



PGES

All-Party Parliamentary Group
for Energy Studies
Founded in 1980

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SC ESNZ Inquiry 7829 Preparing for the winter **Call for Evidence 3185 Submission reference MDO168125**

Response from All-Party Parliamentary Group for Energy Studies (PGES)

The All-Party Parliamentary Group for Energy Studies ("PGES") was established in 1980 to advise parliamentarians on the energy issues of the day. We are the only Parliamentary Group to embrace all areas of the energy industry, providing a forum for high-level discussions of key energy issues facing the country. Our members include Parliamentarians from both Houses, leading academic institutions and industry representatives ranging from SMEs to multi-national corporations.

Unlike other APPGs, we are not a single-issue lobbying group – our purpose is to provide valuable insights into energy markets to inform good policy-making without favouring any particular technology or approach.

Winter preparedness: The title of this inquiry, "Preparing for the winter" is not reflected in the questions, which relate to pricing and consumer protection rather than security of supply which is the more relevant issue relating to winter.

Current energy policy is both driving high costs for consumers and creating serious risks to security of supply. It is simply not possible to replace reliable, dispatchable fossil fuel generation with intermittent renewables in the absence of bulk storage technologies. There is a serious risk that electricity will need to be rationed in coming winters, particularly for industrial consumers, and wider resilience to unplanned outages is declining year-on-year as older fossil fuel and nuclear plant closes, increasing the risk of blackouts.

Energy policy needs to be significantly more realistic if the energy transition is to be achieved at reasonable cost while maintaining reliability. There will be a significant threat to public support if these issues are not addressed with some urgency. Energy security has been eroded, in entirely predictable ways, by poorly designed policy, and while covid and the war in Ukraine were unexpected, they have merely accelerated a situation that was always going to happen under the current policy trajectory.

Key actions that need to be taken to correct the course are:

- Increase domestic gas production and secure more firm supply agreements from producing nations;
- Defer the closure of the remaining coal power station at least until after Hinkley Point C opens;
- Ensure all available gas-fired generation is available to run, such as the mothballed Calon CCGTs;
- Develop new nuclear projects expanding the technology scope to include technologies that can be delivered in under 10 years such as Advanced Boiling Water Reactors which have been built in 4 years in Japan;
- Implement a coherent plan to reduce heat losses in homes (including a reform of the EPC to take account of the quality and condition of materials).

These five actions at a minimum are required if we are to avoid extended periods of high energy costs and uncertainty over security of supply.

1. What role did the UK grid play in the high domestic prices of winter 2022-23?

The grid itself played almost no role in last winter’s high prices – this was primarily due to high international gas prices which drove up the cost of gas and electricity to consumers.

It could be argued that more gas storage might have mitigated such risks, but there is little evidence to support this. In 2017 Centrica said it needed around £1 billion to re-drill¹ the Rough wells so they could be safely operated at the existing reservoir pressure (subsequently, Centrica produced all the cushion gas and a significant portion of the tail gas, dramatically reducing the pressure). There is no evidence this £1 billion of investment would have resulted in a saving greater than £1 billion from full operation of Rough in 2022-23.

There is no analogous argument for electricity infrastructure. The presence of international interconnection created significant risks to GB energy security since France was relying on GB to supply its own market due to widespread unavailability of its nuclear reactors². This was the second time³ in six years that a large portion of French reactors were offline for systemic maintenance concerns. As the fleet ages, it would be unwise to assume GB can rely on French imports in future.

2. What more could have been done to prevent price shocks being passed to consumer bills?

The premise of this question warrants scrutiny, as it assumes it is desirable to insulate consumers from the full impact of price increases. No real efforts were made to insulate consumers from the effects of price rises in other sectors, notably food.

It is useful to consider what policy-makers and consumers want from the energy market and how trade-offs should be resolved.

In a fully deregulated, open and competitive market, one would expect a range of services to emerge. Suppliers would be free to experiment with different tariffs - some consumers might be happy to pay a premium for guaranteed service levels eg a dedicated customer service team much like in private banking. Others might want the cheapest possible rate and be willing to pay extra for customer service on a pay-as-you-go basis in the same way that some software subscriptions work. Others pay a premium for “green” energy.

However, in the past, both the Government and Ofgem expressed alarm⁴ at the variation of tariffs, apparently believing that in a commoditised market, pricing becomes a zero sum game – if some consumers “win” by accessing cheaper tariffs, others have to “lose” by paying more to fund those better deals. The press takes hold of such narratives, as well as complaining about “postcode lotteries” (although regional differences exist under the price cap).

Deregulation allows the market to discover what works for consumers. With the advent of flexible energy assets in the home, (eg heat pumps and electric cars), tariffs designed to capture that flexibility are starting to emerge. These could potentially go further with suppliers optimising assets on behalf of the householder, and/or bundling appliances with the supply contract in the same way that handset costs are bundled with call/data offers in telecoms.

Different offers would have different costs to serve, reducing the likelihood of the market actually being zero-sum. Ofgem’s interventions (including restrictions on door-step selling) significantly reduced consumer engagement because they removed the benefits of engaging ie there was little to choose between available tariffs.

Another problem is that policy-makers and Ofgem allowed a narrative to develop that it is wrong for energy companies to make “excess” profits where “excess” appears to be anything more than a minimal amount. In a fully deregulated market (for tariffs) some suppliers would earn high profits...the key being “earn”. Those profits would be the result of providing services that are valued by customers. It is not profits or tariffs that should be regulated, but service levels - restrictions on customer disconnection and moving consumers to pre-payment meters, as well as minimum service levels (billing accuracy, answering customer queries /complaints, levels of customer satisfaction).

The appropriate way to protect those in fuel poverty is through a social tariff funded through taxation (or through other uses of the benefits system).

3. How should energy companies respond if customers cannot pay their bills and what actions should they not have recourse to?

The primary duty to alleviate poverty lies with the Government. Suppliers, when faced with consumers who are struggling, should offer payment plans and prepayment meters (and it is important that consumers with pre-payment meters do not have to pay more than those on conventional meters – the legacy reasons for the higher cost-to-serve for these consumers do not apply with smart meters). Suppliers can also refer such consumers to agencies such as Citizens Advice to help with budgeting etc.

It is not, and should not be the role of suppliers to go beyond this in the support of vulnerable consumers. Company directors have statutory duties set out in the Companies Act 2006, the most well-known of which, “promoting the success of the company”, the government describes⁵ as:

“The duty states a director must act in a way that they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members (shareholders) as a whole. When making decisions, directors must also consider the likely consequences for various stakeholders, including employees, suppliers, customers and communities. They should also consider the impact on the environment, the reputation of the company, company success in the longer term and all of the shareholders (including minority shareholders).”

It is not the job of private companies to alleviate poverty or provide any other type of social benefit, beyond what is necessary for the long-term good of the company and its profitability.

People have questioned whether energy companies have a “moral obligation” to “do something” about the “cost of living crisis”. However, it is the responsibility of governments to mitigate the effects of high energy costs - as long as energy companies operate in accordance with the law and regulations, not only do they not have wider societal obligations, company directors risk breaching their statutory duties if they try.

Taking the example of Centrica. As a FTSE-100 listed company its shares are widely held by pension funds, index-tracking ISAs, and other common products held by ordinary people as opposed to wealthy individuals/ professional investors. Any use of Centrica’s profits to “help” with the cost of living would mean reducing dividends/ a drop in the share price, since value would leave the company for stakeholders other than shareholders. Those shareholders, some of whom are ordinary pensioners, would have a legitimate grievance were this to happen.

It would also potentially allow Centrica to bankrupt its competitors since the additional profits earned from its upstream gas production business could have allowed it, for a short time, to undercut all other suppliers in the market, thereby restoring its monopolistic position.

4. Has Ofgem got its priorities right in addressing customer protection?

Ofgem has recently adjusted its priorities from promoting competition to preventing supplier distress. The rationale being the high level of cost mutualisation when a supplier fails creates a significant customer detriment.

Ofgem has limited discretion in managing its statutory duties. For example, the regulator has called for a social tariff⁶, believing it to be a more effective way of protecting vulnerable consumers (not all consumers should be protected against high prices – it is desirable for high prices to stimulate a degree of demand reduction).

It is appropriate for Ofgem to regulate service levels, but it has often failed to deliver⁷, allowing suppliers to consistently breach licence conditions relating to customer service levels. Lack of enforcement has been an ongoing theme.

Ofgem should adopt a principles-based approach to regulation. Most of the FCA Principles⁸ could usefully be applied to the energy market, and a properly enforced principles-based regime would enable both the regulator and regulated firms to better understand the basis for the supplier-customer relationship. (Recent failures in the banking market could have been avoided if regulated firms and the FCA gave proper weight to the Principles⁹.)

Over the years, Ofgem's remit has broadened to an extent that is difficult for it to manage. It is one of the largest energy regulators in the world, with an annual budget of £130 million and a headcount of almost 1,500. In comparison the French energy regulator employs just 156 staff¹⁰ with an annual budget of €25 million and the Dutch regulator employs 588¹¹ but covers industries other than energy, with a budget of €70 million.

Ofgem has become cumbersome, and arguably fails to carry out its responsibilities well. There is a good argument for separating retail energy regulation and placing it under the responsibility of the FCA – the sale of gas and electricity is a virtual activity with suppliers managing customer money and credit balances in similar way to retail banks. Ofgem's recent forays into prudential regulation largely replicate work of the FCA following the 2008 banking crisis. It would make sense for the financial services regulator to oversee businesses whose primary activity is handling customer money and whose financial resilience is essential to protecting the interests of those customers.

5. How effective is the Government's approach towards supporting the sector and delivering a functioning energy market?

The Government's approach is not effective, largely because it has not truly determined what it wants from the sector. Policy-makers appear to want consumer choice, but on such narrow terms as to be practically impossible to deliver. They want engagement, but consistently remove incentives for consumers to engage (price caps dis-incentivise engagement – why bother considering alternative tariffs when the regulator has designed something “fair” and there is little variation in the alternatives?).

They want competition and tariff differentiation, but are worried some consumers may over-pay. They want to protect “vulnerable” consumers without having a clear understanding of what is meant by “vulnerability”. And they want to see innovation yet have created a low margin, highly regulated environment that is likely to stifle investment and the development of new business models.

They also expect policy initiatives to have almost instant results – many of the mis-conceptions about the retail market being uncompetitive in the mid-2010s were a symptom of market change happening slowly and organically rather than reflecting a fundamental lack of competitiveness.¹² Some regulatory interventions actively slowed the development of competition, un-intentionally favouring legacy suppliers.

Capping the amount suppliers can charge dis-engaged consumers further reduces their incentives to engage and a degree of moral hazard – to what extent should consumers take responsibility for themselves? In a free market unaffected by cartel-like behaviours, suppliers that are genuinely over-charging should lose market share. That some consumers are unable or unwilling to switch is not a sufficient justification for forcing all consumers to accept higher prices – if people are unwilling to pursue their own best interests why should others do it for them? The exception is for people genuinely unable to do this, but here targeted approaches are more appropriate, in particular a social tariff funded by general taxation.

Most people agree the retail energy market is not working. Policy-makers seem stuck in a rut of unrealistic expectations, unable to manage public sentiment in a world of high costs. Radical reform is required, and policy-makers must determine what they expect from the sector, identifying how the trade-offs in market design should be resolved.

This will enable a rational market design more likely to meet the needs of consumers, but it will require an acceptance of both higher supplier profits and a wider range of tariffs. Rules to ensure equity at renewal, similar to those in the insurance market, should prevent the exploitation of vulnerable consumers, so tariff variation will reflect differences in the cost to serve, rather than being a zero sum game. Genuinely vulnerable consumers can be protected with a social tariff.

Alternatively, if policy-makers want a homogenous environment with low tariff differentiation where consumers to pay for and receive the same service, they should simply re-nationalise the industry. What we have now is quasi-nationalised, where the regulator sets prices and thereby defines business models – profits are uniformly low, and innovation is lacking.

The Government should decide what it wants – a vibrant, competitive market offering genuine consumer choice, or a return to a nationalised industry with no choice, no differentiation, and no perceived lack of “fairness”.

6. Is the legislative framework on pricing controls suitable for protecting consumers?

There are two types of price controls in energy, neither of which is working well for consumers.

In the retail market, the price cap is the only game in town, and the few fixed price offers available are relatively short-term and close to the cap level. Even before the bull run that began in September 2021, there was little tariff variation - most fixed price deals clustered around the cap. Many studies¹³ confirm this is typical in markets with a capped regulated tariff.

Aside from a social tariff for the fuel poor, funded by taxation, service levels rather than tariffs should be regulated. The market should be allowed to set whatever tariffs it likes, subject to controls over the renewals process: suppliers should be required to write to their customers on the expiry of a fixed price deal, and otherwise at least once a year, setting out the tariffs available to them at that supplier and providing information about price comparison websites and the possibility of changing supplier¹⁴. Existing customers should be offered deals that are at least as good as those offered to new customers.

Consumers would be better served if the price cap were abolished, and the various non-supply activities currently carried out by suppliers assigned to more suitable bodies. Suppliers should not be expected to conduct wealth re-distribution – that is the role of governments – but the Warm Homes Discount requires

Response from All-Party Parliamentary Group for Energy Studies – Inquiry 3185

exactly that. Nor should they be responsible for tax collection (other than PAYE/VAT) – the costs of renewable energy should be recovered through taxation not by suppliers.

No other country expects suppliers to install smart meters – these are network equipment and should be installed by network operators.

Suppliers should not be responsible for non-supply activities. The Energy Company Obligation requires suppliers to engage in construction activities, something outside their areas of expertise. This is akin to asking delivery companies to organise and pay for road repairs, or for supermarkets to be responsible for refuse collection. Local governments should take the lead on reducing heat losses in buildings since they already manage the planning and building control processes. It is inefficient, complicating supplier business models in a way that is of little benefit to consumers.

These regulatory burdens deter high quality new entrants from entering the market. Together with removal of price regulation, this would enable the market to deliver a more tailored offering to consumers. There should be a clear understanding that energy companies are no different from other types of suppliers – supermarkets are not expected to alleviate consumer poverty, and neither should energy suppliers. Some suppliers may earn significantly higher profits than is currently the norm, but as long as this is being done legally and regulatory duties are met, that is acceptable, and indeed should be encouraged. The purpose of businesses is to make profits and it makes little sense to be upset when they do.

The other price control relates to networks. Again, Ofgem is not implementing this control very well, in particular in its approach to anticipatory investments. Ofgem has narrowly focused on minimising current costs to current consumers, without considering the potential detriment from delayed investment. The Uncertainty Mechanisms under RIIO-2 have been designed to mitigate these risks, but are likely to be unwieldy and impose significant additional costs – network operators will need to devote resources to building investment cases for Ofgem to study and Ofgem will require resources to evaluate those proposals, effectively supplanting the role of the companies' investment committees – something arguably beyond the scope of what an economic regulator ought to be doing.

Ofgem's approach to network price controls should be less prescriptive and future price control periods should restore the previous approach to incentives, allowing TSOs/DNOs greater discretion over anticipatory investments. On occasion, investments may be made that were not actually necessary, but the cost of these on a per household basis is likely to be minimal, and lower than the costs of delaying investments that are necessary. Current lengthy delays for grid connections are in part a result of the difficulty network operators face in proving an investment is necessary in order to recover its costs.

Policy-makers need a better understanding of energy pricing. There is a mis-conception that renewable energy is cheap/ cheaper than gas. This is not correct in GB where the bulk of the renewable energy comes from intermittent sources (reliant on weather), which adds cost in the following ways:

- Weather is variable so backup energy sources are needed when wind /solar output are low. Whether this is other types of generation (eg nuclear or fossil fuel), or storage, it introduces costs that do not exist in a conventional market;
- Wind and sun levels vary moment to moment, making it more difficult to balance supply and demand in real time – supply is materially more variable than in a conventional energy system. Balancing costs have risen significantly as a result, a trend which is likely to continue.
- Wind generation tends to be located far from demand centres – developers want to locate windfarms where wind is highest, eg off-shore, but this is often not where demand is/ could be located. Significant investments in grid infrastructure are required to deliver this energy to the places in which

Response from All-Party Parliamentary Group for Energy Studies – Inquiry 3185

it will be consumed. Lack of adequate infrastructure means large amounts of renewable generation are curtailed, imposing additional costs on consumers.

There is an expectation that because wind and sun are free, renewable energy will be cheap. However, in a world where the wholesale price of electricity is set by the short-run marginal cost of renewables, wholesale prices could be close to zero or negative. In this world, no form of generation, and certainly no form of renewable generation would ever be able to repay its capital costs through the sale of electricity, as this electricity would be essentially worthless (sold for £0 or less). Therefore, generators will require other income sources to repay capital costs and earn acceptable returns for investors. This alternative income will be added to consumer bills. There is no reasonable basis for assuming renewable energy will result in lower costs to consumers when all these additional costs are taken into consideration.

The widely-held belief that renewables will make energy cheaper for consumers is based on false assumptions and a failure to recognise the full costs of integrating these renewables into the system.

¹ <https://assets.publishing.service.gov.uk/media/5a0c1010ed915d0ade60db73/rough-gas-storage-undertakings-review-provisional-decision-15.11.17.pdf>

² In winter 2022-23 many French reactors were offline due to the stress corrosion issue: <https://www.french-nuclear-safety.fr/asn-informs/news-releases/stress-corrosion-phenomenon-detected-on-reactors>

³ In winter 2016-17 many French reactors were offline after excess levels of carbon were detected in the steel used to construct the pressure vessels: <https://www.french-nuclear-safety.fr/asn-informs/news-releases/Anomalies-and-irregularities-detected-on-nuclear-pressure-equipment>

⁴ A good description of the retail market during this period can be found in this paper by Stephen Littlechild: <https://www.semanticscholar.org/paper/Promoting-competition-and-protecting-customers-of-Littlechild/7c81de1a2166cf32d9c6697cc5cab5091f6dc851>

⁵ <https://companieshouse.blog.gov.uk/2019/02/21/7-duties-of-a-company-director/>

⁶ <https://www.ofgem.gov.uk/news-and-views/blog/what-april-2023-price-cap-means-consumers>

⁷ [https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Market%20Meltdown%20-%20Dec%202021_v2%20\(1\).pdf](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Market%20Meltdown%20-%20Dec%202021_v2%20(1).pdf)

⁸ <https://www.handbook.fca.org.uk/handbook/PRIN/2/1.html>

⁹ <https://watt-logic.com/2023/07/31/regulatethe-regulators/>

¹⁰ <https://www.cre.fr/en/cre/who-are-we>

¹¹ <https://globalcompetitionreview.com/insight/enforcer-hub/2022/organization-profile/netherlands-authority-consumers-markets>

¹² <https://www.semanticscholar.org/paper/The-challenge-of-removing-a-mistaken-price-cap-Littlechild/06f99f99809e03a24e236f08ba19fcd975f054d7>

¹³ Most recently the Centre for Policy Studies (<https://cps.org.uk/research/the-case-against-the-energy-price-cap/>) but also this study from the Universities of Warwick and Exeter (<https://ore.exeter.ac.uk/repository/handle/10871/35580>) and this paper on the Australian experience with price caps by economists Paul Simshauser and Patrick Whish-Wilson (<https://www.sciencedirect.com/science/article/abs/pii/S0140988316303620?via%3Dihub>)

¹⁴ This approach was confirmed in the small-scale database trial which concluded in 2017 (https://www.ofgem.gov.uk/sites/default/files/docs/2017/11/small_scale_database_trial_paper_pdf.pdf)