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“Contracts for Difference allowance in the default tariff cap” – So Energy Response

Dear Danny,

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 of price protection in today’s energy market.

We welcome Ofgem’s call for evidence on Contracts for Difference (CfD) allowance in the default tariff cap. We wish to make the following key points:

- Amending supplier hedging strategies can reduce the price risk associated with CfD but it does not address the volume risk. This risk remains and is unaccounted for within the price cap.
- The historical data presented by Ofgem in Table 1 clearly shows shortfalls in income which are larger than the entire spending envelope of Ofgem’s flagship Debt Relief Scheme. We reject any assertion that these shortfalls are ‘not material’.
- The argument that the volume risk should ‘net out’ over time does not stand up to scrutiny. This is not a cyclical variation, like backwardation and contango. Ultimately, humans and LCCC and humans at various generators with CfD contracts are making decisions that will impact the outturn versus forecast – there absolutely is scope for repeated shortfalls in supplier revenue because the forecast is wrong.
- LCCC forecasting needs to improve – this is the underlying cause of all of the volume risk in the context of the price cap. Ofgem should work with LCCC to incorporate a forecast of CfD volumes into each quarterly change in the price cap. If LCCC is informed in June of a delay in a windfarm coming online in Q4, we see no reason why this cannot be incorporated into the Q4 price cap.
- If the forecasting cannot be improved then we are left with two alternatives:
 - Implement a reconciliation mechanism with mirrors how LCCC reconciles differences between forecast and outturn. If the price cap is representative of the costs and revenue faced by a notional efficient supplier, then it should mirror the reconciliation mechanism a supplier must participate in. Introducing a reconciliation mechanism would not “shift risk to customers and reduce supplier's incentive to hedge”. Suppliers will still need to hedge appropriately to manage price risk. Consumers are already exposed to the risks associated with a price cap that is not reflective of the real world challenges of supplying energy:
 - The risk of supplier failures and SoLR costs is higher.
 - The risk of a poorly designed price cap deterring investment is greater.
 - Implement a further risk premium in the price cap. The issue of CfD volume risk has grown and will grow further in the context of Clean Power 2030. The price cap should reflect what the notional efficient supplier must do in the context of a growing risk with no alternative available mitigations – introduce further risk premiums into the cost stack.

We set out our responses to your questions below.

1. What are your views on the current CfD price cap allowance methodology? Please provide evidence in support of any issues raised.

The current methodology does not support the full recovery of CfD costs. As summarised in the call for evidence the LCCC's approach to CfD forecasting has led an under-estimation of CfD costs, leading to under-recovery for suppliers under the price cap allowance. Specifically, Table 1 of the call for evidence shows that when wholesale market volatility is greatest and, therefore, the amount of risk suppliers have to manage is at its greatest, the allowance is under-recovering by significant amounts. Market volatility increases two types of risk:

- Price risk: the risk that the prices forecast by LCCC will significantly differ from the outturn.
- Volume risk: the risk that the volumes forecast by LCCC will significantly differ from the outturn.

Suppliers are most at risk of failure when markets are volatile. Post-crisis 'cancelling out' of supplier shortfalls are of no use if the suppliers are out of business and SoLR costs have already been imposed on the market. In any case, Table 1 shows there was no such 'cancelling out' following the energy crisis. In the current geopolitical context, Ofgem should ready itself for the next energy crisis and have mechanisms in place to meet it, rather than assuming it will never happen again.

We do not accept Ofgem's assertion that any losses were immaterial. Table 1 also shows that post-crisis recovery of cost has not accounted for losses incurred during the crisis. Even when accounting for the full date range included in the table, there is a shortfall of £18.88 per customer – that amounts to £599m when accounted for every electricity meter point in GB. Not all customers are on the price cap, but during the crisis, 80% of households were. The fact that the losses were concentrated when the number of customers on the cap was at its highest means that even greater losses were incurred. If we assume 70% of households were on the cap in 2022/23 and 2023/24, then that equates to £931m of losses in those two years. For context, Ofgem's flagship Debt Relief Scheme is now expected to reduce the level of bad debt in the energy sector by £300m, according to BFY.¹ It is *very* material.

2. Do you have any views on potential amendments to the CfD allowance methodology? Please include considerations of pros, cons and unintended consequences of any option.

The most straightforward approach is to improve LCCC forecasting. The methodology correctly evaluates the expected cost of CfD for a supplier based on the assumption that LCCC's Interim Levy Rate's are set at the correct level for the full cost of the CFD scheme to be recovered.

In reality, the interim levy rate will never be exactly accurate as it is reliant on 3 variables, 2 of which are forecasts, one of which will invariably move.

- CFD Generation – LCCC produces a forecast of the MWhs each site will generate.
- Eligible Demand – LCCC produce a forecast of how the total MWhs of eligible demand. The total cost of the CFD scheme is then apportioned across this demand to create a £/MWh cost.
- Market Prices – Interim Levy Rates are set at a snapshot in time, market prices will invariably move after this snapshot, and they will be correlated to the two above variables (more CFD generation => lower market prices). Alternative hedging strategies can be used to reduce this risk.

We see no reason why LCCC could not provide an additional forecast, timed to ensure that all available information about future anticipated CFD Generation and Eligible Demand is incorporated into each quarterly price cap. Done right, this should reduce the difference between the forecast and the outturn as all available information is taken into account at the time the price cap is set.

¹ [Energy debt hits record £4.43bn as doubts grow over interventions](#)

If this cannot be achieved, then additional risk premium must be placed in the price cap to account for differences between forecast and outturn.

We discuss a reconciliation mechanism as a potential alternative to future forecasting in the next question.

3. Do you consider reconciliation to be an appropriate measure for the CfD allowance, please provide supporting evidence explaining how CfD costs meet the systematic and material test or what specific characteristics of CfD costs could justify the need for a reconciliation mechanism. This evidence should also include what has materially changed since our previous decision on the CfD allowance and whether such a mechanism would introduce any additional or different risks for suppliers or customers (eg disincentivising suppliers' hedging).

If LCCC cannot improve their forecasting, then additional risk allowance or a reconciliation mechanism is needed. While price risk can be reduced by adopting different hedging strategies, this volume risk cannot be reduced in this way. Suppliers are therefore exposed to this risk. The CFD Generation element of LCCC's forecast is especially difficult to manage as suppliers do have visibility of what might drive a difference between LCCC's forecast and the outturn. If a CfD generator adjusts their anticipated date from bringing a windfarm online, we will not know this. LCCC should have much better visibility.

There are two ways of addressing this issue. One is to place an additional risk premium into the cap to account for volume risk. This replicates what suppliers do with their fixed tariffs. As the price cap is related to variable tariffs, a reconciliation mechanism serves as an additional mechanism available to Ofgem.

Arguably, the reconciliation mechanism is the better outcome as it allows for the difference between the forecast and outturn to be accurately measured and incorporated into future price periods. If the number of customers on the price cap was consistent, it could be perfectly reconciled. The complication is that customers do move from the price cap to fixed tariffs and vice versa – suppliers made significant losses in 2022/23 and 2023/24, when the number of customers on the price cap was at its greatest. Now, as customers move off the cap, fewer price capped customers remain to account for recovering historical losses – this is the 'free hit' phenomenon that arises in multiple areas in relation to the price cap. In comparison, a risk premium would likely be less accurate but more timely in terms of cost recovery.

4. (Question for suppliers) Do you hedge for CfD costs, and if so, what approach do you take (eg reference price, frequency of hedging)?

Yes, we adjust our hedging strategy to reduce the under-recovery of CfD-related costs under the price cap. However, this adjusted hedging strategy carries with it additional risk and it still does not fully allow CfD costs to be recovered.

Details of how we do this are set out in a separate confidential annex.

5. (Question for suppliers) Do you take a different hedging approach for CfD costs of customers under the price cap vs fixed tariff customers?

The amended hedging strategy to account for CfD price risk has been adopted for both price capped and fixed tariffs.

6. (Question for suppliers) Would your hedging strategy change if a reconciliation mechanism for CfD costs was in place?

No. The LCCC already has a reconciliation mechanism in place and we have still adopted an amended hedging strategy. Volume risk remains, despite the LCCC's reconciliation mechanism.

For our fixed tariffs, we can incorporate the volume risk into our risk premiums as we have

control over how we price but we cannot amend the rates once they are fixed at the point of sale.

Ofgem has a choice of adding a risk premium to the price cap or incorporating a reconciliation mechanism.

7. (Question for suppliers) Please provide evidence of the differences between the CfD cap allowance and outturn costs incurred for the CfD scheme. Please include evidence of the relative size of price vs volume effects on the differences.

Due to time constraints and competing priorities, we were unable to provide an analysis separating out the price and volume impacts. We note that they are interrelated – higher wind generation volumes leads to lower day-ahead prices, which leads to greater CfD payments.

We'd be more than happy to discuss this with you further if you have any questions. Please don't hesitate to get in touch.

Yours Sincerely,

Paul Fuller
Head of Regulation

