Written evidence submitted by Ofgem (EPM0030)

Ofgem written evidence: Call for Evidence on energy pricing and the future of the Energy Market 11 March 2022

Who we are:

Ofgem is Great Britain's independent energy regulator. Our principal objective is to protect the interests of existing and future consumers. We do this by:

- Working with Government, industry and consumer groups to deliver a net zero economy at the lowest cost to consumers.
- Stamping out sharp and bad practice, ensuring fair treatment for all consumers, especially the vulnerable.
- Enabling competition and innovation, which drives down prices and results in new products and services for consumers.

We operate in a statutory framework set by Parliament. This establishes our duties and gives us powers to achieve our objectives.

Summary:

1. Wholesale gas prices have risen by over 500% in under a year. This rise in gas prices has put the gas market, and consequently the British retail energy market, under unprecedented strain.

2. The consequences have been:

    - A significant rise in energy prices, with the energy price cap increasing from 1 April for approximately 22 million customers. Those on default tariffs paying by direct debit will see an increase of £693 from £1,277 to £1,971 per year (difference due to rounding). Prepayment customers will see an increase of £708 from £1,309 to £2,017.
    - Many suppliers simply could not cope with such a sustained price shock – with 31 suppliers exiting the energy market since January 2021 with resulting costs to consumers, which are set out in more detail in paragraphs 42 – 50.

3. Throughout the crisis, Ofgem has worked to protect customer interests. Our safety net has protected more than four million customers, making sure that even when their supplier has failed, they have an energy supplier and household credit balances are honoured. The price cap has also meant that customers on their supplier's standard variable or default tariff have been protected against unfair price rises.

4. The primary driver of price rises has been the rise in wholesale costs, which have been reflected in similar or larger scale across the world – for example, European countries have seen almost a six-fold increase in wholesale gas prices, while prices in Asia have increased over four-fold.

5. However, the response in the GB market means that there are two important changes that need to be made to our regulatory framework:

- Companies were not resilient enough and financial regulation needs to be significantly enhanced.
- The price cap, although protecting consumers from unfair prices, needs to be more adaptable to rapidly changing market prices.

6. Alongside managing through the crisis on behalf of consumers, Ofgem is therefore driving reform in both these areas.

7. Ofgem is proposing tougher and tighter financial regulation in the retail market. These proposals can and will be brought in at pace, although we accept that some companies will need time to transition. The measures include:

   - More robust stress testing, already underway, with improvement plans and clear enforcement pathways being put in place to address weaknesses.
   - Greater supervision of industry staff in significant roles, with strengthened assessments for entry to the market and on growth, which take effect from 1 April 2022.
   - Ring fencing of all material economic and operational assets within the control of the regulated retail company. We consulted on immediate measures in January with final decisions later this month, and will consult on new licence requirements in the spring.
   - Measures to protect renewables levies and customer credit balances from firms' balance sheet, for which we intend to publish options in mid-March 2022, followed by a consultation on new requirements in the spring, alongside an impact assessment to determine the correct level of protection.
   - A new capital adequacy framework to ensure firms are more resilient to market risks – while still giving them the flexibility to determine their own hedging strategies. Again, we intend to publish a consultation on capital adequacy requirements in the spring.
   - As we strengthen our regulatory approach, we are also exploring with government potential additional powers to ensure consumers can be fully protected.

8. Ofgem is also reforming the price cap to make it more flexible and adaptable, while still retaining the benefits of its protection for consumers:

   - From 1 April 2022, we have introduced a price cap reopener, which enables Ofgem – in exceptional circumstances only – to change the price cap outside of the 6-month periodic updates.
   - We are also currently consulting on further measures to reform the price cap – including moving to quarterly price cap updates – and we intend to make decisions in time for any changes to be in place from October 2022.

9. The volatility in the gas market is not over. Indeed, it looks likely that we are entering a second, more serious phase that will have further consequences for customers and further financial strain for retail companies.

10. The UK is not dependent on Russia for oil and gas and we continue to have a highly resilient energy system. Nonetheless, the price we pay for gas is set globally. Since the invasion of Ukraine, we have seen a significant increase in wholesale gas prices and volatility – with the day-ahead price peaking at almost £7/therm on 7 March, nearly 16 times the average price

last winter, and substantial intraday swings in prices. We are continuing to monitor the impact on the energy market carefully.

11. We will also continue to work with government and across the sector to build a retail market that will support the longer-term transition to net zero at least cost to consumers. This will require greater flexibility in the system as a whole. It will also change how some consumers engage with their energy use, taking advantage of new products and technologies. We will encourage this innovation, whilst adapting our regulatory approach to ensure we continue to protect the interests of consumers.

Background – the market and licensing framework:

12. Since the energy market was privatised and liberalised, there have been concerns that the dominance of the large incumbent suppliers has meant that competition was not bearing down on costs or driving improvements in customer service and innovation as effectively as it could.

13. Indeed, it was because of concerns about how effectively competition was working that, in 2014, Ofgem referred the energy market to the Competition and Markets Authority (CMA) for a full competition investigation. In its final report in 2016, the CMA found that customers had been paying £1.4 billion a year more than they would in a fully competitive market and proposed over 30 measures to increase competition between suppliers and help more customers switch to better deals, whilst protecting those less able to benefit from competition.

14. More generally, promoting competition – in particular, by facilitating switching and opening the retail market to new suppliers – has been a priority for Ofgem and Government. This did deliver benefits for consumers – with greater choice, more engagement, lower prices, and improved customer service.

15. As a result, the overriding policy priority was to diversify the market and challenge the dominance of the big incumbent companies – and measures to promote greater financial resilience were not implemented by Ofgem at the pace or the scale that, with hindsight, was needed.

16. Ofgem did launch a review of the licensing framework in 2018. This was known as the Supplier Licensing Review. The purpose of this review was to ensure that appropriate protections were in place – when suppliers apply to enter the market, as they operate in the market, and in the event they exit the market – against poor customer service and financial instability. The review resulted in a number of reforms to the licensing framework, including strengthening the rules for suppliers seeking to enter the market, the ongoing requirements for suppliers, and the arrangements when suppliers exit the market. These are outlined below.

17. In 2018, Ofgem tightened the protections for consumers by enabling a potential Supplier of Last Resort to recover costs associated with honouring credit balances for customers who have switched away from the failing supplier at the date the supplier fails. These are known as closed credit balances. This means that even where a customer has switched to another supplier, if they have an outstanding credit balance with their previous supplier who then exits the market, this is also protected.

18. In 2019, Ofgem introduced new entry requirements. These include new checks to ensure supply licence applicants are fit and proper to hold a licence, have appropriate resources to support their entry plan, and understand and have plans to fulfil their regulatory obligations.

19. Overall, we believe that these new entry requirements have operated effectively. Following this strengthening of the entry criteria, the number of suppliers entering the market has fallen – from a high of 18 new market entrants in 2017 to two in 2020 and one in 2021 – and, to date, no supplier that was granted its licence since the new entry criteria came into force in 2019 has since exited the market. Clearly, however, current market conditions are putting further strain on suppliers – and we are continuing to monitor the situation carefully.

20. As part of the Supplier Licensing Review, Ofgem also introduced new ongoing requirements on suppliers active in the energy market, in addition to the new checks that new suppliers must pass when they seek to the enter the market. These came into force in early 2021. These reforms were designed to ensure suppliers are prepared for growth and to meet their regulatory obligations, to increase accountability, and incentivise responsible and appropriate behaviour from those in senior positions, and to strengthen Ofgem's oversight of the market to ensure we can identify potential risks to consumers or competition and enable us to take timely action where appropriate. The specific measures included:

    - A new Financial Responsibility principles-based requirement for suppliers to take action to minimise costs that could be mutualised in future.
    - New check points for suppliers, determined by customer numbers and financial and compliance indicators, at which Ofgem can scrutinise suppliers' readiness for growth and ability to meet their regulatory obligations.
    - A new principles-based requirement to ensure suppliers have sufficient operational capability and adopt overall better risk management practices.
    - A requirement for suppliers to ensure that relevant individuals with significant influence in the business are fit and proper to occupy their role (in line with criteria for being awarded a licence at entry).
    - A new principles-based requirement for suppliers to be open and cooperative with the regulator.

21. In addition, in March 2021, Ofgem published detailed guidance to suppliers on the Financial Responsibility Principle. This guidance states that where Ofgem seeks assurances that a supplier is adhering to the Financial Responsibility Principle, we would expect that the supplier would be able to provide evidence that it has:

    - Plans in place to meet its financial obligations under government schemes by relevant dates.
    - Effective processes, that are consistent with existing licence requirements, for example setting direct debit levels and for checking and returning customer credit balances.
    - Sustainable pricing approaches that allow it to cover its costs over time, or if it is pricing below cost, that the risk sits with investors and not consumers. We will need to see evidence that suppliers can finance their overall business plans.
    - Robust financial governance and decision-making frameworks in place.
    - The ability to meet its financial obligations while not being overly reliant on customer credit balances for its working capital.

22. These measures were aimed at reducing the likelihood and impact of disorderly supplier market exits. Where suppliers do fail, Ofgem also introduced new measures, which again came into force in January 2021, which require suppliers to notify Ofgem if they are engaging in a customer book sale, and strengthened our ability to ensure such transactions do not cause harm to consumers, alongside steps to include contractual terms in supply licences so that administrators are required to apply some of the same standards as suppliers relating to debt recovery when they assume responsibility for a failed supplier's debt book.

23. More generally, Ofgem monitors the market very carefully. When we come across breaches of our rules, we have a range of tools at our disposal. This can include taking formal enforcement action. This is often for the most serious breaches of the rules, or where companies dispute that they have done anything wrong. Other times, it can be quicker to resolve things for consumers by taking compliance action. At all our times, our priority is to deal with the problem and compensate customers as quickly and fully as possible. Last year (2021), as a result of action taken by Ofgem in 41 cases, £180 million was paid by energy companies in fines and redress to customers.

24. Following the introduction of the measures in the Supplier Licensing Review, we had started enforcement proceedings against two suppliers. However, our regime was not fully developed, and our regulatory action was overtaken by the speed of change in the energy market. We accept that, had we introduced tighter financial regulation more quickly, this would have been better for customers. However, we believe that given the size, scale, and pace of the gas price shock, we would still have seen financial failure in the retail market and the associated costs of those failures. Nonetheless, with firmer but proportionate ex ante regulation, these failures would have been smaller in number and occurred later – resulting in overall lower costs for customers.

The prices consumers pay:

25. In July 2018, Parliament passed the Default Tariff Cap. This legislation placed a legal duty on Ofgem to introduce a cap on standard variable and default tariffs for domestic customers. Following this, in January 2019, Ofgem introduced an energy price cap.

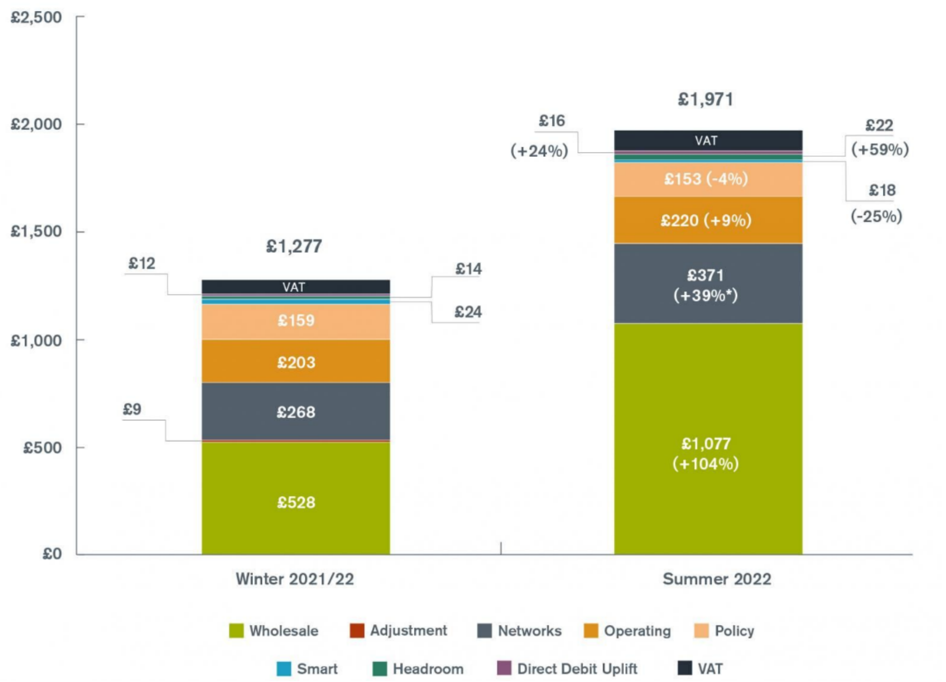
26. The price cap limits how much suppliers can charge customers per unit of gas or electricity, based on the underlying costs to serve energy to customers. This limit isn't on customers' totals bills, which will vary depending on how many units of energy used. To date, the level of the price cap has been updated every six months and based on a methodology that Ofgem has consulted on widely and which is openly available.

27. The energy price cap was introduced to ensure that households pay a fair price for their energy. This means that when the costs of supplying energy to customers falls, these savings are passed onto customers. Equally, when the costs increase, these costs are also passed on to customers. It has driven suppliers to become more efficient, with an estimated benefit of around £1 billion per annum since its introduction.

28. In February, Ofgem announced that the energy price cap will increase from 1 April for approximately 22 million customers. Those on default tariffs paying by direct debit will see an increase of £693 from £1,277 to £1,971 per year (difference due to rounding). Prepayment customers will see an increase of £708 from £1,309 to £2,017. As the graph

below shows, the increase in wholesale costs accounts for the overwhelming majority of this increase.

29. It also includes our decision to adjust the cap in cap periods eight (April - September 2022) and nine (October 2022 – March 2023) to account for the additional costs incurred by suppliers because of rising wholesale market prices and volatility in cap period seven (October 2021 – March 2022). This equates to £61 per customer (based on latest, average consumption figures).



30. The current cost of wholesale energy is being felt across Europe and the world. A shortage of gas plus increased use in Asia and across the globe has pushed up the price of gas. Gas prices have increased by about five-fold in the UK from the same time last year. This follows a similar pattern in European countries, which have seen almost a six-fold increase in wholesale gas prices since the same time last year, while prices in Asia have increased over four-fold.

31. While different European countries have taken different approaches to managing these significant increases in costs, many other European countries have seen significant consumer bill increases across gas and electricity.

The invasion of Ukraine:

32. As the Government has made clear, the UK is not dependent on Russia for oil and gas, and we continue to have a highly resilient energy system.

33. Nonetheless, the price we pay for gas is set globally, and the volatility in the gas market is not over. Indeed, it looks likely that we are entering a second, more serious phase that will have further consequences for customers and further financial strain for retail companies.

34. Since the invasion of Ukraine, we have seen a significant increase in wholesale gas prices and volatility – with the day-ahead price peaking at almost £7/therm on 7 March, nearly 16 times the average price last winter, and substantial intraday swings in prices. We are continuing to monitor the impact on the energy market carefully. While it is too early to predict what the price cap will be in October, a price increase is almost inevitable.

35. Ofgem also stands ready to do whatever is needed to support the government in executing its strategy on economic sanctions against Russia.

Ofgem's safety net:

36. Many suppliers simply could not cope with such a sustained price shock of this magnitude – with 31 suppliers exiting the energy market since January 2021.

37. When a supplier fails, Ofgem has a robust system in place to protect households and ensure our gas and electricity keeps running. This is known as the Supplier of Last Resort (SoLR) process. Through this process, when a supplier fails, Ofgem undertakes a process to move the failed supplier's customers to a new supplier. The SoLR process is competitive. We expect suppliers to put forward their best bids, reflecting the value to them of the customers they will gain.

38. This safety net has protected customers. As a result, the customers of the suppliers that have failed have been transferred to new suppliers, there has been no disruption to the supply of energy to them, any domestic customer credit balances are protected, and the prices customers pay have been limited by the price cap.

39. Instead of appointing a SoLR, Ofgem and Government may appoint a special administrator to temporarily run the business until such time as a new supplier can be found for the customers. This is known as the Special Administration Regime (SAR).

40. In November 2021 it was necessary to use this process when Bulb, a supplier with 1.7 million customers, ceased trading. Again, the appointment of energy administrators has meant that the supply of energy has remained normal to Bulb customers while a longer-term solution is agreed, and any credit balances are also protected. The Government provides the funding necessary to ensure that the administration is managed in a way that protects customers' supply.

41. While customers have seen no disruption to their supply of energy, and households' credit balances have been protected, the number of supplier failures and customers affected has undoubtedly caused concern to consumers. While all customers who are moved to a new supplier through the SoLR process are still protected by the price cap, some will have seen a change from the price they were paying previously.

42. The costs a new supplier bears in the SoLR process are normally borne by the new supplier and the industry, via a levy paid at a later date. Under Ofgem's rules, suppliers acting as SoLR can make a claim for any reasonable additional, otherwise unrecoverable, costs they incur – and these costs must be incurred as economically as possible.

43. Each levy claim is assessed on its merits by Ofgem, in accordance with our guidance. Historically, SoLRs have claimed for the following categories of costs:

- Customer credit balances;
- Working capital; and
- Operational costs (including customer service, IT, complaints/enquiries specific to the SoLR, onboarding costs, communication costs).

44. Our main methodology criteria for assessing whether a SoLR levy claim is reasonable in all circumstances of the case are as follows:

    - Additional: whether the costs claimed are additional to the costs to the SoLR of serving existing customers. In addition, we consider whether these costs would have been expected at the time of the SoLR's bid and whether any commitments were given in relation to these costs in their competitive SoLR bid.
    - Directly incurred as part of the SoLR role: whether the costs were incurred as a result of taking on customers in an emergency situation as opposed to normal customer acquisition routes. It would not be appropriate for us to allow the SoLR to claim for costs they would have incurred through a normal acquisition route.
    - Otherwise unrecoverable: whether the SoLR could have recovered the costs through other means. It would not be appropriate for us to allow the SoLR to claim for costs it could have recovered through the administration process or customer charges, for example.
    - Economic: whether the SoLR had made all reasonable efforts to avoid the cost in the first instance or absorb the cost.

45. Approved levy claims are then paid to energy suppliers by the distribution network companies and recovered from consumers via their charges.

46. On 22 December 2021, we published the initial SoLR claims that we had consented to for SoLRs appointed since 1 September 2021. These claims totalled approximately £1.84 billion. This amounts to approximately £68 per customer of the increase in the level of the price cap that takes effect on 1 April.

47. The main driver of these costs – over 93% – is the unprecedented wholesale gas prices, which new suppliers need to pay to purchase the energy needed to supply the customers they have acquired through the SoLR process. The remaining costs are principally made up of protecting consumer credit balances, and working capital, onboarding, and migration costs.

Wholesale	**Credit balance**	**Working capital**	**Onboarding and migration**	**Total**
£1.7bn	£65.9m	£48.4m	£6.5m	£1.8bn
93.4%	3.6%	2.6%	0.35%	

48. We expect to receive further claims from suppliers that have been appointed as SoLRs after December 2021 and from suppliers who have submitted initial claims and have further claims to make. Until these further claims are received and assessed by Ofgem, it is not possible to provide a definitive total for the total costs of SoLR claims, associated with the supplier failures over the autumn and winter of 2021-22.

49. While it is still subject to significant uncertainty, our current estimate for total claims is approximately £2.2 billion to £2.4 billion. Wholesale costs are expected to continue to make up the overwhelming majority of these costs – approximately 85% – and, as more suppliers repay outstanding credit balances to consumers, we expect the proportion of costs relating to credit balances could increase from 3.6% to approximately 10%.

50. In order to maintain the financial viability of suppliers taking on customers through the SoLR process, levy payments needed to be made promptly to these suppliers. Ofgem did explore options to recover the costs of these levy claims over a longer timeframe. However, given the package of support that Government announced in February 2022, which included spreading the costs over a longer period, this was not taken forward. In addition, any private finance arrangement would ultimately have added to customer bills, in absolute terms.

Stronger financial regulation:

51. While Ofgem had taken steps to significantly tighten the rules for suppliers between 2019 and 2021, we need to go much further and faster in regulating energy suppliers.

52. As a result, Ofgem is implementing tougher and tighter controls on the retail market, focused on financial resilience. These proposals can and will be brought in at pace, although we accept that some companies will need time to transition. Where we need to make changes in licenses, we will publish consultations. The measures include:

    - More robust stress testing, already underway, with improvement plans and clear enforcement pathways being put in place to address weaknesses.
    - Greater supervision of industry staff in significant roles, with strengthened assessments for entry to the market and on growth, which take effect from 1 April 2022.
    - Ring fencing of all material economic and operational assets within the regulated retail company.
    - Measures to ring fence renewables levies and customer credit balances from firms' balance sheet.
    - A new capital adequacy framework to ensure firms are more resilient to market risks – while still giving them the flexibility to determine their own hedging strategies.

53. As we strengthen our regulatory approach, we are also exploring with government potential additional powers to ensure consumers can be fully protected. For example, we may need to consider the existing insolvency rules, how they interact with the SoLR and SAR processes in the energy market, and to ensure that all mutualised costs can be recovered from the failed supplier. Equally, step-in rights, as some other regulators have, would enable Ofgem to literally step into the shoes of a supplier (or request a third party to) to administer the business if we thought there was imminent action that would cause significant detriment to consumers.

Stress-testing:

54. The purpose of stress testing is to assess whether suppliers are robust to a range of scenarios, whether through capital cover or risk management. In February, we issued two requests for information from domestic suppliers: a stress test and an assessment of their risk management control framework in respect of financial risk. We are asking for Board sign

off for each and are currently preparing to receive this information. These initial stress tests take the form of targeted ‘what if’ scenarios which include price volatility, differing levels of customer bad debt, and significant acquisitions or loss of customers.

55. We will discuss the results of the stress tests with individual suppliers, including whether follow-up actions are required to further test or to strengthen their financial resilience. Our primary aim will be to encourage and support suppliers in developing their own robust management control frameworks. Where issues are raised, we will identify a suitable improvement plan for a supplier to rectify these issues. However, if this is not agreed or followed and we consider a supplier is in breach of an obligation such as the Financial Responsibility Principle (FRP) or Operational Capability condition, we will take robust compliance and enforcement action.

56. Alongside this, we are assessing targeted suppliers in advance of receiving that information to identify and prepare for compliance and enforcement action that may be appropriate now or in the coming weeks.

Greater supervision of industry staff in significant roles:

57. In February 2022, Ofgem confirmed measures to strengthen our milestone assessment framework and increase scrutiny around significant commercial developments and senior personnel changes. These changes, which take effect from 1 April 2022, will:

- Require a supplier to pause domestic customer onboarding once it reaches the 50,000 and 200,000 domestic customer milestones for each of the relevant gas and electricity supply licences until such time as we have completed any necessary milestone assessment and the supplier has had sufficient time to take any necessary action; and
- Require that suppliers notify Ofgem about significant planned commercial developments and senior personnel changes a defined period in advance of them occurring, to allow Ofgem time to carry out an assessment of the impacts these changes may have on consumers and for any necessary action to be taken.

Ring fencing of all material economic and operational assets within the regulated retail company:

58. Throughout the current crisis we have continued to closely monitor practices in the retail market. Through that process we identified certain arrangements where suppliers do not own, control, or have the economic or legal rights to the key assets needed to run their business. We consider this results in consumers and taxpayers bearing an unfair and disproportionate amount of risk of mutualised costs. This is because such arrangements can limit the resources a regulated supplier can rely on to meet its obligations and financial liabilities, increasing the amount consumers or taxpayers may have to contribute following the supplier’s failure.

59. As a result, in January we set out our expectations around how suppliers should comply with their existing obligations in this area. We also consulted on changes to the Financial Responsibility Principle (FRP) guidance, as well as additional guidance in relation to the Operational Capability Principle, which will mean that suppliers must have ownership or control over assets needed to operate their businesses, including hedges. The consultation closed on 18 February and we intend to publish a final version of the guidance later this

month, at which point the additional guidance for both principles would come into effect. We are also considering updating licence requirements to further protect consumers from mutualised cost risk due to suppliers having insufficient control over their assets.

60. Alongside this, the Government also introduced an amendment to the Finance Bill to establish a new Public Interest Business Protection Tax. The Act has now received Royal Assent and applies a new tax on the profits that could arise where a business undertakes arrangements that realise a valuable asset for its own benefit and the benefit of its shareholders, and as a result precipitates or exacerbates the collapse of an energy supply business. It will apply in cases where energy supply businesses enter special administration or have a supplier of last resort appointed starting from 28 January 2022. The measure seeks to deter companies taking steps that could prejudice taxpayers and energy consumers and, where relevant cases do arise, to recoup a substantial portion of the costs.

Measures to ringfence renewables levies and customer credit balances from firms' balance sheet:

61. Suppliers should not pass inappropriate risk to consumers and socialisation of losses when suppliers fail must be minimised. In particular, there is an urgent need to ensure that customer credit balances and monies collected for renewables levies are used appropriately, and are not used to fund wider business activities.

62. In the week commencing 14 March, we will publish the options we are considering regarding our view on supplier treatment of Customer Credit Balances, and also publish the options we're considering in respect of the Renewables Obligation. In the spring we intend to publish consultations on requirements for protecting monies collected under the Renewables Obligations and Customer Credit Balances, alongside an impact assessment to determine the correct level of protection. Subject to the legal requirements for consultation and notice periods for decision implementation, we will then move as quickly as possible to implement these protections.

A new capital adequacy framework to ensure firms are more resilient to market risks:

63. The market conditions have been extremely challenging for all suppliers since autumn 2021. While this has been an unprecedented crisis, it has exposed that suppliers have too often had insufficient capital to manage the business of supply, and business models have been overly reliant on customer credit balances for working capital. We consider that the amount of working capital needed to run a supply business should be much higher than we have seen in recent years across the market.

64. For new entrants, this means that we do expect investment up front and on an ongoing basis. For those already in the market, businesses should start planning now for the fact that Ofgem will require more capital in businesses. We are developing proposals at pace to define how this should work in practice. We intend to publish a consultation on capital adequacy requirements in the spring.

Other measures to support financial resilience:

65. Given we are reviewing licence conditions, we have temporarily paused assessment of applications for new supply licences. In October 2021, we temporarily paused assessment of applications for new supply licences, by extending the reasonable period of assessment,

initially to a period of six months, subject to review. In December 2021, we confirmed that we had extended this temporary pause by a further three months (i.e. to nine months in total), and that if a supply licence application is not processed within the period set (or extended) it will not be automatically deemed authorised.

66. Our intent is not to discourage well-financed new entrants, new business models, innovation or risk taking, but to reduce potential harm to energy consumers. In particular, we want to ensure that if suppliers do fail, the resulting costs to consumers are minimal, even in instances of high or volatile energy prices. These proposed reforms will strengthen risk management in the sector: protecting the interests of consumers, providing greater certainty for investors, and strengthening the resilience of the sector.

67. Alongside this, to enable domestic suppliers to better manage risks created by current wholesale market volatility, which could lead to higher costs for consumers in the event of further significant supplier exits from the market, we have introduced two temporary measures, which we believe are in consumers' interests. These are:

    - A requirement for suppliers to make all tariffs available to new and existing customers; and
    - A requirement, where certain conditions are met, for suppliers to pay a Market Stabilisation Charge when acquiring new customers.

68. These measures will come into effect on 14 April 2022 on a temporary basis, to address the risks to consumers in the short term from ongoing wholesale market volatility.

Adapting the price cap for volatile markets:

69. The current price cap methodology, while protecting consumers from price spikes, exposes suppliers to risks that are hard to manage at times of high energy price volatility. If not tackled, these are likely to lead to higher costs for consumers.

70. As a result, from 1 April 2022, Ofgem has introduced a price cap reopener, which enables Ofgem – in exceptional circumstances only – to change the price cap outside of the 6-month periodic updates. The circumstances in which the reopener could be used must be:

    - Rare: a rare event in either nature or scale, the consequence of which was not wholly included in the calculation of the current cap.
    - Externally caused: the cause of the event is external to suppliers within the energy market.
    - Not reasonably avoidable: when even suppliers who have taken reasonable steps to mitigate the impact of the event have limited or no success and face unavoidable changes to their costs.
    - Appropriate: the event impacts the efficient costs of supply.
    - Requires urgent action: urgent action by Ofgem is deemed necessary within the remaining cap period, to mitigate otherwise potential long-term and/or enduring impacts on the market and customers.

71. In addition, we are also currently consulting on further measures to reform the price cap, and we intend to make decisions in time for any changes to be in place from October 2022:

- Moving to quarterly price cap updates (our preferred option), price cap contracts, or a strengthened status quo.
- Reducing the advance notice Ofgem gives to suppliers of the updated price cap level before it comes into effect from two months to one month; and
- A new mechanism to address backwardation costs in excess of the normal seasonal basis risk.

72. Our aim is a competitive and innovative retail market, where consumers have secure energy supplies at fair prices, and have confidence in efficient, competitive suppliers, and where suppliers are resilient to market shocks and can earn reasonable profits commensurate with the risks that they are taking.

Supporting the transition to net zero:

73. The energy transition is at a critical moment. The events over the autumn and winter of 2021 have highlighted the need for wider and deeper changes to ensure that the energy sector is resilient against potential continued global market volatility and is able to deliver the transition to net zero at lowest cost.

74. With the phase out of coal we are heavily reliant on gas. Indeed, gas provides around 40% of our electricity, considerably more when the wind is not blowing, and serves 85% of households for their heating. What is clear from the situation that the market finds itself in today, is that we need to diversify our sources of energy supply. This does not mean giving up on climate goals but instead, moving further and faster to pursue them.

75. With a more diverse market including more renewables, and other low carbon power sources such as nuclear, hydrogen and gas with carbon capture and storage, we will reduce our dependence on global gas markets and be better able to weather the kind of shock we have seen in the past months.

76. Equally strong though, is the imperative that we make this transition at least cost while maintaining our security of supply. Ofgem’s regulatory mechanisms can bring forward billions of investment in new low carbon infrastructure at low costs to consumers. We also know that a smarter, more flexible system will save billions of pounds a year. Put simply, if we can control the time we charge our electric cars, if that same car battery can be a source of stability, we will need a smaller grid and fewer power stations and everyone’s energy bills could be lower.

77. If we are to make a successful transition to net zero, it has to work for consumers as they change the way they fuel their cars and the way they heat their homes. Energy suppliers will play an important role in facilitating the behaviour change that will smooth the journey to net zero.

78. This requires a healthy, competitive and innovative retail sector: we will toughen regulatory standards for energy suppliers as set out above, but will ensure that we also retain the ability for new entrants to bring dynamism, innovation and challenge to the market. We expect a proliferation of new products and services, with data and digitalisation unlocking new opportunities and benefits for consumers. Equally, retailers may well look to bundle energy services with product sales (such as electric vehicle or heat pump sales).

79. We will ensure our regulatory regime adapts to continue to protect consumer interests, with additional support for vulnerable consumers, as the market evolves. In the coming months, Ofgem will lay out our ideas as to how we build a retail market, including considering more radical changes to the retail market and regulatory structure.

Organisational change:

80. Ofgem's priority has been, and remains, to act in the best interests of energy consumers. There are regulatory lessons Ofgem needs to and has learned from this crisis. The Ofgem Board has already commissioned a lessons learned review. As we have outlined earlier, change is already underway.

81. As well as changing our regulatory approach, we are also continuing to adapt our organisational approach. In particular, we have been undertaking a major organisational transformation programme to become more agile, responsive and quicker in our decision making and bring in new skills and capabilities.

March 2022