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“Standing charges: domestic retail options” – 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 can provide a unique view of today’s energy market.

We welcome the opportunity to comment on your options paper. Overall, the direction of travel set out by Ofgem appears sensible. We especially welcome the suspension of work on Payment Method Levelisation (PML) Phase 2. Ofgem has cited implementation challenges in its decision to suspend but Phase 2 would also cause issues to the operation of the market if implemented. Specifically, it would reduce the availability and competitiveness of fixed tariffs at a time when one of Ofgem’s stated objectives is to improve tariff diversity.

Changes can be made to rebalance the unit rate and standing charge elements of the operating cost allowance, so long as Ofgem is prudent in their approach. Ofgem needs to account for both the distributional impact on suppliers and the impact warm weather could have on the revenue earned by the industry as a whole in making an assessment of what a sensible rebalancing looks like.

A review of the Targeted Charging Review (TCR) is also a good idea. We caution, however, that substantial lead times are needed to amend network charge methodology. In order to sell competitively priced fixed tariffs, suppliers need to have a strong understanding of their costs they will bear over the duration the contract at point of sale. Any uncertainty in these costs demands a risk premium be priced in to account for potential cost increases. The prospect of network and policy costs being changed at short notice will necessitate risk premiums and make fixed tariffs uncompetitive compared to the price cap. *Suppliers need at least 12 months’ notice of changes to policy and network costs so that we may correctly price this into our fixed tariffs.*

Kind Regards,

Paul Fuller
Head of Regulation

Q1. Do you have any views on our case for change?

The main conclusions that were drawn by Ofgem in the TCR were the correct. It is more cost reflective to allocate fixed costs to the standing charge and variable costs to the unit. Consequently, cost reflective pricing minimises the chances of ‘gaming the system’ through the likes of triad avoidance.

However, the TCR changes represented a large adjustment to the status quo when it comes to the unit rate/standing charge balance. There were winners and losers from this change and because of the context in which the change took place, the energy crisis, the winners didn’t notice while the losers were especially aware of their loss. Whether the economic rationale was right or wrong, it is clear that a narrative has taken hold which considers the recent increases in standing charges to be unfair. Consumer perceptions matter – if consumers don’t have trust in the market then it will be difficult to navigate the Net Zero transition.

In reducing standing charges, there is a risk of overcorrection leading to the creation of a new set of winners and losers and new problems, which could precipitate further corrections and uncertainty. A balance must be struck. Ofgem must be deliberate, evidence-based and transparent with their delivery of policy changes so that all stakeholders have the best chance of understanding that whatever level of standing charge we arrive at represents the best compromise. Returning standing charges¹ to pre-TCR levels represents a relatively low risk change, as this level of charges is familiar to consumers and market participants. The risk of negative consequences rises if Ofgem pushes for further reductions in the standing charge – we would be pushing into unknown territory, where the consequences are more difficult to predict.

Q2. What are your views on the range (£20-£100) of operating costs we are considering shifting from standing charges to unit rates? Should it be higher? Within this range, is there a value you would favour and why?

While an adjustment is appropriate, there are key constraining factors that provide a limit on the extent to which the operating cost allowance can be adjusted:

1. A further expansion of payment method PML is clearly undesirable and we welcome Ofgem’s decision to suspend PML Phase 2. Beyond the implementation challenges Ofgem has identified in terms of extending PML to cover unit rates, we are deeply concerned about the consequential impact a large and complex system of taxes and cross-subsidies would have on the state of competition in the market. It would introduce uncertainty into the pricing of fixed contracts and reduce consumers ability to protect themselves from volatile prices by fixing. We believe sacrificing consumer choice for the sake of a short term lowering of standing charges is the wrong choice to make.
2. When PML is ruled out as an option, that puts a practical limit on how much of a reduction in standing charges can be achieved by modifying the operating cost allowance. As Ofgem states, suppliers whose customers have lower than average usage would have a negative revenue impact. However, Ofgem does not appear to account for the impact warm weather may have on under-recovery of fixed costs. The further the standing charge is reduced, the greater the likelihood of under-recovery for the whole industry if the weather is warm, necessitating a risk premium to keep the industry financially stable.
3. As Ofgem has identified in their consultation, low income, high usage consumers will be put at risk if the standing charge is reduced too far. Ofgem must take into account how further rebalancing

¹ The standing charges paid by consumers, not the standing charge element of network charges.

of the standing charge through TCR reforms would stack on top of operating cost allowance reform and the impact this might have on low income, high usage consumers. In the short term, there are no good proxies to identify and apply mitigations to alleviate the impact on these consumers.

Q3. What are your views on the trade-offs and impacts we have identified for consumers and suppliers? Should any of these take more or less significance in our assessment, and are there any important impacts we have not considered?

Ofgem has presented a good summary of the trade-offs.

There are two areas where Ofgem has under-stated the impacts on consumers and suppliers:

- While Ofgem has set out the complexity of implementing Phase 2 of PML, it doesn't raise the consequences of implementing Phase 2. We are deeply concerned about the impact a large and complex system of taxes and cross-subsidies would have on the state of competition in the market. At a time when Ofgem is trying to increase tariff choice, PML would introduce further uncertainty into the pricing of fixed contracts, lowering tariff choice. We welcome that Phase 2 has been suspended, but the consequences for the market need to be fully understood if Ofgem were to consider a resumption.
- With the data that's currently available to energy industry participants it is very difficult to mitigate the impact standing charge reduction will have on low income, high usage consumers. More data matching is needed to understand where the most fuel poor consumers live, so we can help them. In any case, these consumers are better served by a social discount, such as an enhanced Warm Home Discount to directly address fuel poverty, rather than increasing their unit rate, only to in some way reduce it back down again.

Q4. What are the changes required, if any, to the price cap to facilitate a reduction in the level of the operating costs charged through the standing charge?

Provided the constraining factors we have set out in our response to Question 2 are taken into account, a simple adjustment in the operating cost allowance is all that's required.

We must re-emphasise that pursuing PML Phase 2 will have a detrimental effect on consumers and the market as it will reduce tariff choice and lock all customers into the price cap. If Ofgem were to resume work on this, the implementation challenges would multiply.

Q5. Could mandating suppliers to have at least one low or no standing charge tariff available to customers help promote competition in this area of the market?

It will be very difficult to mandate suppliers to offer tariffs they believe are not commercially viable. In all likelihood, it would lead to a series of tariffs being made available which are not attractive to consumers. Lower standing charge products are being launched without a mandate,² but it remains to be seen whether there is actually market demand for them. Launching and maintaining low standing charge tariffs for which there is no demand engineers additional cost into the energy system with little benefit to consumers.

² <https://www.rebelenergy.com/news/rebel-energy-and-ebico-living-announce-partnership-to-slash-home-energy-charges>

Ofgem should focus on making the offering of low and no standing charge tariffs more commercially attractive. When SEG was introduced, many suppliers released tariffs with minimal rates in order to comply with the obligation. However, as the SEG market bedded in and wholesale prices rose, the tariffs became more competitive.

A key barrier to competitive low and no standing charge tariffs is the price cap. Its 'one size fits all' nature and Ofgem's continuing desire to set the cap as low as possible constrains suppliers' ability to diversify. The vast majority of consumers are now on the cap and it acts as a reference price for the market. Effectively lowering the 'reference' standing charge through changes to the operating cost allowance and TCR reform will change the dynamics of the market as we would expect non-capped tariffs to also adjust their unit rate/standing charge balance. However, deeper price cap reform is needed to unlock greater tariff diversity. Ofgem's work on Future Price Protection, which considers a looser, or non-universal cap points the way forward in this regard.

Q6. How could we create flexibility in how costs are recovered between the unit rate and standing charge without reducing the protection provided by the cap?

A 'looser' price cap, as set out in Ofgem's Future Price Protection work, is the way forward in terms of creating greater flexibility for suppliers to set charges that are reflective of their individual cost bases.

Q7. In enabling greater diversity in standing charges on default tariffs, what, if any, safeguards would be needed to protect vulnerable consumers?

This is a trade-off. At the moment, we have uniformity, which creates winners and losers across the whole market. If we have greater diversity, there are likely to be fewer losers, as each supplier can optimise their pricing to reflect their unique cost to serve while attracting and retain a certain type of customer – this is one of the features of a competitive market. 'Safeguards' tend to restrict suppliers' ability to optimise their pricing, leading to a closer approximation of today's market with today's winners and losers.

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Q8. What are the key considerations we should take into account in developing options for smoothing spend for prepayment meter customers?

With regards to allowing standing charge debt or arrears to be paid off on a longer timescale so that PPM consumers can apply any top up to consumption immediately, this will inflate industry bad debt still further. Ofgem has acknowledged that this is an issue in the context of other workstreams and this suggestion contradicts that acknowledgement. This change would require system changes to implement, meaning lead times and added cost. Finally, it would create further complexity and confusion for customers – from their perspective a £10 top up will add seemingly random amounts of credit to the meter depending on the time of year. We would expect this to drive complaints from prepay customers and make prepay a less desirable proposition overall.

Q9. Do you have any views on our considerations for the allocation of network and policy costs?

When it comes to amending network charging structures, there is a specific risk with regards to the treatment of fixed term tariffs. Ofgem has stated their desire for greater tariff diversity, which implies more fixed tariffs. In order to sell competitively priced fixed tariffs, suppliers need to have a strong understanding of their costs they will bear over the duration the contract at point of sale. Any uncertainty in these costs demands a risk premium be priced in to account for potential cost increases. The prospect of network and policy costs being changed at short notice will necessitate risk premiums and make fixed tariffs uncompetitive compared to the price cap. *Suppliers need at least 12 months' notice of changes to policy and network costs so that we may correctly price this into our fixed tariffs.*

In more general terms, this is a complex issue. The conclusions that were drawn by Ofgem in the TCR were the correct ones – it is more cost reflective to allocate fixed costs to the standing charge and variable costs to the unit rate and cost reflective pricing minimises the chances of 'gaming the system' through the likes of triad avoidance. However, the changes represented a large in the status quo when it comes to the unit rate/standing charge balance. There were winners and losers from this change and, because the change took place during the energy crisis, the winners didn't notice while the losers were especially aware of their loss. It's clear a narrative has taken hold characterises the recent increases in standing charges as unfair. Consumer perceptions matter – if consumers don't have trust in the market then it will be difficult to navigate the Net Zero transition.

However, in reducing standing charges, there is a risk of overcorrection leading to the creation of a new set of winners and losers and new problems and this could precipitate further corrections. A balance must be struck. Ofgem must be deliberate, evidence-based and transparent with their delivery of policy changes so that consumers have the best chance of understanding that whatever level of standing charge we arrive at represents the best compromise. Returning standing charges³ to pre-TCR levels represents a relatively low risk change, with the risk of negative consequences rising as Ofgem pushes past this reduction to deliver even lower standing charges.

³ The standing charges paid by consumers, not the standing charge element of network charges.