

Future fantastic?

Remaking an energy supply market that's fit for the future



About this report

What follows is a discussion paper that is intended to provoke debate on what the future of the retail energy market might - or should - look like. It is intended to be provocative and we would welcome challenges to the ideas it contains.

Nowcast: the state of play going into the crisis

**It's looking like things could be about to get 'back to normal'.
But is that what anyone wants?**

After intense price spikes, principally caused by the conflict in Ukraine, there are some signs that things could shortly get back towards 'normal' in the electricity and gas supply markets.

Competition has effectively been suspended for the last 18 months as suppliers have been unable to undercut the price cap during a sharply rising wholesale market. But as prices start to fall, the scope for suppliers to offer acquisition deals has increased, and it seems likely that some will be launched this year. Crisis over then, perhaps. But is it? And is going 'back to normal' in anyone's best interests?

Consumers have been able to choose their electricity and gas supplier since the late 1990s, with this freedom to shop around seen as crucial in encouraging suppliers to offer better, cheaper products.

On some measures, competition can be seen to have been a success. For example, the switching rate in Great Britain has tended to be amongst the highest internationally, with those shopping around receiving much better prices than those who do not.

Some might argue that switching benefits everyone. That switchers will get the best deals available, while the disengaged benefit from the improvements in efficiency that this drives. This might well have proven to be the case if it was impossible, or very difficult, to segment the market between engaged and disengaged consumers such that both could share in the benefits. But in practice, segmentation between engaged and disengaged consumers has proven very easy, and the latter have not so much benefited from increased efficiencies as been used to cross-subsidise loss-leading acquisition deals. Up until the recent crisis, which resulted in the vast majority of the market being on the price cap tariff, the disengaged were left on standard variable tariffs, with one level of pricing, while acquisition tariffs for the engaged were set at a different level.

Switching has traditionally been driven by big differences between the (cheaper) prices offered to new customers and the (higher) prices charged to ongoing loyal customers. Price discrimination between engaged and disengaged consumers is a logical and, perhaps, inevitable function of competition, but has brought politically and socially uncomfortable outcomes. Those consumers who would most benefit from engagement and lower prices are often those who are least able or likely to do so. Pensioners, people with disabilities, those on low incomes, and people without higher education are all less likely to switch than the average.¹

Public discomfort with the spectre of significant price discrimination in the sale of an essential service has resulted in multiple investigations into the health of the sector, and significant interventions such as the energy price cap to try and mitigate its detrimental effects.

In theory, competition should drive innovation and consumer service improvements. But there has been less of this than might be expected. With limited exceptions, electricity and gas are still sold as a 'plain vanilla' product where suppliers principally compete on the price per unit sold rather than on service or by offering distinctively different products. The typical domestic energy consumer of 2023 would notice very little difference to the one of 2003 other than that they can now usually service their account online, if they so choose.

Rebuilding from the ashes

If the picture doesn't look rosy for consumers, it does not look much better for suppliers. The sector is currently loss-making, and financially fragile. Lax market entry and compliance enforcement rules resulted in a large number of financially and operationally unprepared suppliers entering the market in the 20-teens. Many of these were solely competing on price, with limited financial firepower to hedge, and often over-reliant on consumer credit balances as a source of funding. Their ability to hold on to their engaged consumers once their acquisition deals had ended, or to cope if wholesale market conditions became less benign, was questionable with foresight, not simply with hindsight. Unsurprisingly, many went bust in 2019-2021, causing billions of pounds in costs to be socialised across other consumers.

While they were around, these now defunct suppliers had an impact on the behaviours of their rivals. Because they were aggressively competing on price, and price alone, they prompted others to do likewise, in order to retain market share. As recently as 2021 it was not unusual to see large suppliers offering several hundred pounds in bonuses to new customers (see figure 1). That any new customer they picked up through this approach was inherently likely to be price sensitive and likely to shop around once their acquisition deal had ended did not seem to be a deterrent, with maintaining market share seemingly taking precedence over any prospect of ever making money on these accounts.

Figure 1 (right): Irrational exuberance? Some new customer incentives going into the current energy crisis.

While the exact valuation suppliers put on new customers is commercially confidential and likely to vary both by supplier and by customer characteristics, we can get some sense of the ballpark by the amount of cashback being offered to new customers by cashback websites.

The following are a range of offers available to consumers just before the current energy crisis started, in 2021.² It should be noted that **these financial incentives are in addition to the benefits that the consumer would receive from simply changing tariff** (eg the price differential that existed between these tariffs and standard variable tariffs).

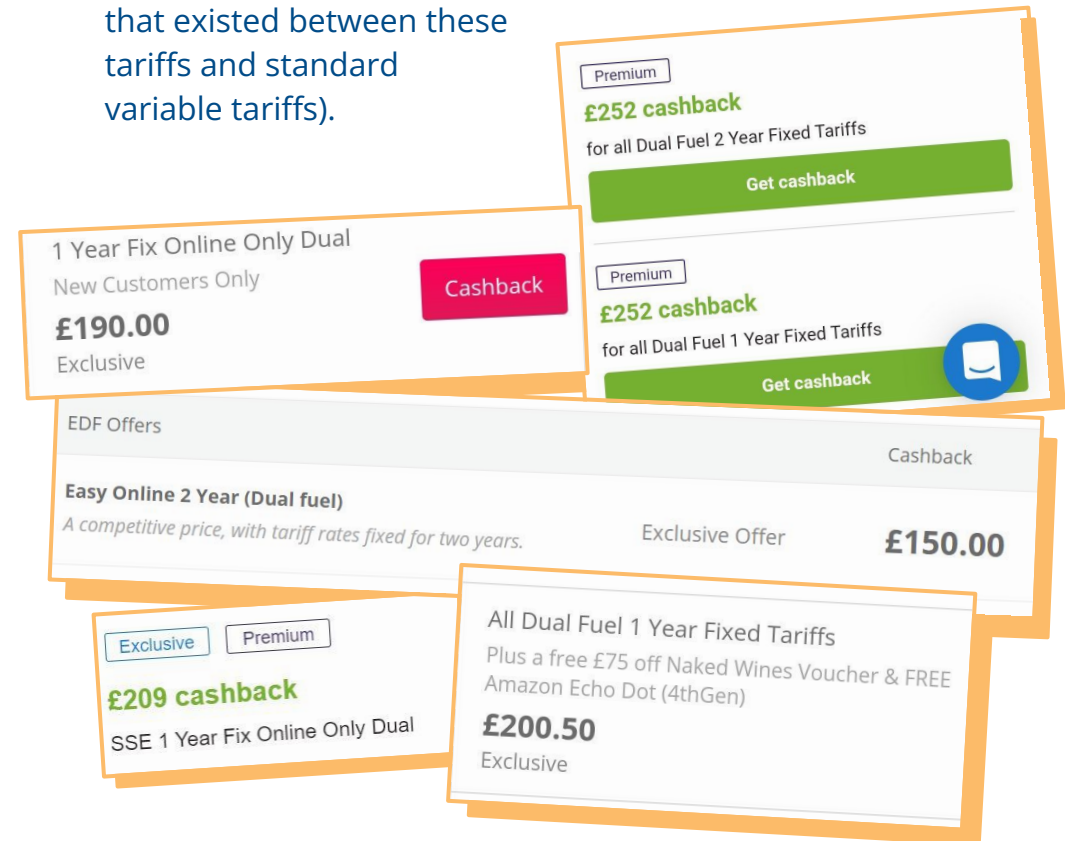


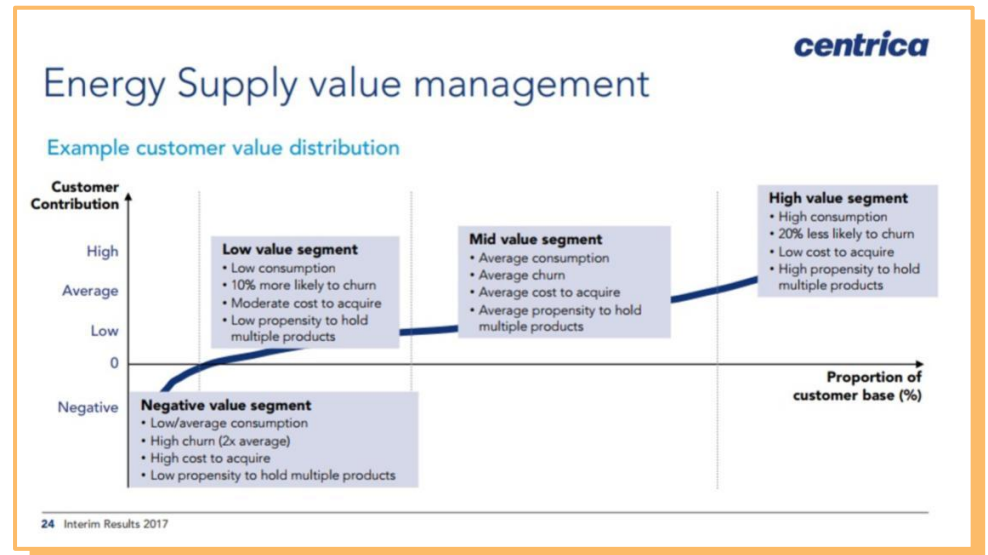
Figure 2, taken from a large supplier's financial reporting,³ neatly summarises the current market model, going into the current cost of living crisis. Disengaged customers with high consumption were the most profitable segment of the market, while engaged customers who used less energy were served at a loss. Given disengaged customers are more likely to be vulnerable than the norm, and the need for both environmental and financial reasons for society to improve energy efficiency, this is not a good combination of outcomes

The purpose of competition in the retail energy market is unclear, given the mixed consumer outcomes it has driven. Many see the market evolving from one where suppliers simply sell kilowatt hours to one where they sell services such as flexibility, or home retrofit. But it is not self-evident why suppliers should hold that role. You don't need to be a supplier to retrofit a home. If others emerge to fill that gap, what role then for suppliers? If their role does not extend much beyond billing and metering, do you actually need competition to do that or would regulating cost and outcomes, much like conventional networks, give better outcomes?

We need to think about what innovation we want, and where we want it. As previously highlighted, with limited exceptions, the GB energy supply sector could not be categorised as highly innovative. Does this matter - can others fill the gap? If it does matter, how is it reconciled with a low margin business

activity? The regulatory response to the failure of many suppliers with unsustainable business models has, understandably, been to take steps to discourage risk-taking. Can one reasonably expect conservatively managed businesses to be highly innovative?

Figure 2, the traditional energy supply value management model



The long shadow of debt

Energy debt is a massive problem overhanging both consumers and suppliers. Recent price spikes have driven huge increases in both the breadth and the depth of debt. Citizens Advice has seen demand for energy advice surge by 188% in the last three years. We dealt with more self-disconnection cases in 2022 than the previous ten years combined. Energy debt and affordability are now the most frequent issues dealt with by our advisors. Many indebted consumers may struggle to pay back their debts in a reasonable timeframe, or at all. The consequences of self disconnection and rationing for those who are struggling to pay are dire, with direct adverse effects on their quality of life, health and economic prospects.

Within industry, there appears to be widespread belief that the current debt mountain - around £2.5bn according to Ofgem - will escalate markedly in the coming months. This could threaten the financial viability of some suppliers and their ability to invest in the services they provide to consumers. Further supplier failures, or under investment in necessary services, could reinforce the consumer harm of high prices.

Historically, bad debt has been principally managed through the use of prepayment metering, however the forced installation of new PPMs (and the remote switching of smart meter customers to prepay) are temporarily suspended due to the exposure of severe failures in the ways some suppliers were installing and using PPMs.

Unaffordable prices

Fuel poverty - consumers being unable to afford enough energy to meet their basic needs - has been stubbornly persistent, and increased markedly during the recent price spikes. Policies to tackle the problem have not kept pace, with the Warm Home Discount only increasing by £10 since its inception, and millions of households still living in energy inefficient homes. While there is a constraint on prices in the form of the energy price cap, it is only intended to ensure that consumers on default tariffs pay a price that fairly reflects the underlying costs of serving them.

That isn't the same as ensuring that consumers pay an affordable price, and highlights some of the limits that constrain Ofgem's ability to deliver good outcomes for consumers. As a regulator it has no tax and spend powers that would allow it to target financial assistance on those who are struggling, and is limited in its ability to put in place cross-subsidies that could help the poorest. It has regulatory oversight over supply, but not over demand (i.e. energy efficiency). Historically criticised for favouring more competition as the solution to all problems, it could be argued that this tendency has arisen because Ofgem simply lacks the tools to attempt other approaches.

To reach Net Zero, almost all homes will require some level of retrofit. The costs of this work are significant and for many homeowners there is currently limited financial support. But affordability is not the only determining factor when it comes to willingness to pay. Our research⁴ has highlighted the following barriers to increased homeowner take-up of retrofit measures:

1. Lack of personalised advice
2. Upfront costs
3. Lack of incentives

All three barriers need to be addressed if we are to create an appropriate package of information, incentives and support for people seeking to decarbonise their homes.

Future fantastic

Where can we go from here? Where should we go from here?

Any supplier whose preferred destination is simply to be allowed to make a decent profit from selling kWhs of electricity and gas should perhaps look away now: you have no future. It seems very unlikely that there will ever be widespread public consent for traditional energy supply making significant profits, and particularly not in an era of crippling high prices. This is almost bound to flow through to a political and regulatory environment that precludes that outcome. Breakeven may be the most that a traditional energy supply business can hope for.

Where there is scope for profitability in supply-related activities, it is in solving the market failure that energy efficiency, heat decarbonisation and flexibility services (collectively referred to here as 'energy services') are much smaller markets than they need to be. Reducing consumers' energy spend, and/or allowing them to make money from their demand patterns and behaviour, is likely to lead to a much more healthy relationship between service providers and consumers. If consumers perceive themselves to be 'winning' on their side of the commercial relationship, they are much more likely to be tolerant of the energy service provider 'winning' - making a profit - too.

Selling the benefits of using less, and using differently

To date, energy efficiency has often appeared to be viewed as something of a chore by suppliers, something they are obligated to deliver under past schemes like CERT, CESP and now ECO, but as a non-core business that is often outsourced. There is a nascent domestic flexibility market, to date largely dominated by Octopus, but few other suppliers have followed suit, because these markets are currently small and may not yet be profitable. It is possible that low trust in the sector may also inhibit consumer engagement. But, in our view, energy services provide the best, and most likely, opportunity for suppliers to reset their relationship with the public, and to deliver profitable services that help consumers reduce their bills while improving their quality of life. The perception of what the retail energy market is for - what product is being sold - needs to change to reflect this more healthy relationship.

In order to support this transition, we will need to tackle the informational and financial barriers that are inhibiting its uptake. Consumer interest in the different aspects of energy efficiency from home retrofit to heat decarbonisation is very low, and there is significant reluctance, or inability, to foot the upfront costs. The able to pay market is particularly problematic and poorly defined.⁵

The solutions to the lack of demand for energy efficiency and heat decarbonisation are likely to come through the creation of markets, interim financial support from the government until that happens (and likely on an enduring basis for poorer households), and enhanced consumer advice.

Energy efficiency has never really been sold as a product to domestic consumers in the UK. You do not see or hear it advertised on television, radio or billboards and, insofar as they are aware of it, consumers often associate it with being given away for free to some groups of citizens. Because of this, it appears to be lower in the public consciousness than it should be, and undervalued. Part of closing that gap should sit with enhanced consumer advice, and we think there is a strong case for the provision of more independent advice to consumers on what the journey to net zero means for them, how they can benefit, and how they will be protected through that journey. But part of the solution to creating demand must involve creating and utilising market forces to sell its benefits. Energy efficiency needs to become desirable, something consumers want to actively seek out and get.

Paradoxically, in the short term, recognising that there is a gap between how much consumers are willing to spend on future proofing their homes and how much they would benefit from such spending, and that the market for energy efficiency is much smaller than it needs to be and would benefit from stimulus, there is a case for public spending on

grants to the able to pay market. While it may appear perverse to provide any public funding to the able to pay, it must be recognised that the alternative - building more power stations, importing more gas - may be more expensive still. The less progress we make on decarbonising our housing stock, the more we will need to make in other sectors where the costs of change are higher.

Historically we were insulating far more homes when grant funding was available to a wider audience than those on benefits.⁶ A sensible policy may well be one that provides some grant funding to able to pay households now while energy efficient markets remain nascent, but that steadily reduces it over time as those markets develop. There will be an enduring need for the provision of upfront financial support for those households who are unable to pay.

While reducing the amount of energy people need to use to live a comfortable life is part of the solution to energy affordability, reducing the price they pay is also part of the puzzle. With average bills at £2,500/year, nearly ten million households - around one-in-three - are spending more than 10% of their income after housing costs on energy. Even if bills return to more normal levels, a significant rump of consumers are likely to struggle. As our recent project with the Social Market Foundation and Public First demonstrated, the case for targeted bill support to low income households is very strong and should be adopted by government.⁷

A lobbyist's charter?

Targeted price support won't remove the need for a price cap, at least in the short term, as the policies have different aims. The price cap's aim is to deliver *fair* outcomes: to ensure that the prices consumers pay fairly reflect the underlying costs of supplying them with energy. Targeted price support's aim is to deliver *affordable* outcomes: to ensure those on the lowest incomes can afford to light and heat their homes. These aren't either/or aims: energy retail needs to deliver on both fairness and affordability.

The introduction of the price cap was driven by widespread concerns that price discrimination in the sector was resulting in higher profits, and lower efficiency, than would exist in a well-functioning market. In order to remove it, policymakers would need to be confident that the market wouldn't simply revert to pre-price cap behaviours. It's hard to see on what basis they could reach such a judgement. But it will face design challenges in the coming years.

One of these is that its relevance may erode if time-of-use tariffs become the standard product offering in the market. It would be very hard to apply price caps to such tariffs given their complexity. But we may be some way off a time where such tariffs become default tariffs; if indeed they ever do. A bigger challenge is the risk that the price cap becomes a lobbyist's charter for a sector that has fully convinced its

regulator of its financial fragility and need for support. The price cap is easily modified, and has been under continuous modification since its inception. If this becomes a vehicle for the uninterrupted introduction of new or increased allowances, or methodological changes that benefit suppliers at consumers' expense, the price cap could lose public and political confidence.

Get smart

It's time to revisit how we are delivering smart meter rollout, because the current approach isn't working and is reducing the benefits that consumers can receive from this technology. A co-ordinated network-led rollout was rejected in favour of a supplier-led approach that is now lagging years behind schedule. The complete rollout of smart metering was originally targeted for 2019. By the end of 2022, only half of households had smart meters operating in smart mode. These are likely to be the 'low-hanging fruit' - the easiest households to reach. If we continue with this approach, smart meter rollout will never be completed; even with further slippage in deadlines we may not get close.

That has consequences for all consumers, delaying the rollout of smarter products and the benefits of a more flexible energy system. But it has particular implications for consumers who remain stuck on dumb prepayment meters, who are traditionally the worst served consumers. They aren't

able to access the best deals, are more likely to miss out on external support from government schemes that cannot be automatically applied, and face difficulties in topping up just to remain on supply that aren't faced by other consumers. If we have to live with prepay as a payment method, it would be much better if these households were on smart prepay than left on dumb prepayment meters.

So should we now be considering moving from the voluntary adoption of smart meters to a mandatory rollout, to allow us to reach the whole population? If network-led rollout is off the table, is there a case for developing a mechanism to allow and encourage suppliers to install smart meters on each other's behalf? Where, eg, blocks of flats have all their meters in a shared cabinet, it surely must be more efficient to replace them all at once than to have them replaced individually.

Fair for the future - taxes versus bills

We should also revisit how we pay for social and environmental policies. At the moment, these are overwhelmingly paid for through bills, rather than through taxation. The distributional impacts of that choice are regressive, pushing more of the costs on to poorer households.⁸ The situation is worsening over time, with current legislation due to add further bill levies, most notably for supporting the development of hydrogen. Well-meaning attempts to move policy costs from electricity bills to gas bills

in order to encourage electrification may have negative distributional and social outcomes if not managed carefully.⁹

The justification for paying for policies through bills not taxes seems to be founded on a view that they are all by definition energy related, and that paying for them through energy bills is therefore logical. This has always been questionable, as the justification for each policy is usually multi-faceted, and not constrained to the sector. Delivering low carbon energy brings energy benefits - clean kilowatts - but also societal benefits - mitigating climate change, clean air. We feel the former of those benefits as energy bill payers, and the latter as citizens, as taxpayers. But the approach to cost recovery exclusively recovers the costs from bill payers.

Likewise, there are real ironies in tackling fuel poverty through schemes that are paid for in a manner that increases bills. Only one of the key causes of fuel poverty, high prices, is driven by the energy sector. Other key causes, such as poor housing, low incomes, or increased need due to personal circumstances such as critical healthcare, are not. Yet we pay for fuel poverty policies exclusively through energy bills, and not as social policy paid for through the broader tax base. The ghettoisation of fuel poverty as an 'energy issue', when its causes are much broader, may impede the holistic thinking needed to adequately tackle its causes.

Regulating the future

What shape future regulatory structures should take is very uncertain. Big Data and smart goods open up a range of opportunities to improve consumer outcomes, that are likely to straddle historical regulatory boundaries. Bundled services, or the provision of a physical asset such as a heat pump or EV charger, alongside a retail energy tariff may become much more common. Energy tariffs may be bundled with financial services products, providing the upfront financing to purchase and maintain these assets. The smart use of data may be required to get the best value from these investments. Indeed, the most value in the whole package - both for the consumer and for the retailers - may lie in the consumer's data and how it can be used. Traditional utilities regulators have little experience in that area of oversight.

For consumers to take best advantage of these new possibilities, it will be crucial that they can understand and control how their data is used. They will need clear and easy mechanisms to switch on - and switch off - third party access to their data. They will also need ways to easily access their own data, so they can understand what they are sharing and what benefits they get from this. To facilitate this, we are likely to see some evolution in the role of regulation to much more greatly encompass personal data and how it is used. Whether that role should - or can - sit with utility regulators is unclear at this point, but will need to be addressed.

The debate around the use of data tends to focus on early adopters of smart products or electrification technologies, such as heat pumps and EVs. But we should not lose sight of the potential for better use of data to improve the outcomes for consumers in vulnerable situations. More sophisticated identification of those in difficulty, and in the provision of support to them, including the design of new products and services that better meet people's differing needs and preferences, must be one of the outcomes prioritised by future regulation.

The role of artificial intelligence (AI) in this is yet to become clear but it has the potential to be radical. AI is likely to have major impacts on economic activities that are repetitive, process driven and don't require manual dexterity - which could include customer services aspects. If well implemented, it could materially improve consumer outcomes and make it much quicker and easier to resolve problems. Suppliers will have to be mindful that the interface between AI and their customers may not always be online; that some consumer inquiries may still be received by phone, and that some delicate situations may be better resolved by human interaction. Will AI be able to identify and respond to human vulnerabilities? How will suppliers triage calls between AIs and human respondents?

It is clear that regulation and consumer protections will need to evolve in order to keep pace with a rapidly changing market. There is no sign that this is happening quickly enough and in a way that will help grow and maintain consumer confidence in making significant changes to their homes or how they use energy in them.

One sensible first step may be to simplify the protection landscape in the home retrofit sector, where the large number of voluntary consumer codes may be causing consumers' confusion rather than giving them comfort.

Your view

This paper has presented a short pen-portrait of the retail energy market as it is, and how it may possibly evolve. We expect to follow it up with a series of further papers considering individual issues in more depth.

Many futures are possible and you may not recognise the one we present, or disagree on the challenges and opportunities that it presents. We would warmly welcome any feedback you may have on this paper, and on how we should further develop our thinking on the future of the retail energy market.



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