SO ENERGY

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"Levelling the cost of standing charges on prepayment meters" – So Energy Response

Dear Sabreena,

So Energy is a leading energy supplier providing great value 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 and have topped the Citizens Advice's Supplier League Table. So Energy is one of the early adopters of the EUK Vulnerability Commitment launched in 2020, helping create a better customer experience for vulnerable customers year on year. In August 2021, So Energy merged with ESB Energy, and our combined business now supplies around 330,000 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 is able to provide a unique view of the quality of service in today's energy market.

We understand the context behind this work and the government's request for Ofgem to consider options for ending the PPM standing charge premium. However, the options under consideration in this call for evidence have the capacity to cause lasting grievous harm to the fixed tariff market and increase energy bills overall. Bearing in mind the intrinsic value of fix tariffs in terms of protecting customers from volatility and allowing vulnerable customers to budget more reliably, we urge Ofgem to reconsider the options under consideration at this time.

Fixed tariffs require suppliers to be able to forecast their costs in advance. The options under consideration, aside from Option 1, all introduce a potentially volatile and unpredictable cost that will require a risk fixed premium to be added fixed tariffs. The fixed tariff market is already under threat. In just over a week's time, it is likely that no fixed tariff will be available to customers below the 1 October price cap.

**Any levelisation mechanism needs to be forecastable over at least a 12 month horizon.** Otherwise, Ofgem is pushing the market towards an outcome where consumers have no choice but to be on the price cap, condemning consumers to volatile quarterly price changes and restricting suppliers' ability to support the transition to net zero through power purchase agreements with generators. Ofgem should consider the following:

1. The size of the standing charge differential has shrunk to 35p per week the differential is a different order of magnitude to when the government made its request. Ofgem should consult with government on the cost of their options versus the benefits in the current context.
2. Options to perfectly levelise and perfectly reconcile inevitably open the fixed tariff market to unforcastable cost volatility and increased cost premiums. It's highly likely that consumers options will be reduced dramatically. However, it may be possible to achieve partial levelisation and reconciliation – Ofgem could fix the level of the levelisation at 35p per week on an ongoing basis and ensure 12 months' notice is provided on any change to that level of reconciliation.

Our response to each consultation question is set out below.

**1) Do you have any views on our proposed case for the introduction of levelisation of payment methods?**

Since the issue of payment method and standing charge differentials was brought to prominence a great deal has changed. Some of the additional costs related to standing charges have fallen away naturally, while UNC 840 has shrunk the size of the standing charge differential to 35p per week, according to the examples presented in the consultation. We are now at a point where, overall, typical SVT customers on prepayment will pay less than those on Direct Debit (DD). This consultation presents an appropriate point at which to consider whether the government would have requested Ofgem to consider payment method differentials in the Spring Budget, had these circumstances been known to them at the time. We are inclined to believe the government would not have made that request. As we look forward, we must consider that the originating problem statement has been materiality addressed but the cost, risk and downsides of tariff levelisation are likely to grow as they are bottomed out.

The concept of a variable debt allowance being funded by customers on separate fixed rate tariffs is a further impediment to allowing fixed rate tariffs to return to the market. It places an additional cost demand under which the supplier has no control or forward visibility. As things stand, suppliers will struggle to forecast these additional costs (both in terms of level of the differential per customer and the volume of customers on each payment method across the market) and therefore risk premiums will need to be added to fixed tariff offerings. Given the value fixed tariffs provide to consumers, including vulnerable consumers the lack of consideration given to the operation of the fixed tariff beyond "Consideration will need to be made to existing fixed price contracts during transition", is a significant concern. As things stand the proposals render the fixed tariff market unviable as suppliers have no forward visibility of the size of the cross-subsidy they must price into their tariffs.

Ofgem is calling for the reform of the existing price cap[1], which is bound to deliver under legislation, while at the same time extending price regulation into the fixed tariff market through the proposal to place restrictions on pricing of fixed tariffs across their channels. Ofgem should be wary of further constraining suppliers to price and manage risk without an overwhelming case for change.

**2) Do you have any views on our proposed policy considerations for levelisation? Are there any additional ones we should consider?**

Need to account for the risks generated through the introduction of levelisation. The risk that monies don't fully reconcile, both likelihood and quantum. Experience with MSC shows that this passing of money doesn't always go right, so we should plan for that eventuality and minimise risk by minimising the total amount transferred (the quantum) and limiting adjustments to standing charges, which substantially reduces the risk of getting things wrong.

**3) Do you agree with our initial preference to levelise PPM and DD Standing Charges?**

On balance we believe Option 1, 'do nothing' is the best way forward. We do not believe it is necessary to proceed with Option 2 in the context of UNC 840 the materiality of the standing charge differential has been largely addressed with prepay paying the lowest under the price cap overall. On the other hand, mandating the pricing of tariffs to a non-cost reflective basis, and attempting to reconcile this by moving money between suppliers carries substantial risk:

1. There is no information in the consultation on how suppliers will be able to forecast the amount of money to be reconciled over a 12+ month horizon. Suppliers will not know how much Additional Support Credit is expected to be provided in the market in the future. The initial estimated allowance is due to be adjusted in the future to account for historical costs, making it extremely difficult to forecast with any degree of accuracy. This means that

[1] https://www.theguardian.com/business/2023/aug/14/change-needed-ofgem-chief-rethink-energy-price-caps

suppliers will have to price in further risk premiums into fixed price tariffs, driving up costs to consumers. In effect this policy is asking all fixed price tariff customers to pay more, not just to cover levelisation costs but also to cover risks associated with future levelisation costs. Suppliers are already struggling to deliver fixed price tariffs below the price cap. This is part of a wider theme of Ofgem paying no regard to the value of fixed tariff offerings in their policy making – cost uncertainty generated by Ofgem's consumer standards proposals are another example of this. If Ofgem values fixed price tariffs, it needs to change its approach and provide certainty of cost over an extended horizon.

2. Reconcilliation processes are never perfect, where suppliers are being asked to charge one amount but pay off another amount, then it is likely that those numbers will reconcile. For example,
    a. if a supplier charges a customer but then agrees to write off or delay the recovery of charges as part of its obligations concerning customers in payment difficulty, then the amounts collected and the amounts distributed will not reconcile. Therefore, does the reconciliation mechanism require a bad debt component?
    b. How will erroneous transfers, where switches are reversed out, be treated under this reconciliation mechanism?

However, this option is far more preferrable than Option 3, as the risk to consumers and competition are not as great. We set this out the additional risks and costs in our response to question 4.

Furthermore, when compared to Option 3, the relationship between ASC and vulnerability is much clearer than with bad debt overall. In the former, ASC is being provided to stop a customer going off supply. With the latter, there are a multitude of reasons why bad debt charges can be incurred and all or not clearly tied to bad debt.

**4) Do you think we should also levelise the bad debt charges across PPM, DD and SC, which would reduce the differential between SC and DD? Please provide any evidence /data that may benefit consumers as a whole.**

No, we do not agree with this proposal. Option 3 carries proposal carries significant additional risks compared to Option 2. Compared to Option 2:

1. The quantum of money being moved around between suppliers is much greater, meaning the consequences for suppliers in terms of cash flow when reconciliation isn't 100% correct are greater.
2. There is a greater likelihood of reconciliation issues once the unit rate needs to be levelised. While there will be issues with reconciling the standing charge, these pale in comparison to the additional complexity that gets introduced once customer usage is taken into account. Industry EAC and AQ and billing EAC and AQ are always in some state of misalignment due to timing issues, different standards for read acceptance etc. Our understanding from paragraph 4.16 of the consultation is that Ofgem plans to not attempt to reconcile back to actual consumption. This guarantees that the money will not reconcile back to what the customer is billed and guarantees a further risk exposure in addition to the issue with non-payment we identified in our response to the previous question. Bearing in mind that overall profit margins are 2.4% under the price cap, it does not require a great deal of variance to wipe out supplier profit margins and undermine the financial resilience of the market.

It is clear that this option would require a much greater risk premium to be added to the price cap than Option 2.

**5) How should we ensure that levelisation transfers are correctly applied to customers on tariffs not covered by the cap (ie uncapped)?**

An appropriate forecasting mechanism needs to be introduced in order for suppliers to price in the cost of levelisation correctly into fixed tariffs. Otherwise a risk premium will need to be added and therefore consumers will face an overall rise in energy costs. As things stand, suppliers have now forward visibility of the size of the cross subsidy at all. We do not know how much ASC will be provided over this winter and therefore what amount should be priced in. This risks undermining an already fragile fixed tariff market.

A great deal of customers are already on fixed tariffs and Ofgem will not make a policy decision until very short notice is provided. It is one thing to forecast movements in network charging driven by inflation and other factors. It's another to deliberately add additional levies to bills at such short notice. Ofgem's approach is not appropriate.

The amount levied on fixed bills should be fixed and sufficient notice should be provided to suppliers on the amount of the levy to be applied that it can be priced into new contracts. This approach may mean that the differential may not be fully closed but it would mean that that pricing risk is minimised, consumer choice is maximised and overall energy costs are kept as low as possible.

**6) Do you agree with our proposal not to levelise across regions?**

Yes, deviations from cost reflectivity should be kept to a minimum in order to manage risk to the industry. It is always less risky and less risky to assign costs where they are generated rather than to subject them to reconciliation. Reconciliation bears additional cost and risk which much be avoided.

We would strongly advocate that where possible, levelisation should take place upstream of the competitive retail market in the regulated cost space. This approach is much easier to levelise and reconcile as it is subject price controls (which can allow for k-factors). Also, the customer base of network operators is far more stable than that of suppliers. This can then be passed through to the final customer in the form of levelised network charges.

**7) Do you agree with our proposal not to target levelisation?**

Yes, unfortunately existing methods to target vulnerable customers are inadequate.

**8) Should we set new licence conditions to ensure suppliers pass the costs/benefits through to all customers?**

No, competitive pressure in the acquisition tariff market should be sufficient to allow the costs to be passed on.

In practice, we do not know how Ofgem will mandate that all costs and benefits will be passed through in the fixed tariff market. Suppliers will not know the exact costs and benefits when setting the price of fixed tariffs as there is no provision in the proposals for forecasting this.

With regards to the requirement to the requirement to benchmark ‘equivalent’ tariffs, this reminiscent of the Retail Market Review ‘four core tariffs’ rule, which the CMA directed should be removed as part of the Energy Market Investigation. Rules of this nature can be extremely difficult to operationalise – if a DD tariff and a PPM tariff are released on the same day in the same region and for the same fixed period, but the DD tariff includes boiler cover, is it equivalent to the PPM tariff? We would argue it isn’t. Ofgem should be cautious about pursuing regulations that constrain supplier’s ability to innovate and provide products and services that meet their customers.

**9) Do you have any views on our other considerations?**

Overall, the redistribution of revenues to meet costs between suppliers represents a significant shift away from anything resembling a competitive market. We are surprised with Ofgem’s confidence in their ability to engineer arrangements that deliberately distort price discovery and competition without serious long term consequences. We foresee that once this mechanism is created, less competitive suppliers will call for Ofgem to use it in order to circumvent competitive pressure and create barriers to entry in the name of ‘fairness’. This rarely ends well for the consumer.

If one was to take a step back and consider wider policy objectives, then there is an argument for more cost reflectivity, not less. The prepay payment method under the price cap could be split into smart and traditional. We are confident that smart prepayment would be priced very competitively with DD and the existing PPM tariff. This could be used as an incentive for prepay customers to move onto smart prepayment and, where smart prepayment cannot be installed, a smart meter could be installed in credit-mode (with alternative debt recovery mechanisms utilised by the supplier). This would incentivise the wind-down of expensive and inflexible traditional smart meter infrastructure and help address the stigma associated with prepayment.

**10) What are your views on the reconciliation mechanism, the type of mechanism, invoicing cadence, and mechanism operator?**

Outside of Option 1, Option 2, Approach 1 is clearly the lowest risk as it minimises reconciliation risk (likelihood of mismatch between what’s collected from customers and what’s transferred between suppliers) and volume risk (amount of money to be transferred, and, therefore, the impact on revenue when it doesn’t reconcile).

In terms of cadence, there is a balance to be struck. The more money that is being passed through reconciliation, the greater the necessary cadence. Otherwise, suppliers will be required to find alternative sources of capital, at cost and this cost will need to be incorporated into the price cap.

**11) Do you have any views on our preferred approach of a fixed reconciliation amount to reconcile standing charges levelisation and a volumetric reconciliation amount based on estimated consumption to reconcile unit rate levelisation?**

We implore Ofgem to not entertain adjustment to unit rates and consequently volumetric reconciliation. Avoiding the adjustment of unit rates de-risks the impact of levelisation and reconciliation substantially.

**12) Do you agree that all domestic customers should be included within the reconciliation mechanism?**

We cannot agree with including fixed tariff customers in the mechanism, so long as there is no effective long term forecasting of cost. To include these tariffs without a forecasting mechanism will drive up the cost to these customers, reduce tariff choice by making fixed tariffs less attractive and make overall energy bills less affordable.

**13) Can you provide an estimate of implementation and ongoing costs on your organisation of the different levelisation options and approaches?**

As things stand, we are not in a position to do so. The turnaround time for responding to the consultation was too short and there wasn't enough certainty on the approach – we're not in a position to cost up 5 different approaches.

**14) Do you have any comments on potentially phasing the implementation of the reconciliation mechanism?**

Customers on fixed tariffs should not be included in the mechanism until a long term cost forecasting mechanism is devised. Once a sensible mechanism is devised, only new fixed tariffs should be included in any mechanism.

**15) What considerations should we take to tariffs that exist prior to the implementation of levelisation?**

A derogation should be offered allowing suppliers to increase charges for these tariffs in order to fund levelisation. However, without accurate forecasting of the cost of this, similar issues will exist for fixed tariffs moving forward – bearing in mind half of consumers were on fixed contracts historically, the overall cost implications if there is no effective forecasting will be significant for the market.

**16) Are there any other financing impacts on your organisation that we have not considered as part of Chapter 4 or the IA?**

Suppliers will not be able to use accruals as working capital as they will know that it must be distributed to others. Suppliers that are owed money through the reconciliation will be short working capital until it is passed through (on a monthly cadence, according to the assumptions set out in the consultation). This factor does not appear to have been considered in the impact assessment. It is worth noting, a volumetric reconciliation makes this issue worse as peak funding requirements align with peak energy use – suppliers will be left short of money when they most need it. An alternative source of working capital must be secured to address this shortfall in working capital, and this must be factored into the IA and any price cap uplift.

The IA treats customers on DD SVT and DD fixed tariffs interchangeably. As we have set out elsewhere in our response, this is clearly not the case. In the absence of a robust mechanism to forecast costs over a 12+ month horizon, additional risk premium will need to be priced into fixed tariff contracts. This has implication for competition, consumer choice and cost to serve.

Overall, this policy will increase cost to serve as it increases risk and limits access to working capital.

**17) Are there any other considerations for the reconciliation mechanism we have not explored?**

The Market Stabilisation Charge presented significant issues for suppliers and these same mistakes should not be repeated in any reconciliation mechanism, namely:

1. It was very difficult to verify that the amount of money to be paid or owed was in fact, correct. More transparency is needed in terms of how the charges have been arrived at.
2. Compounding issue 1, very little time was provided to raise disputes where issues were identified.
3. Finally, where issues were confirmed, the amount of time needed to unwind these issues stretched into months.

Overall, the working assumption throughout most of the document is that the reconciliation mechanism will actually work. Given the pace at which Ofgem is moving, the anticipated lead times for setting up the mechanism suggested by the providers and the experience with the Market Stabilisation Charge, Ofgem should anticipate that it won't and plan accordingly.

Yours Sincerely,

Paul Fuller
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