The Energy Retail Market: Looking to the Future

What does the Energy White Paper mean for the future energy retail market? And, given our starting point, how can we best ensure an innovative and responsive market? Moving beyond such a focus on switching must be part of the answer

Introduction

What do we want from a future energy retail market? I would say that we want a market that delivers fair outcomes for customers, that protects customers who are in vulnerable situations, that helps us as a country deliver on our net zero ambitions through reducing energy waste and enabling customers to move to using lower carbon forms of energy and that does not leave customers behind. Also, that to achieve all this, the market must be a sustainable one. How do we achieve this?

The Energy White Paper

Those aims are pretty consistent with those set out in the "Consumers" chapter of the Government's much-anticipated Energy White Paper, CP 337 "Powering our Net Zero Future" (EWP), published in mid-December. The EWP looks for a fair deal for consumers, to protect the fuel poor and provide opportunities to make savings on energy bills (particularly around energy efficiency home upgrades, switching to clean energy and smart use of energy when it is cheapest), and for affordability and fairness, with confidence that everyone is paying their fair share of the costs of the transition.

In that context it is perhaps surprising that at least some of the EWP thinking appears to be concentrated on today's – or perhaps yesterday's – market, rather than tomorrow's. The focus on promoting switching and short-term relationships with suppliers ignores the fact that longer term relationships may be exactly what the future energy retail market requires. Engagement with the market is the aim but switching should not be a goal in itself. Where customers are aware that they can switch and the process is easily understood and achievable, it should rather be an outcome of those enabling circumstances, where a customer is able to engage and chooses to do so.

Would we choose to start from here? There is no reference in the EWP to the current state of the energy retail market.

Snapshot of a sustainable energy retail market?

Within a week of the EWP's appearance, Shell Energy Retail had posted losses of nearly £32m, referring to a "very difficult competitive environment" where it had had to sell at a loss to compete. Shell is not alone, the available data suggest you would have to look quite hard to find a supplier who is making money: Ofgem's Data Portal and the linked Consolidated Segmental Statements (CSS) for 2019 reveal negative pre-tax domestic supply margins for all but one of the ex-incumbent supply companies with an aggregate 2019 domestic supply margin of minus 1.48%. The 2020 CSSs published so far also show a similar picture. Companies House also shows losses in the latest available accounts for other significant players such as Ovo (to 31.12.2019), Bulb (to 31.03.2020) and Octopus (to 30.04.2019 – 2020 due but not yet available online).

Shell's announcement also referred to some 26 suppliers having shut over the last few years, leaving behind some £300m in debt. It is tricky to track the exact number of exits from the market - being a combination of supplier of last resort (SOLR), trade sale and withdrawal/wind-down exits – but a quick calculation suggests a number around at least mid-thirties in the last few years. That is in a market with 52 active licensed suppliers at Q4 2020 (according to Ofgem's Data Portal, Retail Highlights April 2021), before the two SOLRs in Q1 2021.

At the moment, it would be hard to describe this as a market that is operating sustainably. Whilst I'd accept that company failures are part of the normal operation of a market, I would also suggest that, at the scale indicated above, something is fairly awry. Mutualisation in the supply market means, of course, that those failures are underwritten by their surviving competitors. Even though customers are largely protected through the SOLR process, it does not make for a great customer experience – and imposes additional costs on the remaining suppliers.

The EWP talks about innovative tariffs and products that could contribute to net zero, examples being peer to peer trading, energy as a service and bundling of products. So, if you accept that a sustainable retail supply market is part of that successful transition, and that the relationships and engagement that energy supply companies have with their customers might lead them to be at least part of that offering, this seems an odd omission.

In a positive step forward, the EWP acknowledges and proposes to remove the long-standing market distortions caused by the customer number thresholds for the Energy Company Obligation and Warm Homes Discount. This will resolve the problem acknowledged in the joint BEIS/Ofgem Flexible and Responsive Energy Retail Markets (FRERM) consultation of July 2019, that only the customers of suppliers above the thresholds contribute to the recovery of the costs of either scheme and, the larger a supplier is, the more disproportionately their consumers contribute to the costs of delivering ECO. The FRERM acknowledged that, because those suppliers were competing for engaged customers with other suppliers facing lower or no obligation costs, competitive forces might incentivise the concentration of these costs in the prices paid by consumers who do not engage. Given the FRERM estimated those costs at some £41 per dual fuel customer, whether engaged or not engaged, this has a clear potential impact on price differentials – and will have contributed to any 'loyalty penalty' (discussed below).

The EWP does not deal with another distortion which the FRERM identified, namely the uneven distribution of higher cost-to-serve customers across suppliers in the market which, the FRERM suggested, could lead both to "cherry picking" of customers to avoid serving some types of customers and, in the same way as described above in relation to ECO and WHD, to higher prices being charged to less engaged consumers. This also needs to be addressed and we can hope that it might be picked up further in the proposed strategic dialogue to take place between Government, consumers and industry on affordability and fairness.

Switching

One area of the EWP that received a fair amount of speculative press coverage pre-publication was the proposals in respect of opt-in and opt-out switching frameworks, reflecting an aim to address barriers to consumer engagement and the current nature of default tariffs. This appears to be looking forward to a world without a price cap in place and is described as seeking to avoid the return of a loyalty penalty.

There are a number of comments to be made here. First, the EWP appears to suggest a loyalty penalty exists now. It states that almost all consumers know they can switch, but that many consumers remain on default tariffs, where they stay even though "significantly cheaper alternatives are available" and therefore that they pay a loyalty penalty, but that the price cap "currently limits the extent of the loyalty penalty". In fact, default tariffs are currently by definition fair prices, as they have been set by Ofgem on the basis of Ofgem's view of the costs faced by efficient suppliers in the market, assuming a certain hedging profile. There are lower prices in the market but, to the points raised above, are all of those lower prices sustainable? Do they all reflect prudent operating models and policies and are they accessible by all types of customer? Do they reflect the distortions in the market discussed above?

Secondly, any proposal like this *could* only work in a world where market distortions like those discussed above have been removed – or companies will not be able to compete on a level playing field for any customers put into the process. The EWP contains proposals to deal with one distortion recognised in the FRERM – we do not know what is proposed to be done about the other identified there but that should also be dealt with before moving to take any such step.

Thirdly, just because there is a difference between prices, it does not necessarily make that differential an unfair one. For example, is the ideal that there should be no reward for switching or that all customers should get that reward (if it then exists) if they opt into it or do not opt out of it? This appears to take quite a narrow view of the market - switching is not the only measure of healthy competition and engagement and customers who do not switch are not necessarily unfairly disadvantaged. The former CEO of Ofgem, before the BEIS Committee in January 2018, suggested that he would not expect to see exactly the same prices being paid by anyone and that £50 to £100 in the energy retail market might be a differential that is consistent with effective competition (though going on to comment that whether it was fair was a slightly different thing).

Fourthly, in the FRERM, it was suggested that Government would consider new intervention in the market "if" there was evidence that loyal customers were "likely to once again face unfair pricing strategies" –there cannot be any such evidence at this point in time, due to the existence of the price cap, as described above. The powers are very clearly there, in section 9 of the Domestic Gas and Electricity (Tariff Cap) Act 2018, if a review concludes that protection is needed.

Fifthly, and crucially in the context of the transition to net zero, will switching be such an important indicator of the competitive health of the market as it appears to be viewed to be today and will one-size-fits-all collective tariff switching schemes work in a world when tariffs are likely to be smarter and more personalised? How will such schemes work when there is a wider plurality of business models and where we may instead be focusing on deeper or broader relationships, in terms of other goods and services, that customers may take from that supplier? The EWP rightly focuses on developments that increase customers' engagement with energy. For example, a supplier may have invested in the customer's smart charging unit, or in an energy management system to enable the customer to benefit from using their energy more flexibly. Equally, an energy as a service proposition might require a longer-term relationship, with investment in energy efficiency measures to seek to reduce the customer's bills. These changes will present other consumer protection issues that will need to be addressed, including the risk of tying customers into disadvantageous long-term deals, which any moves to other methods of switching will also need to address.

Sixthly, around the practicalities – how and by whom will these opt in and out switching processes be organised, who will manage it all? Ofgem ran the trials referred to in the EWP – and it is fair to say that, even working with partners, this was quite an undertaking. If this is to be the future, and on a much greater scale, surely another body would have to take that over from Ofgem. Getting the governance around this right will be crucial if it is not to further erode trust in the market.

Finally, even if it is the wrong metric, it is interesting that Ofgem's State of the Market report 2019 (SOTM 2019) described energy switching levels as high compared to those in other utility sectors and retail energy markets around the world, and that its Consumer Survey 2019 found consumer confidence in engaging with the energy market stable, at around three-quarters of the market. So, does a customer stay with their supplier because they are disengaged or, as SOTM 2019 found in respect of 30% of non-switchers, just because they are satisfied with their supplier? What impact will the faster, more reliable switching programme have on this – one would expect that it would be a positive one, boosting switching still further.

Conclusion

I think we all want the energy retail market to be one that is sustainable, and innovative, where customers are able to, and do, engage with the market and where those who are in more vulnerable situations are protected. A market where suppliers and customers can work together to help deliver the country's net zero aims, people are not left behind and there is a fair and affordable transition.

Given the potential issues customers may face as we come out of the pandemic, there is a mountain to climb if we are to reconcile a dynamic and innovative energy market with the need for support for those struggling to pay their bills. The intensive focus on switching as a metric for the health of the market very much reflects today's market but, given the scale of the challenges faced and in the world we hope to move to, is this really where we should be focusing so much of our energies and attention?

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