

16 December 2021

Neil Kenward
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Ofgem
10 South Colonnade
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Email: BillBullen@utilita.co.uk

Dear Neil,

RE: Reviewing the potential impact of increased wholesale volatility on the default tariff cap: November 2021 policy consultation

Thank you for the opportunity to respond to the above document. We are disappointed with the very limited scope of the amendments that Ofgem is proposing, and that Ofgem has failed to address fundamental errors and distortions that its price capping regime continues to impose on the market.

We appreciate the need to work quickly and therefore within the Domestic Gas and Electricity (Tariff Cap) Act 2018 (TCA). We do not believe that this is a barrier to more fundamental change that will go a long way towards removing the market distortions created by the current price capping regime.

The TCA sets out in Section 1(6) the following matters to which The Authority (Ofgem) must have regard:

- (a) the need to create incentives for holders of supply licences to improve their efficiency;
- (b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- (c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
- (d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

Ofgem has demonstrably failed against at least 3 of these tests, and arguably all 4.

Furthermore, there is nothing in the Act that provides for suppliers to be forced to supply consumers at below cost, or that requires Ofgem to operate three tariff caps, or that requires Ofgem to operate any kind of cross-subsidy between market sectors. Most importantly it does not require Ofgem to decide how much profit a supplier should be allowed to make, other than it should protect consumers from suppliers making super profits.

The TCA is also not explicit on how to manage wholesale costs (the biggest single driver of price changes). Clearly there are significant issues with the current mechanism, in particular it doesn't allow sufficient margin for the risks suppliers are being asked to absorb, it doesn't smooth out wholesale market fluctuations particularly well (resulting in consumer price volatility), and it has a

specific failure in referencing prices outside of the delivery period (resulting in significant under-recovery this winter as a consequence of the backwardation in the market).

To address these failures, Ofgem should implement the four changes below:

One Cap - Ofgem should move to a single cap per fuel type and region with effect from 1st April 2022. The simplest way to achieve this will be to remove the direct debit and prepay tariff caps. Nothing in the TCA prevents this. This will allow competition between suppliers to emerge, below the level of the cap, see Section 1(6)(b) of the TCA above.

Better Wholesale Management – this will inevitably require a period of transition, and the sooner that begins the better, otherwise we could be in exactly the same place next winter with regards to backwardation, and post reference period price movements. We suggest moving to a quarterly cap period, with a longer reference period, and only considering prices for delivery during that price cap period. This will introduce some seasonality in the price cap, but that simply reflects reality and not doing so will continue to be a cause of supplier failure (unless there is a very significant increase in the risk margin).

Higher Margin – as suggested in this consultation document Ofgem must increase the suppliers' share of the price cap through a combination of increased opex allowance (with the removal of any cross-subsidy); greater allowance for the wholesale risk being absorbed; and increased profit margin to properly reflect the capital at risk.

Stop Changing the Price Cap Methodology – this not only erodes the incentive to improve efficiency, but also increases regulatory risk which reduces the appetite to invest, and therefore undermines supplier resilience.

In the absence of a more fundamental change in the price capping regime we have the following comments on the specific issues raised by Ofgem in this consultation.

Unexpected SVT Demand

It is clear that although the price cap notionally only covers SVTs, it effectively also covers fixed price contracts because there is no logical reason why a consumer would sign up to a fixed price deal that is above the level of the cap. In any event suppliers choose their retail pricing and wholesale risk strategies, and any error that results in unexpected risk cannot be considered an efficient cost.

During the current crisis Ofgem (and BEIS) has been quite clear on the point of not bailing out failing businesses. In our view it would be unfair and discriminatory if it now supports a measure for one group of suppliers to recover historic **inefficient** costs. In particular where it has historically prevented other suppliers from covering their **efficient** costs and has consistently avoided making any proposal to recover them in future periods, for example prepay specialists.

CfD Costs

We do not accept the suggestion that suppliers will benefit from income from CfDs as a consequence of unexpectedly high wholesale prices, therefore no change is needed. An efficient supplier will hedge CfD volumes in accordance with its normal hedging strategy and sell back at the point of delivery. This minimises the extent to which a supplier will either gain or lose on the supplier costs of CfD.

Backwardation

We disagree with Ofgem's assessment that backwardation is not material. Given the level of margin currently allowed in the price cap, especially in the prepay price cap where cross-subsidies ensure allowed revenue is below the efficient cost of supply, backwardation in the current price cap period is equivalent to 2.1% which is significant, and it is not necessarily going to off-set by any over recovery in future periods.

We set out in Appendix 1 our detailed comments and rationale on the Options proposed by Ofgem. We have estimated monetary impacts (where possible) and assessed whether the impacts are temporary or permanent.

Table 1: Summary of essential changes to the Price Caps for April 2022.

Category	£ per dual fuel customer (all numbers +ve unless stated)	Notes
Cross subsidy removal (between payment methods)	£17 for prepayment -£4.16 for other payment methods	Permanent change
Operating costs	£36	Permanent change
Allowance for risk	£28	Permanent change Varies with energy costs
Profit margin	An increase to 2.85% equates to ~ £16 in summer 22 price cap period	Permanent change Varies with cap level
Backwardation	£28.15 in summer 22 price cap period	Temporary (for one year), as a coefficient can be applied to avoid variances in future (or other amendment to wholesale indexation)
Headroom	£23 ¹	Permanent change Return to the CMA level of headroom
Mutualisation	£3	Temporary, variable based on current RO estimate, excl. FiT
Unexpected SVT demand	£0	Not an efficient cost
Contracts for Difference costs	£0	An efficient supplier will hedge CFD costs
Shaping and imbalance costs	£41	Temporary change (for one year), with revised methodology in subsequent periods
Total	PPM: £120 DD and PORB: £97 Plus for all price caps: £72	Permanent Permanent For a period of one year

These are in addition to the mechanistic changes which will flow automatically through the price cap model. Please note that we believe all these changes can be made using Ofgem's existing powers to amend the price caps.

Headroom

We assess the nominal level of Headroom in the 2021/2022 price cap period as £13.88 for a typical prepay customer. The purpose of Headroom was initially intended to cover errors and give some allowance to compete under the cap. However, it is now clearly not sufficient for that purpose. Over a number of years Ofgem has moved away from the CMA intent, caused suppliers' cost to serve to increase as a consequence of additional obligations and it explicitly relied on Headroom to cover costs that are mutualised across suppliers and not explicitly accounted for elsewhere in the price cap methodology. We believe Ofgem should return to the original intent and level of headroom proposed by the CMA, which would now be £37 per dual fuel customer. This issue is discussed in more detail in Appendix 3.

¹ Based on moving from estimated 2021/2022 prepay value to the proposed £37

These changes will require a number of adjustments to the price cap rather than a single change to one element of the price cap as proposed by Ofgem. The option that is clearly NOT acceptable is Option 5 - doing nothing.

Our submission comprises this letter and the following Appendices:

Appendix 1	Utilita's detailed comments on Reviewing the potential impact of increased wholesale volatility on the default tariff cap: November 2021 policy consultation
Appendix 2	Working Paper, submitted Ofgem November 2021 - Reforms to the retail energy price caps
Appendix 3	Assessment of Headroom

We understand that any proposals to address the current failings with the price cap regime will have an adverse impact on low-income homes, and firmly believe that the correct way to deal with that is to increase benefits and minimum wage appropriately. Fuel Poverty is a social issue not a supplier issue. A social tariff, with costs properly socialised amongst all participants and based on common defined criteria could address the issue. We consider this would be compatible with the TCA. Increased accessibility and funding of Warm Home Discount (to a level which will address the Fuel Poverty Gap) would also work but is not within Ofgem's powers.

We understand Ofgem's concern about supplier resilience. The key reason for a lack of resilience is the current price capping regime which has given suppliers perverse incentives to cut prices of some tariffs, and has eroded the resilience of well managed businesses over several years. Changing the price cap as suggested will address that issue and allow balance sheet repair.

We note that the TCA has a sunset clause of December 2023. We believe that it is essential for Ofgem to maintain that date for the complete removal of price capping. Price capping will not of itself increase competition, indeed given the recent experience it has clearly reduced competition. Price capping energy will become both increasingly difficult and irrelevant as we move towards Net Zero.

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

Bill Bullen
CEO, Utilita

Cc: Jonathan Brearley, Ofgem
Neil Lawrence, Ofgem
Leonardo Costa, Ofgem

Appendix 1 – Non-Confidential

Utilita's detailed comments on Reviewing the potential impact of increased wholesale volatility on the default tariff cap: November 2021 policy consultation

Utilita welcomes Ofgem's review of the existing cost allowances in the price caps and the acknowledgement that costs may have diverged from allowances. However, there are other costs that have diverged from the allowances in price caps, which appear not to have been considered in the consultation document. In addition to excessive wholesale costs, cross subsidies between payment methods in the different price caps, operating costs, headroom and required profit margin to generate normal economic profit are all under accounted for in price cap allowances.

We accept that changes to the price cap are needed, however the changes must address all the issues, not cherry-pick. Ofgem's price cap has created a situation where suppliers are forced to sell at below cost, and hence Ofgem is in breach of their duty to enable efficient suppliers to fund their licensable activities. Unfortunately, there is no easy answer here for customers – the price cap must rise, and the increase is unlikely to be short term. Ofgem is suggesting a two or three stage process in respect of the price cap, but such tinkering will not address the problems. We consider that by this piecemeal approach, Ofgem may be seeking to obfuscate the fundamental issues.

For Ofgem to fall back on a position that it requires 'additional' powers to act to correct the problems with the Price Cap is simply not true. While some options might require legislative change, most do not, and Ofgem has a range of choices available to it. If it fails to act, Ofgem must acknowledge the fact that – despite bearing significant responsibility for the current crisis – it has chosen not to act to protect the longer-term interests of consumers. This is completely wrong and Ofgem should not abrogate its duties in this way.

Ofgem must apply a principled approach, fairly and consistently. In taking forward some of the proposals set out in the document, the underlying precedent which may be set is critical. For example, in considering addressing SVT Demand Variation, Ofgem is to all intents and purposes seeking to bail out suppliers who have chosen to follow a particular business model, where their calculated risk has failed. The approach also only addresses one aspect of the issue – run off contract costs. Other suppliers will be impacted by different aspects, for example managing the fixed acquisition costs part of the supply chain during a period of reduced acquisition. Prudent suppliers will act to limit their risk, but this will have cost consequences – if one set of risks are to be covered, all must be.

The proposed action may be on the basis of scale or unpalatable consequences, but the outcome is the same – for example, in the case of failed suppliers or bailing out those who face SVT demand variation - Ofgem would be specifically addressing issues affecting only a subset of suppliers, who had made a free, fully informed choice of business model.

To take this approach, while refusing to allow other suppliers to recover efficiently incurred costs over a period of years is discriminatory and completely unacceptable.

We have commented first on the five proposals, and then expanded to cover the key areas of the Price Cap which require urgent attention. It is essential that Ofgem recognise there are a number of fundamental flaws with the cap, all of which have contributed to the current crisis. All are important, all are urgent, and Ofgem has current powers to act in all cases.

Summary of Ofgem Proposed Options

Option 1 – to amend the Wholesale Allowance

This is partly a solution, but not in the way Ofgem proposes. As we have set out, Ofgem should amend the observation period, and apply an Annual Co-efficient to produce a better-quality facsimile of the costs faced.

Option 2 – to amend the Headroom Allowance

This proposal should be rejected. Amending the Headroom Allowance without correcting the other aspects of the cap to ensure that the Headroom is available will not address the issue. Conversely, if the errors with the cap are addressed as we have set out, then the Headroom allowance would be sufficient. We have also set out in this Appendix and Appendix 3 our further issues with treatment of Headroom.

Option 3 – Implement a bespoke adjustment.

This may be partly viable as, correctly applied it could be used to deliver the necessary outcomes. A number of adjustments are required to correct the fundamental problems with the price cap, these could be defined as a number of 'bespoke' adjustments, leaving an improved cap as a result.

Option 4 – Amend EBIT

This option was not properly discussed in the paper, as it appears to have been quickly dismissed by Ofgem, however, the price cap does require an increased margin. As we have set out, and has become evident in the current crisis, the current margin does not provide sufficient margin for the effective management of risk, and to allow suppliers to operate a strong balance sheet. We agree that Ofgem needs to undertake significant work on financial resilience, which, in addition to these other changes, will allow the rebuilding of investor confidence in the sector. In addition to the other adjustments we propose, an increase of around one percent in the EBIT allowed would be reasonable.

Option 5 – Do Nothing

This Option must be rejected. Given the parlous state of the industry, doing nothing is simply not an option.

To summarise, we have set out in Table 1 below the specific essential adjustments to the cap which are required. These are in addition to the mechanistic changes which will flow automatically through the price cap model. Please note that we believe all these changes can be made using Ofgem's existing powers to amend the price caps.

Table 1: Summary of essential changes to the Price Caps for April 2022.

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Given the scale of the increase necessary to reflect efficient costs and avoid future interventions should any unusual circumstance arise (i.e., to allow for financial resilience), an almost equivalent and far simpler option would be to adopt the PORB price cap for all payment methods, thereby preventing excessive costs while enabling suppliers to recover efficient costs, all suppliers would then be able to price at levels below the cap.

In response to Ofgem’s specific request for brevity, as elsewhere in this submission, we have done our best to reference previous submissions, rather than replicating points in detail. We rely on Ofgem to refer back to the prior documents where relevant.

Cross subsidy removal (between payment methods)

In its consultation *Protecting energy consumers with prepayment meters* of May 2020, Ofgem considers that efficient PPM costs in 2014 for dual fuel customers exceeds the current PPM uplift in the prepayment price as calculated by the CMA by £0 to £17. £17 is, in fact, an understatement of the PPM uplift, had it been calculated in a consistent way with Ofgem’s assessment of the operating costs associated with customers in receipt of standard credit and direct debit tariffs, and the result

² Based on moving from estimated 2021/2022 prepay value to the proposed £37

of the understated prepayment uplift inherited from the CMA, is that Ofgem considers the direct debit and standard variable caps are set £4.16 above the level of efficient costs³.

We have provided robust evidence in support of the understatement calculation (referenced above) in previous submissions by ourselves and NERA (our expert advisers) in response to recent price cap consultations. We refer Ofgem back to the evidence submitted in June 2021, and the non-confidential Appendix C of that submission, which was placed in the public domain.

Operating costs

The current cap methodology estimates a theoretical level of efficient costs of energy supply, using the lower quartile cost supplier for *categories of cost separately* e.g., general operating costs, working capital costs, bad debt costs and payment method related additional operating costs⁴, and in addition an arbitrary £5 per customer is then deducted from the operating cost allowance.

It is incorrect to assume that suppliers are equally efficient in all types of costs incurred in such complex businesses, meaning far fewer than a quarter of suppliers would meet such a measure of efficient costs, and the result is an allowance for operating costs that is well below the true level of efficient costs. Furthermore, the inclusion of suppliers with atypical and low-cost customer portfolios in the benchmarking exercise meant the lower-quartile supplier selected as a benchmark in each category is likely to be much closer to the true frontier cost than Ofgem intended.

Assessing the reported operating costs in the Consolidated Segmental Statements of suppliers since the implementation of the Default Tariff Cap (DTC) and adjusting reported profitability to meet the level of return expected under the price cap suggests an additional £36 per dual fuel customer is required to generate a 1.9% EBIT margin.

Allowance for risk

Ofgem has recognised in the consultation that risk comes at a cost. The 1% currently included in the price cap is materially less than the cost of risk management and exposure; the value any risk allowance represents is not the cost in any given period, but the long run cost of risk exposure, which is exacerbated by the presence of price capping.

From a risk capital perspective, considering the probability distribution of gross profit under conditions of price capping, risk appetite and cost of capital, Utilita estimates the cost of risk exposure in energy supply to be £16 per supply point, which is £14 more than the current allowance in the price caps. This is a permanent requirement, not a one-off change. Furthermore, the volumetric risk associated with portfolio change under conditions of price capping adds around £10 per supply point (priced using the Black-Scholes option pricing formula).

This risk capital assessment is based on Utilita's probabilistic analysis of risk capital requirement at a particular level of confidence and priced at Utilita's cost of capital. While this is company specific, it illustrates the scale of the requirement for which there is currently little provision. Ofgem could conduct its own analysis of this requirement for an efficient supplier considering, crucially, the level of confidence Ofgem expects an efficient supplier to have of remaining solvent in any given year.

³ Paragraphs 4.17, 4.56 and 4.57 of Ofgem's *Protecting energy consumers with prepayment meters: May 2020 consultation* dated 18 May 2020

⁴ Default Tariff Cap: Statutory Consultation Appendix 6 – Operating costs, and Appendix 8 – Payment Method Uplift.

Profit margin

A profit margin of 1.9% falls far short of allowing a 'Normal' profit in energy supply for two reasons: first, the risk capital requirement is substantially underestimated, as described above, and secondly, the cost of capital calculated by the CMA is also under-estimated.

The CMA used the Capital Asset Pricing Model (CAPM) to estimate cost of capital, despite it being widely understood to be inappropriate for sectors with material idiosyncratic risk. Even for a large supplier, the true nominal risk-free rate considering likely future inflation and the equity risk premium reflecting the idiosyncratic risk of energy supply takes supplier cost of capital to at least 15% (see supplier submissions in response to the DTC consultation), and the commensurate profit margin to at least 2.85% (a 50% increase from 1.9%, reflecting cost of capital being 50% higher than currently provided).

Backwardation

Ofgem considers that the effects of backwardation and contango may net to nothing over the long term. The current situation, however, with backwardation exceeding any historical precedent, means that associated costs are highly unlikely to be recovered before the end of the current price capping regime. Even if this were possible, the cost of the variability of gross profit this introduces is not accounted for in the price cap; it means merely that while the aggregate over the long term is nominally nothing, the variances in any given period - at an appropriate level of confidence - must be funded in the cap.

Based on historical variability of contango and backwardation as they affect the wholesale allowance in the price caps, the backwardation in the current winter period is a 1 in 107 year event for gas and a 1 in 172 year event for electricity⁵. The chances of recovering the loss this winter are extremely slim. Furthermore, the wholesale market forward contract costs remain in backwardation, and therefore the next cap period at the very least will almost certainly be materially affected by backwardation. To correct the extraordinary backwardation of the current period to reflect the normal degree of contango, £12.49 per gas supply point and £15.66 per electricity supply point should be added to the price cap in the next cap period. These numbers are based on the average degree of contango since the prepayment price cap was implemented in April 2017, and the cost in lost revenue of this difference, *ceteris paribus*, in the current price cap period.

For April 2022, rather than using prices over a twelve-month period for a six-month price cap period, Ofgem should use only the prices of those contracts within the price cap period and apply a coefficient to reflect the annual equivalent cost under the normal degree of contango. This change will allow suppliers to hedge without this risk and maintain the benefit of less volatile changes between the summer and winter cap periods.

Headroom

When the CMA recognised the need for Headroom in the prepay price cap, it intended suppliers should be able to recover efficient costs, compete for customers, offer a range of profitable tariffs and make a normal return. Headroom is intended to mitigate supplier risk and to provide some margin for error in support of those aims and to be in addition to efficient costs and 'Normal' profits. It is not intended to be a catch-all to allow for the unfunded imposition of unlimited new requirements on suppliers in addition to meeting mutualisation costs.

⁵ Using fifteen years of forward price data of the ratio of contango and, assuming the ratio is normally distributed, the subsequent probability of the ratio implicit in the current price cap occurring.

The CMA provided for a Headroom value of £15 per fuel, or £30 per dual fuel customer. This equated to 4.23% of electricity costs and 3.48% of gas costs. Under the CMA's methodology and purpose for Headroom, the value for the current full year would be £36.95 per dual fuel customer, which is almost three times more than the current methodology.

When Ofgem implemented the Default Tariff Cap, it diverged from this approach and in the current price cap, the allowed percentage is 1.461% for both fuels. Ofgem has also deliberately diverged from the purpose of Headroom as specified by the CMA, using it repeatedly to cover the shortfalls created by its regulatory approaches. We have set out additional detail in Appendix 3.

In addition to reverting to the original purpose of Headroom, as specified by the CMA, Ofgem should assess the costs of the increased obligations it has placed on the industry since the introduction of the price cap and adjust the price cap accordingly to ensure they are properly funded while the cap applies.

Mutualisation

One very clear and quantifiable group of costs to suppliers, which is not covered by the price cap, are mutualisations resulting from failure of suppliers to comply with payment obligations. These differ from items such as the Last Resort Supply Claim levy, where extra costs would automatically flow through Network Charges, and be recoverable by suppliers.

Ofgem has stated repeatedly, for example, as part of its Supplier Licensing Review, that it considers that mutualisations from supplier failures are sufficiently covered by Headroom. As set out in the preceding section, Headroom is deemed by Ofgem to cover 'competition and uncertainty'⁶ under the price cap. Headroom can only exist where the price cap is sufficient to allow recovery of efficient costs, without cross subsidy, and with all other aspects of the price cap – including supplier margin - being delivered. This is not the case and has not been so for the entirety of the price cap regime.

Over the last four years, Utilita has been required to pay over £3.2m in RO mutualisation alone. Ofgem acknowledges that (as a prepay specialist) we cannot recover our efficient costs, and further as the main supplier impacted by the prepay cross subsidy to credit. Ofgem also acknowledges the negative margins faced by suppliers in infographics on its website. Under these circumstances, we do not understand how Ofgem can assert that the Headroom is 'sufficient'

This means that for the RO mutualisation alone, in year 20/21, £2 per customer was required. We estimate our 21/22 exposure to be of the order of £3m to date, giving an indicative per customer value in excess of £3 for the next cap period.

Unexpected SVT demand

Price capping is an established feature of the GB energy market and the price cap is set at or below the level of efficient costs. On this basis, it is not difficult to anticipate that much of the time prevailing wholesale prices will be such that fixed term tariffs (which do allow for the recovery of suppliers' efficient costs) may well exceed the level of the default tariff cap. The cost of unexpected SVT demand due to customers moving from fixed term tariffs to SVT in these circumstances is not, therefore, an efficient cost, and could have been foreseen.

Companies that have chosen to operate business models incompatible with price capping, do so in the knowledge that material losses could be incurred, and should consider their risk mitigation strategies accordingly. Companies that have elected to pursue these strategies will have done so for

⁶ Para 1.12, <https://www.ofgem.gov.uk/publications/decision-supplier-licensing-review-ongoing-requirements-and-exit-arrangements>

specific reasons, for example to gain market share. As the strategies were pursued, in many cases over several years, it is reasonable to assume the companies benefitted, or they would not have continued.

However, if the strategies subsequently have adverse impacts, the companies, which have chosen these business models, should not be afforded special treatment and bailout by the regulator, where their risk-taking strategy results in an adverse outcome.

Contracts for Difference (CFD) costs

As Ofgem previously directed, actual variances in CFD costs will not be reconciled against the provision in CFD costs within the price cap. Consequently, suppliers are incentivised to hedge the CFD expense to mitigate adverse gross profit performance should actual CFD costs vary. Suppliers will not, therefore, have benefitted from lower CFD costs than anticipated at the time the Interim Levy Rate (ILR) for the winter 2021 cap period was determined.

As CFD costs vary with day ahead prices, as intended in the design of the scheme, suppliers can hedge CFD expense; if, for example, day ahead energy prices rise, CFD costs will fall (as has been the case recently), and if day ahead energy prices fall, CFD costs will rise. To manage this risk, energy suppliers can and do hedge this risk by selling back a proportion of energy that had previously been hedged in line with the price cap methodology at the time the relevant CFD ILR is set, and using day ahead prices on this exposed volume to offset variances in CFD costs (compared with the allowance in the price cap).

Given the ability to hedge CFD cost risk - and Ofgem's previous direction that CFD costs will not be reconciled - a rational and efficient energy supplier would hedge CFD cost in a manner such as that described above. On that basis, suppliers would not be affected by either higher or lower actual CFD costs than provided for in the price cap. As such, efficient suppliers have not benefitted from lower than anticipated CFD costs in the current price cap period, just as they were not adversely affected by higher than anticipated CFD costs in some previous cap periods. To reduce the price cap because of CFD costs does not reflect the changes in cost in this cap period experienced by an efficient supplier.

Shaping and imbalance costs

As Ofgem notes, shaping and imbalance costs reflect the prevailing wholesale prices at the time of delivery, not the average forward prices over the price cap wholesale price observation window. Using current wholesale prices and the existing allowances in the price caps, the current caps understated these costs by £41 per electricity supply point. While in practice Utilita has experienced only modest extraordinary costs of gas shaping and balancing so far (due to our hedging policy), any additional volume resulting from colder than seasonal normal temperatures remains extraordinarily expensive.

To improve the accuracy of this allowance in future, rather than applying allowances to the average cost over the whole observation window, only prices close to the end of the observation window could be used, which are more likely to reflect prices at the time of delivery.

Appendix 2 – Non-Confidential

Working Paper, submitted to Ofgem November 2021

Reforms to the retail energy price caps

Introduction

Price capping was reintroduced into the UK retail market following the CMA investigation that reported in 2016. Initially the CMA proposed a price cap only on the prepayment market, with an initial end date of 2020. However, that soon gave rise to large differentials in other markets, and in 2018 the government passed the Tariff Cap Act, which instructed Ofgem to introduce price caps on standard variable, or default tariffs, in other market sectors, which it did in 2019. This was intended as a temporary measure until 2023, but in summer 2021 the Secretary of State for BEIS proposed that it should be extended indefinitely.

All these decisions were to a greater or lesser extent based on misguided thinking:

1. The original decision by the CMA was wrong because there was clearly as much competition in the prepayment market as in other markets (based on the data they collected). The CMA was excessively influenced by a perception of technical constraints which were not preventing competition in prepayment.
2. Restricting supplier margins is completely contrary to attracting investment and encouraging innovation and competition. It is therefore a fallacy to suggest that price capping will be introduced temporarily until competition improves.
3. The caps were based on an overly optimistic assessment of efficient cost to serve, especially in the light of an increasing burden from government and regulatory activity, and the government's control of the smart meter project
4. SVT, or default tariffs, are a poor proxy for disengaged customers: some new entrant suppliers, often with additional innovation, have built an entire customer base of switched customers using SVTs. Just because some suppliers sought to exploit customer inertia by differentiating prices between fixed price contracts and SVTs, does not mean that the problem is the SVT tariff. The problem is the dominant supplier that is seeking to derive excess profits through differential pricing.
5. A misunderstanding, or an over interpretation, of the regulatory requirement to “protect” customers. In the context of pricing this does not mean driving prices down as low as possible irrespective of the impact on suppliers or whether the prices allow sustainable operation, but simply to ensure that suppliers are not making super normal profits.
6. An insufficient allowance for risk stemming from a lack of appreciation of the cost of risk management and exposure. At the conclusion of the CMA investigation Roger Whitcomb, the chairman of the investigation, stated his view that *“All they [energy suppliers] are actually doing – and I shall get into trouble for this – is metering and billing. They are not making the stuff”*⁷: in fact, as the current crisis demonstrates, energy suppliers are exposed

⁷The Guardian, (2016). Energy suppliers' profits 'far too high for what they do' [online] Available at: <https://www.theguardian.com/business/2016/jul/24/energy-suppliers-profits-far-too-high-for-what-they-do>

to and are required to manage wholesale market price and volumetric risk. To generate normal profit and remain operational in the long run, energy suppliers must finance these risks, something that is almost entirely unrecognized in the price caps.

7. A failure to appreciate the long-term damage caused by regulatory uncertainty: investors in the energy industry require some degree of certainty of profit generation, and the current approach, whereby price caps are continually reviewed for reasons other than the legislative purpose of price capping (being the prevention of excessive prices), greatly discourages the finance required to improve customer experience and for the retail aspects of the energy transition.

The extraordinary wholesale prices of recent months have now exposed some flaws in the current methodology for setting the retail price caps. While extreme wholesale prices have precipitated this, shortcomings of the price cap methodology would have become apparent over time even without any extraordinary price event; now the price capping regime is likely to be extended beyond 2023, it is essential the price cap is reformed to allow sustainable operation of a competitive energy retail market.

Utilita believes the shortcomings of the current price capping regime can be categorised as:

1. The interpretation of the purpose of price capping: which is contrary to the intention of the Tariff Cap Act, which explicitly intended to promote competition, rather than set price caps at a theoretical level of efficient costs, that are regularly adjusted at any suggestion that the price cap allows for over-recovery of efficient costs.
2. The current regime is excessively complex: by having different price caps for different payment mechanisms Ofgem has introduced distortions into the retail energy market that may, and indeed have, lead suppliers to make bad decisions. If there is a price at which Ofgem is prepared to allow even vulnerable low-income homes to pay for their energy, then it should apply to all payment options equally. At the same time, if there is a desire to have a “social tariff”, or other mechanism (e.g. Warm Home Discount) to address Fuel Poverty, this should be an explicit, and properly funded, mechanism, and not an *ad hoc* cross-subsidy between payment methods.
3. Effective pass-through of wholesale costs: as we are now seeing, wholesale prices, even if passed through fairly to consumers, can move retail prices by as much as 25% over a short period, swamping any allowance for margins and operating costs. Given the small margins in retail price caps, it is essential that wholesale price changes, risk capital requirement and realistic efficient costs are passed through accurately so that margins are not eliminated.

Section 1: The purpose and implementation of the price capping regime

Considerations when exercising powers under the Domestic Gas and Electricity (Tariff Cap) Act 2018

Parliament has set out how Ofgem must exercise its powers under this act, namely, with a view to protecting existing and future domestic customers who pay standard variable and default rates, and in so doing it must have regard to four matters:

- (a) the need to create incentives for holders of supply licences to improve their efficiency.
- (b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts.
- (c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts.
- (d) the need to ensure that holders of supply licences who operate efficiently can finance activities authorised by the licence.⁸

The decision to set the cap at what Ofgem considers be frontier efficient costs, even if assessed correctly, is not what Parliament intended. In fact, such an approach frustrates the purpose of the Tariff Cap Act, which is to provide time-limited protection against *excessive* prices whilst ensuring that customers continue to benefit from competition – and in the long-term facilitate a move to a market where more customers can benefit from competition. Indeed, the Government has confirmed to the European Commission that the intention of the default tariff cap is to protect customers from excessive prices until the conditions for effective competition are in place, consistent with the derogation in Article 5(6) of the Recast Electricity Directive.⁹ The default tariff cap is not a vulnerable customer protection mechanism and Ofgem does not have mandate to apply it to that purpose.

This intention is also clear from statements of Ministers in Parliament, as well as the statutory needs set out on the face of the Tariff Cap Act:

- Hansard records that on 26 February 2018, Claire Perry (then Minister for Energy and Clean Growth) stated that the “Domestic Gas and Electricity (Tariff Cap) Bill will, subject to parliamentary approval, put in place a requirement on the independent regulator, Ofgem, to cap domestic energy tariffs until at least 2020. Currently, some consumers are paying up to £300 more than they need to – this cap will help bring this overcharging under control.”¹⁰
- In a statement on 6 March 2018, Claire Perry explained that “The Bill is a time-limited, intelligent intervention that will help to accelerate the transition to a more competitive market. The powers given to Ofgem have to ensure that we do not disincentivise competition, while ensuring that companies have an incentive to improve the efficiency of their operations”.¹¹
- This is consistent with the statement to Parliament made by the then Secretary of State for Business, Energy and Industrial Strategy, Greg Clark, that: “The Government want the market to thrive. We continue to promote competition as the best driver of value and services for consumers.”¹²

⁸ Section 1(6) of the Tariff Cap Act.

⁹ See page 31 of the Department for Business, Energy & Industrial Strategy’s “GB Implementation Plan” dated July 2020.

¹⁰ [Energy - Monday 26 February 2018 - Hansard - UK Parliament](#)

¹¹ [Domestic Gas and Electricity \(Tariff Cap\) Bill - Tuesday 6 March 2018 - Hansard - UK Parliament](#)

¹² Ibid

- Further, in her written statement of 26th February 2018, Claire Perry made clear how important the statutory duties imposed on Ofgem under the Tariff Cap Act were:

'In setting the cap, Ofgem must protect existing and future domestic customers, but must do so in a way that creates incentives for suppliers to improve efficiency, sets the cap at a level that enables suppliers to compete effectively for supply contracts, maintains incentives for customers to switch and ensures that efficient suppliers are able to finance their businesses.'¹³

This emphasis on the importance of setting the cap at a level that means that the cap can coexist with competition is not surprising as it is fundamental to the design of the cap:

- It is consistent with Professor Martin Cave's original vision on which the legislation was founded: in his statement in the final report of the CMA's Energy Market Investigation, Professor Martin Cave said that in his view (in contrast to the view of the rest of the CMA group appointed to the investigation) there was not necessarily an irreconcilable conflict between competition and regulatory measures. He proposed a price cap across the market that attempted to achieve the goal of interim protection and promotion of engagement. One of the aspects that he emphasised would help to achieve this was a "safe-guard (above-cost) element [that] enables the designer of the cap to be confident in achieving a desired level of detriment reduction, but also allows variation in the intrusiveness of the cap, and permits its level to be set to provide appropriate incentives to switch to a cheaper tariff".¹⁴ It was this idea that a price cap could coexist with competition and allow suppliers to make reasonable profits that the Government ultimately endorsed when introducing the Tariff Cap Act, approved by Parliament.¹⁵
- It is consistent with the "mischief" which the legislation was introduced to deal with: The Tariff Cap Act was introduced as a response to the CMA's finding that there was an adverse effect on competition as a result of disengaged "sticky" customers, such that suppliers were able to charge excessive prices that did not reflect underlying costs.¹⁶ This was confirmed in the debates leading up to the passing of the Tariff Cap Act, where Claire Perry confirmed that "the problem, and the reason for the Bill, is that there is a very large group of customers who are sticky—who stay on expensive standard variable and default tariffs because they do not know how to switch, or they are not aware that they can".¹⁷ It was not introduced for the purposes of providing artificially low prices for customers subject to the price caps; on the contrary, it was introduced with the purpose of ensuring cost-reflective pricing. Indeed, elsewhere Ofgem recognises this: "We consider protecting customers to mean that prices reflect underlying efficient costs".¹⁸
- It is consistent with the provisions of the Recast Electricity Directive for "transition to effective competition" price caps which the legislation was carefully designed to comply with. As a result of the harm that price caps can cause to consumers in the long term, the Recast Electricity Directive only permits two kinds of price caps: the first aimed at customers that are vulnerable or fuel poor for the purposes of the Directive and which must meet the conditions laid out in Article 5(3); and the second aimed at customers during a transition to effective competition, which must meet the conditions laid out in Article 5(6). Notably, the latter include the requirement that the price cap is set at a price that is above cost, at a level

¹³ [Written statements - 26 February 2018 - Written questions, answers and statements - UK Parliament](#)

¹⁴ CMA Final Report on Energy Market Investigation (24 June 2016), Statement of dissent of Professor Martin Cave, paragraph 8, Page 1416.

¹⁵ See page 2 of the Government's response to the Competition & Markets Authority Energy Market Investigation dated February 2018, available [here](#).

¹⁶ CMA Final Report on Energy Market Investigation (24 June 2016), paragraph 20.5.

¹⁷ [Domestic Gas and Electricity \(Tariff Cap\) Bill - Wednesday 18 July 2018 - Hansard - UK Parliament.](#)

¹⁸ Paragraph 1.6 of Ofgem's Decision on the potential impact of COVID-19 on the default tariff cap (2 February 2021).

where effective price competition can occur, to ensure that the price cap does not itself hinder the achievement of effective competition. The Government has confirmed that the default tariff cap is a “transition to effective competition” cap and Ofgem has confirmed that neither the CMA PPM cap nor the Tariff Cap are aimed specifically at vulnerable customers.¹⁹ The distinction between the two types of cap – and the fact that any “vulnerable customer” cap would need to be implemented through Ofgem’s powers under the Electricity Act 1989 and Gas Act 1986 – is clear from the face of the Tariff Cap Act (see sections 3(2) and 9(2)) and from Ministerial statements in Parliament.²⁰

Contrary to the statutory purpose of the Tariff Cap Act, the current price capping regime elevates the short-term price protection of customers and, through the deliberate cross subsidy described later in this paper, especially prepayment customers. This conflicts with the aims of Parliament for the Tariff Cap Act to ensure that, whilst protecting customers against excessive charges, the cap coexists with competition and is cost reflective.²¹ Applying an artificially low cap is fundamentally contrary to the temporary nature of the cap as it hinders the aim of Parliament in introducing the legislation allowing for the cap, namely to achieve effective competition – and of course would be to the detriment of customers, given that customers are reliant on competition once the cap ends in 2023.

The events of the current energy crises have exposed the shortcomings of a price capping regime that has, contrary to the intention of Parliament, been set at the very limit of what Ofgem has calculated to be efficient costs (or indeed, in the case of prepayment metered customers, below efficient costs).

Cross subsidy of efficient costs between payment methods

In its consultation *Protecting energy consumers with prepayment meters* of May 2020, Ofgem considers that efficient PPM costs in 2014 for dual fuel customers exceeds the current PPM uplift in the prepayment price as calculated by the CMA by £0 to £17. £17 is, in fact, the under-statement of the PPM uplift had it been calculated in a consistent way with Ofgem’s assessment of the operating costs associated with customers in receipt of standard credit and direct debit tariffs, and the result of the understated prepayment uplift inherited from the CMA, is that Ofgem considers the direct debit and standard variable caps are set £4.16 above the level of efficient costs²². Ofgem admits that allowing the cross-subsidy or, as it terms it, the “tariff differential approach”, means that “suppliers will partially under-recover the efficient cost of each PPM customer with a traditional meter and over-recover for each direct debit customer. Suppliers with fewer PPM customers than

¹⁹ See BEIS’s GB Implementation Plan (31 July 2020), page 31, where the Government confirmed that the Tariff Cap Act “is consistent with the derogation in paragraph 6 [of Article 5]” (i.e., the conditions that apply to “transition to effective competition caps”). Similarly, at paragraph 4.12 of its own Consumer Vulnerability Strategy 2025 (ofgem.gov.uk) published in October 2019, Ofgem stated in respect of the CMA PPM cap and its own default tariff cap: “Both of these price caps cover a range of customers in vulnerable situations, but are not specifically aimed at consumers in vulnerable situations”.

²⁰ See for example Rebecca Pow’s statements in the 30 April 2018 House of Commons Debate where she noted that the Bill “places a new set of duties and powers on Ofgem to protect consumers on variable and default tariffs, and Ofgem already has a duty under the electricity and gas Acts to have regard to the need to protect vulnerable customers” (link [here](#)). In response to proposed amendments that would have introduced vulnerability considerations into the Bill (but were not adopted), Claire Perry also confirmed that “the Bill is in addition to and does not replace or replicate those [existing duties]”, which are under separate legislation (link [here](#)).

²¹ It also conflicts with Ofgem’s own statements as to the nature and purpose of the Tariff Cap Act. For example, paragraph 2.1 of the PPM SMNCC Consultation states that the purpose of the cap is to ensure that customers “pay a fair price for their energy, reflecting its underlying costs.” This reflects Ofgem’s decision dated 6 November 2018 on the [default tariff cap design](#), which noted that: “This cap will protect default tariff and Standard Variable Tariff (SVT) customers from being overcharged for the energy they use” (i.e., cost-reflectivity) and “We have designed a cap that will provide a high level of protection – preventing unjustified price increases and ensuring default tariffs reflect more closely the underlying costs of supplying energy.”

²² Paragraphs 4.17, 4.56 and 4.57 of Ofgem’s *Protecting energy consumers with prepayment meters: May 2020 consultation* dated 18 May 2020

average will be able to over-recover their costs. In practice, most non-specialist suppliers have customer mixes that allow them to recover their efficient PPM costs, or a substantial proportion of them.”²³ Ofgem then states that ‘If we set the PPM uplift at a cost reflective level, that would allow specialist suppliers to recover their efficient costs in full. However, all PPM customers (whether they were served by a specialist supplier or not) would be charged substantially more (before considering the net impact of the smart meter rollout). We consider our proposal protects customers, which is our primary focus, and in doing so has regard to suppliers’ efficient costs, which vary depending on suppliers’ circumstances and business models’.²⁴

Ofgem’s statement that it has regard to suppliers’ efficient costs is nowhere explained, and it fails to acknowledge, in contrast to non-specialist suppliers, that specialist PPM suppliers have customer mixes that would not allow them to recover their efficient PPM costs while acknowledging that some non-specialist suppliers may only be able recover “a substantial proportion” of their efficient PPM costs.

Ofgem returns to this theme later in chapter 4 of the PPM consultation:

‘In principle, we are not opposed to the effect created by allocating a portion of PPM costs to other customers and therefore we propose a tariff differential approach. We consider the impact for customers and suppliers to be consistent with section 1 of the Act, of which the primary objective is to protect customers. In our 2018 decision on the default tariff cap, we decided to set the uplift for standard credit customers using a tariff differential approach that was not fully cost reflective. We considered that this approach protected customers, and in doing so, we had regard to suppliers’ finances, notwithstanding the potentially distorting impact the approach has on cost-recovery.

This approach has greater impact on suppliers with business models that specialise in serving customers with high costs traditional PPMs to recover their efficient costs. We do not consider that is a reason to increase tariffs and reduce protection for 4 million PPM customers, most of whom are not served by specialist suppliers.’²⁵

While noting the greater impact on specialist suppliers, this does not acknowledge that such suppliers will not be able to recover their efficient costs and thus to finance their businesses. Ofgem makes no attempt to justify this approach by reference to their statutory obligations; it appears not to have considered the point, nor that suppliers have a licence obligation to supply PPM customers and therefore must be able to fund this. Indeed, Ofgem’s only attempt to deal with these duties appear in section 2 of the SMNCC consultation and then only to understate their importance. This approach is also a clear departure from the way in which Ofgem considered its finance duty in November 2018, when Ofgem concluded that, ‘Based on our analysis, we consider that efficient suppliers with a range of potential customer bases (including those matching the most disadvantageous customer base of the suppliers in our benchmarking sample) would be able to finance their activities under the cap’.²⁶

Ofgem has attempted to address the cross subsidy in an indirect and incomplete way by allowing the under recovery of efficient costs to offset the recent negative SMNCC allowance. However:

- Ofgem will not allow the net position to become positive, i.e., such that the final SMNCC is a positive amount (as it will be for the credit cap) even where that reflects Ofgem’s own estimate of the efficient cost of supplying PPM customers.

²³ Ibid, paragraph 4.33

²⁴ Ibid, paragraph 4.34

²⁵ Ibid, paragraphs 4.84 – 4.85

²⁶ Paragraph 2.57 of Tariff Cap Decision document.

- Ofgem will not roll forward any “under-recovery” that has not been offset in a cap period. Rather, Ofgem proposes to apply the offsetting on a “per cap” basis rather than a “cumulative” basis.
- Ofgem will only apply its APA if it is a negative amount. This further erodes PPM suppliers’ ability to recover their efficient costs, as Ofgem arbitrarily chooses to apply its APA only if it would further reduce the level of the cap, regardless of whether the data supports such an outcome.

Ofgem’s justification appears to be that it has pre-determined that the cap should not increase because of the final SMNCC and are adjusting the model to achieve that end. For example, Ofgem aims: “to maintain the cost differential between cap levels for PPM and DD customers. This means that we would not set the net SMNCC [for PPM] above £0, to maintain the differential and the level of protection PPM customers currently have”²⁷. Similarly, Ofgem notes that it considers: “that there is a risk that any offset could be too generous to suppliers. A per cap period offset would be less risky on this basis”.²⁸

Maintaining cross subsidies of this sort in price caps set already below efficient costs has two effects: first, that even efficient suppliers, and especially those serving predominantly prepayment customers, will eventually be forced out the market and, secondly, that suppliers are either dissuaded from competing for prepayment customers or encouraged to reduce standards of service for prepayment customers. If Ofgem wishes to persist in maintaining a cross-subsidy between the price caps, there is no impediment to avoiding these detrimental outcomes for both customers and suppliers by having a levelisation process, as exists for the Warm Home Discount and Feed in Tariff. In any case, the solution of a single price cap for all payment methods, with, if deemed necessary, a suitably levelized discounted tariff or annual payment for customers in fuel poverty, would resolve the problems existing in the current regime and allow Ofgem to meet its statutory duty to allow energy suppliers to finance their operations.²⁹

Certainty of cap methodology

Future investment in energy supply and innovation of experience enhancing products and services is predicated on some regulatory certainty. The price cap has been subject to recent amendments that have lowered the level of an already under-stated price cap without contributing to the price cap’s overarching aim of preventing exploitative practices (namely the introduction of a negative non-pass through SMNCC allowance in the prepayment cap, which is now proposed to reduce further, and a proposal to incorporate a prepayment specific seasonal usage profile in the calculation of the wholesale allowance for gas). At the same time as the measures to reduce the cap have been introduced, the regulatory burden of consultations, RFIs, the threat of excessive enforcement action and new measures to support vulnerable customers has increased considerably, something not reflected in the price cap.

The prospect of future reductions in the level of the cap beyond what is necessary to prevent bad practice, especially in the context of increased regulatory costs, discourages innovation, and in future only amendments to address the price cap’s fundamental purpose should be considered.

In summary, it is neither compliant with the intention of relevant legislation nor consistent with a sustainable competitive market to employ a price capping regime at the level of efficient costs, yet alone below the level of efficient costs (as is the case for customers with prepayment meters).

²⁷ Paragraph 7.21 of the PPM SMNCC Consultation.

²⁸ Ibid, paragraph 4.79.

²⁹ s.1(6)(d) of the Act.

The intention of protecting customers from excessive prices while allowing customers to benefit from a sustainable competitive market can be achieved by having a single price cap; excessive prices, as opposed to theoretically efficient prices, are not payment method specific, and customers of all payment methods should receive equal protection. The intentions of the legislation can, therefore, be met by operating a **single price cap for all customers** regardless of payment method, and this cap can be set using the methodology for the SVT price cap (subject to corrections); this will negate any attempts at exploitative pricing while providing enough room for a sustainable, innovative, and competitive market. A single cap will have the additional benefit of removing the current cross-subsidy between payment methods, introduced by circumstances rather than design; this distortion penalises and discourages specialist suppliers, which are the very companies that have delivered the greatest benefits to customers.

Any increased prices for customers in general that result from employing this approach, which would be to a small degree inevitable given the current price caps are set below the level of efficient costs, could be mitigated for customers in fuel poverty through either a tariff set at a discount to the single price cap level, or through an annual payment, like the warm home discount. Payment method is not a good indicator of fuel poverty, and more targeted intervention using, for example, DWP information would be considerably more effective. It is imperative the costs of any such subsidised tariff or direct payment are mutualised between all suppliers, as the WHD and FiT schemes are, to ensure suppliers are not disincentivised from competing for and offering good service to customers in fuel poverty, and that energy suppliers can recover efficient costs, as required by legislation.

Section 2: technical errors in the existing methodology

The level of the price caps with respect to efficient costs

The purpose of retail price caps is to protect customers from exploitative pricing practices, as described above. The purpose of price capping is not to determine which business models, innovations or types of products offered by suppliers should be successful; the market wide effects of the current regime and the extremely low level of the cap, however, do not allow for a plurality of products for customers to select from, discourages innovation and, in the long run, imperils the existence of a competitive energy retail market.

The current cap methodology estimates a theoretical level of efficient costs of energy supply, using the lower quartile cost supplier for *categories of cost separately* e.g., general operating costs, working capital costs, bad debt costs and payment method related additional operating costs³⁰, and in addition an arbitrary £5 per customer is deducted from the operating cost allowance. It is incorrect to assume that suppliers are equally efficient in all types of costs incurred in such complex businesses, meaning far fewer than a quarter of suppliers would meet such a measure of efficient costs, and the result is an allowance for operating costs that is well below the true level of efficient costs. Furthermore, the inclusion of suppliers with atypical and low-cost customer portfolios in the benchmarking exercise meant the lower-quartile supplier selected as a benchmark in each category is likely to be much closer to the true frontier cost than Ofgem intended.

The consequence has been losses for almost all energy suppliers under quite normal conditions since the implementation of market-wide price capping in 2019.³¹ In reality, an accurate estimation of efficient costs in any complex environment is almost impossible to calculate in a theoretical way and, given the extensive competition in retail energy, entirely unnecessary; only the free interactions of many rational actors facilitated by a competitive market, such as energy supply, can determine the true level of the efficient price to charge customers. As such, the price cap should be set at a level that both protects customers from exploitative practices and allows competitive forces to find the true efficient price for a product and service that reflects different customers' preferences. As described above, this is best served by a single tariff cap for all customers. Failing that ideal solution, operating costs should be assessed empirically such that most suppliers can recover their actual costs for customers subject to each of the price caps.

Adequate allowance for risk

The current price cap methodology fails to consider the risks energy suppliers face: as the current crises illustrates, energy suppliers must either hold significant risk capital, with a commensurate allowance for return on this capital, or be allowed a larger margin to enact complex risk management strategies, neither of which is provided to a sufficient degree within the price cap. It is common practice in industries that deal with this sort of uncertainty to account for the cost of risk capital in retail prices³². In banking, for example, banks will calculate, using statistical methods, the capital requirement to be x% confident of remaining solvent in any given year (for a bank targeting an AA credit rating this would be between 99.95% and 99.97% confident)³³; the cost of holding this capital at the bank's cost of capital is accounted for in the cost of retail services provided by the bank.

³⁰ Default Tariff Cap: Statutory Consultation Appendix 6 – Operating costs, and Appendix 8 – Payment Method Uplift.

³¹ <https://www.ofgem.gov.uk/publications/infographic-bills-prices-and-profits>

³² Crouhy, M. et al., 2014. *The Essentials of Risk Management*. 2nd ed. Chichester: McGraw Hill Education, p. 595.

³³ Ibid, p. 598.

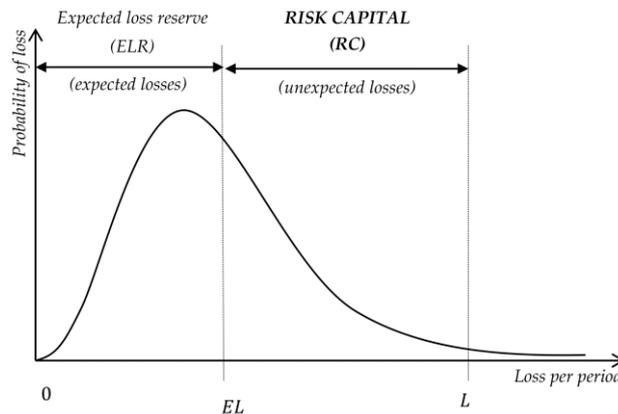


Figure 1 – illustration of risk capital requirement of a company exposed to uncertainty. Source: Dziwok E. (2018) Different Approaches to Regulatory Capital Calculation for Operational Risk. In: Jajuga K., Locarek-Junge H., Orłowski L. (eds) Contemporary Trends and Challenges in Finance. Springer Proceedings in Business and Economics. Springer, Cham. pp 135-143.

This approach of Risk Adjusted Return on Capital was first applied to energy markets in academic literature fifteen years ago³⁴, and is now widely employed in energy markets. Were Ofgem to account for risk capital and the return on risk capital in the price cap, combined with increased prudential oversight of companies entering and operating in the market, there would be no need for future interventions during periods of extreme price or weather events; if no such allowance is provided, Ofgem should be prepared to make regular *ad hoc* interventions as any unusual circumstance arises.

Companies operating in a competitive market also incur risk from portfolio change. The price cap does not consider or quantify the price of risk on wholesale volume for new customer acquisitions. As the price cap is fixed for periods of six months, two months in advance, a supplier seeking to win new customers must accept the risk of wholesale price movements between the setting of the cap and product delivery. Using the Black-Scholes model, and assuming a normal degree of price volatility, Utilita prices this risk relating to new customers at approximately £10 for each new dual fuel customer acquired after the setting of the price cap. Failing to provide for cost of risk on new customers alone eliminates the profit margin in the first year of supply and discourages competition. It is also of the greatest impact on smaller suppliers, which experience the highest proportionate portfolio changes and, therefore, the greatest proportionate volumetric risk.

Cost of capital

The under-stated EBIT margin in the cap is a function of both the unacknowledged risk capital described above, and an underestimated cost of capital. The cost of capital in the price cap is unmodified from the initial CMA determination in 2016, which used the Capital Asset Pricing Model (CAPM) to determine an energy supplier's cost of capital. CAPM evaluates the return of a sector relative to returns of the market as a whole and gives a value for the sector's relative risk. The problem with applying this to the energy sector is that the underlying driver of variability of returns is not related to returns of the market, but unpredictable things like the weather. In the long run, therefore, the beta value is likely to be close to zero, not because the sector is low risk, but because there is little causal correlation between the returns of the energy supply sector and the economy.

The CMA acknowledged this in its final report, stating 'While we accept...[the] argument that there can be significant volatility in the profits of a retail supply business due to weather-related demand fluctuations, government scheme costs and input price changes, we note that these would only have an effect on beta to the extent that the volatility is correlated with overall market returns. Neither

³⁴ Prokopczuk, M., Rachev, S., Schindlmayr, G., and Trück, S. (2007) Quantifying risk in the electricity business: a RAROC-based approach. *Energy Economics*, 29:1033–1049.

volumetric risk arising from fluctuations in the weather, nor changes in government scheme costs, exhibit this correlation'.³⁵

This is correct. However, the CMA failed to follow through to the natural conclusion which is that since there is no causal correlation the CAPM model is inappropriate. The CAPM assumes, contrary to the view of most academics and practitioners³⁶, that 'unsystematic' risks, such as those in energy supply, attract no risk premia.

A further issue with the approach is that the CMA evaluated returns over such a short period (five years), that its calculated value for beta cannot be considered reliable and could have been any number depending, for example, on how well weather conditions correlated with returns of the market.

Using the returns of the Big Six energy suppliers only, the CMA calculated a beta value of 0.7 – 0.8, which being less than 1 and above zero suggests energy is a normal good, with a lower risk than the market in general. This corresponds with the CMA's view of energy suppliers, which it considers to be 'regulated utilities' with a low underlying risk profile. While this may be a reasonable approach when considering network businesses, it is not so for suppliers; energy supply is far from being a regulated utility and is subject to active competition and substantial risks.

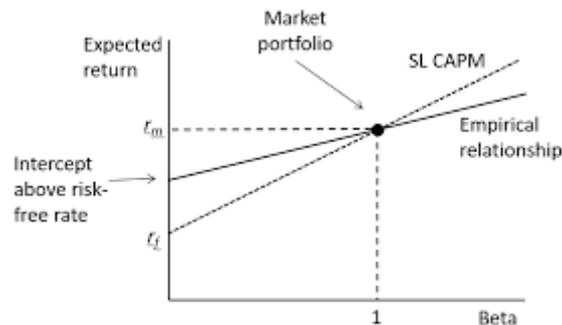


Figure 2 - illustration of underestimated returns of companies with low asset betas. Source: Gray, S., 2018, Low-beta bias and the Black CAPM, *Frontier economics*.

A primary activity of an energy supplier is managing wholesale risk on behalf of its customers; weather has a large impact on both demand and marginal wholesale prices, and hence on the returns of an energy supplier. The correlation of marginal volume and price creates a multiplicative risk for energy suppliers that is well documented in academic literature³⁷. In cases of material idiosyncratic risks, modified versions of CAPM should be employed,³⁸ or an entirely different basis to assess cost of equity should be used.

Correct indexation of the allowance for wholesale energy costs

The indexation mechanism for wholesale costs is affected by forward contracts outside of the period of price cap application. This was intended to be the case as it smooths what would otherwise be regular increases in the cap in winter and decreases in the cap in summer. By considering prices for contracts outside the price cap delivery period, however, it makes it impossible to hedge the wholesale allowance in the cap, as prices outside of the delivery period do not vary in a perfectly correlated way with prices inside the price cap delivery period; this increases costs to customers as,

³⁵ CMA Energy Market Investigation Provisional Findings Report, Appendix 10.4: Cost of Capital, page 24.

³⁶ Laghi, E., and Di Marcantonio, m., 2016. Beyond CAPM: estimating the cost of equity considering idiosyncratic risks. *Quantitative Finance*, 16(8), pp. 1273 – 1296.

³⁷ E.g., Oum Y. and Oren, S., 2010. Optimal static hedging of volumetric risk in a competitive wholesale electricity market. *Decision Analysis*, 7(1), pp. 107 – 122.; Vehvilainen, I. and Keppo, J., 2003. Managing electricity market price risk. *European Journal of Operational Research*, 145, pp. 136 – 147; Bessembinder, H. and Lemmon, M., 2002. Equilibrium Pricing and Optimal Hedging in Electricity Forward Markets. *The Journal of Finance*, 52(3), pp.1347 – 1382.

³⁸ Laghi, E., and Di Marcantonio, m., 2016. Beyond CAPM: estimating the cost of equity considering idiosyncratic risks. *Quantitative Finance*, 16(8), pp. 1273 – 1296.

even were a supplier able to operate under the level of the price cap, the cost of this unnecessary risk introduced by this flaw in methodology would be reflected in retail prices. The aim of avoiding regular seasonal changes to the level of the cap can be achieved without exposing suppliers to additional risk or customers to additional cost by applying a coefficient to the index for the period of price cap delivery i.e., the winter index value would be reduced by a fixed proportion, and the summer index value increased by a fixed proportion that reflects normal conditions of 'contango' in forward energy prices. This entirely technical and likely uncontroversial change could be implemented with little effort and certainly in time for the April price cap.

Fair recognition of the costs of failed energy suppliers

At present, costs associated with energy supplier failures, such as the Renewable Obligation, Feed in Tariff, and energy unpaid gas or electricity allocated on the balancing markets, are mutualised among remaining suppliers. There is no margin for such mutualisation in the price caps, and to make energy suppliers responsible at all has no sound basis; suppliers do not have the balance sheet strength, especially under conditions of price capping, to manage these additional expenses, and do not have the margin allowance to recover them. Mutualisation could occur through the same levy used for SoLR claims, whereby network companies, with much greater access to capital, could recover the costs in future network charges.

Conclusion

The purpose of the Domestic Gas and Electricity (Tariff Cap) Act 2018 is not to limit retail tariffs to a theoretical level of efficient costs, but to prevent exploitative practices. Even if that were the intention of the act, the current price caps are set *below* the level of efficient costs. To return to a sustainable competitive market that will allow efficient suppliers to recover their cost and customers to benefit from choice and innovation, Utilita suggests the following general and technical reforms to the price caps:

1) Technical

- a) The indexation of wholesale energy costs must be corrected by, for example, application of a coefficient, to avoid either under- or over-statement of the allowance for wholesale energy costs.
- b) An allowance for return on the risk capital to which energy suppliers must have access.
- c) A realistic assessment of energy supplier cost of capital.

2) General

- a) A change in the way price capping has been implemented to focus on protection from excessive pricing rather than estimating efficient costs and allowing no possibility of material profit above efficient costs. Such a change will encourage competition, as intended by the Tariff Cap Act.
- b) To achieve the above, given that exploitative pricing is not payment method specific, implement a single price cap for all customers set at the estimated level of efficient costs, plus some headroom, of the most expensive payment method, thereby ensuring efficient costs can be recovered for any supplier and competition can operate sustainably under the price caps. The standard variable price cap, adjusted to make the technical corrections described, would serve this purpose.

Utilita recognises the potential financial impact on customers of price cap reform that will allow the sustainable operation of a competitive market for energy supply. Not all customers, however, are equally affected by the financial strain that generally higher energy prices will impose, and maintaining a regime of below cost price caps for all customers is not an effective solution. Customers in fuel poverty can be more effectively supported with a direct payment to help with energy bills; this payment would be greater than the increase in costs necessitated by price cap reform, improving the financial situation of these customers, and suitable mutualisation of the cost of the scheme will ensure that energy suppliers will both compete to attract these customers and can recover their efficient costs.

We welcome this opportunity to contribute to Ofgem's thinking on retail market reform. Utilita believes all the above proposals could be implemented by October 2022 or earlier and looks forward to being able to compete sustainably below the level of a new price cap, winning customers through keen pricing and an innovative and tailored service.

Appendix 3 – Non-Confidential

Assessment of Headroom

In the CMA Energy Market Investigation Final Report³⁹, there are 123 mentions of Headroom in the considerations associated with the Prepay price cap, in summary, headroom is intended for the following purposes:

- 1) To help ensure that competition in the prepayment segments can co-exist with the cap and to reduce distortion (paragraphs 248 and 256)
- 2) To produce a price cap which is compatible with competition and balances the impact of the remedy on customers and suppliers (paragraph 14.116)
- 3) So that suppliers are able to compete to offer a range of profitable tariffs at different levels (paragraph 14.118)
- 4) Allows some margin for error so variation in costs between those facing suppliers and those in the cap can still be recovered (paragraph 14.118)
- 5) Mitigates the risk that the level of the cap will be below efficient costs (paragraph 14.385)
- 6) Allows efficient suppliers to compete beneath the level of the cap while still earning a normal return on capital. (paragraph 15.136)

This clearly demonstrates that the CMA always intended suppliers should be able to recover efficient costs, compete for customers, offer a range of profitable tariffs and make a normal return. The Headroom is intended to mitigate supplier risk and to provide some margin for error. It is not intended to be a catch-all for the imposition of new requirements on suppliers in addition to meeting mutualization costs. It is also clear that it is intended to be in addition to efficient costs and normal profit.

The CMA provided for a Headroom value of £15 per fuel, or £30 per dual fuel customer. This was subsequently equated to 4.23% of electricity costs and 3.48% of gas costs. Under the CMA's methodology and purpose for Headroom, the value for the current full year would be £36.95 per dual fuel customer, being £23.07 more than the current methodology.

When Ofgem implemented the Default Tariff Cap, it diverged from this approach and in the current price cap, the allowed percentage is 1.461% for both fuels. Ofgem has also deliberately diverged from the purpose of Headroom as specified by the CMA, using it repeatedly to cover the shortfalls created by its imposition of new and unfunded obligations on suppliers.

The table below sets out the most relevant documents and shows this divergence.

³⁹ <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

List of documents citing or implying use of Headroom since April 2017

Publication Date	Document Name	Description of change considered covered	Relevant text reference	Consistent with CMA/Impact
09/04/2018	Working Paper #3: Approach to Headroom	Considers the role of headroom in setting the Default Tariff Cap. The meaning of the term clearly links to the CMA term.	Figure 1: Headroom To enable suppliers to compete and provide an incentive for customers to shop around.	Purpose consistent with CMA
25/05/2018	Default tariff cap - policy consultation - overview	Consults on the DTC and includes Headroom, with the favoured proposal as a percentage of network costs minus total costs.	Appendix 11, Para 1.2 sets out that Headroom might be desirable to account for uncertainty, including intrinsic uncertainty in estimating efficient costs, allowing suppliers to manage volatile pass-through costs and cost variation	Purpose consistent with CMA % headroom in cap divergent from CMA
06/09/2018	Statutory Consultation – Default tariff cap – Overview document	Imposes the DTC, including Headroom	Headroom is based upon uncertainty and variation in efficient costs. No suggestion that this would cover new ‘requirements’.	Purpose consistent with CMA % headroom in cap divergent from CMA
06/11/2018	Appendix 2 – Cap level analysis and headroom	Decision document, confirms the role of Headroom	Headroom to manage uncertainty, and some proportion many need to be used to meet the cost of supplier failures (Para 3.86)	Purpose consistent with CMA % headroom in cap divergent from CMA
21/11/2018	Supplier Licensing Review	Considers activities around supplier licensing, market entry, operation and exit. Consults on increasing supplier obligations.	Does not complete an IA but comments (1.13) that Ofgem has undertaken sensitivity analysis to understand upward pressure on headroom allowance, and consider it appropriate.	Increase to potential obligations covered by Headroom

15/01/2019	Capacity market allowance in the default tariff cap	Looks at the uncertainty implied by the change in the Capacity Mechanism	Noted that have accounted for uncertainty in the cap design, including through a headroom allowance which will reduce supplier impact.	Increase to potential obligations covered by Headroom
10/03/2020	Protecting energy consumers with prepayment meters	Adjusting the default Tariff cap for prepay customers	Headroom – an allowance that ‘tops up’ the cap level for the net impact of uncertainty and to achieve the object of the Act, and meets the other statutory needs set out in S(1)(6).	As DTC and so not consistent with CMA for prepay customers
20/11/2020	Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation	Considering impact of Covid and whether an adjustment to the cap is needed.	Ofgem has not seen significant evidence to suggest that Covid has impacted the costs covered in headroom such that the allowance is insufficient to provide for the net uncertainty. Considers that RO mutualisation is covered by headroom.	Rejection of view that costs exceed headroom.
26/11/2020	Financial Responsibility Principle- Supplier Licensing Review: Ongoing requirements and exit arrangements - Decision	Decision to introduce measures to improve supplier standards of resilience.	Headroom is sufficient to cover mutualised costs of supplier failure.	Not consistent with CMA
17/03/2021	Supplier Licensing Review: reducing credit balance mutualisation	Seeks to reduce supplier ability to hold excessive credit balances and hence to reduce credit mutualisation	Ofgem has not assessed costs a supplier may face in setting up new processes as they would expect consistency with normal activities of well-run suppliers, and hence extra costs should not be significant.	Not consistent with CMA
29/04/2021	Price Cap - final consultation on updating the PPM SMNCC allowance	Sets the PPM SMNCC allowance based on the weighted market average PPM rollout.	Ofgem viewed use of the offset as reducing the need for an extra allowance. In 7.20 Ofgem acknowledged CMA had concluded that its PPM cap undervalued smart meter charges, but that the Headroom ‘while designed for allowing competition under the PPM Cap, would	Ofgem interpretation of CMA view

			have in practice offset under-estimations of costs in the cap methodology.'	
30/06/2021	Final proposals and statutory consultation - Reviewing the Consolidated Segmental Statement	Requires a broader range of suppliers to undertake Consolidated Segmental Statement Reporting.	Ofgem recognises (1.56/1.57) that the final proposals will increase costs to suppliers who were not obligated, but they conclude that based on cost estimates, they concluded that the costs of meeting the proposals are likely to be covered by the Headroom Allowance.	Not consistent with CMA