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"Mandating lower or zero standing charge tariffs" – So Energy Response

Dear Colleague,

So Energy is a leading energy supplier providing great value renewable electricity to homes across Great Britain. We supply over 300,000 customers and as one of the last challenger suppliers left in the market and one that is backed by ESB Group's resources and expertise, So Energy is able to provide a unique view on competition and consumer choice in today's retail market.

We welcome the opportunity to comment on your working paper. However, we note that due to the short turnaround time allowed and the issuing of this paper during the summer holidays, we are not in the position to give it full scrutiny. We reserve the right to object to elements of this proposal at a later date.

Overall, moving away from a zero-standing charge variant of the price cap is a welcome step as it allows suppliers' greater control over their trading and hedging strategies. A single price cap for the market systematically increases the risk suppliers must manage, leading to higher prices for consumers.

That said, a fundamental issue remains. Ofgem has set out the following expected policy outcome: "tariffs are not priced excessively while suppliers are able to recover their costs and a reasonable return". Based on our understanding of the market, quotation journeys and the risks suppliers must manage, we would expect the most likely outcome is that these tariffs will be perceived as excessively priced by the general public, while at the same time not allowing suppliers to recover their costs among the customers who choose these tariffs.

We have explained this self-selection issue in previous responses and will do here again:

1. Energy supply is a very low margin business – 2.5% is considered a good return in this industry. For a typical customers, the standing charge is about £300 per year or 17% of revenue. Losing the standing charge would cause catastrophic losses for suppliers – the only way to control for this risk is by increasing the unit rate.
2. Any customer who goes energy shopping will be taken through a quotation journey. That means, only those customers with usage low enough to save money by taking a zero standing charge tariff will be recommended a zero standing charge tariff. Due to this self-selection phenomenon, revenue loss is inevitable.
3. The only way to protect the financial position of a supplier is to raise the unit rate to such a high level that very few customers would make a saving by choosing this kind of tariff. However, in taking this rational choice:

a. Suppliers will still lose revenue on those customers who do choose the tariff; but
b. The tariff will be priced very high for customers with typical usage.

We are worried that this proposal will damage the reputation of the industry because Ofgem is promising prices will not be 'excessive' but market dynamics dictate that they must be set at a very high level in order to protect suppliers' financial positions. The most likely outcome is that prices will be perceived as being excessive while at the same time suppliers make a loss on customers who do take up the tariffs – the worst of both worlds.

Ofgem has suggested some controls for this around restricting availability of the tariff in order to reduce the risk of revenue loss. Key to these being effective is an unambiguous common understanding of eligibility between suppliers and their customers:

- At a supplier level, the requirements need to be clear enough that the tariffs are simply not displayed to ineligible customers as part of any quote journey. To allow the customer to select a tariff, only to later declare the contract was invalid will be a terrible customer experience and will bring the industry into disrepute.
- Across the industry, the requirements need to be consistent. Having a customer be eligible for a tariff with one supplier and ineligible in another will create confusion and undermine confidence. However, differing eligibility requirements for falling block and non-falling block tariffs may be prudent as the falling block structure is fundamentally better at managing risk.
- Ofgem cannot fudge the requirements, as it has done in other areas of the supply licence, like backbilling. Ambiguity of backbilling rules has resulted in de-facto further policy development through a chaotic series of Ombudsman disputes.

If the goal is to reduce the unit rate of these tariffs, then the best control is a minimum consumption requirement. For a given customer segment, the fewer low consumption customers that are in the equation, the smaller the potential loss of revenue, and the lower the risk. However, we caution, as this is a low margin business, even small losses in revenue can cause enormous damage to the financial positions of suppliers. Every potential lost pound must be accounted for when pricing tariffs. We fully expect that the uptake of these tariffs among customers who are willing to pay more to be negligible, and we certainly would not gamble the future of our business assuming anything more than a negligible uptake. Therefore, we would still expect *significant* uplifts in the unit rate, even with a minimum consumption threshold.

Ofgem has discussed the possibility of allowing a falling block tariff. This will also better help suppliers control for the risk of revenue loss. However, it will require costly and time-consuming system changes for So Energy. It is likely that suppliers who offer a falling block tariff will price lower than those who do not, but this will simply be because they have an additional mechanism to manage the risk of revenue loss. Ofgem must understand that different pricing mechanisms can deliver dramatically different outcomes.

We should stress, this is still a better idea than a zero standing charge price cap, which carries with it all the above risks but, because a single price must be set for the market, is even more likely to result in terrible outcomes for consumers.

Our answers to each question are set out below. We'd be more than happy to discuss our response bilaterally, please don't hesitate to get in touch.

1. Do you have any views on other options to increase customer control over their bills, including innovative payment methods such as variable recurring payments?

This is best left to the market to determine – if it is a good payment method, it will emerge naturally, just as Direct Debit did. If Ofgem wishes to pursue this, then it must provide an impact assessment and appropriate uplift to the cap to fund system and process changes.

2. Do you have any views on how the level of standing charge reduction could be set?

The larger the reduction in standing charge, the greater the revenue risk to suppliers. Any substantive reduction in standing charge introduces the self-selection issue we outlined at the top of our response. Once you have one set of tariffs with a higher standing charge and another with a lower standing charge, this will inevitably be an issue.

3. Do you consider a minimum consumption threshold is required to mitigate significant risk premiums or could competitive pressure in the market provide a natural mitigant to ensure these premiums are in line with efficient cost recovery?

If competitive pressure could deliver that outcome, there would be no need for this obligation in the first place. The self-selection issue we have outlined at the top of our response means that suppliers can provide significant risk premiums and still be left with a loss-making tariffs. It is an enormous risk, demanding enormous risk premiums.

A minimum consumption threshold could lower the premiums but Ofgem should be under no illusion that risk premiums will still need to exist and will still be viewed as substantial to customers with typical consumption. Suppliers are not in a position to sacrifice revenue under the current market framework.

4. Do you have any views on how it could be set and what might be the challenges in implementing a minimum consumption threshold?

Any threshold must be set such that customers who do not meet the threshold are not shown the tariff as an option in a quote journey. To allow the customer to select a tariff, only to later declare the contract was invalid will be a terrible customer experience and will bring the industry into disrepute.

For this reason, the tariff must be restricted to existing customers only. We are reliant on new customers inputting or estimating their consumption in order to generate quotes, making any minimum consumption threshold easily circumventable, either by accident or on purpose. If the quote journey can be easily circumvented, then this will necessitate further risk premiums to account for the resulting loss of revenue as well as managing and resolving complaints.

5. Do you think that the requirement to offer a low or zero standing charge tariff should only apply to large suppliers, rather than all domestic suppliers? If so, do you have views on how this could be set?

It should apply to all suppliers. Offering fixed tariffs is a core competency of being an energy supplier. Thresholds should only apply to non-core, technically challenging, regulations, such as efficiency schemes.

6. How might this policy design affect your approach to customer segmentation or tariff design, particularly if you serve either a high proportion of low-consuming customers or vulnerable customers?

The self-selection issue we set out in the beginning of our response represents a substantial risk to the business. The management of this risk will dictate our pricing strategy. We will make this tariff available to any customer we are obligated to. We will display and recommend the tariff in our quotation journeys in line with existing regulatory obligations.

Every supplier serves a mix of low and high consumption customers. We expect this tariff will be highly priced for typical consumers while at the same time causing suppliers to lose money on the customers who take up the tariff.

7. What are your views on targeting eligibility for low or zero standing charge tariffs to PPM customers as a minimum, or should this be mandated for all payment types?

We would welcome anything that reduces the scope of the proposal as that reduces the risk to our business.

8. What are your views on also targeting eligibility at customers with smart meters?

We would welcome anything that reduces the scope of the proposal as that reduces the risk to our business.

9. Would you support the introduction of a review to assess the policy?

We are concerned that the review will show that the policy has not delivered it's stated aims, but that will be because the aims are not realistic, due to the self-selection issue. Then Ofgem will put itself under pressure to 'do more' and will create further distortions in the market by creating more rules.

10. Would suppliers support regular reporting or disclosure of key tariff characteristics and evidence to demonstrate clear customer communication and active choice to enable market wide monitoring? Is there any other evidence you could provide to demonstrate this outcome that we have not discussed?

In the discussion paper, Ofgem cited a number of pre-existing obligation with regards to customer communication and active choice. Any work to demonstrate good outcomes are being met with respect to these rules should be considered in the round, rather than in the context of a single type of tariff. To do otherwise would create a review of a skewed nature.

11. What practical challenges do you foresee in demonstrating compliance with the low or zero standing charge tariff requirement, particularly in terms of tariff design or communication to customers?

This is a particularly risky tariff to price:

- With the self-selection issue, the only way to make up the revenue shortfall is to get high energy users on the tariff. While we understand that the standing charge may be unpalatable for some customers, we do not think any meaningful number of them will select the zero standing charge tariff when they are quoted more for it than a normal tariff. That would be an irrational choice. We certainly cannot gamble the future of our business on assuming our customers will behave irrationally. With this in mind, the only option that remains is to minimise the number of customers who can make a saving by setting a very high unit rate.
- Any shortfall in usage can turn a customer that was supposed to be profitable at the point of quotation into a loss-making customer. This is especially the case in gas, where the last two winters have been among the warmest since records began, suppressing consumption far below industry AQs. Suppliers will need to set an even higher price to account for this risk.
- Seasonal factors and infrequent meter reads also mean it may take some time to understand what sort of profit or loss we are making from customers on this tariff. This will create a lag in terms of adjusting pricing to account for lessons learnt.

We are confident in our ability to price in the risks and deliver a price that is fully justifiable on an ex-ante basis, especially if the FCA's 'fair value' guidance, which makes clear that firms will not be judged with the benefit of hindsight, is the basis for assessing our pricing approach. We are concerned that Ofgem will put itself under political pressure and assess compliance through an unfair retrospective lens because they set unrealistic expectations as to what the new obligation will deliver. Ofgem states:

"As noted above, in line with our policy objectives, we recognise the importance of suppliers being able to recover their efficient costs for any mandated tariffs on commercial terms. This is likely to mean that the unit rate is higher for a low or zero standing charge tariff when compared to other tariffs. We also recognise the importance of having tariffs that are viable and reasonable for customers. For example, tariffs that are set at levels that do not strongly disincentivise consumers from the objective of improved choice."

We fully expect that we will set the unit rate of this tariff at a price that makes it an unviable option for most consumers. We expect that at the same time, we will struggle to recover efficient costs from those consumers who elect to take up the tariff.

Ofgem's working paper presents a trade-off but it's more likely we will have the worst of both worlds.

Yours Sincerely,

[redacted]