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"Price cap operating cost review benchmarking working paper" – So Energy Response

Dear Dan,

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.

This working paper raises a number of interesting considerations. We welcome the opportunity to provide a sense-check on the trade-offs Ofgem needs to consider ahead of later stages of the consultation process. We have identified a significant gap in these assumptions:

1. If Ofgem are to make an informed decision on the trade-offs they have identified in the working paper (customer protection, financiability etc) it's essential that they know where the cap is positioned now. If decisions on allowances are continually taken in a vacuum, the cap risks becoming divorced from reality.

2. From comparing the price cap vs available fixed tariffs in the market, the cap has clearly drifted over its lifetime to a position where efficiency has been prioritised at the expense of other considerations - no suppliers are able to offer a fixed tariff below the price cap.

3. This has all happened in the absence of an overarching Ofgem strategy on the positioning of the cap within the market. Ofgem's revealed preference is to prioritise efficiency over other key considerations (service, financial resilience, innovation etc). This must be taken into account in decision making moving forwards. If Ofgem were to stack a deliberate decision to prioritise efficiency on top of it's underlying revealed preference, it could put other considerations, such as financial resilience, in a critical position and trigger extremely poor outcomes for consumers.

We answer each of the consultation questions in turn.

1. What is your view on how benchmarking options will lead to different outcomes?

We agree that different approaches to benchmarking will lead to different outcomes. There are clear trade-offs to consider when weighing up options and Ofgem must strike a balance between these options. On one hand, Ofgem must consider efficiency and price protection, which would suggest a lower cap. On the other, Ofgem must consider competition, customer service, resilience and the impact of the cap on public spending, which would suggest a higher cap.

Much of what Ofgem has discussed in this working paper is rather abstract. If we look at the real-world performance of the price cap, we can observe some fundamental shifts in its positioning within the market. Before the crisis, all suppliers were able to price fixed tariffs comfortably below the price cap. This didn't just apply to suppliers that subsequently failed, but to all suppliers. This was evidenced on a consistent basis, regardless of whether the wholesale market was rising or falling. As we draft this response, no standalone fixed tariff is priced below the cap[1].

This fundamental shift in the market clearly indicates that while there was room in the cap to consider efficiency and price protection, the positioning of the cap in the post-crisis context suggests that it is set too low and needs to be corrected upwards in order to strike an appropriate balance overall. Or to put it another way, the cap is already in Outcome 1 under Table 3 and to drive further in the direction of Outcome 1 exposes consumers to significant risks, namely; a lack of competition, poorer customer service standards, a lack of innovation and weaker financial resilience of suppliers.

2. In terms of achieving these overarching objectives, what outcomes should we focus on through the operating cost review?

As set out in our response to question 1, Ofgem must take into account the overarching positioning of the cap in the market in order to identify its current state of balance. The evidence would suggest that the cap is set at a level where suppliers cannot competitively offer fixed tariffs. This is a level that is lower than originally intended, and, without intervention, ongoing damage will be done to competition, customer service, resilience and public spending.

While Ofgem set out that there must be regard to the effect the cap has on public spending in paragraph 3.1, this does not appear to be factored into further analysis, such as table 3. With consolidation in the market and reduced wholesale liquidity, there is increasing likelihood that future supplier failures will lead to suppliers going into Special Administration. Special Administration exposes the taxpayer to significant funding risks and therefore Ofgem must pay regard to this when setting the level of the cap. As a cap can only be set at single level for the entire market and allowable margins are so thin, a continual focus on price protection risks further supplier failures – Ofgem must strike a balance here.

3. Are there any other outcomes that we should consider achieving through the choice of benchmarking options?

As mentioned in our response to question 2, Ofgem must consider the risk of suppliers falling into Special Administration and the knock-on implications this would have for the taxpayer.

We note that in paragraph 3.14 Ofgem states that they "have other mechanisms to address some of the supplier failure risks and costs". It should be noted that profitability is the bedrock of financial resilience. Without it, other mechanisms outlined do not work – investment cannot be attracted, capital targets cannot be reached, RO money cannot be accrued. Ofgem must be careful to not overstate the effectiveness of these mechanisms without underlying profitability.

4. Are there groups of costs captured within the operating cost review that are cross correlated and therefore those costs should be considered and benchmarked together?

As is suggested in the working paper, debt is critical here. So Energy set out in or response to the separate debt allowance review concerns over the level of granularity that debt allowances are being broken down into. When scrutinised at this level of detail, some of the assessments do not appear plausible. For example, the debt review suggests suppliers are underspending versus the calculated debt administration allowance (which adjusts by CPIH) despite the number of customers in arrears with no payment plan having increased 61% since the original benchmark was established. It's possible that in that case, debt administration costs are being apportioned into other elements of the overall debt allowance or there may be other reasons.

[1] Utility Warehouse have a tariff priced approximately 1% below the cap but customers are required to bundle in other services, such as broadband, in order to be eligible.

In any case, it's important to avoid drilling down to a level of granularity where the observed data no longer makes sense.

With regards to crisis-related costs, this is extremely difficult. It is challenging to isolate a recent and relevant time when the market hasn't faced one form of crisis or another, whether it be Covid-19, supplier failures or affordability. Furthermore, all forward-looking assessments of energy prices suggest that prices will not return to 'pre-crisis levels' anytime soon, if ever. Given all that's happened since the price cap was introduced, it may be sensible to include crisis level assumptions into a forward looking assessment of operational costs.

5. How should we treat costs (ie debt-related costs) that may be more uncertain than other costs?

We are unclear what Ofgem's current plans are in relation to debt-related costs. A separate review is underway but it appears to be short term in nature and using 2018 data as a baseline for adjusting allowances. What is the short, medium and long term plan for the debt allowance? Clarification from Ofgem on it's intentions, or perhaps an options analysis on how to take the debt allowance forward, would be welcome.

6. Are there any other costs that we should isolate from the total core operating costs?

We would suggest that pass through industry charges should be separated from the operating cost allowance and updated separately. Ofgem has played an increasingly direct role in the setting of these costs by dictating change programmes and by the oversight of administrators through the Code Administrator Code of Practice. Therefore, applying an 'efficiency incentive' to those costs does not appear sensible.

We would suggest that the separate treatment of smart metering costs should continue. DESNZ's end target for the 4 year programme of installations is only 75% of customers having taken a smart meter. That would suggest that further initiatives to install smart meters will need to be created after the 4 year programme finishes. Furthermore, the exchange of comms hubs for a 4G variant points towards still further roll-out activity.

7. What are your views on setting separate core operating cost allowances for smart meter and traditional meter customers, given the risks we discussed in this section?

We believe this option should be explored further but reserve our final judgement until we see the materiality of any separate allowance. Much of the benefits of smart meters come from what their enable in the transition to net zero, rather than direct cost savings. Therefore, having a financial incentive for consumers to switch to smart meters aligns with our national decarbonisation priorities. However, in order for the incentive to be meaningful, the differential would need to be sufficiently large to bring about the change in behaviour from consumers to make it worthwhile. Adding additional complexity to the price cap for the sake of a small differential may not be provide an overall positive cost/benefit outcome.

8. What other benchmarking parameters do you think we should consider setting separate allowance for?

We cannot think of any at this time.

9. What analysis do you think we should carry out in assessing the materiality of non-efficiency factors using the RFI data?

As set out in our response to the call for evidence, suppliers do not store information at the level of granularity that is needed to carry out such an assessment. Therefore, it will be difficult to draw an informed conclusion from the RFI on cost variations in the way Ofgem anticipates.

10. What other approach do you think we should take in how we account for non-efficiency factors?

See our response to question 9.

11. What is your view on the proxy for suppliers' proportion of high-cost-to-serve vulnerable customers? Would you suggest an alternative approach?

We have examined this issue in the context of developing a social tariff proposal. It is extremely difficult to find accurate proxies to vulnerability. Our conclusion was that direct measurement of household income using cleansed HMRC data was needed find an accurate measure of fuel poverty. Other measures are very flawed and create winners and losers. This conclusion aligns with that of the Social Market Foundation, Citizens Advice and Public First[2].

With regards to other forms of vulnerability, this is also deeply problematic as the PSR relies on the customer notifying themselves as vulnerable and the supplier taking that notification on trust. If consumers are provided with a financial incentive to put themselves on the PSR, we are worried that it could affect the integrity of the data.

Finally, with regards to DNI customers, we foresee multiple pitfalls. How far does the supplier have to take a customer down the debt recovery journey before a customer qualifies as DNI? If it's early in the journey, customers could be registered as DNI without appropriate verification. If it's later, customers may receive site visits (which otherwise would not happen) in order to secure DNI status for that customer. That would drive cost onto the bill and unduly inconvenience customers at the very least.

12. What level of stringency of the cap do you think we should consider?

As set out in our response to question 1, the cap already appears to be in an incredibly stringent position. Suppliers can no longer price a fix below it, which means customers are being exposed to the volatility of a quarterly cap.

Ofgem has made multiple changes to the supply licence over the lifetime of the cap without a full impact assessment of each change – the decision on consumers being the most recent example. Individually Ofgem has largely refused to make price cap adjustments to account for these changes. In aggregate this has added up, as evidenced by the positioning of the cap within the market, post-crisis.

All of this points towards a need to reset the cap in a more sensible position.

13. How should we account for the impact of the expected regulatory changes mentioned above?

Past history demonstrates that changes in the cap lag increases in cost to serve. See our response to question 12 for more information.

The overall approach on stringency will have an impact on the question of expected regulatory changes. The more stringent Ofgem's approach is in 2023/24 the more quickly the cap will fall out of alignment with real-world cost.

14. Which option of accounting for the uncertainties in costs driven by upcoming regulatory changes do you agree with? What other options do you think we should use to account for these costs?

Ofgem should set a looser cap to account for the existing misalignment between the cap and real world costs. Then for subsequent regulatory changes, Ofgem should commit to a full IA and update the cap as it goes, taking into account the impact individual and aggregate changes to the regulations have on cost to serve.

15. How should we account for the limitations in our methodology and the associated uncertainty?

Ofgem should correct for past behaviour in this assessment. If Ofgem's general tendency is to allow the cap to fall short of the real world cost to serve over time, then this assumption should

[2] https://www.smf.co.uk/future-of-energy-bills/

be baked into its forward looking approach and assessment of the best way forward in this review.

16. What approach do you think we should take to set the benchmarks for different operating cost allowances?

Using separate benchmark suppliers carries risk. Suppliers' costs across different aspects of the operating cost allowance are as likely to be driven by differences in operating structure or accounting methodologies as they are by having a genuinely lower cost to serve. Deliberate commercial choices will also play a role – a prepay-only supplier may benchmark very differently from a supplier that serves multiple payment methods. Reverting to an example from the debt allowance review, moving to a granular approach suggested that suppliers are underspending versus the calculated debt administration allowance (which adjusts by CPIH) despite the number of customers in arrears with no payment plan having increased 61% since the original benchmark was established. This doesn't seem plausible. The risk also applies here.

We believe that Ofgem would be better served by benchmarking at a much less granular level as many of these issues and considerations should reconcile themselves out.

Yours Sincerely,

Paul Fuller
Head of Regulation
SO ENERGY