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“Consultation on Medium Term Changes to the Price Cap Methodology” – 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 consultation. Overall, our position remains that price caps are not sustainable in the long term as they expose consumers and suppliers to unmanageable risks which add to the overall cost. The options presented in this consultation, including ‘a strengthened status quo’ are all deeply problematic and we are disappointed to see that the most workable solution, a relative cap, has been ruled out at this point in time. **Volume risk is the greatest threat to the integrity the retail market and must be mitigated as much as possible. Of the options presented, we believe the least-worst option is a quarterly updated price cap with non-linear indexation. This should be paired with an ex-ante allowance for backwardation costs.** To set out our position in more detail:

- The current price cap rewards disengagement from the market and especially exposes challenger suppliers and new entrants to unmanageable volume risk.
- A reopener mechanism, based on weighted average costs is ineffectual.
- To have any chance at a competitive market in the future, addressing volume risk must be prioritised.
- Of the options presented, a quarterly updated price cap with non-linear indexation and a 28 day notice period best manages volume risk and therefore should be pursued.
- We believe price cap contracts leave suppliers exposed to very large volume risks in a falling market. An enduring MSC has been suggested by some as a way to address this but we are worried that it wouldn’t allow suppliers to recover the full cost and it could have substantial knock-on impacts on competition.
- Ultimately, Ofgem is obligated under price cap legislation to have due regard to enabling suppliers to compete for domestic supply contracts, maintain incentives for customers to change contracts and ensure suppliers, including challenger suppliers, remain financeable.

Question 1: Are there any other costs and risks to consumers and suppliers that we should consider?

The summary of the costs and risks facing consumers is good. However, there is no mention of bad debt in the analysis. We expect this to increasingly become an issue as energy becomes less affordable. Additionally, the statement ‘while the future is unknown, the risks are known’ is a dangerous misunderstanding of the current situation. It would be more accurate to say ‘while the future is unknown, our understanding of the risks has improved’. There is a distinct possibility that radical changes to the price cap structure, such as price cap contract, will introduce new risks that are unforeseen or underweighted. We provide more detail on this below.

Question 2: To what extent would a price cap contract without exit fees leave suppliers carrying volume risk in a falling prices scenario? How significant would this risk be? How might it be mitigated?

The price cap contract introduces a substantial and unmanageable volume risk to suppliers in a falling prices scenario. The identified mitigations create unacceptable fairness issues and issues of incompatibility with the legislation that underpins the price cap.

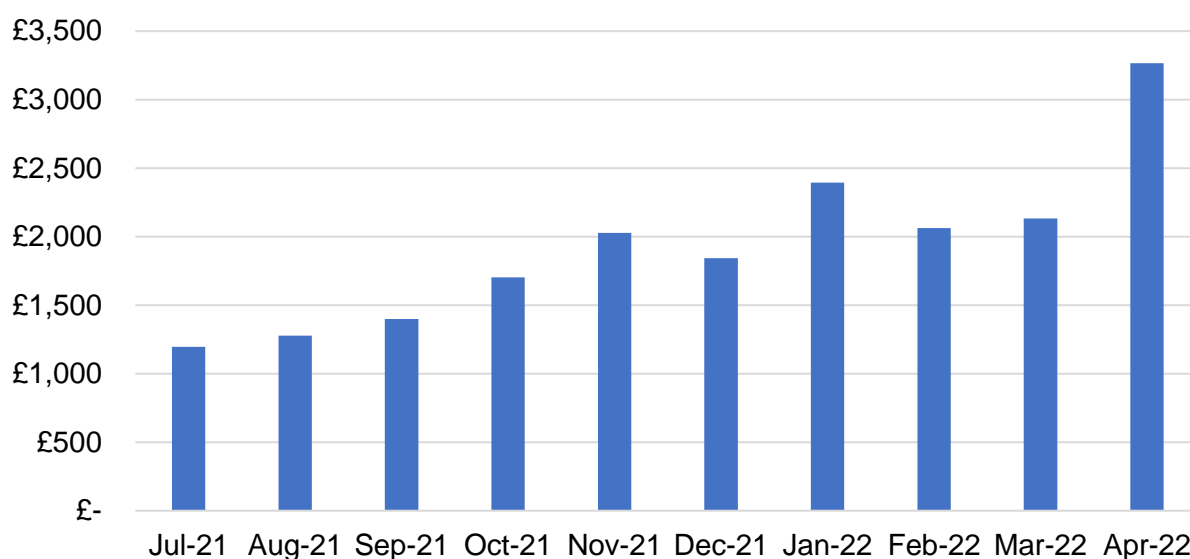
Since this consultation was released, the wholesale price of gas and power has risen significantly, owing to the conflict in Ukraine. Given the current circumstances, it is now reasonable to assume that the price cap will be set at its highest level ever on 1 October and the volume risk in a falling prices scenario will have never been greater.

In addition, the government has committed to extending existing price cap legislation, which means there is scope for future wholesale volatility and volume risk in a falling prices scenario beyond our current circumstances. Finally, the margins provided by the current price cap do not offer a great deal of capacity to manage unforecasted costs.

Set against this context, the option of price cap contracts, especially the 12-month variant, exposes suppliers to unmanageable risk driven by the following factors:

- Because all of the energy for the contract is purchased within a small window, the price that the contract is set at is highly exposed to wholesale market volatility. In Graph 1 below, we provide an indication of the extreme variances in prices that different cohorts of customers may have faced had the price cap contract been in place over the last 9 months.
- The price cap contract requires suppliers to forward purchase 12 months of energy meaning the amount of volume at risk on a per customer basis (should the customer exit the 12-month contract early) is the greatest out of all the options considered.
- Combine the two bullets above and you have the potential for suppliers holding a lot of expensive forward-purchased energy, meaning large losses should wholesale prices fall and customers switch away.
- There is no way of consistently predicting future wholesale price movements and the consequent rates of switching away from price cap contracts. Suppliers with engaged customer bases are especially exposed to this risk.

Graph 1: Illustrative Price Cap Contract rates from Jul-21 to Apr-22 (£/annum for dual fuel medium user)



The analysis presented in paragraph 4.1 of this consultation illustrates the difficulty in managing this risk:

“There remains a falling prices volume risk under price cap contracts as consumers are able to leave before the end of the six or twelve months. Historically around half of consumers are inactive for various reasons and many others have made choices that reveal non-price preferences (or they lacked awareness of cheapest tariffs). Furthermore, while the divergence in price between a particular price cap and the market grows over time, the remaining value (and therefore potential loss for suppliers) diminishes and the resulting risk premium is relatively small (potentially about 6% of wholesale cost for 12-month contract, about 2% for 6-month contract, depending on consumer response).”

The issues with this analysis are as follows:

- There are now a large proportion of engaged customers on the price cap. This is especially the case for suppliers who traditionally had an engaged customer base.
- As we set out earlier, the market is in an unprecedented situation in terms of cost and volatility.
 - We do not know the proportion of previously disengaged consumers that would switch in exchange for a saving of £500 per year as we have not incorporated that situation before.
 - The analysis presented seems to be based on price differentials and does not appear to incorporate the overall affordability of default contracts and how that may impact customer behaviour. We do not know the extent to which disengaged customers will be triggered to engage in switching because they can no longer afford to pay their bills. A customer may not switch to save £300 from their £1,500 tariff but they may switch to save £150 from a £2,500 tariff because the £2,500 tariff is simply unaffordable.

- We do not have data available that can predict what would happen but we can say with confidence that larger price differentials create larger volume risks. The best way to address volume risk is to have tariff prices more closely follow the wholesale price so that such differentials are not encountered in the first place.
- Historical data may show that the divergence in price between a particular price cap and the market grows over time but you only need to have a scenario where the price falls off quickly once to generate a fatal wholesale cost exposure.
- A 6% allowance is suggested as enough of a risk premium to account for future instances of falling prices volume risk and this indicates a flawed approach to risk analysis. Risk analysis may draw on historical data but it is inherently forward-looking. An analogy may explain this best. If a person's house was to flood and they were to seek a new flood protection policy the following year, the insurance company would not provide a quote based simply on there only having been a single flood in the past 100 years. Instead, they would aggressively weight that there was a recent flood and take into account underlying factors such as climate change into calculating the risk of future floods occurring.

We are aware of two suggested mitigations for this risk, an exit fee on the price cap contract or a Market Stabilisation Charge (MSC). Both mitigations are designed to financially deter customers from leaving high-priced price capped contracts where they might otherwise switch away from them.

You have drawn the conclusion that exit fees disproportionately impact low-income consumers and therefore you are not inclined to pursue this approach. However, we should note, if it were to be considered once again, exit fees must be reflective of the economic cost of losing the customer in order to be effective. If a customer is on a £3,000 price cap contract and can save £1,000 by switching, a £15 exit fee will not serve as an effective deterrent from leaving that contract. Exit fees would also be unpalatable to customers.

With regards to the MSC, we have significant concerns about the knock-on impact of using it in conjunction with price cap contracts. Because of the price volatility issue, mentioned above, having an MSC which provides protection to the volume risk issue could present a scenario where customers could have extraordinarily large MSCs, and therefore cost to acquire for the incoming supplier. Given the recent history of wholesale prices, it is not beyond the possibility that a customer on a £3,000 contract could have a +£1,500 cost of acquisition for suppliers.

Our understanding is that the current MSC is levied regardless of what tariff a customer is actually on. The MSC simply assumes that all customers that switch in a given period are on the SVT. However, in a world of price cap contracts you may have 12 different price cap contracts all feeding into the MSC. How would the MSC be calculated, such that the cost borne by a supplier and the amount recouped through the MSC are aligned? In calculating the MSC, would a higher weighting be given to tariffs with higher MSCs on the basis that their customers are more likely to switch? How will weighting the MSC affect incentives to switch, thereby further influencing the weighting of the MSC?

There is a high risk of unintended consequences given the level complexity involved and the impact on competition – MSCs being set to a level such that only the customers on the highest default tariffs have an incentive to switch, massive under-recovery of hedging costs (depending on weighting), suppliers having to adjust acquisition strategies in order to spread the risk of having too great a proportion of customers on a single price cap contract, or other as yet unanticipated behaviour. These risks, complexity and uncertainty will all serve to undermine the competitive framework and deter investment into the sector.

Ultimately, Ofgem is obligated under price cap legislation to have due regard to enabling suppliers to compete for domestic supply contracts, maintain incentives for customers to change contracts and ensure suppliers remain financeable. Introducing the MSC greatly increases the risk of Ofgem failing to discharge its obligations.

Question 3: Quarterly updates are a balance between the reduced volume risks and the increase backwardation risks. Please provide evidence and data on the relative costs and benefits of this.

Two very different risks are mentioned in this question. As we have set out above, volume risk is massive and unmanageable for suppliers with an engaged customer base. It is impossible to effectively quantify and provide an allowance for this risk. On the other hand, the risk of increased backwardation costs is a manageable risk. Backwardation costs can be effectively forecasted and incorporated into the cap ex-ante (we set out how this can be done in greater detail below).

When weighing up these two risks, there is really no comparison. The consequence of one is multiple supplier failures, mutualisation of costs and a loss of consumer and investor confidence in the market. The consequence of the other is an incremental increase in the level of price cap.

Ofgem must minimise supplier exposure to unmanageable volume risk and of the options presented, quarterly updates does the best job of this because of the greatly reduced length in time of the period to which it applies. Improvements to the current position such as non-linear indexation (placing a greater weight on prices towards the end of the observation window) would allow the quarterly cap to even better align with the wholesale price.

Therefore, quarterly updates to the cap, non-linear indexation and an ex-ante backwardation allowance is the best way forward.

Question 4: Please provide further evidence on the impact of quarterly updates and price cap contracts on households and their finances, and how these could be mitigated?

Overall the consultation does a good job of setting out the trade-off between mitigating volume risk and exposing consumers to greater price volatility, although we disagree on the point of price cap contracts reducing volume risk ‘considerably’.

When the price cap was designed, the levels of wholesale volatility seen today were not foreseen and the consequences of this have been disastrous for the market. Recent developments in Ukraine and the impacts they have had on wholesale prices, have underlined the inadequacies of the current price cap framework, even with the re-opener mechanism. At the point we are submitting this response, there are uncertainties to whether the criteria for re-opening the price cap have been met despite the primary source of European gas being at war.

Exposing customers to increased price volatility is unfortunate for all the reasons you have set out in your consultation. However, we do not see a viable alternative, given what we now know about wholesale market volatility and the associated volume risk. Ultimately, the root cause of this issue is the existence of the price cap within a competitive and potentially volatile market. While the price cap is characterised as delivering savings for customers, as time goes on we discover more and more risks, issues and costs associated with maintaining it. Attempts to mitigate this carry their own, often significant, risks, issues and costs, as we have illustrated with regards to the MSC. We question whether the versions of the price cap under consultation

deliver a net benefit when compared to alternatives that have been ruled out of scope, such as a relative price cap.

Question 5: Do you think it is unfair that consumers would sometimes have higher or lower prices depending on the wholesale cost at the time their cohort starts the price cap contract? Do you think over the longer run this would even out?

Yes, we do think this is unfair. The industry may be able to persuade itself that this framework might be fair, as there is no customer discrimination except for time of contract their previous ending. However, it is without doubt the case that customers will find it a grossly unfair situation, and that will destroy trust in the sector and also increase the likelihood of customers gaming the system.

In terms of questions of whether it would even out over the long run, this is only a consideration of the wealthy. Many households simply do not have the savings built up to weather price shocks, even if they benefit from lower prices in future years. In this respect, quarterly updates are advantageous as, while it exposes consumers to the greatest level of volatility in terms of frequency of updates, it minimises the length of time consumers are exposed to a temporary price shock while still providing a reasonable degree of certainty. A 12 month price cap contract would expose a cohort of consumers to a temporary price shock for the longest period of time.

Question 7: What other operational impacts could a quarterly update or price cap contract have? Please provide data on the costs and benefits

SVT price increases do drive calls and a quarterly update provides more opportunities for these calls. However, this has to be balanced with the consideration that the size of each price increase under a quarterly scenario will be less than the status quo. Call centre capacity is relatively static, therefore it is better to have two separate events generating manageable call volumes rather than a single event that overwhelms call centre capacity. This is especially important in the context of the proposal for a shorter notification period.

With regards to price cap contracts, moving all SVT customers onto a single price cap contract from 1 October would create substantial operational issues now and in future years. In the interest of customer service, cost to serve and efficient use of available capacity it is vital that default customers are spread across multiple price cap contracts.

Question 8: Are there any challenges in transitioning to quarterly updates or the strengthened status quo? If so, please provide details.

We do not foresee any transitional issues provided existing hedges are accounted for in setting the price as indicated in your consultation.

Question 9: What would the impact be if suppliers tried to buy the energy requirements for all their customers on price cap contracts in August (for 12 month contracts) or August and February (for 6 month contracts) of each year? Do stakeholders agree there would be liquidity challenges in the wholesale markets? How damaging would this be? Are there any ways to avoid this issue?

The issues you identified in your consultation are valid and important. We would have concerns about wholesale market liquidity during August of each year (for an October start to the price cap), especially with regards to the availability of peak products. This would likely result in higher prices. We would also have serious concerns around the lack of diversification of risk as the majority of customers are in the same price cap contract cohort and cycle. An event similar to the invasion of Ukraine could trigger market-wide failure.

Question 10: If we were to implement the price cap contract, how should we implement it - with an immediate start and single cohort on a price cap, or with a staggered start and six or twelve different cohorts?

An immediate start is not a viable option for the reasons set out in our answer to Question 9.

Question 11: What is a fair and practical way to allocate consumers to different cohorts?

We do not see a way in which those customers paying a higher cohort price will perceive that they have been allocated in a fair way.

From a practical perspective, it is important that the allocation of customers into different cohorts is done in a way that minimises volume risk. With this in mind, the allocation should be mindful of consumer's propensity to engage:

- From September 2021, an increasing proportion of engaged consumers moved onto the SVT for financial reasons. These customers should be allocated evenly across the cohorts in order to account for their greater price sensitivity.
- Using the Competition and Markets Authority's Energy Market Investigation as a guide, customers who have been on an SVT for less than three years should be allocated evenly across the cohorts in order to account for their level of price sensitivity.
- Finally, customers who have been on an SVT for more than three years should be allocated evenly across the cohorts – these are likely to be the least price sensitive.

To be clear, the concerns we have raised with regards to price cap contracts elsewhere in this response are on the basis of a sensible allocation of risk into the different cohorts. If the risk is concentrated in certain cohorts, the volume risk implications are even greater.

Question 12: Should we consider any of these variations further? If so, which one(s) and on what basis? (Please provide evidence)

Ofgem presented a further variation at a consultation workshop, called H1/2 6-month cap. Our understanding is that it is a 6 month cap, based on a 6 month hedge with a 1 month notice period. The cap would be reset in January and July each year in order to reduce the impact of seasonality. In order to reduce the impact of volume risk, non-linear indexation is proposed. In other words, a greater weight would be placed on prices towards the end of the observation window.

This is an interesting proposal and has merit insofar as it reduces backwardation cost. Non-linear indexation can help mitigate volume risk at the expense of exposing consumers to greater volatility. However, suppliers are still exposed to volume risk in volatile wholesale market situations, which is by far the most important consideration. For example, if non-linear indexation was applied to the current price cap, the Ukraine crisis still would have happened too late in the observation window to make the 1 April price cap cost reflective of the wholesale costs we now are experiencing. Questions of whether a price cap re-opener would be necessary remain.

Updating the price cap more often remains the best method of minimising the impact of volume risk. Weighted indexation should be combined with a quarterly cap in order to make that option more resilient to volume risk than would otherwise be the case.

Question 13: Do you have any evidence or data that supports or challenges our assessment of the benefits this? What are the practical considerations for price changes over winter and Christmas?

Overall, we are supportive of the proposal to shorten the notice period to 28 days. It does present some operational challenges for us as a business but there are steps that Ofgem can take to alleviate these issues considerably.

Our first recommendation is that Ofgem provide a forward look estimate of what the price cap will be set at ahead of time, perhaps two weeks in advance. This could be for all the costs that are not impacted by the wholesale price reference period as these would be better known in advance. This would allow suppliers to make pricing decisions ahead of time in terms of where they may price relative to the cap (at the cap, £20 under the cap, £50 under the cap etc.). Suppliers could begin the operational task of notifying the customers of their new rates from the day the new cap is announced.

Our second recommendation is that the current license conditions which provide customers with a price protection window is reformed so as to reduce the number of manual exceptions this rule generates. If the customer is going to get as little as 7 days' notice of a price change, then the price protection window will be relied upon much more heavily. The current rules make the price protection window difficult to automate but faster switching provides an opportunity to simplify those rules considerably while providing the same level of protection as before. We would suggest reviewing the existence of the price protection window entirely.

Question 14: Do you have evidence or data to support a move to a shorter implementation window – such as 14 days? What are the potential risks to consumers of a shorter notice period? And what are the operational considerations?

A shorter window would be preferable to reduce volume risk. Our understanding from the consultation workshops hosted by Ofgem is that an even shorter window is not possible at the current time due to system limitations in notifying traditional prepayment customers.

Question 15: Given the changes in the wholesale market since summer 2021, how should these be reflected in the deadband calculation?

A period of extended backwardation as per the current forward curve outlook could mean perennial under-recovery. In addition, the level of volatility that energy markets expect over the coming years mean that the purpose of the deadband should be questioned and allocation of fair costs to be made as per our response to question 16.

Question 16: Do you have any views on the challenge of collecting backwardation costs from suppliers via RFI?

We have elected to answer these questions as a package. Backwardation, as set out in the consultation, is presented as a single cost with a single risk. However, based on the valuable discussions we have had in the workshops organised by Ofgem as part of this consultation process, our understanding of backwardation has become more nuanced. There are actually three varieties of backwardation and it is important to treat each in turn:

- **'Backwardation A' - costs associated with volumes purchased within the price cap observation window.** This is the cost of summarised in your consultation. The price cap methodology is calculated on the basis of 12 month hedges but the price cap is reset every 6 months. When the market is in backwardation, the forward prices in the later 6 months are lower than in the first 6 (the actual price cap period) and it brings the price cap level below the cost of purchasing energy for suppliers.
 - This cost is known at the time the cap is set. It can be calculated an average could be taken of the difference between the 6-2-6 and 6-2-12 index for the forthcoming cap period.

- Our understanding is that the deadband in your ex-post proposal is to account for seasonality. If you deem this essential, the effect of a deadband could also be replicated in an ex-ante assessment.
- **‘Backwardation B’ – backwardation costs associated with volume risk.** If there is more or less default tariff demand than prudently forecasted, the cost of correcting for this can be significant, both in terms of the cost of purchasing that volume and the backwardation costs associated with purchasing that volume. In this respect, backwardation risk is a component of the larger volume risk issue.
 - Given the difficulties in managing volume risk, adjustments should be made to the price cap within period to mitigate when it becomes an issue. Failing that, an ex-post allowance should be provided for based on the weighted average of costs borne by suppliers. To the extent there is a backwardation element to the cost incurred, this should be factored into the ex-post allowance
- **‘Backwardation C’ – deviating from the implied hedging strategy used to calculate the level of the price cap in order to reduce costs.** Suppliers would deviate from the strategy set out in the cap and make windfall profits if their chosen strategy was less costly than the price cap hedging strategy. Backwardation in this circumstance would be an input into a wider decision on trying to achieve lower hedging costs.
 - Any deviation from the price cap methodology can bring windfall profits but it also exposes suppliers to enormous costs if their ‘bet on the future’ doesn’t pan out. As a prudential regulator, Ofgem should be monitoring this activity and intervening as appropriate.

Question 17: Are there additional costs or benefits of taking an ex-post approach in this instance? If so, please provide details or evidence of these.

No answer

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
Head of Regulation

