SO ENERGY

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“Price Cap – Call for Input on the Operating Cost Allowances Review” – So Energy Response

Dear Dan,

So Energy is a leading energy supplier providing great value 100% renewable electricity to homes across England, Wales and Scotland. Our customers and the wider industry have consistently recognised us 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 after year. 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 is able to provide a unique view of the quality of service in today’s energy market.

We welcome the opportunity to respond to this consultation and provide our input regarding the price cap operating cost allowance. We would like to draw your attention to the following key points:

1. Ofgem needs to consider the impact on consumers of the Opex squeeze during COVID and the gas crisis. If the analysis shows that Opex has fallen out of alignment with the allowance in recent years, then an allowance should be provided, similar to other allowances, such as unexpected SVT demand. Ofgem has incurred a delay in formulating an allowance by not collecting the relevant data until now. This is not a legitimate justification for disallowing the recovery of costs on an ex-post basis.
2. Recent volatility should not be excluded from the forward-looking review. Structural changes in energy markets, such as the removal of Russian Gas from Europe and the move to a quarterly price cap point towards increased price volatility and knock-on operational pressures over the medium and long term. Ofgem needs to create mechanisms that better scale the supplier allowance to manage periods of increased sectoral demands.
3. Ofgem’s continual focus on efficiency above all other things is having a detrimental effect on consumer outcomes. An upper quartile approach should be adopted to allow a diverse supplier community to deliver good consumer outcomes for a single level of price cap.

We provide answers to several of the consultation questions below. We would be more than happy to discuss any of our response bilaterally – please don’t hesitate to get in touch.

1. Do you agree with the scope set out in the introduction section for the operating cost review?

Everything that is in the scope should be considered. However, more needs to be added to the scope, see our response to Question 2.

2. Do you agree with the areas that we consider are outside the scope of this review? Do you consider that there should be anything else in the scope of this review?

So Energy does not agree with Ofgem's plan to exclude 'Allowances set in past cap periods'. Since the initial 2017 allowance was set, there have been significant increases to the cost to serve due to market disruption, new programmes released and operationalised, and the move to a quarterly cap in response to increased wholesale price volatility. This means the allowance in the cap has not been in balance with real-world cost to serve for some time. This discrepancy is real, material and must be recouped.

Looking forward, the removal of Russian gas from the European market and the increasing reliance on LNG, point to lasting price volatility – the UK market is now more exposed to demand spikes in Asia, for example. To provide increased confidence to investors, we believe it is necessary for the allowance to account for increased volatility. A risk premium or upper quartile approach should be considered to account for volatile price periods.

Ofgem has had efficiency as a key price cap policy driver since the cap was established, which when applied correctly and narrowly, can remove inefficiencies from the market. However, after several years of price cap operation, we are now in a market where only lean operating suppliers remain. Very lean operations do not have the innate spare capacity to deal with the consequences of unstable market conditions, leading to worse outcomes for consumers. Benchmarking the leanest of existing suppliers to drive still more efficiency leaves the market without any innate operational resilience. For this reason, suppliers will not be able to innovate, mobilise and or match customer demand for support without sufficient profits from their products. We encourage Ofgem to make provisions in its Opex allowance to provide for good customer outcomes in a volatile environment. The Opex allowance should also facilitate innovation in how suppliers serve their customers through the Innovation Link and Innovation Sandbox should also be considered.

3. What are your views on the case for review we identify in this section?

So Energy agrees that the market has undergone significant change since 2017 when operating costs were set according to supplier data and consequently, activated in the 2019 cap. Though we appreciate Ofgem's acknowledgement of economic and market shocks, we do not feel like the acknowledgement has carried through into the proposals. Instead, the acknowledgement is immediately dismissed with the decision not to include a true up or innovation within the scope of its work. Ofgem should use its RFI data to quantify the deviation between the Opex allowance and real-world cost and provide an allowance to make up the difference.

It is unclear why Ofgem has published a call for evidence[1] and a call for input [2] to consider socialising PPM costs across direct debit customers and look at the underlying cost differences between customers on different payment methods separately when we view them as inherently connected. A revised calculation of the cost differences would surely impact the considerations around socialising. If this is managed by separate teams, it creates an unnecessary communication risk to establishing the future policy position.

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[1] https://www.ofgem.gov.uk/publications/levelisation-payment-method-cost-differentials-call-evidence

[2] https://www.ofgem.gov.uk/publications/price-cap-call-input-operating-cost-allowances-review

4. Do you agree that there is sufficient reason to carry out a review?

So Energy agrees that there has been a significant shift in costs since data was collected in 2017, meaning suppliers' real-world costs are being understated by the current cap operational costs.

5. What cost lines do you think should be included within operating costs?

Economic and market volatility has led to a higher cost to serve and this volatility is likely to continue. We encourage Ofgem to make provisions in its Opex allowance to provide for good customer outcomes in a volatile environment.

6. Do you consider there to be any new costs which may have not been included within the existing core operating costs allowance?

Ofgem is consulting on new consumer standards[3] which will heavily impact operational costs under the cap. The full cost of those proposals needs to be considered should Ofgem decide to move forward with option 1 or 2 from that consultation. Please note that in our response to the consumer standards consultation, we did provide Ofgem with an estimated projection of the cost of each option – it is a substantial cost.

7. Do you consider that any new costs would be offset by corresponding benefits?

Suppliers are no longer being penalised by the six-monthly price cap when significant market shocks occur which result in profit losses for as much as half a year. Ofgem's decision to implement a quarterly price cap reduces the impact market shocks can have on suppliers. However, the quarterly price cap does come with a higher cost to serve. We would not consider the new costs associated with the quarterly price cap to offset the benefit of not being penalised by a six-monthly cap because the losses were so vast. So Energy considers the backwards-looking perspective to highlight the issues that we have flagged already about a true-up mechanism.

From our forward-looking perspective, Ofgem cannot observe that some suppliers are offering longer opening hours only to benchmark costs against suppliers with shorter opening hours. This is not a fair or consistent benchmark.

9. What external events do you think have impacted (or will impact) operating costs? Are these impacts permanent or temporary? Can you provide evidence on how costs have been affected, and by how much (ie per customer)?

We have worked on, and delivered many industry programmes since 2017, some of which have been at a cost to us directly. They include:

Impacted:

- **Market-wide Half Hourly Settlement**. This programme started in 2017 and aims to maximise opportunities by smart metering, delivering consumer benefits and enabling smart and flexible energy systems by October 2025.
- **Smart meter rollout.** Suppliers have continued to roll out smart meters since 2011. From January 2022 all gas and electricity suppliers now have binding annual installation targets to their remaining non-smart customers by 2025.

[3] https://www.ofgem.gov.uk/publications/consultation-framework-consumer-standards-and-policy-options-address-priority-customer-service-issues

- **Ofgem's Faster and More Reliable Switching programme** went live in July 2022, allowing customers to switch energy suppliers within 5 working days, making the process faster, easier and more cost-effective.
- **Implementation of the Government's Energy Bill Support Scheme (EBSS)**, providing a £400 non-repayable discount to eligible households between October 2022-March 2023 to help with their energy bills.
- **The Governments Energy Price Guarantee (EPG)** was introduced in October 2022 for two years, capping domestic customers' energy prices and compensating suppliers for providing energy below cost prices.
- **Ofgem's Supplier Code of Practice for Involuntary pre-payment meters (PPMs)** was published in April 2023.
- **Many Supplier of Last Resort (SoLR) acquisitions**, most notably following the failure of 30 suppliers since the beginning of 2021.
- **The government expanded the Warm Home Discount Scheme from 2022 – 2023**, increasing payments to £150 to those that are eligible.
- **Delivery of the Energy Companies Obligation (ECO) schemes**: ECO 3 began in April 2017, ECO4 and now EC0+, called the Great British Insulation Scheme is running from spring 2023 for up to 3 years and extends support to hundreds of thousands of households more, who could receive new insulation measures for their home but who are not currently eligible for support under existing government-backed schemes.
- **Ofgem's Market Stabilisation Charge (MSC)** was introduced in April 2022, which aims to manage the impact of suppliers' exits on market stability.
- **Energy UK's Vulnerability Commitment (VC) launched in 2020**. The VC is a voluntary industry initiative under which suppliers who sign up for the scheme commit to improving the support they provide to vulnerable customers, over and above existing licence requirements. There are 14 signatories at current, which covers up to 90% of the retail market.

Will impact:

- **Consultation on a framework for consumer standards and policy options to address priority customer service issues**. Proposed as of this May for implementation in December 2024. Two options, both options to increase call centre operation times (7 am – 10 pm or 24hs) 7 days a week, will have a dramatic impact on operating costs. Please see our consultation response for more detail.

Due to the alarmingly short turnaround of consultations in recent times, we are not in a position to provide evidence or data. Please return to the standard consultation timelines in order to allow the supplier community time to correctly represent their and their customer's interests.

10. What time period do you think we should use for the updated baseline for core operating costs and why?

Over the last 5-6 years, the energy market has seen unpredictable weather, Covid, energy and cost of living crises which gives us a reason to see these events, not as disruptions but as the new environment in which we provide energy. There is no reason to suggest that we will return to what used to be considered 'normal' market conditions. Indeed structural changes, such as the removal of Russian gas from the European market and the increasing reliance on LNG point to lasting price volatility – the UK market is now more exposed to demand spikes in Asia. For that reason, it is most appropriate to baseline for core operating costs to be taken from the most recent data available, the year 2022-2023. Any other approach will not provide real-world outcomes. If Ofgem is reluctant to do this, then Ofgem should consider why it considers it necessary to review operational costs, as suggested in Q3.

11. What factors should we seek to correct in setting an enduring benchmark?
Overall approach (Bottom-up Vs Top-down)

Based on our engagement with Ofgem on the RFI associated with this call for input, So Energy does not think the bottom-up approach offers a real-world view of supplier costs. The bottom-up approach set out in the RFI asks for a level of granularity of data greater than we store, meaning we must resort to making assumptions in order to complete the RFI. Our understanding is that we are not unique in that regard. The result is data that is more granular but is not particularly accurate or reliable. With regard to a top-down approach, Ofgem should consider the following factors:

1. The most recent reflecting volatile market data should not be excluded from the assessment. Structural changes to the market such as the move to a quarterly cap and the end of Russian gas in Europe will mean that the more volatile recent period is a more accurate representation of the future than pre-crisis data.
2. Supplier benchmarking should reflect Ofgem's intended outcomes. If Ofgem want longer opening hours, suppliers who offer longer opening hours should be benchmarked.
3. An upper quartile allowance should be considered to allow for improved customer service and resilience in the context of increased volatility.

13. Do you have any alternative approach for calculating the efficient level of core operating costs across suppliers?

In terms of frontier and lower quartile, if Ofgem benchmarks different suppliers for each element of the cap (operational, opening hours, unexpected SVT demand, backwardation etc.), it risks aggregating suppliers up to a supplier that cannot exist in real terms. This is because Ofgem's notional supplier would not have to consider real-world trade-offs. Weighted average would better account for the diversity of business models and help return the market to a state where suppliers are making the profit accounted for in the cap.

14. Which benchmarking approach options do you think we should be considering?

In terms of frontier and lower quartile, if Ofgem benchmarks different suppliers for each element of the cap (operational, opening hours, unexpected SVT demand, backwardation etc.), it risks aggregating suppliers up to a supplier that cannot exist in real terms. This is because Ofgem's notional supplier would not have to consider real-world trade-offs. Weighted average would better account for the diversity of business models and help return the market to a state where suppliers are making the profit accounted for in the cap.

15. How should we develop a framework for choosing between benchmarking options?

The Opex allowance needs to provide enough money to allow a diverse supplier community that serves customers with differing needs without compelling suppliers to reduce customer service to provide a return to investors under the price cap. It has been observed that since the price cap was introduced, key customer service metrics have fallen. It has also been observed that the market has become increasingly volatile since the price cap was introduced and all signs point towards it remaining volatile. Ofgem needs to acknowledge these issues and pivot away from a sole focus on efficiency. One way of doing this would be to go beyond the weighted average and move to an upper quartile allowance to incentivise good customer service for all customers, even those with the greatest cost to serve.

16. What non-efficiency factors linked to customer bases do you think to drive cost variation among suppliers? Should we control for these through an adjustment or benchmark metric?

As set out in our bilateral engagement with Ofgem on the RFI tied to this consultation, suppliers do not store information at the level of granularity that is being requested. Therefore, it will be difficult to draw an informed conclusion from the RFI on cost variations in the way Ofgem anticipates.

19. What is your view on the extent to which we should prioritise allocating costs between different parameters currently not included in our cost data breakdown?

So Energy is mostly concerned that the parameters are reflective of the cost to serve where possible. Where that is not possible or desirable, a risk premium must be added to account for mismatches between the cost to serve and cost recovery across the supplier community.

20. In the event that some of the cost drivers are impacted by recent events, how should we treat these costs to determine an allowance on an enduring basis?

So Energy is mostly concerned that the parameters are reflective of the cost to serve where possible. Where that is not possible or desirable, a risk premium must be added to account for mismatches between the cost to serve and cost recovery across the supplier community.

25. Should we use the same benchmarking approach for core operating costs and the payment method differential? Are there any additional or different considerations than for the core operating cost benchmarking approach?

If Ofgem benchmarks different suppliers for each element of the cap, it risks aggregating suppliers up to a standard that cannot exist in real terms. This is because Ofgem's notional supplier would not have to consider real-world trade-offs. One supplier's 'good' performance on a payment method is as likely to be a factor of how they account for each payment method than real-world performance – for example by how they account for indebtedness across their payment methods. This is not an area in which Ofgem can cherry-pick. Weighted average would account for the diversity of business models and help return the market to a state where suppliers are making the profit accounted for in the cap.

26. Do you have initial views on whether we should benchmark payment differentials individually, or use the same benchmark for each supplier?

If Ofgem benchmarks different suppliers for each element of the cap, it risks aggregating suppliers up to a standard that cannot exist in real terms. This is because Ofgem's notional supplier would not have to consider real-world trade-offs. One supplier's 'good' performance on a payment method is as likely to be a factor of how they account for each payment method than real-world performance – for example by how they account for indebtedness across their payment methods. This is not an area in which Ofgem can cherry-pick. Weighted average would account for the diversity of business models and help return the market to a state where suppliers are making the profit accounted for in the cap.

27. What is your view on how we should allocate the identified cost categories between payment methods?

So Energy urges Ofgem to establish key principles. These are:

- Levelising the tariffs should align with broader social/regulatory objectives.
- Levelising should only be done if it results in incentives that will be net positive or net neutral from a system perspective. This is important for an intentional approach to cross-subsidisation as well as to address any unintentional poor cost reflectivity that could create supplier incentives contrary to consumer interests.
- The costs should be recovered fairly in a way that doesn't result in market distortions that adversely impact competition.

These principles are important for an intentional approach to cross-subsidisation as well as to address any unintentional poor cost reflectivity that could create supplier incentives contrary to consumer interests. Ofgem should ensure that suppliers are incentivised to gain and operate all customers in such a that provides them with the best service and outcomes.

If any cross-subsidy is required, then all customers, and therefore all tariff types should contribute to the cost of levelisation, this will need to be done in a way that seeks to minimise market distortions. As a change which is designed to deliver an overarching desired market outcome, there is no rationale for a subsection of the market to bear the cost. This is important as more customers move onto fixed tariffs and switching suppliers increases, which should be a sign of a competitive market offering value to consumers.

35. Do you agree with our considerations for updating the benchmark? Are there any other approaches we should explore for incorporating future costs?

So Energy encourages benchmarks, allowances and incentives that provide for a diverse, high-quality supplier community and that drive new operational capabilities and service offers in the retail sector. This is not compatible with Ofgem's drive for extreme efficiency benchmarking. Ofgem should consider broader objectives aside from efficiency and as part of that, an upper quartile allowance based on providing a higher level of resilience and quality of service.

36. Which option do you think we should use to allocate costs across the standing charge and unit rate?

So Energy would support maintaining the current approach of setting the cap at nil consumption in line with current levels.

Yours Sincerely,

Joshua Field
Regulation Manager

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