Briefing paper

Sustainability first

The energy crisis and future retail energy markets – bridging to the future

A coherent response is needed to the energy crisis which delivers both in terms of fairness and net zero. This paper sets out the need for the active engagement of civil society groups in these issues and makes the case for the urgent prioritisation of investment in energy efficiency. It then explores different options for providing social protection (population wide and targeted), both short-term to help people get through this winter and medium to longer-term to ensure that retail energy markets are fit for the future.

Introduction

The energy crisis and rising cost-of-living pressures have come together in a perfect storm. At the same time, in this decisive decade for the climate, there is an urgent need to turn net zero commitments into action.

BEIS have put out a call for evidence on the energy retail strategy, although the anticipated call for evidence on affordability and fairness is still awaited. Ofgem have published an action plan on retail financial resilience and asked for input on the price cap methodology. The issues raised are interlinked.

The energy system is broken. Help is needed this winter. The estimated £3bn cost of bailing out failed suppliers is already three times higher than the annual cost of current energy social support measures. A coherent response to the crisis firmly focused on social and environmental outcomes is needed to build confidence and to develop a more efficient and resilient system for the future. Joined-up policy can also help address issues around limited bandwidth and support decision makers as they prioritise.

This briefing sets out Sustainability First's developing thinking in this area for household customers. In **summary**, we recommend:

a) The active engagement of civil society groups. These decisions are too important to be made behind closed doors. Engagement will lead to better decisions that work in practice, build legitimacy and help us stay on track to achieve net zero/other long-term objectives.
b) Investment in energy efficiency needs to be urgently prioritised. The Green Homes Grant could be restructured and put onto a longer-term and more strategic footing. We need a step change in local delivery and upskilling of advisers. Distribution Network Operators' (DNOs) present license duties should be strengthened.
c) Income support is needed for the general population and given some unintended windfalls from high wholesale prices could also be affordable. VAT for a basic level of 'essential' energy should be scrapped and the costs of supplier failures should be spread over time – providing interest rates are reasonable. But this won't deliver long-term solutions.
d) More targeted short-term income support measures are also vital to get through this winter. Consideration could be given to a combination of: increased Universal Credit; the Warm Homes Discount being extended and revamped; Cold Weather Payments being increased and a wider group being made eligible; and Winter Fuel Payments being based on real needs, better targeted and paid through bills. Sustainability First's research has found that certain social groups have been especially hard hit by Covid-19, this includes private sector renters, some minority ethnic groups, lone parents and carers, disabled people and those who were shielding and low-income workers in insecure employment. Targeted approaches must support the working poor.
e) Targeted income support measures are also needed medium to long-term, in addition to continued commitment to the Energy Company Obligation. The energy system of the future will need sharper customer price signals and more dynamic markets. Targeted social support will be vital to sit alongside these changes to provide protection for certain groups. We propose three options for further exploration: making price signals cost reflective of the future energy system, but with a certain level of capacity and energy being made available at a lower unit rate to ensure essential provision is affordable; a new Universal Service Obligation / social tariff for all providers; and the provision of social support all in one place via one or a small number of highly regulated Essential Energy Service Providers for a basic level of usage. This briefing provides further details.
f) Sectoral leadership is essential to steer out of the crisis. BEIS, Ofgem and companies need to work together to strengthen governance processes and ensure these are firmly focused on purpose and the cultural shift needed for a sustainable and resilient future.

Social and environmental issues must be dealt with together

We can't put off climate action whilst we deal with the current cost of living and energy crises. Equally, any focus purely on net zero will erode public support for decarbonisation. We need to use the opportunity created by the crisis to develop a joined up, holistic and strategic response. Typically addressing social concerns has been driven by short-term needs, while climate concerns have been viewed as a longer-term issue, (and often pushed 'right' and off the agenda). This is not fair on young people, future generations, and the natural world.

Civil society must be involved in shaping the response to the energy crisis and developing future energy retail markets

Procedural justice is an important dimension of fairness. To build confidence in future arrangements, consumer, environmental and wider public interest groups need to be actively involved in shaping the response to the energy crisis. If these issues are left to existing suppliers, or if discussions with HMT, BEIS and other parts of government/Ofgem take place behind closed doors, the decisions taken may not be seen as fixing the problem or trustworthy. Similarly, if from expediency only the immediate consumer crisis is tackled, concerns may remain as to whether decisions give sufficient weight to net zero and other long-term interests.

We need to start a national conversation about:

- How much support is needed? What is an adequate level of heating, light and power? This can help identify what an 'essential level of energy needed' looks like. A very rough proxy for this could be mean usage / lower quartile usage.
- Who support is targeted at? Existing support often fails to include the increasing number of working poor or those who have been made vulnerable by Covid.

  There is a need to take account of:
  - Financially vulnerability
  - Housing type, tenure and condition
  - Additional needs (eg physical frailty)
  - Vulnerable situations (eg bereavement)

Civil society groups need to be actively involved in this conversation and can help to develop the criteria for what a future retail market should look like. We are developing our thinking in this area but such criteria could sit within a framework which may include:

a) Deciding what outcome we are looking to deliver e.g. short-term or long-term affordability of energy, or ensuring people have enduring warm and powered homes so can participate in society?
b) Does the proposal support an enduring solution to the problems we are trying to solve? Even a quick-fix needs to support longer terms goals and avoid unintended consequences such as creating poverty traps.
c) Does the proposal meet social *and* environmental objectives?
d) Does the proposal give people control where appropriate to help themselves e.g. help people budget? Will it enable stability in terms of prices and bills and avoid bill shock?
e) Does the proposal encourage new customer responses for both efficiency and carbon reduction?
f) Does the proposal work in practice and will it ensure help goes to those that need it most or where intervention can deliver the most benefits?
g) Is it deliverable in the time available?
h) Does the proposal address distributional impacts of cross-subsidies in a fair way?
i) Does the proposal encourage investment, including around vulnerability, embedding inclusion and net zero?
j) Will the solution be sufficiently flexible and resilient so it can be adapted to changing circumstances?
k) Is the proposal clear and transparent and will it lead to consistent and predictable decision making and build trust in the energy system?

Energy efficiency needs urgent prioritisation

Energy efficiency delivers multiple co-benefits – individual, societal and economic. It helps address fuel poverty, reduces carbon emissions, reduces supply requirements, and provides good green jobs. To date, many energy efficiency programmes have been piecemeal, relatively small scale and short term. Significant strategic investment and support are urgently needed, including:

a) The Green Homes Grant needs to be restructured and extended (e.g. to cover people who have been made vulnerable as a result of Covid) and put on a longer-term footing. Short-term funding will not address the skills and supply chain issues that are facing the sector and wider economy.
b) Trusted local intermediaries need further support and upskilling to deliver energy efficiency advice (e.g. to

provide services to people without prior experience of fuel poverty).

c) Energy efficiency delivery programmes need to be rolled out area by area, street by street.

d) DNO duties on electricity efficiency should be strengthened and built on their new licence condition 31E.

Providing income support for the general population

The energy price cap, originally designed to protect against a loyalty premium, has to date helped to avoid significant bill shock. However, the scale of the collapse in retailers witnessed over the last few months and the scale of the price rises expected in April have demonstrated that the price cap is not a sufficient protection against current challenges.

The price cap is predicted to double from April this year, with average bills expected to increase by more than £700 to £2000. Taken together with the forthcoming increases in National Insurance (around £600 per household on average), income tax threshold changes and wider inflationary pressures, energy price rises are contributing to what Torsten Bell of the Resolution Foundation has called an 'overnight cost of living crisis.' As reported on 7th January, this could lead to the biggest cost of living jump in April since 2008/09. This will impact not only people on low incomes but also those on average earnings.[1]

Given these points, and recognition that there have also been unintended windfalls (for North Sea operators for example) there is a strong argument for income support for the general population to get through the short-term crisis. Several options need consideration:

a) **Scrap 5% VAT on domestic fuel.** Unless tailored, this would be a blunt instrument and would benefit many who do not need financial assistance. However, one option would be to remove VAT from a basic level of energy consumption deemed essential. A quick though imperfect proxy for this could be mean usage / lower quartile usage with potentially some additional allowance for consumer vulnerabilities e.g. those who require extra energy due to disability. This would align with the general principles of essential products being zero rated and would benefit in particular those on low incomes who typically (though not always) have lower levels of energy consumption. It would also provide the beginnings of a rising block tariff which offers a good longer-term model or a low cost or free essential block of energy, with households paying more the more they use. Both VAT and ETS revenues have increased substantially as a direct result of the energy crisis and one way or another there is a strong case for this 'windfall' to be used to in a small part help mitigate the costs of price rises.

b) **Defer green levies / environmental policy costs**. This would defer crucial funding changes needed to fulfil net zero commitments. We do not support this option.

c) **Move environmental policy costs /green levies from bills to general tax**. Moving £8bn of environmental policy costs to taxation would be more progressive than recouping them through household bills and could be relatively simple to implement. Research by Public First suggests that moving policy costs to general tax could reduce the average energy bill of fuel poor homes by up to £178 a year and the overall average energy bill by £168 a year.[2] The following table outlines energy policy costs (as at June 2021) and how they are currently recovered on bills.

[1] Families predicted to face biggest cost of living crunch since the financial crisis, Financial Times, 7th January 2022

[2] Rachel Wolf et al, Public First, 2021

Table 1: Energy policy costs and how they are currently recovered on bills

Policy cost breakdown					
Type	Comp-onent	Fuel	User	Recov-ery	£/year/household
Renewables & Capacity	Renewables Obligation (ROs)	Electricity	All	Volumetric	£70
	Feed-in Tariffs (FiT)	Electricity	All	Volumetric	£20
	Contracts for Difference	Electricity	All	Volumetric	£30
	Capacity Market (CM)	Electricity	All	Volumetric Time of Use	£10
Energy Efficiency & Social	Climate Change Levy (CCL)	Electricity & Gas	Business	Volumetric	n/a
	Warm Homes Discount (WHD)	Electricity & Gas	Domestic	Fixed per meter	£15
	Energy Company Obligation (ECO)	Electricity & Gas	Domestic	Volumetric (TBC)	~£30 Volumetric (TBC)

Source : Cornwall Insight. 'Who pays for supporting the net-zero transition'. Dan Starman, Tom Andrews, Emily Lewis. 2 June 2021[3]

Costs per year are rounded to year to nearest £5 and apply at TDVC.

In terms of short-term affordability, moving policy costs to general tax would largely help electricity and not gas customers. As policy costs currently account for 20.4% of the electricity bill and 1.6% of the gas bill, it would not help pay for gas central heating bills this winter (although in the medium to longer-term shifting policy costs to tax could indeed help remove current price distortions between electricity and gas).

Increasing general tax could also be politically unpopular despite being more progressive. To make it more acceptable the shift could be limited to certain types of levies (e.g: legacy costs or future nuclear costs). However, as can be seen from Table 2, there are precedents for other energy related policy costs being recovered through general taxation (e.g. Commercial and Domestic Renewable Heat Incentives, EV subsidies, R&D funding, Scottish and Welsh energy efficiency programmes).

Table 2: The range of existing mechanisms for recovering policy costs[4]

Recovered via customer bills	Recovered through taxation
Renewables Obligation (RO), Feed in Tariffs (FITS), Capacity Mechanism – recovered on the basis of energy usage (p/kWh). Renewable gas levy	Commercial and Domestic Renewable Heat Incentive (currently running to 2021)
Energy efficiency policy costs – originally per customer but changed to usage basis (gas and electricity) with introduction of the Energy Company Obligation (ECO) following pressure from fuel poverty groups	EV subsidies (cars, charge-points)
	Scotland and Wales energy efficiency programmes
Warm Homes Discount reflects customer numbers – obligation on electricity and dual fuel suppliers	Winter Fuel Payment
	Cold Weather Payment

[3] https://www.cornwall-insight.com/insight-papers/who-pays-for-supporting-the-net-zero-transition-?utm_source=podcast&utm_medium=YMABII&utm_campaign=Podcast_33_YMABII_whopaysIP

[4] Sustainability First. 'What is Fair ? How should we pay for the energy system of tomorrow?'. September 2019 https://www.sustainabilityfirst.org.uk/images/publications/other/Sustainability_First_Future_Energy_Market_Discussion_Paper_September_2019.pdf

Consideration of shifting environmental costs from electricity to gas bills to help drive carbon reduction longer-term, as floated before the current crisis hit, would need to be underpinned by clear principles. For example, while there may be a logic to shift all remaining social costs from electricity to gas, it is hard to understand the in-principle case for shifting electricity market costs onto gas bills – and which at £9.5bn p.a. make up the lions' share of all policy costs - (RO, FITs, CfD, CM costs). Perhaps the hardest policy-cost question yet to be addressed, is that for all heat-use gas prices (and oil) do not reflect the cost associated with their carbon emissions and therefore do not fairly reflect the full pollution cost. This sits at the heart of retailer concerns that gas pricing for heat, bakes in a disincentive to switch to electricity. To introduce a carbon-tax on gas for heat-use at this point might arguably address the clear environmental distortion – but would also exacerbate the immediate hardship of the current energy crisis. One medium term answer might be to hypothecate receipts from a carbon tax on gas-heating - and recycle these to less-able-to-pay households through schemes for energy efficiency and/or a switch to electric heat. While this might offer a 'right' medium-term answer, it may well not be a workable immediate solution.

d) **The costs of supplier failure could be spread over time** (i.e. by Ofgem through deferred network charges). This could make a material difference to bills. However, as the FT reported on 7th January, the savings provided would likely be in the region of ~£70 per household, so a fraction of the ~£700 bill increase expected.[5] It would also be important to ensure that the interest rates incurred by spreading costs over time were reasonable; phasing can't come at any price.

e) **A wholesale price mechanism** (equivalent to Contracts for Difference - CfD) leading to government support/funding when wholesale prices are high and repayment of government loans when prices are low. However, this would remove underlying price signals and could be opaque / difficult to administer. It would take time to ensure robust systems were established for measuring any financial flows around any CfD type arrangements.

There are clearly drawbacks with most of the above options in terms of support for the general population. Sustainability First considers that in the short-term a combination of a version of (a) - where VAT is removed from a basic level of energy consumption deemed essential - and (d) – spreading costs of supplier failure over time (subject to reasonable interest charges) - could be helpful to provide income support to the general population this winter. We would not support the introduction of other measures (beside the changes to energy efficiency investment and support referred to previously) unless wider factors (such as general inflationary pressures) make this necessary.

If support to the general population is to be introduced, we consider that the following questions would need to be addressed:

a) What is the outcome that policy makers are trying to achieve? Is it to help people struggling to pay their bills get through this winter?
b) What level of income support would be needed to make a material difference for people with gas heating in the short-term?
c) What level of energy is deemed 'essential'?
d) How would this intervention line-up with the price signals that are needed for the future?
e) Would the intervention shift the sector in the desired direction of long-term travel?

Income support for targeted groups in the population

The Household Support Fund to be delivered through local authorities in England this winter accepts how critical it is to support the most vulnerable, but at £0.5bn towards food, clothing and utilities, it cannot begin to meet the challenge. The poorest tenth of households spend 7.1% of their incomes on electricity and gas. This compares to 3.9% for the richest income decile. Sustainability First considers that a shift in thinking from 'one-size fits all' to a more granular view of consumer, citizen and community desired outcomes and requirements is needed so that support and engagement can be better targeted. The active involvement of civil society groups can help do this and ensure that proposals are workable in practice and do not only meet the needs of the mythical 'average consumer'.

Short-term income support for targeted groups in the population - Energy specific schemes

a) **Warm Homes Discount (WHD).** This bill rebate is paid out between October and February so we understand would not be that easy to change to make a significant impact this winter. It is also rebated as a single sum so does not automatically help with budgeting. However, it could be reset to bring tariffs

[5] Financial Times, op cit

for targeted customers back to an affordable level and rebated automatically / in smaller amounts. It presently is £140 (due to rise to £150) so would need to increase considerably to represent a worthwhile intervention. Thought also needs to be given to the eligibility criteria recognising that Covid has resulted in new groups struggling to afford their bills. It is also important to ensure it complements and doesn't duplicate other support schemes (see below). This is especially important as the cost of the Warm Home Discount is met through bills. Increasing it would inevitably put further pressure on, and likely raise, bills for the rest of customers, unless the increase was met from tax. However, the mechanism of the Warm Home Discount does provide an established route.

b) Energy Company Obligation (ECO) - This Is a current obligation on larger suppliers to deliver energy efficiency measures to homes. Suppliers are obligated to ensure a targeted level of savings dependent on their market share. The ECO scheme remains a vital element in the energy efficiency landscape. It Is crucial that ECO4 (April 2022-26) continues and is well-funded.

c) Cold weather payments (payments made via the benefit system when there have been three consecutive days of cold weather). These would need to be adequate and go to a wider group than currently.

Short-term income support for targeted groups in the population - Non-energy schemes

d) Universal Credit increase. This could clearly help with budgeting. This would be the most effective way of providing targeted social protection, wouldn't put direct pressure on other energy bill payers and would be relatively quick and simple to implement.

e) Winter fuel payments (funded via tax) – this existing scheme would need to be extended and redirected to be more targeted to reflect real need (not just all pensioners as currently) and to be put through bills (as opposed to the current one-off cheques) to help people better budget.

f) Other government benefits (eg disability allowances).

Sustainability First supports increases to universal credit. If this is politically not acceptable, although none of the other options are perfect, and all would require some changes, some combination of them is needed to provide targeted income support short-term.

In developing a package of measures to help this winter, the following questions will need to be addressed:

a) What does that option cost?
b) Who will pay for the associated increase in costs / support of that option (bill payers or tax payers)?
c) Who is that option targeted at?
d) Will that option provide help this winter or only from next winter onwards?
e) Will that option help with budgeting or is it a one - off payment?

Medium to longer term income support for targeted groups in the population

Sustainability First considers that deeper social protection is also needed for the most vulnerable (sufficiently targeted, as discussed above) in the medium to longer-term. The energy price cap is not the right vehicle to best prepare the sector for a net zero future which is likely to be characterised by sharper price signals and dynamic markets. The long-awaited call for evidence on affordability and fairness Is an important part of this debate.

Radical solutions to the energy retail market need to be developed now to ensure that we steer in the right direction for a net zero world. Building on our previous 2019 strategic framework for thinking about the relationship between costs, charges and tariffs,[6] we have identified three options for developing deeper social protection in terms of income support in the medium to longer-term.

a) **Make price signals cost reflective of the future energy system.** Adopt a new dual-approach to consumer price signals to (1) curb growth in peak-capacity (kW) and (2) to encourage energy-use (kWh) in generally lower-priced periods. A new and transparent split in customer-tariffs in this way would also make it more feasible to make a minimum level of both capacity and of energy available at a lower unit rate per household for some or all households. Household capacity charges could ensure recovery of

[6] Sustainability First. 'What is Fair ? How should we pay for the energy system of tomorrow?'. September 2019 https://www.sustainabilityfirst.org.uk/images/publications/other/Sustainability_First_Future_Energy_Market_Discussion_Paper_September_2019.

certain 'fixed' costs to the system (e.g. generation & balancing and network costs).

Customers could still exceed the minimum level of capacity and pay a higher rate to use more (e.g. as in France or Italy customers could 'subscribe' at 3kW, 5kW, 11kW etc). Customers would need to be 'warned' if they were going to exceed their capacity and there would need to be social protections built in for less-able-to-pay customers – especially those with electric heat.

Household capacity charges of this kind could also be coupled with many new approaches to supply of lower cost energy (kWh) – perhaps via a basic low-cost or free allowance, perhaps cheaper at certain times of day, or perhaps some kind of basic low-cost supply but with a 'rising-block' tariff where those who use most also pay most. Such options could help reduce bills for essential usage and should also help encourage energy saving, and in the main, should be compatible with a competitive retail market driven by new business models. It would help prepare the energy system for the future (e.g. it could be adjusted to be time or season related

Household capacity charges could also introduce a form of 'rough-justice' – where those with EV chargers and electric heat start to make a larger and more transparent contribution towards the system capacity they need. Where there are EV clusters, household-level capacity charges would also make a revenue contribution which was effectively locational (without a need for under-lying complex locational marginal network charging). In Norway, the regulator has recently introduced household capacity charges.

b) **Make social support a condition of entry to the market – introduce a new Universal Service Obligation / social tariff.** Under this option, *all* providers would have to offer a new 'social tariff' at reduced cost to people on low incomes / in vulnerable situations, including the working poor etc (see previous discussion targeting). Currently, the Energy Company Obligation (ECO) only kicks in for companies above a certain size (although this threshold has been lowered). Significant care would be needed in developing the eligibility criteria for such schemes.

Providers could be exempt from policy costs for the customers they have in receipt of the social tariff. Consideration could be given to linking this option with universal service provision and social tariffs in other sectors (such as water) to provide more joined-up customer support.

c) **Provide social support in one place – create one, or a small number, of essential energy service provider(s)**. People on low incomes, in vulnerable situations etc could be 'passported' to be supplied by one or more highly regulated providers for their basic energy services (warmth, cooking, lighting, power to basic electronic devices) at low cost. These provider(s) could also act as a channel for targeting energy efficiency services. Again, significant care would be needed in developing the eligibility criteria for inclusion in these schemes (but it could be built around existing passport benefits).

Essential energy service provider(s) could be exempt from certain policy and/or other fixed costs for these customers. To drive efficiency, consideration should also be given to setting the provider(s) an Average Demand Reduction Obligation. A variation on this option could be to allow other customers to be able to choose to be provided by a 'no frills' essential energy service provider(s) but for these customers to not be exempt from the policy and fixed costs. A greater number of customers could bring down the cost to serve and pool some risks. Attention would also be needed as to what would happen to passported customers who ceased to meet the eligibility criteria (e.g. if they were to continue to be served by this provider, would they then need to pay policy and fixed costs – and could these costs be introduced in a phased way to avoid bill shock?).

Implementing this option could clearly take time. If only one provider was chosen, this could be set up as a joint NDPB / Corporation in a similar way to Nest in the pensions market. Such a market segmentation would enable other energy providers to innovate and develop premium enhanced energy services. Although there is a risk that this could lead to a 'two tier market' – it could also, as has been the case with Nest, have a halo effect in terms of providing a new definition of what good looks like / what to aspire to.

Sustainability First considers that sharper price signals and more dynamic markets will be needed to develop the energy system of the future. However, medium-to longer-term targeted support will also be needed for some groups. We consider that the above options need urgent investigation. For all options, the following questions need to be addressed:

a) What is an essential level of energy use?
b) What level of heat and power is acceptable beyond which market price signals should have free reign?
c) Which of the above options for support would lend itself best to converging markets – whether this is in terms of technologies, combined energy/water social support etc?
d) What impact would this option have on energy security and resilience?

Sector leadership and robust governance to build trust in the energy system

Energy providers need to show sectoral leadership if they are to build trust in the energy system and put the rhetoric around a just and fair transition into practice. They need to actively support and work with civil society groups to address the challenges outlined in this paper together.

To strengthen regulation and governance, Ofgem's proposals on retail financial resilience need to be significantly developed: to improve the focus on corporate purpose and what it means to be an essential services provider in a net zero world; so that 'fit and proper' person tests for Directors are robust and meaningful; to ensure boards are sufficiently experienced and expert, diverse and have the appropriate mix of skills and ways of thinking; and to ensure governance processes can demonstrate, and provide meaningful assurance on, how board decisions are addressing questions of fairness and resilience - short and long-term.

These changes need to be underpinned by a principles-based approach to decision making which is focused on delivering long term sustainable outcomes. This can help change mindsets, attitudes and cultures and align the interests of companies, investors, regulators and government.

This paper was written by Sharon Darcy with support from Sustainability First Associates Maxine Frerk, Judith Ward and Zoe McLeod

Sustainability First is a think tank and charity focused on developing practical approaches to promote social, environmental, and economic wellbeing in essential services.

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