Domestic gas and electricity suppliers

Date: 4 July 2023

Dear supplier,

Open letter on changes in the energy supply market and Ofgem's approach to regulation

Wholesale gas and electricity prices remain historically high, and the energy crisis is far from over. However, prices have fallen significantly since the peaks reached in the second half of 2022 and early 2023. Equally, the retail and wholesale markets have stabilised significantly.

Given the significant change in market conditions, Ofgem is refocusing the approach to retail regulation to adapt to the changed situation for the sector. Ofgem will remain vigilant and keep any proposed changes under review, given the very real possibility that conditions do not continue to improve or worsen significantly.

Fair pricing:

As the Chancellor stated when we met on 28 June, all utility regulators need to ensure that changes in input costs are fairly reflected in the prices that customers pay. On 25 May, we set out our proposals for the price cap profit levels that are needed to maintain financial resilience for retailers. We are therefore expecting that, on average, the sector will move into profit for the first time since 2018. Regulated profits will also be combined with costs recovered from last year.

Ofgem will continue to monitor and adjust the price cap to ensure that it continues to protect consumers and fairly reflects the efficient costs incurred by suppliers – specifically:

- We will keep the price cap formula under review to ensure it mirrors the costs facing suppliers and will be checking that it does not over-reward suppliers as prices fall. This will include examining areas where suppliers were allowed to recover costs from last year to understand whether a similar 'benefit' has been created in current market conditions which should be recovered for consumers;
- We are continuing our work on plans that would ensure that pre-payment meter customers pay no more than those on direct debit, which could take effect once Government support expires in April 2024;
- We are reviewing operating costs, which form a significant component of standing charges;

- We are proposing to establish an allowance for prepayment meters, further funding PPM suppliers to provide support to those households who need it and will keep bad debt allowances for other payment types under review.

The price cap calculations necessarily include indexed allowances in regard of supplier commodity purchasing. However, each supplier makes their own commercial hedging decisions and does so at their own risk – any incremental profits or losses made will reflect a variance to the expected profit allowance. We closely monitor risk taking to ensure suppliers are sufficiently financially resilient to absorb potential losses under a wide range of scenarios and that they are complying with our enhanced Financial Responsibility Principle.

The price cap has many benefits for consumers, but also brings some risks and costs. It may also not be compatible with the more flexible energy market we expect in future. We are exploring whether there is an alternative that could retain price protection for consumers but with greater flexibility and resilience, in order to inform any consideration of the future of price cap policy by the government.

We also recognise the challenges that businesses face from high energy prices. We are working closely with suppliers and trade bodies on arrangements that could help businesses struggling with high energy costs, and are pleased to see a number of companies responding with more flexible contracting arrangements. We are continuing to monitor the extent to which this support is being felt on the ground. While we are observing some good practice, we are also finding evidence that some suppliers may have breached our pricing rules, which we are investigating further and will take action if we find abuse.

Financial resilience:

After years of loss making across the energy retail sector, we expect the sector to return to profit. This is an important sign of a healthy market that can invest and innovate to deliver better outcomes for consumers. Importantly, it will also boost resilience - as the sector returns to profit, it is important that those retailers that are not yet sufficiently well capitalised use profits to improve their capital. We are monitoring financial positions on a monthly basis, alongside quarterly stress tests, and over the summer will be assessing the first Annual Adequacy Self-Assessments received under the enhanced Financial Responsibility Principle. Together these submissions require suppliers to assess their financial positions and risks on a current and forward-looking basis, and in a range of scenarios. Ofgem observe these submissions across the sector and follow up if suppliers appear to be making optimistic assumptions or are otherwise outliers. Importantly, as laid out in our letter of the 25th of May, we expect suppliers that are not yet meeting our new capital requirements to retain profits rather than pay out dividends.

Market stabilisation measures and a return to competition:

In the coming weeks and months, we hope to see growing price competition in the market. Although we recognise that competition is not the only dimension on which to assess market effectiveness, it remains an important driver of value for customers.

In 2022, Ofgem introduced a series of measures to ensure stability of retailers and to protect against further systemic financial failures. As markets stabilise, we will reassess whether risks are now better borne by the market and whether these measures are still needed or should be adapted. Specifically:

- The market stabilisation charge under current market dynamics is soon expected to fall to zero. Over the coming months we will assess whether the market stabilisation charge is still needed or whether it could be removed for the time being;
- The ban on acquisition tariffs could have enduring consumer benefits and will limit the loyalty penalty that existed prior to the price cap. But it could also be disincentivising suppliers from offering new tariffs. Therefore, over the coming

months Ofgem will reassess its costs and benefits and whether it should be amended or removed in line with our wider work on the future of price protection.

The energy retail market is clearly more concentrated than pre-crisis but, as the market moves from one that is loss-making and with prices set by the Government, we will monitor developments to see if our expectations of a return of price competition for customers alongside competition on service standards and innovative products are met. A failure of companies to compete for customers would indicate problems in the retail market that would need to be tackled. As a first step, we are considering whether suppliers should be required to clearly publish all their domestic tariffs to provide customers and third party intermediaries with complete transparency.

Service standards:

There are many examples of excellent service delivery across the sector. I have personally heard stories of suppliers providing best in class support to their customers – including the most vulnerable. But service standards in the retail sector as a whole have declined in recent years. Overall domestic consumer satisfaction with customer service from their energy supplier decreased from 74% in Q4 2018 to 66% in Q4 2022[1]. Consumers have been finding it increasingly difficult to contact their supplier (only 58% of consumers reported to find it easy or very easy to contact their supplier)[2], and our market compliance reviews have found that many indebted customers do not have a debt repayment plan[3].

We accept that market conditions have been challenging for suppliers, but high-quality standards are a fundamental component of a well-functioning market and experience suggests that competition alone will not drive sufficient performance. Further, this Winter, if prices remain as forecast, it is likely that a large group of customers will struggle to pay their bills, so the sector will need to be fully focussed on how best to support customers in financial distress.

Ofgem is consulting on a new consumer standards framework and, included within this will be a focus on the needs of those in financial distress and those with wider vulnerabilities. Through this work, we are engaging with consumer groups and suppliers to ensure we have the appropriate rules and compliance activity in place for this Winter.

We expect suppliers to resource themselves appropriately so that they meet their obligations on government schemes, such as the smart meter rollout and ECO home insulations, and we will take a robust approach to the companies that fail to meet targets. These targets are ambitious, but they are also important for consumers and for the transition to net zero - the sector must rise to the challenge.

High standards of service, particularly for the most vulnerable, are fundamental part of a healthy energy sector. Ofgem will work with suppliers to build on the good practice that exists. Equally, to ensure a clear deterrent for poor behaviour, we may need to increase the financial consequences.

In conclusion:

Ofgem is fully focussed on protecting the interests of consumers. As we adapt to this new phase of the gas crisis, a balance must be struck between the need to maintain a resilient sector, and the need to build a well-functioning and competitive market that offers a fair deal to consumers on prices and delivers better service standards. Many of our customers will be

[1] Ofgem and Citizens Advice Consumer Perceptions of the Energy Market Survey, Q4 2022. Consumer Perceptions of the Energy Market Q4 2022 | Ofgem

[2] Ibid

[3] Market Compliance Review into customers struggling with bills | Ofgem

facing extreme financial difficulty this winter. We will continue to work closely with government, consumer groups and the energy industry to support energy customers, particularly the most vulnerable.

Yours sincerely,

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