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Supporting retail innovation: Policy consultation on ability to provide derogations from certain standard licence conditions; and, granting supply licences for specific geographic areas or premises types

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Dear Rob,

We welcome the opportunity to respond to this consultation seeking views on proposed changes to supply licence conditions relating to both providing derogations from certain supplier obligations and Ofgem's approach to granting supply licences for specific geographic areas and for premises types.

Fundamental drivers such as decarbonisation, decentralisation and digitalisation - enabled by regulatory reforms such as market-wide half-hourly settlement and programmes like the smart meter roll-out - are set to enable new business models and consumer propositions that can deliver significant benefits to consumers. We are strongly supportive of efforts to enable innovation where it can achieve positive outcomes for consumers.

Patron HRH The Princess Royal **Chief Executive Dame Gillian Guy**

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However, reforms to enable more innovation must necessarily be balanced against whether well-established protections risk being eroded and where the ultimate net benefit to consumers lies.

There are also central questions to be answered as to the distributive effects of any intervention and the extent to which changes will benefit one section of the retail market and certain groups of customers while risking leaving others behind. This is particularly pertinent where a consumer's characteristics mean they have faced higher barriers to accessing the current retail market. It is incumbent on all market participants that these barriers be minimised and accessibility encouraged in the future retail market. We appreciate that Ofgem is also acutely aware of these issues with acknowledgement in the consultation document of *"the need to balance the potential tensions between the protections at the heart of these licence conditions with the benefits to consumers from enabling greater specialisation by suppliers."*

In our answers to the specific consultation questions, we look to recognise that balance, but also caution of the high evidence threshold of benefits to consumers needed to justify exemptions from important consumer protections and the need for appropriate safeguards. Where applicable, in considering these proposals we have assessed them against the framework of our Principles for a Future Market¹ that we developed following a 2 year programme of research in relation to the future energy market. The principles set out our vision for what a future energy market should look and feel like for energy consumers.

In order for all industry participants to have confidence in the process of granting derogations or limited licences, Ofgem should consult on a set of clear objective tests it will use for applications. If this is not possible, it should ensure the process provides opportunities to comment on individual applications. Once granted, there also needs to be careful monitoring to ensure that suppliers are not taking advantage of derogations to offer 'vanilla' products while avoiding costs associated with the rules they have derogated from.

As an advice provider, we also see it as vital that Ofgem develop clear, easily accessible information on the consumer impact of the derogations and limited licences that it grants, to enable the provision of high quality advice to consumers using these suppliers.

In general, we think the approach proposed in these reforms - building on the regulatory sandbox and alongside reform of other areas, like code governance - could provide more opportunity to develop new products and services. However, we do not think they can be a

¹ Citizens Advice (2020) [Setting out principles for a future energy market](#)

satisfactory end state and that over time they may give rise to issues, particularly in relation to derogations, which could create an increasingly uneven playing field for companies and consumers. Instead, the learnings from these reforms should inform decisions on more comprehensive and enduring reform of the market at a later stage.

Yours sincerely,

Tom Crisp

Senior Policy Researcher

Question 1. What benefits (including for consumers, decarbonisation and inclusivity) and risks do you envisage if Ofgem were to have the proposed ability to provide derogations from Standard Licence Conditions 22.3 and 27.1?

Before addressing the specific benefits and risks of the ability to provide derogations for SLC 22.3 and 27.1, there are a number of cross-cutting considerations.

There is a risk that when first introduced, early-adopters of the flexibility allowed in the new provisions would be more likely to have an application that had a limited impact on the market as a whole. However, as the scale of applications increased if there proved to be a competitive advantage from derogations, subsequent applications would face a higher barrier to entry, as their application would be balanced against the risk of a number of pre-existing derogations. This could lead to a two-tier market, with existing derogated incumbents able to benefit and new entrants less able to access derogations.

Once in place, any exemptions also create complexity from the perspective of our statutory provider of first-tier energy advice. Content such as advising on the availability of payment methods would either need to be caveated or explicitly restricted to the “non-derogated market”. This could create issues with our future energy market principle that all consumers have the advice and support to make the right decisions. There are also natural questions raised as to what the redress journey would look like for customers of suppliers benefiting from a derogation. Ombudsman Services: Energy may need to consider what this looks like if – for example - the SLC 0 fairness obligation comes into conflict with the derogation.

Another of our principles for the future energy market is that companies provide simple, transparent and comparable information. However, there may be issues if offers were created on a purely localised basis that there would not then be a commercial incentive for third-party intermediaries to offer comparison services for such a niche offer.

The timeframe of derogations are an important factor for Ofgem to consider. The longer the derogation, the more likely that issues of uneven competition arise and a two-tier market develops. However, if they are too time-limited, companies may be unwilling to invest in developing a new product or service. By their nature, some innovative products and services may require longer contracts to be viable, and removal of the derogation could be disruptive for people using the service. In practice – for example in derogations granted from communications rules – there have been extensions beyond the time limit originally planned.² In order to manage these risks Ofgem may need other controls, for example on the number of customers a supplier can take on, or strong alternative requirements on suppliers with derogations to pay towards these costs, or to mitigate the risk of them avoiding costs unfairly.

We do also recognise that given the high risk and complex nature of energy supply, allowing companies to launch into the market targeted narrowly at delivering an innovative service, rather than establishing a conventional supplier and then looking to specialise, does bring advantages. Regardless of the mitigations put in place by Ofgem, this seems unlikely to be possible without comprehensive, enduring reform.

Payment methods

The benefits of exemption from requirements under SLC 27.1 to offer the customer a wide choice of payment methods may centre on innovation to allow a more responsive form of payment in response to price signals – for example accruing credit where power has been sold back to the grid. This form of business model may be incompatible with more traditional methods of payment. Where the business model delivers payments to consumers for being more responsive, there is a clear benefit to those involved and the wider energy system by helping unlocking the nascent domestic flexibility market.

Given that compliance with, and enforcement of, protections on payment methods has been low in the past there may also be some benefits from consumers knowing more clearly what to expect from their supplier.³ It would be a better outcome for a consumer if they avoided a

² Ofgem [Decision Notices](#) on derogation applications show several extensions

³ Citizens Advice (2019) [Paying for energy with a prepayment meter still isn't working well enough](#)

patently unsuitable supplier that was transparently advertised as being suitable only for those favouring a certain method of payment, rather than joining a supplier that formally should be offering all payment types, but in practice are not.

In terms of risks though, this proposal does conflict with our principle that the future energy market should be inclusive by design. The 2019 independent Access to Cash Review found that 17% of the UK population – over 8 million adults – would struggle to cope in a cashless society.⁴ One in 10 users used cash to pay for household bills such as electricity, gas and water. As of March 2019 there were 4.3 million customers on prepayment meters, representing around 15% of all customers in GB⁵. Moves to reduce the number of energy supply offers a consumer can engage with regardless of preferred payment type could therefore affect a significant proportion of customers. There is also a risk of a fundamental competitive advantage being secured by suppliers benefiting from this exemption given the lower cost to serve of certain payment types.

Duty to supply

Regarding benefits to derogations from the Universal Service Obligation, our previous research⁶ has found a heightened willingness to engage with future retail business models when they are locally-focused. In deliberative workshops, consumers were introduced to the concepts of time-of-use tariffs, peer-to-peer trading and energy-as-a-service. Peer-to-peer trading was regarded as clearly the most popular model, with a key reason being the community element and the potential to retain value from any local asset such as solar generation. Targeted white-label propositions have to an extent tried to engender an element of local-focus and retained benefits, but if greater specialisation allowed for better targeting of such initiatives it could also boost the consumer acceptance of the move to net zero. However, we note that similar outcomes on local supply could be achieved through a locally-restricted licence.

Another potential benefit is the scope to create customer propositions that include bundling as an inherent part of the offer. As recognised in previous research for Citizens Advice, bundling can deliver consumers value for money by providing additional products and services at a lower price than accessing them separately; simplification and convenience by providing an integrated, one-stop-shop or deeply joined-up technology approaches; and tailoring via smart bundles that meet exact user lifestyle needs based on information the company has about the customer.⁷

⁴ Access to Cash Review (2019) [Final Report](#)

⁵ Ofgem (2019) [State of the Market 2019](#)

⁶ Citizens Advice (2020) [Future Energy Models](#)

⁷ Delta-ee (2019) [How accessible are future energy supply business models?](#)

However, such offers - while delivering consumer benefits - may not be suitable or desirable for all consumers, with sophisticated tailoring and a universal duty to supply risking being incompatible.

We would note that in relation to duty to supply that the current obligation does not guarantee that all consumers have equal access to the market. Suppliers can act to exclude certain types of meter/tariff types that are outside their target segment(s) by offering them uncompetitive prices. Suppliers also have broad scope to use marketing and acquisition strategies to build the customer base they desire. Given these flexibilities within the current arrangements, there would need to be clear grounds for further flexibility to develop something demonstrably innovative.

In terms of risks to removal of duty to supply, there is an issue as to how it is guaranteed that companies are paying a fair "social cost" - i.e. not simply avoiding higher cost to serve customers. Removing the duty to supply on some suppliers could increase the tendency to compete for a subset of consumers with attractive characteristics.

Allowing those consumers to be more effectively cherry-picked may improve the outcomes they receive at the cost of worse outcomes for those left behind. Hard to serve, or consumers in vulnerable circumstances, may face less choice, and face higher prices as a result, depending on the scale of the derogations offered. While an argument against the need for a duty to supply may be that consumers currently benefit from a competitive market where a large range of suppliers offer a wide array of cheap tariffs, accelerating consolidation means this choice cannot be taken as a guarantee into the medium term.

Question 2. Does the proposed additional licence drafting for Standard Licence Conditions 22.3 and 27.1 set out in Annex 2 achieve the stated aims?

Overall the proposed additional licence drafting in our view meets the required objectives. As we will expand on in response to Question 5, the reference to "consultation with the licensee and where appropriate any other person likely to be materially affected" could be drawn broader to include interested parties depending on the materiality of the change and subject to commercial confidentiality.

Question 3. Are there other Standard Licence Conditions which, in your view, would benefit from the inclusion of the ability to be derogated from? Please provide details and reasoning (including benefits for consumers, decarbonisation and inclusivity).

The question of which other Standard Licence Conditions act as inhibitors to innovation will naturally be most acutely felt by those active in the market looking to bring new business models forward.

Through engaging with smart energy market participants, we have some understanding that energy licence conditions (for example 22A.2 and 22A.3) requiring that all tariffs are displayed using a standing charge and unit rate could act as a barrier to innovation. For example, in an Energy as a Service model for providing heating, a household might purchase hours of heating a home at a specified temperature, plus the cost of a new energy system over the longer term. Or alternatively, an electric vehicle proposition may choose to express an offer in terms of including “free miles” alongside conventional energy supply. Both of these approaches may offer simplicity benefits to the consumer, but currently may not meet the licence conditions.

More broadly – while recognising this question has been looked at relatively recently through Ofgem’s domestic supplier-customer communications rulebook reforms – the extent to which prescriptive communications rules act as barriers to innovative approaches could merit further investigation. In research co-commissioned with Ofgem, the proportion of respondents dissatisfied with ease of understanding bills has remained consistently between 9-11% since Q4 2018.⁸ The percentage satisfied with ease of understanding is lower among the disabled and those with prepayment meters, therefore innovation could act to improve outcomes for those that currently experience worse outcomes in the energy market. We would not consider it desirable or necessary for suppliers to derogate from the principle-based parts of the communications rules.

Question 4. Are there any circumstances you can identify that a derogation under certain Standard Licence Conditions may be more or less appropriate or effective in enabling innovation, than granting a licence for specific geographic areas or premises types? Please provide reasons.

While not identifying the specific circumstances, a derogations-led approach has a flexibility compared to licensing that may offer Ofgem more tools to respond to changing circumstances or findings from any granted exemptions. In contrast, as recognised in the consultation, licensing is more fixed, with any change to – for example – the group of consumers being offered the product risking constituting a breach, or necessitating a further licence application. We think it is likely that companies with firmer plans to only sell products to a specific geography or premises

⁸ Accent (2020) [Consumer Perceptions of the Energy Market – April 2020](#)

type may be more likely to seek a restricted licence, whereas those who may want to sell a wider range of products in future, or want to pilot a product on a smaller scale, are more likely to seek a derogation.

More broadly, we would welcome clarification on the premises-type licence and how this would work in practice in future – for example how narrowly they could be defined, and whether they could be identified through existing industry systems.

As with derogations, we would expect Ofgem to require suppliers to provide a clear rationale for requesting a locally or premises-restricted licence.

Question 5. Do you have any comments on the high-level considerations proposed for assessing derogation requests and/or for applications for a supply licence based on geography or premises type? Do you have any views on how the trade-offs which may arise could be suitably addressed?

We welcome the proposed high-level considerations, while recognising these would be subject to further development as to how they worked in practice, especially in regard to weighting and trade-offs. We would place particular emphasis on the criteria of:

- Would benefit consumers, for example through lower bills or better quality of service.
- Would promote inclusivity and better social outcomes.
- Demonstrates an appropriate approach to managing any risks to consumer outcomes, particularly for those in vulnerable situations

In our view, while decarbonisation and demonstrable innovation are naturally central objectives, the threshold must be that applications can be proven to be ultimately of benefit first to the consumers affected by the derogation, and second - where applicable - that there can be proven to be wider benefits. For example, an innovative offering delivers lower bills and better service to the consumers involved, but also that learnings can be applied more widely.

A further consideration for assessment could be placing controls for derogations on customer numbers. Given the importance of the protections, any negative implications from derogations would be minimised if the total customer base was limited.

We would also raise the issue of given the potential wider implications of derogations granted under the proposed changes, whether the derogation process should be amended, so that other parties can regularly review applications and comment on them before decisions are made.

While being respectful of commercial sensitivity, if there are wider benefits to consumers from an approach enabled through derogation or a limited licence, the wider industry should be able to understand the benefits that the proposal claims to enable, and comment on the extent to which a product requires the derogation that is being requested.

While in current derogation decisions a decision notice is published⁹, there is no opportunity for external engagement with the decision, and limited ex-post visibility on what the impact for consumers has been.

In summary, we would welcome further detail on how derogations/specific licences will be monitored and reported on. Good data will be essential to be available to assess impact and consumer experience, and to inform decisions on any derogation extensions.

⁹ Ofgem (2020) [Decision notices](#)