REC
RETAIL ENERGY CODE COMPANY

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17 December 2021

Dear Sir/Madam,

RECCo response to default tariff cap consultations and open letter regarding the retail energy market

We welcome the opportunity to respond to the open letters published on 29 October 2021 and subsequent default tariff cap consultations published on 22 November 2021 and 15 December. This response represents the views of the Retail Energy Code Company Limited (RECCo) and we are happy for this to be published on Ofgem's website.

About RECCo

RECCo was formed as the corporate vehicle for ensuring the proper, effective, and efficient implementation and ongoing management of Retail Energy Code (REC) and to promote innovation, competition, and positive customer outcomes. Part of RECCo's remit includes providing knowledge and expert opinion on retail energy issues to support the efficient and effective running of the retail energy market. RECCo is therefore providing this response in line with its mission statement and strategic aims.

RECCo response

We welcome Ofgem's thorough review of the default tariff cap. The original policy intention of the tariff cap was to protect disengaged consumers from the adverse effect of the so-called loyalty penalty, not to prevent suppliers from being able to recover their efficiently incurred costs or to insulate all domestic consumers from fluctuations in wholesale prices. That original policy intent remains laudable, but the means of implementation have had a significant and adverse unintended consequence on retail competition.

We recognise that any decision on whether to retain the tariff cap is for government rather than Ofgem, and therefore welcome the current proposals to improve the efficacy of the policy while it remains in effect. We consider that the primary consideration must be to better align a relatively inflexible calculation of an allowable tariff for GB domestic consumers, with a dynamic wholesale market in which prices are driven by uncertain international conditions. The legislation requires that Ofgem must review the level at which the cap is set at least once every six months, though that has become the default cadence. We consider that this should be addressed, better enabling rapid market developments to be taken into account.

The prohibitions on domestic suppliers being able to determine their own cost-reflective charges or to reduce their liabilities through effective portfolio management have resulted in many energy suppliers leaving the market in recent months. Those which remain will be operating at a significant loss while wholesale prices remain far above the levels assumed in the prevailing tariff cap. Whilst several of the proposals are welcome insofar as they recognise changes in the suppliers' cost base, they are all relatively small sums as compared to the differential between assumed and actual wholesale costs.

Although it is widely expected that there will be a further significant rise to the tariff cap effective 1 April 2022, it is not certain that the revised allowance will exceed wholesale prices at that time, especially given the time lag in its calculation. Even if the tariff cap revision allows for a positive margin at that point, domestic energy consumption in the subsequent six-month period will likely be a fraction of the levels of this winter. It may therefore take a prolonged period for suppliers to recoup their current losses.

However, it should also be assumed that if wholesale prices do fall, there will be pressure on suppliers to quickly reduce actual tariffs. Such a reduction may either be mandated by Ofgem, or simply the return of normal market forces, particularly pressure from new entrants who may not have been exposed to current operating losses[1]. This strategy could also be possible for those suppliers with sufficient access to finance to simply write-off the operating losses from this winter period to gain market share. We would therefore welcome clarity on whether there will be an allowance in future tariff cap periods to offset current losses, to the extent that those losses exceed levels which could have been negated by a prudently hedged position. This may be similar to the allowance made for the additional and unforeseeable levels of bad-debt arising due to Covid-19.

We also consider that the default tariff cap must give appropriate recognition to the full range of non-discretionary costs that suppliers face. We consider that it is anomalous that suppliers' contributions to the cost of operating industry codes such as the REC, which is a licence condition, are not recognised and allowed for under the cap. Although these costs are relatively small as compared to many of the allowable items, they are not insignificant.

Currently, the differing treatment of costs may create an incentive for otherwise inappropriate bundling – i.e. recovering costs as part of an existing charge allowed for under the tariff cap rather than as a discrete charge. This may lead to an erosion of transparency, and even a sub-optimal delivery of services if certainty of cost-recovery is prioritised over most effective means of delivery.

We also consider that this would be relatively simply to address, as RECCo's costs will form part of a budget forecast early in the New Year and could be easily factored into the default tariff cap calculations for April 2022. The same should apply to other code bodies. This

[1] Although Ofgem has announced a short moratorium on new licence applications, many of those which have been issued historically and not revoked due to dormancy could be readily acquired.

issue will become increasingly important if industry programmes are to be delivered through code bodies rather than centrally by Ofgem or price-controlled licensees.

Further comments:

- Stimulating and encouraging innovation is vital to help unlock the transition to a low-carbon economy; policy development, including moves towards prudent regulation and the design of the tariff cap must be balanced against the avoidance of undue barriers to entry and the beneficial disruption it brings.
- Consumers inevitably bear all costs, whether directly or indirectly through mutualisation, so it is also important that any changes such as requiring suppliers to strengthen balance sheets must be weighed against the cost to the consumer of doing so.
- The default tariff cap should be critically analysed, and success criteria developed to ensure that it delivers net benefits to consumers. Although any decision to remove the default tariff cap is for government rather than Ofgem, it was originally intended to be a temporary measure to protect disengaged and/or loyal consumers of the traditional incumbents, not to act as a buffer to stabilise prices. If the default tariff cap is now to be maintained for that latter purpose, as some recent commentary might suggest, then its efficacy for that purpose should also be assessed, and consideration given to the conditions for its removal and/or what comes next, given this change in emphasis.
- As part of developing wider potential reform of the retail market, it is important that both the customer journey and suppliers' experiences are analysed and considered where possible. We consider that some of the systemic problems that have been encountered recently may remain even if there is a move to a prudential regulatory regime, as has been proposed. For example, whilst it will remain important to safeguard against cherry-picking, the licence obligations which prevent a supplier from effectively managing their pace of growth or from reducing their portfolio if necessary, may continue to inhibit their ability to act prudently and in a cost-efficient manner.
- We welcome the recent proposals to introduce additional reporting at certain milestones, although it is not currently clear what actions may be required of the supplier upon reaching or exceeding each of those milestones. For instance, whilst it may be reasonable to expect the strength of suppliers' balance sheets to grow commensurate with their customer base, growth does not always unlock additional finance. Simply proscribing new customer registrations may limit liabilities but not immediately address the risk to existing customers and may at the same time deter further investment. An alternative may be a mechanism which enables the supplier to bring the portfolio back within any stress-test criteria that may be set by Ofgem. Whilst we note that the government has appropriately paused development of opt-in and opt-out switching[2], such a mechanism may prove to be a useful option if targeted at suppliers which need to revert to sustainable portfolio numbers.

[2] See: https://questions-statements.parliament.uk/written-statements/detail/2021-12-15/hcws497

Consultation on the potential impact of increased wholesale volatility on default tariff cap

The significant increases in wholesale prices in recent months demonstrates that the indexed value of the wholesale risk allowance is a vital component of the tariff cap. Without being able to quickly recover the costs, wholesale price volatility can be extremely detrimental to suppliers. As we have seen, this can result in insolvency, which is felt throughout the industry, particularly due to the mutualisation of cost arising from the Supplier of Last Resort (SoLR) process, or to cover any shortfalls in renewable obligation liabilities.

It is vital to ensure the wholesale variables are accurate and reflect up-to-date prices. The currently lengthy time lag before wholesale price movements is reflected in the default tariff cap must be addressed.

We welcome the proposal for the ability to change the tariff cap within the 6-month window but are concerned that this is unlikely to go far enough. We therefore welcome the wider further consultation on the general design of the tariff cap. Increased frequency of reviews is fundamental to a more effective tariff cap and as a minimum this should be undertaken at least quarterly. We would also encourage Ofgem to include other short-term options that can be utilised as necessary, such as a monthly update cycle, or clear tolerance thresholds which if exceeded may prompt an ad hoc update (rather than necessarily an exceptional and unforeseeable change in circumstances). This latter option may be an effective alternative to increasing the margin of uncertainty to a higher rate than the current 1%, which will have the effect of increasing cost regardless of the extent of prevailing uncertainty.

Consultation on the process for updating the default tariff cap methodology and setting maximum charges

As indicated above, RECCo welcomes the proposal for the ability to change the default tariff cap within the 6-month window. We consider that the default tariff cap should in any case be revised more regularly, at least quarterly, and/or provide for a dynamic variable of wholesale costs to replace the relatively static calculation, which may be up to eight months out of date. However, it is unlikely to go far enough given the day-to-day changes in the wholesale market prices. To balance this, Ofgem should also consider interim revisions when prevailing costs are known to fall outside reasonable tolerances for its assumptions, rather than simply as an option under *exceptional circumstances* set out in the proposal. Transparency of such tolerances would provide greater clarity of when interim revisions may arise, negating the uncertainty that might otherwise exist while Ofgem deliberates whether an exceptional circumstance has arisen and what to do about it.

Consultation on the true up process for COVID-19 costs

RECCo supports the approach to this process, in particular requesting data via Requests for Information from suppliers to understand the actual costs faced. However, as the default tariff cap will apply to all domestic suppliers, the inclusion of these covid-relief costs could further extend the margin by which any new entrant who did not face these historic costs may be able to place incumbents at a competitive disadvantage.

Consultation on reflecting (prepayment) End User Categories in the default tariff cap

We support this change. It will more accurately reflect the cost of serving a pre-payment metered consumer, whose profile of consumption will differ to that of a credit consumer, as recognised through the (re)introduction of a PPM EUC.[3]

Consultation on Energy Company Obligation (ECO) scheme allowance methodology in the default tariff cap

We support the proposal of using the latest available information to build ECO into the upcoming tariff cap. Although these are contingent upon the passage of associated legislation, we consider that the policy of allowing for a truing up of costs in the following cap period is pragmatic and likely to result in allowances that are more accurate than if Ofgem omitted these costs pending the legislation being passed. We also note that the government proposes to amend the exemptions for the ECO such that the obligations will apply to smaller suppliers, albeit potentially through a buy-back scheme. We agree that the design of both the ECO scheme and the default tariff cap should seek to achieve a level playing field and not add to market distortions.

Consultation on the Warm Home Discount scheme allowance methodology in the default tariff cap

We agree that it will be appropriate for the cost to suppliers of the Warm Home Discount to be allowed, and on the basis of the best available information from BEIS rather than necessarily waiting for those costs to determined. As with the ECO, we understand these allowances are contingent upon government decisions yet to be made, but including them within the tariff cap from April 2022 will ensure that suppliers are able to finance those obligations, and could be adjusted in subsequent periods if necessary.

Consultation on reflecting change to gas SoLR levy costs in the default tariff cap

We agree that targeting SoLR levy costs upon the market sector in which they originate may be appropriate insofar as that leads to more cost-reflective charges. Whilst it may not be ideal for those costs to be bundled with gas distribution network charges, given the current constraints of the tariff cap arrangements and absence of a readily available alternative, we consider that recovery of SoLR costs through an uplift to the recognised and allowed for network charges offers a pragmatic way forward. We consider that alternative and potentially better targeted solutions may appropriately be considered as part of a wider review in due course.

Open letters

We note that Ofgem has recently announced changes to the process by which it will determine claims for costs by the appointed supplier under the SoLR process. We consider that the streamlining of Ofgem's internal procedures is appropriate. This may go some way to mitigate the cash flow implications of a supplier being appointed a SoLR, particularly

[3] A PPM EUC profile was first introduced as part of UNC451AV: 'Individual settlement for prepayment and smart meters'

where this involves taking on currently loss-making supply points. Addressing this cash flow impact may also allow a wider range of suppliers to consider participating in the SoLR process, although it is still uncertain whether the consumer will opt to remain with any appointee once normal market conditions and switching choices return.

Should the tariff cap endure, it will be appropriate to consider the impact it may have on wider issues, such as the funding models for decarbonisation and other innovations. In the longer term, consumers may come to see energy as a service rather than as a commodity product. It will be important, then, to ensure that the tariff cap does not hinder the early adoption of such services, particularly as they are likely to be associated with flexibility services and other innovations that are required to facilitate net-zero and the more immediate carbon reductions by 2030.

Closing remarks

RECCo welcomes the work Ofgem is undertaking in this area and would welcome the opportunity to discuss this response with you. If you have any queries, please contact via info@retailenergycode.co.uk in the first instance.

Yours sincerely

Jon Dixon

Director, Strategy and Development