

Date: 14 November 2017

To all interested parties,

Future supply market arrangements – call for evidence

Ofgem is determined to create a future where competition constrains prices, drives efficiency and delivers the range of services and products that customers need. We want to see a retail market where all consumers, whether they engage in the market or not, receive good services and capture the benefits from innovation, while being protected from risks.

At the time of privatisation, the energy market was designed with suppliers as the primary interface between consumers and the energy system. We now call this the 'supplier hub' model because today's retail market arrangements have evolved around the supplier as the 'hub' of the market, with other entities transacting with consumers via this 'hub'. The supplier's role has been entrenched in legal frameworks, licensing arrangements and industry rules.

Since privatisation, we have seen significant developments in technologies and services across the energy system. For example, households can now generate, store and sell back flexible demand to a system characterised by increasingly intermittent generation. The emergence of big data, largely driven by smart meters, is enabling new services that can help consumers to better manage their energy costs and change suppliers more easily.

But we cannot assume that the institutional roles and responsibilities put in place 20 years ago remain the right ones. Big questions are being asked about the role of network operators, the system operator and the ability of innovators to enter the market. In this context, we are now exploring whether the supplier hub model is still fit for purpose or whether we should consider changes as the energy system evolves.

Why we are asking this question now

Current retail market arrangements can get in the way of beneficial innovation and competition in a number of ways. Evidence from our Innovation Link¹ suggests that the regulatory framework often constrains companies' ambitions or forces them to move more slowly than they might. Existing arrangements can prevent potential new entrants with disruptive business models from entering the market, for example, by giving traditional suppliers privileged access to information and control over processes.

Where innovators are successful in entering the market, they do not always operate directly under our regulatory framework. It can be easiest to regulate these entities indirectly via a licensed supplier (as their agent) but it is not clear this is sustainable. We

¹ Ofgem's [Innovation Link](#) is a 'one stop shop' offering support on energy regulation to businesses looking to introduce innovative or significantly different propositions to the energy sector. We want to support innovative ideas that bring benefits to consumers. This also helps us understand emerging trends in the sector and identify areas in which our regulation may need to adapt to sustain innovation.

need to consider whether this is right. It will also be important to consider the need for wider consumer protections in the context of the recent recommendations of the Competition & Markets Authority (CMA) on Ofgem's role in respect of digital comparison tools.²

We want a regulatory framework that enables new ways of offering energy supply and associated services, where this is in consumers' interests. As we enter a period of price protection in the retail market, we believe now is the time to take a step back and to consider whether current market arrangements are working for current and future consumers and will be able to deliver the level of innovation and competition we expect.

We are also considering current 'default' arrangements in the domestic market, where consumers that do not engage are typically supplied on poor value standard variable tariffs via their existing supplier. It is likely that there will always be some disengaged consumers on default arrangements, given the obligation on suppliers to offer supply. Therefore, in thinking about new arrangements, we'd like to consider whether there are alternatives to price protection for ensuring these customers get a good deal. Before price protection is removed there will need to be confidence that the conditions for effective competition are in place. And we need an enduring solution.

Regardless of the future supply market model and new technologies and services being used, energy consumers will continue to require effective protection. Energy is an essential service, so consumers need more than general consumer protections to guarantee supply, ensure that they receive an appropriate quality of service and pay a reasonable price. As we enable greater innovation within the market, our regulation will need to keep up.

To ensure this happens, we recently announced that we are now considering whether and how to design the retail market differently.³ This letter sets out some of the key issues and calls for stakeholder input to shape the way forward.⁴

Focus of this scoping phase

We are now examining the role that traditional suppliers play in the market and the opportunities for consumers to access and manage their supply in new ways (eg via different types of market participants or even accessing their supply directly). This includes domestic and non-domestic suppliers, and is about how we regulate the supply of electricity and gas, and associated services – regardless of who provides them.

To be clear, we are considering fundamental issues relating to the current structure of the market, and how this market may need to evolve to enable greater innovation and competition in the future. This is in parallel to ongoing policy work to engage today's consumers and to support and protect the disengaged within current market arrangements. We will work with government on this future framework.

At this stage, we are interested in stakeholder views on:

- **Whether the current supplier hub arrangements are fit for purpose** to deliver our overall objectives in the context of the rapid change in technology and business models we are seeing and expect into the future, including being clear on any barriers to innovation.
- **Where any regulatory change should be focused and why.** In other words, we want to know whether fundamental change is required or whether the current supplier hub model can adapt. And, if changes are required, we want to explore

² The CMA's digital comparison tools market study final report can be found [here](#).

³ Dermot Nolan [speech](#) at Energy UK Annual Conference, 19 October 2017.

⁴ We have listened to, and are building on, the views that stakeholders have already shared with us. This includes the responses to our [discussion paper on non-traditional business models](#) and [lessons from Innovation Link](#).

what this would mean in practice and the impact this would have on consumers, including the vulnerable.

- **How any changes to the supplier hub model could best align with and ensure wider market activities continue to be performed efficiently,** including things like balancing and settlement activities and recovery of network costs.

We will also consider knock-on implications for other parts of the energy system and Ofgem initiatives. For example, making it easier for different market participants, including consumers, to access and share data, in line with relevant data protection regulations, should help maximise the benefits of smart metering and half-hourly settlement. We will also need to ensure that energy continues to be balanced and settled effectively and that network, systems and policy costs are fully recovered. The role of the supplier and wider market context within which it operates is set out in Annex 1.

We want your views

We see this as the beginning of a dialogue with interested parties, including innovators, suppliers, consumer groups, academics, government and other regulators. Given the scale of the opportunities and challenges, we want to hear views from across the energy sector and beyond. We are open to all views and encourage fresh thinking on the issues.

Annex 2 sets out questions across four topics – we're keen to receive your views on these. These are complex issues and will take some time to work through. We have not yet determined whether fundamental changes are needed, nor what those changes could look like or how they could be implemented. We aim to set out our initial views on a way forward in Spring 2018.

We welcome your input at any stage, however it would be helpful to have any early views by 22 December 2017 to accelerate our thinking. Please send responses to futuresupply@ofgem.gov.uk. We will also look to convene workshops to discuss these matters with stakeholders over the coming months.

I look forward to hearing from you on these important issues.

Neil Barnes
Associate Partner
Consumers & Competition

ANNEX 1 – ROLE OF THE TRADITIONAL SUPPLIER AND WIDER MARKET CONTEXT

Current arrangements are characterised by the central role of suppliers

Under the current energy market arrangements, consumers must access the system through a licensed supplier. Suppliers recover all costs from consumers through a tariff. New parties wishing to enter the market must become a licensed supplier or contract with one in order to settle energy purchase and sale transactions in the centralised system. As a result, the supplier is the primary 'hub' or intermediary between consumers and the energy system, with suppliers competing for consumers' energy demand.

Energy is an essential service, so ensuring households have access to supply is non-negotiable. Suppliers therefore have a special obligation to supply domestic customers, and have a duty of care towards these customers, including where the customers are inactive or vulnerable.

While there are some differences⁵ between electricity and gas supply obligations, the supplier is generally responsible for activities such as:

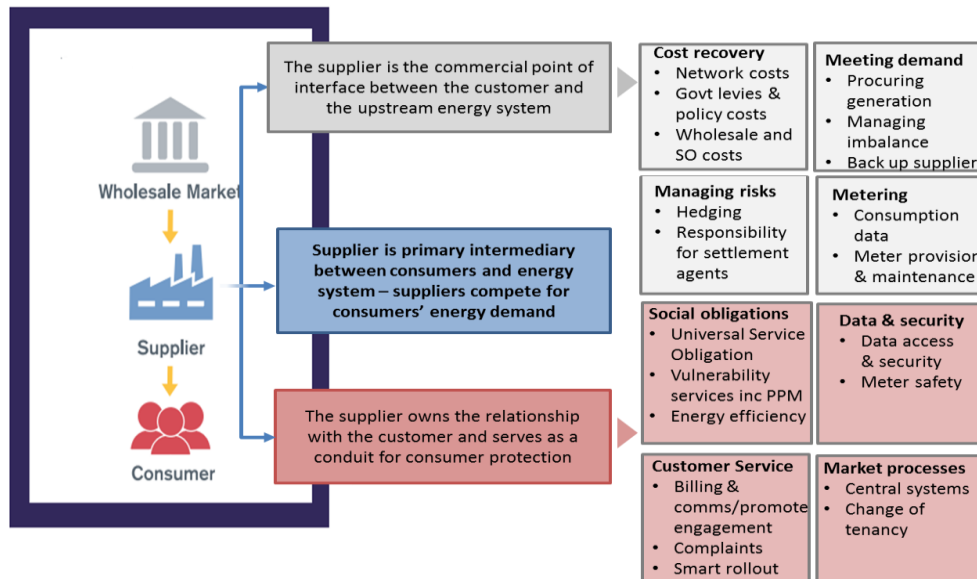
- Providing the commercial point of interface between the consumer and the energy system (which is why this is sometimes referred to as energy retailing).
- Settling system costs incurred on behalf of its consumers, including network charges, wholesale energy costs, system operator costs and final consumption levies imposed by the government.
- Metering gas and electricity consumption, including provision of meters, and providing this data to consumers.
- Meeting wider social and environmental obligations, including under government schemes.
- Suppliers are also required to meet certain standards of conduct and service under licence obligations, including special responsibilities towards the vulnerable.

In delivering the above activities, and as the primary interface between consumers and the market, the supplier essentially has three roles:

- Acting as a settlement agent, dealing with all the various pass through components of the energy bill and recovering the cost from consumers based on metered consumption.
- Managing the risk arising from the differences between prices paid by consumers and costs incurred – particularly in relation to wholesale energy costs.
- Acting as a conduit for consumer protection.

The diagram below sets out a range of functions that suppliers perform.

⁵ For example, in the gas market it is the shipper, not the supplier, who has responsibility for activities like settlement.



Considering the future of supply within a broader market context

The supply market does not exist in isolation and, as we now consider the current arrangements, we are mindful of linkages with other policy areas across the energy system, such as:

- The different roles and responsibilities of different market participants now and in the future. This could include suppliers, system operators, aggregators, technology companies, peer-to-peer platforms, and other intermediaries that provide energy services to consumers.
- The type and level of regulation, including entry requirements, for different market participants, existing and new, including intermediaries that we may not directly regulate through the licensing regime.
- Current metering arrangements, given the importance of metering and meter data to the functioning of a smart, flexible energy system.
- Data access arrangements, in line with relevant data protection regulations.
- Balancing and settlement obligations, including the responsibility and ability of 'suppliers' to generate or buy enough energy to match their customers' demands, and associated cost recovery mechanisms.
- Recovery of other costs, including network and policy costs, particularly where smaller suppliers have been exempt from some costs to encourage market entry
- Interoperability of processes and technologies across the system (eg smart meters).

We have already been engaging with stakeholders on a number of these issues, and it will be important to consider future supply market arrangements as a part of the wider energy system regulatory framework.⁶

⁶ For example our work with BEIS on the [Smart Systems and Flexibility Plan](#) provides a roadmap for delivering a smarter, more flexible energy system. Our [Strategy for Regulating the Future Energy System](#) sets out our current priority actions to address the key challenges and opportunities that future changes could create for different aspects of the energy market and regulatory arrangements.

ANNEX 2 – CALL FOR EVIDENCE

We are seeking stakeholder input on the following topics, to progress our thinking on future supply market arrangements that will deliver the best consumer outcomes by enabling innovation, ensuring effective default arrangements are in place and providing comprehensive protection.

Topic 1 - Guiding criteria to evaluate a successful supply market

We want a market where competition and innovation deliver good outcomes for consumers, including lower bills, lower environmental impacts, improved reliability and safety, better quality of service and better social outcomes. We want our regulatory framework to be fit for purpose over time.

To ensure the regulatory framework is best placed to enable delivery of these outcomes, it will be important to set out guiding criteria to frame any future supply market arrangements. This will allow us to keep focused on our goals, and to make sure any reform options we develop are in line with the supply market that will deliver the best outcomes for consumers.

Guiding criteria could include:

- Consumers can access energy supply and energy services however they choose to do so, without undue restriction.
- Consumers that do not actively engage in the energy market still receive a good quality of service and pay a reasonable price for their energy.
- Consumers, including the vulnerable, are adequately protected no matter how they access energy services.
- Bearing in mind relevant data protection regulations, there are no undue barriers for consumers and wider market participants seeking to share access to their energy system data with other market participants.
- Firms offering intermediary and other services to consumers can compete on an equal basis.
- Costs of operating the energy system are recovered in a cost-reflective manner, and risks allocated and managed effectively.

It is important that the set of criteria are consistent with our aim to: **promote competition**, including for disengaged consumers, **enable innovation** in business models, products and services, where this is in consumers' interests, and **ensure protection** for all consumers, particularly the vulnerable.

Q1 What are your views on the above criteria? Are there other criteria that should guide our assessment of current and possible future market arrangements?

Topic 2 – Barriers to innovation

We know from our Innovation Link that new business models are seeking to break into the energy market, and offer new energy services to consumers. For example, new opportunities are presented by smart meters providing access to more granular and timely data on consumption patterns, the increased value of flexibility across the energy system, greater penetration of distributed renewable generation and battery storage reducing in cost and increasing in capacity.

The proliferation of new technologies and business models has the potential to address the two-tier retail market by providing new products (such as local energy, energy

management or multi-utility billing) that encourage new groups of customers to engage and by making it easier for customers to switch (eg via intermediaries that act on customers' behalf to switch supplier).

However, in many cases, firms find their business models are not compatible with the regulatory framework and have to adapt. This often means needing to partner with a supplier, become a supplier or scaling back altogether the services they are able to offer consumers.

There are also questions around how new retail entities can interact effectively with wider energy system and back-office arrangements in a decentralised, electrified, smart and flexible world. For example, a challenge with peer-to-peer models is the inability to have multiple suppliers servicing a single consumer, and knock-on challenges with balancing and settlement. A similar challenge exists for the provision of 'roaming billing', where a consumer may wish to access their supply account from different supply points at different points in time.

At the same time, it is important that all firms, including innovators, pay their fair share of the cost of participating in the energy market. This includes ensuring efficient allocation of costs associated with network operation and with environmental policy costs, for example.

Q2 What are the most significant barriers to disruptive new business models operating in the retail market? Please draw a distinction between regulatory barriers and commercial barriers (eg there may not be enough potential consumer demand to justify market entry).

Topic 3 – Alternative default arrangements

By 'default arrangements' we are referring to the market arrangements in place to protect consumers when they do not engage in the market (eg suppliers' contractual obligations to consumers and the essential service requirements). We are also referring to protections from events outside the consumer's control (ie their supplier exits the market, and the consumer requires a new mechanism to access supply). In other words, these are the arrangements in place to ensure that consumers are always able to access supply and protected regardless of their level of engagement.⁷

In the current GB supply market arrangements, consumers can only access the energy system through a licensed supplier. As a result, the supplier is the primary intermediary between consumers and the energy system, with suppliers competing for consumers' energy accounts. Because energy is an essential service, there is a high bar for a supplier to refuse to supply a domestic customer, and suppliers are subject to a range of obligations to treat consumers appropriately. More broadly, we consider suppliers to have a duty of care towards these customers, including where the customers are inactive or vulnerable.

Currently, customers who do not make an active choice of supplier are placed onto a 'default' tariff. This is most commonly a standard variable tariff (SVT), which means that it is evergreen with a unilateral right to change terms, including prices, given suitable notice.⁸ These default arrangements are a fundamental feature of the retail energy market, because it would clearly not be acceptable for a supplier to terminate supply at the end of a contract period. This makes energy supply different to most other commercially-provided consumer services.

Around 12 million non-prepayment domestic customers are currently supplied on these default tariffs, and a significant proportion of these have never switched or do not switch

⁷ To be clear, this is distinct from activities that can support increased consumer engagement more generally (eg prompts to engage on regular supplier-customer communications).

⁸ Standard condition of electricity supply licence number 23 – Notification of Domestic Supply Contract terms

regularly. Most of these consumers remain with the six largest suppliers, all of whom are the successor companies of the former monopoly providers. Evidence from the CMA shows these customers are paying significantly more for their essential energy service than they need to. That's why the Government has brought forward draft legislation to implement price caps for this section of the market – to protect disengaged consumers from detriment.⁹ We have also sought to prompt increased consumer engagement in the market, most recently through trialling various interventions. Nevertheless, there will inevitably be some consumers that do not engage.

Current default arrangements have entrenched the role of the consumer's current supplier in providing safeguards for the disengaged, but this has been at the expense of innovation and competition. We want to explore if there are alternatives to the current default arrangements in the longer term. Everyone should have access to an essential service, however there are questions around the universal supply model being the right one. For example, should all suppliers continue to be obligated to provide default arrangements, or is there the potential for a smaller group of traditional suppliers to hold this responsibility? Or there is a way for non-traditional suppliers to provide default supply arrangements?

We would want any alternative approaches to deliver appropriate levels of protection for the disengaged, and ensure that those on default arrangements are not unduly disadvantaged. For example, can we set default arrangements that promote more effective competition for the disengaged and so avoid having to regulate prices for some customers in perpetuity? This could include some form of opt-out collective switching, where groups of customer accounts are auctioned centrally unless a customer chooses to opt out. Such a reform would likely require legislative change.

An alternative could also include default arrangements provided by a party other than a traditional licensed supplier, by a smaller range of nominated suppliers, or even one in which consumers access the energy system directly rather than through an intermediary.

Q3 What other supply market arrangements would provide a better default for disengaged consumers, whereby they are protected adequately and are able to access the benefits of competition?

Topic 4 - Consumer protection

There is a set of standard licence conditions for each licensable activity, including supplying gas and electricity to consumers.¹⁰ Suppliers are obliged to comply with the standard supply licence conditions from the day the licence is granted, and must understand the duties and obligations imposed by these conditions. The licences also set out that the licensee must become party to and/or comply with certain industry codes.¹¹ As we see an increasing variety of services offered to consumers in the energy market, we (and other regulators) will need to consider how best to protect consumers from any associated risks.

One way to do this is to make sure our supply licence obligations are fit for purpose, and enable greater innovation and flexibility in how consumers are served. This has been a key focus of our work to transition towards an increased reliance on principles-based rules for suppliers, and a reduced reliance on detailed prescriptive rules.¹²

⁹ We are fast tracking temporary price protection for consumers at risk of being vulnerable. Our consultation on proposed changes can be found [here](#).

¹⁰ The Standard conditions of the gas supply licence are [here](#) and the Standard Conditions of the Electricity Supply Licence are [here](#).

¹¹ Information about industry codes and standards can be found [here](#).

¹² Information about our work to transition to an increased reliance in principles-based rules to regulate suppliers can be found [here](#).

The supply licences are based largely around one definition of 'supply'. We are also considering whether this is the best way to ensure consumers receive a quality service from other types of energy 'suppliers' (and associated service providers) as the supply market evolves over time. Protection from new risks might be required. Relying on the current supply licence may not be the best way to ensure consumers are protected in a future where how – and from whom – consumers access their supply and associated energy management services looks very different from today.

Regardless of who consumers may engage with for their energy needs in the future, including any default supply arrangements, there will be a need to protect consumers from harm. Consumers could still experience harm from intermediaries entering the market and not providing appropriate levels of service or care. One option could be a general authorisation regime with graduated obligations depending on the scope and/or scale of supply-related activities being performed. Other options might be to change the scope of current licencing arrangements, or to rely more heavily on wider consumer protection powers.

We are interested in views on how we can ensure consumers remain protected, however they access supply and engage in the market.

Q4 How big an issue is it that we do not currently regulate intermediaries in the energy market? Is there a case for doing so? If so, how would we best do it? We are especially interested in frameworks that enable a wider variety and increased number of market participants to provide supply.