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Making a positive difference
for energy consumers

Rt Hon Jeremy Hunt MP
Chancellor of the Exchequer
HM Treasury

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Date: 14 March 2023

BY EMAIL ONLY

Dear Chancellor of the Exchequer,

Non-domestic Market review update

Thank you for your letter on 9 January highlighting your concerns for business customers. As you know from my letter to you on the 30 January, we have been very concerned about the reports we have had from customer groups and via our own monitoring about the behaviour of some suppliers. We opened compliance reviews and a broader non-domestic market review towards the end of last year and have completed the first stage of our analysis.

Although large parts of the non-domestic market are showing signs of recovery from a challenging period of high and volatile wholesale energy prices, our emerging evidence suggests there are areas that remain of significant concern, where we will need to take deep dives into key issues impacting certain segments and suppliers. Specifically:

- We have found cases where 'deemed' contract[1] rates are higher than is explained by market conditions. We have clear rules around rate setting for these types of contracts and will be addressing this with companies where this is found to be the case.
- We have seen significantly higher security deposits being required. Although risks have changed different parts of the non-domestic market, both through the volatile wholesale price of energy and through wider economic challenges. Ofgem will seek to understand with suppliers whether these are proportionate.
- Standing charges have also increased significantly in some cases; where this coincides with the start of EBRS this will form part of our assessment of compliance with EBRS rules.

[1] A deemed contract will exist where a customer is consuming energy but is not under any contractual obligations that they have signed with a supplier. We have rules that require these default rates to the cost of supplying the customer and cannot be unduly onerous.

- We will require more evidence from the sector to assure compliance with the rules of the EBRS scheme. We will continue to work with suppliers and the Department for Energy Security and Net Zero and HM Treasury to understand and assure compliance. For some suppliers we are already investigating potential breaches through our compliance processes and will take enforcement action if necessary.

There are some issues that have been raised by non-domestic customers that Ofgem does not have the legal powers to intervene on. For example, contracts signed in Autumn last year are now much more expensive that current wholesale market conditions would deliver. Unless there is evidence of misselling, Ofgem cannot unpick private law contracts between commercial customers. However, we will work closely with trade bodies and non-domestic retailers to see if there are common sense ways for both sides to address this. For example, contracts could be reassessed to spread costs over a longer period of time, therefore avoiding a 'cliff edge' for business customers in April. I will personally call together relevant stakeholders to see if we can collectively find the best way to manage this very real problem for many businesses.

When taken together with the evidence that certain groups, such as the hospitality sector, are struggling to secure contracts, these are strong signals that some segments of the non-domestic market have not yet returned to the level of competition experienced before the gas crisis. We will link this evidence with the input we get from stakeholders from our Call for Input[2], which closes at the end of this month, to look at what changes need to be made to licences or regulations to better support business customers.

The annex to this letter sets out in more detail what we have learnt so far from this period of intensive analysis. We have been working closely with officials from HM Treasury and the Department for Energy Security and Net Zero to factor in their views from government's work and will continue to do so as we progress our review.

Next steps

As stated above, we will progress compliance and enforcement actions against existing rules. Where our non-domestic review shows further regulatory protection for customers is needed, we will action changes to our rules, or signal to government where legislation or other government action may be needed that is beyond our powers to resolve. We may also make a market investigation reference to the Competition and Markets Authority (CMA) if we have reasonable grounds to suspect features restrict, prevent or distort competition; we will be briefing the CMA on our initial findings. We will publish our full report and consult on suggested actions in summer.

[2] Call for input on the Non-Domestic gas and electricity market | Ofgem

Actions that don’t need licence changes can begin to be implemented from this summer and any licence changes will follow our statutory process and be concluded by the end of the year.

We have an intensive programme of work to support business customers. I would be very happy to discuss our findings and our work with you, directly. I have copied this letter to the Secretary of State for Energy Security and Net Zero. We will continue to engage as we all work towards securing better outcomes for business customers.

Yours sincerely

Jonathan Brearley
Chief Executive

Annex 1: Key findings

The non-domestic sector has over 60 suppliers with a very wide range of business models. There is significant variability in the profit of non-domestic suppliers between years, even within a supply company, and between suppliers. An average profit range of suppliers with large market shares runs from negative 3.6% up to positive 3.5%, between 2016 and 2022. Not all suppliers are profitable, although more are forecasting a profit this financial year than since 2020, when most posted negative profits. In any market, suppliers need to be able to make reasonable profits. However, given the challenging 12-18 months for the energy sector, including customers, we want to explore the drivers of this trend to check this is a result of a competitive market rather than at the expense of customer interests through licence or regulation breaches.

Non-domestic customers, too, are diverse. They range from small business customers with low energy usage or few employees and turnover, to large industrial customers. These customers use a huge amount of energy, are often energy intensive users and have specialist energy staff to manage their own wholesale trading activity. There are also domestic customers that take their supply via a non-domestic contract, for example mobile park homes. This diversity in both suppliers and customers means evidence gathering is complex because most customers have bespoke contracts and arrangements tailored to their individual energy needs.

We are in the process of gathering more evidence to understand if the issues we are seeing are temporary due to the challenging environment, supplier or customer segment specific or more systemic. The diverse nature of the business sector provides a rich evidence base but increases the complexity and it will take us time to ensure we have robust findings to help us take the right actions.

Our first stage of analysis shows the impacts of the market and economic conditions have clearly contributed to the issues some customers have faced. **But some of the data raises concerns that some suppliers may have breached licence conditions, acted against the intent of the EBRS, and poor behaviour towards customers may not have been effectively constrained by competitive pressure, in the way we would expect.** In many cases, with some clear exceptions, we can see a return towards normal market trends after problems last year related to the wholesale market led to reduced offers to enter into contracts to supply energy. But we have seen some suppliers have unexplained jumps in contract charges, some coinciding with the introduction of the EBRS, and have observed inexplicable rises in security deposit values. We will be investigating these concerns further.

We set out below further details of the key findings in the areas highlighted in the letter.

1. Offers to agree an energy contract

- **Our evidence is showing that since November 2022 customers are increasingly able to receive an offer for an energy contract. But that may not be the case for certain customer groups (for example the hospitality sector).**
- There is no obligation for suppliers to supply all non-domestic customers that approach them to ask for an offer to supply. There was a temporary increase in October of suppliers declining to contract compared to the first 6 months of the year (39% for power and 13% for gas).[3] This increase aligns with a period of more volatile and high wholesale energy costs. There is some limited evidence to suggest some sectors, such as hospitality, are more likely to be continued to be declined by a supplier.
- We will carry out further investigation into whether there is a problem with certain segments or customer groups and engage with stakeholders about viable solutions.

2. Deemed contract rates

- A deemed contract will exist where a customer is consuming energy but is not under any contractual obligations that they have signed with a supplier. Deemed contract rates are generally higher than contracted rates because the risk of bad debt is higher with customers that a supplier does not have a contractual relationship with, and because the supplier may not have details of energy usage patterns and therefore is exposed to more market risk**.**
- **We have observed an increase in the last year of customers moving onto deemed contracts, particularly by business customers that use smaller amounts of energy.** The number of businesses on deemed rates increased by 16% for power and 18% for gas between October and November 2022.
- Because a customer cannot choose the terms for deemed contracts, our rules ensure these default rates reflect the cost of supplying the customer and cannot be unduly onerous. Our review has shown that rates in general increased broadly in line with expectations as wholesale prices rose. But specific suppliers have unexplained and significant price increases. We will be engaging with them on their compliance with our license conditions.
- We will also be looking more closely at how often suppliers review their deemed rates and what triggers changes to a supplier's rates. In addition to compliance checks, we will also consider whether we need to issue additional guidance or make changes to the license condition.

[3] This data includes existing customers whose contract renewal was declined by their supplier and where new customer offers were declined. There is some evidence from suppliers that quality of data held on offers (and on security deposits) that do not lead to a contract is lower than for signed contracts.

3. Security deposits

- Security deposits are a payment made by customers to a supplier before they can start their energy contract, to cover the energy supplier's costs if the customer later defaults and is unable to pay. Suppliers may request a security deposit if a customer fails a credit check. Suppliers may also use alternative ways of securing the risk of non-payment, including through requesting up-front payments of expected bills, or by taking out credit insurance.
- During 2022, the monthly number of requested security deposits in electricity fluctuated around 400 per month for power and 150 per month for gas. But this rose from September, doubling by November for power and rising by a quarter for gas.
- For many power customers, the level of security deposits rose in alignment with rises in bills from August 2022, with a median value of around £10,000 by the end of the year. But the data shows that **some customers faced dramatically higher requests for security deposits,** especially towards November. This could have had a significant impact on these customers. For gas, the value of the security deposits suppliers requested was much higher in September – going from a median of around £30,000 before then, rising up to £68,000. This dropped to more typical rates by the end of the year. But some customers faced very steep increases from August. There was a peak in gas day ahead prices in August, which started dropping in September, albeit it was still high then. So, this could reflect different hedging strategies across suppliers. However, this behaviour does invite questions.
- We will do further work to explore the reasons for some suppliers' steep increases. We will also be digging more deeply into whether the requests for security deposits changes across different segments of customers, and how this maps across to supplier policies, such as debt and disconnection pathways.

4. Standing charges and risk premia

- **Given wholesale price increases, as expected, we found a substantial increase in the annual cost of a contract since July 2022. But pricing behaviour by some suppliers raises concerns.**
- We found standing charge[4] changes to be very variable across suppliers, which we expect as they allocate different costs into the standing charge. Unit rates have been steadily rising in line with wider market trends. But for some suppliers, we identified some particularly large increases within standing charges and/or unit rates. In some cases, the risk premia they were reporting also appeared unusual.

[4] Standing charge is a fixed cost that is charged by the supplier irrespective of the volume of energy used

- We will investigate further with those select suppliers where we have seen significant changes to standing charges and/or unit rates or risk premia[5]. If these unexplained increases coincided with the start of the EBRS, we may also start compliance engagement with them for a possible breach of these rules.

5. Energy Bill Relief Scheme (EBRS) compliance

- **The majority of suppliers (58%) require further evidence to assure compliance with Ofgem's role in the monitoring of the EBRS rules.** We will continue to work with the Department for Energy Security and Net Zero (ESNZ) and suppliers to understand and assure compliance across the EBRS scheme.
- We have started compliance proceedings against a small proportion of suppliers where we have serious concerns they are not compliant. We are aware ESNZ also commenced their supplier audits to assure accurate EBRS discounts are being applied; we will work with them as necessary to progress these audits.
- Our compliance activity will continue through March and beyond the end of the scheme, until no more compliance issues are raised to us. Any concerns identified in our review of supplier deemed rates will be shared between our EBRS and deemed rates compliance programmes to inform any necessary enforcement activity or future policy changes.

[5] The increase in wholesale price volatility increases the risk a supplier is exposed to when purchasing energy. To manage the increased risk and costs, suppliers may either pause from making any new contract offers or increase their risk premium on any contract that they offer.