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NON-CONFIDENTIAL VERSION

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Dear Anna

DEFAULT TARIFF CAP - STATUTORY CONSULTATION

First Utility welcomes the opportunity to respond to this statutory consultation on setting the default tariff cap (the "**Cap**").

First Utility was one of the first challengers to take on the Big Six, entering the market when the incumbents still controlled more than 99% of domestic energy supply. We are proud to have been part of the "originals" (as described at a recent Cornwall Insights event) and to have helped transform the market into one with intense competition for active customers. Today, First Utility has a circa 3% market share and the independents just over a quarter, a testament to the innovation, low prices and varied service offerings we and others have brought to bear.

We very much recognise that this proud record does not mean our business model is entitled to specific support or particular consideration.

First Utility is, however, entitled to have the impact of this significant regulatory intervention fully considered. And we are deeply concerned that such a tight Cap will disproportionately affect not only First Utility but all scale suppliers with engaged customer bases. This is our principal concern, and relates specifically to the low headroom and profit margin allowed on capped tariffs, and the interface with the Government's policy cost threshold.

As Ofgem's own Impact Assessment acknowledges, the low profit margin on capped tariffs will require even efficient suppliers to increase their Fixed Tariffs. [✂]

This concern is further exacerbated by the moral hazard enabled by the Supplier of Last Resort regime, which allows an important minority of suppliers to both offer irrational prices to win new customers, and to take unsecured large credit balances upfront to fund their working capital, given that any cost to their customers is refunded by the industry.

Our second concern relates to the likely enduring nature of the Cap if initially set too low. It is essential that any price intervention ensures today's competitive market can continue to develop. However, the predicted impact of an overly tight Cap will itself erode such development, making any positive competition assessment in 2020 impossible, and resulting in a Cap sustained beyond this period and likely out to 2023.

Looking back to the lifting of the last energy retail cap, and taking today's political environment into account, it is likely there will be further pressure to continue the Cap even beyond 2023 via new legislation. The longer the Cap is expected to continue, and the longer suppliers believe they will be expected to lose money, the more likely it it is that price competition will cease and suppliers will exit the market. This needs to be factored into Ofgem's decision-making regarding the price of the initial Cap.

Our third concern relates to the time constraint Ofgem believes itself to be under, and the implications of this for the overall robustness of its analysis of consequences and effects of the Cap. Whilst we recognise Ofgem's careful efforts in gathering and reviewing data and views, and its willingness to set out its initial and further analysis and options, a theme of the consultations to date has been what is possible in the time available. Whilst the legislation calls for exercise of Ofgem's duty to impose a market-wide cap "as soon as practicable", and the framing of the competition analysis infers an in-force date, it does not explicitly provide a date by which the Cap must be in place. This feeling of time constraint may have prevented Ofgem fully taking into account its wider statutory duties and objectives, including in relation to the legislation itself. We believe that there are material areas for concern in the weighting and balancing of the matters to which Ofgem must have regard under the Act, and its overall approach to achieving its objective to protect current and future customers.

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The four concerns highlighted above are fully borne out by Ofgem's own Impact Assessment, as we set out in detail below. The fact this Impact Assessment has failed to sufficiently influence the level of the Cap itself underscores our concerns that the implications of this market-wide intervention have not been as fully considered as they could be, above all the lasting detrimental effect on both efficient suppliers and the competitive market as a whole.

As Ofgem acknowledges, the majority of Fixed Tariffs on the market today are loss leading. By capping profit on default tariffs at 1.9%, in order to make a "normal" profit margin of 1.9% across a supply business as a whole, Ofgem's Impact Assessment acknowledges that:

"Suppliers will need to use a combination of increases in Fixed Tariff prices and reductions in operating costs to achieve normal profit".

The Impact Assessment concludes that the Big Six can likely weather this storm:

"Large suppliers tend to have more disengaged customers; therefore, they are more likely to be able to increase Fixed Tariff prices without losing customers."

However,

"Smaller suppliers with less brand recognition and generally more engaged customers, may need to maintain low prices in order to compete", as their engaged customers will otherwise switch away to suppliers with prices *"below the benchmark due to policy cost exemptions".*

In other words, at the current Cap level, Ofgem explicitly acknowledges that the only suppliers able to compete will have either a disengaged customer base (the Big Six) or are below the policy cost exemption thresholds and therefore enjoy more than a £50 advantage (worth c.£27 for Energy Company Obligation (**ECO**), £14 for Warm Home Discount (**WHD**) and up to £20 for Smart).

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We strongly believe that, under such a tight Cap, prices will rise in the longer term as efficient suppliers could well choose to exit the market. This will ultimately undermine competition to a degree which cannot be accepted under the matters to which Ofgem must have regard.

First Utility therefore urges Ofgem to:

1. Ensure all costs are fully allocated under the Cap, including in particular the appropriate uplift for Unidentified Gas. The 0.96% allowed by Ofgem (£2.17 on an annualised basis) is materially divorced from the actual costs suppliers are facing, [✂], a material sum given that just £20 profit margin is to be allowed.

2. Refresh the Impact Assessment to consider the impact on all suppliers. We note that the Impact Assessment "*only considered the largest six suppliers"* at an individual level; this is

not sufficient given this is a whole-of-market cap, and non -Big Six players have close to a 25% market share. Ofgem must also set out the views of key analysts regarding the length, duration and effects of the Cap, to demonstrate it has adequately considered market sentiment.

3. Where adverse impacts are identified, propose appropriate mitigations, such as recommending Government remove the Policy Cost threshold as a condition for extending the Cap beyond 2020, and immediately reforming the Supplier of Last Resort regime.

4. Given the adverse and material impacts suggested above, propose a Cap with initially higher headroom, such as Option 3 of the Impact Assessment, a Cap of £1,164 (with UIG and other adjustments on top of this) with headroom of c. £38. We note that, at this level, the average default tariff customer can still expect to see savings of £60 in 2017 prices; and up to £131 in some cases. The worst of the overcharging would therefore be curbed, but with the ability for *"more suppliers to continue to compete under the cap with lower Fixed Tariff prices"*, according to Ofgem's own Impact Assessment.

Given Ofgem's admitted "*significant uncertainty*" regarding *"the indirect impacts of the cap"* on *"suppliers and consumers, and the subsequent market dynamics",* together with an acknowledgment that the Cap would have a stronger impact the longer it is place, we urge Ofgem to err on the side of initial caution.

Ofgem could decrease initial headroom over time once both the initial impact of the Cap and its likely duration was clearer, giving the Regulator more opportunity to respond to events.

Below we now discuss these positions in more detail, with as much consideration as possible in the short time allowed.

<u>In Detail</u>
<u>Cost Stack</u>

We welcome Ofgem's careful consideration of matters raised in the previous consultation, in particular its decision to choose a "Bottom Up Cost Assessment", which is transparent and reasonably robust.

On wholesale costs, we welcome Ofgem's decisions to change the winter/summer ratios to better reflect higher gas use; to apply loss factors calculated over the chargeable peak periods as per our earlier suggestion; and to include allowances for forecast error and imbalance; shaping; volatility and risk, at levels we broadly support.

We welcome the allowance for transaction costs, but suggest [✂] as a minimum (rather than 0.38% for elec and 0.32% for gas), [✂]. While this is a small component of cost, it is important not to disincentivise hedging, especially given failure to do so increases the risk of supplier failure, which is fully indemnified by the rest of industry.

The need to incentivise hedging is especially important given the Impact Assessment notes that power market liquidity might further decline as suppliers move to a the common 6-2-12 hedging strategy. In this respect, we are deeply concerned that, in August, Ofgem proposed to suspend the Market Making Obligation (**MMO**), which requires the Big Six "vertically integrated" suppliers to act as market makers by mandating them to trade certain products openly at certain times of the day.

We believe that suspending the MMO ahead of winter will result in a sharp reduction in GB wholesale market liquidity, significantly increasing the cost for independent suppliers buying electricity, thereby reducing competition and increasing costs at a time when the Cap itself will further decrease liquidity.

In addition, the structure of the wholesale component of the Cap itself relies on reported prices being an accurate reflection of the costs suppliers actually face; as liquidity declines further, this will be less accurate and the risk premia for independent suppliers will by necessity need to increase.

For these reasons, Ofgem should maintain the MMO until an appropriate alternative liquidity support measure can be introduced in 2019.

We also have significant concerns regarding the treatment of Unidentified Gas. The 0.96% (£2.17 on an annualised basis) used by Ofgem is the figure defined by the Allocation of Unidentified Gas Expert (AUGE) as the <u>ideal</u> number to aim for as for the whole industry over a fouryear period: it is not a reflection of current reality, or the reflection of the fact that domestic-only suppliers face significant extra undue costs due to the allocation process

feeding the cost towards residential supply points. The industry average is closer to 6%, [✂] for the first Cap period alone, a material sum given the £20 profit margin allowed.

Ofgem is correct that suppliers do have a part to play by submitting more readings. However even the most prudent of suppliers (e.g. those which submit a portfolio-wide meter reading every 12 months) will need to make allowances for the issue of Temporary UIG until other domestic suppliers submit meter readings. This can take up to four years and may not fully reconcile, with “Temporary” UIG then becoming a “Permanent” cost.

In addition, Ofgem does not take into consideration the issues caused by I&C shippers (who are not impacted by the Cap), including only 67% of daily readings being provided.

Whilst Xoserve is leading a cross industry project, they have gone on record to say that they are not responsible for reducing volatility of UIG. Xoserve will provide recommendations to the industry once the task force has completed its work and it will be the responsibility of the industry to implement any proposed improvements through industry code at additional cost to us.

Ofgem do not consider that these uncertainties warrant explicit allowance in the Cap however any improvements will likely take a minimum of 12 months to develop and deliver. We urge Ofgem to increase this allowance given the material cost to suppliers.

On the Capacity Market, we welcome Ofgem correctly indexing clearing prices to CPI and applying loss factors calculated over the winter peak period per our suggestion. A full appropriate costing of the Capacity Market would require allocating the cost to Nov-Feb only, but we recognise this would introduce step changes between Cap periods so we understand why Ofgem does not want to do this. However, we note this adds more pricing risk to suppliers and should be considered as part of the headroom allowance, alongside the volatility of CfDs.

In terms of the 6-2-12 hedging strategy, we broadly agree that Ofgem has picked the “least worst” option, but note the basis risk inherent in this approach which is another justification for more appropriate uplifts for risk and volatility. We also note that the proposed suspension of the MMO will mean that the prices that Ofgem propose to use to update the Cap to reproduce a 6-2-12 hedging strategy will become a less accurate reflection of supplier’s actual hedging strategies and the costs that they face in the wholesale market. This creates a serious concern with Ofgem’s proposal to suspend the MMO, as highlighted above, and is why we strongly recommend keeping the MMO in place until an alternative backstop of liquidity has been agreed.

We are also concerned that Ofgem has moved away from its position in the May paper regarding a bespoke approach for the first Cap period in recognition that suppliers may

have bought gas and power already and could therefore be “out of the money”.

The Statutory Consultation Document suggests this proposal had unanimous support from suppliers but that Ofgem changed its mind due to concerns April prices had increased by over 30% and the bespoke approach would have led to a cap £30 p.a. higher (i.e. £1167), costing consumers £7 extra over the first cap period.

We are concerned this revised position risks artificially narrowing the gap between new Fixed Tariffs and the first capped SVT price, which will hamper supplier efforts to encourage customer engagement as the Cap comes in. Most importantly, the revised approach risks a c. £125 jump in the SVT price for the next Cap period, which would be announced just a month after the Cap comes in (in February for the April Cap). We believe such an approach would create significant consumer dissatisfaction and risk bill shock for some over winter, and propose Ofgem instead considers smoothing such a stepped increase as originally proposed.

On Policy Costs, we welcome Ofgem’s considered responce to supplier concerns, moving to £/MWh and £/customer rates for RO, CfD FITs, FITs and AAHEDC.

For CfD FITs, we welcome the inclusion of an uplift for green exempt electricity at the Cap as per our suggestion. Since the May 2018 consultation, BEIS has also consulted on widening the Energy Intensive Industry (**EII**) exemption. If this is approved, but is not included in the Low Carbon Contract Company (**LCCC**)’s IRL or forecasts at the time of setting the Cap, we ask Ofgem to confirm it will undertake a similar adjustment for the additional exempt volumes.

We also recommend Ofgem applies a risk premium to LCCC’s IRL or forecast, as CfD FITs have the volatility of wholesale prices but can’t be hedged by suppliers. Over half of CfD FITs generation is wind and will be getting support per the intermittent market reference price (IMRP) index which uses day ahead prices. This proportion is likely to grow, making a risk premium more important.

Likewise on FiTs, since the May 2018 consultation, BEIS has consulted on widening the EII exemption. Currently, chargeable FITs volumes are taken from the RO calculation. BEIS proposes widening the EII exemption from April 2019 for FITs but only April 2020 for RO. We likewise ask Ofgem to confirm it will make an adjustment to the 2019/20 RO volume if further EII exemption is approved for FITs for 2019/20.

On **Network Costs**, we recognise basing BSUoS on historical final settlement data is the “least worst” option. Currently BSUoS is charged on generation and demand users. We ask Ofgem to confirm it will adjust the final settlement data should industry change proposals result in BSUoS becoming charged only on demand, doubling these costs.

On **Operating Costs**, we welcome Ofgem's approach to the Standard Credit uplift of £83 - although we would welcome clarification as to whether this uplift needs to be consistent across all tariffs.

We welcome the decision to move to an uplift of £83 uplit, given, as discussed as part of the information-gathering exercise, supplier price to compete in the Direct Debit segment. Ofgem's previous proposal to smear the majority of Standard Credit costs across Direct Debit participants would have distorted the benchmark and, more importantly, created a non-cost reflective Standard Credit uplift of just £22, making it difficult for capped suppliers to compete in this segment. We thank Ofgem for its movement here.

That said, as acknowledged by the Impact Assessment, some suppliers have significantly higher operating costs and bad debt due to their customer base. It is therefore appropriate that Ofgem did not select a frontier supplier to set efficient operating costs, but rather lower quartile.

We are confused and concerned, however, by the £5 efficiency DF saving then netted off this lower quartile supplier. We would welcome further clarification on how Ofgem came to this figure (including any other options considered) in order to enable us to consider and respond on this.

In particular, we note that the Impact Assessment makes it clear that achieving top quartile efficiency is already a huge challenge for most suppliers, as, "*in order to achieve normal profit levels, suppliers that maintained Fixed Tariff prices would need to improve profitability by between 1 and 13 percentage points".* Notwithstanding the difficulty in understanding the justification for this adjustment, we would suggest Ofgem removes the £5 efficiency saving and instead increases headroom which could be tightened later if efficiency savings are considered insufficient.

In terms of amortising customer acquisition costs where suppliers have not already done so, we believe Ofgem's decision to use the current switching rate of c 17% to create a five year average customer lifecycle is unreflective of the rapid turnover in the active portion of the market; we believe three years should be the absolute upper-bound here. In simple terms, moving from a five year customer life cycle to three years would add c.£8 - £27 to the cap, a material sum.

Further, we note that today's customer acquisition costs would be unaffordable under the Cap. Ofgem acknowledges today's Cost to Acquire is £60-200. Amortising this over 5 years gives an acquisition cost of £12-40 per annum, meaning that it would take 6.4 years to break even on a non-discounted payback, and over 10 years to make the £20 profit targeted as a "normal" margin under the Cap. A rational supplier simply would not compete for

customers under such a tight Cap. We discuss this more below.

We agree Xoserve and Elexon's costs should be within Operating Costs, but would welcome more transparency around this as they are effectively industry charges: ideally these should be treated as a pass-through (as with Smart Costs) rather than indexed as proposed.

As a general note, Ofgem appears to argue that Operating Costs in 2017 may have been atypically high and that is one reason for the relatively low-level of headroom selected overall: we disagree and consider that industry costs have increased since then and are likely to continue to increase.

On Smart Costs, we thank Ofgem for making the industry charges 'passthrough' element more transparent, but we note transparency of the non-pass-through element could be improved. We broadly welcome the Smart Meter Net Cost Change model proposed and agree it should be updated in October 2019 as costs related to the final stages of the rollout become clearer.

However, we are concerned that not all the costs of faster switching that suppliers face will be included in the DCC Fixed charges. It's unclear how these will be included in the SMNCC or any other components of the Cap. Given the transformational importance of this programme, it is important its impact is properly accounted for.

With these important changes, we believe the overall cost stack is broadly appropriate and we are grateful to Ofgem for its considered work in this area.

We nevertheless have substantive concerns regarding the overall level of the Cap. **The low level of the Cap is the result of judgements regarding the level of headroom (1.45%, except on network costs) and profit (1.9%) allowed on capped tariffs, which we believe need urgent revisiting.** We are particularly concerned that Ofgem has not had appropriate regard to efficient suppliers' ability to finance their activities. This raises a concern that, in the time available, Ofgem has not been able fully to assess and weight the factors to which it should have regard in pursuing its statutory objective. The Impact Assessment raises particularly acute issues of concern here.

<u>Headroom and Profit</u>

The Consultation suggests that the "true" 2017 headroom allowance is £36 (£39 inc VAT) once suppliers consider the "uplift" from Ofgem selecting lower quartile rather than the most efficient supplier as the operating cost benchmark; uplifts for uncertainty in the wholesale allowance and finally the headroom allowance as a whole.

However, the above categories of cost uplifts serve very different purposes to the overall headroom allowance.

For example, Ofgem selected a lower quartile supplier in recognition that there is *"some variation in suppliers' operating costs...that do not relate to the efficiency of the supplier*", above all vulnerability. This judgement is essential in order to meet the Act's requirement for supplier financeability.

Likewise the uplifts for uncertainty and risk in the wholesale allowance form a core part of a supplier's ability to hedge - which Ofgem already admits will likely become more expensive under the Cap -, and to manage uncertainty such as the Beast from the East, or events such as Brexit, which is unmentioned as a potential upcoming risk in the consultation document.

In summary, the risk uplifts highlighted as part of headroom are designed to reflect the average expected actual cost: they are not allocated towards "unknown unknowns" such as errors in calculating costs; and nor are they designed to support competition.

The objective of headroom itself should be to guard against the uncertainties of quantifying and allocating costs; to enable efficient competition below the Cap (to which we will shortly turn); and to consider the inherent uncertainty created by such a significant mass-market intervention. Such uncertainties are why an allowance of £10 in 2017 prices is unacceptably low.

In terms of the low profit margin, the Impact Assessment states a desire for efficient suppliers to make a "normal" EBIT profit margin of 1.9%, versus a market average of 3% today.

We consider that 1.9%, or £20 profit margin per customer across a supplier's base as a whole is an extremely low figure (ignoring the fact this profit is on SVT customers only, which we turn to in a moment)**, given:**

- **the level of political risk in the market;**
- **The increasingly complex and uncertain regulatory regime**, with high penalties for non-compliance. For example, the fine for a delayed switch - even where the supplier is not demonstrably at fault - will be £25 from the end of this year, higher than the "normal" profit margin allowed under the Cap;
- **the amount of investment required in transforming the industry** - including not only mandatory programmes such as Faster Switching, which have not been considered in detail under the Cap, but discretionary investment in innovation such as smart home management, electric heating and transport and peer to peer trading;
- **the returns enjoyed by other market participants in a more secure investment environment**. We note that various industry bodies - who could be considered to have

a degree of security through licence award or long-term contract - earn in the range of 8%-15% margin: DCC's margins for both smart and faster switching partly reflect an assessment of risk and the rightness of reward, with a proportion of margin being at risk. While these may not be direct comparators, we think that review of the 1.9% margin would be justified taking into account other industries and entities within the energy industry.

- **The fact the market is inherently cyclical, tied as it is to wholesale prices**, As the CMA noted in Appendix 9.10 of their Energy Market Investigation, *"Between 2007 and 2009, the Six Large Energy Firms made economic losses on domestic customers of around £125 million per year, while between 2010 and 2014, they made profits in excess of the cost of capital of just under £560 million per year."* We have once again entered a period of high wholesale prices, and this has already and demonstrably significantly impacted supplier profitability.

We finally note that previous Ofgem enquiries, e.g. under the 2011 Retail Market Review proposed an EBIT profit margin of at least 3%.

In spite of these concerns, we reluctantly accept that the CMA's profit figure has become a *de facto* benchmark.

However, it is clear that the CMA believed the 1.9% margin should be applied at the supplier level. We do not believe Ofgem's existing proposals to cap default tariffs at 1.9% will allow an efficient supplier to make a 1.9% return over their portfolio as a whole.

Ofgem has benchmarked efficient operating costs under the Cap (lower quartile with a £5 efficiency reduction - which we comment on above), and then allowed suppliers a 1.9% return on capped default tariffs.

However, because default tariffs typically make up 40% of a supplier's base (with another 15%+ capped on the separate PPM tariff), in order to achieve a "normal" profit of 1.9% across their base as a whole, the Impact Assessment acknowledges that*: "Suppliers are likely to need to use a combination of increases in Fixed Tariff prices and reductions in operating costs to achieve normal profit".* This is of course exacerbated for suppliers like First Utility with a higher proportion of customers on Fixed Tariffs, to which we will shortly turn.

Indeed, the Impact Assessment notes that the market wide EBIT will be -1% post Cap - a fall of 4% points - unless suppliers not only improve their efficiency but increase their Fixed Tariff prices significantly: *"five of the six largest suppliers would not be able to achieve normal profit if they were not able to increase Fixed Tariff prices, unless they improved their efficiency beyond the efficiency level of the most efficient large supplier."*

By setting a Cap which requires even efficient suppliers to significantly increase the price of their Fixed Tariffs in order to make a "normal" return, Ofgem has:

1. Increased the likelihood that more customers will see price increases than price reductions, with serious implications for energy market engagement.
More customers are on Fixed Tariffs (10.7m) than Defaults protected under the Cap (10.2m). At the Cap's current level, Ofgem appears to accept that the majority of capped suppliers will increase Fixed Tariffs, resulting in close to a neutral impact on consumers as a whole. The Impact Assessment argues that this is acceptable because *"whilst we consider it possible that the Cap could result in bill increases for Fixed Tariff customers, there will be redistribution benefits from this that are not reflected in monetised impacts...we would put a greater weight on the social value of savings to these customers compared to those of higher income groups."*

If distribution is an important consideration, we would suggest a more proportionate response would be for Ofgem to continue an extended Safeguard Tariff for vulnerable customers as originally planned. This could be set a lower level than the wider Default Tariff Cap, better supporting vulnerable customers on the one hand and competition on the other as the wider default tariff Cap could be set at a level which would not significantly curtail the Fixed Price market.

[✂] High Fixed Tariffs are not a hypothetical concern: the combination of the upcoming Cap and rising wholesale prices has already had a negative impact which will only increase.

2. Built-in an assumption that even efficient suppliers will be loss-making for a significant period of time.
As the Impact Assessment acknowledges, the average Fixed Tariff length is 18 months, with some substantially longer. As a result, *"in the short run, particularly in the first year of the cap, suppliers may be less able to mitigate the direct impact of the default tariff cap".* This appears to be a disproportionate approach, expressly going against the Act's requirement for Ofgem to have regard to a supplier's ability to finance activities required by the licence.

Such a potentially punitive approach also has implications for and is arguably highly prejudicial to public shareholders (largely pension funds), who will be funding this lost revenue as share prices decline. This will inevitably have implications for the investment climate in the sector, and at a time when innovation is needed and indeed forms a key part of Government initiatives to support consumers (e.g. midata, the just-announced smart data review).

3. Made it unlikely that scale suppliers will compete for new customers. Ofgem acknowledges today's Cost to Acquire is £60-200. Amortising this over 5 years gives an acquisition cost of £12-40 per annum, meaning that it would take 6.4 years to break even and

over 10 years to make the £20 profit targeted as a “normal” margin under the Cap (on a non-discounted payback). This compares with an average customer tenure of 3-4 years for customers that switch.

4. Unilaterally transferred customers from existing to future market participants

There are now more than 70 suppliers in the GB market, many of which are seeking to gain market share through loss-leading acquisition tariffs, a rational strategy in a competitive market where profit can be made over the longer term. Capped suppliers, however, will not be able to match these tariffs and still finance their activities, even where they have improved their efficiency to a level beyond which could be considered reasonable to meet the efficiency objective required by legislation. As a result, the Impact Assessment suggests that *“suppliers could see a reduction in their market share of 7% by pricing their Fixed Tariffs at the cap level”.*

This transfer of customers from existing to future market participants is perverse, unwarranted and clearly demonstrates why the majority of price caps - including Ofgem’s most quoted example of the 2.2% profit margin cap placed on Power NI in Northern Ireland - are placed on dominant incumbent players as a means to curb the potential for abuse of market power, rather than market-wide as in this case.

A Cap which results in efficient players losing market share appears to indicate a lack of balance between the four matters to which Ofgem must have regard under the legislation, above all the need for efficient suppliers to be able to finance the activities authorised by their licence (including the new activities which will likely be demanded over the period of the Cap).

5. Disproportionately impacted suppliers with engaged customer bases because, as the Impact Assessment acknowledges, “*the extent to which a single supplier is able to converge prices depends on the degree to which its own customer base is engaged”.*

The Impact Assessment concludes that: “*Large suppliers tend to have more disengaged customers; therefore, they are more likely to be able to increase Fixed Tariff prices without losing customers, while smaller suppliers with less brand recognition and generally more engaged customers, may need to maintain low prices in order to compete...If these suppliers are unable to offset the reduction in profitability, either through increased Fixed Tariff prices or through reduced costs (either by improving efficiency or cutting controllable costs), then they will make losses. This could result in some suppliers exiting the market.”*

This expressly contradicts Ofgem’s own stated objective to set the Cap at a level where *“it is possible for an efficient supplier to achieve normal profits”*. This seems a disproportionate and even perverse outcome, taking account the legislation’s overarching objective and the matters to which Ofgem must have regard.

As noted earlier in this response, the Impact Assessment "*only considered the largest six suppliers"* at an individual level, which we believe is inappropriate given the far-reaching implications of the market-wide Cap.

6. The issues raised above are compounded by the continuance of the policy cost threshold. Even in a scenario where there were no new entrants seeking to build market-share through loss-leading tariffs, [✂] would still be unable to match the Fixed Tariffs of profitable below-threshold suppliers given the c £40-60 advantage they enjoy (£14 for WHD, £27 for ECO and up to £20 for smart, as Ofgem's Smart Meter Net Cost Change Index now acknowledges).

Indeed, the Impact Assessment expressly acknowledges that: *"Small suppliers may incur costs below the benchmark due to policy cost exemptions. They may also have fewer standard credit customers, meaning they do not require all of the payment method uplift on direct debit tariffs. As such, whilst we would expect Fixed Tariffs available on the market to remain at pre-cap levels of dispersion (relative to underlying costs), we expect this will primarily be from those medium and small suppliers."*

This is an unacceptable competitive distortion and one which needs urgent addressing so as to prevent this Cap becoming wholly discriminatory.

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[✂]

<u>Conclusion</u>

At current Cap levels, Ofgem by its own admission has set up a competitive market which will only continue if suppliers:

- Enjoy a material structural advantage, such as a disengaged customer base (the Big Six) or a policy cost exemption (for below threshold suppliers); OR

- Price irrationally and take a significant and potentially sustained loss to maintain market share (replacing existing customers); OR

- Believe they will be able to increase prices significantly once the Cap period ends in 2020, thereby increasing political pressure to continue the Cap to 2023 and potentially beyond.

In all cases, Ofgem expects Fixed Tariffs significantly to increase in price, resulting in detriment for 10.7 million customers, more than those covered by the Cap, which will further reduce “demand side” competitive pressure as engagement decreases. Such a market will likely see prices rise in the longer term as even efficient suppliers will choose to exit the market and, by Ofgem’s own admission, market entry is likely to decline substantially.

We contend there is a proportionate and simple set of solutions to this problem: a slightly looser Cap, set at a level which allows an efficient supplier to be able to compete for customers; the removal the policy cost threshold beneath the Cap; and the reform of the Supplier of Last Resort process to remove the moral hazard which is facilitating irresponsible pricing.

The above package of measures would largely mitigate the need to increase Fixed Tariffs so aggressively, thereby enabling efficient suppliers with engaged customers to continue to compete and thereby maintaining the competitive market.

This package is also essential to ensure that the four matters to which Ofgem must legally have regard - efficiency, competition, incentives to switch and financeability - are as fully regarded as possible in pursuit of the overall statutory objective to protect current and future customers.

We would be happy to discuss any of the issues raised in this response and to work to provide any further information in as short order as we can if that would be helpful.

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We thank Ofgem once again for its engagement and work and look forward to your final response.

Yours sincerely

[not signed]

Natasha Hobday
Group Policy and Regulation Director