

Medium-Term Price Cap Adaptation team
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“Adapting the price cap methodology for resilience in volatile markets” – So Energy Response

Dear Colleague,

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. As one of the last challenger suppliers left in the market, and one that is backed by ESB’s resources and expertise, So Energy are able to provide a unique view on the energy market and future reform.

We welcome the opportunity to respond to this call for input and are keen to work with you on protecting consumer interests. As stated in your paper, the current crisis has made clear that the price cap exposes suppliers, and therefore consumers, to unmanageable risks. Changes are needed to bring resilience to the market and restore investor confidence.

We have provided responses to support your call for input and summarise our position at a high level:

- While we understand that Ofgem is bound by legislation mandating a default tariff cap, we want to be clear that no price cap can be sustained within a competitive market in the long term. The risk of a future crisis caused by a price cap cannot be fully mitigated.
- We challenge the assumption that a relative price cap is not in line with price cap legislation. It would be useful if Ofgem could publish a more detailed explanation of this position.
- The price cap could be substantially de-risked in the medium term if default customers were moved to a relative cap. While we don’t believe it necessary, a backstop of prepay and WHD customers remaining on the current cap could work alongside a relative cap. This would allow suppliers to better manage their hedging risk, while vulnerable customers benefit from the temporary stability offered by Ofgem’s mandated strategy. It can also allow for the cap to be eventually replaced with properly targeted solutions that work in a HH settled market.
- In terms of the options presented, Option 2 represents the best compromise of better aligning the cap with the wholesale market while not introducing new issues. Option 1’s reopener mechanism creates uncertainty for suppliers while Option 3 is not feasible within the suggested timeframe. Changes to the notification period ahead of price capped tariff increases would also shorten the lag between the observation window and changes in the cap, also de-risking further.

- Our preferred option for implementation in October 2022 would be to remove any form of price cap. Failing this, we would recommend a relative price cap, paired with a ban on exclusive tariffs.

Question 1: what is your view on the nature and scale of the volume risk facing suppliers, and the case for changing the current price cap methodology?

The current crisis has exposed all energy suppliers, large and small, to substantial additional costs that will not be recovered. So Energy has shared with you details of these costs in the course of our bilateral engagements. As noted in your consultation on short-term interventions to address risks to consumers from market volatility¹, a similar unanticipated SVT volume risk presents itself should the wholesale price fall substantially following the setting of the price cap. Additionally, there are substantial costs to suppliers from the current backwardation in the wholesale markets. These costs have not been included in this consultation's assessment of key financial impacts that suppliers face as a result of the current energy crisis and therefore Ofgem should be mindful to look wider than just 'volume risk' alone. The magnitude of the issue we face today, and potential future risks threatens the viability of the market.

The current cap adapts an approach that was designed for traditional prepay customers – a sector of the market that historically has been less active – at a time when wholesale pricing was benign. The recent increase in wholesale volatility caused an outcome unintended when the default tariff cap was designed - the vast majority of engaged consumers are choosing default cap tariffs, exposing suppliers to enormous losses.

The underlying cause of this issue is that the cap mandates that a supplier run two incompatible hedging strategies in parallel, one for their acquisition tariffs and one for their price-capped tariffs. The latter strategy must follow the approach used for calculating the cap or risk their costs falling out of alignment with what is recoverable through the cap. Any time the two hedging strategies diverge enough to cause an inversion in prices, for example default price capped tariffs becoming cheaper than acquisition tariffs, engaged customers will move en-masse to the other type of tariff and suppliers will be exposed to a unmanageable costs. There is no reason to believe that wholesale markets will become less volatile – the risks of these inversions will remain significant under the current design.

While we recognise the scope of your consultation, it is important to note that the recent issue with unanticipated default tariff volumes is just one example of a more fundamental issue with the price cap. Suppliers exist to protect consumers from the volatility and complexity of the upstream market, in return for a reasonable rate of return. Price caps remove many of the tools available to suppliers to manage these risks effectively, including passing on reasonably incurred costs. As stated in our response to your consultation on the impact of increased wholesale volatility on the default tariff cap², the failure to allow suppliers to pass on reasonable costs 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. Ultimately, crises such as the one we are currently in are inevitable when a price cap exists in a competitive market. The frequency of those crises will depend on the extent to which suppliers' ability to manage risk is restricted by the cap.

¹ <https://www.ofgem.gov.uk/publications/statutory-consultation-potential-short-term-interventions-address-risks-consumers-market-volatility>

² <https://www.ofgem.gov.uk/publications/price-cap-consultation-potential-impact-increased-wholesale-volatility-default-tariff-cap>

Question 2: what is the best way to tackle this issue whilst protecting consumer interests?

Before addressing the question directly, it is worth examining extent to which the current price cap truly protects consumer interests, in light of the current crisis:

- The cap was designed to address unfair pricing by suppliers:
 - Analysis of historical tariff pricing indicates that those suppliers who tended to offer the cheapest tariffs in the market have failed and the cost of offering those tariffs socialised. With the benefit of hindsight, it appears that the large differentials in tariff pricing were caused by unrealistic pricing at the low end of the market and the assumption that suppliers were pricing unfairly at the high end of the market was flawed.
 - Looking at pricing within suppliers, the current market rules encourage suppliers to maximise price differentiation to encourage switching. It is justifiably viewed as unfair by consumers that they have to switch suppliers in order to access the cheapest available rates. A ban on acquisition-only/exclusive tariffs would address these fairness issues better than the current price capped arrangements. Similar rules have been introduced by the FCA in the insurance market recently and appear to be working well.
- With regards to supplier profitability, it is now clear that a target 1.9% Return on Capital Employed (ROCE) does not represent a reasonable rate of return for suppliers in light of the recent crisis and the extent of the risk suppliers manage on behalf of consumers. Furthermore, it has proven impossible in light of the current crisis to achieve even a 1.9% ROCE under the current price cap framework.
- The legacy incumbent suppliers have cut costs substantially in recent years. Further cuts to costs that are within suppliers control will damage supplier resilience and ability to manage volatile wholesale markets on behalf of their customers.
- The crisis makes clear that the way in which the conditions for effective competition are assessed are not fit for purpose. Using the approach set out in Ofgem's most recent assessment, one could either conclude that competition has improved because suppliers universally price their default tariffs at the price cap or that competition has worsened due to a fall in switching. New ways of determining whether the market is efficient and fair are needed.

With regards to your specific question, the wholesale volatility issue identified in your paper can be fully addressed in one of two ways - default tariff consumers can be placed on a pass-through tariff, removing the need to hedge, or responsibility for hedging default tariffs can be returned to suppliers.

Exposing domestic consumers, especially vulnerable consumers, to wholesale market volatility through a pass-through tariff is not an advisable option. Each of the three options proposed in the paper adjust consumers level of exposure to wholesale pricing to an extent, but a substantial inversion risk remains under all three options.

The other option, allowing suppliers to take responsibility for hedging their default tariffs once more could be achieved either by removing the cap entirely, or by introducing a relative cap between a supplier's cheapest and default tariffs. You state that you do not believe such a relative cap is in line with price cap legislation but have not provided specific legal opinion on why this is the case. We could not identify what wording within the legislation rules out the use of a tariff cap. We would welcome clarity on this matter as a relative cap, in conjunction with a ban on acquisition-only tariffs, has the potential to:

1. address the wholesale volatility issue identified in your paper, both in a rising and falling market;
2. give suppliers more flexibility to manage risks more generally, making the market more resilient; and
3. better protect consumer interests than the current arrangements. There would be less dramatic differentials between acquisition and default tariffs both within suppliers and between suppliers. There is enough competitive pressure in today's market to keep prices at a reasonable level overall.

The wholesale volatility risk could also be reduced by changing the scope of the current default tariff cap. Although we do not agree with this position, we understand some consumer groups believe that the stability offered by Ofgem's mandated hedging strategy carries an inherent value. A set of backstop arrangements for a subset of default tariff customers could be held in place – for example for customers on the Warm Home Discount and customers with traditional prepay meters – similar to the safeguard tariff cap that predated the current default tariff cap.

Ultimately, as set out in our response to question 1, all price cap arrangements in a competitive market carry substantial risks when set over a long enough period of time. Even if a relative cap was adopted, a path toward an alternative set of arrangements in which customers are protected without the need for a cap is essential. Furthermore, it's unclear whether any price cap arrangement is workable following the introduction of Mandatory Half-Hourly Settlement.

Question 3: which adaptations to the price cap are preferred and why, including any additional options not set out in this paper? (Please provide an outline description of how any alternatives would work

Our preferred option for implementation in October 2022 would be to remove any form of price cap. Failing this, we would recommend a relative price cap, paired with a ban on exclusive tariffs.

Of the three options set out in the paper, our preference is Option 2. Option 2 provides a greater degree of certainty for suppliers than Option 1. As stated in our response to your consultation on updating the default tariff cap methodology and setting maximum charges³, we have concerns about the lack of clarity surrounding when the price cap might be re-opened and the uncertainty this brings.

Option 2 could be improved further by substantially reducing the amount of notice suppliers must provide for increases in default tariff prices. We believe there is scope to reduce the lag between forward wholesale prices and their recovery through the cap could be reduced to close to 4 months. The 20 working day price protection window would still give consumers ample time to switch tariff or supplier following a price increase. We are keen to work with you on developing this proposal in further detail.

Option 3 presents a number of practical challenges:

- System changes would be needed, squeezing the time allowed to finalise the policy details. For example, our billing provider considers introducing an adjustable exit fee to be a substantial change. It would likely take 12 weeks to be introduced.
- The transition from the current arrangements to Option 3 would be difficult. It would not be practicable to move all SVT customers to Option 3 arrangements on 1 October. Customers

³ <https://www.ofgem.gov.uk/publications/price-cap-consultation-process-updating-default-tariff-cap-methodology-and-setting-maximum-charges>

would need to be transferred to the new arrangement on a phased basis. This would be complicated.

- It is unclear how renewals would work – would consumers have visibility of their renewal and default offer, both of which would carry an exit fee, before their contract comes to an end? How much time would they have to make a decision?
- As the most novel of the proposals, it is likely other issues would be identified through the policy development process, complicated delivery by 1 October. There is also the potential for issues to be identified after the policy is implemented if the policy development process is rushed. It does appear feasible to have a workable proposal in place by 1 October.

We hope you find this input helpful. As we stated at the beginning of our response, 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

