

Ofgem consultation on innovation in the energy retail market

Energy UK response

28 November 2024

About Energy UK

Energy UK is the trade association for the energy industry with over 100 members - from established FTSE 100 companies right through to new, growing suppliers, generators, and service providers across energy, transport, heat, and technology. Our members deliver nearly 80% of the UK's power generation and over 95% of the energy supply for 28 million UK homes as well as businesses.

The sector invests £13bn annually and delivers nearly £30bn in gross value - on top of the nearly £100bn in economic activity through its supply chain and interaction with other sectors. The energy industry is key to delivering growth and plans to invest £100bn over the course of this decade in new energy sources. The energy sector supports 700,000 jobs in every corner of the country.

Energy UK plays a key role in ensuring we attract and retain a diverse workforce. In addition to our Young Energy Professionals Forum, which has over 2,000 members representing over 350 organisations, we are a founding member of TIDE, an industry-wide taskforce to tackle Inclusion and Diversity across energy.

Introduction

The retail energy market will be the enabler of the system-wide changes needed to ensure industry and government can tackle the ongoing challenges of affordability and energy security, while meeting our Net Zero targets. Innovative products and services delivered by the retail energy market will play a critical role in ensuring customers can participate in - and benefit from - this revolution.

Energy UK welcomes Ofgem looking into how it can make changes to encourage innovation in the retail market, and we share government and Ofgem's desire for customer participation in energy supply to levels which will unlock a fully flexible energy system. But enabling innovation should be the backbone of Ofgem's decision making relating to its rules and compliance, not a separate workstream.

Ofgem's consultation follows DESNZ' 2023 barriers to innovation consultation. As noted in our response to DESNZ' consultation, we agree with government that the supplier hub model is the robust basis to support the delivery of a more flexible and decarbonised energy system. It offers customers a single point of contact which connects them with an

increasingly complex energy system, and will drive suppliers to compete to discover what works for different groups of consumers in this new world. We continue to believe that a framework of rules and incentives applied consistently across market participants, smart infrastructure and a competitive market - backed up by the right support for vulnerable customers – will set the right conditions for a successful transition. We also noted that customers have different priorities and desire different outcomes, and that government and Ofgem must therefore actively support variety/differentiation in product offerings without undermining the level playing field needed to support sustainable competition in the consumer interest. We argued for an enduring targeted support mechanism; a review of the key components of the price cap (focused on ensuring loyal customers are protected, and that there are still incentives to innovate, invest, and compete); and asserted the need for a viable plan to continue the smart meter rollout beyond 2025.

This response argues that:

- The market is already delivering innovative products, and trust scores are improving¹², despite likely being impacted by high energy prices.
- Some customers will naturally want to engage more than others. While engagement delivers the best outcomes for the market, low engagement can be understandable and acceptable.
- A consistent approach to regulation and enforcement will enable investment that underpins innovation – political intervention outside of Ofgem’s published roadmap to extend the rule book makes the market unattractive to investors.
- Ofgem has looked at reviewing its rules for similar reasons before (including a move to principles based regulation and various licence reviews), but the licence has only ever grown in its size and complexity. Real reform will require considerable work to build consistency and renew trust in a principles-based direction of travel.
- Derogations or partial application of rules could lead to distortions in the market, as well as uncertainty and complexity.
- Innovators themselves should retain some benefits from taking a risk to innovate, partly by securing sufficient protections for consumers around such risks: it goes without saying that sustainable innovation is that which benefits customers.

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Supplier role

Energy suppliers compete to supply every home and business in the UK, using sophisticated forecasting and buying power to secure and protect optimal prices on behalf of their customers. They can package up network and policy costs and spread the overall bill costs over the year to even out bills and offer flexibility propositions - which pass on incentives for access to cheap and green electricity - tailoring risk appetite and preferences to suit consumers. At the same time they are responsible for fitting and maintaining metering equipment, and are the delivery mechanism for government support via energy efficiency schemes and direct payments, such as the price support delivered to every household and many businesses as a result of the gas crisis. Suppliers also proactively identify customers who are vulnerable or who have vulnerable characteristics; manage individual customer debt

¹ Levels of trust in - and satisfaction with - consumers’ own supplier have improved, with three in five (60%) stating that they trust their own supplier to treat them fairly, Ofgem Early Consumer Impacts of Market Conditions Survey Wave 5, September 2024

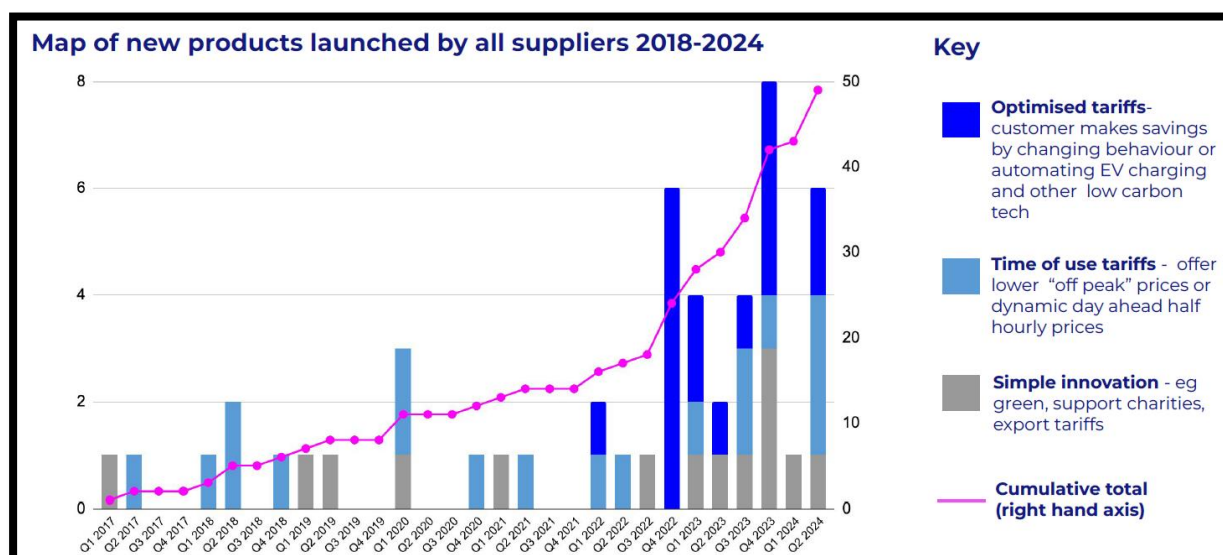
² Market conditions and sector differences need to be considered when comparing trust scores among industries. Banking is not a direct benchmark to the energy industry as it provides different services and caters for different customer needs and circumstances.

through repayment plans; and invest tens of millions of pounds a year in voluntary initiatives to support their customers. Suppliers are already at the forefront of the transition to a more flexible market, and provide different tariffs for different customer needs and characteristics. Dynamic tariffs are nothing new – the non domestic market already sees widespread use of these, and Economy 7 and Economy 10 tariffs have been an established part of the domestic supplier offering for decades.

Rate of innovation

Ofgem's consultation suggests the outcome it wishes to achieve relates to the 'acceleration' of certain types of tariffs being delivered, and new routes to market for innovators.

Regarding Time of Use products, the retail market is already seeing innovation, and this has been the case since the energy crisis, as the chart below illustrates. Over the last two winters, the Demand Flexibility Service (DFS) has delivered almost 7GWh of demand response and engaged over 2.4 million homes and businesses. One of our members now has around 10% of its customers on a smart tariff, for example.



Ofgem must also steer clear of limiting its concept of innovation as it applies to new products and services. For instance, innovation can be seen in areas like customer service, such as in the way suppliers reach out to vulnerable customers who need support.

While Ofgem assumes a market with a large number of tariffs is an optimal outcome for customers, Energy UK notes that the view leading into Ofgem's Retail Market Review in 2010 was that a market with many tariffs was too complex. This review concluded in 2013 with proposals which limited each supplier to offering no more than four core tariffs at any point in time. It is our view that – rather than defining an acceptable rate of product provision or routes to market - Ofgem should look at the bigger picture of whether it can improve the attractiveness of the current market to investment and provision of services which keep pace with customers' needs. It should look at how it is enabling suppliers to take appropriate risks in innovating and trying new services and service propositions. Some may not be taken up or - if taken up – not be sustainable in the long term. Innovation is trial and error, if it is anything. If Ofgem tries to over-explain what innovation should look like, it poses a risk of inhibiting innovation and won't necessarily lead to the best outcome for customers.

Level of customer interest and engagement

The retail energy market serves every customer in the country - a diverse population with a range of priorities and preferences when it comes to their energy supply. For many, their priority is to reduce their consumption and their bills; for others it is to secure finance for upgrades which will decarbonise their homes or transport. Some are early adopters of low carbon technology and very engaged, while others would be happy to consent to a third party make energy related decisions for them.

Ofgem must consider how conflicting but desirable outcomes can be delivered at the same time: those for individual customers (including those choosing not to participate); and those for customers as a whole (such as participation in flexibility initiatives). We must examine customers as they are, rather than theoretical customers who interact with the system in optimal ways. While the DFS showed that there is appetite for such interaction, we also see customers who simply do not want a smart meter, nor are they drawn to new services.

Promoting investment in innovation through consistency and trust

Ofgem notes it is focusing on measures which are quick and easy to implement in its consultation. However, enabling innovation is a concept which should be considered beyond a narrow workstream, and to Ofgem's whole approach to regulation. This approach requires consistency and trust between industry and government – features which need to be renewed within the current landscape to enable the market fully to evolve.

In commercial organisations the generation of new lines of business requires not just new ideas, but a risk/reward calculation from investors who are often global businesses operating in multiple sectors. We have heard from industry and investors that regulatory uncertainty reduces the comparative attractiveness of the GB retail energy market to new investment, which is essential to bringing innovative products forward. Recent political interventions resulting in new rules will not have helped in this regard³. Longer-term confidence about the market rules would drive open and fair competition between resilient and responsible suppliers.

Outcome-led regulation vs prescription

Ofgem highlights previous exercises it has undertaken to try and streamline regulation or otherwise attempt to reduce the regulatory burden on suppliers, including the introduction of Principles Based Regulation. Ofgem notes that these exercises happened before the market was hit by the recent gas crisis, and that this required Ofgem to strengthen its rules around supplier resilience. Energy UK notes that, both before and after the price shock, the size of the energy supplier licence has only ever increased and now comprises a highly complex combination of rules and principles, which sit alongside industry codes, non-binding guidance and best practice.

As the provider of an essential service the retail energy market presents a challenging political environment for government, and in the past Ofgem has found it difficult to make comprehensive changes to its rules. With this in mind, Energy UK is interested to understand whether Ofgem is prepared, while maintaining strong minimum standards of service, to take the calculated political risk to remove some rules in their entirety in order to give suppliers opportunities to differentiate, diversify, trial and test products. Removing the scope for specific innovative products reduces confidence in market opportunities.

³ For example new expansive powers being introduced in the recent Energy Prices Bill which allow Secretaries of State to intervene in Ofgem's SVT cap setting. Ofgem's wholesale costs review was also concerning because of retrospective changes to the price cap.

Ofgem has some big strategic projects on the horizon – including Consumer Standards and its data strategy – which should provide more clarity on what is expected of industry. Ofgem’s Consumer Confidence is a step in the right direction but, again, has many prescriptive rules sitting behind it. If delivered in the right way, outcomes-led regulation will drive competitiveness which will lead to better customer outcomes overall, and also be more futureproof than prescriptive rules. However, outcomes-led regulation will not work if it is undermined or made more complex by the continuation of – or introduction of - prescriptive rules, and an inconsistent process for the introduction of new rules.

Compliance

While it is essential that Ofgem has the right information to enable it to monitor the market, data provision via formal and informal Requests For Information represent a high burden on suppliers. While not directly a barrier to innovation, this can draw supplier resource and focus to compliance as opposed to innovation, and we believe Ofgem has not yet struck the right balance here. Energy UK welcomes Ofgem’s consideration of how this information is provided, provision of data, and suggests a rolling programme to assess RFIs and monitoring approaches to ensure the efficiency and timing of these is appropriate for suppliers while meeting Ofgem’s needs.

Suppliers need space to trial, market-test and withdraw products, as in other sectors, and Ofgem’s treatment of legitimate product failure is important. A move to outcomes-led regulation will improve things in this regard, but Ofgem could also make changes to existing mechanisms used for this purpose. Stable and predictable customer-centred regulation should provide the “guardrails” for safe product testing.

Derogations

In its consultation Ofgem considers whether derogations or a differentiated/restricted licence for some providers would improve innovation. Energy UK believes this will not deliver the outcomes Ofgem desires, and has concerns that this could result in a two tier licence and create market distortion. We caution against eroding universal service and there are many potential unintended consequences of creating different rules for different players – for example uncertainty which – as noted above – has a knock-on impact to investment. There are also examples of where such distortions have led to rent seeking behaviour, and extra costs on customers, both when they are exploited and when they are unwound⁴. Regulation – particularly around customer protection - needs to be consistent across all market participants and new entrants need to be held to same standard as existing players. This is particularly important as new types of business enter the market.

Ofgem should instead be focused on improving the incentives for new parties to enter the market so that they are willing to overcome some of the barriers posed by the licence - rather than diluting the licence and the protections it offers consumers. Supporting innovation from the parties that are already in the market as well as new entrants is critical to success.

Ofgem should also be regulating emerging non-supply services e.g. TPIs, aggregators etc and ensuring there are consistent consumer protections across firms. Consumer trust in all actors delivering energy-related services is vital to the transition to net zero.

⁴ An example is Ofgem removing some embedded benefits from network charges in 2018 as a result of distortions being present in electricity network charging after reviewing its implementation of these benefits. This ultimately meant two rounds of consultation and process implementation for Ofgem and companies, damage to business models, as well as confusion, cost and disruption for customers.

Default Tariff Cap

The current default tariff cap influences how suppliers design the full suite of their tariffs (not just their default tariff) and directs supplier hedging strategies. As we noted in our recent response to Ofgem's Call for Input on Power Market Liquidity⁵, liquidity levels have decreased in recent years, which is reported to have impacted the ability of some suppliers to hedge the necessary volumes of the contracts indexed against the default tariff cap. Variation in hedging strategies is a driver of competition and therefore innovation, and constraints in the availability of hedging tools could impact levels of innovation, as discussed in Eurelectric's recent position paper⁶. Ofgem should therefore explore how to allow suppliers scope to innovate in their hedging strategies.

Smart metering, MHHS and net zero price signals

Ofgem rightly identifies progress in the development of smart meter coverage, Market wide Half Hourly Settlement (MHHS) and Net Zero price signals as forming the foundation for the future energy market, and should be focused on how to move progress forward in these areas.

Ofgem needs to do more to drive consumer flex, including removing barriers to low carbon tech takeup, supporting delivery of MHHS which is timely and robustly-tested, and widening access to markets to enable consumer flex.

Confidence and customer engagement are chicken and egg, and this can be seen in the smart programme in particular, where uptake is influenced by negative media sentiment (get latest SEGB data).

DSR schemes have already seen some uptake and benefits to customers being delivered, and we expect to see further movement in this direction, but high levels of smart penetration are needed to drive larger benefits which will make it seem more worthwhile to customers. Customers need to see the value in flexibility schemes before they participate in them, and it is disappointing to see that the revised DFS will be less effective in supporting consumers to engage in flexibility. Uncertainty around the future value of flexibility means that many consumers, including non-domestic customers, are holding back on investing in technology that would support flexibility. Ofgem has a role to play in creating more certainty and giving consumers the confidence to invest.

The MHHS programme will deliver cheaper bills to consumers, more streamlined processes for suppliers and support the energy sector in reaching net zero. MHHS will enable more products and services to be offered such as vehicle solutions and more time-of-use tariffs.

Ofgem's role in the completion of the smart rollout includes designing the framework for the future DCC and Energy UK welcomes the dedicated work being done in this area to ensure stakeholders have input in this area. It is also worth noting that some suppliers are increasingly facing issues when handling smart meter refusal. Not only do legacy metering systems threaten both direct and wider smart rollout benefits to customers – including the ability to provide flexible products - the continuation of the legacy system also has impacts on industry costs and service provision. While it is accepted by industry and government that smart meters are the default meter, this is not backed by regulation currently, and we need to work together to find a resolution to this issue.

⁵ <https://www.energy-uk.org.uk/publications/energy-uk-response-to-ofgems-call-for-input-on-power-market-liquidity/>

⁶ <https://www.eurelectric.org/publications/supplier-hedging-the-eurelectric-guidebook/>

More widely, sound code expertise within Ofgem will lead to clearer definitions in its rules, which would drive regulatory certainty.

For further information or to discuss our response in more detail please contact Daisy Cross, Head of Future Retail Markets at daisy.cross@energy-uk.org.uk.