



Ofgem Open Letter - Future supply market arrangements – call for evidence

E.ON Response

Executive Summary

We support Ofgem in proactively looking at options for how the energy market may evolve. We would support the removal of or amendments to any regulatory barriers that may exist to enhancing the experience of consumers of the energy market.

The current arrangements for licences (generation, transmission, distribution, shipping, supply and the DCC) were implemented to support an inter-connected energy network. The logic for this governance model will continue to be for as long as this inter-connected energy market exists.

Although not explicit within the call for evidence it seems that it is looking solely at the electricity supply market and not gas. In the gas market there is the concept of licensed shipping and supply activities, each with distinct functions designed to help foster competition, this appears not to have been considered. In our response therefore we assume that the focus of this call for evidence is solely the electricity supply market. Should this assumption be incorrect, we would wish to revisit these comments with Ofgem.

We feel that this call for evidence does not fully articulate or recognise the flexibility that currently exists within the electricity supply arrangements, as well as the existing intensely competitive nature of the market. Options such as 'licence lite', white labelling, exempt supply arrangements and 'sleeving' provide evidence that the existing arrangements are flexible and can evolve over time to cater for evolutions in the electricity supply market.

We are glad to see that the call for evidence highlights the consumer protection benefits that the existing licensing regime brings. Not only do they help from a commercial perspective in ensuring that the inter-connected energy market operates but they also guarantee that customers' interests are protected in a market which provides an essential service.

The supplier hub model has continuously evolved since the inception of the competitive market in the 1990s. Current developments can be seen to be supporting the implementation of advanced and smart meters. Discussion and evaluation are underway as to how the supplier hub model should evolve to support the implementation of more granular, half-hourly settlement, for all customers. This is expected to facilitate innovation in the products that are available to customers and how they manage their energy use.

We therefore conclude that the evidence points to the current arrangements operating well, striking an appropriate balance between supporting innovation and protecting consumers in a market for a product and service that is vital to modern life.

The argument set out in this open letter is that innovation would be encouraged if Ofgem acts to remove or lower current regulatory hurdles. We agree with this concept but are surprised that



there is no mention or consideration of whether it would also be useful to understand whether any incentives could be developed to encourage innovation.

Incentivising innovation is an area which Ofgem are familiar with from regulatory schemes that reward networks for considering new thinking and solutions.

Greater consideration of what incentives could be developed for the retail market is potentially a better method of looking to encourage innovation as this may act as a greater motivator than a slightly reduced set of rules and regulations.

Competition in itself leads to a certain level of innovation but, unless there is a degree of regulatory certainty, innovation can be stifled because the risk/reward balance does not encourage the investment that innovation requires. In the retail supply to business market the difficulty of establishing whether a customer is a micro business through the use of business parameters (employees and balance sheet total) leads to considerable uncertainty. In these days of flexible employment contracts and exchange rate volatility customers cannot apply the parameters themselves.

To avoid regulatory risk suppliers almost inevitably deem a SME customer to be a micro business. This leads to extra costs and inefficiencies.

We favour the application of consumption thresholds only and as this principle has been established by the CMA we would urge Ofgem to review use of the CMA segment as the sole definition of a micro business in the energy market.

This approach would give certainty to suppliers around the services they had to deliver and give customers the protections they could expect. It would also provide increased certainty of the risks faced by suppliers of investing/innovating in either the micro business or the non-micro business sector.

An area where current regulation increases risks and costs for energy suppliers is the unfair application of additional costs to support various Government and regulatory schemes. These are levied upon suppliers based upon the size of their customer base without consideration as to the impacts on competition or innovation that they create. These obligations present a distortion in the market that needs to be addressed to ensure that costs are recovered fairly across all consumers in the market.

Another aspect of regulation that Ofgem should look to address is the co-ordination of reforms and changes to the market whether these be to support innovation or to enhance consumer protection. Uncoordinated regulatory and Government policy changes in the past have increased costs for suppliers unnecessarily and ultimately reduced the speed and pace of innovation in the market. Changes that are introduced by Government and regulators with limited or no forewarning also have a detrimental impact upon the market, impose unexpected costs on suppliers and ultimately undermine investor confidence and should be avoided.

The suggested criterion for evaluating innovative regulatory reform seems reasonable and is focused on providing good customer outcomes. However we have an important concern about the



processes for vetting new entrants to the market. It is important for new entrants to have a commercially viable operating model and we therefore recommend that Ofgem introduces a financial stress test for new suppliers. Lack of strict financial criteria for new entrants results in a distortion of competition; new entrants have a competitive advantage if they have insufficient risk capital and are inadequately funded. When such suppliers become insolvent, these risks are then distributed to other suppliers and customers via the SoLR process.

Answers to specific questions:

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?*

The criteria suggested by Ofgem are reasonable and a good basis upon which subjectively to judge whether any proposed changes would benefit electricity consumers.

Ensuring that customers' interests will continue to be best served by any proposed changes to the supplier hub arrangements is critical. This was central to the establishment of the arrangements established to support a competitive market.

Many of the suggestions for change to the current supplier hub arrangements seem to be motivated by organisations wanting to advance their own commercial interests and in many cases the benefits to consumers are difficult to understand or identify. We used the adverb "subjectively" above deliberately. However, we believe that it would be far preferable to have an objective set of measures by which to judge any potential change.

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 (e.g. there may not be enough potential consumer demand to justify market entry).*

There is a balance to be maintained when developing a regulatory regime to ensure that the interests of consumers are protected but that it does not stifle innovation within a market place. It has been established over many years that, at least for some residential customers, consumer protection regulation in the electricity sector will remain a clear requirement. This is due both to the inherent safety concerns regarding the commodity and also because it is a basic requirement for a modern society to function.

We believe that the current arrangements in the most part achieve this balance and that the electricity supply licensing arrangement can be judged to be successful in this regard.

The flexibility included within the current governance arrangements provides an opportunity for innovation and at the same time provides a framework that ensures oversight and enforcement powers for the sector regulator.



Innovation has allowed a wide variety of different electricity supply models to evolve outside of that originally envisaged when the supplier hub arrangement and licence regime were first introduced.

Examples of this include licence lite and white labelling, whereby innovators have entered the market with different offerings for a broad range and number of consumers but without the need for complex and expensive systems to support the integration with the electricity system.

For individual and community scale customers, the licence exempt arrangement has provided a route for the provision of new services for customers. More recently innovation has been seen with the implementation of 'sleeving' services from established suppliers.

The exempt licence arrangements in particular allow for innovation to be introduced for new business models that take advantage of lower cost localised renewable energy generation and storage.

We have not found the need to obtain a separate supply and generation licence to be particularly onerous or to be a barrier to developing innovative new business solutions.

The restrictions regarding holding a network licence as well as a supply or generation licence are more onerous and have prevented the development of a number of solutions for community energy schemes that we have considered developing in the recent past. If these restrictions were relaxed it might have allowed us to progress with a number of potential projects.

However we appreciate the logic in having this separation and therefore, before reforming the licencing arrangements regarding energy network operators, a thorough assessment would be needed as to the long term effects on retail competition that this might have for the energy market.

The need for the supplier hub arrangements becomes relevant when an interaction with the interconnected energy system is needed. A flow of energy in a part of the system needs to be managed and balanced to ensure that it operates safely. Rules for how this operates and what participants in the system must do are therefore justifiable. Providing flexibility around these rules and how the system evolves will help support innovation but does not undermine the need for these rules to exist to maintain a level of service that consumers demand. They are a baseline, around which innovation can continue to develop, as experience has already shown.

The examples of innovations that have occurred indicate to us that there is scope for innovation to occur in the market at the moment. Such an example is the support for on-street electric vehicle charging and the development of small scale electricity storage solutions.

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?

We believe that a competitive retail supply market should provide the choice and opportunities for all customers to become engaged with the energy market. We do not believe that an intrusive regime of price caps and political interference in the market will ultimately benefit customers, whether they be engaged or disengaged.



When considering less engaged customers and whether they are benefiting from competition it is important to understand against what criteria this is being judged.

Should the measure be solely one of relative price levels, as the CMA recently focused upon in its investigation, or should it be against other factors such as, for example, levels of service? Other measures that might be applied include the ability for customers, either engaged or disengaged, to access innovation from the market or the levels of customer service that they receive.

The sector will have evolved by the time the price cap is reviewed. One of the key drivers in the future for disengaged customers becoming more involved in the market may be the types of commercial offering available to them. It is therefore important that an alternative regime encourages innovation within the market.

The regime that is finally chosen to address this issue should consider the impact that it will have upon the levels of service, the innovation in commercial offerings as well as the outright price that it provides to disengaged customers. Only a balanced approach will ensure that future disengaged customers are not disadvantaged and ultimately move to being more active involved in the market.

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.

We have supported previous attempts to improve the regulatory oversight of intermediaries and continue to be in favour of more involvement from Ofgem in this area. We are disappointed with the progress made to date in this area with regard to Third Party Intermediaries (TPI) operating in the business market.

We have tried unilaterally to improve the market with our own initiatives but without the broader support from a change to the regulatory regime these efforts have been thwarted. Overall standards in this sector have not improved and action is overdue. There have been commercial costs to us from our actions to try and improve the TPI business market, for example in developing our own Codes of Conduct for expected behaviour, but we believe that these are worthwhile in ensuring that the market is improved for customers.

Intermediaries play an important role in the successful functioning of a competitive energy market. At the inception of the market the size and role which they would play was not understood. Over the years the nature and scope of the services offered in the sector has evolved to reflect the needs of customers and technological developments. This can be seen as a success for competitive market forces as competition has driven service providers to evolve to keep up with the needs of their customers.

The argument for additional regulation in this area stems from the need to protect consumer interests from the behaviour that some participants have displayed in the past. This has seen clear detriment to affected customers and presented a negative view of the wider energy industry.



Relying on general consumer protection legislation and trading standards enforcement may not be appropriate due to resource constraints and prioritisation. It is therefore efficient to utilise the existing skills and knowledge of Ofgem for the energy sector.

The suggestion of a broader supply licence which could perhaps include elements that encompass intermediaries is an interesting concept. It is not immediately clear to us as to how the scope of the licence might be amended to cater for this suggestion. It may also take time for this approach to be implemented which is concerning considering the issues affecting TPI in the business market are clearly apparent in the market today and need addressing as a matter of urgency.