Please reply to: Sharon Darcy, Director, Sustainability First

Email: sharon.darcy@sustainabilityfirst.org.uk

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Dear Ofgem / BEIS,

Ofgem / BEIS Consultation on Flexible and Responsive Energy Retail Markets

Sustainability First is a think tank and charity that works in the energy, water and waste sectors. We have significant experience of consumer and public interest issues, regulation and the demand side (see www.sustainabilityfirst.org.uk).

In responding to Ofgem's consultation on the consumer impacts of half-hourly settlement, we set out some over-arching comments about the need for Ofgem and BEIS to take a more strategic and consumer-centric view of the cumulative impact of this, and all the other reforms that are currently being discussed, including the retail market review. We have developed this thinking into a discussion paper ("What is Fair – How should we pay for the energy system of tomorrow?") which we attach and would ask BEIS and Ofgem to consider as part of our response to this consultation.

We intend to host a roundtable to discuss this paper in the near future and hope that BEIS and Ofgem would find that helpful as they develop their thinking on retail markets and other projects (including network charging reform and half-hourly settlement) which we maintain all need to be considered together.

Overall we agree with the direction of this consultation and would stress the importance of having at least outline thinking developed in some areas to provide a framework within which other Ofgem work can be taken forward. For example:

- The need for clarity on who needs additional protection: We agree with the need to think about how best to protect those who do not engage in the market. In our view the primary focus should be on consumers in vulnerable situations (rather than those who choose not to engage). This means thinking about customers on low incomes who are particularly impacted if they end up paying more than they need to – or those who for whatever reason might struggle to engage in a market that is likely to become more complex over time and require access to broadband and smart technology to fully participate. Given the dynamic nature of vulnerability and the energy market itself, we consider that any protection arrangements need to be sufficiently flexible to be able to catch as far as possible all those that may need help.

- The best mechanism for providing customers in vulnerable situations with that additional protection. The consultation notes that there is a question as to whether all suppliers should have to meet the current universal service obligation. An alternative model would be, for example, to have specific suppliers (appointed through auction) who would accept the additional costs of serving the full range of customers. Under such a model these suppliers could be exempt from paying certain

elements of charges (network fixed costs or certain policy costs) for some or all of their customers as a way to address the "fairness" dimension of charging. If such an auction failed to attract sufficient interest, the idea of creating a new default energy retailer designed with the specific purpose of providing services for customers in vulnerable circumstances and those that struggle to engage in smart markets, and funded by cross subsidy from the wider customer base, could be explored;

- The extent to which underlying charge structures can be expected to be passed through into retail prices. This is discussed in some depth in our paper. The consultation highlights the question and commits to monitoring the position. In particular it notes that in future network charges might be levied directly (rather than passed through suppliers) which might help facilitate a wider range of retail market models. Reflecting on these options is vital context for some of the debates around network charging reform where fairness is a consideration in setting the charges but where the resulting structure will not necessarily be passed on in end retail tariffs, potentially undermining that policy intent. Our paper argues that now is precisely the time for radical thinking rather than looking incrementally at individual issues and also raises the question of how more cost reflective network charges will in practice be translated into end user tariffs.

Our key asks to ensure a procedurally fair energy system going forward are summarised below:

- *The need to look at the full picture*
- *The need for a wider public debate on fairness and the principles for cost recovery in this new world*
- *The need for clarity on the respective roles of government and Ofgem around distributional issues*
- *The need for better data to underpin policy making and regulatory oversight in this new data-driven world*
- *The need for radical, strategic thinking but from a consumer perspective*

We have also attached as an annex brief responses to the specific questions raised in the consultation where we have evidence or views.

We note that the recently published Access and Forward-Looking Charges working papers touch on some of these issues and hope that our discussion paper will also be of interest to the Ofgem team working on that. We have not had a chance to fully reflect the thinking in those papers into our discussion paper but will do so in any updated version.

Yours faithfully,

Sharon Darcy

Responses to specific questions

1. Do you agree with our vision for the future of the energy retail market, the outcomes we are seeking to achieve and our characterisation of the key challenges we need to overcome?

Yes. However in relation to the loyalty premium we would argue that any targeted price intervention should primarily focus on customers in vulnerable situations not customers at large who choose not to engage.

2. Are there examples of new products, services and business models that would benefit current and future consumers, but are blocked by the current regulatory framework?

Local energy solutions face particular problems but these are probably as much around developing a viable business model (given local services are not properly valued in the current charging framework) as they are about the inability to have geographically limited licences.

3. Are there current or emerging harms to energy consumers which are currently out of scope of the regulatory framework? Do these differ for domestic and non-domestic consumers?

As noted in the consultation, players like auto-switching services are not covered.

With the potential for many more innovative tariffs, including load control arrangements, there will be new risks that need to be addressed. Where unlicensed intermediaries have the ability to control loads there would seem to be particular risks.

4. Would it be beneficial to allow suppliers to specialise and provide products and services to targeted groups of customers? If so, how can this be delivered while balancing the need for universal service?

Yes – as set out in the consultation this would allow them to take a much more consumer-centric approach.

One option would be to appoint (perhaps through auction) suppliers who are willing to take on the additional responsibility of universal service, with those additional costs potentially recovered across all suppliers. While it would seem reasonable for customers with additional needs to have access to a narrower pool of suppliers who have committed to meet those needs it probably would not be acceptable to customers simply to force them onto a single designated universal service provider. However, if such an auction failed to attract sufficient interest, the idea of creating a new default energy retailer designed with the specific purpose of providing services for customers in vulnerable circumstances and those that struggle to engage in smart markets, and funded by cross subsidy from the wider customer base, could be explored. Customers would of course be able to switch away from such a provider.[1]

Given the transient nature of some aspects of vulnerability it would remain important that all suppliers have to meet certain minimum standards of protection (e.g. on disconnection).

[1] A possible parallel from the pensions sector could be the establishment of Nest as a default pension provider specifically created by Government as part of its Automatic Enrolment Programme to meet the needs of those on low to moderate incomes who were otherwise not engaged in saving for retirement in defined contribution schemes.

5. Are incremental changes to regulation sufficient to support the energy transition and protect consumers? Or does this require a more fundamental reform, such as moving to modular regulation?

Given the scale and nature of change in the energy system it seems likely that fundamental reform will be needed in future and it is right to start considering the options now. The concept of modular regulation would seem to be more flexible. However the discussion in the consultation does not address the perceived problems with a licensing model (which seems to be implicit in modular regulation). Telecoms has had an authorisation model for many years and there would be value in looking at the lessons to be learned from their experience.

6. Are there any other potential market distortions we should be considering as part of our review?

No comment

7. Would removing the thresholds for the Energy Company Obligation and Warm Home Discount help remove imbalances in the retail market, and could this be done without significantly increasing barriers to supplier entry or expansion in the retail market?

In addition to the imbalances mentioned there is the problem that customers in receipt of Warm Homes Discount (WHD) will be discouraged from switching supplier because they will not necessarily continue to receive that discount. If some suppliers are to be exempt from providing WHD in future (as a result of changes to the universal service arrangements) then transparency is important so that customers in receipt of WHD can be confident in switching supplier.

8. How could the delivery burden on suppliers from the Energy Company Obligation be reduced, for example through the introduction of a buyout mechanism?

In considering how best to reduce the delivery burden it is vital that the end outcome of improving energy efficiency levels for households in fuel poverty is not jeopardised. As such a trading mechanism is to be strongly preferred to a buy-out, unless as suggested the funds from the buyout could be ring-fenced and used to deliver energy efficiency services.

9. What effect does the range of Energy and Climate Change Policy Levies have on the retail market?

Aside from the impacts on different size players (whose customer bases will vary in terms of demographics) the fact that recovery of these levies is overwhelmingly through electricity bills creates a fairness issue for low income households reliant on electric heating and a distortion in the incentives for heat de-carbonisation.

10. What actions could government take to reduce any negative impact of Energy and Climate Change Policy Levies?

Thought should be given to where policy costs are more appropriately recovered through taxation as the costs of meeting net zero can be expected to create an unsustainable increase in bills, particularly for those on the lowest incomes. All suppliers should be expected to contribute but with levies designed to create exemptions for those customers least able to pay.

11. Do you agree that now is not the time to make further changes on system and network cost recovery, metering and access to data as part of this retail market review?

Our paper argues that now is precisely the time for radical thinking rather than looking incrementally at individual issues and also raises the question of how more cost reflective network charges will in practice be translated into end user tariffs.

It may well be premature for example to move responsibility for metering (before the end of the rollout) but having a blueprint for what the regulatory framework of the future would look like would provide a context for other major policy decisions currently being debated. Major reform will take a long time and early thinking is needed.

12.What total costs do suppliers face with regards to bad debt and supporting consumers who struggle to pay for their energy?

No comment

13.How could any potential distortions related to high cost-to-serve customers be addressed, for example by the provision of additional support services for customers struggling to afford their energy?

Additional debt support services at a market level is an interesting idea that merits exploration.

In talking about high cost-to-serve customers the consultation focuses on particular aspects such as debt. However with a move to market-wide half-hourly settlement there will be new groups of customers who are high cost to serve (because they have particularly peaky demand). While Ofgem has been clear in its work on half-hourly settlement that customers would not be forced onto time-of-use tariffs, as this consultation highlights there are incentives on suppliers to cherry pick and to avoid high cost to serve customers. More work is needed to understand the characteristics of these higher cost to serve customers. This will need to be kept under review as the market evolves.

14.Would addressing market distortions (for example size-based obligation thresholds for some policy schemes, supporting those who are struggling to afford their energy bills) help reduce incentives for suppliers to adopt pricing strategies that lead to excessive prices for loyal consumers? If so, to what extent (providing quantitative evidence, where possible)?

It is not obvious that removing distortions changes the incentives around loyalty premiums (although we would support it for other reasons). Large suppliers may argue that they have to pursue such strategies now to compete with small suppliers but it will always be a more profitable strategy to recover more of your fixed costs from sticky customers and less from active ones.

15.What are your views on the measures being considered to address loyalty penalties in different markets? What approach or – combination of approaches – would be most effective in the energy retail market?

The focus should be on improving the working of the market. Direct price interventions should be focussed on those for whom energy remains unaffordable or who are unable to engage in the market (for example because of lack of access to broadband etc).

16.What other approaches could be adopted to ensure loyalty penalties do not re-emerge?

No comment

17.What protections or support may be required to engage consumers in vulnerable situations in the future market?

This is a vital and complex question that requires proper attention. Some initial thoughts are that:

- Ofgem needs to understand the distributional impacts of changes that it is making – including ensuring it has access to much better data to enable it to do so. This will allow it to identify where direct price intervention is needed to protect consumers in vulnerable situations.
- Ensuring clear and honest communication with customers around the structure of innovative tariffs and services is important to protect all customers but essential for those in vulnerable situations. Ofgem could usefully examine the extent to which current communications around economy 7 tariffs can be seen as treating customers fairly given the concerns that have been raised in the past by Citizens Advice on levels of customer understanding. Exploring this would provide valuable pointers to what is needed in a more complex future market.
- Ofgem needs to work with others (including government departments, other regulators and consumer and third sector groups) to ensure that all consumers have a fair 'opportunity' to engage in future markets (e.g. access to broadband, smart kit etc). In doing so, it may need to look beyond the boundaries of its own responsibilities to 'call-out' issues that others may need to pick up.[2]

[2] This issue is explored in Sustainability First's work on a 'Sustainable Licence to Operate' – see Pillar 3 of our strawman:
https://www.sustainabilityfirst.org.uk/images/publications/fair_for_the_future/24071_F4TF_Fair_STRAWMAN_v8a_WEB_MID-SIZE1.pdf