

## Submission to DESNZ Review of Ofgem

28 February 2025

From Stephen Littlechild<sup>1</sup>

### Introduction and summary

The present DESNZ review of Ofgem’s role, powers and responsibilities is timely. There is indeed a rapidly changing energy market, partly because this is now “a more digital, fast-moving sector” and partly because of net zero policy considerations. And recent experience, in the UK and around the world, suggests that there may be tensions between some net zero measures and customer views. It is therefore important to find net zero products and processes that are appealing to customers rather than imposed on them.

The review terms of reference seem to suggest that Ofgem may need new and increased powers to play an appropriate and effective role in this changing market. That may indeed be the case with respect to regulation of the transmission and distribution networks, and perhaps the generating sector. Although even with existing powers, Ofgem has already taken productive steps to increase the role of customer and other interest groups in formulating business plans underlying network price controls, based on the so-called ‘negotiated settlement’ approach. This has helped to bring about greater mutual understanding and agreement on the way forward, and has also allowed a greater element of variation and discovery of new and better ways forward. As I have suggested elsewhere, there is scope for Ofgem to go further with respect to the precise level, form and frequency of revising network price controls.<sup>2</sup>

I suggest in the present submission that additional powers – indeed, even the existing powers – may be counter-productive with respect to the retail supply of energy in a competitive market. This is because, even with the best of intentions, regulation inevitably increases costs, slows down innovation and impairs the ability of suppliers to discover and respond to evolving customer preferences. Several examples are given of where well-meaning regulatory interventions - for example attempting to secure “fairness” for certain customers - have restricted competition and innovation, and increased costs, all to the serious disadvantage of customers generally.

To address the challenges of the future, competition needs to be more effective, with retail suppliers better able to innovate, and to perceive and respond to the preferences of customers themselves rather than being saddled with additional regulatory restraints reflecting what regulators think customers ought to have, or what it would suit regulators for them to have.

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<sup>2</sup> E.g. [https://www.jbs.cam.ac.uk/wp-content/uploads/2024/02/eprg-S.-Littlechild\\_Submission-to-CMA\\_June2020.pdf](https://www.jbs.cam.ac.uk/wp-content/uploads/2024/02/eprg-S.-Littlechild_Submission-to-CMA_June2020.pdf)

Indeed, suppliers must be able and incentivised to explore, propose and implement new possibilities that regulators and customers themselves had not previously thought of.

A quarter century of experience suggests that even well-meaning regulation can restrict rather than promote competition. And even where particular regulations that have been found harmful to competition have been removed, they are soon replaced by other regulations that also turn out to restrict competition. So while there is a strong case for removing or modifying particular retail regulations, notably on retail pricing and on the entry of new suppliers, this would not continue to be effective over the longer term because other restrictions would creep back in.

In order to meet the challenges going forward, would it be better to deregulate completely the retail energy market? This would enable energy regulation to focus on the transmission, distribution and generation sectors. The retail energy market would of course continue to be subject to supervision and potential action by various bodies including the Competition and Markets Authority, the Department for Energy Security and Net Zero, and Parliament, and there would continue to be a role for bodies such as Citizens Advice.

But I accept that such a radical change would need thinking through, and in some cases other arrangements would need to be made if Ofgem no longer regulated the retail sector. So it may be that a further DESMZ Review could focus specifically on that possibility, with a view to designing a regulatory framework better suited to promote both competition and the satisfactory achievement of net zero.

### **The origins of retail energy competition and regulation**

Back in the 1970s, a few towns in the USA had a choice of retail electricity supplier if a competing distribution company was willing to lay a second cable down the street. This was obviously uneconomic on any scale, and did not last long. In the early 1980s, a few large businesses in Chile were able to negotiate with a nearby generator because their local utility was obliged to provide access to its distribution system. But again this was not implemented on any scale.

In the mid-1980s, as adviser to the Secretary of State for Energy when the electricity system was being privatised, I suggested that use of system charges (for access to the transmission and distribution systems) could, in effect, enable any customer to buy from any generator, anywhere in the country. A new group of “retail suppliers” could act as intermediaries. We could have “retail competition” as well as competition in generation. This proposal was accepted, and the retail electricity market was opened in stages over the period 1990-1998.

But I was less successful with respect to licensing suppliers. I suggested that, since this would be a competitive market, there was no more need to licence electricity suppliers than there was a need to licence grocers or supermarkets or petrol stations. I was told “the Secretary of State might like to licence suppliers”. There were other battles to fight so I conceded this one. But now it seems worth returning to the question whether, or how far, Ofgem needs to regulate the competitive energy supply market.

## **Retail competition worked**

Retail competition in energy was completely novel, but it worked and increasingly worked well. Briefly, most of the incumbent suppliers entered each other's markets, there were new entrants to challenge the incumbents, there were innovative business models ("supplier in a box"), new customer platforms (like Kraken at Octopus Energy and Kaluza at Ovo Energy), eventually over ten times as many entrants as incumbents, different kinds of tariffs, specialisation (e.g. in prepayment meter customers), significant switching between suppliers, and entrants eventually taking over incumbents. The UK retail market was copied around the world, though the UK remained the best and most competitive retail market in the world, at least until the retail price cap.

## **But there have been increasing regulatory restrictions**

Retail regulation has been well-intentioned but not always helpful. For example, in the late 2000s Ofgem introduced a non-discrimination condition and limited suppliers to four simple tariffs. The aim was to protect certain allegedly vulnerable customers and to make it easier for customers to compare tariffs. But in 2016 the CMA found both measures were anticompetitive, and Ofgem dropped them.

Then there was the price cap. Admittedly it was not Ofgem's suggestion, it was a lapse in judgement by the CMA in an otherwise constructive report. But Ofgem seemed happy to implement the price cap on PM customers in 2017/8 and indeed extended it to WHD customers. Then, after it became an issue in the general election, the Government extended the price cap to all domestic customers, on a temporary basis. Again this was not Ofgem's decision, but Ofgem's reports on the price cap did not indicate particular costs or risks. And then came the severe problems associated with the wholesale price increases, and the price cap was extended indefinitely.

The price cap did indeed provide some protection for vulnerable customers, but support could have been provided in other ways without the price cap. The adverse consequences of the price cap were extremely severe. For example, the number of domestic suppliers fell from 66 to 22: two thirds of suppliers exited the market. And in order to survive, all suppliers now had to adopt the hedging model assumed by Ofgem, rather than the variety of approaches that were previously explored.

Admittedly, in retrospect, some of the suppliers were underhedged or not well-financed, which Ofgem has used as a justification for more stringent entry and capital requirements. But many of the exiting suppliers were hedged and well-financed. For example, established suppliers like Gaz de France, Vattenfall, Mitsui, Gulf Oil, BP and most recently Shell were well able to cope financially. Rather, they left the UK retail energy market because the price cap in particular, and retail regulation generally, made the UK retail energy market an unattractive place to do business. And they have also been missed as counter-parties offering suppliers wholesale market access.

## The Ban on Acquisition-only Tariffs

Ofgem's self-imposed concern for fair prices has several times caused it to restrict competition to the disadvantage of customers generally. A recent example concerns "acquisition tariffs".

Some suppliers sometimes offered lower prices to attract new customers than they offered to their existing customers. Some other suppliers argued that this was unfair to existing customers, and committed themselves to making any offers to new customers open to their existing customers. With freedom of choice, either policy is fine: let customers and the market decide whether customers care about this or not. There is room for both types of suppliers.

But the second set of suppliers argued for Ofgem to impose their preferred policy on all suppliers. That is problematic in itself: do we really want a rule that if all customers can't have a particular product then none of them can? Surely a dog-in-the-manger policy is not conducive to innovation. It would also be anticompetitive: it is the kind of measure that cartels use to restrict competition between themselves and to keep up price. To its credit, Ofgem resisted, at least at that time.

Later, with the serious financial problems caused by the conjunction of the price cap and the significant increase in wholesale prices, Ofgem temporarily banned suppliers from offering lower prices to lure customers away from existing suppliers that had taken out expensive hedges for these customers. This was understandable at the time, but it was another indication of the severe adverse effects of the price cap on competition and customer choice.

When the crisis passed, Ofgem decided, rightly, to abandon this temporary Ban on Acquisition-only Tariffs (BAT). But then it changed its mind and decided to retain the BAT. This a serious restriction on competition, to the disadvantage of customers generally. The comments of Uswitch (updated 30 July 2024) are worth citing to bring home the serious adverse consequences of this measure.

**Richard Neudegg, director of regulation at [Uswitch.com](https://www.uswitch.com), said:** "The decision to continue with the Ban on Acquisition-only Tariffs (BAT) is a hammer blow to households seeking cheaper energy bills, especially as a difficult winter approaches.

"The ban was introduced as a temporary measure to help stabilise the market during the energy crisis and to protect suppliers, but it has done nothing for consumers other than artificially raise prices.

"Ofgem's own analysis concludes that retaining the BAT is 'likely to result in net costs to consumers through increased prices'. It is disappointing to see an economic regulator go against the evidence, especially on choices that could bring down household bills.

"Now the market is in a more stable position, the ban is reducing the chance of suppliers from offering discounted prices and cheaper deals to both new and existing customers, at a time when they are desperately needed.

"Lifting the ban would increase the pressure for suppliers to reward their existing users with better value deals, because if they don't, another supplier could offer them something better. In fact, they'll have a stronger reason to offer their own customers better deals, as they will be less likely to move. The argument that 'only new customers will see good deals' doesn't hold water when the alternative is 'no one sees good deals'.

“This is a missed opportunity for Ofgem to remove the protective bubble around suppliers and to support consumers, who are already facing the prospect of higher bills this winter. Now was the time for action, not more deliberation.”

### **Costs of and restrictions on new entry**

After the problems caused by supplier failures, Ofgem imposed tougher capital requirements on suppliers. These have been severe: for example, Utilita (which challenged Ofgem’s decision) had to put up capital of £100m, British Gas £700m. These costs of course have to be recovered from customers in the form of higher prices. But the problem was not simply one of suppliers holding inadequate capital: there were regulatory problems too. Ofgem’s retail price cap had not predicted and could not accommodate the significant wholesale price increases that occurred. So those suppliers that had been responding to a significant set of customer preferences by offering (in effect) unhedged pass-through of wholesale prices were most adversely hit and prevented from continuing in business.

In 2003 Ofgem made a conscious decision to simplify the licence application process, which had become over burdensome and was taking longer than necessary. But following a review in 2018/9 Ofgem imposed significantly tighter entry conditions. It also slowed and/or paused the processing of applications for potential new entrants into the market. For example, applicants for a supply licence are subject to an assessment period which in 2021 Ofgem extended from 4 months to 9 months. Ofgem also removed the tacit authorisation provision for granting a supply licence if it has not decided on the application by the end of that period. All this is intended to better protect customers, but it increases the costs and risks for new applicants, deters new entry, and requires new suppliers to charge higher prices if and when they do get into the market. In turn, all this reduces competition, to the advantage of the incumbent suppliers rather than customers. Perhaps not surprisingly, in response to Ofgem’s 2021 Licensing Review, most existing suppliers supported tougher restrictions on prospective new suppliers while most other respondents did not.

Again perhaps not surprisingly, given the price cap and the costs of the entry process, recent interest in entering the domestic retail market has been rather negligible. For example, since November 2020 four applications to enter the domestic electricity market seem to have been abandoned; one application was refused (and the supplier took Ofgem’s decision to judicial review); only one application, made back in 2023, has just been granted; and only one application is still in process.<sup>3</sup>

To indicate how much more costly the new entry procedure has become, back in 2005 Ofgem asked me to report on the experience and views of new entrants into the retail market. The

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<sup>3</sup> Applications with no Ofgem decision and presumed abandoned: Macht Ltd 25 Nov 2020, Nation Energy Ltd 25 March 2021, Viper Energy Supply Ltd 17 June 2021 and Putney Energy Ltd 10 May 2022. Alaska Energy Ltd applied 12 October 2021 and was refused 4 July 2022. Scorpia Energy applied 18 August 2023 and licence granted 20 February 2025. BBD Energy Ltd applied 23 December 2024.

entrants suggested that it cost about £300,000 for a small supplier to enter the market.<sup>4</sup> I am told that Stephen Fitzpatrick read it and said, “If it’s £300,000, I’m in.” His company Ovo entered the market, grew faster than any other company for several years, eventually took over SSE and is now one of the Big Six suppliers.

What is the cost of entry for a small supplier now? I am told that it is in the range £0.75 - £1 million. Two or three times as high as before, an enormous cost, which of course deters new entry and has to be recovered from future customers, if indeed new entry is allowed to take place at all.

### **Ofgem’s present approach**

The case for retail competition is not just that it is conducive to efficiency and lower costs and prices. More generally, it is a rivalrous process for discovering and providing what customers want. But Ofgem’s Consumer Confidence programme has three key strands:

“defining the outcomes **we want** the sector to deliver”, “Redesigning the regulations and incentives to deliver those outcomes”, and “ensuring Ofgem has the right powers ... to allow **us to act to deliver the outcomes we want to see**”.  
(emphasis added)

There seems to be a tension between retail competition as a process for discovering and providing what *customers* want, and Ofgem’s view that regulation should be designed to deliver what the *regulator* wants.

### **The way ahead**

How to reconcile these two aims? How to get back to discovering and delivering what customers want, in a way that is consistent with net zero and other emerging policies?

The Prime Minister is concerned that the UK is characterised by “a morass of regulation” and “thickets of red tape that... was allowed to spread through the British economy like Japanese knotweed”. He proposes to “clear out the regulatory weeds and allow a new era of British growth to bloom.” (*The Times*, 29 January 2025)

How best to clear out these regulatory weeds? Can there be piecemeal reduction or removal of existing restrictions on retail suppliers and retail competition? And a commitment not to introduce new restrictions? But removing regulations one at a time will be unduly time-consuming and new regulations will inevitably creep in. So I fear that won’t work.

President Trump has recently signed an Executive Order requiring that “whenever an agency promulgates a new rule, regulation or guidance it must identify at least 10 existing rules, regulations or guidance documents to be repealed”. But we don’t want to promulgate any new regulations, we just want to get rid of some existing ones.

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<sup>4</sup> Stephen Littlechild, *Smaller Suppliers in the UK Domestic Electricity Market: Experience, Concerns and Policy Recommendations*, 29 June 2005. Available at <https://www.jbs.cam.ac.uk/wp-content/uploads/2024/02/eprg-smallersuppliersintheuk.pdf> The estimate of £300,000 is on p 18.

Regulators are under pressure to be seen to regulate. It is no criticism of them to say that they simply cannot resist regulating: that's what they are there for. If you are a regulator, why aren't you regulating?

Is the answer, quite simply, to remove the ability to regulate the retail part of the energy market? To go back to my original concept of retail supply as an unregulated business activity, like groceries and supermarkets and petrol stations? This could leave in place Ofgem's duty and ability to regulate generation, transmission and distribution, updated as appropriate to reflect net zero considerations. And leave in place too the other economy-wide regulatory bodies like the CMA and the relevant Government departments, again updated as appropriate. These bodies would then take such measures as necessary to reflect net zero considerations. The retail suppliers would be the intermediaries between such policies and measures, and retail customers, constantly and now more effectively searching for ways to enable customers to benefit from the ever-evolving energy market.

In short, could one remove the need for a licence to supply energy, and instead of Japanese knotweed, let a thousand flowers bloom?

This is an appealing thought. However .... Ofgem has accumulated a large number of regulatory commitments in the last forty years, many of which apply to the retail supply market. For example, I understand that supplier licences have become de facto tools for levy imposition, and have been told that the entire CFD regime would fall apart if licencing were removed without another route for levy-funded schemes. So, to remove Ofgem's role immediately without making adequate provision for all these arrangements would be premature.

Against this, my concern is that a continuation of present arrangements could unduly restrict or disincentivise suppliers. This in turn could limit their ability to explore and provide options conducive to net zero that customers would find attractive.

What this seems to suggest is that DESNZ might usefully review, as a separate project, the merits or otherwise of requiring Ofgem to continue to licence and regulate energy suppliers. This would create the space for a wider debate around the role of retail energy regulation, so that one could assess the pros and cons of giving energy suppliers the same kinds of freedoms that are generally considered productive for most UK businesses, and that could better contribute to the achievement of net zero.