

Ofgem's supply model is broken

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The collapse of half the energy suppliers, and the spectacular implosion of Bulb, has been at the great expense of consumers and taxpayers. It is also a spectacular example of regulatory failure. Apart for the failures of the Financial Services Authority (FSA) to regulate the banks properly in the run-up to the great financial crash in 2007/08, it is out there on its own. No heads have rolled as a cost of perhaps £200 has been imposed on every household.

You might think that such a failure would lead to a fundamental rethink of the Ofgem – and government – model for supply and supply competition; that Ofgem would go back to fundamentals and ask some profound questions about the design of the supply market. But not a bit of it: Ofgem is doubling down on the model that it (and its predecessors Offer and Ofgas) have been pursuing since the privatisation of gas in 1986 and electricity in 1990. The old mantra remains about “competition that leads to lower prices, better customer service, and the innovations we need to make the transition to net zero”; except that it has resulted in this crisis.

Competition about what? Competition for whose benefit? Competition that led to the extraordinary abuse which Ofgem failed to keep a lid on, and that resulted in the price cap? Competition that has led to all these suppliers going bust? What about the costs of competition as well as the benefits? These are the fundamental questions that Ofgem should be addressing, and which its latest (and almost certainly not the last) set of interventions should be addressing.

What is supply?

The most important point to make, and which should be obvious, is that much of what suppliers do is a pretty basic utility service: they collect monies, having billed and metered their customers. These “services” are increasingly about cost pass-throughs, collecting the monies for the use of the system, the contracts for differences (CfDs), the

Renewables Obligation, and the transmission and distribution network services over which the suppliers have no control. They are also in the debt-collection business, often outsourced to the less savoury world of bailiffs and enforcers, who offer little that could be called “better customer services”.

The original supply model, much associated with Stephen Littlechild, had the merit of coherence. In this model, electricity and gas were just commodities like any other, and the job of privatisation was to get the state out, to liberalise and promote competition. The suppliers would, in effect, be agents of customers, shopping around for the best deals directly from generators. The generators would in turn compete in real time in the wholesale spot markets.

The vital link in this model was between suppliers and generators. It broke down, most notably with the Energy Market Reform, introduced by Ed Miliband at the start of the last decade. Instead of suppliers shopping around amongst the generators, the state has become the *central purchaser* of almost all new generation. Generators now compete for contracts *from government*, and these costs are then passed through to final customers via the suppliers. The result is that there is almost no competition between generators seeking out suppliers, but rather a cost pass-through. These costs are *collected* by the suppliers, and their main job is therefore the billing, metering and debt collection.

At no point in its recent interventions does Ofgem acknowledge this huge hole blown in the Littlechild model. Instead, Ofgem focuses on a separate issue. For Ofgem, the supply model is all about the transition to net zero and new “innovations” it sees coming thick and fast, about electric car-charging, special tariffs, and tariffs designed to help balance the system. All impartial of course, but all separate and distinct activities.

Crucially, Ofgem continues to allow the suppliers to hang on to customers’ money – and not to ring-fence customer credit balances. These instead can, for Ofgem, be used as working capital and to fund innovation. Let’s come back to the idea that your money, paid in advance, should be at the service of your supplier, and indeed the very idea that you should be paying in advance, and turn a critical eye on the services model of supply.

Meters should be in distribution not supply

Billing, metering and debt collection are distinct and separate activities. At the core is the metering. Almost every other country in Europe rightly puts the meters in distribution, as part of the core network services. But in the UK meters were deliberately split out of distribution in the UK at the behest of a very powerful group of incumbents and their lobbyists. It was – and still is – a fundamental mistake. What these incumbents wanted was to capture the customers, so they could sell on their various gas boiler and household services. They wanted to bundle, and if they had the customers' meters, then all the easier to sell these bundled services, and especially in the context that most customers were not interested in switching.

Better still for the incumbents, what if, when the requirement for smart metering came along, in the hands of the suppliers, the smart meters went dumb if the customer switched to another supplier? There would be even less reason to switch, and more hassle too. The roll-out of smart metering has been another great government and regulatory failure: late, more costly, and with thousands of SMETS1 meters that went dumb on switching and have now had to be upgraded.

Think what would have happened if the meters had stayed in distribution. Like much of Europe, the meters could have been fitted on a street-by-street basis, instead of only when specific customers requested and agreed to having a smart meter installed. Instead of my village being “done” in one go, it has been a patchwork of specific fitting, with the separate costs of the team doing the work. It is hard to think how it could have been made more costly than this. Yet Offer and then Ofgem thought this would be a good idea.

Think next about the implications for competition of a supplier-driven smart meter programme. Instead of the smart meter providing an independent and separate exogenous data point so that lots of energy service companies could compete to offer their services to the customers, the meter and the incumbent supplier go together. In a competitive market, there would be all sorts of businesses offering specialist services, from car-charging to balancing tariffs. With independent access to the smart meters via the distribution companies, they could deliver all sorts of innovations. But if it is a question of “sign up for supply to company X, and then company X bundles a series of

services together”, innovation is actually likely to be lower. Not surprisingly, this is what has happened. Far from encouraging innovation, the Ofgem model has inhibited it, and there is no evidence that the supplier model has been superior to the European models with meters in distribution.

The incumbent suppliers will no doubt say that there are a host of problems that limit access to data. This may indeed be the case, but then they need to explain how this works much better across Europe where the meters are in the hands of the distribution business. These are not insuperable barriers if the political and regulatory world is there to address them, as it should be with only 13 years left to reach the 2030 net zero target for the power sector.

Getting customers to pay in advance to fund innovation

Your money paid in advance is not a good way to promote innovation. The Ofgem argument is that this is all about striking “the right balance between resilience and competition”. It is not clear what exactly Ofgem means by this, though it is its central point right up front in its new proposals. “Resilience” might mean “supplier resilience” – i.e. to make sure more suppliers don’t go bust. If this is what Ofgem has in mind, then the whole sector is on very shaky ground. It would mean that suppliers need you and me to pay in advance so that they have working capital. Ridiculously this is then justified as following the “banking regulation model”. Since when is the business of billing, and metering and debt collection like banking? Why do you have to lend money to suppliers to keep their businesses afloat?

As to the balance between this resilience and “competition”, presumably this is still all about getting more small suppliers to enter the market. Perhaps Ofgem thinks that there are such advantages to new businesses with better billing, metering and more robust (some might say brutal) debt-collection enforcement?

Ofgem’s enthusiasm to tax customers to pay for innovation has a longer history. Ofgem started the process of awarding extra money to regulated businesses, notably distributors, by auctioning funds to bidders for it. Quite why an economic regulator – rather than the government – should decide how much and how to tax customers to pay for innovation is an interesting point. Perhaps it reflects the Treasury’s

(understandable) preference to unload all and every cost from taxpayers to customers. But that spending should be at the decision of elected governments, not regulators.

Spot wholesale markets and the absence of long-term contracts

The reason why the UK is suffering so badly as a result of the developments in the gas markets of Europe is not because it imports lots of gas from Russia. It is because it relies overwhelmingly on spot purchases. Indeed Ofgas and then Ofgem deliberately set about destroying the old long-term contracts between British Gas and the North Sea gas producers in the late 1990s, when it was very opportune to do so, as spot prices fell. The UK government helped to persuade Europe to follow a similar spot market model in the EU's Internal Energy Market.

When spot prices are falling, this is pretty attractive. But it never seems to have occurred to governments and Ofgem that spot prices might *rise*, as they have now done, and that without any long-term contracts or any serious storage, rising spot prices exposed customers to shocks they might not want nor indeed be able to weather, and that it might bring down the pack of unhedged suppliers.

That is what has happened. It was probably inevitable at some stage. But suppose for a moment there were suppliers who worried about rising spot prices. How could they compete against the spot market supplier model? What happened was the new entrants drove all the incumbents to spot pricing in order to hang on to customers. The consequences were inevitable: a rise in the spot price created havoc and left customers very exposed.

Customers don't necessarily actually want spot pricing

In all this, little thought was (and is) given to what customers actually want. In a spot world, consumers without deep pockets are very exposed, as we have seen – indeed, so exposed that the government has had to intervene to fix prices and underwrite the resulting losses on a scale which starts to match the total education budget (!). It has been enormously expensive.

It never seems to have crossed the minds in Ofgem and the government that customers might like their own long-term contracts – with prices changing, say, every year. The

riposte might be “there is no barrier to suppliers offering such contracts.” But there is, because of the structure of the market that has been deliberately engineered towards spot pricing. The proof is, as they say, in the pudding – no one has.

Much worse, Ofgem, in its pursuit of “resilience” for the suppliers, has shortened the price cap period from six months to three. Prices can now change every 12 weeks. From a customer perspective it looks like a path back to spot prices and the instability and insecurity that brings. Why would any supplier go long on contracts, given that it can pass any wholesale price charges on, and customers can be captured if and when spot prices fall? This is another serious mistake.

Imagine instead starting the other way around. Start with what customers might actually want. Start with *customer* resilience. Start with a one-year price cap. That would force the suppliers to hedge properly, and in turn to look for long-term contracts from generators and gas producers.

This is not as difficult as some suppliers – and Ofgem – make out. As more and more of the electricity generation is close to zero marginal cost, there is no change in its costs relative to the spot market. The costs of wind, solar and nuclear generation do not change when the gas price goes up. Furthermore, most are increasingly on fixed-price contracts via the CfDs. A zero-marginal-cost wind turbine or a solar panel is more like a utility than a spot market company. The government commits the customers to these longer-term contracts. The supply price cap should reflect this, and not be so driven by the wholesale price forecasts.

For the gas, the conventional model was for gas producers to seek long-term contracts to offset their sunk and fixed capital development costs. That is how the North Sea gas industry was able to develop so fast and effectively in the 1980s. If the UK government wants to let more licences in the North Sea for gas developments, then a condition might be that the licence requires longer-term contracts. This would have the additional advantages of lowering the cost of capital in a world of rising interest rates. It is what British Gas originally did.

Social tariffs

All of the above disasters could have been avoided if Ofgem and the successive governments had not been obsessed with a spot market-driven commodity vision of energy markets and what they thought would be good for customers. But there is one more twist: the very idea that the energy markets are just consumer commodity markets like any others, from carrots to chocolates and cars.

The point that needs to be made loud and clear is that energy, like transport, broadband and water, is a *fundamental social primary good*, which each citizen needs in order to participate in society and every business needs in order to participate in the economy. Energy is special, and to be a citizen is pretty difficult without it. The state has a duty to ensure the supply of electricity, and, as it has recognised with the price guarantees and its massive interventions in 2022, to ensure too that citizens can afford it.

Citizens are provided with health and education independently of the ability to pay. Water customers cannot be cut off. The government is subsidising the roll-out of broadband (and insisting on access to ensure that the basic social services are provided). The government greatly subsidises transport especially for old and vulnerable groups. These are all things that a decent society does, and in the transition to net zero with all its costs, taking citizens along will be a necessary condition.

In the old, much despised, nationalised industries, this was much easier to manage because they were statutory monopolies. There were widespread subsidies to the specific classes of customers. Achieving these citizen provisions in a privatised, liberalised and competitive world is different and requires careful regulation. The good news is that since so many of the costs are now fixed and not subject to competition (distribution, transmission, CfDs and renewable energy), there are quite a lot of options to address the unavoidable distributional issues. Whilst Offer and especially Ofgas thought that social issues were matters for social security which the government should fix, and all customers should brace themselves for their full energy costs, in a world of significant fixed cost pass-through, there is no right answer to who should pay what proportion of these fixed costs.

Economists often make this a lot worse by appealing to the Ramsey rule – that the costs should be recovered inversely to their demand elasticities. That would produce some distributionally horrible results, although arguably that was indeed what happened as savvy switchers benefited at the cost of those non-switchers who were less savvy and often poorer.

A social tariff provides a basic entitlement. It is not the “full costs” (otherwise there would be no need for a social tariff). The costs of the social tariff are recovered from others. It can be means-tested; or it can be a universal entitlement.

What Ofgem should be doing

The supply model that Ofgem has been advocating is bust. It will be made worse by continuing to fail to properly ring-fence customers’ monies and by pushing the price cap back towards a spot-based one (with revisions every 12 weeks). These steps may help to keep suppliers afloat, but the suppliers exist to serve us, not the other way around. We should not be lending them their working capital and taking on quasi-spot contracts to reduce their exposure to the spot markets, upon which too many of them have been based.

The way forward is pretty simple. The supply market should be separated from the energy services market. The former is about billing, metering and debt collection, and this should be a very low-margin service. The smart meters should go back to distribution, as they are almost everywhere else. Energy services businesses should compete to provide energy services, not billing and debt collection. Access to the smart meter data is the key to these great opportunities. The supply price cap period should be lengthened to one year. The price cap should be based upon the generation costs and not purely the wholesale price, and in particular should reflect the fixed costs of wind, solar and nuclear. In this world there is no need for windfall taxes, as the electricity market shifts increasingly to a capacity-based utility-style model. There should be an allocation of the system fixed costs between the customers to meet the requirements of a social tariff.

Do this, and then we can get on with the great task of a transition to net zero with some confidence. With just 13 years to go to the 2035 target, and with 27 years to net zero in

2050, there is no time to lose. We need a system plan, system architecture, and a proper system regulator, maximising competition through auctions of contracts. That and much of the above was all set out in the *Cost of Energy Review*.¹



[Net Zero: How we stop causing climate change](#)

Paperback published Sept 2021 (William Collins).

¹ Helm, D. (2017), "[Cost of Energy Review](#)", 25th October.