National Audit Office

The energy supplier market

The Department for Business, Energy & Industrial Strategy and Ofgem

REPORT

by the Comptroller and Auditor General

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The energy supplier market

The Department for Business, Energy & Industrial Strategy and Ofgem

Report by the Comptroller and Auditor General

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Gareth Davies
Comptroller and Auditor General
National Audit Office

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The National Audit Office study team consisted of:

Catherine Hayes, Helen Holden, Robert Sabbarton and Emma Taylor under the direction of Simon Bittlestone.

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157–197 Buckingham Palace Road
Victoria
London
SW1W 9SP

020 7798 7400

www.nao.org.uk

@NAOorguk

Key facts

29

number of energy suppliers that have failed since July 2021

£2.7bn

Ofgem's current best estimate of the cost of transferring customers of failed energy suppliers to new suppliers through the 'supplier of last resort' (SOLR) process and missed payments to support renewable generation, which equates to around £94 per customer. This cost is very uncertain and could go up, or down.

2.4m

total number of customers that have moved to new suppliers through the SOLR process since July 2021

Nearly six-fold the increase in the weekly average wholesale price of gas that took place between February 2021 and December 2021

78% increase in the bill for a typical customer purchasing energy at the price cap since its introduction, rising from £1,105 per year in the winter of 2018-19, to £1,971 in the summer of 2022

1.6 million approximate number of customers of Bulb Energy in November 2021, when it was placed in special administration

£0.9 billion amount spent on running Bulb Energy through the special administration regime in 2021-22

£1.0 billion amount budgeted to run Bulb Energy through the special administration regime in 2022-23. The actual cost could be above or below this amount

Summary

Introduction

1 Most households and businesses in Great Britain are supplied with gas and electricity through the energy system. There are four main components of this system: generation; transmission; distribution; and retail. Energy retailers (known as suppliers) purchase gas and electricity from the wholesale market and sell it to homes and businesses. Some energy companies that own and operate energy suppliers also own and operate other elements of the energy system. Suppliers have a potentially important role to play in achieving the government's net zero target by offering products and services that help customers to reduce their energy consumption and supporting optimal use of the energy system to minimise consumer costs.

2 The Department for Business, Energy & Industrial Strategy (the Department) is responsible for setting and developing energy policy in the UK. The Office of Gas and Electricity Markets (Ofgem) regulates gas and electricity markets in Great Britain. Ofgem's principal objective is to protect the interests of existing and future consumers. In doing so it must have regard to factors including the need to secure that licence holders can finance their regulated activities. In performing its duties Ofgem must consider the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes or residing in rural areas.

3 Since the energy market was opened to competition from the 1990s, domestic energy consumers have been free to choose their domestic energy supplier. In the decade after it was opened to competition the energy supplier market consisted of six large energy companies, and a similar number of small suppliers; however, since 2010, smaller companies began to enter the market in greater numbers. The total number of domestic suppliers went from 12 in December 2010 to 23 in May 2022, with a peak of 70 suppliers in mid-2018. By September 2021, the new entrants held around 40% of the market share.

4 In 2019, the Department introduced a price cap on some types of tariff, which Ofgem has been required to operate since. The Department intended that the price cap should ensure that customers pay no more than a fair price for their energy, as determined by Ofgem's analysis of supplier costs. The price paid by a typical customer purchasing energy by direct debit at the price cap will have increased by 78% from £1,105 per year in the winter of 2018-19 to £1,971 in the summer of 2022.

5 Between mid-2021 and spring 2022, the wholesale market price that suppliers paid for gas and electricity increased to unprecedented levels. By December 2021, weekly average wholesale gas prices (to which electricity prices are closely linked) had risen to nearly six-fold the level in February 2021. Partly because of the increase, during the period between July 2021 and May 2022, 29 energy suppliers failed, affecting nearly four million households in the UK.

6 Ofgem and the Department have two main processes for maintaining continuity of supply when a supplier fails: the supplier of last resort (SOLR) process and the special administration regime (SAR). Under the SOLR process, Ofgem transfers customers from a failed supplier to an existing supplier to maintain their continuity of energy supply. In cases where SOLR is not viable, a SAR is where a temporary special administrator continues running the failed company until it can be sold as a going concern, or the customers can be transferred to other suppliers.

7 This report aims to set out the facts regarding the recent exit of energy suppliers and to evaluate Ofgem's and the Department's roles in the events leading to the exits and how well they handled them. It covers:

- the nature and regulation of the energy supplier market (Part One);
- how supplier exits have been handled and what they have cost (Part Two); and
- the regulation of the energy supplier market and how this contributed to the exits (Part Three).

The report does not cover wider issues relating to the supply and price of energy, such as policy considerations relating to the generation of energy, instalment of insulation, or whether and how to reduce the impact of the increase in energy prices on consumers. The report also does not assess the effectiveness of changes to supplier market regulation that Ofgem and the Department are currently introducing.

Key findings

The Department's and Ofgem's handling of supplier exits

8 **The Department and Ofgem ensured the four million customers whose supplier failed did not experience an interruption to their supply.** Since July 2021, Ofgem has transferred nearly 2.4 million customers of 28 energy suppliers to alternative providers through the SOLR process, without any interruption to their energy supply. The Department and Ofgem had prepared in advance for the collapse of a large energy supplier, which meant they were prepared to put Bulb Energy into special administration in November 2021, ensuring there was no immediate impact on its approximately 1.6 million customers (paragraphs 1.12, 1.13, 2.3, 2.17 and 2.20, and Figure 5).

9 **Many customers of failed suppliers have experienced increases in their bills while some have also faced other challenges.** Issues which customers experienced included: an immediate increase in their energy costs as they transferred to a higher tariff, which Citizens Advice estimates has cost the average customer £30 more per month for the remainder of the duration of their original contract; uncertainty regarding transfer of protected credit balances from one provider to another; loss of debt repayment plans that help customers struggling to pay debt arrears, which particularly impacts on vulnerable households; and the inability to resolve issues relating to the supplier which had gone into administration (paragraph 2.4 and Figure 6).

The costs of supplier exits

10 **The final cost to customers of suppliers that have exited the market is still very uncertain but Ofgem currently estimates it will be around £2.7 billion, which would equate to around £94 per customer**. Suppliers who take on the customers of failed suppliers are reimbursed for the resultant costs through the SOLR process. This spreads the cost of exits across all energy bills rather than just the customers of failed suppliers, who also may see an increase in their bills as they are moved to a different tariff. There are several elements to these costs, some of which are very uncertain and could cause the final cost to go up, or down:

- Ofgem has approved claims worth £1.8 billion (around £66 per customer paying for energy at the price cap) for the SOLR of 2.2 million customers from 22 suppliers that failed between September and December 2021, mostly to cover the cost of buying wholesale energy for these customers above the level of the price cap (paragraph 2.8).

- Ofgem expects to approve a further £548 million of related claims under current rules both in relation to additional claims from the 22 suppliers for which it has already approved first claims and the suppliers which failed outside the claim period or had not previously submitted claims. Ofgem is consulting on its approach to reimbursing the additional costs that suppliers who acted as SOLRs faced, to ensure it is fair. The decision will impact the extent to which costs being passed on to customers through the levy will increase and could potentially be significant (paragraphs 2.8 and 2.10).
- Some failed suppliers missed payments into the government's schemes to support renewable generation, which means a further £296 million may be added to customers' bills (paragraph 2.8).
- Ofgem is seeking a court ruling to determine whether it and others, such as SOLRs, can make a claim as a creditor in the administration of a failed supplier. If Ofgem wins its case this could reduce the total cost to customers by up to around £0.5 billion but is likely to be significantly less than this (paragraph 2.11).
- The costs of supplier failure are likely to have been offset by some customers having cheaper bills in previous years because new entrants to the market increased competition. However, the significance of this is uncertain and it is likely that some customers will be disproportionately affected over the whole period, particularly those who were less active in switching between suppliers to obtain cheaper tariffs (paragraph 2.13).

11 **The overall costs of supporting Bulb Energy will not be known until it is sold or it exits special administration by other means.** During 2021-22 the Department spent £0.9 billion to enable an administrator to run Bulb Energy. The Department will need to continue funding Bulb Energy's operations until it exits administration, either because it is bought by investors or through other means, such as reallocating its customers to one or more other suppliers. HM Treasury has budgeted an additional £1.0 billion to run Bulb Energy during 2022-23. The actual cost is very uncertain partly because, in line with government spending guidance, the Department and HM Treasury chose not to hedge, which means its running costs are affected by the ongoing volatility in wholesale markets. The costs incurred may be offset by proceeds of any sale, although this is subject to what value a potential buyer places on Bulb Energy. The Department has the power to recover the final net cost from bill payers through a levy, at a time of its choosing (paragraphs 2.18 to 2.22).

The regulation of the energy supplier market and how this contributed to the exits

12 **By 2021 many suppliers lacked financial resilience to deal with wholesale price increases.** An independent review by the consultancy company Oxera commissioned by Ofgem following the 2021 supplier exits found that the business models adopted by many new suppliers exposed them to supply or demand shocks. For example, energy suppliers that failed operated with lower liquidity levels (less access to cash) than their peers and were more reliant on customer credit balances to finance their day-to-day operations. This meant that they were heavily exposed to volatility in the energy market (paragraphs 3.2 and 3.3).

13 **Ofgem's approach to licensing and monitoring suppliers increased the risk and cost of supplier failure.** Since the market was opened to competition, Ofgem has been keen to encourage new entrants to improve customer choice, ensure competitive prices and encourage innovation. It accepted that some energy suppliers would fail as part of the normal functioning of a competitive market; Ofgem saw its role as minimising the impact and disruption for customers of any failure. Prior to 2019, it operated what it has termed a 'low bar' approach to licensing new suppliers. It did not undertake detailed scrutiny of licence applicants' financial situation nor require commitments of shareholder equity prior to market entry and did not formally refuse any supply licence applications. Ofgem also did not monitor in detail suppliers' financial stability, including the sustainability of their business models. Oxera's review found some suppliers did not have enough "skin in the game" and that there were several regulatory options which Ofgem could have pursued which would have mitigated either the risk or cost of supplier failure (paragraphs 3.4, 3.5 and 3.10).

14 **Ofgem began tightening rules to improve suppliers' financial resilience in 2018 but did not introduce changes to address the risks relating to existing suppliers until 2021.** In November 2018, following an increase in supplier failures and some inadequate service provision, Ofgem consulted on increasing entry requirements for new energy suppliers and tightening the rules on financial resilience for existing suppliers. In July 2019, Ofgem introduced new assessments of applicants for a supplier licence but did not introduce tighter rules for existing suppliers until January 2021. Ofgem plans to assess the extent to which earlier implementation of its changes would have reduced the risk or cost of supplier failures, or both (paragraphs 3.7 and 3.8).

15 **Ofgem did not consider what impact the price cap might have if there was significant volatility or sustained periods of price increases in the wholesale energy markets.** When introducing the price cap Ofgem undertook some modelling to understand its potential impact on supplier resilience, primarily in relation to the 'big six'. Although it understood that the price cap could make suppliers – especially small suppliers – more vulnerable to price shocks, it did not stress-test the price cap's design in depth. Nor did it consider how the price cap might interact with the SOLR process. The exact impact of the price cap on the supplier failures is uncertain but it is likely that many suppliers would have failed even without its existence given their lack of financial resilience. However, the cap has affected the market in other ways, such as increasing the costs passed on to customers when suppliers have failed (paragraphs 3.22 to 3.24).

16 **The Department has announced plans to enable the price cap to be extended but is yet to evaluate its costs and benefits or consider alternative forms of price cap.** The price cap has achieved some benefits for consumers, such as encouraging suppliers to achieve efficiency savings that can be passed on to bills. However, it may also have had some long-term disbenefits, such as reducing competition in the market by limiting the price differentials that suppliers can offer at times of high wholesale prices. Neither the Department nor Ofgem has undertaken a full evaluation of the costs and benefits of the price cap for consumers. In February 2022 Ofgem set out changes it expected to make to the cap to ensure it reflects the underlying costs and risks to energy suppliers of supplying energy to default tariff customers. Ofgem told us that there may be benefits from alternative forms of price cap but that these may require the Department to make legislative changes. In May 2022, the government announced that it intended to bring forward legislation which would include enabling the extension of the price cap beyond 2023 (paragraphs 3.23 and 3.27 to 3.30).

Ofgem's planned changes in relation to the regulation of the energy supplier market

17 **Ofgem is exploring changing the licensing regime to prevent shareholders of failed companies making a return at the expense of consumers.** On insolvency, administrators of failed suppliers will monetise assets of the company. This could include hedges (contracts to purchase wholesale energy at a fixed price in the future), which potentially hold market value at the point of collapse. When a supplier fails, the value of any hedges remains as an asset of the failed company and is used to pay off creditors, and potentially shareholders. The SOLR then incurs the cost of re-hedging or buying energy at the spot price, which it can then pass on to consumers through the SOLR process. Ofgem is exploring introducing changes to the licensing regime so that hedge values recovered from failed suppliers are used to offset SOLR costs. In its view this may partly help to reduce the cost to consumers of failure and incentivise better stewardship of suppliers as shareholders would be more at risk from failure. Ofgem told us that, in its view, legislative change is also needed to fully protect consumers (paragraph 2.12).

18 Ofgem is tightening the rules for suppliers to improve their financial resilience and seeking new powers and resources to enforce them. In December 2021, Ofgem published an action plan on retail financial resilience setting out plans to strengthen the financial resilience of suppliers and ensure that risks are not passed on inappropriately to customers. It is also seeking additional resources from HM Treasury, and new powers to enable it to take a more proactive approach to monitoring and responding to issues of financial resilience. Some stakeholders told us that Ofgem had previously been slow to react to potential licence breaches and some were concerned that Ofgem was requesting new powers when it had not made full use of its existing ones (paragraphs 3.11, 3.12 and 3.18 to 3.20).

19 There is a risk that Ofgem's changes could hinder both effective competition and the supplier market from contributing to the achievement of net zero. Some of the new suppliers that entered the market offered more innovative products and services that support customers to reduce their energy consumption or make their energy usage more flexible. They also created greater competition on the price of bills. Some stakeholders have warned that Ofgem's reforms to the supplier market could prevent the entry of new suppliers that would offer this price competition and innovation in future if the market returns to more benign conditions. Ofgem is introducing its reforms ahead of further clarity being provided on the role of suppliers in achieving net zero. The Department published its *Energy Retail Market Strategy* in July 2021, setting out its vision for a market that enables net zero. But in December 2021 it announced that this strategy needed revisiting to take account of the supplier failures (paragraphs 1.10, 3.4, 3.15 and 3.17).

Concluding remarks

20 Ofgem could not have prevented the increase in wholesale prices in 2021 from significantly affecting consumers, but it did not do enough in the years that preceded it to ensure the energy supplier sector was resilient to external shocks. By allowing many suppliers to enter the market and operate with weak financial resilience, and by failing to imagine a scenario in which there could be sustained volatility in energy prices, it allowed a market to develop that was vulnerable to large-scale shocks and where the risk largely rested with consumers, who would pick up the costs in the event of failure. Ofgem has operated the SOLR process effectively in that it has ensured households faced no disruption to their supply. But the sheer number of supplier failures means a significant additional cost on every bill at a time when wider cost increases are already causing major financial challenges for many households. Ofgem has rightly recognised that it must quickly improve its capacity to oversee the financial resilience of individual suppliers and the sector as a whole.

21 Ofgem, along with the Department, must also ensure the supplier market recovers from its current state, where high wholesale prices combined with the price cap has stifled some aspects of competition, and where ongoing volatility means many suppliers still face financial risks. But this recovery needs to facilitate a longer-term transition of the supplier market to one that truly works for consumers and supports the achievement of net zero. This is a significant and difficult task, requiring Ofgem and the Department to maintain the capacity to consider the longer-term objectives while managing the short-term challenges of stabilising the market. This will require a nuanced approach to regulation that finds a balance between its aims of competition, innovation, resilience and affordability for consumers.

Recommendations

22 The Department and Ofgem together should:

a in line with plans to revisit the *Energy Retail Market Strategy*, **set a date by which they will review the changes needed to retail market regulation so that the supplier retail market aligns with the achievement of net zero**. They should also establish interim milestones, including establishing by the end of 2022 high-level principles around the role suppliers will play in achieving net zero with which to test whether any short-term financial regulations are compatible with these principles;

b **establish a process by the end of 2022 for considering how new interventions in the retail market, like the price cap, would react in a wide range of scenarios**, to mitigate the risk that interventions implemented at pace do not sufficiently consider the risks and unintended impacts;

c **undertake a review of the costs and benefits of the price cap to inform decisions about the operation of the cap and alternative forms of price protection.** This should include consideration of whether alternative types of price cap, such as one that focuses on vulnerable households or is based on the relative cost of different tariffs a supplier offers, better achieves its objectives for the retail market; and

d **review and update the SOLR process in response to issues which have emerged over the last year.** This includes issues that arose in its implementation, such as uncertainty over credit balances caused by delays in the transfer of customer information, and addressing the imbalance of risk between suppliers and consumers, which currently enables suppliers to exit from the market with little risk and even potentially to make a financial return.

23 Ofgem should:

e **define and agree a set of a set of objectives for its regulation of the retail market against which it should review and report its performance at least annually.** This should be a balanced set of measures based on available qualitative and quantitative information relating to consumer outcomes on issues such as price; quality of service; stability and predictability of tariffs; and delivery of the innovation needed to achieve net zero. This should include input from all the parts of Ofgem that interact with the retail market;

f **build regular review points into its current round of changes to the regulation of suppliers**, including the new financial responsibility principles, for it to consider whether its approach continues to support its range of objectives, including the achievement of net zero and ensuring consumers do not overpay for energy. This should include consideration of whether it is continuing to balance adequately the need for financial resilience and enabling innovative business models to enter the market; and

g as part of its regular reviews, **consider whether it is able to monitor adequately compliance with its new rules around financial responsibility.** This should include considering whether it has sufficient understanding of the business models that suppliers use. It should also consider whether its powers and resources enable it to enforce the new rules and address any issues blocking its ability to take rapid and effective compliance and enforcement action against suppliers where necessary.