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Dear Maureen

Discussion Paper: Developing a framework for assessing whether conditions are in place for effective competition in domestic supply contracts

We welcome the opportunity to comment on this Discussion Paper.

Shell Energy Retail, as the rebranded challenger supplier First Utility, has a highly engaged customer base, with typically less than a fifth of our customers on our default tariff at any one time.

Noting the characteristics of much of the rest of the market, we therefore recognise the political impetus behind the Default Tariff Cap (**Cap**) for disengaged customers.

However, market-wide price caps are unusual and we are also mindful of the distortive impact of the Cap on competition, innovation and investment. On that basis, we are keen for the framework being established to be as robust as possible. We strongly believe that stakeholder input is essential to build an appropriate set of conditions within that framework and the supporting methods and guidelines. We urge Ofgem to enable stakeholders to have the chance to comment further on Ofgem's proposals for the framework once Ofgem has worked through the many comments we anticipate it will receive on the Discussion Paper.

Ofgem should also consult with stakeholders on its proposed annual recommendations to the Secretary of State or, at the very least to describe the direction of travel for comment and discussion before a final report is made:

In terms of this Discussion Paper:

- **Ofgem should consider the structural factors that limit as well as support the development of a competitive market that provides good outcomes to most consumers, above all the 200,000 account ECO and WHD policy costs threshold.** This £40 per customer advantage skews the playing field, distorts competition and adversely impacts consumers, above all those on lower incomes. This should be explicitly evaluated by Ofgem as part of this annual workstream.

- **With some caveats, we broadly accept the conditions for effective competition**, i.e. structural factors, that competition will work well good outcomes are available for most consumers

- **Innovation and investment in the energy transition should form a <u>fourth</u> condition of effective competition,** i.e. how far the energy market is delivering the products and services need to ensure consumers switch to low carbon power, heat, transport and services and the UK's legally-binding Net Zero target is met. One option for a metric to evaluate this condition could be for Ofgem to consider the "Innovation Sales Rate" (**ISR**) - the amount of revenue the market is achieving from sales of "new" products and services versus historical products and services (e.g. energy supply and boiler care vs smart home and EV charging) - to determine how fast the market is transitioning to low carbon services. Where this transition is slow, Ofgem should consider the potential impact of the policy framework supporting innovation, including the Cap itself.

- **In terms of the metrics underpinning each condition: we think the category of "Small and Medium Suppliers" should be split into two, given the current bundling will mask critical competitive dynamics**. For example: Small Suppliers (below 200,000 customer accounts) are in growth phase, offering highly loss-leading tariffs to build market-share and are therefore not directly comparable to "steady state" suppliers, as well as taking the benefit of certain structural distortions (set out further below).

- **Ofgem should consider the outcomes produced by non-traditional competitors,** as we would expect these to increase significantly in the coming years. Their introduction could be both positive but could also be the opposite, where poorly and inconsistently regulated.

- **Customer outcomes should also be split by income decile and by markers of vulnerability**, so the greatest action can be targeted on those suffering the most detriment.

- **Ofgem should produce an annual Impact Assessment considering the likely effect of the Cap in the past year, the likely effect of the Cap over the coming year and the impact of the Cap if it lasted until 2023, when the current legislation has a sunset clause.** As we set out below in our response to question 1, lifting the Cap will require an annual judgement about the appropriate balance between protection and competition which perhaps makes the Cap's early removal difficult for the relevant Secretary of State until the legislation lapses. Given the impact of the Cap, if it lasts five years, could be much more punitive than if it lasts for less, future Impact Assessments should consider in more detail its likely market effects.

We now turn to the consultation questions in more detail:

Consultation Questions

<u>1: Are there any features of effective competition that are not covered in our definition?</u>

Broadly speaking, we accept Ofgem's definition of effective competition within the confines of considering when and how to best to lift the Cap, that is, only "in the context of this review" as stated by Ofgem itself. However, it is still worth noting that the proposed definition places considerably less weight on the need to support demand-side engagement than previous Ofgem or CMA remedies.

Indeed, as Professor Amelia Fletcher has noted, intervention in the GB market has moved from disclosure remedies; to "shopping around" remedies; to "switching" remedies and finally to outcome-control regulation which *"directly specify what outcomes we should see in the market… in contrast to the core demand-side remedies...which endeavour to achieve good market outcomes through improving consumer decision-making."*

Professor Catherine Waddams highlights this changing trend in regulation as likely reflecting "*impatience with the retail energy market because it is not delivering equally good outcomes to all consumers, since consumers do not all respond to the offers available".* We agree with Ofgem that programmes such as Faster Switching and Smart Metering will transform the energy market, enabling accurate bills, next day switching and a wealth of new smart services which should unlock far greater consumer engagement.

However, we also agree with Professor Waddams that: *"Price differentials are an inherent part of almost all real-world markets, and the focus on equal outcomes rather than equal opportunities raises fundamental questions about willingness to accept the outcomes of deregulated markets, and in particular price differences within markets….If so, this will pose a challenge to build market frameworks which reflect new concepts of discrimination and political preferences for greater equality of outcome."*

2: What are your views on the conditions for effective competition we have proposed? Are they clear and is there anything else you think we should take into account?

Overall, we agree with the three conditions proposed, namely that structural changes should be in place which facilitate competition; the competitive process is expected to work well in the absence of the Cap; and that good outcomes should be expected for most consumers; with some caveats.

On structural changes:

- **Ofgem should be specific on the *structural changes* being referenced and the indicative timetables at play.** In a sense, smart metering is not a structural change, it being a requirement for Ofgem to consider. For other changes, it's not clear when e.g. the database remedy will be in place or the implementation of Midata. We also don't consider that the future energy retail market review is yet sufficiently concrete in terms of direction of travel to be considered as a structural change in this context.

- **Ofgem needs to be more specific as to the types of *market development* that can and should fall into the "structural changes" category**. For example, Ofgem highlights changes to switching via intermediaries in the Discussion Paper, but what other categories should be considered here?

- **We would be concerned if the key structural changes had to be fully delivered for the purposes of this condition.** Rather, we think Ofgem should take account of progress made and likely delivery as otherwise, programme roll-over will itself signal the failure to meet this element of this condition, which is not appropriate;

- The Faster Switching programme is costly and complex, resource-intensive and a material set of changes to key industry processes. Underpinning the Cost Benefit Assessment of this programme is the presumed importance of switching, which is why current customers are being asked to fund its development. Switching is also seen as a key component in “rigorous” competition, as set out in this Discussion Paper, and also as the central element underpinning the CMA’s 2016 package of reforms. And yet the wider narrative behind the Price Cap suggests switching is no longer considered the primary mechanism to drive effective competition, and that policy should protect all customers who do not switch for whatever reason, rather than protecting specific groups which find it harder to engage e.g. vulnerable customers. A central challenge for Ofgem is therefore to balance the distortive impact of a protection for non-switchers with the prioritisation of switching in the rest of its work.

- **Ofgem should also consider the structural factors which <u>limit</u> effective competition**. We believe the Policy Cost Threshold is damaging to competition, as set out below, and believe this should be explicitly evaluated by Ofgem in order to support policymakers reform the schemes as planned in 2021/22.

On good outcomes for most consumers:

- We urge Ofgem to consider guidance around their meaning of “rigorous” competition, and “good” outcomes, as well as “most” consumers. Are there outcomes Ofgem expects to see, e.g. as reflecting of “rigorous” competition? How will “most” be interpreted if personalised offers, energy as a service and other innovations do start to take a small hold?

We also propose a further condition for effective competition:

- **Ofgem should explicitly consider “innovation and investment in the energy transition”,** i.e. in products and services which will support consumers switch to low carbon power, heat, transport and services, whether that be “Heat as a Service” or home batteries to support low-income groups manage Time of Use Tariffs. Innovation on low carbon services is essential if the UK is to meet its new Net Zero Target, but may not be forthcoming for a number of reasons, from too high a cost curve (in which case Government incentives or regulation may be needed) through to the structure or level of the Cap impacting investment in innovation. Give the importance of Net Zero to the public and policymakers, and the necessity of evolving the retail market to meet it, we believe innovation should therefore be a separate category in its own right.

- Within this, consideration should be given to the % of lower income customers accessing innovative services. As Professor Catherine Waddams warns:

  > *“New technology, such as smart meters and smart appliances, may change consumer engagement by ‘automating’ some responses, and enabling new forms of third-party intermediary to reduce the necessity for ongoing individual consumer choices. However, it is not clear that such technology will alleviate the distributional concerns, at any rate in the short term, since those most vulnerable to detriment are also least likely to be able to invest in and take advantage of such improvements. While the CMA was more optimistic about technical developments, it concluded that customers in vulnerable groups were at particular risk.”*

3: What are your views on the structural changes that we propose to include in our framework? Are there any specific changes you think we should consider?

Subject to the points made in our previous response, we agree that Ofgem should consider the structural changes brought about by regulatory and Government policy, including Faster Switching, and electricity settlement. These programmes in particular (together with smart metering, which we note Ofgem is required to take into account by the Act of Parliament) are aimed at improving both the supply and demand side of competition, taking a more traditional view of competition.

By 2023, we hope to see a radically different market, where customers receive instant and accurate bills; can switch between pre-pay and credit mode; can switch supplier within a day; and have a granular understanding of their data.

As stated above, Ofgem additionally should consider the structural factors which limit effective competition. We welcome the Discussion Paper's acknowledgement that the Cap could impact competition and its impact will be tested as part of the Annual Review, and we ask that other policies are explicitly considered alongside this.

For example, Warm Home Discount (**WHD**) customers were the least likely of all customer groups to have considered switching in the past 3 years, according to the CMA. This is perhaps no surprise given 75% of suppliers are not required to offer the WHD, and vulnerable people that switch to those suppliers would lose their £140 rebate. Reforming the WHD so that all suppliers are required to offer it would remove this barrier to competition.

In addition, the 200,000 customer account threshold for paying the Energy Company Obligation (**ECO**) and WHD gives each exempt supplier a £40 per customer cost advantage. Ofgem's modelling allows an efficient supplier to make a 1.9% profit on SVT customers. But even the most efficient larger supplier cannot win new customers and make a profit because of the £40-50 cost advantage enjoyed by sub-threshold suppliers. The combination of the profit Cap for default customers and the threshold exemption for active customers is forcing the need to be loss-making to grow. And the threshold will end up reducing the incentive for larger suppliers to become efficient, because they cannot win customers even when they do so.

Given that both the ECO and the WHD will be reviewed in 2021/22 - a year or so after Ofgem's first submission to the Secretary of State on whether the Conditions for Effective Competition have been met - we urge Ofgem to provide a data-based analysis of the impact of these policy cost thresholds on competition - including with the Cap - to enable policymakers to take this into account when reforming policy.

In addition, the above problem is exacerbated by the risk and cost of mutualisation - the process whereby responsible suppliers pay the debts of suppliers who have defaulted on their industry obligations - which has grown exponentially in the past 15 years as (i) light touch entry requirements; few solvency checks and low levels of enforcement have facilitated some irresponsible business models, and (ii) Government has introduced more (and increasingly expensive) industry schemes to mutualise, including the mutualisation of customer credit balances where a supplier fails.

£160m of mutualisation costs occurred in 2018/9, around £90m of which were ROCs, £4m FiTs and £60m industry credit balances. Responsible suppliers effectively lose twice when this happens. First, by losing customers to rivals who are pricing below cost because they are defaulting on their green taxes - we estimate such suppliers enjoy a c. £130 per customer pricing advantage, plus another £50 advantage from being above the small supplier threshold for ECO, Warm Home Discount and the smart rollout obligations. Second, responsible suppliers, having lost customers to these rivals, lose again by then paying the cost of mutualisation once these cheaper rivals fail, or default on their obligations.

We welcome Ofgem's new rules on licencing, but urge them to introduce fiscal responsibility rules for existing market participants as a matter of urgency.

4: Are there any indicators of the competitive process not listed here that you think we should consider in our analysis?

As a general point, the division of the market into two categories when considering all metrics - Larger Suppliers and Small and Medium Suppliers - does not reflect the commercial and competitive realities of the market.

First, Small Suppliers (below 200,000 customer accounts) are in growth phase, offering highly loss-leading tariffs to build market-share. Historically, a significant minority of smaller suppliers have offered a poor customer experience, and a larger percentage have cherry-picked customers, e.g. by only offering online payment so in seeking to understand customer outcomes, Ofgem needs to consider carefully the access to, and outcomes offered by, different sizes of retailers. This is particularly important given the correlation the CMA and Ofgem made between SVT customers and those struggling with various challenges to engaging in the market. In terms of understanding the distributional impact of competition on the market, Ofgem should understand how far all customers are able to access the cheapest tariffs.

Second, Small Suppliers have an inbuilt £40+ cost advantage per customer due to exemptions from the Energy Company Obligation and Warm Home Discount, which means they can win customers from even the most efficient larger supplier. It is impossible to overcome the policy cost advantage through efficiency alone.

Bundling the two categories together risks masking some of the most important competitive dynamics currently occurring in the market: Ofgem must strip these two categories out. Cornwall Insight already provides well-regarded market commentary in these two sub-groups which Ofgem could easily co-opt for this report.

Ofgem should also consider products, tariffs and services offered by non-traditional competitors as we would expect these to increase significantly in the coming years. Their introduction could be both positive where the intermediary is well-run but could also represent some risks, e.g. where some third party intermediaries have offered sub-standard services.

In terms of the indicators related to market structure: we do not think the three measures proposed for innovation (measures going through the regulatory sandbox; number of smart meters and number of In-Home Displays) capture innovation particularly well: it is possible for all three numbers to be significant and for customers to notice little benefit. As noted above, Ofgem is required to take the smart meter rollout into account. Further on IHDs, Ofgem could also look at other means of interacting with customers with smart meters (e.g. mobile or online) which provides equivalent information to IHDs for customers. We also assume that for initiatives going through the regulatory sandbox to count under this target, they would need to be sufficiently credible proposals which are capable of being launched into the market.

In addition to these measures, we would propose Ofgem monitors the annual “Innovation Sales Rate” (**ISR**) - the amount of revenue the market is achieving from sales of “new” products and services versus historical products and services (e.g. energy supply and insurance vs smart home or EV charging). This could help Ofgem and policymakers determine how far current policy, including the Cap, is supporting innovation, or the opposite. The inclusion of this or similar metrics would also help balance out the Discussion Paper’s current focus on switching: in a world of true innovation, we might expect less rather than more switching given products such as Heat as a Service will require much longer-standing customer relationships.

Properly constructed, a separate Innovation Report could by itself support innovators understand and enter the GB market.

This standalone report could also explain where the market was failing to deliver against Committee on Climate Change Net Zero projections, e.g. regarding the number of home retrofit measures needed by a certain date, or the % uptake of hybrid heat pumps, and provide qualitative support as to the likely barriers, from fiscal (VAT rates, little incentives) through to regulatory, which include insufficient “headroom” under the Cap to enable investment.

In this respect, we note Ofgem’s recent decision *"to implement a £30m use-it-or-lose-it allowance to provide flexibility for gas distribution companies to deliver ambitious and innovative bespoke initiatives that go beyond business as usual in supporting customers in vulnerable situations.”*

We also think access to data needs to be considered, either here, within the structural changes category or as a stand-alone category. Ofgem should audit how far progress is being made, industry-wide, on data cleansing, centralisation of processes and access to industry data. Key here is measurable programmes with clear milestones and direction of travel.

Turning to the Consumer Behaviour metrics, the focus on switching could be problematic given Ofgem’s own Impact Assessment suggests switching could fall by 30% as a result of the Cap. This potential issue may only become clear once the market has passed through a whole wholesale market cycle.

In addition, more innovative products as services, e.g. “Heat as a Service” could see consumer outcomes improve at the same time as switching declines (given they require a longer lock in). By stripping out the “Innovation Sales Rate”, as suggested above, Ofgem could consider the complex interplay between these two factors and consider more holistically the customer experience.

Finally, it might be useful to strip out length of time on SVT / Capped Default, given consumer detriment is best considered over a number of years.

In terms of the Supplier performance metrics, as stated above, it is essential that performance is measured in three categories rather than two, with sub-200,000 account Small Suppliers placed in a separate category; this will allow the regulator to consider more clearly the interface between profitability and acquisition tariffs, including how far sub-threshold suppliers are pulling the competitive price below even the most efficient of prices.

5: What are your views on the consumer outcomes that we propose to assess in determining whether the conditions are in place for effective competition?

As stated above, tariff prices and quality of service should be stripped out between Small, Medium and Large Suppliers rather than the first two categories being bundled together at present, given the customer outcomes will vary significantly between different categories of suppliers. For example, cherry-picking from some new entrants means not all customers can access the best deals, which should be reflected in the metrics.

The metrics should also be broken down by customer income decile as a proxy for vulnerability and also by payment type, to determine how far the tightness of the Standard Credit Cap is hampering innovation for these customers.

As also stated above, customer outcomes should also be reflected as far as possible for non-traditional suppliers and intermediaries.

6: Is there any other aspect of effective competition that the framework should consider?

As we note in our response to question 2, we believe Ofgem should also consider how far structural factors are limiting as well as improving competition, and also how far investment in innovation is being facilitated under the Cap.

Our only final comment is that Ofgem should produce an annual Impact Assessment considering the likely effect of the Cap in the past year, the likely effect of the Cap over the coming year and the impact of the Cap if it lasted until 2023, when the current legislation has a sunset clause. As we set out in question 1, lifting the Cap will require an annual judgement about the appropriate balance between protection and competition which perhaps makes the Cap's early removal difficult for the relevant Secretary of State until the legislation lapses.

If you would like to discuss any of the points raised in our response or have any specific queries, please do let us know.

Yours sincerely

[Not signed]

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