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By email only

Dear Anna,

Re: Safeguard Tariff Cap Development

Working Paper #4: Treatment of environmental and social obligation costs under the default tariff cap

Working Paper #5: Updated competitive reference price

This submission together with the attached confidential appendix comprises Utilita's response to the two working papers above.

We do not believe that the proposed cap is an appropriate measure at this time. The CMA identified that the Big Six had a wide range of prices. We believe this is what was both restricting the growth of competition, and resulting in some customers paying excessive prices. We therefore believe a relative price cap on the Big Six is what is required, and would note that such a cap avoids much of the complication and risk of adverse consequences that these Working Papers are addressing.

Our experience of the Prepayment Charge Restriction (PPM Cap) has given us a unique insight into the methodology used by the CMA to establish the PPM Cap, which has demonstrated a number of deficiencies in its design, that we believe are resulting in market distortions undermining the original aims. These deficiencies should be looked at closely by Ofgem, and remedied before finalising the methodology of the default tariff cap currently proposed.

The key issue for this response is the current approach used within the PPM Cap to remunerate suppliers for their environmental and social policy costs. We have included a confidential appendix to this submission which sets out detailed analysis of environmental and social policy costs, and how their current treatment operates under the PPM Cap.

It is essential to recognise the intention behind the default tariff cap. That intention is to protect customers from excessive charging on poor value standard variable tariffs, it is not to create a perfect supplier, set a supply price control by the back door, or to remove competitive incentives from the market. Equally the default tariff cap should not result in unsustainable, uncompetitive tariffs which may produce further price convergence to the detriment of consumers.

This means that the default tariff cap must reflect the reasonable costs of a supplier doing business under normal circumstances, and with the ability to make normal profits. Suppliers will then make efficient decisions on how to compete for customers, and customers in their choice of supplier product offering.

While we are in agreement with Ofgem's approach of examining aspects of its thinking in working papers in advance of the consultation document, we have concerns in a number of areas.

Unless these issues are properly addressed, we fear the same problems will be replicated in the default tariff cap. We comment on each working paper in turn below.

Working Paper #4

Controllability and predictability of costs

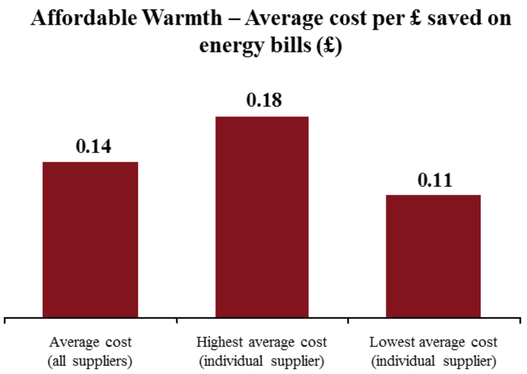
We are in general agreement with Ofgem's assessment of the seven current social and environmental schemes, and whether suppliers have the ability to exert any material control over the cost of complying with the schemes.

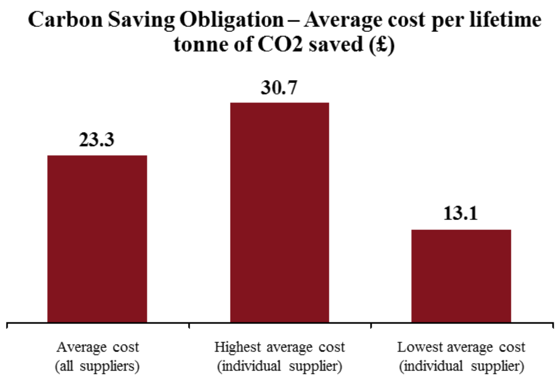
Under the Renewables Obligation (RO), Ofgem must consider the buyout price and the level of the RO in each year. As this is published in advance, it is a straightforward matter to use actual figures in this case. While we note suppliers may achieve some limited cost benefit, for example, by paying for certificates early, this will have associated costs the supplier will trade off, and so should not be subject to effective penalty.

In respect of the Energy Company Obligation (ECO), there is a substantial body of evidence that the cost of meeting suppliers' ECO targets varies by supplier and by period (see our confidential appendix). We believe that the CMA's approach to remunerating policy costs in the PPM Cap was fundamentally flawed due to the failure to reflect this variation. There are several issues in this area with the PPM Cap, which we describe below:

a) The CMA took as a point estimate of total policy costs in 2015, the average of the six large energy firms' (SLEFs) environmental and social policy costs published in their Consolidated Segmental Statements (CSS). This point estimate did not definitively represent the costs of compliance in that year to meet companies' ECO targets. For example, suppliers' costs are not necessarily the same year on year, with potential adjustments or carry forwards between years. A single year estimate will therefore not offer an accurate or proportionate picture of the costs faced by one supplier in meeting their total ECO targets.

b) Suppliers report substantial differences in the costs of meeting their ECO targets. The charts below show the ranges in costs reported by suppliers in complying with the Affordable Warmth and Carbon Savings Obligations from April to December 2017[1]. These figures are notable for the wide variation between highest and lowest costs. This shows using averages can mask major differences between suppliers, and failure to address this issue will adversely impact those suppliers with higher costs of compliance.





c) As Ofgem notes, suppliers may have some choice in methods of compliance, however certain key elements of meeting suppliers' ECO obligations are outside suppliers' control. For example, SLEFs have major economies of scale. Their size increases buying power, and so substantially reduces the overall costs of ECO compliance. The group of suppliers facing the highest ECO costs (proportionately), are likely to be those that have just become fully obligated and are exiting from the taper mechanism. They have full obligations (as per the SLEFs), but far less buying power to reduce their costs of compliance.

In conclusion, we believe that the ECO allowance in the default tariff cap must not be based on a point estimate or market average, but must ensure that all fully obligated suppliers are able meet their reasonable costs of compliance.

Approach to policy cost allowances

We have considered carefully the options for calculation of historic costs. We believe the most appropriate route will be to apply a straightforward, bottom up approach, applying an index if required. Unnecessary complexity should be avoided. If an index is required, we agree that OBR is generally suitable for use in a domestic cap, providing that no policy changes have occurred mid-period. However, this will only be the case if the baseline is correct, if it is not, use of the OBR as an index will not compensate for the underlying error.

[1] Source: BEIS, Household Energy Efficiency National Statistics (Table 2.81a).

In some cases, policy costs may be known in advance, for example RO costs, in which case, actual costs should be used.

Where actual costs (per kWh) are not known in advance, a simple approach should be applied. For example, with Feed in Tariffs (FiT) costs, taking the cost for a domestic customer in the prior year and indexing to current year would be sufficient. This could then be repeated for each year of the default tariff cap.

It will also be important for Ofgem to make provision for in-period changes. The current drafting of the proposed energy bill considers a six-monthly review of the level of the cap, but makes no provision for a review of the methodology. This is not adequate on the basis that the Government's approach to social and environmental policy may change over the period any default tariff cap is in place.

There should be provision within the mechanism of the cap to flex to accommodate unforeseen changes, whether these are due to the inclusion of additional policies, or significant changes in the costs of existing policies or cap items. Examples noted under the PPM Cap include the change to Eii costs and the major increases in DCC costs which has been recognised by Ofgem during this process.

Working Paper #5

Our general comments above should also be taken to apply to this working paper, as appropriate.

The working paper notes the benefits of familiarity in some approaches. We strongly oppose this as a rationale for repetition, where it is clear that there are significant deficiencies in an approach. Using only two tariffs as the basis for an industry-wide decision, where these did not reflect the range and types of offers available, or costs faced, cannot be considered robust. On this basis we oppose option 2.

While superficially, option 1 may offer some attractions, applying adjustments, selecting and limiting tariffs included to those where the supplier has been selected as 'pricing competitively' may lead to significant and ongoing distortions in the market. We therefore oppose option 1.

Of the remaining two options, we would prefer a properly constructed, thought through, and rigorously tested bottom up approach. This would need to include flexibility for significant change, and would have to accommodate suppliers of varying sizes.

Rigorous development and testing is essential, because very small errors, when applied to a full portfolio, will have extremely serious consequences. The CMA asserted an EBIT of 1.25% to be adequate. Taking an average customer on Ofgem medium consumption, this equates to an annual bill around £1000, and an EBIT of £12.50. An error of half of one percent therefore would wipe out almost half that EBIT. The margins for error are extremely small, and as identified above, the intent of the cap is to protect against excess.

As we have previously noted, we believe that a standard variable default tariff cap should apply only to the SLEFs. If this were the case, a number of the issues identified in this submission would fall away. However, where application is to be universal, the methodology must cater for all types of supplier. Where customers have moved away from SLEFs, they have actively engaged in the market, and can be relied on to engage again if they are not satisfied with the offers made available to them.

If option 3 is to be taken forward, we believe it must reflect prices that relate to a broad cross section of suppliers and to a range of tariffs, both fixed and variable. We also suggest that there could be some form of weighting to ensure that limited (by number), unsustainably low, acquisition tariffs do not unduly influence the reference price. This would avoid market distortion and reflect the range of suppliers and offerings available to consumers in the market, while protecting against excess charges.

Although limiting the benchmark to a smaller number of suppliers may appear simpler, the additional transparency afforded by using a broader cross section will result in a more rigorous approach to identifying an efficient level of costs.

We trust this submission has been helpful, and would be pleased to meet with you to discuss the confidential submission, and any points in this letter in more detail.

Yours sincerely,

By email

Alison Russell
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