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Dear Anna,

Re: Price Cap: Final Consultation on updating the prepayment SMNCC Allowance

1. INTRODUCTION

- 1.1 This is Utilita's non-confidential response to Ofgem's consultation dated 29 April 2021 (the "**PPM SMNCC Consultation**")¹. As you are aware, Utilita is primarily a smart prepay supplier, focusing on providing high quality services to a sector of the market which is frequently poorly serviced.
- 1.2 The PPM SMNCC Consultation focuses on the non-pass-through ("**NPT**") element of the Smart Metering Net Cost Change ("**SMNCC**") allowance for customers with a prepayment meter ("**PPM**") for the purpose of setting a cap on supplier charges pursuant to the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the "**Default Tariff Cap Act**"). The SMNCC is intended to take account of changes in operating costs due to smart meter rollout by suppliers compared to the baseline smart meter rollout costs in 2017.
- 1.3 This response addresses the key issues that Ofgem has considered as part of the PPM SMNCC Consultation, and the resulting proposed PPM SMNCC values. Our detailed comments are at **Appendix A**.
- 1.4 In order to prepare this response, we commissioned Nera Economic Consulting ("**NERA**") to provide its expert economic review of Ofgem's proposed methodology. References in this response to the "NERA Report" are to NERA's accompanying report entitled "Response on Prepayment SMNCC allowance" dated 15 June 2021. A full copy of this report is enclosed at **Confidential Appendix B** with a non-confidential version of the report at **Appendix C**.

¹ Namely the consultation entitled "Price Cap: final consultation on updating the prepayment SMNCC allowance" and, so far as relevant to issues read across into the PPM SMNCC Consultation, the parallel consultation published on the same day in respect of the credit SMNCC allowance, namely a consultation entitled "Price cap - final consultation on updating the credit SMNCC allowance" (the "**Credit SMNCC Consultation**").

- 1.5 Our analysis demonstrates that Ofgem's decision on the core SMNCC is compromised by errors of approach and methodological flaws, which materially overstate the savings derived from the smart meter roll-out, do not reflect the costs that an efficient supplier would incur from the smart meter rollout and are not consistent with the legal framework Ofgem must operate in. Those errors are then exacerbated by Ofgem's arbitrary proposed limitation on the resulting SMNCC to prevent it becoming positive and Ofgem's adjustment to correct for any over-recoveries (but not under-recoveries) arising from the application of the SMNCC from 1 January 2021 (but not before). The inevitable inference is that Ofgem have designed proposals that are calculated to prevent efficient PPM suppliers from recovering their costs both on a cap period basis and across the life of the cap.
- 1.6 If Ofgem implements the SMNCC as proposed, it will fail to protect existing and future domestic customers who pay standard variable and default rates and, as such, will fail to facilitate a move to a more competitive market – thus breaching the purpose for which the Default Tariff Cap Act was introduced.

2. OFGEM'S PROPOSAL

- 2.1 After calculating the core SMNCC allowance by reference to an unnecessarily complex and opaque methodology that increases the risk of error, Ofgem then proposes to apply certain adjustments to that core SMNCC to establish the final SMNCC allowance. Those adjustments seek to ensure an outcome whereby the cap for PPM can only reduce. That is so regardless whether such an outcome is supported by evidence of efficient costs and regardless of the need to reflect costs in setting the cap. An approach of artificially reducing prices is recognised by the CMA to be detrimental to customers' interests, but Ofgem is pursuing this policy for PPM customers.²

3. OFGEM'S ERRORS

- 3.1 A fuller analysis of the errors and capricious approaches in Ofgem's proposals are set out in the Appendices, which have a substantial impact on the resulting SMNCC. However, we would highlight the following:
- 3.1.1 The calculation of the PPM NPT SMNCC is inaccurate and overstates cost savings as a result of the smart meter rollout compared to the 2017 baseline. The NERA Report shows that Ofgem's estimated savings in premise costs and operational (cost-to-serve), and the level of smart meter costs already embedded in the operating cost allowance are all overstated. These errors are unarguable and will require correction before any SMNCC is introduced. NERA also finds that (prior to Ofgem imposing an arbitrary cap at zero) the electricity SMNCC would be *positive* in all periods (historical and future). That means that contrary to the outcome Ofgem would impose by its proposals, the smart meter rollout has actually increased the efficient

² See paragraph 2.29 to 2.30 of Appendix A.

costs of a PPM supplier relative to the level embedded in the operating cost allowance and PPM uplift.³

- 3.1.2 Ofgem fails fully to offset the “under recovered PPM costs” that it admits exist. Ofgem has made a number of arbitrary – and unjustified – decisions that are inconsistent with the basis on which the cap is required to be set (namely to protect existing and future domestic customers who pay standard variable and default rates, by ensuring that prices are cost reflective). These arbitrary decisions include: preventing the SMNCC from becoming positive even when the model and data determine that it should be; and not rolling forward any “under-recovery” that it has not thereby been possible to offset in a cap period. This means that for a given cap period, any under-recovered PPM costs in that cap period that cannot be offset against the negative SMNCC allowance will not be carried over to the next cap period.
- 3.1.3 Ofgem applies its “advanced payments adjustment” (“APA”) only if it is a negative amount (i.e. a “clawback”). Where the APA would otherwise be positive, i.e. a further allowance, no adjustment is made to account for this.⁴
- 3.1.4 Ofgem applies an arbitrary cut-off date for the application of the NPT SMNCC, meaning that it does not reflect the net costs of the smart meter rollout. The application of the SMNCC with an effective date of 1 January 2021 is arbitrary and highly selective and ignores: (a) the fact that suppliers have borne the very significant net costs of the smart metering rollout for years (without being allowed to recover them); and (b) the fact that there has been a huge under-recovery of pass-through smart metering costs throughout the period of the CMA and Ofgem caps to date.⁵
- 3.1.5 Ofgem has failed to adjust the cap’s methodology to reflect significant additional costs incurred by PPM suppliers as a result of additional obligations imposed on them since the cap was set. It is wrong for Ofgem to have completely ignored these additional obligations in its proposals and not provide additional allowances to reflect the inevitable further costs they will entail. It further demonstrates how selective Ofgem’s approach is to the PPM NPT SMNCC.⁶

4. OFGEM’S LEGAL ERRORS

- 4.1 Ofgem appears to be operating as if it is free to design the cap as it wishes and to pick winners by preferring certain business models (i.e. those with

³ See paragraphs 2.1 to 2.9 of Appendix A.

⁴ See paragraphs 2.10 to 2.18 of Appendix A.

⁵ See paragraphs 2.19 to 2.24 of Appendix A.

⁶ See paragraphs 2.25 to 2.28 of Appendix A.

below average levels of PPM customers, notwithstanding the relative inefficiency of such suppliers compared to new entrants such as Utilita), allowing cross-subsidies between different groups of customers on no verifiable or legitimate basis, artificially lowering prices for certain groups of customers (thereby increasing prices for others) and fudging outcomes.

4.2 In fact, Ofgem is bound by the confines of the legislation under which it is operating and public law principles. Ofgem's proposals are not consistent with the legal framework Ofgem must operate within and Ofgem is far exceeding any regulatory discretion permitted to it as the economic regulator by Parliament within that legal framework.⁷ Notably:

4.2.1 Ofgem has misunderstood the purpose of the Default Tariff Cap Act and proposed a cap that is not cost-reflective, does not allow PPM suppliers to recover their efficient costs and focuses attention on benefiting a particular category of vulnerable customers over all else. Ofgem would be acting ultra vires were it to proceed with these proposals.⁸

4.2.2 Ofgem does not conscientiously and properly have regard to the statutory duties prescribed under the Default Tariff Cap Act.⁹

4.2.3 Ofgem has not ensured that the cap it sets is consistent with the requirements of the Trade and Cooperation Agreement, as implemented by the European Union (Future Relationship) Act 2020, namely the requirements to be clearly defined, transparent, non-discriminatory and proportionate. In particular, the cap is clearly not proportionate and discriminates against all suppliers of PPM customers because Ofgem has set allowances for PPM which are too low. It is especially discriminatory against those suppliers with a lower than average credit customer mix: Ofgem's design requires suppliers to cross-subsidise losses on PPM customers by over-charging customers using other payment methods because the PPM Uplift is too low.¹⁰

4.2.4 Ofgem has not ensured that the cap it sets is consistent with the requirements of the Recast Electricity Directive and the Gas Directive, namely the requirements for the gas cap to be clearly defined, transparent, non-discriminatory, verifiable and guarantee equality of access to consumers and, in the case of electricity, being a "transition to effective competition" cap, set at a price that is above cost, at a level where effective price competition can occur. In particular, PPM suppliers have under-recovered for electricity supply in every single cap period since the first cap was introduced in 2017. As the regulator responsible for overseeing these arrangements, Ofgem cannot ignore

⁷ See paragraphs 3.1 to 3.3 of Appendix A.

⁸ See paragraphs 3.4 to 3.16 of Appendix A.

⁹ See paragraphs 3.17 to 3.22 of Appendix A.

¹⁰ See paragraphs 3.23 to 2.35 of Appendix A.

this under-recovery simply by saying it partly occurred on someone else's watch.¹¹

- 4.3 Even if it were the case that Ofgem was entitled to design the cap as it wished, Ofgem's proposed approach would be irrational due to (i) the inconsistencies in its approach, both internally within the SMNCC model and as between PPM and credit customers; and (ii) the arbitrary nature of some of Ofgem's decisions in designing the SMNCC that effectively game the outcome. It would also be based on a number of errors of fact and law.¹²

5. IMPACT OF OFGEM'S FLAWED APPROACH

- 5.1 Ofgem's flawed methodology for, and approach to, the SMNCC is highly damaging to PPM suppliers on a number of levels.
- 5.2 Any consultation process which twice in as many years requires participants to engage specialist advisers at enormous cost in order to be able to respond, has to be wrong and anti-competitive. In splitting its proposals over multiple consultations (which are intended to be ongoing beyond the current consultation) exposes suppliers to unnecessary legal uncertainty and peril. While most of the key decisions will be taken as a result of the current consultation, it is unhelpful to develop the cap through incremental decision-making where suppliers are unable to see the impact of the whole until the end point. This has further exacerbated the costs for suppliers to engage with these consultations, due to the need to understand the legal implications of each incremental element.
- 5.3 That there is no ability to recover those costs, even where they are unavoidable as a result of the manner in which Ofgem's consultation process has been designed, merely exacerbates this unfairness. Ofgem's design of the consultation process to prevent suppliers from seeing the data on which Ofgem relies to support its proposals makes it impossible for suppliers to respond to that consultation without incurring substantial third party costs. Suppliers cannot review and comment on the proposals without instructing specialist advisers because Ofgem has prevented them from seeing the data themselves; access to the model in a vacuum is meaningless. Further, the proposed model is so complex that suppliers have to engage specialist economic advisers to be able even to understand it. The costs of engaging those specialists and reviewing two complex consultations on these issues are very substantial (£ hundreds of thousands). Given they are caused by Ofgem's consultation process, we would suggest that at very least they should be considered a cost of the smart meter rollout and recoverable as part of the cap.
- 5.4 There is an immediate financial impact that some suppliers may not be able to survive and which is unfair: suppliers are not being allowed to retain any benefit from the investment that they have made in the smart meter rollout

¹¹ See paragraphs 3.26 to 3.27 of Appendix A.

¹² See paragraph 3.28 and 3.29 of Appendix A.

programme and which has not been compensated for in any way. This is on top of the fact that there has been no adjustment to the price cap for the many additional costs imposed on suppliers and the fact that suppliers are already facing extremely challenging circumstances.

- 5.5 To put this into context, PPM suppliers have already suffered greatly from the regulatory interventions imposed by the caps since 2017. The financial effect on Utilita of the errors in the CMA's original methodology, 'corrected' but not recompensed by them with effect from 1 October 2019, together with the compounded understatement of the PPM Uplift over the same period, is many £ tens of millions. The continuing understatement of the PPM Uplift since then and ongoing until the end of the cap period (2023), will be many more £ tens of millions. Yet Ofgem not only do not intend to recompense any of that historical under-recovery, but also to manipulate the SMNCC so that (i) the ongoing under-recovery in the PPM Uplift cannot be fully recovered and (ii) PPM suppliers can only see a reduction in the cap in future.
- 5.6 There is also a wider impact on suppliers' abilities to raise capital for investment. Investors need an expectation of making a return on their investment, but also need predictability and confidence in the regulatory regime. Ofgem's approach undermines this.
- 5.7 It is recognised that interventions by the CMA, and the consequent risks, are difficult for the business community to manage. The CMA is rarely asked to intervene in an industry, it is even more rare that they impose a price cap. The constant, annual revision of the price cap here is equivalent to running a CMA inquiry on the energy supply business every year. That is highly damaging to the market and stability.
- 5.8 All of this is not simply a matter of fairness to PPM suppliers. Allowing suppliers to finance their activities and setting price caps on a cost-reflective basis such that competition is enabled and fair markets can develop and thrive, is part and parcel of protecting customers. Ultimately, it is not in customers' interests for prices to be set artificially low. As noted by the CMA:

"It is not in the interests of prepayment customers for the PCR to be maintained at an artificially low level, as this may lead to suppliers cutting costs, with less competition and lower service standards".¹³

"[The PCR] is not currently at a level that allows efficient suppliers to earn a normal rate of return, to be incentivised to remain in the segments and to serve prepayment customers better and to allow for competition below the level of the cap. This does not serve the interests of prepayment customers. While prepayment customers will have to pay for an increase in the level of the PCR through an increase in their bills, we consider that setting the PCR at a level that means it can meet all its aims will result in better market outcomes for prepayment customers, and we note that none of the respondents to

*our consultation on the provisional decision disagreed with this point."*¹⁴

- 5.9 Unfortunately, Ofgem appear to have lost sight of this principle of both economics and law.

6. WHAT OFGEM SHOULD DO

- 6.1 It is vital, in order for the PPM price cap to protect customers in accordance with the legal framework (by being cost reflective and thereby facilitating a transition to a competitive market), for Ofgem to make the following changes to its proposals:
- 6.1.1 Recalculate the core SMNCC as per NERA's recommendations. This is a bare minimum and reflects merely corrections of Ofgem's errors in their application of their own proposals.
 - 6.1.2 Acknowledge and accept that the SMNCC can and should be positive (in the same way as for credit customers) where that is the out-turn of the application of the data to the model and where cost-reflectivity so requires. This will correct Ofgem's failing to ensure full recovery of the PPM cost offset.
 - 6.1.3 Refine the approach so that the core SMNCC (as recalculated) is applied so that it reflects the net costs or benefits of the entire smart metering rollout over the whole of the PPM cap life, starting from 1 April 2017, including both non-pass through and pass through smart metering costs, and thus abandon the arbitrary application of the APA from 1 January 2021 only.
 - 6.1.4 Review the cap to take into account the additional costs imposed on PPM suppliers, as a result of additional obligations imposed on them since the cap was set.
- 6.2 If Ofgem for some reason is unable to assess fully the changes proposed in this response by 5 August, it will be necessary to use £0 as the contingency PPM SMNCC for Cap Period 7, as it is clear that no weight can be placed on the SMNCC model.
- 6.3 For Ofgem's final decision regarding the PPM SMNCC, Ofgem should adopt the PPM SMNCC that NERA has proposed for each remaining cap period, subject to any adjustment to the rollout profile assumption that is necessary to reflect BEIS's final smart metering decision following a further consultation. The only alternative would be for Ofgem to abandon the proposed PPM SMNCC allowance entirely.
- 6.4 Once this has been done, it is vital that Ofgem focus on ensuring the regulatory framework is stable and predictable and conducive to investment. Constant re-evaluation benefits nobody and merely points to the unreliable nature of Ofgem's proposed cap and its methodology.
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7. NEXT STEPS

- 7.1 We hope this response assist Ofgem in reaching a decision in line with its powers and duties and the relevant statutory objectives to which Ofgem is required to adhere and/or have regard. We would welcome the opportunity to discuss Ofgem's proposals and our response to the consultation with Ofgem further.
- 7.2 We are also available to provide any information that Ofgem would find useful in reaching its decision and would welcome an opportunity for such a discussion.

Yours sincerely,

By email only

Bill Bullen,
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