

08 June 2022

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Dear Leonardo,

**Re: Price Cap – consultation on the true-up process for COVID-19 costs and Price Cap – May 2022
Consultation on credit and PPM SMNCC allowances**

Thank you for the opportunity to comment on the consultations listed above. This submission covers both consultations and comprises both this letter (which is not Confidential) and Confidential Appendix A. For convenience, we have addressed the two consultation documents under separate headings.

Utilita is a smart supplier, specialising in providing a quality smart service to our prepay customers. We offer only variable contracts to domestic customers and as such we have been operating entirely under the price cap(s) since their inception in 2017. We have engaged throughout this period with Ofgem's consultations on this matter; we remain frustrated and disappointed at Ofgem's repeated failure to engage properly with our concerns. The price caps have failed to allow Utilita, as a specialist supplier, to recover our demonstrably efficient costs. They have resulted in negative margins and - due to the way in which Ofgem has formulated the caps - have resulted in a significant loss of justified revenue to our business.

We have employed specialist economic and legal advisers to provide advice and support and to ensure that our arguments are well supported with rigorous analysis. While expensive, this has been essential due to Ofgem's approach of only allowing suppliers to engage at the detailed level if they do employ such advisers. This makes engagement with price cap processes extremely costly and effectively precludes suppliers from engaging unless they can make such (unfunded) expenditures.

Ofgem has generally either failed to engage with the points we have made or has dismissed them based on poorly justified grounds. We therefore do not accept Ofgem's dismissal of our arguments and continue to consider our points fully justified.

While we have not repeated all our previous points here, we restate our letters submitted (on all matters relating to the Prepayment Charge Restriction and Default Tariff Cap) to date, with particular reference to the detailed supporting analysis undertaken by our advisers, which sets out clearly a number of errors made and perpetuated by Ofgem.

In respect of the two documents above, our economic advisers, NERA have undertaken further analysis. They provided us with a short, internal paper on the PPM SMNCC consultation elements,

which they considered carefully and deemed fully compliant with their adviser undertakings. We have used the internal paper in the preparation of this submission, but do not intend to submit a separate NERA paper on this occasion.

Price Cap – consultation on the true-up process for COVID-19 costs

Ofgem seeks limited views in this consultation document, given that the approach is generally to conclude that Ofgem does not need to make a change to its previously outlined path. However, there are several areas of concern.

a) Inclusion/exclusion of suppliers

In Appendix 4, Ofgem excludes one supplier because it is prepay heavy. We assume this refers to Utilita. We do not support Ofgem's approach. As stated previously, prepay customers do have debt (and bad debt) and Ofgem's oversimplistic approach does not reflect the actual position, please see below.

In addition, given Ofgem repeatedly excludes a supplier on the basis that it is 'prepay heavy', if that does relate to Utilita, it is highly frustrating to receive repeated mandatory requests for information that is not used. The price cap does not allow for recovery of specialist suppliers' efficient costs, and to repeatedly add reporting burdens for RFIs to support the price cap process when the information is destined not to be used is wasteful of resources and manifestly unreasonable. At the very least, it would be preferable to discuss with us in advance if the data is likely to add value, and then a proportionate approach can be taken.

b) Debt on prepay meters and working capital impacts

In the consultation document, Ofgem repeats its view that debt is a credit customer issue, not a prepay customer problem. On this basis, it rejects the need to make allowance for suppliers managing debt via a prepay meter.

Prepay customers will have debt for two main reasons - debt acquired as a result of being given the support needed when they are vulnerable, and debt acquired as a credit customer leading to the requirement to use a prepay meter. In both cases, the debt arises either driven by or in compliance with the licence, and Ofgem's approach does not reflect reality.

Where suppliers must provide on demand support to customers, for example via Additional Support Credits (ASCs), Ofgem should recognise that this has an associated cost. While the debt is often modest, the customer may still take a long period to repay it if they are in difficulty, and Ofgem seeks to drive ever longer repayment periods and payment holidays. No allowance is made under the cap to manage this demand on capital as the debt is 'carried' by the supplier.

Equally, customers may acquire a debt as a credit customer, and need to repay it using a prepay meter. While we agree the initial debt arose in credit mode, the debt repayment period is frequently substantial, especially in respect of larger sums – again this cost must be carried by the prepay supplier. This will not be covered by the allowance under the credit cap, even where the supplier is the same supplier. We have provided confidential Appendix A, which illustrates these points.

The working capital impacts of these issues are not insignificant, and should be allowed for under the cap.

Ofgem's approach to debt on prepay meters is to assert that as the debt arose only in credit mode, the allowance within that cap covers the issue. It does not. As average debt levels rise, and

repayment periods become increasingly attenuated, supplier costs increase and are in no way met by the minimal allowances which were included while that customer was in credit mode.

The supply licence requires increasing levels of support for prepay customers, and also extended repayment periods and other associated customer management actions which will help support these customers when they are vulnerable. While we support the need for such activities, we continue to believe the associated costs should be recognised and funded. Currently Ofgem fails to do this.

c) Revenue Leakage on prepay meters

This area also has working capital impacts on suppliers and is not addressed by Ofgem. The issues relate to issues within industry processes where suppliers do not receive the revenue that they should from the prepay meters.

In this instance, we consider that Ofgem should include questions in their RFI which assess accurately the level of revenue leakage experienced by suppliers. Ofgem should then determine the appropriate allowance to be made within the cap.

Price Cap – May 2022 Consultation on credit and PPM SMNCC allowances

Moving to the consultation on the SMNCC allowances, we instructed our advisers (NERA) to consider points we made previously in response to Ofgem’s consultations in relation to the PPM SMNCC. NERA were to assess whether our points in respect of identified errors had been addressed (in whole or in part), any relevant observations and any new errors or points arising. For convenience, we have tabulated the main errors below and then considered each in order.

Briefly, the first three errors (of the largest magnitude) set out relate to long-standing issues with Ofgem’s approach to modelling the PPM SMNCC, which we have repeatedly brought to Ofgem’s attention and Ofgem has repeatedly declined to correct. Ofgem claims that its approach to modelling the SMNCC is mature¹ and that it does not intend to substantially revise the model following responses to this Consultation. However, given the material cost under-recovery that suppliers of prepay customers face as a result of these errors, it is unclear how Ofgem’s position can be consistent with its duties to facilitate recovery of efficient costs by licensees.

The remaining errors relate to changes that Ofgem made to its estimate of traditional prepayment meter asset lives and PRC terms in its February decision, where it indicated that suppliers would have the opportunity to comment as part of the current Consultation².

Unfortunately, given the imposition of adviser undertakings by Ofgem in order to allow advisers to engage effectively with the consultation process, NERA is not able to disclose detailed financial impacts to us, but has instead indicated orders of materiality using a similar approach to that often used by Ofgem when considering impacts.

¹ Ofgem (3 May 2022), Price Cap – May 2022 consultation on credit and PPM SMNCC allowances, p. 4

² Ofgem (February 2022), Decision – Price Cap – February 2022 decision on credit and PPM SMNCC allowances, p. 15 article 2.27 and p. 21 article 2.58

Table 1: Overview of Errors in the PPM SMNCC Model

Error	Description	Impact of Correction on SMNCC	Relative materiality
1	Ofgem overestimates the smart metering net costs (SMNC) embedded in the 2017 DTC, because it overestimates the LQ supplier's 2017 PPM SMNC.	Makes the SMNCC less negative for PPM and credit for both fuels.	££
2	Ofgem unjustifiably limits application of the PPM cost offset (up to PPM SMNCC = £0).	Allows the PPM SMNCC to become positive (in practice only affects electricity).	£££
3	Ofgem fails to compensate suppliers for historical under-application of the PPM cost offset.	Makes the PPM SMNCC for electricity more positive.	£££
4	Ofgem incorrectly links the amortisation period for traditional electricity PPMs to the asset life rather than the PRC term.	Makes the PPM SMNCC for electricity less negative.	£
5	Ofgem underestimates the asset life of traditional gas PPMs.	Makes the PPM SMNCC for gas less negative.	£
6	Ofgem underestimates the PRC term of traditional gas PPMs.	Makes the PPM SMNCC for gas less negative.	£
7	Ofgem unjustifiably excludes data on traditional gas PRCs from two suppliers, causing it to mis-state the extant traditional gas PPM age profile.	Depends on whether Ofgem corrects its estimate of SMNC embedded in the 2017 DTC.	£

Source: NERA analysis of PPM SMNCC disclosed model and data

1. Estimate of Smart Metering Net Costs embedded in the 2017 DTC

The effect of the error (which we previously described) is that Ofgem overestimates the embedded SMNC, assuming a higher level of embedded costs than is actually embedded in operating cost allowances and consequently estimates that a larger reduction (in operating cost allowances) is necessary to achieve alignment with its estimate of current smart meter costs than is actually the case.

The 2017 DTC uses the lowest quartile (LQ) supplier, but Ofgem erroneously estimates using the weighted average of a notional LQ supplier's prepay and credit SMNC in 2017. As the actual LQ supplier had rolled out very few smart prepay meters (and so had an SMNC near zero), the notional LQ supplier's SMNC is above the actual LQ supplier's SMNC and hence Ofgem overestimates the embedded SMNC.

Ofgem suggests that a correction is not necessary as it already adjusts, and this would be a 'second adjustment'³. We respectfully suggest that this may be a misunderstanding of the error, as we do not propose a second adjustment, merely that Ofgem should correct a mistake made in the adjustment it currently applies.

2. Limited application of the cost offset, and

3. Historic under-recovery

The DTC includes a PPM uplift reflecting the additional cost to serve of prepay over credit customers. Ofgem has identified that this uplift understates the extra cost to serve by £7.95 (electricity) and £8.97 (gas) in 2017 prices.

³ Ofgem (5 August 2021), Price Cap – Decision on PPM SMNCC allowance, p.25, article 2.69-2.71

Ofgem therefore makes provision for suppliers to recover this amount. The issue is in the way in which the provision is applied. Ofgem unjustifiably limits the application of the offset such that if the pre-offset SMNCC is positive, no offset is applied. However, if the pre-offset SMNCC is negative then the offset is applied, but only up until the PPM SMNCC is £0.

Ofgem justifies the approach by saying that it protects prepay customers from a sudden increase in prices, and that where suppliers have an average mix of customers across payment methods, the underestimation of the PPM uplift is compensated by overestimation of the main DTC. We do not believe that forcing credit customers to cross-subsidise prepay customers is justified, but in any case, the sums are so unequal, that the approach only works if a supplier has substantially more credit than prepay customers.

Ofgem acknowledges this point, but fails to offer any remedy, preferring to “err on the side of ...underfunding suppliers who serve less of the market”⁴. This approach is unacceptable, it penalises and discourages suppliers - such as Utilita – who specialise in doing our best to meet the needs of the very customers that Ofgem says it wants to protect by this decision.

Ofgem should allow the full cost offset to be applied in each period, to ensure that all suppliers (especially those trying to serve prepay customers) can meet their costs.

The previous under-recovery should also be permitted. Ofgem should deliver this by using the Advanced Payments Adjustments mechanism to compensate suppliers for its failure to fully apply the cost offset in prior periods.

4. *Traditional Electricity PPM Amortisation Period*

Ofgem applies an inconsistent approach in terms of alignment of amortisation periods, asset lives and PRCs. In this case, it sets the amortisation period for traditional electricity PPMs equal to the meter asset life (15 years), when it should be set equal to the period of liability for PRCs (14 years) – as had been the case previously.

Ofgem supports this decision by stating the amortisation period could plausibly be aligned to either asset life or PRC, and that they selected asset life to align to the approach on credit meters and the 2019 CBA⁵. Unfortunately, this does not reflect the underlying purpose.

Amortisation period and PRCs allow the orderly commercial expression of risk-sharing. PRCs compensate MAPs when an asset is replaced before the investment cost has been covered by rental income. Allowing MAPs to achieve [certainty of] cost recovery reduces their cost of capital, with associated benefits. If the PRC term is shorter than the amortisation period, this certainty (and benefit) is lost, increasing costs. Consequently, the PRC period needs to be at least as long as the amortisation period, rather than aligning to the technical life of the asset.

While Ofgem has linked amortisation period to asset life for credit meters, this is incorrect, and does not justify repeating the error for prepay meters. Although the 2019 CBA appears to use the same assumption for asset lives, we believe that in this case, the same assumption is used for all three – asset lives, PRC period and amortisation period. As all three match - the problem is avoided.

4 Ofgem (5 August 2021), Price Cap – Decision on PPM SMNCC allowance, p. 73, Article 3.111

5 Ofgem (February 2022), Decision – Price Cap – February 2022 decision on credit and PPM SMNCC allowances, p. 23 article 2.67

5. Traditional Gas PPM Asset Life

Ofgem has set the traditional gas PPM asset life to 12 years, we consider that this is too low. NERA's previous analysis showed that the traditional gas PPM asset life should be 15 years, based on analysis of the supplier data disclosed.

In contrast, Ofgem claims that the selection of a 12-year asset life is supported by the same data using an 'implied expiry' approach⁶. The description of the approach made available is only at a high level; NERA advise that the actual analysis used to support the claim is not included in the disclosed data, so this cannot be confirmed.

However, based on the available description of the Implied Expiry (IE) approach, it may be flawed:

- The IE approach estimates the number of meters expiring at each age tt by subtracting the number of meters observed at age $tt+1$ from the number of meters observed at age tt , after a starting point from which the number of meters declines with age.
- This method of estimating the number of meters expiring at each age relies on the implausible assumption that the only driver of difference in the number of meters by ages is meter expiry. In reality, other factors (such as fluctuations in the number of meters installed per year) also affect the number of meters at each age.
- The disclosed data show the implausibility of Ofgem's assumption: for some ages after the starting point, the number of meters at age $tt+1$ exceeds the number of meters at age tt . If Ofgem's assumption were correct that the only factor that affects the number of meters of different ages were expiry, one could only have more meters of age $t+1$ than age t where older meters were somehow brought back into operation after expiry. Ofgem does not explain how it accounts for such increases in meter numbers.

NERA's preferred approach, previously shared, compared distributions of meters. Ofgem rejected this 'Comparing Distributions' approach, commenting only that it "overstates the importance of the 'tail' as the tail would represent a greater fraction of the remaining meters"⁷.

6. Traditional Gas PPM PRC term and Amortisation Period

Ofgem sets the traditional PPM PRC term to 12 years for gas, we believe this is too low. In previous submissions, NERA advised their analysis found that the traditional gas PPM PRC term should be 15 years based on analysis of supplier data from the September 2019 RFI.

Ofgem's analysis produces a 13 year PPM PRC term, but it proposes to cap the value at 12 years as it considers it implausible that the PRC term would exceed the asset life. Looking at the relationship of PRC term and the technical life of the meter asset, there are two options:

- PRC terms and technical asset lives may vary - as above, PRCs are a commercial construct to support risk-sharing and will reflect commercial negotiations related to recovery of metering costs, including placing some costs at the end of the meter lives as PRCs. If this is the case and this option is chosen, the Ofgem decision should reflect the evidence, which does not support the artificial capping of the PRCs

⁶ Ofgem (February 2022), Decision – Price Cap – February 2022 decision on credit and PPM SMNCC allowances, p. 13 article 2.21-2.26 and p. 67 Appendix 10

⁷ Ofgem (February 2022), Decision – Price Cap – February 2022 decision on credit and PPM SMNCC allowances, p. 13 article 2.20

- PRC terms and technical asset lives must align because commercial parties would not pay penalties for the removal of average meters. This tends to evidence that the approach to meter age data is flawed and the estimated asset life of 12 years is too low.

NERA further advises that exclusion of two sets of meter age data in the disclosed data is not fully explained. If they include these data, and apply Ofgem's method to estimate the PRC term, a PRC term of 15 years results, which is consistent with their previous findings and our submissions.

7. Extant Traditional Gas PPM Age Profile

Ofgem excludes the same two sets of meter age data as noted above from the calculation of the age profile of extant traditional gas PPMs. NERA advised that both datasets included large numbers of younger meters. We believe that this may have had the consequence that Ofgem underestimates the degree of premature replacement occurring and consequently to underestimate the present-day costs of smart metering.

In conclusion, we continue to believe that Ofgem has failed to update the prepay SMNCC in a way which fairly reflects the costs faced by suppliers to prepay customers. Ofgem has perpetuated pre-existing errors, continued to prevent prepay suppliers recovering their efficient costs and has not taken this opportunity to correct the present errors or the past under-recoveries.

Instead, Ofgem has continued to enforce an unjustified cross-subsidy into the market, which favours larger suppliers with smaller prepay portfolios and operates to discourage specialist suppliers who want to offer a high-quality service to this market sector.

Finally, Ofgem has failed to fairly reflect the costs of managing debt on prepay meters, erroneously assuming that a minimal allowance in the credit cap might meet the cost 'tail' of managing debt on prepay meters.

We hope this submission has been helpful, and would, of course, be happy to discuss any points in more detail with the team.

Yours sincerely,

Alison Russell
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