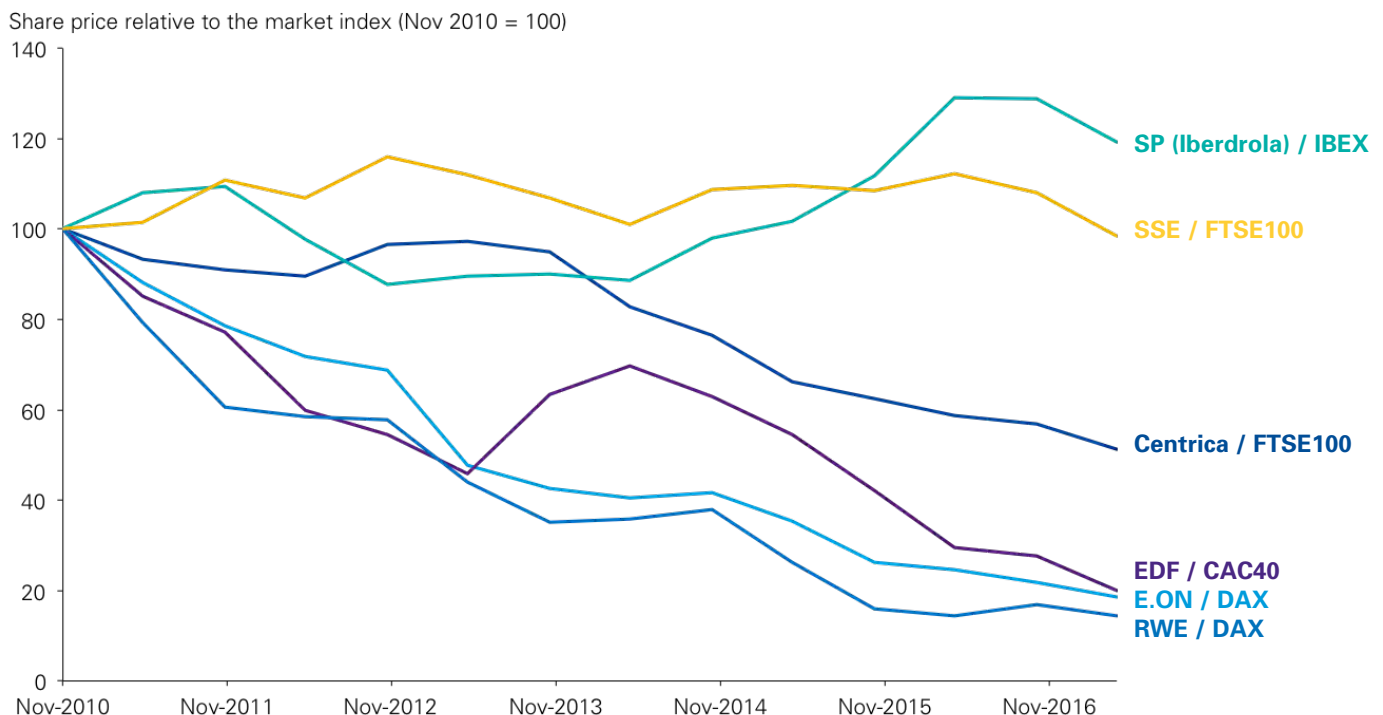
For consumers, the price cap could lead to greater confidence and trust in the energy market, given the 'Government-backed nature of the tariff cap.

There are international precedents as to what happens to consumer confidence where there is a regulated tariff. In France, trust in energy suppliers is well above the European average in a market where the majority (85%) have never switched and remain on a regulated tariff. Likewise, when a price freeze was introduced in Belgium in 2012, consumers' confidence in the market improved by around 7% over the following two years, the highest increase in the EU in this period¹⁸.

However, a number of business organisations have warned about the impact in investor confidence. For example:

- Josh Hardie, Deputy Director-General at the CBI, has said that the price cap could lead to unintended consequences by "dampening consumers desire to find the best deal on the market and hitting investor confidence"¹⁹.
- Lawrence Slade, CEO of Energy UK, similarly warned that the uncertainty created by price regulation could be "potentially putting at risk the billions in investment and jobs needed to renew our energy system"²⁰.

Figure 8: Relative performance of Big Six share prices



Source: KPMG analysis based on Ofgem's gas and electricity market shares by company, 2016

¹⁸ Country reports, Belgium, Europa.eu, 2014

¹⁹ The new energy price cap con? The Telegraph, 2017

²⁰ Energy bill caps put billions in investment at risk, say suppliers, The Guardian, 2017

These fears appear to be playing out. The announcement, on 8 May 2017, was met with an immediate impact on the share prices of some of the UK listed larger suppliers. Moreover, although the Big Six suppliers are often accused of benefiting from high profits, the majority have underperformed against their home stock market indices (see Figure 8). Looking ahead, analysts predict that a cap on SVTs could see earnings per share fall by around 15-20 percent in 2018/19²¹.

“[The price cap will be] potentially putting at risk the billions in investment and jobs needed to renew our energy system.”

Lawrence Slade
CEO of Energy UK

15%

fall in earnings per share
prediction following a cap on
SVTs (2018/19)

²¹ Shares in utilities drop on the Conservative party's pledge to put a cap on energy bills, City A.M., 2017

What would the impact be on investment and innovation?

Many energy suppliers, particularly the Big Six with their high proportion of customers on SVTs, claim that the cap will reduce their profitability. There are approximately 20 million customer accounts on standard variable tariffs²². If, as suggested, bills for these customers fall by around £100 per annum, then £2 billion of revenue could be lost to suppliers. This could constrain the ability of suppliers to use this money to fund innovation and improvements in customer experience. At a time where Smart Meter roll-out is creating the biggest opportunity for innovation in a generation, there is a risk that a chance for a step-change in energy usage and market engagement is missed.

There are fears too for cross-selling, if a cap is introduced in an overly restrictive manner. If transparency to customers about their basic, regulated tariff becomes the priority, the cap could block the effective bundling of services, such as energy, water, phone and broadband. Offering free or subsidised services or products, like boiler servicing or smart thermostats alongside a tariff may be off the menu. Even if the cap itself does not specifically restrict suppliers' ability to bundle multiple products, it could mean that those customers on the regulated tariff are less likely to move away from the comfort of a capped tariff for basic gas and electricity supply to access more innovative energy services. On the other hand, some smaller suppliers may feel there is scope to continue to offer differentiated products in the market in order to increase their market share.

²² Energy plans: What is a 'standard variable' rate tariff and how does it compare? Ofgem, 2017

Conclusion

The re-regulation of retail tariffs would mark a sea change in attitudes to UK energy policy, after nearly 30 years of relying on markets and competition to deliver the best deal for consumers.


While it would bring the UK more into line with the practice in a number of other countries. It remains to be seen whether the Government does follow through on its Manifesto commitment and how long this intervention will last. It would be possible to link the outcome to the roll out of smart meters (as with

the PPM cap), smart tariffs (Time of Use Tariffs) and the introduction of 24 hour switching. But Ministers would then have to argue that they have 'fixed' the perceived problems in the market and made switching sufficiently easy that the safeguard cap is no longer required. Alternatively, the end point might be linked to the outcome of the Independent Review of Energy Costs that the Government has promised. If this identifies ways to reduce energy bills – the Government has set a target of having the lowest

energy prices in Europe – then this may reduce the pressure for state intervention in the retail market.

Whatever the end point, a regulated price cap would change the way the GB energy market works for many years to come. If a price cap is introduced, a business-as-usual response is unlikely to succeed against the changing regulatory environment. Boards need to be considering now how best to respond to this fundamental change in the way the energy market works.

Questions for the board to consider:

-  **How would we sustain our existing strategy and targets for earnings and customer numbers?**
-  **How would we realistically offer competitive tariffs where prices are regulated?**
-  **How would this change open up new opportunities to differentiate ourselves? Or would we sell up and exit the UK retail market?**
-  **How would we diversify our offering into other parts of the value chain or customer base?**
-  **Would continued investment in improving our customer experience offer the same returns if there is price regulation?**
-  **How would we fund innovation in new services/products?**

Annex: International experience with regulated tariffs

Regulated tariffs are not without precedent: the UK had regulated prices before privatisation. Some other European countries, even those where energy markets are privatised, continue to have regulated tariffs. This annex outlines some examples of how regulated prices function in Belgium, Spain and France.

France

While the UK is looking to impose a regulated price on a liberalised market, France has moved in the opposite direction, keeping a regulated price but allowing customers to benefit from market prices since 2007.

The regulator (CRE) is responsible for setting regulated prices for domestic customers from the incumbent energy suppliers. However, consumers are free to switch to alternative suppliers at market prices. By the end of 2015, 12% of domestic customers were on contracts at market prices, of which over 99% were with alternative suppliers²³. This is broadly comparable to UK levels of switching (c. 15%).

In 2014, the French consumer was more positive towards the energy market than typical European consumers, with relatively few complaints, above average trust and overall rating of performance above European averages²⁴.

Belgium

Belgium introduced a freeze on energy prices to final consumers in 2012, following rapid price rises. The freeze applied to customers on variable tariffs and reduced bills by around 17 – 52 Euros per annum for electricity and 42 – 82 Euros per annum for gas.

The regulator (CREG) monitors the price cap (which is indexed quarterly), rejecting excessive changes. CREG also publish social tariffs for low income customers on per KWh basis. The safety net will remain in place in principle until at the earliest 31 December 2017. During this period so far, market concentration has decreased among energy suppliers.

Between 2012 and 2014 (the period in which the freeze was introduced), consumers' confidence in the market improved by around 7%, the highest increase in the EU in this period²⁵.

Spain

Spain fully opened the market to alternative suppliers in 2003. Since 2009, Spain has moved away from a regulated tariff to a market based solution, the PVPC regulation (voluntary price for small consumer), that includes an ex-post application of actual hourly market prices on individual hourly consumption, or a flat price offered by the last resort supplier (LRS) for those contracted up to 10KW (94% of consumers)²⁶. Additionally, a Last Resort Tariff was defined for vulnerable consumers. All suppliers are free to set competitive tariffs for all customers²⁷.

By the end of 2013 around 60% of the market remained on the PVPC tariff, down from 76% in 2011. Similarly, switching rose from 5% in 2009 to 12% in 2012²⁸ (again similar to the UK)²⁹.

Unlike France and Belgium, Spanish consumers continue to have lower trust and satisfaction in the market than most EU countries³⁰.

²³ Summary of the annual report of the CRE (Energy Regulatory Commission) to the European Commission, 2016

²⁴ Country reports, France, Europa.eu, 2014

²⁵ Country reports, Belgium, Europa.eu, 2014

²⁶ Country reports, Spain, Europa.eu, 2014

²⁷ Electricity tariffs in Spain, edp

²⁸ Electricity tariffs in Spain, edp

²⁹ Spanish energy regulator's national report to the European commission, CNMC, 2015

³⁰ Spanish energy regulator's national report to the European commission, CNMC, 2015

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