Energy price cap: technical approach to Market-Wide Half-Hourly Settlement

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About Energy UK

Energy UK is the trade association for the energy industry, representing companies investing billions of pounds to secure our country's current and future energy needs.

From growing start-ups to major electricity generators, grid and infrastructure developers and energy suppliers, our members are driving change across power, heat, transport and flexibility.

We provide a collective voice for the sector working with governments, regulators, charities and other organisations to provide crucial insight that shapes policy, offers solutions and promotes best practice.

Our broad view across the whole system supports evidence-based positions which are not tied to particular technologies, and are focused on delivering strategic benefits for people, businesses and the economy.

We champion initiatives such as our Vulnerability Commitment, which pushes suppliers to go beyond regulation to support customers with additional needs, and TIDE, the industry's drive for greater inclusion and diversity. Through our Young Energy Professionals Forum, we support the development of future leaders.

We are equally committed to our team and are proud to be recognised as a 'Gold' Investors in People employer.

Introduction

Energy suppliers have dedicated significant resources to market-wide half-hourly settlement (MHHS) migration and are moving at pace to deliver the long-term benefits for consumers. MHHS presents an opportunity for the market to benefit customers through tailored offers. Through engagement with flexibility offers, customers can help to reduce the costs of the energy system and lower their bills.

We welcome that Ofgem acknowledges that, without reform, the price cap risks stifling tariff innovation, as well as undermining cost recovery and financial resilience at a critical point when MHHS will add to the costs and risks facing suppliers.

Energy UK has several key recommendations as Ofgem develops its approach:

- Ofgem should ensure that the price cap is cost-reflective, supports investment and provides regulatory freedom for the market to innovate.
- Commercial tariff innovation that incentivises and rewards customer flexibility on time-of-use (TOU) fixed contracts outside the price cap is dependent on two key factors:
  - The scale of the engaged customer market. This is shaped by numerous factors including commercial strategies as well as how the price cap operates and is communicated by Government and Ofgem. This is alongside legacy barriers to passing through the value that consumer flexibility actions offer the energy system.
  - Scope for tariff investment is limited by insufficient headroom within the price cap, particularly given the scale of customers on the cap. The role of the price cap under MHHS needs reform and greater headroom is required. This is further explored in our recent report Demand Better: A smarter fairer energy retail market, which calls for Ofgem to publish a multi-year roadmap for the evolution of the price cap.
- Whilst the Clean Flex Roadmap has helped provide clarity on Government ambition for flexibility, there is currently a lack of strategy for harnessing both flexibility and the role of fair or regulated pricing together. Price restriction interventions might seek to enhance flexible demand and/or provide protections, but they will also reduce supplier control of their pricing strategies, adding costs and reducing the price differentials that drive behaviour change.
- Creating multiple price caps goes beyond the original intended purpose and scope of the cap, increasing cost under-recovery risks for retailers and causing confusion for customers. This is an area where outcomes-based regulation is needed to reflect the tailored tariff solutions that can better reflect customers actual interests and needs.
- Demand profiles should be updated mechanistically and regularly, so that the cap keeps pace with changes in the default tariff cohort. Affordability concerns should be addressed transparently through targeted policy support, rather than by suppressing cost-reflective cap allowances.
- Ofgem should use supplier data from customer migrations under MHHS from January 2027 and should not attempt to define cost allowances using elective settlement data.
- Ofgem should also prioritise a review the gas wholesale allowance approach given the changes in consumption habits.

Multiple price caps should be avoided

As Ofgem's own data implies many engaged EV customers favour fixed tariffs to access the benefits of cheap off-peak charging, which is fast becoming a competitive niche in the domestic fixed tariff market. As such, carving out a specific TOU variant is unnecessary as these customers repeatedly take up fixed tariffs, with little or no time in between spent on a default tariff. Therefore, such a variant would add cost and complexity for little or no benefit.

Creating multiple price cap variants would increase complexity and risks creating confusion for customers. Customers will have different combinations of technologies and tariffs to suit their circumstances. Creating one price cap to try to cover all these situations would create significant cost under-recovery risk and be overly expensive for some customers while being too generous to others. Trying to create a cap for each different circumstance would cause a significant regulatory burden and under-recovery risk.

Attempting to predict customers' intention when rolling off fixed TOU contracts may also lead to poor customer outcomes. Consumers might have good reason to roll on to the default rate, such as changes in usage or periods of significant market uncertainty.

While any customer can be in a vulnerable circumstance and be unable to engage with their supplier (such as a previously engaged customer rolling off a fixed contract), the right approach is not for market design to be shaped around edge cases disproportionately. To do so would not be consistent with principle of proportionality in the CMA's 4Ps that DESNZ encourages Ofgem to consider in its recent review.

We are also concerned by Ofgem's recent unpublished guidance on licence interpretation on customers rolling off fixed tariffs without stakeholder engagement. Ofgem effectively made a new policy pre-empting the present consultation, which is still at a very early stage. This is poor regulatory practice. Proper consultation is vital to avoid unintended adverse consequences. SLC 22C.12 makes clear that guidance and revisions to guidance should only ever follow consultation, not precede or pre-empt it, as Ofgem has done in this case.

Balance of risk, opportunity and support in energy retail

As set out in the consultation, without reform, the price cap risks stifling tariff innovation, undermining cost recovery and financial resilience at a critical point when MHHS will add to the costs and risks facing suppliers.

Without further change, the role of the current universal default price cap is likely to face issues of fairness, reduced efficacy of price protection, and reduced MHHS benefits.

In the short-term, this is best addressed by further steps including: avoiding scope creep over pricing restrictions, increasing the headroom allowance and examining the gas wholesale allowance.

Fundamentally, the price cap was designed as a consumer protection measure to ensure disengaged domestic customers on default tariffs are fairly charged based on the efficient cost of supply. As such, Ofgem is going beyond the purpose of the price cap and the objectives of its supporting legislation when it suggests that it could seek to incentivise specific customer behaviours when making methodological reforms to it.

Customers who do not shift their demand include both those who can but choose not to shift their demand and those who are unable to shift their demand. Ofgem recognises this but does not attempt to address it. As set out in Energy UK's response to DESNZ's similar proposals in 2024, the focus of protection should be separate targeted support interventions for vulnerable consumers that have barriers to engagement.

The key benefits of MHHS should be realised by suppliers innovating via the fixed market and competing to attract and support customers to achieve the lowest cost load shape. Therefore, for the price cap, the key consideration for Ofgem should be weighing up the balance of ensuring costs are borne equitably by default customers and that suppliers are able to recover their efficient costs and maintain their financial resilience. This may mean that some costs are not spread equally across all relevant customers, and should be aligned with broader principles of the work explored in DESNZ's future default tariffs call for evidence.

MHHS will mean that the price cap for default customers will either become more expensive over time to reflect the cost to serve, or, they will be cross-subsidised by those on flexible tariffs. Affordability concerns should be addressed transparently through targeted support policy, rather than by suppressing cost-reflective cap allowances.

An area that needs further work is the current E7-style weighted average compliance tests which could constrain innovative TOU default tariffs and make genuinely cost-reflective peak pricing difficult.

Ofgem has not made any proposals in relation to gas costs. There is a clear evidential case for action to address the impacts of seasonality and lower consumption on cost recovery via the gas wholesale allowance in the price cap. Gas consumption is consistently trending downwards (as supported by analysis in Ofgem's recent review of Typical Domestic Consumption Values), with recent winters have been consistently milder, this has left suppliers systematically under recovering their gas costs. We encourage Ofgem to prioritise a review of gas wholesale costs and assess whether a more dynamic approach is required to ensure the price cap is reflective of reasonably incurred efficient costs for gas.

Using the right data at the right time

The use of elective settlement data as a basis for assumed behaviours for the wider energy market is not fit for purpose because they are a self-selecting group.

Ofgem notes in paragraph 2.48 that it has based its demand profile analysis on Profile Class 0 elective customer consumption, and it is only speculative as to how representative this group may be when extrapolated across broader price cap customer consumption. This dataset is extremely limited in scale and broader applicability.

For example, it would be economically rational for those consumers currently included in elective datasets to be those with a beneficial load shape. Just as it is rational for suppliers' MHHS migration profiles to prioritise beneficial load shapes at the start of their migration activity.

Elective data sets will also likely disproportionately include those customers who have actively chosen to engage with smart metering and TOU tariffs, and are potentially more engaged with low-carbon technologies, such as electric vehicles (EV) and heat pumps. As such, it is highly unlikely that the demand profiles derived from these limited initial datasets will be representative of the broader set of price cap customers.

Ofgem should not consider fundamental changes to the wider price cap approach on the basis of incomplete and potentially misleading data. Reliable annual consumption patterns which can demonstrate the impact of seasonality on overall consumption will be necessary data to have a clearer view.

Ofgem should consider the near-term incremental commodity and non-commodity cost increases underway when the requisite data is available. Non-commodity costs should be treated consistently with commodity costs. Where suppliers face half-hourly or peak-driven charges, the cap methodology should reflect those same cost drivers.

Ofgem should have the necessary evidence from the demand data submitted by suppliers in January to make a useful assessment of initial cost impacts. It is not appropriate for Ofgem to suggest in paragraph 2.78 that the wholesale risk allowance is appropriate. It is intended for very specific costs and risks that have not gone away. We also dispute the claim in this paragraph of the consultation that recent decisions represent a ‘buffer’ for cost recovery.

As the migration is staggered, suppliers are exposed to the cost of each customer demand profile from the point of migration; so that should be the relevant milestone for the price cap, while shorter settlement is delivered by July 2027. The end of 2027 will be too late.

In anticipation of behaviour driven by market-wide half-hourly settlement, Ofgem should prepare for significant uncertainty of impact. Suppliers' different approaches to customer acquisition, the uncertain speed of flex market access in the UK and evolving customer perceptions of TOU tariffs will fundamentally limit Ofgem’s ability to anticipate the speed of change. As a result, Ofgem should set out plans to update the demand profile used to determine the price caps frequently to ensure that it reflects default tariff customers.

Given the lack of certainty surrounding expected customer behaviour post-migration, and the range of variables which could significantly influence demand in the future, Ofgem must commit to reviewing the approach to **setting demand profiles** for the price cap on at least an annual basis from the point changes are made for the medium-term, to ensure its approach remains fit for purpose, adapts to developments in the market, and reflects an equitable distribution of costs. Further, we **support quarterly updates of allowances** following a pre-established mechanistic process to ensure it remains cost reflective.