RES0005

Written evidence submitted by E.ON

About E.ON

- E.ON is one of the largest energy companies in the world. Across Europe, we have over 54 million customers and operate c1.5 million km of energy networks. E.ON is the largest electricity supplier in the UK. We supply nearly one in five households and small businesses across Britain with 100% renewable electricity on all tariffs, as standard, at no extra cost. As npower Business Solutions, we are the largest electricity supplier serving the large industrial and commercial sector.

- E.ON has committed to the 'Race to Zero' with a science-based net zero by 2050 target; We have installed smart meters for more than 4m of our UK customers, and saved households across Britain more than £10 billion on their energy bills over the lifetime of the energy efficiency measures we have installed.

- E.ON no longer owns or operates conventional, large-scale fossil-fuelled power stations; we were a pioneer of major investment in renewable energy, particularly offshore wind in the UK, and have become so respected in providing and installing energy efficiency, smart meters and other building energy solutions for our domestic and business customers, we now do so commercially for other energy suppliers' customers as well as our own.

Executive Summary

- The last ten years has seen a significant and catastrophic failure of energy policy and regulation in energy retail. More than 8 million households will have felt the impact of more than 50 energy supply companies leaving the market over the past five years. Over half of those failures happened during Winter 21/22 as global gas prices spiked.

- We expect the total cost to customers of these failures (including the ongoing costs of maintaining Bulb's operations, whether paid for via tax or ultimately by customer bills) to be at least **£5 billion** over and above the unprecedented price increases we are witnessing due to the global gas crisis which has manifested itself over the last 12 months.

- This is additional expenditure that could have been avoided if Government and Ofgem had taken action earlier to prevent unscrupulous behaviours in the market that were clearly against the interests of customers.

- Volatile global energy prices were not the cause of supplier failures in Britain. The evolving global energy crisis simply highlighted and exacerbated the underlying fragility of the energy retail sector in Britain created by poor oversight of the market and an underappreciation of the vital role played by the energy retail sector (as opposed to the profit-making network and generation & production sectors).

- Where a proportion of customers will have saved money during this time – mostly educated, 'savvy' customers that were encouraged to continually switch to the unsustainably cheap deals offered by many of the now failed suppliers - all customers now face the unnecessary, additional costs of this policy and regulatory failure.
- We endorse and support the findings and recommendations of both the National Audit Office's analysis[1] of these failures and of NERA's analysis[2] which highlighted the moral hazard and illusion of competition that Government policy and Ofgem's regulation regime has created in the energy retail sector in Britain. We also support and highlight the excellent work done by the BEIS Select Committee's inquiry '*Energy Pricing and the Future of the Energy Market'* in illustrating these failures with testimony from the directors of some of the failed energy suppliers in question.
- Over the last ten years, policy and regulation has sought to increase the number of energy suppliers in the market as rapidly as possible but failed to implement the prudential regulation needed to ensure all new suppliers operate responsibly. With no capital of their own and without the expertise needed to weather challenging times, many newer suppliers were encouraged to cut corners to undercut their rivals and grow by gambling with customers' rather than investors' money, knowing that if their gamble failed the rest of the market (i.e. other remaining suppliers and their customers) would be forced to pick up unpaid bills and debts via the Supplier of Last Resort process.
- **We need simple, clear rules in place, informed by the 2008 banking crisis, that prevent the misuse of customers own money by all participants at all times**. It is imperative that the Government and Ofgem learn the clear lessons of the recent supplier failures and act swiftly and decisively to fix the outstanding flaws in the energy retail market.

There are **four** specific actions that should be delivered urgently:

i. Ofgem to finally (after many years) introduce strict rules over the use of customers money as working capital, including the ringfencing of customer credit balances and RO receipts for all energy suppliers.

ii. Ofgem to implement stronger capital adequacy tests that require investors to put their own equity capital at risk incentivising shareholders to ensure energy supply companies are well run and able to navigate the significant risks inherent in energy retail in a prudent way which help address the current moral hazard.

iii. BEIS to legislate to reform the Supplier of Last Resort (SoLR) process to ensure outcomes for customers and investors match those seen in the Special Administration Regime (SAR), and that both regimes deliver outcomes for customers that match other non-energy company administration regimes. This means that investors of failed suppliers should not expect to receive their original investment back (ultimately funded by remaining energy suppliers and their customers); and

[1] https://www.nao.org.uk/report/the-energy-supplier-market/

[2] NERA GB Energy Retail - Moral Hazard and the Illusion of Competition: https://www.nera.com/publications/archive/2022/energy-retail-in-great-britain--moral-hazard-and-the-illusion-of.html

iv. BEIS to legislate to require more frequent (quarterly) payments of the Renewables Obligation. Unfortunately, in April 2022 BEIS announced that, contrary to its original proposal, it will not be taking forward plans to introduce more frequent payments of the Renewables Obligation.

Support for the conclusions and recommendations of the National Audit Office

We support the NAO's findings of the policy and regulatory failures that led to these additional costs being borne by customers and highlight the real risk of further impacts unless urgent fixes are implemented; namely:

- **Government and Ofgem allowed a market to develop that was vulnerable to large-scale shocks** - Ofgem did not do enough in the years preceding the unprecedented wholesale cost increases and volatility in 2021/22 to ensure the energy retail sector was resilient to external shocks. By adopting a 'low bar' strategy to market entrance and allowing many suppliers to enter the market and operate with weak financial resilience, and by failing to imagine a scenario in which there could be sustained volatility in energy prices, Ofgem allowed a market to develop that was vulnerable to large-scale shocks.

- **Government and Ofgem allowed a market to develop which encouraged reckless gambling with customer money** – Government policy and regulation current means that the cost of failure in energy retail largely rests with consumers. Ofgem's approach to licensing and monitoring suppliers combined with the SOLR process effectively means that shareholders have nothing to lose from taking large risks, knowing that all customers will cover their losses in the event of failure and subsequently exiting the market. In fact, the intensifying of unsustainable competition by Ofgem through this growth in unsustainable suppliers was self-fulfilling, suppliers had to adopt these inefficiently high-risk models in order to compete. The status quo will see this race-to-the-bottom continue, with increasingly more suppliers having to adopt these strategies in order to compete. Oxera's report[3] for Ofgem confirmed that those energy suppliers that failed tended to operate with lower liquidity levels (less access to cash) than their peers and were more reliant on customer credit balances to finance their day-to-day operations. Government oversaw the Renewables Obligation scheme which enabled suppliers to operate in the market without committing large amounts of their own capital or charging tariffs that covered their costs (as suppliers collect consumer money to cover the cost of the Renewables Obligation throughout the year but only pay this over once a year, in August, enabling them to use the money as a form of temporary working capital).

- **Implementation of the price cap highlighted these flaws in the market** - Members of the Ofgem board told NAO that, in retrospect, it was clear that no one in Government or Ofgem did sufficient joined-up thinking about the connections between the price cap, the low barriers to entry to the market and the lack of financial monitoring. Neither the Department nor Ofgem has undertaken a full evaluation of the costs and benefits of the price cap for consumers. Ofgem did not consider what impact the price cap might have if there was significant volatility or sustained periods of price increases in the wholesale energy markets. It did not stress-test the price cap's

[3] https://www.ofgem.gov.uk/publications/review-ofgems-regulation-energy-supply-market

design in depth. Nor did it consider how the price cap might interact with the SOLR process. Ofgem considered that by including some financial headroom in the price cap, and updating the cap every six months, it had mitigated this risk. They were wrong.

- **The price cap has also added new risks for suppliers and may need reform** - Ofgem told NAO that there may be benefits from alternative forms of price cap but that these may require the Government to make legislative changes. Government has announced plans to enable the price cap to be extended but is yet to evaluate its costs and benefits or consider alternative forms of price cap and currently intends to maintain the current constraining price cap legislation as is.

- **The supplier administration process needs reform to protect customers** - Ofgem is exploring changing the licensing regime to prevent shareholders of failed companies making a financial return at the expense of consumers (such as by introducing changes to the licensing regime so that hedge values recovered from failed suppliers are used to offset SOLR costs). Ofgem told NAO that, in its view, legislative change is needed to fully protect consumers.

- **Those customers that didn't switch are now more than paying for the savings switchers made in the past** - The costs of supplier failure may have been offset for some customers, by those customers having cheaper bills in previous years by switching. However, the significance of this is uncertain and many customers, including those who are more likely to be vulnerable, are disproportionately affected over the whole period, particularly those who were less active in switching between suppliers to obtain cheaper tariffs.

- **Ofgem's approach to licensing and monitoring suppliers increased the risk and cost of supplier failure -** Members of the Ofgem board told NAO that, while the board had been uncomfortable about the state of the market for some time and knew it had needed reform, it did not have the space or time to focus on this due to Ofgem's many other priorities, such as the implementation of the price cap which absorbed a substantial amount of Ofgem's capability. Some stakeholders told NAO that Ofgem had previously been slow to react to potential licence breaches and some were concerned that Ofgem was requesting new powers when it had not made full use of its existing ones. Some suppliers NAO spoke to were concerned that some of the new information requirements that Ofgem is introducing are burdensome and that Ofgem has not made enough use of publicly available information, such as company accounts, to inform its monitoring of the market.

- **Both Government and Ofgem must ensure the energy retail market recovers from its current state where ongoing volatility means many energy suppliers still face potentially unmanageable financial risks** - This recovery needs to facilitate a longer-term transition of the energy supplier market to one that truly works for consumers and supports the achievement of net zero. This is a significant and difficult task, requiring Ofgem and Government to maintain the capacity to consider the longer-term objectives while managing the short-term challenges of stabilising the market. This will require a nuanced approach to regulation that recognises the trade-offs and finds a balance between its aims of competition, innovation, resilience and affordability for consumers.

E.ON Full Written Submission

1. Energy policy over the last ten years has focused on promoting the entry of competitors into the retail sector, as distinct from promoting competitive market conditions. However, this 'competition at all costs' approach failed to implement the prudential regulation needed to ensure all new suppliers operated responsibly.

2. With no capital of their own and without the expertise needed to weather challenging times, many newer suppliers were given specific cost advantages and allowed to cut corners to undercut their rivals and grow by gambling with customers' rather than investors' money. These suppliers knew that if their gamble failed, all customers in the market were providing them with free insurance via the flawed Supplier of Last Resort (SoLR) process. The SoLR regime encouraged little investor rigour of business plans in the knowledge that creditors would still be able to get back most (or even all) of their money in the event of a supplier going bust. This effect snowballed by promoting, even encouraging, excessive risk taking in a benign wholesale market environment in an attempt to aggressively compete with what were now, clearly, unsustainable prices and business models.

3. The policy and regulatory framework in place over the last ten years did not therefore create true competition in energy retail, only the illusion of competition as measured by the sheer number of supply companies, which peaked at over 70 in 2018. Far too many poorly capitalised and badly managed companies were allowed to enter the energy retail market and grow their customer base by offering unsustainably low prices despite timely warnings from those in industry[4] and customer champions[5] that the market was not working well.

4. More than 8 million households[6] will have felt the direct impact of the flaws in this policy and regulatory approach through the more than 50 energy supply company failures over the past five years. All c28 million households in Britain are now paying the price. Over half of these failures happened during Winter 2021 as global gas prices spiked, highlighting the financial fragility and lack of technical expertise created in Britain's retail energy market. The report by NERA[7] estimates that 1 in 3 customer switches between suppliers in 2021 took place due to customers being rescued from failed suppliers under the SoLR process rather than being chosen by customers through traditional customer competition.

5. E.ON has consistently warned Government and Ofgem of the flaws in the current policy and regulatory framework for energy and supported plans for reform. For example,

    5.1. In 2018, we welcomed Ofgem's intention to finally strengthen the rules used before granting a supply licence as part of their supply licence review but warned that the review had come too late and did not go far enough. In particular, the proposed reforms did nothing to solve the problem in the short term of financially weak suppliers operating in the market being allowed to act in a financially unsustainable way to the detriment of others[8].

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[4] E.g., E.ON 2019 retail market submission

[5] CA market meltdown paper: https://www.citizensadvice.org.uk/about-us/our-work/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-policy-research/market-meltdown-how-regulatory-failures-landed-us-with-a-multi-billion-pound-bill/

[6] E.ON calculation of customers involved in SOLRs, Bulb, and npower

[7] NERA GB Energy Retail - Moral Hazard and the Illusion of Competition: ibid

[8] E.ON submission to Ofgem Supply Licence Review (2018)

5.2. In 2019, due to our concern that customer money was being misused as working capital by some suppliers and the size of unpaid bills being built up by some suppliers was a significant risk to the market and our customers, we submitted letters to both BEIS and Ofgem[9] requesting that "…*A change in legislation to enforce more frequent payments for the Renewables Obligation (RO) and other schemes should now be seriously considered. We ask Ofgem to request this action of the new Government as a priority".*

6. Warnings about two of the key requirements of a more prudential style of regulation have therefore been considered by Government and regulator since at least 2018. However, Ofgem subsequently abandoned initial plans that suppliers must protect at least 50% of their customer credit balances and 50% of government scheme costs due to push back from other suppliers in the industry. In 2021, proposals to ensure credit balances were refunded annually and protected over a certain threshold were consulted on but, again, these proposals were received poorly by new energy suppliers and Ofgem again abandoned their implementation. Had these measures been implemented sooner, we may not have seen either the large number of consumers being directly impacted by failed suppliers or the high cost of mutualisation that all consumers are now facing as a result.

7. Citizens Advice's recent report[10] was damning of regulation in the sector over recent years: *"Ofgem allowed unfit and unsustainable energy companies to trade with little penalty. Despite knowing about widespread problems in the market, it failed to take meaningful action".*

8. The failure of suppliers, both old and new and small and large, as we now know, comes with a substantial cost to customers and taxpayers. The clean-up bill for this winter's crisis in energy retail could easily exceed £5 billion[11] and add more than £100 to household energy bills at a time when global energy prices are already increasing energy bills to unprecedented levels. This huge cost of failure will either be borne by the customers of well managed companies or taxpayers, with investors of failed companies often bearing little or no consequence - particularly under the SoLR regime.

9. E.ON remain convinced that a market approach to retail energy supply is the best way to produce the innovation and investment needed to ensure customers can receive products and services they want at a price that is fair. A market approach is also the most effective way to create the most cost-efficient energy system, ultimately ensuring that costs are kept as low as possible for all customers as we invest for the future and complete the transition to a zero-carbon electricity market by 2035 and a net zero economy by 2050.

10. In particular, E.ON believes that maintaining the UK's commitment to reach net zero emissions by 2050 is the correct course of action and E.ON is committed to Science Based Targets under the 'Race to Zero' commitment. Energy retail companies like E.ON, with sufficient scale and scope, will be vital in the next ten years to deliver the new products and services that households and businesses will need to effectively change their behaviour and radically lower their emissions.

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[9] E.ON letters to BEIS and Ofgem [19/12/19]
[10] CA 'Market Meltdown' ibid
[11] Citizens Advice estimate cost of failures since Sept 2021 is £2.6 billion. Add £1.7 billion HMG set aside to allow Bulb to continue to operate until February 2022.

11. Immediate and sustained action is required by Government and Ofgem to rectify the catastrophic failure of policy and regulation that led to the current crisis in energy retail and make the sector investible again. Ofgem should learn from recent supplier failures and ensure it proactively makes use of the tools and powers already available to it. Furthermore, new policy and new attitudes are required across Government, regulator and industry to swiftly deliver a new policy and regulatory framework that focusses on creating attractive market conditions that allow prudent, sustainable and innovative energy retailers to thrive and grow. Achieving net zero emissions for the entire UK economy must be at its heart.

12. Firstly, lessons must be learnt from the banking crisis. Prudential style regulation of commercial entities involved in the energy retail sector must be put in place urgently. Government and Regulator must move quickly to fix the most obvious flaws in the regulatory structure of the retail market, to prevent a recurrence of this crisis. E.ON fully supports proposals to:

    12.1.1. **Reform the supplier failure process**: there is a clear need to rebalance the cost of failure between customers and investors and enable better scrutiny of business plans by the capital markets.

    12.1.2. **Deliver prudential style regulation of energy suppliers**: through stricter tests for new entrants, robust financial stress testing for all players and strengthening existing regulations including more rigorous assessments of increasing customer numbers and enhanced monitoring;

    12.1.3. **Prohibit the misuse of customer money as working capital**: via ring-fencing customer credit balances and introducing ringfencing or more frequent payment of industry costs (such as RO payments).

    12.1.4. **Remove market distortions**: deliver in 2022 the legislative powers needed to end small supplier exemptions (and other similar advantages previously given to new entrants to the supply market).

    12.1.5. **Address free riding risks**: in order to ensure that there is no “free-riding” whilst market flaws are addressed, currently unused supply licences that free-riders may be able to take advantage of should be revoked.

13. Secondly, **the supplier failure regime must be rapidly overhauled**. Unlike typical administration processes for failed companies outside of the energy sector, the SoLR process effectively guarantees that 100% of any creditors’ investment is repaid by mutualising costs over the remaining market (i.e. the customers of more prudent supply companies). This has two key impacts on the effective running of the energy retail market.

    13.1.1. The cost of failure is mutualised, with remaining suppliers and their customers picking up those costs instead of investors as would be the case in other markets. This incentivises new entrants to gamble with customers’ money, knowing that if they fail, customers are providing them with free insurance.

    13.1.2. Critically, this may mean investors may not properly scrutinise their investments in the energy retail sector, as failure is less of an impact in energy retail than in other markets, meaning that new energy supply companies are not subject to the kind of capital market scrutiny of their management and business plans that should be expected in a well-run market.

14. **Ofgem must progress its plans to require suppliers to ringfence customer credit balances and RO receipts urgently. These two sources of free insurance under the current regime are the primary driver of the reckless risk taking we have seen in the recent past which has driven significant costs (up to £5bn – see above). The cost of taking this action is often grossly over-stated, and the benefits significantly understated.**

    14.1. In its recent report[12] published alongside Ofgem's consultation, NERA calculated the cost to suppliers of insuring customer credit balances and RO receipts as £1.80 per customer (on the assumption that suppliers' credit ratings fall to reflect the lower risks in their business given they can no longer gamble with their customers' money). Even where certain suppliers' credit ratings only fall to a limited extent, NERA estimates the average insurance cost across all customers at £3.10 per customer.

    14.2. The benefits of ringfencing credit balances and RO receipts are much broader than simply having funds to pay this money back to customers of failed suppliers. The proposals encourage less extreme risk taking and more sustainable business models, so the benefit is in reducing the overall cost of failure (i.e. the full £5bn we have seen in recent months), a large part of which is hedging costs. NERA estimates this value at over £20 per customer.

15. Reform of the SoLR process should ensure that investors effectively scrutinise business plans and help provide confidence to the market over the enduring viability of organisations. It will also reassure customers that future propositions in the market are financially viable and sustainable, helping to support healthy retail competition and attract investment and innovation.

16. Thirdly, **we should initiate longer-term reform of the retail market design**. We agree that there may be a need for a form of enduring price protection for customers, but it is also important that the design of such protection does not inhibit the necessary retail innovation required for the energy transition to net zero. Flaws in the existing price cap methodology must be understood alongside a recognition that there is no perfect answer when addressing them.

17. Flexibility in any new legislation extending the default tariff cap beyond its current sunset date in order to allow Government and/or Ofgem the ability to adapt and evolve price protection mechanisms is vital. The current legislation handcuffs the regulator in practice and does not result in the best outcomes for either customers or the market.

18. E.ON notes that under the SOLR regime too much of the cost of supplier failure is borne by customers and too little by investors. NERA recently[13] neatly summed up the current situation: "*The current arrangements around supplier exit privatise the benefits of success and socialise the costs of*

[12] https://www.ofgem.gov.uk/sites/default/files/2022-06/Proposed%20Reforms%20on%20Protecting%20Credit%20Balances%20and%20Renewables%20Obligations%20%20Evaluating%20Cost%20and%20Benefits%20%285%29.pdf

[13] NERA 211216 GB Energy Retail - Moral Hazard and the Illusion of Competition: ibid

failure. It is therefore not a coincidence that suppliers have been failing and imposing costs on consumers."

19. Rectifying the balance of these risks is vital to the proper running of this market. Without change to the supplier failure process, reforms to the normal running of the retail market will be undermined as investors do not need to properly scrutinise the business plans of suppliers in which they invest, which will drive further reckless risk-taking. There is a role for BEIS to drive this work across sectors to deliver the right outcomes, noting that much of the failure process is influenced by general insolvency law rather than specific energy regulation.

20. The role of the administrator in the SoLR process also needs reform. Administrators currently are only incentivised to obtain as much money as possible out of the process for their investors. There are no duties to customers or costs to the wider market. This needs to be addressed. For example, administrators under the SoLR regime should have obligations to transfer final credit balance data to the supplier of last resort before they can access funds to pay creditors / investors. Unfortunately, Ofgem has no authority over administrators but do over the SoLR regime via enforcement action and their supply licence. This imbalance is often exploited by administrators.

21. As an illustration of the difference in approach between SoLR and the Special Administration Regime (SAR) used with the largest failed supplier to date (Bulb), one of the creditors for Bulb has stated[14], "*…the decision to put Bulb into the SAR means that the Investment Adviser is not currently able with confidence to ascribe any value to the assets of Bulb over which it has security and accordingly it is currently assuming that these will have no value at all after repayment of the Government's capital. <u>The Investment Adviser notes that, had a Supplier of Last Resort process been adopted, it would have expected full repayment of its loan in a relatively timely manner."</u>*

22. The SoLR process must be reformed to at least a position similar to SAR. Under the current SoLR regime, customers are separated from the assets of the business and the costs of honouring credit balances and other costs must be borne by the new supplier, which are ultimately paid for by the entire market. In contrast, under SAR, the customers and assets remain with the firm, and its customers continue to have a claim on the assets of the business (e.g. credit balances and any in-the-money hedge contracts for wholesale costs). As a result, the SAR has the potential to reduce the costs socialised over the generality of customers and taxpayers.

July 2022

[14] Sequoia Economic Infrastructure Income Fund Ltd, Monthly Investor Report, 30 November 2021