To:
Neil Barnes, Associate Partner, Consumers and Competition
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Dear Neil

Future supply market arrangements – call for evidence

1. I am responding to this Call for Evidence on behalf of environment think tank Sustainability *First.* Sustainability *First* is a small charity that works in the energy, water and waste sectors. We have significant experience of consumer and public interest issues, regulation and the demand side (see **www.sustainabilityfirst.org.uk).**

General comments

2. The smart energy supply market offers major new opportunities for innovation, which if properly encouraged and regulated can help deliver a low carbon economy in the UK at the lowest cost.

3. For this to happen, it is important to frame any consideration of future arrangements around the actual needs of consumers, rather than the needs of the energy system or specific parts of the energy value chain. Focusing on the outcomes that consumers and citizens want to see will be important to guide change. Sustainability First's New Energy and Water Public Interest Network has identified the desired long-term public interest outcomes for the sector as being ***energy services*** that provide heat, light, power for communications, transport etc and deliver value for money, quality customer service, clean power, resilient services, where possible place based well-being and fair services.[1]

4. If the energy supply market were a purely commercial market, it might only be necessary to remove the barriers to innovation and allow active innovators and active customers to explore such opportunities. But Ofgem is right to say that energy is an essential service so that ALL customers, not just active ones, should receive adequate consumer protection, including an appropriate quality of service and a reasonable price for their energy. Innovation, as well as bringing new benefits, can also bring new threats and these need to be anticipated and guarded against if the interests of all customers, current and future, are to be protected.

[1] http://www.sustainabilityfirst.org.uk/images/publications/new-pin/New-Pin_Mid_Project_Report_-_Key_Messages_.pdf

5. It is clear that requiring domestic customers to have only a single supplier constrains market innovation. But this constraint had a purpose. The universal service obligation – the requirement under section 3A of the Electricity Act 1989 for the Secretary of State and the Authority to have regard to the need to ensure that all reasonable demands for electricity are met (and the equivalent provision for gas) – is made more complicated in the situation where a customer has more than one supplier. In other words, which supplier picks up the USO obligation? This has a number of aspects:

   (i) Default supplier

6. However innovative the market structure becomes and whatever smart appliances and other forms of flexibility were available, it would be unacceptable if a customer were unable at any time to make a reasonable demand for additional electricity – switching on a light, say – or gas. This means that at any time one of the customer's suppliers must, in effect, be the default supplier, picking up the obligation to supply those additional units. The default supplier would also have to pick up the obligation to supply in circumstances where the customer's other supplier(s) have failed to meet their contractual obligations and / or in situations of supplier of last resort.

7. At present, the provision of the meter, whether smart or otherwise, is the responsibility of the supplier. Unless this were to change, for instance, to make the DNO responsible for metering, which would in itself be a major upheaval, a decision would need to be taken as to which supplier retained this responsibility and the related costs. The simplest solution would be for it to be the default supplier, but there would need to be arrangements for a fair allocation of metering costs between suppliers.

8. The process of switching supplier would be more complex. Ofgem's programme for faster and more reliable switching would need to be capable of encompassing the situation where customers have more than one supplier.

9. The default supplier faces a number of problems. First, how does it gain customer data in order to bill the customer? A smart meter will only register total imports and exports in any time period. One possibility would be for the separate contract, eg for electric vehicle charging, to be on a separate hard-wired circuit and for the smart meter to have the specification and be configured to record this separately. In the absence of this approach, there would therefore also need to be some form of central register of contractual information for each customer so that contracted-for imports and exports of energy could be netted off the customer's total imports and exports to identify the purchase obligations of the default supplier. If the default supplier was not to do this itself, perhaps on grounds of commercial confidentiality , then perhaps a much-expanded version of Elexon could undertake this task as part

of coping with half-hourly settlement for domestic customers. The extent to which block-chain technology would be able to address this issue remains to be seen.

10. Second, the increased uncertainties faced by the default supplier would add to the costs of its purchasing strategy and probably lead to greater use by it of the balancing market. For those customers who remain predominantly supplied by a default supplier, this could well lead to higher prices. And there is no guarantee that a supplier would want to take on the additional risk associated with such a task. So would it be necessary to mandate a limited number of suppliers to undertake the task, and how would it be ensured that they were being appropriately reimbursed (neither too little nor too much) for the task?

11. Third, creating two different classes of suppliers leads to questions of how various on-costs, such as network charges and green levy recovery should be apportioned between them. This is dealt with further below.

(ii) Need for cost reflectivity

12. If tariffs are not cost-reflective, then smart active customers can exploit this in ways that are at the expense of other, less active customers.

13. Those customers that engage in the smart energy market and take action will respond to the tariff prices they see and not to the underlying cost of supply. Even today, active customers can make substantial savings from the variability in price of tariffs offered by different suppliers. In the smart world, the opportunities will increase since actively engaged customers could avoid network charges and green levy through greater use of own generation and exploiting the options available from elective half-hourly settlement. Indeed, with the information available from smart meters and the likely active involvement of third party intermediaries, the smart electricity customer will have a wider range of opportunities open to them to select the cheapest ways of meeting their own particular preferred profile of energy needs. (For instance, if they have a larger proportion of peak time use than the average customer, they may choose to stay on a flat-rate rather than a TOU tariff.) To the extent that the prices they face are not reflective of the underlying costs and a fair share of the supplier's margin, this will be at the expense of all other, less nimble, customers. This is not only unfair to other customers, but could also run counter to the aim of delivering a low carbon energy future.

14. Ofgem has taken a lead in addressing these issues in relation to network charges through the Charging Futures Forum and its Targeted Charging Review on residual charges. But this is only part of the picture. How green levy charges are recovered and the issues raised by elective half-hourly settlement also need examination to develop ways of addressing these issues that are fair to all customers.

15. It is not only active customers who will be able to make use of smart meter data to cherry pick. With the customer's consent, his or her smart meter data will be able to be made available to other suppliers and intermediaries. Suppliers and intermediaries will be on the look-out for profitable customers and to discourage those customers who would impose an additional cost burden. Whilst no doubt a statutory provision could be created to prevent an alternative supplier from refusing to accept a new customer who has requested a supply, there are many ways, such as directed marketing, short of an absolute refusal that can be used to cherry pick profitable customers. This could be difficult to detect and prevent.

Detailed comments

16. Our comments are addressed principally at questions 1 and 4.

Topic 1 - Guiding criteria to evaluate a successful supply market

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?

17. In a recent paper[2], Sustainability First proposed two key objectives for the smart energy market to seek to ensure that less engaged customers continue to receive a fair deal These are: (1) to encourage arrangements that encourage companies to price competitively and to innovate to meet the changing needs of the market, and (2) to avoid particularly unfair pricing for any domestic customer. It is pleasing to see that these are reflected in Ofgem's guiding criteria. Some other comments, reflecting the discussion above, are worth making:

- **Consumers can access energy supply and energy services however *and whenever* they choose to do so, without undue restriction** The universal service obligation means that, whatever encouragement is to be given to flexibility, customers still need to be able exercise free access to the supply system.
- **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** As argued above, this should mean, as far as possible, and recognising the needs of customers with vulnerabilities, that suppliers should face cost-related charges.
- **Consumers, including the vulnerable, are adequately protected no matter how they access energy services** All changes have distributional effects and create winners and losers, and therefore need sensitive handling including particular attention being given to those who have difficulty in engaging with the market.

[2] http://www.sustainabilityfirst.org.uk/images/publications/other/Sustainability_Firs_-_Jon_Bird_-_Discussion_paper_-__Engaged__and_Sticky_Customers_-_final_-_030417.pdf

- **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** These firms must provide equal access, both direct and in relation to marketing, to all customers. It is not acceptable that firms should be able to cherry-pick customers.
- **Costs of operating the energy system are recovered in a cost-reflective manner, and risks allocated and managed effectively** Suppliers currently have freedom to decide how they recover costs and margin from customers. Costs that suppliers face need to be cost-reflective and regulatory care needs to be given to checking that the way these costs and margin are recovered from customers are not particularly unfair (criterion 2 above).
- **Need for clear, joined up consumer redress arrangements** Consumers should not be left confused and without knowing who has responsibility to sort out their problems amidst increasingly complex value chains and liability arrangements.

Topic 2 - Barriers to innovation

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).

18. Given the volume of change that is currently taking place in the energy system, it is not always possible to identify what is cause and effect here or to be able to measure the real impact of any barriers, compared to the perceived impact. However, we recognise that perceptions can clearly be important in deterring new entrants and can send unwelcome signals that the sector is not receptive or open to change.

19. Recent Sustainability First research on innovation for the New-Pin network identified that some of the most significant barriers for new business models operating in the retail market were: access to central hubs / core processes to which new entrants need to plug in in order to operate (e.g. data sharing codes, architectures and platforms that have been designed for the 'old' system or have evolved as 'accepted behaviours'); sharing customer data (the UKRN's recent report *Making better use of data: identifying customers in vulnerable situations* shows what can already be done in this area with the necessary push and regulatory co-operation); consumer protection arrangements (see paragraph 21); and sharing other sources of data (more could be done to proactively share the data sets that Government, regulators and existing industry players hold beyond the 'usual suspects').

20. One specific barrier is the current absence of an adequate regulatory structure to sell heat as a service. Current legislation requires providers to charge per unit of gas used – rather than, for example, linking payment to a temperature profile. Removing this barrier would encourage innovative approaches to more cost-effective heating.

Topic 3 – Alternative default arrangements

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?

21. Exploring the full range of trustworthy default arrangements for disengaged customers will be important. A focus on opting out of any change, rather than opting in, is likely to be beneficial. The concept of bulk collective switching for those that haven't yet switched appears at least superficially attractive. However, significant care would be needed to ensure that default suppliers were carefully assessed if a 'two tier' supply market was to be avoided. It would also be important to understand whether such switches would have a positive or negative impact on on-going consumer engagement with their energy provider. If they reduced engagement, they could potentially make the goal of energy service focused companies / flexibility services more elusive.

22. It may be helpful to look at the experience of automatic enrolment in pensions for insights into how to make this type of very long-term behaviour change programme work in practice. The success of automatic enrolment has in part been due to the cross-party consensus that had been built by the Pensions Commission that this was a solution to an otherwise intractable problem and in part to the creation of Nest as a default pensions provider with strong corporate governance focused on the member interest.

Topic 4 - Consumer protection

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.

23. On consumer protection generally, a number of issues have been identified above that could face customers, especially the less engaged, with greater risks from innovatory market solutions: the likelihood of two classes of suppliers and the obligations that each should face, the prices faced by customers who remain with the default supplier, and the possibility of new suppliers cherry-picking more

profitable customers. These all need to be adequately guarded against before embarking on major change.

24. Consumer protection arrangements are likely to need to evolve as smarter energy markets and more bundled / integrated services emerge. Further consideration is needed as to: what consumer protections will be necessary for *all* energy consumers (eg notice of being cut off, information on spend etc); what protections will be needed for *customers in vulnerable circumstances* (ideally cross utility sector to enable more joined up support); *where generic consumer protections* may be sufficient; how *consumer redress* can best evolve in a more complex world; and how consumer protections can best adapt to provide the space to enable consumer facing innovation *trials and tests* to take place in a timely manner.

25. The term 'intermediaries' covers a range of activities. Aggregators that have the ability to affect direct load control seem to have greater potential to impact on health and wellbeing than a switching site, for example. The level of consumer protection required ought to relate in some way to the sorts of risks implicit in that activity.

26. As a growing reliance is placed on intermediaries, particularly for 'hard to reach' groups, it will become increasingly important to ensure that the services that they provide protect the consumers that they say they are serving. Regulation in this area will need to be proportionate and to take account of what is 'fit and proper' in terms of conduct in this area.

27. Consideration is also needed as to how best to regulate intermediaries that use complex algorithms to make decisions. It can be difficult to assess whether this type of 'black box' technology is acting in the interests of the consumers that it may claim to serve. [3]

Yours sincerely

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[3] See, for example, http://www.oecd.org/daf/competition/Algorithms-and-colllusion-competition-policy-in-the-digital-age.pdf