



# Consultation Response

## Reviewing the potential impact of increased wholesale volatility on the Default Tariff Cap: November 2021 policy consultation

Office of Gas and Electricity Markets (Ofgem)

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## **About this consultation**

Volatility in the wholesale energy market has led Ofgem to reconsider the additional space required within the Default Tariff Price Cap ('the Cap') to account for unexpected spikes in wholesale costs. Ofgem have put forward their preferred reform to the Cap methodology - involving a change to the existing wholesale risk allowance. This would afford additional space in the Cap value to account for increased wholesale volatility.

## **Key points and recommendations**

Rising wholesale cost increases mean consumers are facing significant increases to their energy bills from April 2022. These increases are happening alongside the proposed changes to the Cap methodology, the impact of other policy costs, and those for dealing with failed suppliers. Ofgem must commit to working with Government to mitigate the impact of this price shock in the Spring.

Ofgem must further consult on the precise figure proposed for the adjusted wholesale risk allowance. Whilst there are some estimates about its impact on consumer bills, there is continued uncertainty about how much these bills could rise by in April and beyond.

Ofgem must review the cumulative impact of proposed reforms to the Price Cap, and other measures. Consumers must not unfairly shoulder the costs of reducing risks for suppliers.

and care; are comfortable, safe, and secure at home; and feel valued and able to participate.

## Response

We welcome the opportunity to respond to this consultation. The Price Cap was designed to ensure default tariff customers pay a fair price whilst ensuring suppliers can charge the efficient cost level for energy. Age UK understands the impact that surging wholesale energy costs have had on suppliers. In theory, the Price Cap was designed to ensure suppliers can effectively sustain their business model while reducing the risk of consumers paying above market rates. The Government has recognised that this protection is particularly important for those consumers who are disengaged from the market and are unlikely to switch from a longstanding default tariff<sup>1</sup>.

Our response to this consultation comprises two parts. Firstly, we have specific recommendations regarding Ofgem's preferred amendment to the Cap, via adjustments to the wholesale risk allowance. Our second recommendation is for Ofgem to champion calls for greater consumer support as an essential part of confronting the present energy crisis.

Ofgem have outlined five options for adjusting the methodology of the Default Tariff Price Cap. These options are designed to allow the Cap to better account for increased volatility in wholesale energy prices. Ofgem's 'minded-to' position is to amend the wholesale risk allowance. The wholesale risk allowance is presently fixed at 1% of the core direct fuel allowance for gas and electricity. Its purpose is to ensure the value of the Price Cap is set after accounting for a degree of variability in the wholesale energy costs paid by suppliers. The risk allowance sits alongside the headroom allowance as the two in-built mechanisms for managing market uncertainty. Beside these there is an allowance for earnings before interest and taxes (EBIT allowance) and wider costs are included within the Cap, such as policy costs and VAT.

Ofgem's proposals to amend the risk allowance should allow the Price Cap to better account for increases in wholesale prices. However, it will result in a small increase in the Cap value which will be passed onto consumers. The risk allowance is presently set at 1% of direct fuel costs. Presently, wholesale costs represent £528 of the total Price Cap value<sup>2</sup>. We therefore estimate that the wholesale risk allowance represents around £5 of the total Price Cap value.

While it may be expedient for consumers to see the wholesale risk allowance amended, Ofgem have not set out clear proposals for what this risk allowance will be increased to. We cannot comment on whether a change in the risk allowance is the best option without knowing what sort of range of increase Ofgem is proposing. Ofgem will need to propose an adjustment to the allowance and provide an impact assessment of the additional consumer cost this will entail from April onwards before we can agree or contest this change. We would welcome further consultation on the precise figure proposed for any new wholesale risk allowance as soon as possible.

However, we do agree with Ofgem's view that increasing the EBIT or headroom allowances would not be suitable solutions at this time. Increases in EBIT would not be appropriate during a consumer crisis – as this will pass greater profits onto suppliers at a time when consumers are struggling.

headroom allowance would likely represent a much higher cost to consumers as this allowance accounts for a wider range of supplier expenses beyond wholesale prices.

We welcome Ofgem's commitment to mitigate



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- <sup>7</sup> BEIS, 2021. Annual Fuel Poverty Statistics in England, 2021 (2019 data). Department for Business, Energy, and Industrial Strategy. [Online]. Available at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/966509/Annual\\_Fuel\\_Poverty\\_Statistics\\_LILEE\\_Report\\_2021\\_2019\\_data.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966509/Annual_Fuel_Poverty_Statistics_LILEE_Report_2021_2019_data.pdf). [Accessed 05/08/21].
- <sup>8</sup> Age UK, 2021. The Cost of Cold Campaign. Age UK. [Online]. Available at: <https://www.ageuk.org.uk/our-impact/campaigning/the-cost-of-cold/>. [Accessed 01/12/21].
- <sup>9</sup> EFCP, 2021. Energy bills set to hit highest peak since price cap introduced. End Fuel Poverty Coalition. [Online]. Available at: <http://www.endfuelpoverty.org.uk/energy-bills-set-to-hit-highest-peak-since-price-cap-introduced/>. [Accessed 29/09/21].