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03 January 2023

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Dear David,

Re: Statutory Consultation: Strengthening Financial Controls; EFRP SLC Notice – ELEC; EFRP SLC Notice – GAS; CCB SLC Notice – ELEC; CCB SLC Notice – GAS

Thank you for the opportunity to comment on the above statutory consultation and licence drafting. As you are aware, Utilita has engaged actively on both the full suite of industry reform and resilience consultations over the last eighteen months and on the price cap throughout its life in its original and successor forms (now referred to as the Default Tariff Cap or DTC). In the case of the DTC, we have also engaged specialist advisers to participate in confidentiality rings, and to further support our arguments with expert advice and analysis.

We have welcomed Ofgem moving to act to improve resilience and support a number of actions taken, for example the ban on acquisition tariffs, protecting credit balances and addressing issues around mutualisation of failures. We have also been clear that we believe such actions are overdue. We believe that the Select Committee correctly identified a number of regulatory failings by Ofgem, and we understand Ofgem's need to move quickly to be seen to address the Select Committee's concerns.

We also note that Ofgem's proposed approach to supplier costs and resourcing remains unchanged; by refusing to change we believe Ofgem risks further failures. Following the Select Committee's report, as well as the feedback it has clearly received from banks and the investor community, we had hoped that Ofgem would implement a more realistic and practical approach to costs, including explicit funding of key obligations. The approach needs to reflect a robust bottom-up assessment of regulatory demands made[1], the realistic costs of meeting those demands and then make a proper allowance in each case.

Over the last year, the MCR demands, increased regular and adhoc reporting, stress testing and other demands on suppliers have escalated and continue to increase. These demands carry costs which must be capable of being met by suppliers supplying SVT customers under a price cap. This has been demonstrated clearly following the flight of Fixed Term Contract customers to SVT in the wake of the energy crisis, and the difficulties arising as a consequence.

Ofgem's approach of noting that as these, and other demands to date have been met by suppliers, no extra funding is necessary fails to reflect lost opportunity costs, levels of demands made, and most critically, the resulting balance sheet depredations which has rendered the sector unattractive to investors. Asserting financial resilience requirements without funding them will not make them happen. Suppliers need time, normal profits and regulatory certainty to make repairs.

Moving to proposals made in the consultation, we disagree with the approach of requiring a fixed £amount of net assets per customer across the industry. The minimum capital requirement must be

[1] Whether the regulatory demands relate to, for example, capital adequacy, financial support given to customers who cannot pay for their energy, regulatory reporting required, or any other supplier obligations specified by Ofgem.

linked to price and the individual supplier's risk, with matching of assets and liabilities. Ofgem recognise this in section 3.4 of the associated Guidance, but the proposed minimum range of £110-220 per customer does not achieve the desired result. This sum far exceeds the practical requirement minimum for Utilita, given our business model of mainly smart prepay.

Ofgem recognises that further future changes will be needed and that this approach would be more complicated, but it is unclear why these changes cannot be implemented before April 2025 with the current range of £110-220 to be used as an initial guide (subject to business model). In section 4.62 of the Impact Assessment (IA) Ofgem has proposed an approach to weight the WACC, so it is unclear why this approach cannot simply be extended to individual suppliers' capital requirements.

We note that while Utilita does not operate net assets per customer at these levels, our smart prepay business model in combination with our levels of efficiency and hedging policy has meant that we have been able to weather these crises.

It remains our view that a minimum capital requirement regime is not compatible with a price capped environment. Ofgem should ensure suppliers are adequately capitalised and properly remunerated for the risks they are taking; allow suppliers to manage their risks (including price) accordingly, and rely on market forces, competition and innovation ensuring fair prices for consumers[2].

We are also disappointed in Ofgem's terminology of "ratchet up" as this implies that there will be continued pressure to continue to increase capital when cautious and prudent business models may actually require less than the set £net assets per customer. We believe this will lead to discrimination against business models like Utilita's as well as imposing inefficient financial arrangements on some supplier business models while other business models are actively being supported, for example by not requiring protection of CCBs.

Ofgem recognises that 93% of the SoLR levy claims are for unhedged energy with the balance being RO or CCBs (IA, paragraph 4.35). This consultation is disproportionate in its approach to the underlying issue of unhedged energy, these costs came from both small and large suppliers. The difference being larger suppliers had enough reserves to continue trading until Ofgem was faced with a 'too big to fail' situation and added the unexpected SVT demand allowance allowing suppliers to recover their losses.

Within the IA (4.92) we are concerned by Ofgem's assumption that Large legacy suppliers will retain 75% of hedges during a SAR while Challengers will only retain 20%. While this reflects historic data and may be out of date it highlights the need for Ofgem to implement a minimum capital requirement for each supplier based on their risks and business model, rather than a one size fits all policy. There is a 55% difference between these two categories of suppliers where currently both will be required to hold the same level of net assets.

Ofgem also recognise this in 4.34 (IA) and go on in 4.36 (IA) to assume the value of hedges of a large supplier exceeds the capital requirements and therefore does not incur a cost of the capital adequacy requirements. Utilita is not considered Large or Challenger supplier under these definitions, but it is well hedged and does not have the implied net assets required of £80m to £176m.

While the net assets definition is a simple one, unfortunately it is too simple to achieve Ofgem's goals efficiently. The definition of net assets includes illiquid fixed assets and does not take into account any off balance sheet assets or liabilities. We understand that Ofgem's consideration excludes long term liabilities (3.47) but we disagree with this assessment, we consider that a proportion of long-term liabilities could prudently be included.

[2] Please note that Utilita does support some form of properly allocated and funded social tariff to support the most vulnerable in our communities, but we have not made further reference to this point in this consultation.

There are only two ways to increase Net Assets:

> New equity – this is likely to be at the expense of existing shareholders who are also likely to have endured no returns for the last few years due to the DTC and Ofgem policy failures over a prolonged period of time. There is currently no new investment case for Utilita while Ofgem continues to discriminate against its business model. An increase in margin and reduction in risk is required
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> Retained profits – this requires suppliers to be able to make and retain profits. Ofgem proposes that no additional allowance be made for the minimum capital requirements. If the price cap is to be correct (which we dispute) and suppliers can make a 1.9% profit then it would take between 5 and 10 years to produce the level of capital required, based on an (historic) average of £1,100 per annum dual fuel bill.

Ofgem also suggests that the reason no new allowance is required for the minimum capital requirements (IA 4.70) as it was already included by the CMA, yet Ofgem has already implicitly admitted by its actions in increasing the prepay price cap in October 2019 that the CMA price cap model was erroneous and did not reflect the efficient costs of supply. We therefore believe it is inappropriate to continue to rely on this as a basis going forward and must be properly assessed prior to implementation. We further ask that Ofgem specifies where in the DTC algebra and excel models this allowance is included (see appendix A)

Ofgem continues in paragraph 4.70 (IA) to assert the 'moral hazard' that suppliers have chosen not to hold levels of capital. This has not been a choice for suppliers, suppliers have not been able to pay dividends for a number of years and have been incurring losses. This has not been a choice made by suppliers, but an outcome imposed on them by a failure of regulation and poor policy decisions.

New equity and (retained) profits are closely linked, suppliers have been loss making for a number of years, as demonstrated by the infosheets on the Ofgem website, so it is unclear how suppliers are to raise new equity when Ofgem refuses to adjust the price cap to allow a reasonable return.

The FRP and new measures on new entrants mitigates effectively against the risk of smaller suppliers taking excessive risks (as identified in the IA 4.79). This means the focus must be on ensuring the remaining suppliers:

1) adequately price fixed tariffs to cover any future unexpected SVT ensuring that this cost is not borne by SVT customers in the future. It is untenable that going forward an SVT customer picks up the cost of unexpected SVT demand.
2) have suitably hedged FTC or have enough capital to deliver expected volumes under stressed conditions
3) have enough capital to cover margin calls in a falling market
4) have enough capital to cover extreme weather events

We continue to believe that the risk of unexpected SVT can be covered by ensuring an amount of capital is held for each fixed price deal offered. These costs should not be borne by the SVT customers when the 'unexpected SVT' customer (uSVT) has previously benefitted from FTC prices and terms. For example, the quarterly price cap means that a supplier (assuming even distribution of contract end dates) is exposed to 1½ months of unexpected SVT, before excluding any calculation for maximum exposure due to timing of an unexpected SVT event relative to the price cap reference period.

Ofgem can monitor suppliers' hedging policy on FTC, and where suppliers are under hedged can apply the under hedged percentage by month to a value linked to the futures market. No supplier should be offering an FTC without hedging in full of having enough capital to deliver it, and to support their customer afterwards assuming the customer will remain with them, given the Ban on Acquisition Tariffs. This is no different to an insurance company withdrawing products from given markets due to a breach in maximum exposures.

Capital to cover margin calls and weather events should be relative to price and linked to the hedging policy of that supplier and take in to account their specific trading arrangements, for example un-collateralised amounts. A fixed £ per customer will result in suppliers being both under and over-capitalised.

We agree with Ofgem's assessment that over time these measures should reduce the cost of capital but stress that it still needs to enable suppliers to recover their efficient costs. Amongst the various consultations in the last month Ofgem appear to have regard for some different business models but have not address the under recover of efficient costs in the PPM price cap due to cross subsidy between payment methods and erroneous SMNCC allowance and therefore continues to discriminate and cherry pick which business models it supports

While we disagree with Ofgem's decision not to protect CCBs, we agree Ofgem's has a need to support different business models and innovation but reiterate that it is not supporting a Prepay business model which in the long run will disadvantage the most vulnerable in society.

With regard to the protection on CCB's, we require clarity on whether these will remain protected under the SoLR Process (we note in the Impact assessment 2.15 that Ofgem recognises this, but it is not clear if this is the intention). If Ofgem deems it is reasonable not to protect CCBs on the basis of allowing different business models then Ofgem must allow suppliers to differentiate themselves and compete on this basis. Protection of CCBs creates a moral hazard and incentive for consumers to seek the lowest price regardless of the business model chosen.

In principle we agree with the ringfencing of ROs and have responded accordingly but would like to draw specific attention to our response in question 12. It is unclear what the consequences are should a supplier not have the required capital to ringfence the RO balances or alternative methods do not meet the licence conditions due to charges placed on the company.

In all our correspondence and meetings with Ofgem since the introduction of the price cap Utilita have repeatedly informed Ofgem that the price cap was inadequate and predicted the failure of suppliers. We have also shared specific details of the losses that Utilita has made over the years due to errors in the price cap which has reduced our resilience, we have also informed Ofgem that continued policy failings have made the Supply sector a higher risk with limited returns and therefore less investable which all culminate in the risk of suppliers not being able to meet the obligation as it is currently proposed.

We trust this submission has been helpful and we would welcome the opportunity for a discussion of any points in more detail. Please contact my colleague, Alison Russell who will be happy to co-ordinate.

Yours sincerely

By email only

Ashley Milne
Chief Financial Officer