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Sent by email to: [marketsstrategy&delivery@ofgem.gov.uk](mailto:marketsstrategy&delivery@ofgem.gov.uk)

Dear Tom

**Supporting innovation in the electricity retail market: exempting small suppliers from the Universal Service Obligation (USO)<sup>1</sup>**

Please find attached Centrica's considered response to the consultation.

In summary:

- We strongly disagree with Ofgem's proposal for selective exemption from the USO. Our starting point is that there should be a strong presumption against *selective* regulatory exemptions which risk undermining the competitive level playing field and encouraging unsustainable business models. To overcome this presumption, we would expect Ofgem to present a fully reasoned and evidenced case for its proposal which, regrettably, it has not done.
- The claimed benefits set out in the consultation document are speculative, ill-defined, and unsubstantiated. Equally troubling, the risks associated with selective exemptions are underplayed and not completely addressed by the proposed 50k customer threshold as Ofgem suggests. Indeed, Ofgem's appeal to the customer numbers threshold as an all-purpose mitigation is undermined by contrary indications in the consultation document which call into question how rigorously it will be maintained and enforced in practice.
- While we applaud the stated goal of supporting innovation, we are concerned that a focus on exemptions to support specialisation is a distraction from wider reforms needed to support investability and innovation at scale across the entire sector

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<sup>1</sup> [Supporting innovation in the electricity retail market | Ofgem](#)

including larger suppliers. Consequently, we urge Ofgem not to pursue its present proposal any further but instead prioritise these wider reforms.

Yours sincerely

**Don Wilson**

Regulatory Economics and Policy

## Appendix 1: Response to Ofgem's consultation questions

1. *Do you agree with our proposal to exempt suppliers with fewer than 50,000 customers from the USO?*
2. *Do you agree with our assessment of the risks and mitigations?*

No, we do not agree with Ofgem's proposal for selective exemption from the USO or its assessment of risks and mitigations.

As we argued in response to Ofgem's previous consultation, selective regulatory relaxation should not be pursued lightly.<sup>2</sup> Experience shows that previous policy aimed at encouraging new market entrants succeeded in stimulating market entry but ultimately failed when market conditions exposed unsustainable business models leaving consumers to pick up the tab for risks that should have been borne by investors.

As well as competitive distortion, selective exemption from regulatory obligations also results in inconsistent consumer protection. These risks have been recognised explicitly by policy makers through progressive *reductions* to the regulatory thresholds applicable to Warm Home Discount (WHD) obligations from the original 250k customer threshold.<sup>3</sup>

The case Ofgem presents for its proposal is cursory in the extreme; it amounts to mere assertion that the universal service obligation it proposes to relax *could* pose challenges to specialisation, which Ofgem believes *could* be beneficial – *unsupported by any serious evidence or analysis*.

The consultation document fails to articulate clearly why specialisation is considered necessary to support tariff innovation in conjunction with low carbon technologies (LCTs) and demonstrate how the proposed exemption enables this in practice. Critically, it also neglects to consider *whether the wider goal of supporting innovation in the retail market would not be better served by enabling all suppliers to compete on level terms*.

This is a serious omission. We are concerned that a narrow focus on putative niche market entry risks distracting from more profound changes needed to support innovation at scale. Investability is key to supporting innovation, and the necessary conditions to drive change inevitably depend on the supporting regulatory and policy framework.

Among the key issues Ofgem needs to consider as a priority are:

- The general disincentive to retail investment caused by extremely low retail margins;<sup>4</sup>
- The corresponding lack of commercial headroom available to sustain the sort of savings necessary to incentivise large scale customer adoption of innovative tariffs and service propositions.

These issues need to be addressed through reform of the price cap in a way which supports rather than hinders increased take up of competitive time of use (ToU) tariffs and customer flexibility *outside of the default tariff cap*. This should include consideration of whether the cap should evolve to become more of a backstop than a first recourse, supplemented by

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<sup>2</sup> [Innovation in the energy retail market | Ofgem](#)

<sup>3</sup> [Warm Home Discount: better targeted support from 2022 - GOV.UK](#)

<sup>4</sup> [Ofgem State of the market report](#)

targeted interventions to support affordability for those in greatest need, and funded through progressive taxation rather than additional bill payer levies.<sup>5</sup>

Positive action on this front will increase the scope for tariff and service innovation in support of decarbonisation goals by *all* suppliers, maximising the opportunities available to *all* domestic consumers. A clear roadmap for the direction of travel on price protection will help mitigate the adverse impact or regulatory uncertainty on investability, which is key to supporting innovation and longer-term consumer benefits at scale.

The present proposal is a retrograde step in this respect, because it threatens to reverse the previous direction of policy *away* from selective regulatory exemptions, increasing the perceived risk of further such exemptions or raising of thresholds.<sup>6</sup>

Ofgem presents its proposal as a proportionate ‘test and learn’ intervention. But what this means in practice is unclear, given that Ofgem has not articulated in any detail what it expects the impact of its proposal will be and what metrics will be applied to judge the success (or otherwise) of the policy.

Ofgem states:

*“We recognise potential risks and we consider these risks manageable at the proposed threshold.”<sup>7</sup>*

All else equal, a lower threshold will tend to mitigate risks that would be more pronounced with a higher threshold. It is, of course, conceivable that the risks Ofgem identifies are mitigated *in circumstances where the policy fails to stimulate the market entry and innovation Ofgem hopes will result*, especially if Ofgem fails to address more profound sector wide risks to investability due to low returns and regulatory uncertainty. But mitigating risks by failing to deliver benefits cannot provide justification for an ill-considered ‘experimental’ intervention.

Ofgem’s appeal to the proposed 50k threshold as an all-purpose mitigation is undermined by its presentation of the threshold as *“a proportionate and pragmatic starting point” (emphasis added)*.<sup>8</sup> Whether “pragmatic” or not, Ofgem’s claim that the threshold is “proportionate” cannot be sustained when it makes no attempt to calibrate either risks or benefits. Moreover, it is hard to place any confidence in the threshold proposed in circumstances where Ofgem a) overtly refers to it as a “starting point” and b) reserves the right to vary the number without any clear commitment to conduct an open, transparent and evidence-based consultation.<sup>9</sup>

This choice on Ofgem’s part fuels concern that no substantial reliance can be placed on the 50k threshold enduring. If no material market entry or innovation results from its proposal,

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<sup>5</sup> [Energy UK urges Government to introduce social discount for households most in need](#) - Energy UK

<sup>6</sup> The proposed licence amendment allows Ofgem to vary the 50k threshold without any requirement for consultation. Ofgem offers no clear explanation why the entry barriers to specialisation it perceives will not resurface as barriers to expansion as the threshold approaches, creating predictable upward pressure on the threshold unless robust safeguards are put in place.

<sup>7</sup> Consultation document, paragraph 2.11

<sup>8</sup> Consultation document, paragraph 2.7

<sup>9</sup> The draft licence amendment proposes to exempt electricity suppliers from the obligations set out in SLC 22.2 or 22.3 *“if it supplies electricity to fewer than 50,000 Domestic Customers or such other number as may from time to time be directed by the Authority.” (emphasis added)*

the temptation will be to argue that the threshold was too restrictive and should be relaxed and/or that other selective regulatory exemptions should be pursued. This does not inspire confidence that Ofgem will rigorously enforce the 50k threshold in practice. Indeed, the tentative language Ofgem uses further undermines confidence that strict enforcement can be relied upon:

*“We may undertake targeted readiness assessments of suppliers benefitting from the exemption. These assessments could draw on information such as suppliers’ growth projections and business plans, helping us understand whether suppliers are preparing to comply with the full suite of obligations that would apply once the threshold is reached.” (emphasis added)*

Our concern about the reliability of the proposed threshold stems also from the imprecise and incoherent nature of the cursory benefits case Ofgem presents.

As a thought experiment, however, *assume* that Ofgem’s supposition that tariff innovation depends on specialisation which adherence to the USO precludes is correct. In this case, it is unclear how market entry by new suppliers, each restricted to a maximum of 50k customers, could have more than a marginal impact on tariff and service innovation across the broader domestic electricity market comprising an estimated 28.2 million households.<sup>10</sup>

Ofgem does not explain how putative new entrants could maintain the supposed benefits of specialisation once they cross the 50k exemption threshold. Nor does it explain how existing suppliers above the threshold could respond to a niche opportunity that depends on a regulatory exemption they do not qualify for.

The only remaining route potentially available to specialist new entrant suppliers to reach a substantial market share would involve recourse to multiple licenses with each licensed entity continuing to benefit from exemption by remaining below the threshold. But this is, of course, something Ofgem (rightly) says it will not allow.

While we welcome Ofgem’s recognition of this potential loophole and stated intent to close it by applying the threshold to the cumulative total of domestic electricity customers served by any licensees of the same ultimate parent company, it is not clear how i.e. by what legal mechanism Ofgem intends to apply and enforce this restriction in practice.

Rather than focus on the loophole, however, we believe Ofgem should abandon its proposal altogether – or at least until it presents a properly reasoned and evidence-based case to stakeholders.

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<sup>10</sup> [Subnational electricity and gas consumption summary report 2024 - GOV.UK](#)

## Appendix 2: Additional observations

While the consultation document itself does not contain more specific questions, Ofgem has indicated separately<sup>11</sup> that it is seeking stakeholder views on the following key areas:

- *Potential benefits for innovation, flexibility, and new business models*
- *Impacts on consumers and customer choice*
- *Competition effects and implications for existing suppliers*
- *Threshold design, readiness requirements, and monitoring*
- *Safeguards against avoidance through group structures or multiple licences*

For completeness, therefore, we briefly address each of these areas below.

### *Potential benefits for innovation, flexibility, and new business models*

The rationale and evidence to support Ofgem's contention that specialisation is a) necessary to support tariff and service innovation and b) seriously impaired by current universal service obligations is scant and not compelling as it stands.

To the extent that Ofgem can make a case along these lines, it needs to explain why universal service obligations are a barrier specialisation below the 50k customer threshold but not above it.

### *Impacts on consumers and customer choice*

The impacts on consumers and customer choice are not clearly articulated in the consultation document. As noted above, failure to explain and evidence how widespread consumer benefits can be expected to arise from an intervention that is confined to niche, small scale operation is a serious omission.

Since Ofgem does not present any theory or evidence of how its proposal will succeed in attracting specialist market entrants whose business model depends critically on regulatory exemptions below the proposed 50k customer threshold but not above that threshold, it is likely that any increase customer choice of supplier will be confined entrants who are content to operate at limited scale indefinitely.

### *Competition effects and implications for existing suppliers*

Selective regulatory relaxation does not provide a sustainable means of supporting innovation because it deliberately skews the competitive playing field to enable 'cherry picking' by exempting some suppliers from obligations and associated costs borne by all other competitors.

While entry assistance has sometimes been justified by policy makers by appeal to a competitive spur to existing market players, the case for such intervention is weak in the

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<sup>11</sup> August 26 Regulatory Directors call

case of an already competitive market characterised by low retail margins. If Ofgem's thesis that specialisation cannot be pursued in the presence of USO holds, existing market players will be unable to respond unless the obligation is lifted on a much wider basis – which is entirely contrary to the present proposal and requires a broader consideration of the rationale and appropriateness of maintaining USO licence obligations.

- *Threshold design, readiness requirements, and monitoring*

Ofgem's statement that it "may" undertake targeted readiness assessments to help it understand "whether" suppliers are preparing to comply with the full suite of obligations above the threshold does not inspire confidence that thresholds will be rigorously policed and enforced in practice.<sup>12</sup> At the very least, we would expect Ofgem to place a bar on new customer acquisition unless it can be satisfied that suppliers will comply fully with obligations that apply above the threshold.

- *Safeguards against avoidance through group structures or multiple licences*

Ofgem presents the proposed threshold as an all-purpose mitigation against risks to unfair competition, but the threshold will be meaningless if it can be circumvented through group structures or multiple licences.

While we welcome Ofgem's recognition of this potential loophole and stated intent to close it by applying the threshold to the cumulative total of domestic electricity customers served by any licensees of the same ultimate parent company, it is not clear how i.e. by what legal mechanism Ofgem intends to apply and enforce this restriction in practice.

Clearly, Ofgem must not allow any relaxation subject to thresholds that it cannot effectively enforce. More broadly, however, given the weak case so far presented for *any* selective relaxation we consider Ofgem should abandon the present proposal altogether – in which case the question of how to close loopholes falls away.

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<sup>12</sup> Consultation document, paragraph 2.5