"Energy pricing and the future of the Energy Market" – So Energy Supplementary Response

6 July 2022

Context

We are grateful to the Committee for being invited to give oral evidence on Tuesday 22nd March and we have followed the subsequent sessions very closely.

In response to Ofgem's recently published financial resilience proposals, which include plans to protect consumer credit balances and Renewables Obligation (RO) money when suppliers fail, So Energy would like to submit additional written evidence that we hope the Committee will consider. As well as commenting on the proposals themselves, we will also comment on the assumptions in the recent NERA Economic Consulting report used by Ofgem to justify these proposals and underpin their Impact.

Summary

Ofgem's proposals will further increase bills for consumers, and our modelling indicates that ringfencing credit balances and RO accruals could add £38 per year to customer bills.[1] Furthermore, the unreasonably quick implementation timeline will put significant pressures on suppliers to raise the capital needed, negatively impacting supplier financial resilience which is the opposite of what the measures intend to do. Our understanding is that Ofgem is planning a 'weighted average' price cap uplift which will not cover the implementation costs of most suppliers. *This will damage their overall financial resilience.*

Ofgem's Proposals

Ofgem's consultation has three main elements:

1. Restrict irresponsible business models by limiting Direct Debit payments to one month in advance. We support this initiative.
2. Limit the amount of customer credit balance and RO money mutualised under Supplier of Last Resort (SoLR) through limiting access.
3. Introduce a capital adequacy regime to ensure suppliers are capitalised enough to weather future crises. Proposals here are in an early stage of development.

There is a tension between 2 and 3. Financial resilience means having more capital on hand to meet the next energy crisis but ringfencing means putting existing sources of capital beyond the supplier's reach, necessitating its replacement with more expensive alternative sources of capital. **The only reasonable way of resolving this tension is by increasing prices.** Ofgem is seeking to commence ringfencing from this winter, which means prices will need to rise when they're already projected to reach a record high. That will allow the energy retail sector, which has been unprofitable for years[2], the ability to improve its capital adequacy, either through retaining profits or attracting investment.

Ringfencing proposal

The recent NERA report makes clear that the cost of raising additional capital in order to facilitate the ringfencing of credit balances and money for RO payments will vary dramatically between suppliers. Across the report, their estimates range from a Weighted Average Cost of Capital

[1] Calculation based on a 20% Weighted Average Cost of Capital. If tariffs continue to rise, the cost of ringfencing will rise beyond £38.

[2] We note that Ofgem has acknowledged that the 1.9% rate of return allowed under the price cap may not be appropriate and has committed to a review, however, no timeframe has been provided.

(WACC) of 20% for a supplier with a CCC credit rating to 1.12% bond yield for a supplier with an investment-grade BBB rating.

Ultimately, NERA assumes the cost of ringfencing the RO money and credit balances will fall as suppliers become more financially resilient. Suppliers that have a CCC credit rating will obtain a B credit rating and the WACC will fall. **However, NERA doesn't appear to indicate how long this might take to achieve.**[3] Our understanding is that adjusting a company's credit rating is a gradual process and would likely take several years of sustained profitability.

The NERA report acknowledges that tariffs will need to rise to meet this cost. In section 5.4.2 of their report, they discuss the possibility of suppliers raising their tariffs by more than the cost of implementing ringfencing, and returning additional profits to shareholders:

"Competition between non-failed suppliers may be sufficiently healthy that tariffs are already driven by underlying costs, in which case their tariffs would not increase beyond the level required to comply with the proposed interventions…we assume no impact on the tariffs of non-failed suppliers beyond the increases in costs that they would experience."

The NERA report presumes that suppliers have the freedom to adjust their pricing, up to the extent that they're constrained by competitive pressure. NERA also assumes in Section B4 "that small suppliers are able to increase their tariffs above the cost of compliance by a greater extent, because the potential cost of a new risky entrant is higher than in the main results." In other words, smaller suppliers will have the freedom to increase their tariffs by more than larger suppliers which is useful in meeting the greater cost of ringfencing.

However, the energy retail market doesn't work that way. All suppliers are constrained by a single price cap for the entire market. In effect, Ofgem sets the amount of revenue a supplier can draw in through the price cap and is the main driver of a supplier's cost to serve, through the obligations set out in the supply licence. This includes the financial responsibility principle and the operational capability principle.

At the current level of the price cap the market is loss-making and lacks financial resilience. This provides a dilemma for Ofgem:

- Option 1: Provide a price cap allowance that allows all suppliers to cover the cost of implementing RO money and credit balance ringfencing. This will need to be a substantial allowance and for some suppliers will be more than they need. In principle, suppliers that are overfunded could choose to price below the cap but that seems unlikely given the overall lack of profitability in the market. Following the logic of the NERA document, the size of the allowance could be reduced over time as the creditworthiness of suppliers improve but this will take several years. Ofgem will obtain the full benefits set out in their IA but at a far greater cost than they have assumed.
- Option 2: Provide an allowance that only covers the cost of ringfencing RO and credit balances for a limited number of suppliers. As a consequence, the financial resilience of suppliers who do not receive adequate funding will get worse because they won't be able to fund an alternative source of capital. The worst affected suppliers will be faced with difficult decisions about whether it is appropriate to continue to trade in light of rising costs and capped revenues. Ofgem will save on implementation costs, but the assumed benefits of this policy will not be realised. The risk of this approach pushing further suppliers into SoLR is substantial. Our understanding is it is this latter option Ofgem intends pursuing by providing a 'weighted average' allowance.

At no point in Ofgem's consultation is there a recognition that a difficult decision needs to be made regarding what suppliers Ofgem is willing to save and what suppliers Ofgem is willing to see fail

[3] This is the NERA 'Partial Effectiveness' scenario, which Ofgem have adopted for their impact assessment.

through setting a single price cap allowance. Ofgem’s impact assessment, which is based on the NERA report, does not address this issue – it assumes the cost of Option 1 and the benefits of Option 2. The assumption seems to be that if difficult trade-offs can be ignored, they no longer exist. This flies in the face of the Oxera report’s recommendations, which calls for Ofgem to explicitly account for impacts on consumer interest and effective competition when making policy trade-offs.[4] Ofgem’s assessment of the impact is fundamentally flawed, not fit for purpose and needs to be complexly re-engineered.

Our proposals

We believe that financial resilience and minimising mutualisation costs are laudable goals for the industry, but they cannot be achieved *on the cheap*. There is going to be a substantial cost to consumers but ultimately, it’s necessary to provide confidence in energy and build a foundation for the transition to net zero. There are prudent steps that could be taken to lessen the cost of implementation, but these have been ignored by Ofgem in favour of wishful thinking.

Our proposals are outlined below:

- **Phase in ringfencing over time:** Suppliers have faced substantial losses in recent times. The suppliers that have survived the current crisis have had their finances severely tested. Investor confidence in suppliers is therefore low. Phasing ringfencing requirements in over a longer period of time than is proposed will lower the initial cost of raising capital and allow suppliers to rebuild investor confidence, while at the same time sending clear signals to potential new entrants on the level of capital needed to participate in the supply market. It also allows for the possibility of consumer bills falling from their current record levels before further price cap allowances are added.
- **Prioritise the RO over credit balances:** We have provided evidence to Ofgem making clear that, in terms of moral hazard, the RO money is far more of a material risk than credit balances, especially in the context of Ofgem’s proposed ban on limiting up-front Direct Debit payments to 1 month (a proposal we support). Ofgem’s proposal to stack the funding requirement of the RO money and credit balances on top of one and other, substantially increases the cost of the policy for little added benefit.
- **Ensure capital adequacy requirements do not stack on top of RO money and credit balance ringfencing unnecessarily:** Ofgem acknowledge in the consultation that capital adequacy requirements may lessen the need for, and perhaps even displace, ringfencing. Therefore, if implemented incorrectly, it may drive unnecessary costs for consumers. Based on our engagement with Ofgem and the recent consultation, we do not have confidence in their ability to manage a transition from ringfencing to capital adequacy requirements without incurring unnecessary costs. Ofgem must restore confidence by being honest about the costs, benefits and trade-offs associated with their intended interventions.

Ofgem’s engagement with suppliers

Whilst Ofgem has run engagement exercises with suppliers when consulting on these proposals, based on discussions we have had to date with Ofgem, we do not believe our (and some other suppliers’) significant concerns with the proposals are being considered. The fact that Ofgem have issued a 100+ page consultation with associated 100+ page NERA report over the summer and provided suppliers with just four weeks to respond points towards a “box ticking” exercise.

[4] See section 5, ‘Recommendations and lessons learnt’ of the Oxera report.