

16 December 2021

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Dear Neil,

RE: Price Cap - Consultation on the process for updating the Default Tariff Cap Methodology and setting maximum charges

Thank you for the opportunity to respond to the above document. In these November consultations, we are treating the document entitled “Reviewing the potential impact of increased wholesale volatility on the default tariff cap: November 2021 policy consultation” as the ‘main’ document. While we have not copied into all the responses, Ofgem should consider the content of our main submission with each of these letters.

Recent events have exposed the fundamental flaw of bottom-up price capping, namely that it is not possible for a bottom-up methodology, intentionally set at the level of theoretically efficient costs of energy supply, to allow sustainable market operation.

We welcome Ofgem’s acknowledgement in the consultation document that ‘There are limits to how any cap methodology can reflect all possible scenarios in a cap period’. However, the solution is not the introduction of potential intra-period price cap reviews that will, inevitably, be impossible to anticipate and only serve to increase the risks to which energy suppliers are exposed.

Unpredictable ‘in period’ reviews – especially those leading to sudden reductions in the cap - will have clear commercial consequences. Such reviews are almost certain to cause substantial, unrecoverable, financial loss and damage to suppliers, and risk precipitating more industry exits. In addition, the level of uncertainty imposed by this approach will further damage the confidence of investors in the sector, which is already very fragile.

Instead of this proposal, in our main submission, we propose a formalised quarterly approach.

Utilita has taken a rational response to the price capping regime by organising its business practices according to the constraints imposed by regulation. One of several reasons why Utilita does not offer fixed term, fixed price contracts to domestic customers is the risk of these contracts’ prices materially exceeding the variable prices available under default tariff caps. This differential could endanger the existence of the business in periods where wholesale prices rise quickly, and significant tranches of customer contracts are due for renewal.

Suppliers may decide to incur the risks of diverging from this approach, but there is no obligation to do so. Individual suppliers taking such risks (in accordance with their preferred business models)

must not be treated as special cases that are encouraged to profit from a high-risk strategy, safe in the knowledge that an intra-period review of the price cap will be undertaken to mitigate any material loss that results from short-selling energy.

Many suppliers do choose to operate a business model that is incompatible with effective risk management under the current price capping regime, where customers are offered fixed term contracts that are not aligned with price cap periods. Such fixed term contracts are likely to be unsustainable if the market moves against the supplier and the supplier is not fully hedged. Equally, the business model relies, to a large extent, on being able to offer customers a comparable, new fixed term contract in due course.

Given this proposal - to provide for interim changes - has come about during an episode of high wholesale prices that affects larger suppliers operating this model, it is logical to assume that intra-period adjustments will be carried out to counter excessive outcomes, good or bad, affecting such suppliers.

Events triggering an intra-period review would, therefore, generally be in response to the fortunes of larger suppliers not operating a business model or risk management practices compatible with price cap regulation. This could have serious adverse consequences on any supplier taking the rational decision to manage its risks in line with price cap regulation; specifically, where the high-risk strategy of short-selling energy is highly profitable - an intra-period reduction would be triggered, but any suppliers taking a responsible approach to risk management would not have benefited from any short-selling.

In response to this proposal, a rational supplier that had previously managed its risks in line with the price cap could adopt a similar strategy to that of the larger suppliers. However, given the intra-period review would only occur in extreme circumstances and presumably with some delay, the weaker balance sheets of a smaller supplier could not (usually) tolerate such an approach. As a result, should this proposal be implemented, it will be impossible for any but the largest suppliers to operate over the long term where price capping exists. It will also significantly increase the risks of market entry, especially where, as in the current position, the extant price caps do not allow suppliers to recover efficient costs or make (and retain) reasonable profits.

Utilita welcomes Ofgem's understanding that the price caps in their current form do not allow for adequate management of the risks of energy supply and unless reformed will inevitably force efficient suppliers to exit the market. The laudable aim of 'manag[ing] the risks to the market and customers resulting from the interaction of the cap and changing market circumstances in the future', however, is not met by mid-period cap adjustments under conditions that are impossible to anticipate and likely to be tailored to the needs of larger suppliers. Such mid-period resets fail to address the costs of uncertainty and cannot be in the interests of consumers in the long (or even medium) term.

Ofgem can solve this problem, and indeed many others, by moving away from attempting to manage all aspects of supplier margin, which is impossible, and instead allowing competition to operate by increasing the margin available to suppliers; this will allow suppliers to manage their risks, of which the current crisis is an example, and for a plurality of business models to operate in the market, benefitting present and future consumers.

If, despite the above, Ofgem decides to implement this proposal, the practicalities must be considered, and the risk asymmetry faced by suppliers in terms of compliance and enforcement is significant. The expected consequence of a mid-period change in the price cap would be an increase

or decrease in the resulting constraints on consumer prices, and the impacts vary. Price changes need careful planning and communication with staff and customers and incur costs. This was recognised by the CMA and underpinned the timing for the price cap notices.

It is also clear that for prepay customers in particular, there are greater price change risks in No WAN/Intermittent WAN scenarios in SMETS2 (and SMETS1 E&A) than in our SMETS1 estate. The successful processing of OTA upgrades and price change Service Requests displays noticeable regional variation. There are two risks associated with prepay customers in regard to price changes.

Secure SMSO currently provide the capability to apply a tariff change to the meters by use of UTRN where OTA fails. When adopted via the DCC this capability is lost and reliance is solely placed on application via OTA. SMETS1 E&A solution introduces an increase in latency and hence risk of the tariff failing to be applied via OTA, but without the fallback (UTRN) we currently have available.

Recent indications¹ are that the OTA success rates for price changes within CSP North may even be below 58% for both ESME and GSME (average, across October 2021) therefore significantly reducing our capability to update a tariff across our SMETS2 estate. The equivalent for enrolled SMETS1 is well below 90% with around 13% stated failure. Given our portfolio, these numbers will be significant and pose a higher risk to short notice change.

The increased risk exposure to suppliers makes an ARS approach to enforcement in these cases an essential part of the role of a reasonable prudential regulator, to avoid inefficient enforcement for minor technical non-compliances.

In addition, as we have set out previously, we consider that it is appropriate that suppliers should be permitted to recover not only their efficient costs, but the prescribed headroom. Suppliers must also be allowed to earn and retain a reasonable margin under the cap. To introduce mid-period changes without recognition of the impacts on costs faced by rational and responsible suppliers can only increase regulatory risk to unacceptable levels.

We hope that this submission is helpful and as we proposed in our recent call, we will look forward to discussing the content with you in a bilateral meeting. Please let us know when will be convenient for you and your team; we will be happy to co-ordinate diaries.

Kind regards

By email

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Leonardo Costa, Ofgem

¹ DCC Performance Measures Tariff Updates - October 2021, SECMOD122A (or SECMP0122A) Appendix