Written evidence submitted by So Energy (EPM0025)

So Energy's response to the BEIS Select Committee inquiry on "Energy pricing and the future of the Energy Market"

31st January 2022

About So Energy

So Energy supplies over 300,000 households across Britain and is one of the last challenger suppliers left in the market after the recent wave of supplier collapses. In August last year we merged with ESB Energy, the UK supply arm of the Irish utility company ESB Group, and now operate a combined business under the So Energy brand.

So Energy was founded in 2015 and has been consistently recognised for outstanding customer service, having been a 2020 Which? Recommended Provider and topped the Citizens Advice supplier rankings more than any other supplier since it started comparing the market in 2017. ESB is Ireland's largest energy company with 90 years of experience in electricity generation, transmission, distribution and supply who have invested over £2billion in Britain's energy infrastructure over the past three decades. In the UK ESB is constructing 450MW of offshore wind with joint venture partners and has a further 2GW of onshore and offshore wind in the pipeline. They also operate electric vehicle charging networks across London, Coventry and Birmingham.

The partnership benefits from both company's customer-centric values and green credentials, ESB's extensive resources and expertise, and So Energy's challenger brand and ethos. This gives us a strong platform to grow and roll out new systems, services and products for customers to help them transition to net zero living. Both companies have supplied exclusively 100% renewable electricity, and So Energy has recently launched a first-of-a-kind solar and battery storage solution for customers.

Executive summary

So Energy welcomes the Committee's very timely inquiry. As one of the last challengers left in the market, and one that is backed by ESB's considerable resources and expertise, we believe we are able to provide a unique view on the current market conditions and future market reform. Despite starting from the foundations of a sustainable business model and secure financial position, the current policy and regulatory framework - and particularly the operation of the energy price cap - has significantly impacted our ability to manage risk and operate efficiently since wholesale prices started to rise last summer.

The Government and Ofgem's "switch switch switch" mantra has guided key policy and regulatory decisions since Ofgem's Energy Supply Probe reported in 2008 (and then reinforced by the Competition and Markets Authority's inquiry which concluded in 2016). These decisions have consistently encouraged a race to the bottom on price and, with the increasing frequency of supplier failures, there is real evidence of underlying moral hazard leading to riskier hedging practices. All of this has come at the expense of investing in services, systems and solutions for the long-term benefit of customers.

Our response outlines the policy and regulatory interventions required to support customers and suppliers to build a more resilient and fairer energy market, which can be broadly grouped into three categories:

1. *Short-term temporary actions*: A range of options are being considered to alleviate the impending bill shock when the price cap is expected to increase on 1st April towards £2,000 per year for the 22 million households who are now on price capped Standard Variable Tariffs (SVTs). With no intervention, this would represent an increase of over 50%, equating to an additional £60 per month, or more, for households to stomach. We would be supportive of a mechanism to smooth this sharp increase in costs over an extended period, to alleviate the extreme short term pressure on bills and to allow wholesale prices to re-align as expected with current forward prices. Alternatively, a combination of other measures such as removing VAT from bills, deferrals of network and other industry charges, and expanding and increasing the Warm Homes Discount could be sufficient. Crucially though, a combination of these three measures would be needed in order to get anywhere close to alleviating the bill shock or providing enough support to suppliers.

2. *Medium-term actions*: Following the emergency short-term action outlined above, further policy and regulatory intervention is required ahead of the next price cap change due in October 2022. As part of this, our overwhelming preference is to replace the price cap with alternative measures (see longer term actions below) in order to give suppliers the flexibility to more effectively manage wholesale risks whilst continuing to protect customers. If the price cap were to remain from October 2022 onwards, we would support the introduction of a much more flexible mechanism in the form of a relative cap that would limit the differential an energy supplier could charge between their cheapest tariff and SVT.

3. *Longer-term actions*: As well as all the above actions which will help overcome the current wholesale crisis, Government and Ofgem need to build a more enduringly resilient market for suppliers and a fairer market for customers to ensure the sector is better prepared for future wholesale spikes. Policy and regulation needs to address the underlying cause of unfair and unsustainable pricing practices - existing rules which allow suppliers to offer heavily discounted tariffs (exclusive tariffs) to new customers and shield these deals from their loyal customers whom they overcharge. All suppliers should be required to make all new tariffs available to existing customers rather than just potential switchers, something the Financial Conduct Authority (FCA) has recently introduced for the home and motor insurance markets as part of efforts to tackle loyalty penalties.

We expand on all of these points in our answers to the specific inquiry questions below. We would welcome the opportunity to give further written and oral evidence as part of your inquiry.

<u>Answers to specific questions</u>

The regulatory requirements companies must meet in order to trade as a regulated entity in the retail energy market.

Not answered.

The mandate, role and performance of Ofgem in setting regulation and supervising regulated entities.

The current policy and regulatory framework presided over by Ofgem has significantly impacted our ability to manage risk and operate efficiently since wholesale prices started to rise last summer. This is something we expand on in our answers to subsequent questions.

More broadly, it is clear that regulatory interventions from Ofgem over many years have contributed to the current crisis and created a dysfunctional market framework. The “switch switch switch” mantra, which has guided Ofgem’s policy and regulatory decisions since the 2008 Energy Supply Probe and particularly since the 2016 Competition and Markets Authority (CMA) inquiry, has encouraged a race to the bottom on price and there is real evidence of moral hazard resulting in riskier hedging practices by some suppliers. Switching rates, coupled with the number of suppliers operating in the market, have been seen by Ofgem (and also Government) as the primary indicators of a successfully functioning and competitive market.

This has come at the expense of investing in services, systems and solutions for the long-term benefit of customers. In light of the current crisis, and the investment from suppliers needed this decade to help households transition to net zero living, a complete overhaul in the way Ofgem measures a successfully functioning and competitive market is required. New ways of determining whether the market is efficient and fair are required.

The performance of previous policies introduced to stimulate effective competition within the retail energy market, and an assessment of the impact on competition of proposed future regulatory frameworks.

In this section we focus on three areas; the loyalty penalty; supplier entry requirements and monitoring; and other short term measures to alleviate the impending bill shock. These are addressed in turn below:

Loyalty penalty

Over the past two years we have been engaging with Ofgem and Government to highlight an issue that has encouraged unsustainable pricing and a race to the bottom on price at the expense of supplier resilience and long-term investment. We see this as one of the root causes of supplier instability in the market.

Following recommendations from the CMA's 2016 inquiry, Ofgem relaxed tariff rules in 2018 to enable suppliers to offer discounted deals for new customers (exclusive tariffs) through Price Comparison Websites (PCWs). This has fundamentally changed the structure of tariff pricing across the UK retail market to a position where a loyalty penalty is now ingrained into the operating models of energy suppliers.

The vast majority of suppliers responded to this rule change by offering heavily discounted tariffs to new customers on PCWs - deals which aren't available to existing loyal customers, meaning they pay much higher rates as a result. Suppliers maximise price differentiation to entice customers to switch meaning the underlying margin of these PCW deals are often negative, which in turn creates an unsustainable "race to bottom" on price. This has been a contributing factor to some of the supplier failures we have seen recently. This has also created a "loyalty penalty" benefitting the minority of digitally enabled switchers and harming the majority of loyal customers, many of whom are vulnerable and digitally excluded from navigating PCWs.

To fix this Ofgem should ban this practice by requiring suppliers to make all new tariffs available to existing customers. Ofgem is now considering this as part of its "Potential short-term interventions to address risks to consumers from market volatility" consultation, but only as a temporary measure in response to the crisis. We call for this to be made permanent. There is also recent regulatory precedent in other sectors for this, as the FCA introduced a rule to stop this very practice for the home and motor insurance which came into force on 1st January 2022. The FCA acted as part of its work to protect customers from loyalty penalties and we urge similar action in energy given it has highlighted loyalty penalties as a problem in the sector.

Supplier entry requirements and monitoring

Another contributing factor to supplier instability has been the insufficient checks on suppliers entering the market and the ongoing monitoring of these suppliers as they operate in the market.

We support Ofgem plans to increase checks and monitoring including on hedging and capitalisation but we need more detail from Ofgem on how the collected data will be used. We also support plans to tackle mutualisation risk which will reduce moral hazard and incentivise suppliers to price their tariffs in a more sustainable manner.

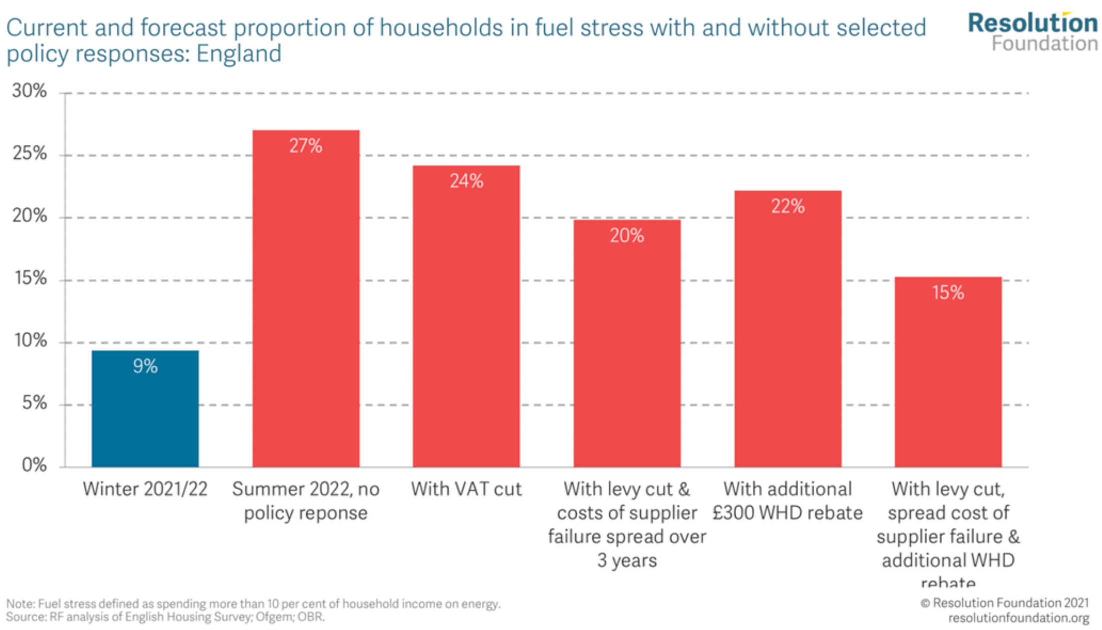
Specifically, Government should prioritise the overhaul of how the Renewables Obligation (RO) is funded by suppliers by shortening the period over which this needs to be paid. As a first step, this will reduce the potential sums exposed to mutualisation. More importantly, this will reduce the likelihood that a supplier could continue to grow a loss making retail business by adding customers and without significant external investment. Suppliers should not be allowed to use customer credit balances to fund tariffs priced below gross cost, and the current RO payment mechanism enables this practice. Changing the RO payment terms would re-align the structure of the market to incentivise greater focus on financial resilience within suppliers. We highlight that any change to RO payment terms should be introduced over an extended period of 2 years or more to ensure underlying financial resilience is protected, as existing suppliers need to be given time to adjust working capital and tariff pricing accordingly.

However, none of these measures will improve financial resilience if the market is consistently margin negative as it has been for several years now. Reforming the price cap and ensuring suppliers are incentivised to price sustainably (as we outline above) must be prioritised.

Other short term measures to alleviate the impending bill shock

We would be supportive of a mechanism to smooth this sharp increase in costs over an extended period, to alleviate the extreme short term pressure on bills and to allow wholesale prices to re-align as expected with current forward prices.

Alternatively, a combination of other measures such as removing VAT from bills, deferrals of network and other industry charges, and expanding and increasing the Warm Homes Discount could be sufficient. However, a combination of these three measures would be needed in order to get anywhere close to bridging the gap between the current price cap level and proposed level from 1st April, as per [recent Resolution Foundation analysis] outlined below.



The functioning and performance of the 'energy price cap' and an assessment of its use in the future, and an assessment of the role of auto-switching.

We do not believe a price cap can be sustained within the competitive energy market in the long term because it restricts the ability of suppliers to manage wholesale risk and operate efficiently. The price cap has invariably played a role in some supplier failures and this has led to an increase in costs that will ultimately be borne by consumers. The risk of a future crisis can be increased or decreased depending on the price cap design but it cannot be fully mitigated so long as a price cap is in place as suppliers are not allowed the opportunity to quickly respond commercially to market pressures.

We outline below several specific flaws in the price cap design:

- Although it wasn't the intent of the price cap, many stakeholders have touted how the cap has shielded consumers from recent wholesale market volatility. However the cap has simply delayed an increase in prices, and rather than a gradual rise month by month, bill payers will be hit with a huge spike on 1st April 2022.

- The current crisis and associated costs of managing risk on behalf of customers has shown that the price cap design does not allow for a reasonable rate of return.

- Building on this, the price cap removes many of the tools available to suppliers to protect customers from the volatility and complexity of the upstream market, including passing on reasonably incurred costs. The failure to allow suppliers to pass on reasonable costs has contributed to the failure of some well-run suppliers and has eroded investor confidence in the market as a whole.

- The price cap requires suppliers to run two incompatible hedging strategies in parallel, one for their fixed-rate tariffs (which can be flexed in response to the market at any point) and one for their price-capped SVTs (which change just twice a year following the level set by Ofgem). The recent wholesale volatility has seen unforeseen and unprecedented numbers of customers moving from expiring fixed-rates deals to their suppliers' SVT, exposing suppliers to significant unmanageable costs.

We therefore support replacing the price cap with alternative measures (outlined in the answer to the question above) in order to give suppliers the flexibility to more effectively manage wholesale risks whilst continuing to protect customers.

Failing the removal of the cap, a relative price cap that limits the differential between a supplier's cheapest tariff and their SVT would allow for more flexibility. This would address the identified wholesale volatility issues by returning control of hedging to suppliers, give suppliers more flexibility to manage risks more generally, and better protect customers by limiting tariff differentials. Transitioning to a relative price cap from an absolute cap would also offer a smoother medium-term exit pathway from the price cap arrangements when market conditions allow.

The future of Bulb and the recovery of public funds and the cost to consumers of other energy supplier failures.

As we mention above, the policy and regulatory framework has increasingly encouraged suppliers to offer unsustainably priced tariffs backed by risky hedging strategies. This has undoubtedly contributed to recent supplier failures.

To minimise the chances of these sorts of failures happening in the future we support the intention behind Ofgem's "Action plan on retail supplier resilience". However, when we examine the proposals in detail, the focus is mis-placed. In a market where underlying margins are negative, no amount of regulation can improve supplier resilience. Instead, Ofgem needs to focus its attention on changing the competitive dynamics of the market to encourage suppliers to operate more financially sustainable business models.

With regard to costs to consumers of supplier failures, So Energy strongly supports measures that spread or defer Supplier of Last Resort costs, as we have outlined in our response to ongoing Ofgem consultations.

The role of retail market reform in the context of the UKs net zero transition and domestic energy security requirements.

Energy suppliers are the direct touchpoint for customers as they transition to net zero living, so suppliers will play an increasingly critical role this decade in helping the Government deliver their net zero obligations. In order to do this though, suppliers need to be in a financial position to invest in services, systems and solutions like bespoke tariffs, accessible apps, and home battery products. Customers also need to trust their supplier to deliver these.

On investment, the current market conditions have resulted in negative profit margins which adversely impacts the ability of suppliers to dedicate resources and investment to longer-term net zero-related services, systems and solutions. Future investment and innovation in net zero products like our own solar and battery package - the UK's first full service solar and battery package - is impossible until suppliers are able to self-fund these projects and current market conditions do not allow it. Markets cannot exist without investment and this will not be forthcoming unless there's a reasonable expectation of a return.

This crisis and the resultant supplier failures have also damaged customer trust. If customers cannot rely on suppliers to operate in a financially responsible and sustainable way, then they will not be likely to trust energy suppliers to help them transition to net zero this decade, by doing things like physically going into customers' homes to install smart meters, batteries and solar panels, remotely taking control of smart appliances and managing all the accompanying personal data.

The comparison of UK wholesale prices and additional costs with the wholesale prices and additional costs across Europe.

The root causes of the wholesale price rises are global and are being felt across all European markets. However most European markets, including ESB's native Ireland, do not operate an energy price cap which has meant suppliers in these markets have been able to raise prices more gradually, which has in turn prevented bill shock that the UK is about to face.

All other major European markets, including Ireland, have also not witnessed the widespread supplier failings that the UK has faced over the past six months. Again, this is largely due to the absence of a price cap, and has meant customers in these countries have not had to pay the equivalent of the Supplier of Last Resort costs that UK bill payers have had to pay as a result of suppliers exiting the market.

January 2022