

Ofgem  
10 South Colonnade  
Canary Wharf  
Stepney  
E14 4PU  
Email: [FutureConsumers@ofgem.gov.uk](mailto:FutureConsumers@ofgem.gov.uk)

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**“Innovation in the energy retail market” – So Energy Response**

Dear Colleague,

So Energy is a leading energy supplier providing great value renewable electricity to homes across Great Britain. We supply over 300,000 customers and as one of the last challenger suppliers left in the market and one that is backed by ESB Group’s resources and expertise, So Energy is able to provide a unique view of the state of innovation in today’s energy market.

Innovation is not an intrinsic good and can lead to worse outcomes for consumers than the status quo. It can drive additional cost and complexity for consumers. It can demand behaviour change consumers are uncomfortable with. Ofgem needs to establish guiding principles around how it manages regulatory change that is designed to foster *good* innovation. Innovation that delivers value for both individual consumers and the market as a whole. Having considered the matter, we have identified some important principles and their underlying rationale.

1. Incumbent providers should be free to completely adopt any innovative licence, derogation or business model. For example, if a new type of supply licence is proposed, incumbent providers should be able to migrate their entire customer base across to that new licence without this creating issues for consumers or the market. Ofgem should apply this sense test when designing innovations. If the market no longer delivers good outcomes if everyone was to take up the innovation, that would indicate that it is undesirable or in some way flawed. An innovation that only ‘works’ if it is adopted by a subset of new entrants or by no one at all is not a useful innovation. Ofgem created the Triad Avoidance regime and it led to rent-seeking businesses entering the market. Through avoiding network charges, these businesses provided savings to some at a cost to all. Then when Triad Avoidance was unwound, many customers who had invested in Triad Avoidance bore losses, damaging confidence in the market. These types of mistakes must not be repeated.
2. Third Party Intermediaries (TPIs) must not be baked into the design of the market. A market that is dependent on TPIs is an inefficient market with high search costs. It is an outcome to be avoided rather than a goal to achieve. Energy shopping directly acts as an effective alternative route to market, constraining TPIs ability to price high commissions. If the market is designed around TPIs, this alternate route will be lost and commissions will grow and grow.
3. More counterparties makes managing change more difficult. The more commercial organisations that are involved in a change, the more complex, costly and time-consuming that change becomes. Ofgem should be mindful of the impact creating new counter-parties will have on its ability to deliver change in the context of a Net Zero transition. If anything, Ofgem should seek to simplify the types of market participant in order to help deliver future regulatory change more quickly.

1. What innovation is currently happening in the domestic and non-domestic retail markets? What is the scale of this innovation?

We are beginning to see consumers<sup>1</sup> take advantage of the benefits of Net Zero. Uptake of solar, batteries, heat pumps, and the flexible use of electricity is on the rise. However, in terms of the journey the nation needs to undertake to transition to Net Zero, we are still very much in the foothills and there remains an Everest to climb.

2. What innovation should happen to meet consumers' needs and meet net zero?

We cannot say for certain. Much of what needs to happen will be shaped by the broader plan set out by the government. France almost entirely decarbonised its electricity grid 20 years ago by building a fleet of nuclear power stations – no retail innovation necessary. Future innovation will be determined by:

- a) The makeup of the GB generation portfolio; and
- b) The extent to which consumers are truly willing to change behaviour to optimise the build out and utilisation of that portfolio.

With regard to GB generation, key decisions, such as the outcome of REMA and the future of forward liquidity remain outstanding. These decisions will have a significant impact on the level of consumer behaviour change that is needed.

With regards to consumers' willingness to adapt their behaviour, we do not know the extent to which customers can and will do this. We know that early adopters are willing and able, but we do not know mass market uptake. There are issues with distinguishing between customers who are 'unwilling' vs 'unable' to adapt – a financial incentive to nudge the 'unwilling' towards more flexible energy use, is a financial penalty for the 'unable'. We do not know how to reliably tell one from the other. If the 'unable' are more likely to be vulnerable (and that would appear to be a reasonable assumption given the cost of EVs, solar etc.) questions arise regarding the morality of punishing the 'unable' in order to incentivise the 'unwilling' with the goal of optimising the use of GB renewable generation.

These are deeply complex issues that go far beyond simple considerations of market design.

3. What will impact consumers of new, innovative products and services? How can we maximise the benefits and minimise the risks?

Innovation is not an intrinsic good and can lead to worse outcomes for consumers than the status quo. Ofgem needs to establish guiding principles around how it manages regulatory change that is designed to foster innovation. Having considered the matter, we have identified some important principles and their underlying rationale.

A lesson needs to be learnt from Embedded Benefits and Triad Avoidance. New business models entered the market centring around Triad Avoidance but these businesses generated savings for their

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<sup>1</sup> Note as a domestic supplier, our response refers to the domestic market, unless otherwise stated.

customers by avoiding network charges, which subsequently had to be paid by other consumers. This is rent-seeking behaviour. When Ofgem identified the issue and unwound the incentive underpinning these business models, the customers who had invested in Triad Avoidance late on, never recouped their investment. Customers paid more than they should while the rent-seeking activity was underway, then other customers made a loss on investment when Triad Avoidance was unwound. This is an example of bad innovation.

Sense checks, such as the one set out at the beginning of our consultation response should help identify these potential pitfalls and help Ofgem avoid them. It is generally a good idea to play an incentive or innovation out to its ultimate conclusion, that it is the dominant feature of the market, and understand what impact that would have on the market and consumers. This will help identify risks and verify benefits.

#### 4. Are there any additional enablers or barriers to innovation?

Innovation is not an intrinsic good and can lead to worse outcomes for consumers than the status quo. Therefore, some 'barriers to innovation' are in the interest of consumers and should be retained.

A useful sense test for what barriers to innovation should be removed and what should be retained is to consider the universal adoption of said innovation, including by incumbent suppliers and all customer types. If 100% adoption is considered a good thing for consumers and the market, then the barrier should be removed. If 100% adoption breaks the market or highlights rent-seeking behaviour, then the barrier should not be removed.

#### 5. What is the most significant barrier to innovation? Why?

We believe that identifying 'good barriers' and 'bad barriers' using the sense test we have set out in our response is a more useful lens through which to view this question. Ofgem needs to satisfy itself that removing a barrier and the subsequent universal adoption of innovations would be a good thing for consumers.

We note that all of the enablers listed in the consultation can also act as barriers to innovation. Each one of the points made by Ofgem relies heavily on cost effectiveness, a working infrastructure and customer behaviour. For example, data and technological enablers can only happen if LCTs are affordable, the smart meter can communicate, and the customer allows the supplier to use the smart data for marketing and product development. These are big 'ifs' and their success or failure will largely depend on the regulatory framework.

As things stand, the price cap acts as the most significant barrier to innovation in the supply market. A great deal of the revenue suppliers earn is tied to Ofgem decision making with regards to the cap. These decisions can be difficult to predict over any appreciable time horizon, making it more difficult for investors to weigh up their decisions.

#### 6. What innovation is not happening because of regulatory barriers?

The current 'tight' price cap continues to make it difficult for suppliers to offer non-capped products at a saving against the default tariff. It also leaves suppliers with less available funds to invest in

innovation and less room to take measured risks. Ofgem needs to progress price cap reform in order to foster innovation.

With regards to derogations and licencing, we believe that identifying 'good barriers' and 'bad barriers' using the sense test we have set out in our response is a more useful lens through which to view this question. Ofgem needs to satisfy itself that removing a barrier and the subsequent universal adoption of innovations would be a good thing for consumers.

#### 7. Should we do further work to improve routes to market?

When considering any changes around routes to market Ofgem should apply the sense test we have set out in this response. It needs to satisfy itself that if all customers were served via this route to market, it would the market deliver good outcomes for consumers. Ofgem would need to be comfortable with incumbents migrating customers from their existing supply licences to this new route to market. If Ofgem believes that only new entrants can avail of the new route to market while the incumbents are in some way from barred from adopting this, then it must play this scenario forward. If the new route to market is truly compelling, the new entrants will displace the incumbents and the market will arrive at universal adoption of the new route to market anyway.

Without such a sense test, there is a substantial risk of a 2 tier market, where one tier derives a competitive advantage from rent-seeking behaviour. Ofgem would subsequently need to intervene to unwind this innovation, which will likely come at great cost to consumers and damage investor confidence. Ofgem needs to avoid this outcome.

#### 8. What is the most attractive route to market? Why?

The evidence would point to obtaining a supply licence as the most attractive route, as that is the dominant regulatory underpinning. If alternatives were sufficiently commercially advantageous, then incumbent suppliers would seek migrate their customers to these alternative licence arrangements.

Just because Ofgem has not designed a sufficiently attractive alternative to a standard supply licence to date, doesn't mean that it will not do so in the future. If it does, Ofgem must be comfortable with the outcomes for consumers - should that alternative be universally adopted.

#### 9. If you think that we need to improve routes to market, which option do you think should be our top priority and why?

Any new routes to market should also be open to incumbents by migrating their existing customers and Ofgem should be comfortable with universal adoption of that new route to market. If it is not, then there is something wrong with the proposed alternative route to market.

#### 10. What are your views on the options presented for amending routes to the market? What would be the risks and benefits of each option?

Any new routes to market should also be open to incumbents and Ofgem should be comfortable with universal adoption of that new route to market. If it is not, then there is something wrong with the proposed alternative route to market.

11. To facilitate innovation, which licence conditions would most benefit from being reformed?

The sense test we have set out in our response should be applied to potential innovations. Ofgem should be comfortable with universal uptake of an innovation before trying to facilitate it.

Some existing licence conditions are set out in a manner that makes them more difficult to automate. This increases cost to serve. For example, rules around the Price Protection Window generate windows of varying length, depending on the specific circumstance. Simplifying the rules in this area would facilitate automation of the window in supplier systems, reducing cost.

12. Are there any other improvements to routes to market which should be considered as part of enabling significant innovation in the retail market?

Before considering derogations, restricted licences, individually modified licences, reformed licence lite, exempt licences or any other routes to market, Ofgem should apply the sense test and satisfy themselves that universal adoption would be good for consumers and the market.

Yours sincerely,

Paul Fuller  
Head of Regulation