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Ofgem's Forward Work Programme 2023/24

E.ON welcomes the opportunity to comment on the activities that Ofgem should prioritise, as set out in its Forward Work Programme consultation on 15 December 2023.

Executive Summary

Energy market conditions continue to be volatile, and the interaction between the market and the many interventions introduced by Government and Ofgem to mitigate some of the negative consumer outcomes require careful consideration to ensure they do not further exacerbate market distortions which are to a large extent driven by the current retail regulatory regime.

This forward work plan represents a significant opportunity for Ofgem to develop a roadmap out of the energy crisis, and towards a more sustainable and forward-thinking sector that can grasp the opportunities afforded by the transition to net zero and truly innovate for the benefit of all consumers. This however will not be possible without a rethink of the current regulatory framework.

The current regulatory regime is attempting to achieve the benefits of competition whilst, at the same time, overlaying prescriptive, one-size-fits-all price regulation. This is a contradiction in terms and the regime is in need of urgent reform by Ofgem and Government to return the sector to profitability and attract the investment needed to play its role in meeting net zero. We must be honest and transparent about the trade-offs involved in the regulatory choices being made and avoid further embedding an incoherent framework as an unintended consequence of detailed policy implementation.

The current belief that we can have all of the benefits of competition and all of the benefits of prescriptive one-size-fits-all regulation, at the same time, is not only increasing costs to customers but is also a primary reason for the sector's continued unprofitability.

Customer Interest Framework

Ofgem is correct to highlight the trade-offs it will be required to make when developing energy policy and making decisions on the structure of the market going forward; we have consistently highlighted some of these trade-offs to Ofgem through consultation responses throughout 2022.

However, although Ofgem states that the purpose of the framework is to provide clarity and consistency in the way that these trade-offs and customer interests are considered, it is not clear how the pillars will interact with each other when more than one pillar may apply as there appears to be no guidance or weighting to each topic area to support the decision-making process and any compromise that needs to be made.

Nevertheless, we do agree with the core guiding principles of each of the 4 pillars within the framework and urge Ofgem to go further in identifying and quickly addressing market distortions in each topic area. We have set out below the key considerations that Ofgem must take as it continues to develop future energy policy.

Fair Prices

Achieving fair prices across the sector and preventing excessive profits is clearly a key priority for Ofgem. However, Ofgem should be mindful of the sectors it regulates which have been making increasingly low, or no profits, and the impact that has on the market overall. There is a risk that in the retail market Ofgem conflate fairness with affordability, especially as some of the stated objectives are demonstrably at odds with current market conditions. Whilst we agree that Ofgem should be concerned with preventing excessive profits, it cannot be ignored that most if not all suppliers have been loss-making since the introduction of the price cap, despite an allowance built into the cost stack to allow for a theoretical EBIT. Given this fact, and the impact on prices that supplier failures have had thus far, there is little to suggest that there is a prospect of even modest profits, let alone excessive.

With that in mind, Ofgem must go further to ensure that suppliers are able to achieve a fair return which compensates for the excessive risk they continue to be exposed to. The recent EBIT consultation assumes that suppliers are adequately compensated for their costs via the individual allowances, and that the interventions taken thus far (by Ofgem and Government alike) have mitigated supplier risk to an acceptable degree. This is clearly and demonstrably incorrect, as we have set out within our response to that consultation, and any policy decision made on the basis of these assumptions will run counter to the stated objective of achieving fair prices.

The sub-objective of achieving cost efficiency also warrants further consideration. Ofgem's current approach to achieving efficiency via the price cap forces suppliers into a narrow mode of operation, and the shift towards a notional efficient supplier model as a way of determining the EBIT return will reduce any diversity in the sector even further.

A competitive market would see suppliers innovating and diversifying as they focus on different areas of their business to develop efficiencies and beat their competition. The concept of a notional supplier to set price cap cost components like EBIT risks removing that diversity as all suppliers are likely to structure themselves in a similar way to the notional supplier as the only way to survive in the long term (as doing anything else risks costs that cannot be recovered under the cap). Whilst we understand Ofgem's intention to model a notional supplier, given the constraint that a single cap level must apply to all suppliers, Ofgem must recognise that this risks undermining competition in the market and thus removing any downward pressure that competition would have on pricing.

Quality & Standards

We fully support any approach which ensures high standards of customer service, in line with our licence obligations, and which supports and prevents harm to customers, especially those in vulnerable circumstances. The many interventions taken by Ofgem and Government thus far in response to the energy crisis have increased demand from customers across the sector. Whilst these interventions were necessary to stabilise the market and support customers, more focus should be given to how information is delivered to consumers going forward, and how Ofgem and the different branches of Government can work together, and with suppliers, to deliver clear and consistent messaging which avoids increasing demand into suppliers across all channels.

Resilience

Ofgem are correct to highlight resilience as a key pillar in future policy decisions. We have been consistent in our support for more stringent measures to curtail excessive risk taking, and we were strongly in favour of the swift implementation of ringfencing customer credit balances (CCBs) and RO payments to immediately change the behaviour of any supplier relying on customers' money to fund other parts of their business and significantly reduce the moral hazard.

While we are supportive of Ofgem's proposals in this space and its overall shift to a more prudential-styled framework, Ofgem needs to develop an overall vision for this new regulatory model and a framework to articulate how each component fits with the others, and how they work alongside existing regulation. We are already seeing evidence of disjointed and overlapping regulations, RFIs and other requirements which are a symptom of not having this in place.

The resilience of suppliers is clearly linked to price control frameworks and the returns available to them. As previously mentioned, most energy suppliers have been loss making since the introduction of the price cap, despite the EBIT allowance included within the cap. Although Ofgem are currently consulting on the methodology for setting the EBIT allowance, the approach they are taking is rushed and the reluctance to provide the analysis used to develop the notional supplier model or make assumptions regarding the level of risk mitigation already provided is clearly flawed. By attempting to review supplier profitability through the lens of EBIT alone, they assume an efficient supplier can earn whatever EBIT allowance it sets. This is clearly not the case. This flawed approach creates real risks for market stability because suppliers simply won't be able to cover their costs. Ofgem must conduct a robust review of the price cap design and all cost allowances, not just the EBIT allowance. This is the only sensible way to ensure true cost reflectivity for consumers, and a sustainable return for suppliers which encourages investment, competition and innovation.

Strategic Priorities

Ofgem's strategic priorities appear to be in line with our expectations, and we broadly agree that these are areas that warrant an enhanced degree of focus moving forward.

While Ofgem have laid out their priorities in the short and long term, much of the detail is focussed to a within year and year +1 time horizon. We would like to see more detail on the longer-term pipeline out to 5+ years to allow us to plan accordingly and input into the shorter-term priorities in a fully informed way. It would also be beneficial for Ofgem to provide analysis of the success of their previous forward work plan to ensure that any deliverables that were deferred or deprioritised as a result of the energy crisis or other unplanned market developments are reflected accordingly.

It is unclear currently how this plan sits alongside the Net Zero review conducted by Chris Skidmore MP, and how the recommendations from that review will influence Ofgem's policy focus. Although the review has not yet led to any defined Government policy, there is clear benefit in a common direction of travel on both Net Zero and wider energy policy.

We provide our thoughts below on the short and long-term priorities that Ofgem have highlighted.

Short Term

Ensuring prices are fair

Ofgem must address the shortcomings inherent within the current price cap if it is to ensure that prices are fair. To this end, if the price cap is to remain a key feature of the market going forward, Ofgem must make a full bottom-up assessment of each allowance within the price cap a key priority for 2023. Pushing out the completion of the review of individual price cap allowances until Winter 24/25 (as Ofgem's price cap programme of work suggests) makes little sense if Ofgem wants to achieve this goal in the short-term.

A full bottom-up review of the price cap and its individual components will enable true cost reflectivity and allow Ofgem the ability to review the price cap under the lens of affordability for customers. It will then enable a firm grounding for any future bill support, including alternate price controls such as a social tariff.

Creating resilience across the sector

The capital adequacy regime which Ofgem is currently consulting on has a direct link to the design of the price cap. As we have outlined above, and in our response to the EBIT consultation, there are serious flaws in the design of the price cap that are leading the market down a path towards limited competition where all suppliers look and act in the same way (based on the notional supplier), and with limited innovation. A capital adequacy requirement based on the current price cap design further embeds the consequences of this model.

Consideration must also be given when reviewing the potential scope to extend regulations into non-domestic space. Any further interventions into non-domestic should be backed up by robust evidence and a compelling case for change. Otherwise, the relatively competitive non-domestic market may see its competitiveness and innovation decline in much the same way the domestic sector has following the introduction of the price cap. Any initiatives to address short-term/medium-term issues owing to extraneous factors should be suitably time-limited so that the market is not burdened with regulatory requirements that are not needed in the long term.

We are very supportive of the proposed review into whether wholesale market liquidity is sufficient. We have seen over recent years real challenges for liquidity in the electricity wholesale market, and a lack of liquidity means that a supplier cannot reliably hedge at the daily benchmark set by Ofgem. Under current market arrangements, suppliers are effectively forced into the market at certain times and for certain products if they want to hedge in line with the price cap methodology. Generators in contrast have no such regulation that influences their behaviour.

Whilst some of the challenges could be ameliorated in the short term through adjustments to the price cap methodology, action must be taken to address the underlying root causes of a lack of liquidity in the market. This must go beyond a rudimentary data gathering exercise and Ofgem must ensure that it meaningfully engages with the industry to understand the myriad of issues that suppliers are currently facing. This may require new metrics that need to be tracked beyond bid-offer spreads and churn. We have been consistent in raising the liquidity issue to Ofgem throughout 2022 and urge Ofgem to prioritise this investigation to drive out actionable measures that can be taken to resolve these challenges as soon as possible.

Monitoring and enforcing quality and standards

We broadly agree with Ofgem's two main objectives in regulating heat networks. As the expected implementation draws closer, we look forward to increased engagement with Ofgem and the

opportunity to share the knowledge and experience we have gained from operating in the sector. This will help ensure Ofgem designs a regulatory regime which is fit for purpose for all participants.

Long Term

Facilitating infrastructure investment

We are fully supportive of Ofgem encouraging and incentivising network companies to speed up connections and invest in strategic reinforcement. We must be cognisant that this could mean more costs being placed on customers' bills through the network charges, and so all efforts must be made to deliver costs effectively, including using flexibility to defer traditional reinforcement where appropriate, and investigate how best to spread the costs across customers and time.

We would also encourage Ofgem to look at whether the RIIO concept of network regulation is fit for purpose to deliver Net Zero, much in the same way that REMA is doing for wholesale markets.

In regard to the nuclear RAB model, the CCUS model and hydrogen model, we believe that these are essential projects for the UK to progress with as soon as possible but would caution that the additional cost should be borne by the taxpayer and not the billpayer to avoid exacerbating the cost-of-living crisis, and also to ensure that costs are apportioned as progressively as possible. While this is ultimately a decision for BEIS to make, Ofgem should take the lead in highlighting the potential issues for billpayers.

Developing and delivering market reforms

We are very supportive of all flexibility markets being open to all technologies, including demand side and aggregation of smaller assets. Additionally, it is critical that MWHHS doesn't slip in terms of delivery date, that smart meters are installed in as many homes as possible and that measures are in place to ensure that the DCC maintains an on-track delivery schedule.

With regard to network charging reform, we would strongly urge Ofgem to restart the DUoS SCR and TNUoS taskforce as soon as possible, ensuring that it is fully resourced by Ofgem. This work needs to be completed as soon as possible to feed into REMA as a sensible counterfactual to the options where locational signals are sent via the wholesale market rather than through network charging.

Reforming governance arrangements

We would like to see the FSO given the powers it needs to be the holistic overseer of Net Zero in terms of governance, and potentially move all system operation (including that at distribution level) into one body at the FSO.

Yours sincerely
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