

Flexible & Responsive Energy Retail Markets

16 September 2019

Introduction

Energy UK is the trade association for the GB energy industry with a membership of over 100 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership covers over 90% of both UK power generation and the energy supply market for UK homes. We represent the diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 27 million homes and every business in Britain. Over 680,000 people in every corner of the country rely on the sector for their jobs, with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry invests over £12.5bn annually, delivers around £84bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to HMT.

This is a high-level, industry response to the Flexible & Responsive Energy Retail Markets consultation published as part of the joint Ofgem and BEIS Future Energy Retail Market Review. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

Energy UK welcomes the joint review and believes that the time is right to ensure that the regulatory framework is appropriate for the future energy retail market, taking into consideration the evolution of technology and ways to interact with the market, the protections that may be required for customers in vulnerable circumstances, and the pressing need to cost-effectively decarbonise. The retail energy market has evolved considerably since it was created by privatisation two decades ago, and the review should not dismiss the benefits that the current supplier hub has provided to the evolution of the market and what it delivers for consumers.

We agree with the vision set out in the consultation, although would urge that the scope of the review's ambition matches the scope of the challenge of delivering upon that vision. We are concerned that the current scope of the review may be more focussed on addressing the issues of today, rather than building a framework for tomorrow's market. For example, Energy UK believes that bringing TPIs into scope of regulation necessary to prevent customer detriment in today's and tomorrow's market. To achieve this, the review should consider the way in which the services and opportunities offered by TPIs in the future may evolve to encompass more than the present switching-focussed offers. However, we note the review's intention of phased approach to any reforms and that this consultation represents initial thinking on a number of policy areas.

Energy UK welcomes the review's consideration of distortions created by obligations and policy levies, and potential measures to remove or minimise these distortions. We believe that the continued use of

energy bills to pay for national policies aimed at supporting people in fuel poverty as well as the transition to a low carbon economy has a distorting impact on the market, which would be more effectively and fairly financed through general taxation. Where such obligations remain, Energy UK agrees with the principle that removing the thresholds could help improve market imbalances.

Energy UK believes that the review will need to take into careful consideration a number of factors when exploring market interventions. As a principle, Energy UK believes that any interventions should not undermine competition in the wider energy retail market and resulting distortions should be minimised. It will be important to acknowledge that the different issues the review is seeking to assess would not all be addressed by one overarching solution. Different concerns would need different considerations.

We would welcome further engagement with the review team ahead of any decisions on the way forward, and would be happy to help facilitate wider engagement with our membership during the review's policy development process.

Consultation Response

Q1 – Do you agree with the vision, outcomes and characterisation of the key challenges to overcome?

Energy UK is broadly supportive of the vision and outcomes identified by the review for domestic customers. In reviewing this future framework, it will be important to build on the successes of the 'supplier hub' model. In an extremely complex industry, it has been successful in insulating the end-consumer from this complexity and risk through a simple, single relationship. This has also provided a valuable policy delivery tool for government and Ofgem that has yielded significant benefits for customers. At the same time, it has enabled effective regulation of supplier practices to ensure customers' supply and data are protected and that market participants contribute a fair share towards system costs.

The retail market has changed dramatically over the last decade. New suppliers have entered the market, challenging incumbents and winning market share, bringing innovative concepts across the sector to the benefit of customers. However, this is just the start of the journey. The energy sector is transitioning to a low carbon future, coupled with a data and technological revolution. How consumers can engage with energy, and the services they are offered, will continue to evolve and could be very different in the future. This joint review offers a significant opportunity to ensure that the future market framework, which could be in place for the next couple of decades, is truly able to be adaptive to this evolution and support the net-zero transition. We would, therefore, urge the review to ensure that it remains cognisant of not just present-day issues but is taking into account long-term impacts or opportunities of reform options.

We support the review's assessment of the need for regulatory simplicity, improving clarity and regulatory certainty for firms whilst ensuring that complexity does not undermine customer protections. Importantly, customers will need to have confidence that the regulatory framework will provide adequate protection no matter what energy services or products they adopt, and that there are clear lines of accountability and redress mechanisms. This is why Energy UK was supportive of Ofgem's Future of Retail Regulation programme which has most recently overhauled the previously prescription-based requirements for supplier-customer communications. By placing a greater reliance on principles-based regulation, we believe the regulatory framework can be futureproofed, whilst also ensuring industry thinks more innovatively about how it can deliver good outcomes for customers, and secure the investment necessary for these innovations.

We welcome the review's intention to join up with the work that the Government and Ofgem are already undertaking across a number of areas, such as codes reform, the microbusiness review and the Energy Data Taskforce. It is important that the Government takes a joined-up approach to the reforms across the various workstreams. For example, at the same time that BEIS and Ofgem are considering options for regulatory reforms within this review, BEIS is proposing to create a joint Ofgem and Ofcom general authorisation regime for third-party intermediaries through its Smart Data Review.¹ In addition, there is a risk of impending "regulatory clash" through the DCMS' proposed implementation of the European

¹ <https://www.gov.uk/government/consultations/smart-data-putting-consumers-in-control-of-their-data-and-enabling-innovation>

Electronic Communications Code Directive (EECC), which would see Ofcom have regulatory oversight of energy supply if bundled with certain communications services.² For information, we have also attached Energy UK's response to the DCMS consultation on implementing the EECC with this response.³

Proposals for a Future Regulatory Framework

Q2 – Are there examples of new products, services and business models that would benefit current and future consumers, but are blocked by the current regulatory framework?

Energy UK's members will be best placed to provide detailed responses to this question on an individual basis.

However, for the future market, it will be important for the review to address the requirement of the regulatory framework to ensure that customers are best able to benefit from greater innovations in flexibility. This includes ensuring an appropriate framework is in place to enable independent aggregators to access appropriate markets without a full supply licence in its current form if it is not necessary, enabling these actors to realise the potential consumer value of offering their flexibility to the network.

Bundled services are increasingly being explored as options for reducing the upfront costs of low carbon technologies. Business models developing for delivering heat as a service or broader model incorporating installation of heat, electric vehicle, energy efficiency, generation and smart devices with a long-term contract are currently at risk of being blocked by regulatory frameworks. These models show potential both for reducing overall costs to those otherwise unable to pay, and for low cost decarbonisation of public buildings including housing. Ensuring appropriate frameworks are in place to protect customers and providers models is necessary, but these cannot be constrictive to the point that the potential fiscal benefit of a longer-term contract is negated by a lack of certainty over the longevity of that contract.

Energy UK is also aware of developing models for services such as peer-to-peer trading of energy and community energy projects which come across issues due to the complication of existing regulations, which could act as a barrier to such innovation in the future market. While trials of peer-to-peer trading have been progressed in GB, these were only possible thanks to a wide range of exemptions from existing regulations. There may be some models or services, such as community energy schemes, that are blocked due to costs and complexities associated with becoming a fully licensed supplier, or partnering with one. There are also concerns that current white labelling arrangements could create barriers to innovation by the assumption of whole house service. We note that these are examples that the review will already likely be considering.

In addition, the review should also be cognisant of the restrictions on availability of data and ease of data-sharing from the current regulatory framework. We welcome moves to smooth pathways to greater innovation via data access and sharing, such as Midata, the wider BEIS Smart Data Review, and the work of the Energy Data Taskforce. The review should ensure it fully takes account of these developments and explore how the regulatory framework can best build upon these welcome developments.

As a principle, the review should be wary of second-guessing what the future customer may want, or what future businesses or technologies may offer, based upon current blockages. Instead, any framework for the future retail market must be flexible enough to accommodate evolving consumer expectations and technological innovations, while ensuring sufficient protections are in place for consumers, regardless of their level or type of engagement.

Q3 – Are there current or emerging harms to energy consumers which are currently out of scope of the regulatory framework? Do these differ for domestic and non-domestic consumers?

² <https://www.gov.uk/government/consultations/implementing-the-european-electronic-communications-code>

³ Also available here: https://www.energy-uk.org.uk/publication.html?task=file_download&id=7225

The energy retail market has seen a growth in new services and market players that are outside of the traditional licensing regulatory model. Just over half (54%) of those domestic customers who switched tariff or supplier in 2018 used a price comparison website, compared with 45% in 2017.⁴ We are also seeing a growing number of auto-switching sites entering the market, as well as non-traditional players providing switching services. In the non-domestic sector, it is not new for third parties to play a larger role in the switching and engagement behaviours of customers. In 2018, over two-thirds (67%) of small and microbusinesses used an energy broker to help choose their current energy plan.⁵ With a majority of energy customers now making use of such services, there is a risk of customer detriment as the regulatory framework has not adapted to these evolving customer behaviours, for example by being misinformed or mis-sold tariffs with incomplete information. This is a particular concern with customers in vulnerable circumstances using such unregulated services, as highlighted in the recent report from the independently-chaired Commission for Customers in Vulnerable Circumstances.⁶ In examining these issues, the review will also need to consider the future roll that TPIs may take in the market, outside of current switching-focused services, to ensure that customers remain protected within the regulatory framework.

The Commission also raised concerns about the growth in usage of unregulated heat networks, as well as decentralised energy, heating oil, liquid petroleum gas (LPG) and solid fuels. The potential for customer detriment resulting from such heat sources being outside of the current regulatory framework should be addressed by the review, if not addressed within separate workstreams.

The unprecedented number of supplier market exits in the previous 18 months has highlighted a pressing consumer harm through the nature of administrator regulation, compared with suppliers. Whereas suppliers must abide by the protections within the supply licence, once that has been revoked due to the supplier's failure and the Supplier of Last Resort (SoLR) process invoked, the failed supplier's administrators are not bound by any licence. This in effect removes many protections for those customers, particularly those in vulnerable circumstances. It will also impact that supplier's previous customers, as the administrator would not be held to abide by the licence conditions like those around back-billing. Energy UK has raised these concerns previously, such as through Ofgem's Supplier Licensing Review,⁷ as has Citizens Advice.⁸ We would urge the review to consider the best means to address this detriment, whether it is by bringing such administrators into the regulatory framework directly, or reforming the Energy Supply Company Administration regulations to expand its scope from the failure of just the largest suppliers.

We also note the financial implications for consumers of SoLR events, primarily those from the mutualisation of debts. Through Ofgem's Supplier Licensing Review, Energy UK provided an example of an ongoing requirement that Ofgem could consider exploring as part of its future consultation might be the introduction of a new licence condition, governed by Ofgem's monitoring and enforcement parameters, requiring licensees to take all reasonable steps to avoid mutualisation of their debts in the event of supplier failure.⁹

There is great potential for consumer and system benefits from the continuing evolution in technology and the products on offer in the market. However, the review should explore that potential of new consumer harms that may arise if not accounted for in the regulatory framework. Energy UK is collaborating with Citizens Advice and the Association for Decentralised Energy (ADE) to review consumer protections for domestic and SME customer participation in DSR and identify whether gaps exist. Particular areas that may need further consideration include: bundled products, multiple parties interacting with the consumer and split incentives. The findings of this work will be published and shared with Ofgem in due course. Energy UK does not believe that intervention is needed at this time however.

Further, the growth in the uptake in EVs has seen the creation of EV-related services and products which fall out of current regulatory scope, leaving customer protections lacking. The work that Energy UK is undertaking as part of the EV Energy Taskforce (EVET) has highlighted a number of areas of

⁴ https://www.ofgem.gov.uk/system/files/docs/2018/10/consumer_engagement_survey_2018_report_0.pdf

⁵ https://www.ofgem.gov.uk/system/files/docs/2018/10/micro_and_small_business_engagement_survey_2018_report.pdf

⁶ https://www.energy-uk.org.uk/publication.html?task=file_download&id=7140

⁷ https://www.energy-uk.org.uk/publication.html?task=file_download&id=7199

⁸ https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/SoLR%20report%20FINAL_v2.pdf

⁹ https://www.energy-uk.org.uk/publication.html?task=file_download&id=7013

potential detriment relating to EV services specifically. There is considerable work ongoing in this space, including as part of the EVET, the BSI energy smart appliance work and OLEV's smart charging standards consultation. While many of these pieces of work consider consumer protection to some degree there does not appear to be any party taking a holistic view at the current and future roles, responsibilities and protections in place. Energy UK suggests that a full review of customer protections be undertaken as part of the Future Energy Retail Market Review. More detail will be provided with the publication of the EVET final report and we would welcome any further engagement in this area that the review may find useful.

In addition, in the future energy retail market we may see greater convergence between markets, and the regulatory framework may not be best suited to ensure consistent consumer protection, and a level of regulatory simplicity that best enables innovation to come to market. For example, the approach being taken by the proposed implementation of the European Electronic Communication Code Directive (EECC) would see Ofcom having regulatory oversight of energy supply that is part of a bundle with relevant communications services/products. There would then be a risk of 'regulatory clash'. If markets were to see a greater level of convergence, based upon the increase in data availability and usability, serious consideration is needed on how best to ensure that products across different markets are regulated appropriately to minimise customer harm and not discourage innovation.

The consultation paper notes the Balancing and Settlement Code modification P379, to enable consumers to buy and sell electricity from/to multiple providers through Meter Splitting, and that Ofgem may consider whether to make any complementary changes to rules in licences if the modification is approved and implemented. We consider that it would be important for the impacts and potential consumer harms arising from such a fundamental change to the market and how consumers interact with it to be considered and addressed by the wider review of regulatory frameworks, rather than through a separate Ofgem process which could duplicate or contradict work undertaken by the review.

Q4 – Would it be beneficial to allow suppliers to specialise and provide products and services to targeted groups of customers? If so, how can this be delivered while balancing the need for universal service?

Energy UK does not believe that specialisation and universal service are necessarily in tension to the extent that innovations would be unduly blocked from coming to market. Suppliers are already able to, and do, target specific products at particular customer groups through marketing and advertising strategies.

We fully agree with the review's position that energy is an essential service and that it is crucial for consumers to have access to energy, an acceptable minimum level of service and to be offered choices transparently and without discrimination. Reforming the current universal service obligations (USO) by simply removing the duty to offer terms could see customers being disenfranchised and may risk some customer groups being profiled and discriminated against, which is at odds with energy being an essential service. There is also a risk of creating a two-tier market if some suppliers or service providers are allowed to be exempt from a wide range of obligations and protections, creating an unfair playing field between competitors.

However, that no such duty exists in the non-domestic market, and no related detriment has been observed, may indicate that there is scope to reform the domestic USO in a way that can maintain customer protections, whilst maximising the benefit of future innovations. Energy UK believes that such a reform would be wider and more fundamental than is being discussed by the review in its consultation document. We would, therefore, welcome clarity as to the review's considerations as to the scope of any reforms it would seek to explore.

Q5 – Are incremental changes to regulation sufficient to support the energy transition and protect consumers? Or does this require a more fundamental reform, such as modular regulation?

Energy UK has long called for Ofgem to be required to directly regulate TPIs in the energy market, both domestic and non-domestic, as we see an increasing risk for customer detriment with the growth in unregulated third-party services. With auto-switching services, for example, the customer relationship is being primarily owned by the TPI acting as the service provider, with the customer's relationship with

supplier being secondary. However, the supplier retains full responsibility for all obligations and requirements related to the relationship, whereas the TPI has none outside of general consumer law (in the domestic market). These risks of harm may very well increase as new innovations come to market which make use of greater data availability in the digitalised energy system.

We welcome and support the review's consideration of bringing TPIs within the scope of Ofgem's regulatory powers. However, it would risk creating a two-tier regulatory regime by stopping short at only introducing a general authorisation regime for TPIs in energy, in contrast to the licensing regime for suppliers. As energy is an essential service, it would be detrimental to customers (and distortive to competition) if a customer was afforded less robust or fewer protections should they chose to engage with a TPI for their energy needs rather than directly with a supplier.

We believe that in the long term, the review should give greater consideration to an activity-based or "modular" licensing approach for all players in the market, as discussed in Energy UK's *Future of Energy* report.¹⁰ As previously highlighted, this review is potentially a singular opportunity to reform the regulatory framework to ensure that the future energy market of the coming decades is able to maximise the benefits of digitalisation for consumers. We are concerned that the current scope of the review may be more focussed on addressing the issues of today, rather than building a framework for tomorrow's market. However, we recognise that the review is seeking a phased approach to reforms, and would welcome continued engagement on this longer-term, more fundamental option of reform over the course of the review to explore its feasibility and impacts.

In the shorter term, as highlighted as an option in the Review consultation, it could be more prudent to support Ofgem in issuing new licences for new activities to ensure consumer protections no matter how a consumer may choose to engage with for their energy needs. This will be particularly important to implement consistent protections for customers in vulnerable circumstances, and provide all customers with the reassurance to enable a greater take up of innovative services. In particular, it would need to address the emerging harms that Energy UK has previously outlined.

As a principle, in whatever reform ultimately taken forward, in the long or short terms, the regulatory burden needs to sit equally between market participants. For example, if two entities are performing the same activities (such as customer communications or marketing) or taking advantage of the same infrastructure then they should have the same burden, costs and protections in place for consumers. The risk of creating further market distortions must be avoided as best as possible. Importantly, the reforms being made through Ofgem's Supplier Licensing Review in terms of market entry and ongoing requirements should not be undermined.

Q6 – Are there any other potential market distortions that should be considered as part of the review?

Energy UK believes that there are a number of additional potential market distortions which should be considered as part of the review:

- The smart meter rollout and its requirements across suppliers of different sizes should be considered as a separate and distinct distortion to the wider provision of metering, and the review should ensure it considers the impact of current obligations and any post-2020 obligation.
- Supplier exemption thresholds to delivery and administer schemes (in addition to ECO and WHD as the review covers):
 - Feed-in-Tarff – supplies above 250,000 customer accounts obligated.
 - Smart Export Guarantee – suppliers above 150,000 customers obligated.
 - Green Deal Arrangements Agreement – suppliers above 250,000 customers obligated.
- Current exemptions to policy costs, such as the Energy Intensive Industries (EII) exemption.
- Any new distortions that are created by regulatory or other changes, such as BSC mod P379 to allow multiple suppliers at a meter. This should include considerations on the risk of any services being able to avoid obligations or costs that create an unlevel playing field.
- The impact of mutualisation and the moral hazard created by the Supplier of Last Resort protections, with the debts of unsustainable businesses being effectively subsidised by

¹⁰ [https://www.energy-uk.org.uk/files/docs/The_Future_of_Energy/2019/FutureofEnergy_ReportSection_Chapter1_04.19\(1\).pdf](https://www.energy-uk.org.uk/files/docs/The_Future_of_Energy/2019/FutureofEnergy_ReportSection_Chapter1_04.19(1).pdf)

customers of other suppliers. A contributory factor here is regulatory failure to effectively enforce licence obligations.

- Current market distortions against flexibility, and the potential impact of any change to network charging arrangements.
- Considerations of market imbalances should also include the market impacts of regulated and obligated suppliers competing against non-regulated providers of similar services.
- The risk of as yet unknown distortions that result from any decisions taken by the review. It would be prudent for the review to keep distortions under review as the project develops its thinking and proposals.

Q7 – Would removing the thresholds for ECO and WHD help remove market imbalances, and could this be done without significantly increasing barriers to supplier entry or expansion in the retail market?

Energy UK agrees with the principle that removing the thresholds could help improve market imbalances.

Current exemptions impact consumers in a number of ways:

- ▶ **Distribution of costs** – costs are spread only across the customer base of obligated suppliers. This has the potential to become increasingly pronounced if a growing proportion of the market switches to non-obligated suppliers who remain under the threshold, resulting in a regressive impact on consumers supplied by obligated suppliers.
- ▶ **Access to benefits** – some customers lose out because their supplier may not be required to offer certain services. For example, a customer whose supplier is not required to provide WHD will not be able to benefit from the WHD or the Safeguard Tariff (if they have a credit meter) unless they switch supplier.
- ▶ **Impact on switching** – conversely some customers currently in receipt of benefit from the WHD or the Safeguard Tariff (if they have a credit meter) may be less inclined to switch supplier, because of a real or perceived fear of losing access to such benefits and being worse off.

There are also impacts for suppliers:

- ▶ **Barrier to growth** – an arbitrary threshold based on customer accounts creates a cliff-edge with customer number 250,001 becoming very expensive.¹¹ Once a threshold is reached, multiple obligations come into effect.
- ▶ **Splits the market** – exemptions create a two-tiered system as some market participants are subject to additional cost from obligations, while others are not.
- ▶ **Cumulative impact** – the cumulative impact of passing the costs of policy through to consumers via energy bills could affect a company's ability to compete with those not exposed to these costs. This has the potential to become more pronounced if a growing proportion of the market switches to non-obligated suppliers who do not grow to sufficient size to eventually cross the threshold.

The continual use of exemptions does not provide a sustainable solution to help lower the burden of policies costs for all consumers and suppliers or help ensure that consumers are able to benefit from these policies.

Energy UK, therefore, believe that obligations placed on suppliers, and their associated costs, should be fair for all customers, i.e. they should be equitable across all consumers. As a point of principle, certain customers should not carry a disproportionate share of scheme delivery or lose out on potential financial benefit as a consequence of their choice of supplier.

Obligations should, therefore, satisfy the following criteria:

- Be fair for all customers;
- Shield small suppliers from disproportionate compliance costs they may face due to their size;

¹¹ We note that thresholds between obligations may be set at different levels, and that BEIS has committed to lowering them over time.

- Avoid creating artificial barriers to growth as a result of high incremental costs of compliance;
- Provide certainty;
- Avoid distorting competition; and
- Be compatible with state aid rules and other relevant legislation.

On WHD in particular, recent moves by BEIS to lower the threshold are welcome. However, government could and should have gone further. Energy UK supports a shift to a fully data matched WHD Broader Group, in essence combining the current Core and broader Groups to one larger Core Group in the future. Energy UK members also support the idea of a centrally administered pot of money for industry initiatives. We believe both reforms would significantly reduce the compliance costs associated with participation in the WHD scheme for all market participants, the main reasoning behind the existence of the WHD small supplier exemption.

With this in mind, we are also concerned that there is a lack of consistency between current policy development within BEIS and the wider review. For example, whilst the review considers thresholds to be distortive to a competitive market, the Smart Export Guarantee is taking effect from 1 January 2020 having been developed and implemented with a supplier threshold in place.

Q8 – How could the delivery burden on suppliers from the ECO be reduced, such as through a buyout?

Energy UK has previously shared a paper with BEIS on such reforms to ECO, which we have attached as Annex 1 to this response.

Q9 – What effect does the range of policy levies identified above have on the retail market?

Policy costs currently play a part in ensuring that electricity is a more expensive fuel for customers than mains gas, resulting in higher energy costs for those with electrical heating systems and disincentivising any transition to make greater use of electricity for space heating purposes. The review should consider how the continued use of electricity bills to fund environmental and social obligations may have a detrimental impact upon the take up of alternative heating technologies and the UK's ability to meet its new 2050 net-zero legislative target.

The use of mutualisation to cover shortfalls in delivery/funding resulting from supplier non-compliance with certain obligations also creates a moral hazard across the retail market. The mutualisation process leads to suppliers, and in turn their customers, being responsible for the action/inaction of their competitors. Given recent experience with the Renewables Obligation (RO) in particular, it may also be beneficial for the review to consider the policy design of the RO in terms of mutualisation and the lack of credit or insurance cover being required. Alternatively, actions could be made available at an earlier stage for lack of payment. We note that Ofgem is considering a licence condition to allow for earlier action to be taken against suppliers not making prudent provision to discharge their obligations under vent schemes and policies through its ongoing Supplier Licensing Review.¹²

More broadly, the review should consider the impacts of the continued use of obligations on the future market and its potential evolution. For example, if obligation costs can be avoided to an unfair extent by the installation and usage of technology, such as micro-generation and storage, then there is a potential to exacerbate many of the challenges for consumers and industry outlined above. Such considerations would need to be explored alongside overarching issues such as decarbonisation and the protection of customers in vulnerable circumstances.

Q10 – What actions could government take to reduce any negative impact of these policy levies?

Looking forward there is a wider question to be considered of whether the current model of supplier obligations remain fit for purpose.

As a point of principle, the energy system is not an efficient surrogate for intelligently developed and delivered government social policy.

¹² https://www.ofgem.gov.uk/system/files/docs/2019/05/update_slr_ongoing_and_exit_final.pdf

With the funding agreements for key social programmes scheduled to end in the early 2020s (i.e. Energy Company Obligation (ECO) in 2022 and Warm Home Discount (WHD) in 2021), and with the potential for new data sharing initiatives following the Digital Economy Act 2017, it is time to review the use of supplier obligations to ensure they remain fit for purpose as a vehicle for funding and delivering government policy.

If obligations and policy levies are continued in the future market, they should be designed in a way that is simple to administer even for the smallest suppliers.

Q11 – Do you agree that now is not the time to make further changes on these issues?

Energy UK agrees with the review's assessment. However, we would urge Ofgem and BEIS to ensure that any indirect changes to these areas as a result of the review are considered, including any impact of changes on potential market distortions.

Q12 – What total costs do suppliers face with regards to bad debt and supporting customers who struggle to pay for their energy?

Energy UK's members are best placed to provide detailed feedback on this question.

We note Ofgem, as part of the construction of the Default Tariff Cap, has already collected estimates from suppliers of the additional costs of serving vulnerable customers (using the Priority Service Register as a proxy). Should Ofgem or BEIS feel they require additional data, we would be keen to explore how we may be able to work with them to facilitate this.

Energy UK has, however, already been exploring the topic of 'Unpaid Gas and Electric', customers where suppliers have exhausted collections activity, a PPM cannot be fitted for a variety of reasons, and, whilst disconnection may still be an option, the supplier has not disconnected the meter point. These customers do not engage with the supplier which then means, effectively, that they are receiving free supply, although their debt is still accumulating. This supply is not free for the supplier however, and the costs are passed on to other customers, including those who are vulnerable. Energy UK members were asked to respond to a voluntary RFI to help quantify the issue, the findings of which have been attached separately to this response.

It is also worth the review reflecting on the recent findings of the independently chaired Commission for Customers in Vulnerable Circumstances¹³. The report highlights many examples of good practice and innovative initiatives by energy companies with regards to bad debt and supporting customers who struggle to pay.

Q13 – How could any distortions related to high cost-to-serve customers be addressed?

Energy UK's members will be best placed to provide data to determine any impact of genuinely higher cost-to-serve customers, outside of supplier inefficiencies, and we would encourage the review to proactively engage with suppliers in seeking relevant data.

We would, therefore, support the review in its exploration of potential solutions if it does determine there to be distortive impacts which could cause detriment in the future market, although we recognise the scale of the challenges that it faces. We would welcome further engagement with the review team ahead of any decisions on the way forward including facilitating engagement with Energy UK's members. The policy development of any intervention would need to be approached cautiously with rigorous assessment of impacts, particularly in the future market which the review is aiming to enable.

In general, Energy UK believes that if the review were to recommend market intervention to address this issue, then any such action should seek to adhere to these underlying principles:

1. Distinct issues and detriments would not all be efficiently addressed by one overarching solution. Different concerns would, therefore, need different considerations and actions to minimise further distortions being created.

¹³ [Commission for Customers in Vulnerable Circumstances](#), Final report, 2019

2. Any market interventions to address identified distortive impacts of high cost-to-serve customers should not be a means for suppliers' inefficiencies to be funded, either directly or through risk of gaming.
3. The review should consider the impact of any market interventions, particularly in light of any decisions as to regulatory reforms to ensure that further market distortions are not created between suppliers, or between suppliers and other energy market participants.

As an example, the consultation document refers to additional third-party support services which could be provided for consumers struggling to afford their energy. While the exact details of the proposal are currently lacking, there is a risk of creating further customer harm if it is designed in such a way that it removes competitive margins in debt management, removes incentives for suppliers to improve customer experience, or act to prevent customers getting into debt into first place.

Q14 – Would addressing market distortions help reduce incentives for suppliers to adopt pricing strategies that lead to excessive prices for loyal consumers? If so, to what extent?

Energy UK's members will be best placed to respond to this question individually.

Q15 – What are your views on the measures being considered to address loyalty penalties in different markets? What approach – or combination – would be most effective in the energy retail market?

AND

Q16 – What other approaches could be adopted to ensure loyalty penalties do not re-emerge?

AND

Q17 – What protections or support may be required to engage consumers in vulnerable situations?

Energy UK believes that the review will need to take into careful consideration a number of factors when exploring market interventions, whether it be those outlined by the CMA or other, alternative actions. As a principle, Energy UK believes that any interventions should not undermine competition in the wider energy retail market and resulting distortions should be minimised.

It will be important to acknowledge that the different issues the review is seeking to assess would not all be addressed by one overarching solution. Different concerns would need different considerations. With regards to any targeted interventions, there will be a challenge in defining customer groups that are relevant and identifiable in practice by suppliers, as seen with obligations like ECO and WHD.

Furthermore, as previously discussed, this review needs to ensure that it gives appropriate attention to a future market, and not be solely focussed on issues of today. In this regard, the review should give consideration to the needs of customers in the future market, particularly those that may find themselves in new or different vulnerable circumstances to those experienced today. Consideration will also need to be given to how any interventions interact with innovations such as bundled products and time-of-use tariffs.

We would welcome further engagement with the review team ahead of any decisions on the way forward, and would be happy to help facilitate wider engagement with our membership during the review's policy development process. The policy development of any intervention would need to be approached cautiously with rigorous assessment of impacts, particularly in the future market which the review is aiming to enable.

We would also again call attention to the recent findings of the independently chaired Commission for Customers in Vulnerable Circumstances. As highlighted by the Commission:

“societal changes in recent years have left millions of households across the UK struggling to afford their household bills... It is clear that a dramatic and sustainable improvement in the position of vulnerable energy customers will only come if there is also concerted action to tackle

*the root causes of poverty in Great Britain. Three million people are in severe financial difficulty, and people struggling with their household bills has become the “new normal”.*¹⁴

There is also a much wider debate to be had about how we as a nation support the most vulnerable households in our society, and the boundary between the role of the state and that of utility companies. While the energy sector undoubtedly has a role to play, the energy sector alone cannot solve issues of vulnerability, particularly financial vulnerability.

If you would like to discuss the above or any other related matters, please contact me directly on 020 7747 2931 or at steve.kirkwood@energy-uk.org.uk.

¹⁴ [Commission for Customers in Vulnerable Circumstances](#), Final report, 2019

Alternative options for delivering and funding energy efficiency policy

Position paper (March 2019)

Executive Summary

- ▶ By funding policies such as the Energy Company Obligation (ECO) through energy bills, government is placing a burden on suppliers to not only deliver specific policy outcomes, but to recover the costs from consumers.
 - ▶ Supplier obligations on energy efficiency are also becoming more complex to deliver, and the present model, which in the past has largely delivered high volumes of similar low-cost measures, does not appear appropriate to adequately reach households in fuel poverty and address the potential complexity of upgrading some of the worst quality housing, that any future scheme will now have to address.
 - ▶ This mode of funding is regressive, and disproportionately affects low-income, vulnerable and fuel poor customers. Funding should be sourced from general taxation.
 - ▶ However, if supplier obligations are to continue, modifications should be made to any scheme put in place after the end of ECO3 to broaden the range of organisations that can deliver measures, and spread the costs of the scheme more equitably across suppliers.
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Introduction

Funding and delivery arrangements for the third phase of the Energy Company Obligation (ECO) are now underway, with ECO3 set to run until March 2022. This paper sets out Energy UK's view on how the Government commitment to maintain the £640m p.a. spend on domestic energy efficiency programmes until 2028 should be funded and delivered after the end of ECO3.

Energy UK's believes future social and environmental policies could be designed to:

- ▶ ensure greater progress is made on the government's targets to address fuel poverty, energy efficiency and clean growth.
- ▶ open up delivery to a wider range of organisations with interests in improving energy efficiency and reducing fuel poverty.
- ▶ reduce potential distortions and barriers to entry in the retail energy market in relation to obligations.
- ▶ enable more equitable and efficient distribution of the costs and benefits of energy efficiency improvements.

We would be happy to discuss the options presented in this paper with you in more detail and indeed, hope to develop these options further in collaboration with BEIS.

Existing funding arrangements for energy efficiency measures

Energy UK fully supports the objectives behind the government's energy-related social and environmental policies, and the important contribution they make in helping to achieve government's 2030 fuel poverty and 2050 carbon emissions reduction targets, helping consumers to manage their energy use and total consumption. Improved energy efficiency can also help reduce households' exposure to rising energy prices.

In recent years, ECO has been the primary driver of the uptake in energy efficiency measures in the domestic retrofit market with over 2.4 million measures delivered under ECO up to September 2018.¹⁵

¹⁵ Ofgem (2018) ECO public reports and data, <https://www.ofgem.gov.uk/environmental-programmes/eco/contacts-guidance-and-resources/eco-public-reports-and-data/scheme>

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However, there are a number of disadvantages to delivering measures through an obligation model that call into question its suitability for the future:

- ▶ **Regressive funding** – the cost of ECO is recovered through customer bills, meaning households on low incomes and vulnerable to fuel poverty contribute the same amount to the scheme as higher income households. Households with lower incomes, in vulnerable circumstances and those in or at risk of fuel poverty are also more likely to be with larger suppliers and less likely to switch suppliers to one that does not currently face obligation costs.
- ▶ **Quality and complexity** – We have welcomed BEIS taking forward the recommendations of the Each Home Counts Review, with a view to improving the quality of delivery across the supply chain. Looking further forward, the expected complexity of future installations may require alternative delivery models that better incorporate build quality and manage the task of providing whole-house approaches where retrofits involve the installation of multiple measures. The shift with ECO3 to target low income, vulnerable and fuel poor households is expected to require more technically complex retrofits, or other remedial work to treat these properties effectively. Households with low incomes or in fuel poverty occupy some of the worst quality housing in the UK and a more coordinated approach may be needed to successfully address this type of housing, as the level of technical skill needed will be higher. It is unlikely that domestic energy suppliers have the necessary skills or expertise to do this alone.
- ▶ **Market impacts** – the current model has distortionary effects by limiting the obligation to suppliers that have a certain number of customers, or supply a certain amount of electricity and gas. While this is intended to reduce the barriers to entry into the retail energy market by smaller suppliers, it also means in practice that these suppliers have a competitive advantage over larger ones. This issue has become more pronounced as more suppliers have entered the market in recent years.
- ▶ **Effects on the private market** – the reliance on obligations has crowded out investment in a private energy efficiency market, leading to a supply chain that is reliant on subsidies and vulnerable to boom and bust cycles. This is evidenced by extremely low uptake of energy efficiency measures among households that are able to pay for improvements.

Supporting households in vulnerable circumstances, and those that are in or at risk of fuel poverty, is a priority for the Government and industry alike. Energy UK is set to publish an independent report from the Commission for Customers in Vulnerable Circumstances this year, while BEIS is working to update the Fuel Poverty Strategy. There has also been attention from MPs, with the BEIS Select Committee conducting an inquiry into energy efficiency. All of these developments suggest it is timely to consider how future energy efficiency schemes after ECO3 should be designed to support those most in need.

Future Options

Our clear preference is that social and environmental policies are in future funded through general taxation. If the Government continues to fund these policies through energy bills, the costs involved must be fairly distributed so that the customers of all suppliers contribute towards the cost of these policies.

We have set out a number of options below around how best to fund energy efficiency measures for the segment of the market that is unable to pay themselves. These options fall into three categories:

- ▶ Delivering energy efficiency measures through a non-supplier obligation scheme, funded via general taxation.
- ▶ Continuing to deliver energy efficiency measures via supplier obligations, with modifications to better enable delivery by other stakeholders, as well as broaden obligations to more of the supplier market.
- ▶ Delivering energy efficiency measures through an obligation on DNOs and GDNs, rather than suppliers.

Appendix 1 provides a full summary of the strengths and weaknesses for each of the models, while **Appendix 2** outlines further considerations that would need to be considered in any future scheme design.

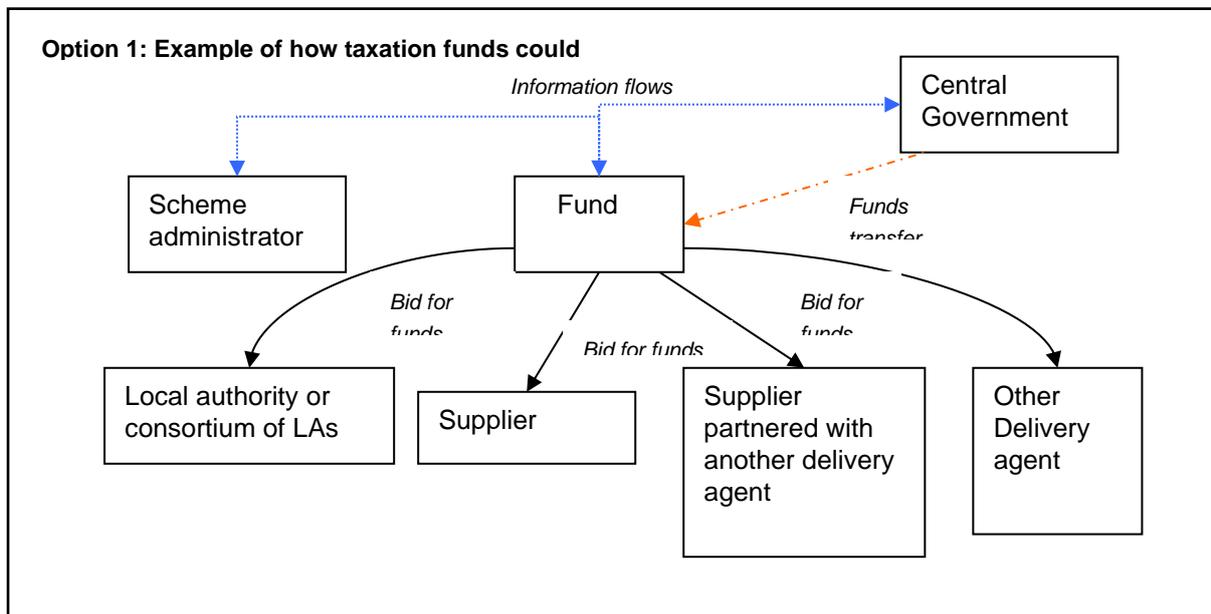
Option 1: Delivery facilitated by a central body with funding through general taxation (preferred option)

We strongly believe that the fairest and most progressive method of funding social and environmental policies is through general taxation. Importantly, it would address the regressive nature of existing obligations and ensure that people on low incomes, households in or vulnerable to fuel poverty and those below the tax threshold are not required to contribute, but can still access and benefit from these policies.

Funding these policies through general taxation could result in a real cost reduction to consumer energy bills. It would remove a major regulatory burden in the retail market as well as eliminate the market distortions created by exempting a portion of the supplier market from obligations. It could also enable new delivery models to come forward involving a wider range of delivery agents, including local authorities and community groups. This could result in a more cost-effective scheme compared to the current model, through competitive tendering by delivery agents.

Funding could be targeted for specific uses and delivered in a variety of ways, for example:

- ▶ A national energy efficiency scheme could administer a fund for energy efficiency measures that a wider array of stakeholders including private construction firms, local authorities, Registered Social Landlords, National Health Trusts, the devolved governments and community groups could access. Suppliers that wanted to participate in the delivery of measures, with their experience and expertise in delivering measures through obligations, could also tender for funding individually or in partnership with other organisations.
- ▶ Target funding to fuel poor and vulnerable households via data-matching with DWP or ring-fencing funds to specific areas or social objectives, e.g. areas with multiple indices of deprivation, rural communities, specific measure types or types of dwellings to be treated.
- ▶ Create a recyclable fund, whereby organisations can access funds at low cost.



Option 2: Funding policies through a modified supplier obligation model with alternative mechanisms

Our clear preference is that social and environmental policies are funded through general taxation. If the Government continues to fund these policies through energy bills, however the costs involved must be fairly distributed, so that all suppliers contribute towards the cost of these policies proportionate to their size, and costs are shared more evenly across all customers.

Therefore, any future obligations must be designed so that funding is be separated from delivery. This would allow suppliers to contribute commensurate to their size, but not necessarily act as delivery

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agents. It would also open the market up to other players and make full use of competitive pressures to further reduce costs. However, for suppliers that do deliver, it is important that they can recover their fixed costs.

There are a number of ways we consider this could be designed:

- ▶ a buy-out mechanism that allows suppliers to opt to pay into a fund for the cost of delivering measures, without an obligation to deliver.
- ▶ a mechanism that allows suppliers to trade all or parts of their obligations.
- ▶ levelisation of the costs of the obligation across all suppliers.

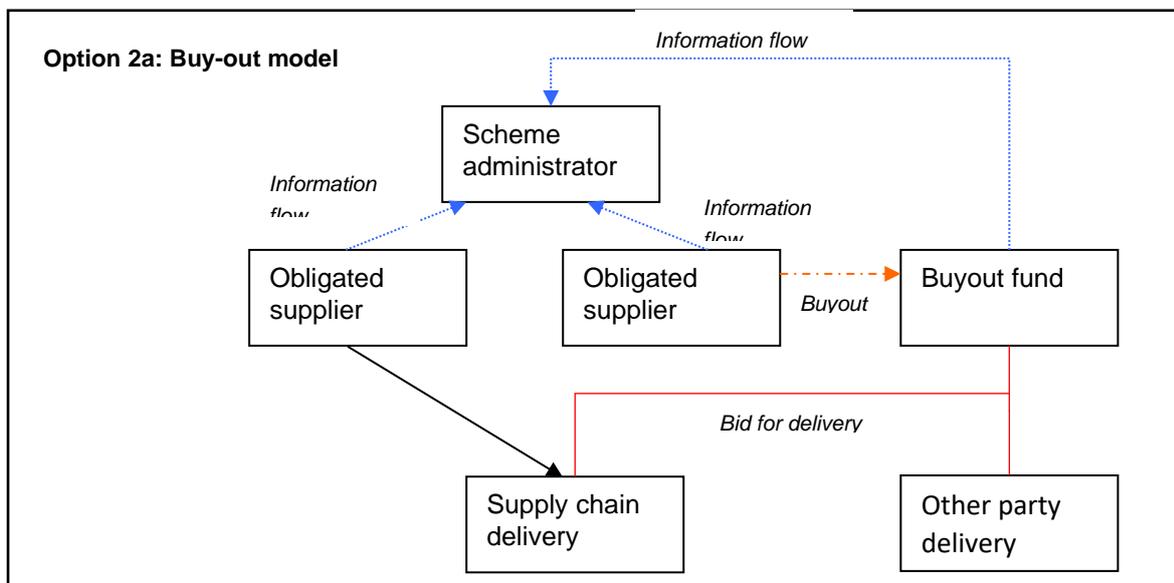
Option 2a: Obligated suppliers pay into a buy-out fund

- ▶ Suppliers can opt to pay the cost of their obligation to a fund. The obligation is then considered met.
- ▶ Suppliers and other delivery partners could bid for funds for delivery.

This option involves setting a delivery obligation on all suppliers, but suppliers are able to pay a buy-out fee if they do not want to deliver their obligation themselves. The funds collected could be treated similar to funds raised through taxation, with a number of delivery models, opening up the market if other delivery agents could bid for funds from the buy-out, including obligated suppliers who see an opportunity in the market.

The buy-out fee would need to be set administratively by the Government and could change periodically following monitoring and evaluation of costs. This option has the benefit of capping costs to consumers and therefore, minimises price volatility. However, this option would be dependent on the ability of the government to secure delivery at the buy-out price.

Once a supplier has paid into the buy-out fund they would be considered to have met their obligation. A scheme administrator would be needed to ensure compliance. The period for completing a buy-out could be fixed to a deadline, after which a delivery obligation would apply. This option allows suppliers to choose to deliver if this fits with their business model, or contribute their fair share via a buy-fund. It avoids creating a market barrier and if designed well, should incentivise participation as those that choose to deliver could benefit from taking on others' obligations.



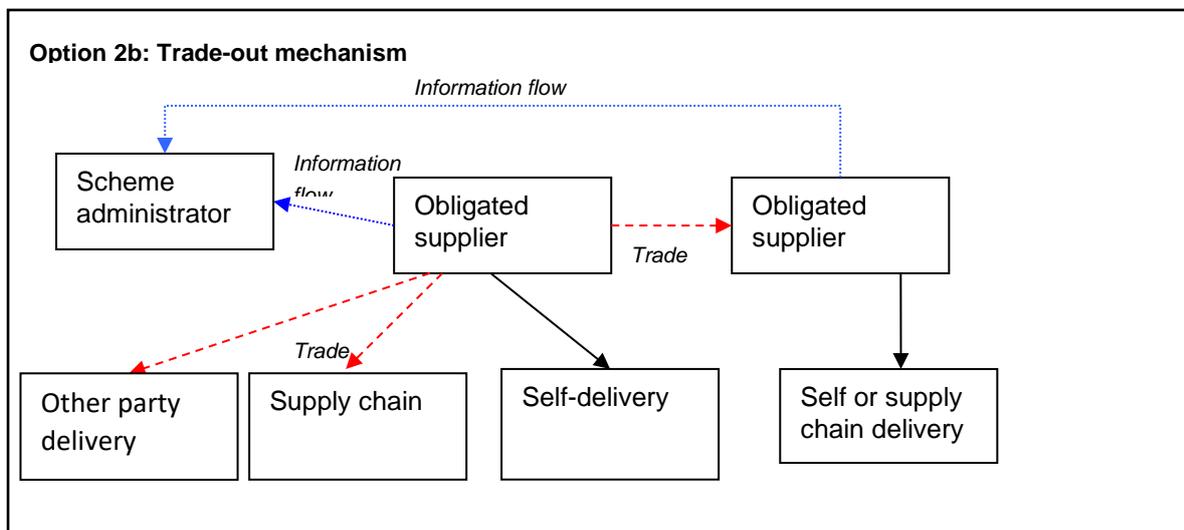
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Option 2b: Trade-out mechanism

- ▶ Suppliers can trade some or all of their obligation with other suppliers or delivery partners.
- ▶ Price is set competitively.
- ▶ Could operate with or without a threshold.

This option again involves setting a delivery obligation on all suppliers, but suppliers are able to trade-out their obligation with other obligated parties or other accredited delivery agents. Under ECO3, suppliers can trade with other obligated suppliers. We see no reason why they should not also be able to trade with another party, subject to reasonable controls. Trading out would operate on a market-based model, meaning suppliers would be able to trade out their obligation to other parties, but the price would be set by the market.

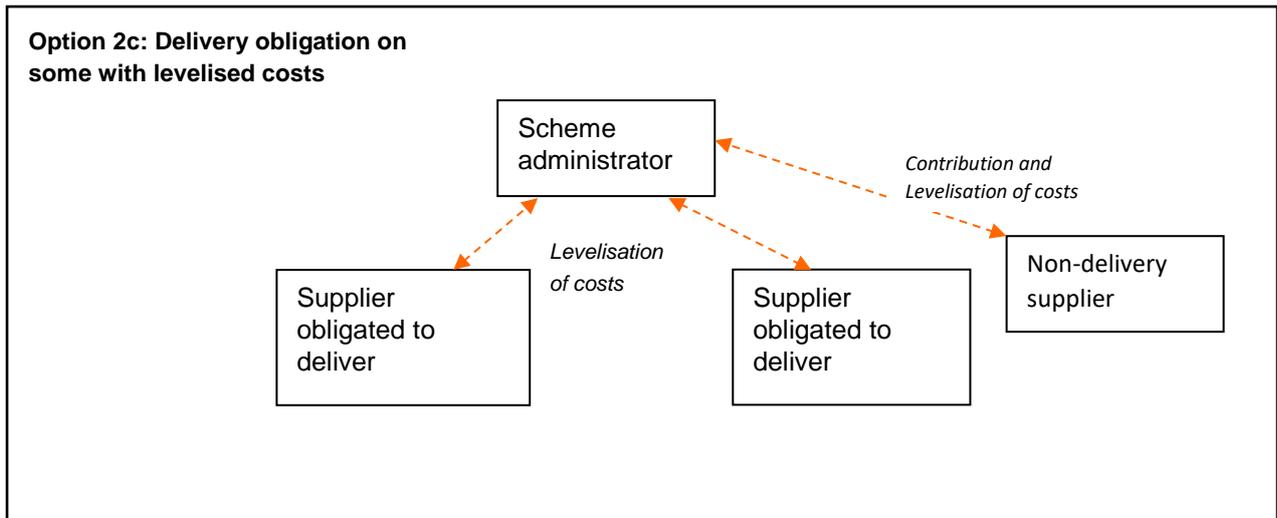
Once traded, the supplier is absolved of responsibility for delivering that part of their obligation. A scheme administrator would be needed to ensure compliance.



Option 2c: Levelisation of costs

- ▶ Assumes supplier-led delivery and customer thresholds remain.
- ▶ Smaller suppliers contribute to costs of running the scheme, without having to deliver.

This option allows all suppliers to contribute to the costs of delivering policies, but does not necessarily require all suppliers to deliver measures. The contribution would need to be set by the government and would be proportionate to the size of a supplier. Suppliers with a certain number of customers would be obligated to deliver, while suppliers below any threshold would be required to contribute to the cost of the scheme via a levelisation process. This option provides relief to fixed costs, while ensuring fair distribution of costs.



Option 3: Networks

An obligation is placed on Distribution Network Operators (DNOs) or Gas Distribution Networks (GDNs) taking the role of obligated suppliers in terms of funding and delivery. DNOs and GDNs could be well placed to deliver an obligation as:

- ▶ network operators would have an opportunity to target improved energy efficiency in areas where this could reduce the need for network reinforcement.
- ▶ costs may be shared more evenly across customers as all customers effectively contribute to network costs through Distribution Use of System (DUoS) and National Transmission System (NTS) charges. This would also mean a lower cost on a per consumer basis.
- ▶ networks cover fixed geographical areas, which could potentially have some advantages in terms of delivering similar measures in particular areas, though these advantages are likely to reduce as the more straightforward opportunities for energy efficiency improvements diminish and energy efficiency measures become more complex and heterogeneous.

However, we note that this option would be unlikely to address the regressive elements seen in the current scheme, where all customers contribute to the scheme at the same rate, regardless of their ability to pay. Additionally, a DNO-based funding model would only recover costs from electricity and gas consumers. Consumers of higher-emission fuels would continue to be exempt from funding.

This option would require further consideration, and any funding and/or delivery model on DNOs and GDNs would also need to be reflected in the Price Control Financial Model.

Appendix 1: Summary table of options

Option	Strengths	Weaknesses
<p>Option 1: General taxation (Preferred option) Gov raises funds through general taxation. Funds could then be tendered out, opening delivery to a wider range of participants – i.e. not just energy companies, but other market players.</p>	<ul style="list-style-type: none"> ▪ Progressive tax based on ability to pay. ▪ Opportunity for more market players to tender for contracts. ▪ Suppliers can still choose to participate in delivery. ▪ Opportunity to consider wider incentives than least-cost ▪ Market finds the right price. 	<ul style="list-style-type: none"> ▪ Costs could increase if competition for funds is low.
<p>Option 2a: Delivery obligation on all with buy-out fund Suppliers can opt to pay the cost of delivering their obligation and are absolved of responsibility if they pay the buy-out. Other obligated parties or other delivery agents could bid to deliver measures.</p>	<ul style="list-style-type: none"> ▪ Fixed maximum delivery price. ▪ All suppliers and their customers contribute. ▪ Opens market up to different delivery agents. ▪ Suppliers can still choose to participate in delivery. ▪ Tendering delivery allows market to find the price. 	<ul style="list-style-type: none"> ▪ Government has delivery risk if all suppliers opt for the buy-out and low competition to bid for buy-out funds. ▪ Imputed tax.
<p>Option 2b: Trade-out mechanism A delivery obligation on all suppliers but suppliers are able to trade-out their obligation to other obligated parties. Once traded, the supplier is absolved of responsibility. The trade-out price would be set competitively by the price suppliers and delivery agents are willing to pay.</p>	<ul style="list-style-type: none"> ▪ Option to self-deliver or trade obligation. ▪ Relief provided for fixed costs by allowing obligation to be traded. ▪ Market finds the price ▪ Opportunity costs for those that take on others' obligation. ▪ Could build on brokerage. ▪ Delivery risk is traded out. ▪ Opens market up to different delivery agents. 	<ul style="list-style-type: none"> ▪ Costs could increase if competition is low.
<p>Option 2c: Delivery obligation and levelised costs Suppliers above a set threshold are required to deliver their obligation, but all suppliers are required to contribute to the cost, proportionate to their size.</p>	<ul style="list-style-type: none"> ▪ Takes advantage of supplier economies of scale in terms of delivery. ▪ All suppliers and their customers contribute. ▪ Assurance of delivery. 	<ul style="list-style-type: none"> ▪ Whether pricing accurately reflects cost for the additional obligation to deliver.
<p>Option 3: Networks Distribution network operators and gas distribution networks take the role of obligated suppliers in any of the above options.</p>	<ul style="list-style-type: none"> ▪ Potential opportunity to support energy efficiency to defer the need for network reinforcement. ▪ More equitable distribution of costs across customers than the current ECO model. ▪ Potential advantages in area-based delivery. 	<ul style="list-style-type: none"> ▪ Funding is still regressive if structured the same way as current supplier obligations.

Appendix 2: Further considerations

Across these options, we consider there are a number of features that will require further consideration in any future scheme.

Funding Gap

While the Government's commitment to maintaining funding for energy efficiency schemes at its current level until 2028 is welcome, research indicates that there is a funding gap of £4.5bn needed to meet the target set out in the Clean Growth Strategy for all fuel poor and private rented sector households to reach EPC band C by 2030, and as many homes as possible to be EPC band C by 2035.¹⁶ Further investment in the private market, and from Government to support those who are unable to pay, is needed to ensure these important milestones are met.

Overall objectives

We consider that overall energy efficiency policy objectives should inform the design of a future scheme from the outset, as some models are more compatible with certain objectives than others. ECO's original focus as a market-based mechanism was arguably better-suited to its original primary goal of achieving carbon savings than its current focus, where social factors are more of a consideration. It has been noted elsewhere that certain alternative scheme designs, such as a demand reduction obligation, would create similar challenges to tackling social issues.

Customer thresholds

If supplier obligations remain post-2022, we would question the need for a threshold on suppliers as exists currently. Our view is that thresholds for ECO create distortionary impacts in the supplier market, that have become more pronounced as the number of suppliers has grown. We consider this has had the following impacts:

- ▶ **Barrier to growth** – in previous schemes an arbitrary threshold based on customer accounts creates a cliff-edge with the first customer over the threshold becoming very expensive. We acknowledge that this issue has been minimised with the introduction of the tapering approach in ECO3, but is still a factor.
- ▶ **Splits the market** – exemptions create a two-tiered system as some market participants are subject to additional cost from obligations, while others are not. This also creates further regressive effects towards customers in vulnerable circumstances or experiencing fuel poverty, as these customers are more likely to be with larger suppliers and less likely to switch suppliers.
- ▶ **Cumulative impact** – the cumulative impact of passing the costs of policy through to consumers via energy bills could affect a company's ability to compete with those not exposed to these costs. This has the potential to become more pronounced if a growing proportion of the market switches to non-obligated suppliers who do not grow to sufficient size to eventually cross the threshold.

In some circumstances a threshold may be necessary by design, such as in a model that envisages levelisation of costs across the whole industry. Were this the case, the level of the threshold needs to be carefully considered in line with the existing and projected makeup of the domestic market across the life of the scheme.

Proportion of obligation funding on gas and electricity supplied

As ECO is focused on reducing heating demand, the source of future funding costs, which is currently assumed by BEIS to be funded on a 50/50 basis from electricity and gas bills, should be funded from all heating fuels proportionally. This would avoid distorting competition across heating technologies by overloading electricity bills with policy costs. This could also encourage the shift to decarbonised heating sources on a polluter-pays principle.

¹⁶ Frontier Economics (2017), Affordable Warmth, Clean Growth: Action Plan for a comprehensive Buildings Energy Infrastructure Programme, <http://www.frontier-economics.com/uk/en/news-and-articles/articles/article-i4324-affordable-warmth-clean-growth/>

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Targeting

As eligibility criteria has narrowed in successive schemes to support social objectives, adequately identifying suitable recipients for energy efficiency measures has become more onerous, and search costs are likely to comprise more of the overall spend on delivery of measures. Any future scheme should make use of the powers under the Digital Economy Act 2017 for government and suppliers to share information for the purposes of supporting fuel poverty schemes. A data-matching service to identify potentially eligible households based on DWP data has the potential to cut search costs.

Scheme provider

The administrator in any future scheme may not need to be the regulator. Indeed, it may be preferable in some of the options to envisage a new administrator, for example an organisation with the specific objective of facilitating delivery via a fund, and with the technical expertise and focus to develop contractual relationships with the supply chain and other delivery partners.