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So Energy's Response to Ofgem's Default Tariff Cap Reform Consultations

Dear Neil,

So Energy is a leading energy supplier providing great-value, 100% renewable electricity to homes across England, Wales and Scotland. We have consistently been recognised by our customers and the wider industry for our outstanding customer service since we were founded in 2015, including being a Which? Recommended Provider in 2020. In August 2021, So Energy merged with ESB Energy and our combined business now supplies over 300,000 domestic customers.

We welcome the opportunity to respond to these consultations. We agree that recent unprecedented wholesale volatility has exposed significant deficits in the price cap methodology, and has resulted in impacts far removed from the original *raison d'être* of the cap. With the energy markets currently in an escalating crisis, the cap is now the tariff of choice for engaged customers, meaning it is capturing both far more customers and the types of customers that were never envisaged when the associated legislation was passed by parliament. It is unfit for purpose. Major change is urgently needed to reflect the significant additional costs and uncertainties that suppliers are bearing in order to prevent further supplier failures and protect investor confidence.

We also agree in principle that steps should be taken to allow the cap to be more responsive in the event of future volatility. Steps should be taken to ensure that the cap reflects the real costs of supplying energy to consumers, such as reflecting the costs associated with the upcoming ECO4 scheme, as well as recovery of current wholesale energy costs, in the next price cap period.

However, we are concerned that the proposals, as outlined, do not adequately address or provide solutions to these challenges:

- We believe that the assessment of suppliers' ability to anticipate rises in SVT demand suffers from hindsight bias. Any allowance should reflect the actual adjustments the supplier community made; a position shared by Energy UK.
- A number of material increases in the cost of supply are not accounted for in the consultation - specifically increases in mutualisation costs, industry costs, shaping costs and working capital costs.
- The assessment of which deviations between price cap assumptions and the associated outturn will 'even out' over the remaining life of the cap appear inconsistent. In the context of the Government's recent commitment to extend the price cap beyond 2023, it

is difficult to understand why you assume that backwardation costs will even out while CfD costs will not.

In the following paragraphs, we provide new facts and evidence to help inform your decision-making going forward. We have also worked closely with Energy UK in the development of their response and would be happy to engage with you bilaterally or through Energy UK on these issues over the coming weeks. Please note Annex A is marked confidential.

Potential Impact of Increased Wholesale Volatility on the Default Tariff Cap

Unexpected SVT demand cost estimate

We welcome your proposal to provide an additional allowance in the cap to account for unexpected changes in SVT demand owing to the capped SVT becoming the cheaper than the available fixed-term contracts (FTCs). In the analysis, you have made a number of assumptions about suppliers' ability to anticipate this eventuality and have proposed that the size of this allowance be discounted by 70%. We believe that there are key flaws in these assumptions.

You present the following rationale:

- Large legacy supplier FTC offerings became more expensive than capped tariffs from May 2021.
- Average FTC offerings across all suppliers became more expensive from June 2021.
- Therefore, suppliers were likely to have anticipated a marked increase in their SVT demand from spring/summer 2021 and you would have expected suppliers to adapt their hedging and risk management strategies accordingly.

However, there are several important elements that need to be considered within this analysis:

- Customers have three choices when they renew - to move onto the SVT, to renew an FTC or to switch. Customers had the ability to save in comparison to moving onto the SVT by switching to another supplier into September 2021. As long as such FTCs were available in the competitive market, this factor carried a heavy weighting in SVT demand forecasts.
- A substantial increase in the price cap was forecast and subsequently announced for 1 October. The anticipated rise in SVT prices made FTCs a more attractive proposition to consumers and this affected forecasts of future SVT demand.
- Most importantly, rising wholesale prices in June did not guarantee continued rises in September or the dramatic acceleration in price rises we witnessed. This uncertainty affected forecasts of future SVT demand. If wholesale prices had fallen instead of the anticipated rise, suppliers who adjusted their hedging strategies would have faced a substantial loss on their position.

You state that "some efficiently run suppliers were able to limit their exposure to the fully unhedged cost by 70%, by adapting their hedging strategy early, in anticipation of higher volume of SVT customers". However, any assessment of the efficiency of a hedging strategy is retrospective, whereas the purpose of hedging is to manage risk on a forward-looking basis. By adjusting their hedging strategy in such a fashion, those suppliers exposed themselves to the risk of the wholesale price falling, FTCs becoming cheaper than the SVT, the rise in SVT demand not materialising and suffering a substantial loss on their position. This analysis suffers from hindsight-bias – just because an adjustment of hedging strategy

has subsequently proven to be efficient does not mean it was necessarily a prudent decision to take at the time.

Today, Ofgem and suppliers today face a risk of the wholesale price falling sharply and consequential *falls* in SVT demand. It is the same risk as we have seen in recent months, only in reverse. Your recent consultation¹ proposes measures to help mitigate the impact of this risk, should it crystallise, but you are not able to state if and when these mitigations may need to be implemented given “considerable uncertainty around future wholesale prices”. Just because one expects wholesale prices to rise or fall doesn’t mean one can predict if it will actually happen, when it might happen, the extent to which it might happen, the consequential impact on SVT demand and how to hedge accordingly.

We believe Ofgem should reflect the real increase in costs borne by suppliers as a result of unanticipated SVT demand. The correct method for calculating any discount on this allowance would be to collect data from all suppliers, rather than a restrictive sample, on the extent to which they’ve adjusted their hedging strategies in anticipation of increases in SVT demand and use this data to apply a weighted average discount. We highlight Energy UK’s response to this consultation proposes the same approach.

Finally, *costs associated with unanticipated SVT demand are increasing day by day*, placing an ever-greater strain on suppliers. Our most recent estimates suggest that cost per customer has risen to £982 (please see confidential Annex A for more details), and this rises to £1,090 when an 11% weighted average cost of capital is applied², and assuming the costs are appropriately recovered over the coming 12 months. It is inconceivable that suppliers should be expected to subsidise customers to this extent. The substantial increases in wholesale prices in recent days will have driven that number up further. It is vital that Ofgem makes its decision on any allowance based on the most up-to-date data available and that a forward-looking element is included in the calculation of the allowance to capture the period between your final decision on the allowance and the next price cap period coming into effect.

Other material increases in the cost of supply

We welcome the opportunity to provide evidence of other costs that have increased materially and need to be accounted for in the next cap period.

With a shortfall of over £218m across both RO schemes, we are surprised that you have not proposed an adjustment to account for this in the next cap period. This level of mutualisation means that there is a material misalignment between the cost assumptions in the price cap methodology based on 2017 data and real costs faced by suppliers.

Similarly, industry costs, such as those associated with the Retail Energy Code, have risen in recent years to the extent that they have deviated materially from the allowance set for them in the cap. Suppliers do not have the ability to substantially cut back on these costs without threatening the delivery of policy initiatives driven by Ofgem, so the costs must be borne. Our colleagues in Energy UK have provided an excellent breakdown of the rise in these costs since 2017.

¹ [Statutory consultation on potential short-term interventions to address risks to consumers from market volatility \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/statutory-consultation-on-potential-short-term-interventions-to-address-risks-to-consumers-from-market-volatility)

² This calculation of weighted average cost of capital is drawn from the CMA’s energy market investigation. Note, for smaller suppliers the cost of capital is higher: [Energy market investigation: Analysis of cost of capital of energy firms \(publishing.service.gov.uk\)](https://www.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/614441/energy-market-investigation-analysis-of-cost-of-capital-of-energy-firms.pdf)

This failure to update the price cap in line with rises in real supplier costs has been a longstanding issue. However, in the context of the current wholesale price crisis, this failure to address deficiencies in the price cap in a timely manner has contributed to the failure of well-run suppliers and has eroded investor confidence to such an extent that the viability of the whole industry is threatened. If investor confidence in the energy market is to be restored and the Government's net zero goals delivered at a reasonable cost, these deficiencies must be urgently addressed. We strongly encourage you revisit and update these cost assumptions.

Inconsistency of approach in determining what changes in cost warrant an allowance

Many of the allowances in the price cap are forward-looking, which means they will inevitably deviate from the actual costs faced by suppliers. However, you expect these variances to balance out over the lifetime of the cap in general.

In this consultation, you've changed this longstanding view, stating that CfD costs will not likely be recoverable over the lifetime of the cap while, for example, backwardation costs will be recoverable. Although it has not implemented the necessary legislation, the Government has committed to extend the price cap beyond 2023. You propose to incorporate ECO4 costs into future price cap periods because it's stated Government policy, even though the legislation underpinning ECO4 isn't in place yet. Given the Government's stated commitment to extend the price cap, we believe that the CfD costs will even out over the extended lifetime of the cap. Therefore, we believe the proposal to claw back these CfD costs is inappropriate.

If you were to proceed with the proposed approach on CfD costs, then logically future iterations of the price cap would need to make similar allowances for less and less material deviations, as the end of the price cap draws nearer. The logical end point of this approach would be to introduce a k-factor into the cap in order to ensure any over/under-recovery in one price cap period is adjusted for in the next. This is not advisable as it will lead to much larger swings in the price cap and create greater risks of unforeseen changes in SVT demand.

Taking powers to update the price cap in exceptional circumstances

We are supportive of this proposal in principle. Recent wholesale price volatility has shown that a reasonable price increase in the short term can remove the need for larger price increases later on and keep energy costs affordable for consumers. The price cap needs to be substantially more cost reflective and flexible than it is.

However, further clarity is needed on what the likely triggers for a re-opener would be, as any uncertainty in relation to reopening places disproportionate risk on suppliers, which will erode investor confidence given recent experience. From the point of view of providing comfort and clarity to investors, there needs to be an even-handed approach to re-opening the price cap in rising and falling markets. Any decision to re-open would specifically need to account for circumstances such as the recent wholesale crisis in deciding whether it is warranted. We are happy to work with you to suggest refinements in your approach in this regard.

Approach to incorporating ECO4 costs into the next price cap period

We are supportive of your proposal to incorporate the forecasted costs of ECO4 into the next price cap period, using data drawn from BEIS' draft impact assessment. The proposal to update future iterations of the cap if costs in BEIS' final impact assessment materially

deviate from the draft, is also sensible. However, any proposal to claw back costs in the event that ECO4 were cancelled, however unlikely, needs to reflect suppliers true avoided costs. The Government has asked suppliers to prepare for ECO4 ahead of legislation being in place. A mechanism for the recovery of any sunk preparation costs is necessary, should there be a sudden reversal in policy.

We hope you find this evidence helpful. As we stated at the beginning of our response, if the price cap is to be retained and sustained, we would welcome the chance to engage and work with you on developing a cap that delivers in today's volatile markets. Please don't hesitate to contact us should you require any additional information or clarity on our views.

Yours Sincerely,

Paul Fuller
Regulation Manager

