

Introduction:

- We are writing to you in response to the BEIS Select Committee’s inquiry into “Energy pricing and the future of the Energy Market”.
- Policy Exchange is an independent, non-partisan educational charity seeking free market and localist solutions to public policy questions. Charity Registration Number: 1096300.
- Our submission draws on two of Policy Exchange’s recent reports:
 - **Beyond the Energy Crisis (December 2021)**, which argues for banking-style “stress tests” on energy suppliers and an increased focus on “smart electricity tariffs” to reduce energy bills and cut emissions.
 - Link: <https://policyexchange.org.uk/publication/beyond-the-energy-crisis/>
 - **Powering Net Zero (December 2020)**, which proposes “local electricity pricing” as the key to delivering a Net Zero energy system.
 - Link: <https://policyexchange.org.uk/publication/powering-net-zero/>

Summary:

- A well-functioning retail energy market is critical not just for customers, but also for the Government’s wider policy objectives including Net Zero and energy security.
- The current crisis could have been mitigated through stronger regulation of energy suppliers.
- However, the current crisis is primarily caused by a big increase in wholesale gas prices. Even if the Government had implemented different policies, this increase would still have created severe challenges for the energy sector and for customers.
- Coming out of the crisis, we need to learn lessons on the need for stronger financial regulation of energy suppliers.
- We also need to focus on longer-term reforms to promote domestic “flexibility”, which can reduce costs, cut carbon and enhance energy security. These reforms should focus on smart tariffs and implementing “local electricity pricing” in Great Britain’s wholesale electricity market.

Questions in the Committee’s Call for Evidence:

The regulatory requirements companies must meet in order to trade as a regulated entity in the retail energy market.

- Since August 2021, twenty-five energy suppliers have exited the market.¹ In addition, Great Britain’s seventh-biggest energy supplier, Bulb Energy, entered administration on 24th November 2021.²

¹ <https://www.ofgem.gov.uk/publications/check-whos-taken-over-your-energy-supply>

² <https://www.gov.uk/government/news/bulb-customers-protected-as-energy-provider-enters-special-administration>

- The main cause of these supplier failures is a rapid increase in wholesale gas and electricity prices as the global economy has emerged from the coronavirus pandemic. However, the current crisis has also exposed significant weaknesses in Ofgem’s regulation of energy suppliers’ finances.
- In 2019, to address known weaknesses in regulation, Ofgem tabled new proposals to “strengthen our regulatory regime, drive up standards among energy suppliers and minimise industry and consumer exposure to financial risks and poor customer service”. These new requirements came into place in the first quarter of 2021.³
- Given the number of suppliers that failed during 2021, these strengthened regulations were clearly insufficient. Ofgem has recognised this and, in December 2021, proposed new measures to reduce the risk of future failures.⁴
- As well as scrutinising new entrants, Ofgem must also strengthen its ongoing regulation of existing suppliers.
- New energy suppliers have injected much-needed competition and innovation into the retail energy market; this has the potential to reduce bills for customers. However, market failures during 2021 suggest that the balance had shifted too far towards promoting new entrants and smaller suppliers.
- Supplier failures have led to billions of pounds of that will be recovered from all customers’ energy bills, increasing bills further.

The mandate, role and performance of Ofgem in setting regulation and supervising regulated entities.

- Ofgem’s recent proposals (published in December 2021) are a step towards a more sophisticated system of prudential regulation, similar to the measures introduced in the banking sector following the 2008 Financial Crisis. These measures are a step in the right direction.
- There are questions for Ofgem to answer about why so many energy suppliers have gone bust. We think there are two areas that warrant particular scrutiny:
 - **Financial requirements:** The Government and Ofgem’s wanted more energy suppliers to enter the sector to promote competition and reduce bills. Questions:
 1. Why did Ofgem not introduce more stringent financial requirements on energy suppliers (both new and existing)?
 2. How did Ofgem ensure that promoting new entrants was balanced with its statutory requirement to protect the interests of consumers? (The cost of the current supplier failures will largely be borne by customers through the “industry levy”).
 - **Interaction between Ofgem’s regulations and the Energy Price Cap:** The Energy Price Cap, in place since January 2019, imposes significant restrictions on the prices that energy suppliers can charge their customers. If suppliers hedge in line with the

³ <https://www.ofgem.gov.uk/publications/decision-supplier-licensing-review-ongoing-requirements-and-exit-arrangements>

⁴ <https://www.ofgem.gov.uk/publications/building-energy-market-resilience>

cap, then they are more likely to be able to withstand the restrictions imposed by it. Unfortunately, many suppliers did not hedge sufficiently. Questions:

1. Did Ofgem appreciate that the price cap would impose restrictions on suppliers' ability to quickly pass-through increases in wholesale energy prices?
2. How did Ofgem adapt their regulations to take into account the Government's Energy Price Cap?

The performance of previous policies introduced to stimulate effective competition within the retail energy market, and an assessment of the impact on competition of proposed future regulatory frameworks.

- The Government and Ofgem have implemented a range of policies to promote competition.
- One of those is the exemption for small suppliers from policy obligations, namely the Warm Home Discount (WHD) and the Energy Company Obligation (ECO).
 - Today, suppliers with fewer than 150,000 customers are exempt from WHD and ECO. Suppliers with between 150,000 and 250,000 are partially exempt from participating in the WHD scheme.
 - Because smaller suppliers are exempt from these obligations, they have a cost advantage over larger suppliers – this cost advantage may be partially offset by the economies of scale achieved by larger suppliers.
 - This approach encourages new entrants and allows them to offer cheaper prices to their customers. This is contrary to the principle of a level playing field for all suppliers, and thus distorts competition.
 - In the Retail Energy Strategy (page 5), the Government states that it plans to address this market distortion by reforming the thresholds for ECO and WHD. In our view, these thresholds should be removed.
 - If WHD and ECO were applied to very small suppliers, they could still pay other suppliers or companies to administer these schemes on their behalf. Alternatively, very small suppliers could be permitted to pay into a central fund administered by Ofgem that would be distributed to the suppliers participating in WHD and ECO.

The functioning and performance of the 'energy price cap' and an assessment of its use in the future, and an assessment of the role of auto-switching.

Price Cap:

- Some legacy suppliers have cited the Energy Price Cap as putting downwards pressure on their profitability, implying that they would have charged higher prices if the cap was not in place.
- The cap has contributed to very low profitability amongst the large energy suppliers in general. According to Ofgem,⁵ the average pre-tax margin achieved by large legacy suppliers in 2020 was minus 1.32% for electricity and minus 0.44% for gas.

- Losses have increased during 2021 as wholesale gas and electricity prices increased rapidly. If these losses continue, then more suppliers may go bankrupt and/or exit the market voluntarily.
- Our main concern with the price cap is that it is inflexible and thus places a heavy financial burden on energy suppliers; arguably, the energy price cap has contributed to energy suppliers going bust. Because the cap is only updated every six months, it prevents energy suppliers from quickly passing through increases in underlying costs.
- If more suppliers had hedged in line with the cap, then more of them would have been able to withstand the increase in wholesale prices.
- Given the presence of the price cap, Ofgem should have ensured that suppliers were either hedging in-line with it or held sufficient collateral to withstand an increase in wholesale prices.
- In our recent report, *Beyond the Energy Crisis*, we argued that the Government and Ofgem should take a two-stage approach to the Energy Price Cap:
 - In the short-term, the Government and Ofgem should consider relatively minor changes to the price cap to reduce the financial burden on energy suppliers. This should include updating the cap more regularly.
 - In the medium term, the Government and Ofgem should make bigger changes to the price cap. These changes should make the price cap more flexible and reduce the financial burden that it places on energy suppliers.
 - In addition, bigger changes to the energy price cap are needed to ensure that the price cap works with smart tariffs (e.g. Time-of-use-Tariffs), which are important for Net Zero.
 - In the medium term, the Government should introduce either:
 1. A “relative price cap”, which would cap the difference between suppliers’ cheapest and most expensive tariffs. Policy Exchange argued for a relative price cap at the time that the Energy Price Cap was introduced.⁵
 2. A “social tariff”, which would cap energy prices only for vulnerable and low-income customers. The market for all other customers would be uncapped, which would rely on competition to keep prices low.
 - Our current view is that a “relative price cap” offers the best alternative to the current price cap because it ensures that both engaged and disengaged customers pay a similar amount for their energy, without relying on pricing restrictions that place a heavy financial burden on energy suppliers.
 - A relative price cap could also be designed to work with innovative “smart tariffs”, which will be needed for Net Zero.

Auto-switching:

⁵ <https://www.ofgem.gov.uk/publications/infographic-bills-prices-and-profits> (accessed 12 Jan 2021)

⁶ <https://policyexchange.org.uk/energy-price-cap-should-be-relative-not-absolute/>

- Commercial auto-switching services are an attractive proposition to some customers, who want to know that they are getting a good price but are not interested in researching the cheapest deals each year.
- However, one risk with auto-switching services is that they do not currently fall under Ofgem’s Supply Licence regime.
- We recommend the Government and Ofgem expand the licensing regime to include “third-party intermediaries” such as auto-switching services, price comparison website, aggregators and others.

Government proposals on switching:

- In the Retail Energy Strategy, the Government proposed “opt-in” and “opt-out” switching as a way promote competition and reduce energy bills.
- In our report, *Beyond the Energy Crisis*, we argued that these proposals were a major intervention in the energy market that could have unintended consequences. We therefore recommended that the Government pauses development of opt-in and opt-out switching, instead focusing on our ways to reduce bills.
- We are therefore pleased to see that the Government has paused development of opt-in and opt-out switching.

The future of Bulb and the recovery of public funds and the cost to consumers of other energy supplier failures.

- Given the coming increases in energy bills, there is a clear argument to delay the repayment of the SOLR levy, as proposed by Ofgem.

The role of retail market reform in the context of the UK’s net zero transition and domestic energy security requirements.

- Suppliers are the gateway for individuals engaging with the energy market.
- Therefore, the Government and Ofgem should ensure that regulations encourage suppliers to focus on offerings that will reduce bills, cut emissions, and enhance security of supply.

Why change is important:

- Today, domestic electricity demand is relatively inflexible, which means that there are relatively few customers increasing their demand to soak up excess wind and solar generation or conversely reducing demand at times of low supply. This is mainly because there are few incentives for customers to flex their demand for electricity.
- If the demand side does not become more flexible, then the Electricity System Operator will increasingly need to pay wind and solar farms to turn off during periods of high production, which would increase energy bills.
- Market conditions during the coronavirus lockdown in spring and summer 2020 showed warning signs that Great Britain’s electricity market is not prepared for a future with more

wind and solar. During lockdown, the market share of wind and solar rose due to lower electricity demand; this caused “system balancing costs” to rise significantly, as the ESO had to intervene in the electricity market to keep the system stable.⁷

- In many ways, the conditions during lockdown were a preview of the future electricity system. For more discussion of this topic, see Policy Exchange’s 2020 report, *Powering Net Zero*.⁸
- Domestic customers can make a substantial contribution to flexibility, for example through smart Electric Vehicle chargers and smart heat pumps.
- If customers use more of their electricity during off-peak periods, they can reduce the overall cost of operating the electricity system, as well as reducing emissions and reducing peak demand. Demand flexibility therefore contributes to reducing costs, cutting emissions and improving security of supply (all three parts of the “energy trilemma”).

What change could look like:

- We recommend that the Government should focus on “smart electricity tariffs”, which allow customers to reduce their energy bills by using more of their electricity during off-peak periods and/or periods of high wind and solar generation.
- We also recommend that the Government should introduce “local electricity pricing”, which would reward customers for using electricity when it is abundant in their local area.
- For example, drivers in Scotland could charge their electric vehicles cheaply when it is windy (as there are lots of wind farms in Scotland), whereas drivers in Cornwall could charge their electric vehicles cheaply when it is sunny (as there are lots of solar farms in Cornwall).

The comparison of UK wholesale prices and additional costs with the wholesale prices and additional costs across Europe.

- We note that the Government publishes data from National Statistics on the Gov.UK website here: <https://www.gov.uk/government/collections/quarterly-energy-prices#2021>

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⁷ <https://policyexchange.org.uk/electricity-markets-under-pressure/>

⁸ <https://policyexchange.org.uk/publication/powering-net-zero/>