

“It’s time to reconsider Ofgem’s role in retail”, Utilities Weekly, 31 March 2025

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Introduction and summary

Two ongoing reviews of Ofgem’s role, powers and responsibilities – by DESNZ and the Treasury - are timely, because the energy market is changing rapidly. Energy is now “a more digital, fast-moving sector” and environmental considerations are increasingly pressing. But recent experience, in the UK and around the world, suggests that there may be increasing tensions between some net zero measures and customer views. It is therefore important to encourage the discovery and adoption of environmentally friendly energy products and processes that are appealing to customers rather than imposed on them and resisted.

The terms of reference of the DESNZ review seem to suggest that Ofgem might need new and increased powers to play an appropriate and effective role in this changing market. My submission to that review² expressed concern that this might mean further restriction of the competitive retail supply market. Even with the best of intentions, regulation often increases costs, slows down innovation and impairs the ability of suppliers to discover and respond to evolving customer preferences.

Even where harmful regulations are removed, they are soon replaced by other regulations that also turn out to restrict competition. This led me to wonder whether, in order to meet the challenges going forward, it would be better to deregulate completely the retail energy market? Let energy regulation focus on the transmission, distribution and generation sectors. But I accepted that such a radical change would need thinking through.

The present article draws upon my DESNZ submission to explain and illustrate the problems of unduly restrictive regulation of the UK retail energy sector. It presents some evidence of the excessive regulatory costs imposed on licensees (and hence on customers). Then it contrasts the number of recent applications to enter the domestic retail electricity market and the generation market. And suggests the case for reviewing Ofgem’s role in the regulation of the domestic supply market.

Finally, but importantly, I briefly examine Ofgem’s five “pledges” set out in the recent Treasury paper, published after the DESNZ review had closed. The time is right to make the kinds of changes in retail regulation set out in the Treasury/Ofgem pledges. However ... the

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² Stephen Littlechild, Submission to DESNZ review of Ofgem, 28 February 2025, available at <https://www.jbs.cam.ac.uk/wp-content/uploads/2025/03/eprg-littlechild-2025-submission-to-ofgem-review-rev.pdf>

commitment to retain the retail price cap quite simply sabotages those otherwise commendable proposals for regulatory reform.

The origins of retail energy competition and regulation

In 1983, 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 novel proposal was accepted, and the retail electricity market was opened in stages over the period 1990-1998.

I also suggested that, since this would be a competitive market, there was no more need to licence and regulate electricity suppliers than there was a need to licence and regulate grocers or supermarkets or petrol stations. But I was told “the Secretary of State might like to licence suppliers”. There were other battles to fight so I conceded this one. But subsequent experience suggests we should return to the question whether, on balance, licensing and subsequent regulation of energy suppliers has had a positive impact.

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 growing and 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. It also 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 retail price cap. Admittedly it was not Ofgem’s suggestion, it was a lapse of judgement by the CMA in an otherwise constructive report. But Ofgem not only implemented the price cap on prepayment customers in 2017/8, it extended the cap to Warm Home Discount customers. Then, after the cap became an issue in the general election, the new Government extended it to all domestic customers, initially on a temporary basis. Again, this was not Ofgem’s decision, but Ofgem’s reports on the price cap did not indicate any particular downsides. And then came the severe problems associated with the significant wholesale price increases, for which the price cap was totally unprepared and inappropriate. Nonetheless, the

price cap was extended indefinitely, contrary to the CMA's express insistence that it be only temporary.

Although the price cap was justified as limiting price increases to customers, support for vulnerable customers could and should have been provided in other less expensive ways. 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, the remaining suppliers now had to adopt the hedging model assumed by Ofgem, rather than explore a variety of approaches to see which customers preferred. Of course, all customers had to pay for those hedging costs.

Admittedly, in retrospect, some of the new suppliers were underhedged or not well-financed, which Ofgem then used as a justification for more stringent and costly entry and capital requirements. But many of the exiting suppliers were well-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 counterparties offering suppliers wholesale market access.

The Ban on Acquisition-only Tariffs

I have written elsewhere about the problems caused by the retail price cap.³ Others have been equally critical.⁴ But surely a regulatory commitment to ensure “fair prices” sounds commendable, or at worst innocuous? However, faced with pressure from some customers paying higher prices than others, it is too easy for a regulator to require that all prices be the same, regardless of the underlying economic situation, thereby restricting competition at the expense of customers generally.

An upcoming case in point is the proposal for zonal electricity pricing, which will reflect regional cost differences more accurately than has been the case hitherto. Some are arguing the case for this, on efficiency grounds. But pressures are already mounting from customers in the south (facing higher buying prices) and from generators in the north and Scotland (facing lower selling prices), that this would be unfair. We have yet to see how Ofgem deals with this.

But an actual example where regulation has responded to the “fair prices” argument, and thereby restricted competition to the disadvantage of customers generally, is instructive. It concerns so-called “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,

³ <https://www.jbs.cam.ac.uk/wp-content/uploads/2024/06/eprg-Future-of-domestic-price-protection-as-submitted-May-2024.pdf>

⁴ E.g. “Government is ‘committed to retaining the Default Tariff Cap’, even against a wave of industry input suggesting that it is no longer fit for purpose. In our opinion, the Default Tariff Cap has never been fully fit for purpose and has done significant long-term damage to the British economy.” Hattie Lunn, Cornwall Insight, *Energy Spectrum*, Issue 941, 10 March 2025, p 5.

and committed themselves to making any offers to new customers open to their existing customers too.

With freedom of choice, either policy is fine: let customers themselves and the market decide whether customers care about this or not. There is room for both types of suppliers and customers.

But the second set of suppliers urged Ofgem to impose their preferred policy on all suppliers. That is surely problematic: do we really want a rule that if all customers can't have a particular price or product then none of them can? A dog-in-the-manger policy is not conducive to innovation and is anticompetitive: the kind of measure that cartels use to restrict competition between themselves and to keep up price. To its (temporary) credit, Ofgem initially resisted.

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, although it was yet another indication of the severe and unanticipated 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. Capitulation. Uswitch described this as “a hammer blow to households seeking cheaper energy bills”.⁵

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. Again, these costs have to be recovered from customers in the form of higher prices.

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 the assessment period.

I was astonished and concerned to learn recently that the cost of entry for a small supplier has now risen to about £1 million. The entry process 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

⁵ <https://www.uswitch.com/media-centre/2024/07/Ofgem-decision-to-retain-BAT/>

competition and innovation, to the advantage of the incumbent suppliers no doubt, but to the disadvantage of customers.

What has been the consequence of the price cap and the high costs of the entry process? Recent interest in entering the domestic retail market has been negligible. Furthermore, at least four existing retail suppliers have requested to be excluded from supplying the domestic retail market (where they had apparently not been active).

And Ofgem has not been encouraging. Since November 2020 four applications for supply licences to enter the domestic electricity market seem to have been abandoned; one application was refused (the supplier took Ofgem's decision to judicial review); only one application, made back in 2023, has just been granted; and one application is still in process. So, total new entrants: one in over four years, offset by four voluntary exits.

In contrast, in 2024 Ofgem issued 160 generation licences, and 63 so far in 2025 – about five per week! So, there is a strong interest in participating in the UK energy market, but only where regulation is welcoming rather than alienating.

Ofgem's present approach

The case for retail competition is not just that it is conducive to efficiency and lower costs and prices. It is also a rivalrous process for discovering and providing what customers want. But Ofgem's Consumer Confidence programme doesn't see things this way. It 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 thus seems to be a tension between retail competition as a process for discovering and providing what *customers* want, and Ofgem's view that consumer confidence is about delivering what the *regulator* wants.

The way ahead?

How to enable competition to discover and deliver what customers want, in a way that is consistent with environmental 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? My submission to the DESNZ review was concerned that removing regulations one at a time would be unduly time-consuming and new regulations would inevitably creep in.

Is the answer, quite simply, to remove Ofgem's duty to regulate the retail part of the energy market? Ofgem would still regulate generation, transmission and distribution. But retail energy supply would be an unregulated business activity, like groceries and supermarkets and petrol

stations, albeit still subject to the CMA and relevant Government departments. These bodies would pass such measures as necessary to reflect consumer and environmental considerations. Retail energy suppliers would be intermediaries, constantly and now more effectively searching for ways to enable customers to benefit from the ever-evolving energy market, consistent with environmental policy.

In short, could one remove the need for a licence to supply energy, and instead of Japanese knotweed, let a thousand flowers bloom? That was 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 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. But I suggested that DESNZ might usefully review, as a separate project, the merits or otherwise of requiring Ofgem to continue to licence and regulate energy suppliers.

The Treasury's new approach

Subsequently, the Treasury has issued its policy paper *New approach to ensure regulation and regulators support growth* (17 March 2025).⁶ It comments that “the current regulatory landscape is not functioning as effectively as it should. Our system now too often holds back growth and inhibits private sector investment.” It refers to regulation that “can be too complex and duplicative, stifling progress and innovation”. All this sounds spot on.

The Treasury has also worked with key regulators to develop some “regulatory pledges”. Ofgem's five pledges to the Treasury review seem at first a very constructive and welcome way forward. They variously commit to “support new entrants into the market”, “more options for consumers to take advantage of different pricing and to flex their usage accordingly”, working with DESNZ to consider how “the energy retail market ... could better enable innovation to support consumers, system transformation and growth”, providing “flexibility in retail rules to allow new entrants or existing companies to try new commercial approaches”, and to “work with government to develop ways of rewarding consumer-led flexibility”.

What a dramatic and welcome change from recent regulatory policy! This seems so encouraging. Surely the Treasury, DESNZ and Ofgem deserve every support in moving in this direction?

But wait: “Ofgem will ensure that the price cap continues to protect consumers who are not able to engage, but that it can adapt to a changing market”. Oh dear. There are much better, less costly and less distorting ways of protecting vulnerable customers. The price cap and adapting to a changing market are quite simply a contradiction in terms. As has been argued

⁶ <https://www.gov.uk/government/publications/a-new-approach-to-ensure-regulators-and-regulation-support-growth/new-approach-to-ensure-regulators-and-regulation-support-growth-html>

elsewhere in a stinging explanation of “why the retail energy market is so dysfunctional” and why “a vicious circle awaits of system costs borne by fewer and poorer consumers”.⁷

To avoid compromising the whole regulatory framework, surely Government needs to signal now the end of the “temporary” retail price cap? This would enable better protection focused on vulnerable customers, the faster discovery and adoption of new ideas, and more economic accommodation of evolving environmental pressures. And perhaps set the stage for a more considered evaluation of whether we actually need Ofgem to regulate the supply market.

⁷ Robert Buckley, “Treasury regulation review: Midas touch or Sisyphean task?” Cornwall Insight, *Energy Spectrum*, Issue 943, 24 March 2025, pp 5-7.