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In competitive markets, firms can - and do - get into financial difficulties from time to time. Typically when that happens, better-run competitors expand their market shares and new firms enter the market in their place. Regulators tend to intervene to prevent failures only when they are concerned that the 'stability' of the sector as a whole is under threat, such as with prudential regulation in banking. But these interventions are not without risk of unintended consequences. This blog examines the potential long-term impacts that Ofgem's current proposals could have on the energy retail market in the UK.

A tale of healthy failures and regulatory failures

Since liberalisation of the UK retail energy market, suppliers have gone bust when energy prices rise if they had not bought appropriately in advance (they got their 'hedging strategies' wrong). Conversely, suppliers can also do very well when prices fall and they are able to take advantage of their hedge (or the lack of it), by pocketing additional profits or - regulators would hope - gaining market shares via aggressive introductory tariffs.

> Bailing out failing firms drives the wrong incentives for future behaviour. However, introducing or strengthening prudential regulation is not without its risks.

Managing exposure to risk of future energy prices and the resultant retail price level has always been a really important competitive parameter in the energy market. When a badly-run supplier gets this wrong, its failure should not be a source of harm to consumers or society, provided it is managed in an orderly fashion and without undermining competition.

However, in recent times the introduction of the well-meaning default tariff price cap - that protects disengaged consumers on Standard Variable Tariffs - has had the unintended effect of putting substantial pressure on well-run, prudent companies. For the most exposed suppliers, unsustainable losses mounted: as wholesale prices unexpectedly increased sharply over six weeks, the regulated retail price cannot be raised until the next review period in April 2022.

It is not for this blog to discuss whether introducing measures to protect disengaged consumers was a worthy policy move and - if so - whether a price cap was the most effective tool to pursue it. But the current crisis shows that retail price caps are notoriously difficult to get right in practice, while avoiding distortionary effects. And it also shows - as if further proof was needed - that regulated prices are easier lowered than increased, even if such increase was in response to an openly recognised regulatory failure in the cap-setting methodology.

Too much competition in energy retail?

As the casualty count keeps rising (some commentators expect that 10 or fewer suppliers may survive the crisis) one cannot help wondering if the UK retail energy market was unsustainably competitive. It seems to us that the issue here was one of too many competitors, which actually brought very little in terms of the benefits typically associated with competition as they were for the most part lacking compelling USPs.

Indeed the government has not even considered a short-term 'regulatory holiday' to nurse the industry until the next price cap review - somewhat unusually for an executive that has otherwise been trigger-happy in suspending competition law to counter emergencies from the pandemic. Perhaps a diffuse dissatisfaction with the current atomised market structure, with the perception that entry requirements had been too loose for too long, explains such inaction.

At the time of writing, almost 30 suppliers have entered administration, either via the Ofgem-run Supplier of Last Resort (SoLR) framework or, for Bulb, the government-run Special Administration Regime (SAR). Recent estimates put the cost of the crisis at around £4bn, with energy consumers on the hook (via SoLR) for approximately £2bn, and the British taxpayer (via SAR) for £2bn. This seems a steep price tag for the incremental service and consumer protection gains brought about by these additional suppliers.

The longer term damage includes a loss of trust in liberalised energy markets, the impact of which is more difficult to estimate yet no less worrying. Loss of consumer engagement, loss of investors' backing and over-burdened surviving suppliers may see retail competition retreat alongside a more heavy-handed approach by the regulator.

Never let a good crisis go to waste

These days Ofgem is incredibly busy managing the orderly transitions of customers to the nominated Supplier of Last Resort. At the same time, it has consulted on short-term changes to the price cap methodology, in time for the next review of the level of the cap and is seeking views on wider changes to build resilience in the market.

So aside from the immediate firefighting, what long-term solutions could the government and Ofgem consider to take advantage of this crisis? In a 'first best' world, active consumers keep suppliers working hard for their custom. The complication in the real world is that not all consumers are engaged, and so may not get good value for money. Furthermore, the government encourages the retail market to contribute to its net zero agenda.

In a 'second best' world, **removing the default tariff price cap** that protects disengaged consumers is not a politically realistic option for government. Unless alternative protection mechanisms for disengaged consumers can be found, it will be difficult to convince politicians that the retail price cap is disproportionately costly: the hidden true cost of the price cap does not usually make the headlines as easily as a price cap reduction 'we saved each household £60 per year'. Unfortunately, the socialised costs of supplier failures are mounting up. And, to the extent that the price cap suppresses price signals (reducing the incentive to cut discretionary energy use), suppliers and consumers are not as incentivised to change their behaviour and support the national efforts towards net zero.

> Straight-jacketing suppliers to follow a narrow set of "acceptable" hedging strategies devised by the regulator would eliminate one of the key enablers of retail competition

The proposed changes to the price cap set out by Ofgem are underwhelming: a quarterly price reset would not have prevented the current

crisis, when prices increased sharply over 6 weeks. Even intervening 'when appropriate' is likely to lag the price changes by several months, increasing the risks borne by suppliers. More disconcertingly, the proposed 6-month fixed default tariff could confuse consumers, restrict the switching that is seen as the engine of competition in this market and may provide little additional demand certainty as retailers have rarely enforced, or been able to put into practice, 'exit fees'.

> ...having fewer, larger, robustly managed players may well be desirable - despite the short term pain.

Prudential does not mean risk-free

Last week Ofgem published proposals on strengthening suppliers' financial resilience and potential adjustments to the price cap methodology. It will consult on new licence conditions in Spring 2022 to improve the effectiveness of **financial regulation** of the energy retail market, including (i) adequate hedging and risk management (ii) protections on use of capital to avoid socialised costs, and (iii) new accountability and governance requirements. These come alongside proportionality requirements and support for the transition to net zero.

This sounds very sensible in principle, as this crisis has exposed that a significant number of suppliers may have indulged in 'moral hazard', under-insuring against price risk for their customers in the knowledge that if those risks were realised, costs will be socialised and consumer supplies unhindered. It has also shown how the SoLR framework cracks at the seams when industry-wide shocks are at play (rather than just badly-managed individual firms), with Bulb already too big to be absorbed within it and going directly into the government-run SAR. Bailing out failing firms drives the wrong incentives for future behaviour.

At first sight, Ofgem's proposed action plan appears relatively light-touch and far from dirigiste: first, it sets out a list of outcomes it would be hard to disagree with; second, it outlines an action plan that creates the conditions - via data gathering and stress-testing - for Ofgem to rely on suppliers' boards to self-assess their risk management and to enhance governance and accountability within suppliers. Ofgem contends that this approach would not discourage well-financed, innovative entrants with new business models and risk-taking approaches.

However, in practice the effect of these measures to strengthen financial regulation is not without its risks. Over time the regulator's view of what is compatible with the Financial Responsibility Principle or Operational Capability condition will emerge, even if Ofgem is not setting out formal targets or thresholds (such as capital adequacy ratios or liquidity requirements under Basel III). Regulators have to tread carefully when constraining the ability of energy suppliers to **manage risk**- even more so, regulators that do not have depth of expertise in prudential regulation.

The way suppliers manage price and volume risk is one of the key differentiators that drive the success or failure of different retail energy companies. Straight-jacketing suppliers to follow a narrow set of 'acceptable' hedging strategies devised by the regulator would

eliminate one of the key enablers of retail competition, in an otherwise commoditised market where wafer-thin margins limit the scope for price competition. As the government and Ofgem push to deliver net zero, it would be most unhelpful if the scope for innovation in risk management and business models was restricted by regulation.

Requirements to set aside **more capital** on a prudential basis can help - experience from the financial crisis shows that firms may end up being too thinly capitalised without intervention. Likewise, **good governance** provides additional protections to ensure businesses are run well. However the risk is that overly strict requirements would unnecessarily raise barriers to entry or expansion, thereby reducing the number of energy suppliers in the market to a level that consumers suffer (again). While this may not be an overriding concern right now given the widespread dissatisfaction with the influx of suppliers over recent years, it may become a thorny issue if the reduced number of suppliers begins to take its toll on customer service or price.

Conclusions

The task in front of Ofgem and government is extremely complex, given that the price cap is here to stay: improve the resilience of the retail energy market without exacerbating the risk of moral hazard, all the while promoting innovation and net zero targets. To the extent that scale is helpful in capital raising and risk management, having fewer, larger, robustly managed players may well be desirable - despite the short term pain.

Ofgem has set out its proposals for longer-term changes to the default price cap and on financial regulation of energy suppliers. It is critical that firms get ahead with thinking through the options open to the regulator, and what these will mean for their business and their ability to compete in the market.

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