BEIS/Ofgem consultation:

Flexible & responsive energy retail markets - E.ON submission

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E.ON

- E.ON's business strategy is to lead the transition to a decarbonised energy system, offering every one of our more than 30 million customers across Europe an energy solution that's smart, sustainable, and personalised.
- This is best illustrated by our recent decision (July 2019) that, after many years of being one of the leading investors in renewable energy projects in the UK, we are now able to provide all of our residential customers across Britain with a 100% renewable electricity supply – on all tariffs as standard, and at no extra cost.
- We have previously considered the British retail energy market a good place to invest: characterised by predictable, evidence-based policy within a robust, long-term market framework. This confidence has changed significantly over the last few years as interventions in the market, exemplified by the price cap, have significantly increased the risk of operating in this market. Ofgem and Government must become less interventionist and prescriptive to encourage greater innovation. The risk of unexpected policy and regulatory intervention in the UK has now become very high, increasing the cost of capital and deterring investment in innovation.
- We want to continue to invest in and bring positive economic impact to the UK, so we welcome the joint BEIS/Ofgem work on the future of energy retail market design which we note will feed into the process for assessing whether the conditions for effective competition are in place.

Executive Summary

- E.ON agrees with the aims behind the Consultation, that we should transition to an energy market that is competitive, innovative, fair, safeguards the vulnerable and delivers clean affordable energy. In E.ON's view, the best way to deliver that aim is through a market with the right incentives and policy framework in place, that offers a level playing field to those operating in the market and is not distorted in favour of certain players and allows companies operating within it to earn a fair rate of return. That description does not reflect the current UK energy retail market.
- The UK energy retail market is broken. Competition is intense but is not healthy or effective, and has led to a situation where few, if any, market participants, can make a sustainable return. This affects investors' appetite to invest in the retail part of the energy system, which is not in the long-term interest of customers or wider Government policy.

- The unfair and discriminatory treatment of established suppliers, which is acknowledged in the Consultation as distorting competition in the market[1], must stop. Policy and regulation continue to operate as though the energy retail market still consisted only of six established suppliers, imposing significantly greater costs on such suppliers – a significant impact on effective competition.
- There must be an end to free-riding in the market. Newer entrants to the market cannot be allowed to evade the obligations that go with being participants in the energy market and then to crash out of the market, harming customers and leaving more prudent suppliers to pick up the pieces through mutualisation. It is referred to only in passing in the Consultation[2] but has become a feature of the market in recent years and one which has caused real pain to more prudent suppliers and their customers.
- Whilst E.ON would agree that the fact of companies entering and leaving a market is in keeping with the normal operation of market forces, it becomes abnormal when it occurs at the level and to the degree recently seen in the retail energy market. It is not normal that 15 suppliers should have exited the market via Supplier of Last Resort since 2016 – and that their customers have had to be rescued and their liabilities underwritten by others in the market. It is not normal that around a further ten suppliers should also have exited the market in the same period, in a number of cases because of the incredibly difficult and challenging market conditions, including significant and long-standing players such as Cooperative Energy and SSE. Whilst it is possible to cater for those with innovative business models wanting to dip in and cream off any value out of the market, thought also has to be given to how those who serve the less profitable customers in the market and pick up the pieces when other fail, can also keep operating in the market, can make a fair return on the investment they have made in the market and can continue to attract investment.
- In that context, the price cap is incredibly important. Ofgem must relax the price cap to allow suppliers to earn a fair return on the costs to serve all customers and allow a transition period for suppliers to attain the efficiency level set out in the price cap. However, it is not enough merely to raise the cap; measures must also be put in place to tighten the conditions of operating in the market and thereby ensure that the true costs of operating in the market are properly reflected so that companies cannot keep evading their obligations, pricing below cost and misusing customers' funds, with apparent impunity.
- The cost of serving customers in vulnerable situations must be more fairly distributed across the market. It is a fact, which appears to be acknowledged in the Consultation[3], that larger legacy suppliers have a greater proportion of customers on the Priority Services Register (PSR) than newer players in the market and that this may have arisen through [deliberate] strategies that have seen those suppliers "cherry pick" their customers[4]. The Consultation also acknowledges the suggestion that the distribution of customers who are genuinely high cost-to-serve could contribute to uneven costs between suppliers in the same manner as thresholds for obligation

[1] Chapter 4, page 27 et seq.
[2] Chapter 4, page 30
[3] Chapter 4, page 32
[4] Chapter 4, page 32

under the Warm Home Discount and Energy Company Obligation schemes (and, indeed, other inequalities between suppliers not specifically drawn out in the Consultation).

- The additional costs of providing the required services to vulnerable customers are significant. Government and Ofgem must review options to fairly and equitably socialise these additional costs to ensure both that such customers remain attractive to all suppliers and that the retail energy market remains attractive to investors. As is acknowledged in the Consultation, Government and Ofgem should work with industry to explore tools which would facilitate a more equitable distribution of the costs of dealing with the most extreme cases of debt across the market and reduce the impact of any potential market distortion.[5]
- At the same time, Government and Ofgem must be more transparent and honest about the costs of decarbonisation and the extent to which these are recovered through energy bills. A situation cannot be allowed to continue where others sit back and allow energy suppliers to be the focus of all blame for cost increases and subsequent price rises that are the result of policy decisions.
- A large part of the Consultation is focused on whether the regulatory framework is inhibiting innovation and therefore whether there should be some relaxation to enable entrants or participants to dip in and exploit one part of the market, without having the burdens imposed upon them that full market participation entails. Notwithstanding that and sitting alongside it, it is acknowledged in the Consultation that cherry picking of attractive customers (and the neglect and inadequate treatment of higher cost to serve customers and those in vulnerable situations) has already had a distorting impact on the market. Allowing participants to dip in, just picking the bits of the regulatory framework they wish, and not providing a full service to all customers, is likely to exacerbate this issue.
- Where the current regulatory framework evolves to allow future services and products, for example, with reference to modular regulation, care must be taken to learn the lessons of the hazards of allowing a "pick and mix" approach to regulation which has enabled cherry-picking to occur that provides benefits to some customers whilst leaving others to pick up avoided costs, etc. Ensuring market participants cannot cherry-pick or free-ride will be key to ensuring competition remain effective and healthy in future.

Consultation 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, we agree with the vision set out in this consultation where a smart flexible energy system is promoted through innovation for consumers, whilst ensuring that there are appropriate protections in place for those customers who may be in vulnerable circumstances and/or cannot effectively engage in the market.

We have provided the following points for the five areas outlined in the consultation document:

[5] Chapter 4, page 33

One – Wide choice of energy services

We agree that the future energy retail market needs to support the development of innovative products and services, making energy personal for customers. To enable the UK to meet the legally binding 2050 net zero target that was enshrined into law in June, millions of homes will be required to take individual actions, and new consumer offerings have the potential to enable this to happen.

However, the policy interventions which have taken place over the last few years, in particular the default tariff cap, have resulted in a situation where investment confidence in the retail energy market has been materially impacted. This has created an environment where funding to develop, trial and implement innovative products and services is severely restricted and the ability of energy suppliers to play their role in achieving these outcomes has been reduced.

We believe the supplier hub is likely to remain an essential model to ensure customer protections are maintained, customer interactions do not become too complex, and system costs are fairly and efficiently apportioned. However, we do accept that the model may need to evolve to facilitate the introduction of new products or services from a range of providers.

Currently the supplier often acts as the interface with the consumer on behalf of the entire energy industry. This has provided many benefits to the customer, including a single point of contact, access to a universal service, a range of customer protections, and a conduit to allocating costs to the final customer from across the energy value chain. Careful consideration will need to be given to any changes to ensure that these benefits are maintained or improved.

Furthermore, it will be important to ensure that customer benefits from innovative products or services do not simply represent the avoidance of certain industry costs for a portion of customers that leaves others to pay more, and that we do not end up in a situation where confusion abounds as to each service provider's responsibilities. This would likely result in customer detriment and would not help facilitate engagement in the market or the delivery of the required customer decisions to enable net zero.

In order to avoid a market where certain service providers can 'cherry pick' the provision of services that may be the most profitable or carry the least regulatory obligations, it is important that there should be a level playing field in the market and that the 'least attractive' services and/or customers are not left to a default provider to service. Every supplier should be actively seeking to attract all types of customers including those that are more vulnerable and/or more costly. Policy or regulatory intervention may be required to ensure this.

Two – Consistent consumer protection

As referenced above, any change to the existing supplier hub model needs to be carefully considered to ensure that there is no detriment to customers, particularly those in vulnerable circumstances. The current model is relatively easy for consumers to understand, and in the event that a customer has a complaint with their energy supply they know to contact their supplier in the first instance for redress. If the supplier is unable to resolve their issue, a customer can then engage with the ombudsman process for dispute resolution. In an environment where the customer could receive energy-related services from a variety of different providers, it will be important for the customer to know to whom to talk if they have an issue, and that they understand which provider can, and should, provide them with relevant consumer protections.

To attract the development of new energy-related services, which is essential to help deliver the changes necessary to meet the net zero commitments, it is important that there is a clear framework to follow, including a clear understanding of regulatory obligations and protections for specific services and products, and that these regulatory standards apply equally to all service providers and are enforced appropriately.

In the last few years there has been a significant increase in new electricity and gas suppliers, encouraged by very light touch checks on entrants. These low barriers to entry, however, have produced unintended consequences in the market which have not been in the interests of customers. In some cases, new entrants have entered the market ill prepared and have subsequently crashed out, leaving prudent suppliers to pick up the pieces; this has resulted in an extra cost that existing suppliers are forced to pass onto their customer base, further damaging the perception of the industry. This behaviour is still happening today and must be stopped urgently. Some 15 suppliers have exited the market via Supplier of Last Resort since 2016 – and their customers have had to be rescued and their liabilities underwritten by others in the market. Lessons from this experience need to be reflected in any new arrangements that are introduced to meet the future needs of the industry.

Currently a number of consumer protections, such as the Energy Company Obligation (ECO) and Warm Home Discount (WHD) are only mandated on suppliers once they have reached a certain size. This does not provide a level-playing field in the market, something we have covered in more detail elsewhere in this response. It also means that customers who qualify for, or require these protections, are limited in their choice of provider. This is a poor outcome for consumers and again, the lessons from this need to be reflected in any new consumer protections that are introduced.

Three – Minimal market distortions

We strongly agree that in the future energy retail market, energy suppliers should not face policy obligations and responsibilities that distort competition between different businesses or business models. Currently there are a range of obligations and responsibilities on established suppliers that result in a higher level of costs compared to newer suppliers. This impacts the ability of efficient established suppliers to offer tariffs that compare favourably to those of many smaller suppliers.

A comprehensive list of these market distortions is included in Table 1a in the appendices below, however examples include:

- The Energy Company Obligation (ECO): The ECO3 Impact Assessment produced by BEIS in 2018[6] calculated that the six largest suppliers faced costs of £25 to £27 per dual fuel customer in delivering their obligation, whereas the smallest twelve obligated suppliers only faced costs of £6 to £7 per customer, and the numerous remaining suppliers below the scheme threshold faced no cost at all;

[6] Referenced in the Consultation at page 29

- Warm Home Discount (WHD): Similarly to the ECO obligations, suppliers below a certain threshold are not obligated to provide WHD for those of their customers who are eligible under this policy measure Government has implemented in order to provide vulnerable customers with lower energy costs. Whilst broader questions might be asked as to why this gap in the welfare state for vulnerable customers is delivered via energy bills, the cost of delivering WHD introduces a significant additional cost burden that medium and large suppliers incur;
- Larger established suppliers typically have a larger proportion of higher cost to serve customers, especially those in more vulnerable circumstances that require more specialist or prolonged service provision. This is illustrated by Ofgem's findings[7] that larger, established suppliers have a much higher proportion of their customer base on the Priority Services Register (PSR). Newer entrants are often able to ensure their customer base contains more lower cost-to-serve customers with much lower levels of debt risk, causing a significant distortion in the market and the risk of effectively ghettoising certain higher cost-to-serve vulnerable customer groups.
- Larger established suppliers are required to participate in Ofgem's requests for Supplier of Last Resort process whereas other suppliers are not. This means that, where no supplier volunteers to become a supplier of last resort, only the larger suppliers can be nominated, again distorting the market and reinforcing the dynamic of a two-tier market where service providers in the same market are treated differently.

Four – Competitive prices for all

We strongly agree that consumers are best served by a healthy, competitive marketplace. The evidence clearly shows that the cost of provision of energy to customers in Britain is efficient compared with other major economies globally. Statistics[8] from across Europe show that wholesale gas prices are relatively constant while retail prices for both gas and electricity in Britain remain close to the average of prices across European economies. Energy customers in Britain, using the regulatory frameworks and processes developed in Britain that rely on a liberalised, free market, are served well.

The larger than expected differential between highest and lowest prices in the market prevalent over the last few years is, in our view, a direct impact of the unlevel playing field that currently exists for different participants in the market. This is effectively acknowledged in the Consultation, which notes the distortion caused by ECO and WHD, equating them together to around £41 in a bill[9], acknowledges that larger suppliers will incur this across their whole customer base but not be able to recover it in the lowest prices offered to customers in the market (the so-called acquisition prices) because they are competing with suppliers who do not face these costs and so the £41 will become a higher number because it is recovered from only a sub-set of customers and not their whole base

[7] https://www.ofgem.gov.uk/system/files/docs/2018/11/vulnerability_report_2018.pdf
[8] https://ec.europa.eu/eurostat/statistics-explained/index.php/Electricity_price_statistics
[9] Consultation, page 29

– or cannot be recovered at all. As the Consultation says, this results in a price signal "that does not represent the underlying efficiency of the supplier"[10].

These points are somewhat at odds with the suggestions elsewhere in the Consultation that customers who did not engage faced a "loyalty penalty" of £75-100 more than the "efficient costs of serving them"[11] because we have just been told that the market design and distortion has caused these costs to be levied upon a certain sub-set of customers and that that price signal does not represent the underlying efficiency of the supplier.

There is a perception that the lowest energy prices, consistently available from the smallest and newest entrants in the market, are evidence that prices set by other suppliers are too high and therefore unfair. This, in our view, is very far from the truth. We have consistently argued - and the level at which the price cap has been set, on a cost recovery stack basis proves - that the lowest prices available in the energy retail market today are unsustainable as they do not recover the full cost of operating in the market. The large and increasing number of supplier failures over the last few years illustrates the unsustainable nature of many business models and the unhealthy balance of risk and reward that appears to be driving such behaviour in many new entrants.

We, along with other experts in the energy industry such as the ex-regulator Stephen Littlechild and his colleagues[12], continue to reject the calculations used by the CMA in their energy market investigation to show a level of financial detriment to customers due to market power. The assumptions and methodology adopted in these calculations were inappropriate and poorly judged, relied on a pool of data that was too small and not fit for purpose, and resulted in conclusions that, if the same calculations were repeated today, would result in a wholly different outcome. The fact that the centrepiece of energy policy today is based on the conclusions of this wholly inappropriate set of calculations continues to be a major concern.

The concept of a loyalty penalty, apparently prevalent in many customer markets in Britain, particularly where customers sign up for a service over a period of time, appears to us to be a dangerous concept: appealing for political intervention to prevent detriment to customers, but thereby halting any chance of effective and healthy competition.

In this paper, we comprehensively highlight above our concerns with the market today, particularly the causes for the existence of large differences between highest and lowest available prices in the market at any one time. Whilst we do accept the need to strive for greater efficiency in the market, on a continuous improvement basis these differentials are predominantly caused by a combination of the avoidance of some policy costs and the failure to price in the full costs of operating in the market today, which has led to some suppliers falling into administration, the costs of which are borne by other customers and suppliers.

It is our view that if action were taken to level the playing field for all suppliers in the energy retail market as described in this submission, the differential between the highest and lowest prices available in the market would substantially close. However, there will (and it might be argued, should, to encourage switching) always be some variation in prices between suppliers, a point

[10] Consultation, page 28
[11] Consultation, page 15
[12] https://www.eprg.group.cam.ac.uk/tag/s-littlechild

accepted by the Chief Executive of Ofgem in evidence presented to the BEIS Select Committee[13], of somewhere between £50 and £100.

BEIS' own consumer research data[14] suggests that across different markets, households engage with energy provision more often than other similar sectors (financial, etc), and importantly, that the main reason why households choose not to switch energy provider is because they are happy with their current service.

Looking forward, innovation in products and services will mean that households and businesses may be prepared to pay for services other than the simple provision of a commodity. Large industrial customers already see value in the provision of a suite of energy services that goes far beyond an efficient price of supply for their electricity and gas demand. Different business models are usual, with examples including guaranteed reductions in bills based on long-term investment in energy solutions designed to lower energy use, as well as new sources of revenue such as through Demand Side Response or on-site generation.

This approach is likely to become more prevalent in businesses and households of all sizes across the UK, and may be required to deliver the kind of energy transformation needed to meet the UK's net zero target. The persistent use of price caps in retail markets may act as a significant brake on the development of such services. However, we recognise that some protection may be required for certain vulnerable customers who are unable to effectively engage in the marketplace.

Five – Ensuring consumers in vulnerable situations receive services they need

The market should be designed so that all suppliers are actively seeking to supply all groups of customers including those in vulnerable situations. This is not the case today, with some suppliers actively only targeting a small segment of the market, often requiring all of their customers to either pay in advance via Direct Debit, or via Pay-As-You-Go, despite the licence requiring all licensed suppliers to provide a broader range of payment options. This approach is clear, public and explicit from the Terms and Conditions of such companies and excludes many vulnerable customers. We struggle to understand why this situation has been allowed to continue when it is in clear breach of the supply licence and is another example of the two-tier market in place between suppliers.

Government and Ofgem should take action to ensure that the provision of services to vulnerable customers does not remain unattractive. They should formally recognise that it costs more to serve vulnerable customers and, as the Consultation acknowledges[15], a mechanism to share these costs equitably across the supplier base should be explored to address these concerns. A failure to do so will increasingly make it untenable for some suppliers to continue to provide these more expensive services whilst at the same time seeing the rest of their customer base being under extensive competitive pressures from other suppliers that do not have to bear such costs.

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[13] http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/prelegislative-scrutiny-of-the-draft-domestic-gas-and-electricity-tariff-cap-bill/oral/76719.html

[14] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/817872/BEIS_Public_Attitudes_Tracker_Wave_30_key_findings.pdf

[15] Chapter 4, page 33

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?

Our experience has shown that the regulatory framework in the UK market is much more extensive and prescriptive than those in other markets such as Germany. This has impacted the development of some new products, making them commercially unviable due to the significant investment that would be required to comply with the existing rules.

An example of this is a tariff that was intended to appeal to a specific segment of the market where customers could buy and sell energy at spot market rates to meet their own consumption requirements. The customer would pay a monthly subscription fee to access the tariff and would also pay a transaction fee every time they completed a trade. Although the tariff would have been compliant in Germany, in the UK there were multiple regulatory constraints which contributed to the product not being taken forward in the UK. Some of these are outlined below to give a flavour of the issues:

- Energy related charges can only be collected through either a standing charge, a unit rate or a separate charge, the definitions of which do not allow for subscription and transaction fees;
- The price a customer pays can only increase during a fixed term tariff if they are set out in advance, or they follow a publicly available index, neither of which would be applicable in this example. Depending on the market, and the customer's trading pattern, it is highly possible that at some point during the term their charges would increase;
- With this particular tariff proposition, it would not be possible to provide the customer with a quote for the year ahead, as the price they pay would have been determined by the market and their own trading activity. The 'Informed Choices' principles in the licence are quite prescriptive and do not facilitate easy comparisons for this type of tariff;
- 'Could You Pay Less' (CYPL) messaging is required on many of our customer communications. For the reasons outlined in the above point, it would not be possible to provide accurate CYPL messages as this relies on a degree of certainty in the prices the customer would be paying;

To encourage engagement in the market we have also investigated introducing additional products or services that are bolted onto a tariff (a "bolt-on"). For example, a bolt-on could provide a smart controlled thermostat, or an Amazon Prime subscription that a customer would pay for on a monthly basis on top of the usual tariff price.

While it is possible to offer such additional services, the current regulatory framework makes it more difficult than it needs to be, affecting the commercial viability of such innovation, particularly where the bolt-on provides a non-energy related service. For instance, should a customer with a non-energy related bolt-on fall behind on their payments, it is not possible to apply non-energy related debt to repayment plans through a pre-payment meter (PPM) without the customers consent. In addition, such a debt cannot be taken into consideration during change of supplier events, either for the purposes of objecting to the transfer, and for PPM customers the debt could not be transferred utilising the Debt Assignment Protocol.

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?

Our view is that there are three key harms to energy consumers today which are covered by the scope of this consultation and need urgent attention, namely:

- The unfair and discriminatory treatment of established suppliers in the market must stop. Policy and regulation continue to operate as though the energy retail market still consisted of only six established suppliers, imposing significantly greater costs on such suppliers and representing a significant impact on effective competition. This is explained in more detail below.
- There must be an end to free-riding in the market. Newer entrants to the market cannot be allowed to evade the obligations that go with being participants in the energy market and then to crash out of the market, harming customers and leaving more prudent suppliers – and the customers of those suppliers - to pick up substantial additional costs through mutualisation. This is explained in more detail below.
- The additional cost of serving customers in vulnerable situations must be more fairly distributed across the market. It is a fact that some established suppliers have a significantly greater proportion of customers on the Priority Services Register (PSR) than newer participants in the market. This is explained in more detail below.

However, we agree that the future of energy service provision is changing, and the scope and consistency of protection regimes may need review: customer journeys and some harms are increasingly out of scope of the current regulatory regime. Household heating from oil has long been under a different regulatory regime to the electricity and gas system. Heat via district heating, as well as the provision of some energy services such as the installation of insulation or solar panels, are also often subject to different regulatory regimes and consumer protection regimes when compared with that of the electricity and gas supply.

Increasingly the customer journey for a range of energy-related services may be achieved largely through third parties that are not regulated in the same way as electricity or gas suppliers: through price comparison websites, energy brokers, automatic switching sites, smart home hubs and more.

We believe that Government should adopt the following principles for future regulation:

1. Customers should benefit from a consistent level of consumer protection whatever their customer journey for energy services.
2. The provision of customer protections should result in the level of interference and cost to business to achieve those protections being minimised, whilst ensuring that any costs are fairly distributed across actors in the marketplace for such services and that competition therefore remains effective.
3. Groups of customers that cannot take advantage of new products or services should not be disadvantaged and may need protection or support.
4. The provision of any such support should be funded fairly and equitably from across the marketplace, or from taxpayers and support accessed via the welfare state.

The possible introduction of modular regulation in the longer term, based on the services that retailers are offering, the expansion of regulatory scope to include other energy-related areas, such as price comparison websites and other TPIs, and the other aspects of regulatory reform that may be required to allow innovative products, services and business models to thrive, such as the removal of the universal service provision, should be investigated and considered with these principles in mind.

There is however a risk that the apparent benefits of new products, services or business models, may actually be hiding the loss of certain consumer protections, or simply hiding the avoidance of certain costs that others in the marketplace have to then absorb. For example, the removal of the universal service provision may boost the development of innovative business models for energy related products and services but could risk ghettoising certain customers that have consistently higher costs to serve as suppliers would have no obligation to service such customers and could be driven to actively avoid high cost-to-serve customers.

Lessons must be learned by Government and regulator from the significantly detrimental impacts that have arisen from making barriers to entry into the energy retail market too low in an effort to boost competition. Prudent, well-run energy suppliers, their customers, and the reputation of the British energy retail market itself, have all been significantly impacted by the ability of new entrants to 'free-ride'. There must be an end to free-riding in the market.

Newer entrants to the market cannot be allowed to evade the obligations that go with being participants in the energy market and then to crash out of the market, harming customers and leaving more prudent suppliers to pick up the pieces through mutualisation.

Similarly, the provision of modular regulation could risk a similar sort of behaviour and negative impact, if new business models allowed new entrants to avoid legitimate industry costs and the provision of key protections to customers.

These concerns withstanding, we support the further investigation of modular regulation, and the continued pressure to review current regulation and remove that which is unnecessary or duplicated elsewhere, in consumer protection law for example.

As the energy retail sector evolves, a review of the effectiveness and function of the current regulations will be increasingly required. In particular, despite being one of Ofgem's aims, the pace of change to replace prescription with principles within the supply licence has not really happened. To help facilitate the smooth introduction of new products and services it is important that the additional flexibility provided by principle-based regulation is reflected in the supply licence at the earliest opportunity.

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?**

See answer to 3 above.

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?

We believe the level of change already present in the market presents considerable risk, and additional change should be avoided or coordinated across all planned industry change programmes to avoid energy suppliers overstretching their bandwidth for change and disrupting the ability to operate stably and sustainably.

We also urge Government and regulator to consider the need for all energy suppliers to have sufficient bandwidth to enact their own discretionary change programme as well as that deemed necessary for the entire industry by Government and regulator. It is only through these discretionary change programmes that real innovation and differentiation between energy suppliers can proceed.

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

We welcome the acknowledgment in the consultation paper of the following issues, which we consider the key barriers to effective competition in the market:

- The unfair and discriminatory treatment of established suppliers in the market must stop. Policy and regulation continue to operate as though the energy retail market still consisted only of six established suppliers, imposing significantly greater costs on such suppliers: A significant impact on effective competition.
- There must be an end to free-riding in the market. Newer entrants to the market cannot be allowed to evade the obligations that go with being participants in the energy market and then to crash out of the market, harming customers and leaving more prudent suppliers to pick up the pieces through mutualisation.
- The cost of serving customers in vulnerable situations must be more fairly distributed across the market. It is a fact that larger legacy suppliers have a greater proportion of customers on the Priority Services Register (PSR) than newer players in the market.

  Government and Ofgem must review options to fairly and equitably socialise these additional costs to ensure both that such customers remain attractive to all suppliers and that the retail energy market remains attractive to investors.

In addition, it is worth noting the basic premise that the use of energy bills to pay for national policy aimed at supporting people in poverty as well as the transition to a low carbon economy is a distorting impact on the market itself. Going forward, the Government must be explicit over the policy costs which are being paid for directly by energy customers. Please see our answer to Q9 below.

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?

We strongly believe that removing the thresholds for ECO and WHD entirely and obligating all suppliers equally, based on their number of customers, would remove a significant source of imbalance and distortion in the energy retail market, as well as the added benefit of increasing the funding pot available to deliver ECO measures and ensuring that all customers eligible for WHD can access this support no matter who their energy supplier.

The full cost of delivering ECO and WHD approaches £1 billion, resulting in an additional cost per customer of c£22-27 to deliver ECO and c£13 to deliver WHD. More details can be found in Table 1a in the appendices.

E.ON has supported the work of Energy UK in developing policy options for removing these exemptions and we support the paper presented to Government in July 2018. We support the current ECO regulations where all obligated suppliers can trade or transfer their obligations with other parties, including other energy suppliers. Suppliers can choose to trade their obligation with an obligated supplier, meaning the other supplier takes on the risk and consequences of failing the obligation as well as delivery, or transfer their obligation with a supplier or other delivery partner and retain control over their target. E.ON has already fulfilled the obligation for a number of other suppliers through the transfer and trade mechanisms and widening this out to all suppliers appears relatively straightforward.

The exemption of some suppliers from offering WHD is a significant detriment to customers. WHD is the single major policy Government has enacted to support the most vulnerable in society in paying their energy bills. All energy suppliers should be obligated to offer WHD to all eligible customers with no exceptions or exemptions. This would be the fairest way of funding the obligation through energy bills and would ensure that all eligible domestic energy customers have access to the rebate. The current exemption grants small suppliers a commercial cost advantage whilst simultaneously disadvantaging their own customers who would otherwise be eligible for the rebate.

In 2018 E.ON became the first obligated supplier to deliver elements of WHD on behalf of a newly obligated supplier, allowing the smaller supplier to access the expertise and systems needed to deliver the obligation at a cost comparable with larger suppliers. The introduction of the Digital Economy Act now means that the data-sharing element of WHD, the Core Group, can be expanded to include all customers currently eligible for the Broader Group. Wider data-sharing would significantly reduce administration costs, allow those most in need to receive the discount, and level the playing field for all suppliers, including new entrants to the market.

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

We believe the current trade and transfer mechanisms are working well and therefore expanding this through a central buyout mechanism to further support smaller suppliers is a sensible proposal. To ensure that a buyout mechanism does not result in unnecessary compliance risks and administration costs we believe the scheme should be designed in line with the current ECO trade regulations, i.e. bidding for delivery of the buyout measures should be limited to obligated suppliers who can absorb smaller obligations and be held liable for any under delivery.

We also believe that the difference of Trading and Transferring measures from one supplier to another, compared to a third party partner delivering obligations for a supplier needs to be explained through an impartial platform such as BEIS. Our understanding is that new small suppliers entering the market may be being advised that third party partners can deliver 100% of their obligation – this is not accurate. Through this mechanism, suppliers are still required to submit the required information on the measures installed to Ofgem and are ultimately responsible for their target.

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

The basic premise is that the use of energy bills to pay for national policy aimed at supporting people in poverty as well as transitioning to a low carbon economy is having a distorting impact on the market, regardless of the need or usefulness of the policy itself:

- Costs are added to the energy bill of an average dual-fuel customer to pay for these policies, essentially a highly regressive tax that means those least able to afford it contribute the same as the most well off, and potentially more as the least well off may find it most difficult to invest in measures to avoid higher energy costs (e.g. energy efficiency, solar PV, etc.)
- This policy also acts as a brake to the further development in the useful outcomes these costs pay for, such as ECO, as the burden on customers may be considered to be too high to increase such costs further to pay for additional measures.
- The current policy mechanisms distort the relative costs of electricity versus gas, artificially distorting the relative cost of electricity use against gas use. This is a significant hindrance to the commercial development of lower carbon heating alternatives that rely on electricity, such as heat pumps, and in phasing out gas use as the predominant source of heating.
- Serious consideration should be given to removing policy costs from energy bills entirely, or at least to measures to more appropriately balance the costs between electricity and gas bills, particularly in the context of the drivers needed to meet our net zero target.
- At least c£50 (5%) is added to the energy bill of an average dual-fuel customer in VAT. This could also be varied in future to reduce energy costs, depending on the tax rules in force.

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

See answer to Q9 above.

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?

We agree that given the range of initiatives that are already in motion, now is not the time to propose any specific reforms in these areas.

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

The current retail energy market in Britain does not incentivise suppliers to invest in attracting and supporting customers in potentially vulnerable circumstances.

All customers are different and offering good quality service to customers in potentially vulnerable circumstances can offer positive commercial opportunities for suppliers and is an essential service to those in most need. However, it is a fact that on average customers on the Priority Services Register (PSR) cost more to serve than non-PSR customers.

Of this, a portion per customer is attributed to bad debt. The remainder is due to the additional systems, processes, training of staff, and other services we have invested in to ensure all customers are treated fairly.

Just over 35% of our electricity customers and almost 30% of our gas customers are on our Priority Services Register (PSR), much higher than the average level for other suppliers in the market (~20% for both electricity and gas), and 3-4 times the level of some other suppliers[16].

The additional costs involved in providing good quality service to higher cost-to-serve vulnerable customers creates a competitive disadvantage for a supplier against other suppliers if a greater proportion of their customer base is made up of these higher cost-to-serve customers than their competitors. Equally, newer energy suppliers can engineer their customer base such that they consistently have a significantly lower proportion of high cost-to-serve customers resulting in lower operating costs for such a supplier and subsequent competitive advantage against their competitors.

This 'cherry-picking' of the lowest cost-to-serve customers, engineering a competitive advantage for a supplier in the market, can be delivered through various methods: marketing to particular customer segments correlated with low costs-to-serve and low debt risks, for example, or accepting only certain payment methods associated with similarly low costs-to-serve and low debt risks.

There is clear evidence today that some suppliers are actively only targeting a small segment of the market that may correlate with lower debt risk, for example, often requiring all of their customers to either pay in advance via Direct Debit, or via Pay-As-You-Go, despite the licence requiring all licensed suppliers to provide a broader range of payment options. This approach is clear, public and explicit from the Terms and Conditions of such companies and excludes many vulnerable customers. We struggle to understand why this situation has been allowed to continue when it is in clear breach of the supply licence and is another example of the two-tier market in place between suppliers.

This distortion in the intensely competitive energy retail marketplace is a significant issue for established market participants, for the effectiveness of competition in the market, and in particular, poses a significant risk for the long-term quality of service for customers in vulnerable circumstances across the market. It creates a two-tier market of suppliers for such customers: those that invest in supporting vulnerability over the long-term, and those that do not, who avoid attracting such customers where possible, and avoid additional cost by doing so, thus gaining competitive advantage,

[16] https://www.ofgem.gov.uk/system/files/docs/2018/11/vulnerability_report_2018.pdf

lowering prices to low-cost, non-vulnerable customers, but leaving established suppliers to absorb the additional costs of providing good quality service to high cost-to-serve customers.

As the Consultation acknowledges[17], Government and Ofgem must review options to fairly and equitably socialise these additional costs to ensure both that such customers remain attractive to all suppliers, competition is healthy and effective, and the retail energy market remains attractive to investors.

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?

The cost of serving customers in vulnerable situations must be more fairly distributed across the market. It is a fact that established suppliers have a greater proportion of customers on the Priority Services Register (PSR) than newer players in the market.

As the Consultation acknowledges[18], Government and Ofgem must review options to fairly and equitably socialise these additional costs to ensure that such customers remain attractive to all suppliers and that the retail energy market remains attractive to investors.

There are a number of examples already operating in the energy and other markets which could be used as a potential model for a fairer distribution of these costs. In particular, we think the current levelisation schemes used to fairly distribute the costs of WHD & FIT costs across the market could act as a starting point.

A practical and effective definition of vulnerability is likely to be required for any scheme. PSR or eligibility for WHD, ECO or other welfare state benefits may serve as a starting point. A social tariff, as used in other sectors, is also worth investigation. The fundamental principle however must be to ensure that vulnerable customers remains attractive as a commercial proposition to all energy suppliers and that any mechanism provides as solution to the market distortion currently negatively impacting the market.

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)?

The larger than expected differential between highest and lowest prices in the market prevalent over the last few years is, in our view, a direct impact of the unlevel playing field that currently exists for different participants in the market. This is effectively acknowledged in the Consultation, which notes the distortion caused by ECO and WHD, equating them together to around £41 in a bill[19], acknowledges that larger suppliers will incur this across their whole customer base but not be able to recover it in the lowest prices offered to customers in the market (the so-called acquisition prices)

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[17] Chapter 4, page 33
[18] Chapter 4, page 33
[19] Consultation, page 29

because they are competing with suppliers who do not face these costs and so the £41 will become a higher number because it is recovered from only a sub-set of customers and not their whole base – or cannot be recovered at all. As the Consultation says, this results in a price signal "that does not represent the underlying efficiency of the supplier"[20].

These points are somewhat at odds with the suggestions elsewhere in the Consultation that customers who did not engage faced a "loyalty penalty" of £75-100 more than the "efficient costs of serving them"[21] because we have just been told that the market design and distortion has caused these costs to have to be levied upon a certain sub-set of customers and that that price signal does not represent the underlying efficiency of the supplier..

In addition, the ability to free-ride in the market – to take imprudent financial risks or operate unscrupulously; for example, operating at a loss for long periods using loss-making customer tariffs to gamble that customer growth will pay off financially before bankruptcy occurs – is often a strategy adopted by smaller players in the market as the risk/reward balance of such behaviour in both policy and regulation is significantly tipped towards reward. The benefits of such behaviour significantly reward the new entrant, while the costs are generally borne by other market participants and their customers.

The current interventionist approach, including the default tariff cap, was put in place to address the perception that the difference between the highest and lowest prices available in the market was too wide, and therefore that some customers paying the highest prices were being treated unfairly. On the contrary, we argue that the evidence actually shows that the cost advantages and risk/reward balance for imprudent or unsustainable behaviour shown above is at the heart of the reason for wide differences between the highest and lowest prices, and that predominantly, it is the very lowest prices that do not reflect the true costs of delivering energy to customers.

The imposition of the default price cap provides further evidence of this. The methodology used to calculate the level of the price cap attempts to reflect the true and efficient costs of operating in the energy retail market. The cap is, by definition, a fair cost of energy to customers. It is difficult therefore to understand how any supplier, subject to the actual costs of operating in the market and operating in a sustainable, prudent and scrupulous manner for the long-term, could offer a price to customers consistently significantly below that of the price cap. This is however, the behaviour that has so far been seen by numerous market participants, in particular the numerous suppliers that have subsequently gone bankrupt.

We strongly believe that by levelling the playing field - by ensuring that all participants in the energy retail market are subject to the same costs and risk/reward balance in behaviour over the long-term - the risk of poor outcomes for all customers will be significantly reduced, effective competition will be allowed to thrive, and the significant market intervention of price cap could be removed without detriment to customers.

The key actions Government and regulator should take are:

[20] Consultation, page 28
[21] Consultation, page 15

- The unfair and discriminatory treatment of established suppliers in the market must stop. Policy and regulation continue to operate as though the energy retail market still consisted only of six established suppliers, imposing significantly greater costs on such suppliers - a significant impact on effective competition.
- There must be an end to free-riding in the market. Newer entrants to the market cannot be allowed to evade the obligations that go with being participants in the energy market and then to crash out of the market, harming customers and leaving more prudent suppliers to pick up the pieces through mutualisation.
- The cost of serving customers in vulnerable situations must be more fairly distributed across the market. It is a fact that larger legacy suppliers have a greater proportion of customers on the Priority Services Register (PSR) than newer players in the market.
- Government and Ofgem must review options to fairly and equitably socialise these additional costs to ensure both that such customers remain attractive to all suppliers and that the retail energy market remains attractive to investors.

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 concept of a loyalty penalty, apparently prevalent in many customer markets in Britain, particularly where customers sign up for a service over a period of time, appears to us to be a dangerous concept: appealing for political intervention to prevent detriment to customers, but thereby halting any chance of effective and healthy competition.

In this paper, we comprehensively highlight above our concerns with the market today, particularly the causes for the existence of large differences between highest and lowest available prices in the market at any one time. These are, in our view, caused by the avoidance of some policy costs and the failure to price in the full costs of operating in the market today, which has led to some suppliers falling into administration, the costs of which are borne by other customers and suppliers.

It is our view that if action was taken to level the playing field for all suppliers in the energy retail market as described in this submission and to ensure that the costs of operating in the market are properly reflected in prices, as well as customers' money not being able to be misused for improper purposes, the differential between the highest and lowest prices available in the market would substantially close. However, there will always be some variation in prices between suppliers, a point accepted by the Chief Executive of Ofgem in evidence presented to the BEIS Select Committee[22], of somewhere between £50 and £100.

Ofgem should ensure they personally interview all new suppliers before issuing a supply licence, and those responsible for suppliers that free-ride should not then be able to set up again in the market under a different licence and new name.

[22] http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/prelegislative-scrutiny-of-the-draft-domestic-gas-and-electricity-tariff-cap-bill/oral/76719.html

Government should legislate to require the Renewables Obligation, and other similar obligations, to be collected quarterly, with a guarantee of funds prior to payment (either through accrual or by posting security), in order to minimise the risk of large unpaid bills, and to act as an early-warning signal regarding the potential financial difficulties of a supplier.

Government should legislate to ensure administrators of failed suppliers have to consider consumer interests and follow Ofgem rules. For example, the back-billing rules restrict suppliers from only back billing for 12 months, but there are reports of debt recovery agents that are back billing for a number of years as they don't have to comply with the same obligations.

BEIS' own consumer research data[23] suggests that across different markets, households engage with energy provision more often than other similar sectors (financial, etc), and importantly, that the main reason why households choose not to switch energy provider is because they are happy with their current service.

Looking forward, innovation in products and services will mean that households and businesses may be prepared to pay for services other than the simple provision of a commodity. Large industrial customers already see value in the provision of a suite of energy services that goes far beyond an efficient price of supply for their electricity and gas demand. Different business models are usual, with examples including guaranteed reductions in bills based on long-term investment in energy solutions designed to lower energy use, as well as new sources of revenue such as through Demand Side Response or on-site generation.

This approach is likely to become more prevalent in businesses and households of all sizes across the UK and may be required to deliver the kind of energy transformation needed to meet the UK's net zero target. The persistent use of price caps in retail markets may act as a significant brake on the development of such services. However, we recognise that some protection may be required for certain vulnerable customers who are unable to effectively engage in the marketplace.

If policy-makers, regulator and competition authorities in the UK continue to consider action to counter perceived loyalty penalties, it is imperative that consistency in the approaches and action taken, and in the lessons learned in what actions deliver the desired results efficiently and effectively, are maintained across different markets and sectors, including similar markets in other countries.

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

See our answers to Q14 & Q15. It is our view that if action was taken to level the playing field for all suppliers in the energy retail market as described in this submission and to ensure that the costs of operating in the market are properly reflected in prices, as well as customers' money not being able to be misused for improper purposes, the differential between the highest and lowest prices available in the market, the so-called loyalty penalty, would substantially close.

[23]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/817872/BEIS_Public_Attitudes_Tracker_Wave_30_key_findings.pdf

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

We believe that, if policymakers and regulator take the actions we have outlined in this response, competition in the energy market will become healthy and effective and for those customers that are able to effectively engage with such a market, which we argue are the overwhelming majority of customers, the best outcomes will be delivered by a market-based approach.

However, for those customers that are unable to participate in the market, particularly those in vulnerable circumstances, it is likely they will require additional protections.

It is our view that affordability of essential services, such as energy, is predominantly associated with levels of poverty and in the first instance, protections required to alleviate poverty are most effectively and properly delivered via Government as part of the welfare state.

For energy specifically however, a key part of Government policy to help ensure the affordability of energy bills sustainably and over the long-term must be energy efficiency. Making energy efficiency a national infrastructure priority and ensuring policy mechanisms that deliver measures to those that need it most are implemented urgently and effectively, must be a key plank of energy and welfare policy.

For energy suppliers, the main priority must be ensuring that customers in potentially vulnerable circumstances can rely on a service that is appropriate for their circumstances and that any customer that requires, and is eligible for, further support from third parties understands and obtains that support efficiently and effectively.

However, to support a thriving and effective competitive market, the use of enduring price caps for specific groups of vulnerable customers, or other mechanisms such as social tariffs, should be explored. For energy, we have noted that such a role for market participants involves additional costs that can be avoided by certain behaviour. Please note our answers to Q12-13.

In addition, the growing use of digital methods of communication for customers, and the growing use of products and services in the energy sector that rely on new technologies, particularly those that will be required to transform our economy to one that is low carbon, present a significant risk to certain customers. There is a significant risk of a growing 'digital divide' in customers in addition to the current known divides between customers that can effectively engage in a market environment today and those that may not be able to.

Service providers can take active steps to help close this digital divide, and it may make commercial sense to so. However, this is not an issue that is unique to energy and it is most effectively tackled by Government and other bodies.

In particular, there is a risk that the costs associated with closing such a digital divide – either the additional costs involved in maintaining older infrastructure so customers are not forced to use new technologies or left without a service (for example, the infrastructure required to service energy customers that are *not* using smart meters, or the additional costs associated with providing paper bills compared to online communication), or the costs in helping to educate and inform customers about new technologies so they are capable and confident in using them (for example, community programmes that support older people in using computers and the internet) – could be avoided by some market participants in the same way we have shown is already happening in energy for customers in other vulnerable circumstances. This can significantly distort any market and prevent effective competition from taking hold and is a compelling reason for policymakers to ensure that the responsibility for such actions is held at a Government level.

Appendices

Table 1A: Additional costs incurred by established market participants due to discriminatory policy and regulation

Additional cost	Applies to?	Quantification of additional costs to eligible portion of market:
Energy Company Obligation (ECO)	250,000+ customer threshold* NB: Government have announced this threshold will drop to 150,000 over two years but should be zero	- Total target: £640m - Per customer cost of target: o £21.84 (Ofgem) o £23.09 (Baringa report) o £25 to £27 (BEIS ECO3 IA)
Warm Homes Discount (WHD)	As above	- Total obligation: £340m - Per customer cost of target: o £13.40 (Ofgem) o £12.96 (Baringa report)
FiT licensee	250,000+ customers = mandatory	- Total: £4.2m
Smart metering Central Delivery Body	250,000+ customers : Suppliers must establish, support and monitor the work of the Central Delivery Body. Small suppliers are exempted from meeting the costs of the Body with the exception of fixed operating costs	- Total industry c£41m (excluding fixed operating costs)
WHD – moving standard credit customers to the Direct Debit level of the cap (despite extra costs)	Suppliers with WHD customers (as above)	
ECO additional costs	Ofgem acknowledges that from April 2019 the largest suppliers could incur ECO costs above the level allowed for in the cap.	
Additional costs of serving vulnerable customers	Larger suppliers' proportion of PSR customers outweighs small and medium size suppliers by ~3:1.	
Consolidated Segmental Statement	Large suppliers owning both supply and generation	
CMA Database remedy	250,000+ customers on default tariffs for 3+ years. (Primary financial cost likely to be outweighed by the financial implications of losing more customers or increased cost of customer retention).	
		- **Over £1 Billion additional cost per annum.**

Table 1B: Mutualisation costs; Direct costs of 'free-riding'

Cost	Cost to the rest of the market (and other customers)
Renewables Obligation 2017/18	- Industry: £53.4m
Renewables Obligation 2019/19	Estimate so far: - Industry: £45.2m
CM mutualisation	Current shortfall forecast: - Industry: £4.8m
FiTs (see reference in Table 1A above)	Industry explicit mutualisation: - £4.2m
Last Resort Supply Payments	-