

Ofgem

By email only: retailpriceregulation@ofgem.gov.uk;
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17th Jan 2022

Dear Sir/Madam,

RECCo response to consultations on interventions to address risks to consumers from market volatility

We welcome the opportunity to respond to the suite of consultations published on 15th December 2021 including:

- Statutory consultation on potential short-term interventions to address risks to consumers from market volatility
- Statutory Consultation on strengthening milestone assessments and additional reporting requirements
- Adapting the price cap methodology for resilience in volatile markets

This response represents the views of the Retail Energy Code Company (RECCo) and we are happy for this to be published on Ofgem's website.

About RECCo

RECCo was formed as the corporate vehicle for ensuring the proper, effective, and efficient implementation and ongoing management of Retail Energy Code (REC) and to promote innovation, competition, and positive customer outcomes. Part of RECCo's remit includes providing knowledge and expert opinion on retail energy issues to support the efficient and effective running of the retail energy market. RECCo is therefore providing this response in line with its mission statement and strategic aims.

RECCo response

RECCo welcomes Ofgem's thorough review of the default tariff cap and proposals for action to address some of the issues in the retail energy market. Whilst we note the range of proposed interventions, we are concerned that each set of proposals appears to be developed in isolation, with no obvious assessment of their mutual compatibility and/or cumulative effect. Before any decisions are taken by Ofgem it may be appropriate to holistically assess each proposals compatibility and avoid double counting of impacts. While we appreciate that Ofgem is working at pace, issuing several parallel consultations on the same subject immediately prior to and over the Christmas period will not have helped stakeholders form and provide a considered response.

We recognise that there is little, if anything, that Ofgem can do to mitigate the long-term impact of international determined wholesale process on the GB retail prices. Given that, we consider that the key issue for Ofgem is how to prevent those wholesale costs being compounded by matters that may reasonably be within its control. In particular, given that the consumer of failed suppliers have safety nets provided by the Supplier of Last Resort and Special Administration procedures, as well as credit balance protection, the focus should perhaps be on limiting the contagion caused by the mutualisation of failed suppliers' liabilities, any other consequential impacts upon their competitors and other market participants. The lessons learned from this current energy crisis must result in a more robust market design, where liabilities continue to rest with a Suppliers' investors rather than being passed through to its and other Suppliers' customers, and that those investors are able to earn an appropriate level of reward for taking on those risk. This doesn't currently appear to be the case.

In the absence of a clear roadmap to a better functioning market, we are concerned that some of the proposed interventions appear only to mitigate the unintended consequences of other policies. As such, they may have further consequences, such as hindering the sort of long-term transformation that the energy market needs to undertake in order to meet the challenge of net zero and better protect consumers from cost impact of increasing world demand for commodities such as natural gas.

We recognise that immediate and potentially short-term interventions may be appropriate to mitigate the impact of the current situation upon consumers, but these should be driven by clearly defined outcomes and an exit strategy. Although it is welcome that some of the proposed interventions are proposed to last for six months only, that is predicated on the efficacy of future reforms to the default tariff cap expected to take effect October 2022, and therefore not yet certain.

Originally intended to end in 2020, it now seems certain that the government will legislate for the default tariff cap to extend beyond the 2023 data allowed for in the Act,¹ and on the rationale of it insulating consumers from wholesale price volatility rather than its original intent of protecting disengaged consumers from the adverse effect of the loyalty penalty. However, we recognise that any decision on whether to retain the tariff cap is for government rather than Ofgem, and therefore welcome the current proposals to improve the efficacy of the policy while it remains in effect.

Even well-designed regulations can have unintended consequences if they are not adapted to changing circumstances. The default tariff cap is not sufficiently responsive to the cost drivers it seeks to reflect, and the unforeseen detrimental impact upon the retail market may now outweigh any benefit. For instance, the recently attributed benefit of shielding domestic consumers from the impacts of wholesale price increases is a temporary delaying effect only and comes at the expense of even steeper price rises when the cap is adjustment and huge financing cost to market participants.

While we recognise the further risk to market stability that could arise from future predatory and unsustainable pricing, the solution cannot be to prevent or disincentivise consumers from switching to lower tariffs if and when they again become available. We encourage Ofgem to explore further options which would strike a more appropriate balance between the financial stability of remaining domestic suppliers and the immediate as well as long-term interests of consumers. For instance, it may be possible to achieve the same intent by introducing a tariff collar to sit alongside the existing cap, or such other means of prohibiting below cost and unsustainable pricing. In the meantime, it is to be hoped that Ofgem and the government can find an appropriate solution to directly assist those consumers who can least afford to bear the consequences of wholesale price rises.

Closing remarks

We would welcome the opportunity to discuss our response with you. If you have any queries, please contact Jenny Smith in the first instance at: info@retailenergycode.co.uk.

Yours sincerely,

Jon Dixon

Director, Strategy and Development

¹ The Domestic Gas and Electricity (Tariff Cap) Act 2018

Appendix 1: Statutory consultation on potential short-term interventions to address risks to consumers from market volatility

Ofgem has proposed three separate temporary measures to improve the sustainability of domestic energy suppliers' business models and reduce market volatility; those are:

- 1) Requiring suppliers to make all new tariffs available to existing customers;
- 2) Allowing suppliers to charge exit fees on certain Standard Variable Tariffs; and
- 3) Requiring suppliers to pay a Market Stabilisation Charge when acquiring new customers.

Although only option 3 would have a direct impact upon RECCo, we comment on each of the options as they would have an effect on the wider REC objectives. Whilst we note that each of these options is intended only to be a temporary measure, once interventions have been implemented, they can endure beyond the timescale originally envisaged and/or for reasons which differ from the original policy intent.

Ofgem recognises that each of the proposals may have a diminution on competition, which it considers would be outweighed by the greater harm that may otherwise be caused by further supplier failures and market instability.

Option 1

While we consider that Option 1 has merit, we do not consider that it would wholly fulfil the stated rationale for the proposal or should be limited to being a temporary measure pending wider reform of the default tariff. Indeed, we consider that a requirement for suppliers to make all new tariffs available to existing customers could be a more effective remedy for the loyalty penalty, and is therefore an alternative to the default tariff cap.

In terms of the stated rationale, we recognise that the aim is to reduce the incentive for suppliers to offer significant tariffs reductions in order to acquire new customers, particularly if that involves pricing at unsustainable levels. We recognise that suppliers may be able to pursue aggressive growth strategies by undercutting competitors, while subsidising those offers from a relatively static portfolio of existing customers. However, the proposal would only require the supplier to make the new tariff available to the existing customer base, not to proactively switch them to it. Therefore, the risk to the supplier may still be limited, to the extent that those customers may be disengaged or otherwise disincentivised from initiating a change of tariff or change of supplier.

In order for the policy to be wholly effective, it may be necessary to introduce limited terms for standard variable tariffs, such that the supplier is required to offer existing customers their best rate periodically and for that tariff to be applied by default, even if the customer does not engage. While this would imply that only the proportion of customers whose tariff is up for renewal would be offered the new tariff - along with any newly acquired customers - this would offer greater stability and certainty to the supplier, allowing them to adopt a more robust and sustainable pricing strategy. It would also ensure that all customers will benefit from downward pressure on prices that effective competition should bring, but may have traditionally been realised only by those who actively switch. This may also have wider benefits in terms of strengthening the customers relationship with and level of trust of their supplier, which will be an increasingly important component of the transformation to a net-zero energy industry.

Such an approach would be closer to the model that has been adopted by the Financial Conduct Authority in relation to the insurance market. Another approach may be to allow differential pricing between new and existing customers, but to limit the extent of that differential. For instance, if new tariffs could be no more than a certain percentage lower than for existing customer, the supplier would be able to strike a more appropriate balance between acquisition and passing through cost-savings

and therefore mitigating the loyalty penalty. This may have a comparable effect as the proposed Option 1, but a potentially lower detrimental impact upon competition. We consider that it would be appropriate for Ofgem to conduct further assessment of the efficacy of these and other proposals, and of the experience of similar policies in other markets², as a potential remedy to the loyalty-penalty in its own right, rather than only as a short-term measure to disincentivise predatory pricing.

Option 2

We consider that it would be inappropriate to charge consumers exit fees to switch away from a Standard Variable Tariff (SVT). This would penalise consumers for exercising choice, and significantly undermine the flexible nature of an SVT with no additional reciprocal benefit. It is not clear that such an exit fee would currently be possible without further modifications to the supply licences and contractual terms and conditions, each of which are likely to require a lead time that would significantly eat into the temporary application envisaged for this policy.

We are also concerned that seeking to introduce such exit charges would be a confusing concept to consumers and perceived as unfair, further reducing whatever confidence many consumers may have in the energy market. Finally, we are concerned that there would be a negative distributional effect of the proposal, allowing some consumer to switch where they consider that saving on offer elsewhere would outweigh the exit fee, while foreclosing the opportunity to those consumers who could not afford to pay such a fee.

Option 3

We understand the exceptional circumstances caused by unprecedented wholesale gas prices and Ofgem's concern that a sudden fall in wholesale prices might expose suppliers who have over committed to expense forward gas contracts. However, we do not consider that it is appropriate to impose the financial consequences of an incumbent's past hedging decisions upon an incoming supplier that a consumer chooses to switch to. Whilst in principle a Market Stabilisation Charge may avoid some of the issues of a direct exit fee, its effect would be the same insofar as the incoming supplier who would be subject to the Charge would have to price that into the offer to the consumer, or otherwise seek to recover it from them at a later date.

Indeed the consequences may be worse insofar as those costs may not be apparent to either the supplier when it makes its offer or to the consumer when they make their choice of supplier. If calculated perfectly, the Market Stabilisation Charge should have the effect of switching being a zero-sum game for the consumer, whereby the Charge to the incoming supplier imposes an addition cost to them which would be equal to the incumbent's cost to serve them, though there would of course also be additional administrative costs. While the approach may appear to be simple to apply in theory, it is not clear to us how the Charge would be calculated or can be equitably applied to Suppliers in practice. We do not believe the administration of it would be trivial and we believe that any methodology or application of it, is likely to be disputed, further increasing the costs of administration.

Introducing such a 'balancing-up' charge subsequent to the decision to switch would be a price shock to the consumer which may prompt them to abandon the switch, or at best be further dissatisfied with their experience of the energy market. This would be particularly damaging if it is perceived by consumers as energy suppliers collectively acting to maintain high retail prices at a time when the media would no doubt be reporting on the dramatic fall in wholesale prices which Ofgem confirms

² This sort of approach is used in telecoms, where Ofcom's fairness for customers programme includes a requirement to 'warn customers between 10 and 40 days before their contract comes to an end. See: [Fairness for Customers - Ofcom](#)

would be a pre-condition of this policy being given effect. These negative perceptions and other distortions that the policy may have on the competitiveness of the market may endure long beyond the intended duration of the Market Stabilisation Charge and/or any systemic risk that it seeks to mitigate.

To the extent that the Market Stabilisation Charge does not wholly stymie switching activity and wholesale prices continue to fall, engaged consumers may seek to make further cost-savings by further switching to emerging new tariffs. The original incoming supplier may therefore be unable themselves to recover the cost of the Market Stabilisation Charge. In effect, the policy may therefore simply redistribute risks and cost rather than on the whole mitigate them.

We consider that Ofgem must continue to explore alternative remedies to mitigate any financial instability that a sudden fall in wholesale prices might cause to heavily committed incumbent suppliers, while not foreclosing the benefit of those wholesale price reductions being quickly passed through to consumers. Ofgem should also be cautious of inadvertently establishing a de facto standard for a hedging strategy, which insures incumbent suppliers against the downside of an overly cautious approach at the expense of their competitors and or consumers. Even in exceptional market circumstances, participants must appropriately be exposed to the risks and enjoy the rewards of their own commercial decisions.

To the extent that the market may appropriately require regulatory and/or governmental intervention to ensure short-term stability, we consider that there may be options to provide this underpinning whilst continuing to support rather than stymie or distort competition. In this respect there may be further lessons that can be taken from financial sector and its recover from the crisis of 2008.

Question 1: Have we correctly identified and assessed the risks to consumers from continued wholesale market volatility?

Ofgem have predominately identified the immediate price related impacts to consumers, including bearing the financial risk of Supplier exits via mutualised costs, and the costs of energy as an energy bill payer. However, the risks to consumers are wider than these immediate impacts.

Notably, trust and confidence in the energy market is a considerable risk which, if it materialises to a significant extent, can take a long time to resolve. The regulator has proposed a suite of interventions, the impact of which must be considered both individually and in the round. It is important to also consider the longer-term impacts on consumers.

Should consumers lose further trust in the market following interventions, this could be even more complex to resolve. As consumer trust and engagement decreases, there may be a reduction in appetite to commercially invest in the market. Investment, especially long-term investment, and disruptive innovative business models are both needed to support the transition to net-zero, in addition to offering customers more choice, generally putting downward pressure on prices, and increasing the quality of offerings. Removing this incentive indirectly by a reduction in consumer trust and engagement in the market could therefore affect the energy transition.

Considering the end-to-end consumer journey, alongside scenario-based analysis could help identify and assess the risks to consumers. It is not necessary the impact of the proposal(s) itself which could lead to a detrimental outcome, but rather what that proposal could lead to and behaviours it may drive.

Question 2: Do you believe that intervention is warranted in the interests of consumers?

For intervention to be justified, there must be a deep understanding and clarity about the scope of the intervention, its duration, criteria for exiting the intervention, and the impacts (and consequential impacts) of the intervention across all time frames. Although the consultation sets out a brief rationale

for each of the options, that rationale is focused primarily on the impact to incumbent suppliers of a rapid reduction in wholesale prices providing competitors opportunity to undercut them. Although Ofgem has recognised that the proposals would have a negative impact by dampening competition, there is very little assessment of the wider detrimental impacts to consumer confidence in the market if the result is wholesale price falls do not quickly translate into immediate reductions in retail tariffs. We are concerned that Ofgem is in effect not just determining a relatively static default tariff cap, but also a de facto standard approach to hedging, and insuring against that approach subsequently proving to be overly prudent and inefficient. We consider that this may set a dangerous precedent.

Appendix 2: Statutory Consultation on strengthening milestone assessments and additional reporting requirements

We agree that it is prudent for Ofgem to introduce additional reporting requirements for new and growing market participants. This should appropriately be considered as part of a package of measures, ensuring that the assessment offers meaningful insights, does not impose undue regulatory burden upon the targeted supplier, and that appropriate remedial actions are available to address any issues identified.

We note Ofgem currently thinks that it may take 30-60 days for it to complete a rigorous assessment, provide feedback and for any necessary action to be taken, and has invited comments on that timeline. While this appears to be a reasonable timeline, we consider that certainty of that timeline will be more important to the organisation being assessed and to the wider market, than the length of the timeline itself. This will be necessary for them to plan their own business activities accordingly, including communications to current and prospective consumers. We therefore consider that Ofgem should commit to a specific timeline, which it would be able to adhere to regardless of externalities, for instance the impact of two or three Suppliers reaching the relevant the milestones at the same time.

These commitments and the timeliness of Ofgem's assessment will be critical given the proposed cessation on new customer acquisitions while it is ongoing. This will not only be disruptive to the Supplier, but could impact upon consumers, third party intermediaries and other participants in the switching process. It will therefore be important that the start of the assessment can be notified in advance based on predicated growth rates, rather than triggered by the unpredictable timing of actually passing a prescribed milestone. This will allow for the process to be appropriately managed and coordinated, including effective communication explaining the reasons for the pause to consumers, rather than it potentially be perceived as an issue of concern which may unduly damage the supplier's brand. Such communications might appropriately be a joint effort, including Ofgem and PCWs rather than solely the Supplier in question.

While committing to specific and short assessment timescales may be a challenge for Ofgem, this is a good practice that other organisation adopt. For instance, the Competition and Markets Authority has a statutory timelines for the completion of an appeal on Ofgem's industry code decisions, which are a more varied and potentially more complex matter than the proposed assessments. Also, planning on the basis of expected growth rates rather than being tied explicitly to the threshold number should provide necessary flexibility.

The temporary pause to customer acquisitions should be capable of being delivered through existing code processes if appropriately codified. This should also allow for an overall quicker timetable than may be possible if Ofgem is required to issue provisional order etc, as may ordinarily be the case for a cessation to customer onboarding as a result of enforcement action. This may also complement the market entry conditions and reporting that are now applied under the REC as part of the performance assurance regime.

To support this, a growth plan could be submitted as part of the application for a Supply licence and the Supplier could give prior notice to Ofgem to ensure that the assessment could happen as predictably and forecasted as possible.

In general, determining whether the Supplier's growth plan will be successful should be a matter for the company in question and its investors, rather than for the regulator to assess. However, under the current market circumstances this appears to be a proportionate measure. We consider that the assessment could be principle-based, and potentially done in collaboration with an agency such as the Financial Conduct Authority (FCA) which has experience of applying stress tests in the financial sector. This might appropriately allow for the assignment of a risk category to the Suppliers' plans,

which may allow for the risk-based scheduling of any subsequent assessments, rather than solely the prescriptive and potentially arbitrary milestones proposed.

We consider that it would also be appropriate for Ofgem to develop mechanism to limit and reduce unsustainable Suppliers' portfolios to levels which the strength of their balance sheet would support. At present a Supplier has little control over the pace of growth of their portfolio, depending on consumer reaction to the strength of their offer relative to their competitors. The potential for collective switching further hinders their ability to adopt prudent and predictable growth strategies. We consider that Ofgem could appropriately amend the effect of Standard Condition 22³, with a view to allowing greater Supplier discretion over their pace of growth. This could be readily achieved through absolute but temporary cessation on new customer registrations and therefore avoid the risk of cherry-picking.

It may also be appropriate for Ofgem to pursue the requirement of a 'living will' for Supplier companies, requiring them to have in place an appropriate exit strategy, regardless of whether they have any current plans to do so. This could appropriately capture measure to mitigate the risk of future mutualisation. For instance, in addition to requiring that the Renewable Obligation is paid more frequently and therefore does not build up the shortfalls in contributions seen in the past, it may be appropriate to consider certain liabilities being held in escrow accounts accessibly only for that purpose. Similarly, it may be appropriate for Suppliers to be able to work with Ofgem to reduce their portfolio in a managed way rather than rely upon less predictable attrition through normal switching. This could for instance follow a process similar to that for Supplier of Last Resort, but not necessarily need to await the appointment of an administrator or transfer the portfolio in full. This would obviously be a last resort for a Supplier but may be an option to retain a viable if smaller going concern and avoid the mutualisation of its liabilities.

An effective competitive market requires that businesses can take risks and, if necessary, to fail. Ofgem should appropriately focus on limiting the impact of such failure on consumers and other market participants, rather than seeking to prescribe appropriate levels of risk. Any assessment of risk should also be sufficiently flexible to recognise the differing risks that may be associated with innovative and otherwise non-standard business models. Whilst we recognise a more a flexible and bespoke approach to the risk-assessment of certain business models would be needed to avoid undue discrimination and may require a greater tolerance of risk than those targeted towards the generic mass-market, this must be balanced against the wider consumer benefit that may also arise from such innovation.

³ SLC22: Duty to offer and supply under Domestic Supply Contract Licensee's obligations

Appendix 3: Adapting the price cap methodology for resilience in volatile markets

Question 1: what is your view on the nature and scale of the volume risk facing suppliers, and the case for changing the current price cap methodology?

Supplier and consumer interactions with the market shows that the current regulatory backdrop is not fit for purpose. From Ofgem's own data⁴, 27 Suppliers have exited the market in 2021, with 25 of them (93%) exiting in the last 5 months of the year, which is normally a peak switching time for consumers (especially November). Supplier exits are felt throughout the industry, particularly due to the mutualisation of cost arising from the Supplier of Last Resort (SoLR) process and covering any shortfalls in renewable obligation liabilities. In addition, Supplier exits during this time of normal peak switching activity impacts switching rates not only through less consumer choice, but also trust in the retail energy market. Consequently, switching over this period decreased, with electricity switches in October 2021 being 37% lower than October 2020, and gas 42% lower over the same period.

Given the facts regarding Supplier and consumer interactions in the retail energy market, experiences of Supplier exits and associated costs including mutualised costs, and the likely detrimental consequences of 'do nothing', the scale of the risk facing Suppliers is material and extremely detrimental to the retail energy market. In a competitive market, consumer protection partly relies on competitive pressures to increase quality and apply downward pressure to prices. The retail energy market regulation and therefore price cap must support consumer protection. The price cap methodology must be updated to help manage the risks faced by Suppliers, which directly impact consumer choice, and therefore consumer protection.

While this consultation focused on one discrete facet of the retail energy market – the price cap methodology – there are a raft of further issues that need consideration, including the requirement of a price cap. As RECCo stated in the response to Ofgem on the default tariff cap consultations on 17th Dec 2021, the original policy intention of the tariff cap was to protect disengaged consumers from the adverse effect of the so-called loyalty penalty, not to prevent Suppliers from being able to recover their efficiently incurred costs or to insulate all domestic consumers from fluctuations in wholesale prices. We recognise that any decision on whether to retain the tariff cap is for government rather than Ofgem. However, while the cap is in place, it must better reflect actual costs faced by Suppliers.

Question 2: what is the best way to tackle this issue whilst protecting consumer interests?

Protecting consumer interests in a competitive market relies on creating the conditions such that competitive pressures allow consumers to choose which Supplier(s) to contract with. The real threat of losing customers should have sufficiently negative consequences for Suppliers that they strive to retain customers through increasing quality and innovative offerings, and/or reducing prices. This should create a competitive tension between Suppliers and protect consumers by offering choice. The retail energy market is clearly not operating in this manner currently, partly due to wholesale costs which makes customer acquisition extremely risky and creates uncertain trading conditions for Suppliers, which impacts investor confidence. This in turn, reduces consumers choice, reducing their bargaining power, meaning consumer protections are further reduced. To change this situation, the issue of wholesale costs must be addressed with the aim of ultimately increasing consumer choice and therefore protection.

It must also be noted that, should the tariff cap endure, it will be appropriate to consider the impact it may have on wider issues, such as the funding models for decarbonisation and other innovations. In the longer term, consumers may come to see energy as a service rather than as a commodity product. It will be important, then, to ensure that the tariff cap does not hinder the early adoption of

⁴ <https://www.ofgem.gov.uk/retail-market-indicators>

such services, particularly as they are likely to be associated with flexibility services and other innovations that are required to facilitate net-zero and the more immediate carbon reductions by 2030.

Taken together, current challenges around providing the conditions for consumer choice and managing mutualised costs borne from Supplier exits (which consumers ultimately pay), balanced with the design of the future market we need to help achieve climate related ambitions, requires a holistic and joined-up approach. Any amendments to the price cap, including those proposed for the wholesale price adjustments, must be assessed in a holistic and longer-term manner to reduce the risk of adverse consequences.

To do this, we suggest using several techniques. For example, viewing the same policy development through various consumer and/or user 'stories' could support the analysis to ensure that current and future needs across multiple existing and potential stakeholders are considered. The business models which have got us to where we are today, may not be the same business models needed to help launch us to where we need to be in the future. Designing around these complexities through use cases/stories and tracking various consumer journeys (noting that consumers may become even more diverse as technology advances) through the designs could support consumer protections. It could identify different ways of achieving the same outcome while ensuring all consumers have choice, commercial entities gain confidence to invest, and the market can develop to achieve the ambitions we have set out to achieve.

In terms of the wholesale component of the price cap, approaching this challenge with the same level of assessment while simultaneously keeping focus on the future design implications, could help ensure that any solution implemented is aligned to the wider longer-term ambitions, in addition to resolving the issue at hand and supporting the increase of consumer protection.

Question 3: which adaptations to the price cap are preferred and why, including any additional options not set out in this paper? (Please provide an outline description of how any alternatives would work)

RECCo welcomes the proposal for the ability to change the default tariff cap within the 6-month window. We consider that the default tariff cap should be revised at least quarterly, and/or provide for a dynamic variable of wholesale costs.

Increased frequency of reviews is fundamental to a more effective tariff cap and as a minimum this should be undertaken at least quarterly. Indeed, we see no reason why the energy component of the price cap should not be updated on at least a monthly basis. Ofgem should consider interim revisions when prevailing costs are known to fall outside reasonable tolerances for its assumptions, rather than simply as an option under exceptional circumstances set out in the proposal. This may be an effective alternative to increasing the margin of uncertainty to a higher rate than the current 1%, which will have the effect of increasing cost regardless of the extent of prevailing uncertainty. Transparency of such tolerances would provide greater clarity of when interim revisions may arise, negating the uncertainty that might otherwise exist while Ofgem deliberates whether an exceptional circumstance has arisen and what to do about it. This could be seen as a hybrid version of Ofgem's proposed Option 1 and Option 2.