

Thursday, 03 March 2022

Neil Kenward
Director of Strategy and Decarbonisation
Ofgem
10 South Colonnade
Canary Wharf
London E14 4PU

Dear Neil,

Re: Consultation on Medium Term Changes to the Price Cap Methodology

Thank you for the opportunity to comment on the above consultation. Utilita's submission comprises this letter and the attached appendix 1 which covers the questions raised in this particular consultation. In addition, our submission should be considered to include the commentary in our submissions to the recent consultation documents during December, January and February.

Unfortunately, we have been disappointed to note that Ofgem has failed to take account of many points raised by ourselves (and other participants) pressing for long standing issues and inequities to be resolved. Instead, Ofgem has sought to address specific points raised by participants who may have employed risky strategies, for example in terms of hedging policies and fixed term contract provision, without adequately pricing in the risk of unexpected SVT demand, and who are now looking to Ofgem to provide solutions at the expense of consumers.

Many of these solutions are unnecessarily complex, and yet still fail to address the fundamental flaws in the price cap. In particular, many salient points we raised in response to the '*Call for input: Adapting the price cap methodology for resilience in volatile markets*' have not been recognised or addressed. We replicate key elements below and refer you to our full letter in response to the Call for Input, dated 11 January 2022.

We set out in our submission that adaptation alone would not meet the need, and that broader reform was needed. Failures in the price capping regime have been instrumental in undermining the financial resilience of suppliers. While Ofgem is taking some steps in respect of immediate wholesale impacts, it is completely failing to recognise and address the long running issues which have damaged supplier balance sheets over years. The proposals put forward either do not go far enough, or in some cases look likely to damage competition beyond recovery.

Suppliers need to be allowed to make and retain a normal profit and be rewarded fairly for managing risk. In return, they can compete for customer business in a fair market with a level playing field. This approach, if applied consistently, predictably and fairly, will allow suppliers to rebuild their balance sheets and hence the industry.

The following continue to apply:

- 1) The regime is too complex – there are three price caps rather than one, covering standard variable tariffs and not fixed price contracts.
- 2) Wholesale cost management – is inadequate, embedding structural issues such as backwardation while failing to smooth wholesale price shocks due to the short reference period. In addition, the mismatch between cap period and reference period drives further issues.

- 3) Insufficient supplier allowances due to the flawed methodology, unrealistic assessment of efficient costs and damaging cross subsidies that skew incentives for investment in engaged customers at the cost of disengaged and the most vulnerable.

And hence we believe that Ofgem has continued to fail in its clearly stated duties under the Domestic Gas and Electricity (Tariff Cap) Act 2018, to have regard to (and to balance) the critical matters under Section 1(6)¹.

While we acknowledge that the proposals in this document have far reaching implications, we do not generally support the proposals. We do not believe that removing customers' ability to select a variable contract of their choosing or implementing more frequent price caps will be in consumers' interests in the long run.

The issue is not the current methodology, though it can and should be improved, as we have consistently argued. The issue is suppliers of Fixed Price Contracts not pricing in the risk of unexpected volumes of SVT customers, in combination with a regulatory failure to address unsustainable pricing policies by such suppliers. The combined costs of the resulting market failures substantially outweigh any savings claimed from price capping, based on publicly available information.

Utilita had regard for the current methodology from the beginning and we believe were the most stable supplier during the recent crises, we remained fully hedged to insulate customers throughout the winter from excessive price increases without incurring material losses that warranted a bail out. We appropriately managed our volume risk while others will still be onboarding customers and we are not reliant on unsuitable acquisition tariffs to draw in customer credit balances to fund our operations and to satisfy investors. Our point is the methodology is not the cause and does not warrant the measures being proposed nor will they fix the market.

We hope that this submission has been helpful and would be happy to discuss these issues with the team.

Kind regards

By email only

Alison Russell
Director of Policy & Regulatory Affairs

¹ S1(6) The Authority must exercise its functions under this section 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 the following 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 are able to finance activities authorised by the licence.

Appendix 1 – Utilita’s response to the questions in the document

For convenience, we have also replicated the questions from the document

Chapter 2 – The case for change

Question 1: Are there any other costs and risks to consumers and suppliers that we should consider?

The current crisis illustrates the futility of attempting to regulate at such a detailed level the revenues of energy suppliers. Energy supply is subject to innumerable risks and is in fact not at all like the regulation of the much more predictable revenues of distribution companies.

Addressing some new specific risks will not fix the fundamental flaw of the price cap, namely it allows, even under normal conditions, insufficient revenue to generate economic normal profit; the relevant legislation does not require Ofgem to interfere in such a detailed way and rather than seeking to set the price cap at the very limit of theoretical efficient costs, Ofgem should set the cap such that it protects customers from *exploitative* pricing while allowing competition to operate beneath the cap under normal conditions with sufficient margin to manage the myriad risks of energy supply.

Ofgem are aware of the relevant costs to suppliers, and has identified the key areas, however we strongly disagree that they are properly accounted for, and adequate recovery allowed. We refer Ofgem to our previous responses particularly around allowing prepay suppliers to fully recover their efficient costs and we note Ofgem’s continued failure to meet its duties under Section 1(6) of the relevant Act².

Reference continues to be made to the functions of Headroom, which we consider has been an over-used catch-all for various costs. Our analysis shows that these costs clearly exceed Headroom and should be accounted for specifically, for example mutualisation. We agree that there are costs that both Ofgem and suppliers will be unaware of as the market continues to evolve, and we consider that such unexpected and unpredictable costs should rightly be included in Headroom in the initial year of occurrence. If a cost will clearly continue, then it needs to be allowed for specifically in a clearly defined way, as Headroom does not expand to cover such ongoing usage.

Chapter 4 – Changes to the price cap methodology

Question 2: To what extent would a price cap contract without exit fees leave suppliers carrying volume risk in a falling prices scenario? How significant would this risk be? How might it be mitigated?

We do not believe the price cap contract to be a workable solution. A fixed deal with no exit fees is not a fixed deal and therefore suppliers will face asymmetric risk of customers moving as prices fall, creating a win-win for customers and a further loss for suppliers. We also believe this will create a confusing market for consumers and at a time where we need to rebuild trust this will simply confuse them.

Volume risk would remain as historical behaviour is unlikely to hold in extreme circumstances. Under normal conditions, the volume risk would be low, but it is also low during normal conditions under the existing methodology. A rapid and significant fall in prices will likely result in a larger proportion of customers switching than historical behaviour would suggest.

Question 3: Quarterly updates are a balance between the reduced volume risks and the increase backwardation risks. Please provide evidence and data on the relative costs and benefits of this.

There is no need to find a ‘balance’ between volume and backwardation risks. The backwardation risk exists only because of the peculiar construction of the price cap wholesale allowance methodology. An adjustment for any excess backwardation or contango can be made for a given price cap period at the time of the calculation of the price cap in question, independently of any other considerations.

² N.1.

Question 4: Please provide further evidence on the impact of quarterly updates and price cap contracts on households and their finances, and how these could be mitigated.

As Ofgem notes, the quarterly approach, as proposed, exposes households to more volatile energy prices.

A quarterly update of retail prices does not have to be matched with a quarterly wholesale price observation period. A longer period of observation could be used, with a degree of overlap with respect to delivery period, that would reduce the volatility of the retail price. This can be constructed in such a way that retailers are not exposed to additional price risk, but volume risk would become more costly and were prices to fall the reduction in retail prices for customers would be delayed.

A price cap contract may work for highly engaged customers, but risks having a hugely detrimental impact on disengaged and vulnerable customers, especially those on prepay meters.

Question 5: Do you think it is unfair that consumers would sometimes have higher or lower prices depending on the wholesale cost at the time their cohort starts the price cap contract? Do you think over the longer run this would even out?

We consider that this would be very unfair indeed.

We believe Ofgem and some suppliers are grossly underestimating the political repercussions of this approach, where from month to month the price cap level could change by many hundreds, or even over a thousand pounds; customers would be rightly incensed that their finances, in many cases precarious, are at the whim of global energy prices. Consumers may consider that suppliers have abrogated their primary responsibility of protecting customers from that volatility, despite the fact that the price cap contract would be an Ofgem construct.

We sincerely believe that should this methodology be implemented, in any future period of highly volatile energy prices there would be widespread calls for a new raft of drastic regulatory action or even government intervention, including renationalisation, to protect households from the uncertainty of global energy markets. Poorer customers will be especially exposed to a lottery of potentially financially crippling energy costs.

We firmly believe that this outcome will be detrimental to the whole industry and particularly damaging to suppliers such as Utilita and our customers, many of whom are vulnerable and struggle financially.

Question 6: What opportunity and impact could each proposal have on consumer engagement? And where there may be negative impacts, please provide options to address these. (Please provide evidence.)

Firstly, the price cap should be set at a level that enables competition below it. To date, due to the flawed implementation, the price cap has failed to achieve this, with the majority of suppliers (but those which failed) pricing close to the cap or reporting significant losses.

We consider the price cap contract approach is overly confusing from what is currently understood as an SVT.

While a Quarterly cap allows risk to be transferred to customers quicker and has the lowest cost to customers due to the earlier transfer of risk, we believe many customers will struggle with the resulting volatility, especially not being able to plan for the full winter.

In all instances a price cap fundamentally means reduced diversity in hedging and risk management and any scenario will be at risk of extreme/black swan events.

We continue to believe that a simplified approach as we have previously argued could be easily delivered, would be clearly understood, would carry less risk overall and would allow rebuilding of the industry and effective competition.

Question 7: What other operational impacts could a quarterly update or price cap contract have? Please provide data on the costs and benefits

System limitations of legacy gas prepayment meters managed by Siemens may prohibit correct charging of customers under the price cap contract methodology as there are a limited number of 'tariff sheets' that will likely not allow for the greatly increased number of tariffs required to be extant at any given time.

The levels of changes and updates required will also need to be carefully considered in managing the disposition of tariffs onto prepay meters in these scenarios.

Question 8: Are there any challenges in transitioning to quarterly updates or the strengthened status quo? If so, please provide details.

Transitional arrangements are likely to be needed if suppliers are required to update hedging policies. Careful consideration will also be needed of other developments, for example proposals to update RO payment mechanisms to ensure they are suitably addressed.

Question 9: What would the impact be if suppliers tried to buy the energy requirements for all their customers on price cap contracts in August (for 12 month contracts) or August and February (for 6 month contracts) of each year? Do stakeholders agree there would be liquidity challenges in the wholesale markets? How damaging would this be? Are there any ways to avoid this issue?

We agree that Ofgem has described the correct risks. We also consider that there is a risk of suppliers achieving a different price to the price used in the cap given the extraordinary activity that would occur, which would be of great cost considering the very large amount of energy to which any difference would apply.

Question 10: If we were to implement the price cap contract, how should we implement it - with an immediate start and single cohort on a price cap, or with a staggered start and six or twelve different cohorts?

We do not support the Price Cap Contract proposal. Having all customers in a single cohort would cause the liquidity problems described by Ofgem in advance of question 9. Arbitrarily distributing customers between cohorts will unfairly create winners and losers among customers and suppliers.

Question 11: What is a fair and practical way to allocate consumers to different cohorts? Possibly GSP group as unambiguous and would reduce the frequency of close neighbours receiving radically different energy prices.

We have not been able to suggest a fair approach and do not support the Price Cap Contract proposal.

Question 12: Should we consider any of these variations further? If so, which one(s) and on what basis? (Please provide evidence)

The six-month hedge variation could be modified to remove the seasonality of energy prices: a fixed coefficient could be applied to the summer and winter average observed prices to reflect the degree of contango implied in the basis of the price cap. The average summer wholesale price would be

increased by a fixed proportion and the average winter wholesale price decreased by a fixed proportion, thereby removing backwardation risk without exposing customers to seasonal prices.

More generally, the primary proposals do not allow the functioning of a competitive market that will best serve the interests of customers. The current methodology provides customers with some protection from volatile energy prices (arguably not enough, and that a longer price observation period should be used) and some of the proposals will expose customers to highly volatile energy prices. Ofgem should adopt a much more straightforward and effective approach of allowing sufficient allowance to cover the cost of the risks to which energy suppliers are exposed and allow competition to operate below the price cap under normal circumstances.

Chapter 5 – Reducing the notice period to a minimum of 28 days

Question 13: Do you have any evidence or data that supports or challenges our assessment of the benefits this? What are the practical considerations for price changes over winter and Christmas?

The existing timescales are hard to manage and place significant burden on suppliers. Reducing those timescales without a clear and unambiguous confirmation from Ofgem that a reduced and much simplified price change notification process would be a significant issue.

Suppliers also need a clear guarantee that all industry parties, including DCC and SMSOs have sufficient capacity to deliver to such compressed timescales.

Question 14: Do you have evidence or data to support a move to a shorter implementation window – such as 14 days? What are the potential risks to consumers of a shorter notice period? And what are the operational considerations?

No additional comment

Chapter 6 – A new mechanism for managing backwardation costs

Question 15: Given the changes in the wholesale market since summer 2021, how should these be reflected in the deadband calculation?

There is no need for a 'deadband', the span of which is an arbitrary one. There is no reason why all backwardation or contango that diverges from that implied in the original cap construction cannot be provided for in the price cap. Backwardation is a risk created by the price cap, not one that occurs naturally, and is perfectly possible for the risk to be eliminated in its entirety through amendment to the methodology used in setting the wholesale allowance.

Question 16: Do you have any views on the challenge of collecting backwardation costs from suppliers via RFI?

An RFI is not necessary; the degree of backwardation or contango will be apparent from the construction of the wholesale cost allowance for each price cap period and a suitable adjustment for any variation from the implied degree of contango in the original cap can be accounted for in the wholesale allowance.

Question 17: Are there additional costs or benefits of taking an ex-post approach in this instance? If so, please provide details or evidence of these.

As the degree of backwardation or contango is apparent at the time of setting the price cap, there is no need to perform an ex-post adjustment. Doing so only unnecessarily delays suppliers' cashflow (for

which there is no provision in the price cap that is already set at below the level of efficient costs) or delays the benefit customers would receive under conditions of contango.

In general, we do not believe that the consultation adequately addresses this problem. We consider that it is not necessary to consider how suppliers might to a small degree be able to manage this risk (at the expense of price risk), as the risk can be eliminated entirely and independently of all other risks by simply adjusting the wholesale allowance to account for the difference in the implied degree of backwardation or contango between the prevailing and original price cap.