

08 October 2018

Anna Rossington
Deputy Director
Retail Price Regulation
Ofgem
10 South Colonnade
Canary Wharf
London E14 4PU

Email: alisonrussell@utilita.co.uk

By email

Dear Anna,

Re: Statutory Consultation – Default tariff cap

This letter and appendix forms Utilita Energy Limited's (Utilita) response to the Default Tariff Cap (DTC).

Utilita is a smart prepayment supplier, and most of our customers are therefore covered by the Prepayment Charge Restriction (PPM Cap). We do also have a small minority of customers (including vulnerable customers) who pay by credit or direct debit, and who may be impacted by the DTC.

We have engaged actively in the development of both the PPM Cap and the DTC. We have engaged reputable and experienced consultants to assist us in carrying out detailed and robust analysis, which we have shared in confidence with Ofgem and the CMA. This analysis demonstrates conclusively that Utilita is one of the leading suppliers in terms of the efficiency with which we can support PPM customers, including the most vulnerable in that group. We are happy to undertake further confidential discussions based on this analysis.

Our analysis also demonstrated that the PPM Cap, as developed by the CMA, has significant deficiencies, and that the CMA failed to take account of a number of factors affecting the PPM Cap. The result is that the PPM Cap is inadequate and fails to deliver the expected margin and headroom assumed by the CMA. It is important to note that while the amounts associated with each deficiency seem small on a per meter level, when scaled up over a portfolio, with an assumed minimal return of only 1.25% (1.9% in the DTC), the impact is significant.

As we have noted in previous submissions, the CMA, in their EMI Final Report asserted an efficient supplier would be able to make a return of up to 5%. The detailed analysis undertaken for us by external consultants shows this is not the case.

We continue to oppose the imposition of a broad standard variable tariff (SVT) cap across the industry. We believe that it will do great damage to the competitive market, leading to price convergence, reduced choice for customers and consequently a reduction in switching. This has already been evidenced in the short period the PPM Cap has been in place. Ofgem has identified the risk in the consultation, though based on our experience, we consider the expected effect may be underestimated.

The operation of a cap drives towards a purely cost related culture rather than a differentiated, service-oriented culture. While self-service options may help maintain service standards at efficient cost, the result is likely to be an increased risk of poorer quality service for customers, reflecting the need to minimise operating costs.

As cultural and social drivers change in the wider community, service industries such as energy providers, must be able to compete freely to meet customers' needs using a range of offers. Some customers will be strictly price focused, others will prefer a high flexibility, high service approach, which may cost more. Applying a cap as broad as the DTC removes such choice to the detriment of consumers generally.

We do not believe that the DTC offers anything other than very short-term protection for those customers who are covered by the cap at the expense of those who are not.

The imposition of the DTC fails to address the underlying issue, which is the application of differential prices by incumbent suppliers, to the detriment of customers. The cap also adversely affects all suppliers, whether or not they apply differential prices, to the detriment of the competitive market.

However, we accept that the DTC is being implemented by legislation, and hence an obligation has been placed on Ofgem to bring forward appropriate arrangements.

In the consultation, Ofgem has sought to address many of the key deficiencies we identified, either by their bottom up approach or by specific adjustments. In our view, the issues in the CMA methodology resulted from hasty development of the methodology, at the end of the Energy Market Investigation. Ofgem has undertaken significant additional work, including securing extra data from suppliers, and as a result, has been able to deliver a number of essential improvements.

The improvements include:

- a) More accurately applied policy costs, which better reflect the actual position
- b) Bottom up analysis to support the establishment of an appropriate cap level
- c) An assessed allowance to address previously unrecognised smart metering programme costs
- d) Arrangements in advance to update the smart cost assessment in a timely manner.

These changes mean the cap applied will be more advanced than that developed by the CMA. This will make a significant difference in the sustainability and equitability of the DTC, for Credit and Direct Debit customers.

The CMA EMI Final Report made a number of assumptions about the category of 'other costs'. Following our consultants' analysis on these costs, we can conclusively demonstrate that the increases in DCC costs are not covered by falls in 'other costs'. We are pleased Ofgem has recognised this, and provided a specific adjustment for DCC costs, which will be adjusted.

The CMA also made inadequate allowance for Policy Costs in the PPM Cap, resulting in a permanent under-recovery. The DTC must avoid a similar error. While it appears likely the error will be less than under the PPM Cap, the DTC does not adequately allow for the cost impact of obligations on non-SLEF suppliers. Such suppliers face higher relative costs of fulfilment due to scale. This does not mean that such suppliers are inefficient in the way they manage their costs, simply that they do not have the same leverage on their suppliers. This should not be compounded by the DTC.

While Ofgem has successfully identified and addressed a number of deficiencies, a new issue has been introduced – the approach to UIG. The recognition that UIG presents a substantial risk, and the consequential proposal to include an allowance, is welcome. The issue is in the level. Xoserve is undertaking a detailed programme of analysis to identify cause and reduce the volatility and levels of UIG. Currently, we understand xoserve has quantified the levels of UIG as around 4-8%, and with significant volatility.

Shippers are recipients of UIG rather than being able to control it. Although an individual shipper can submit meter reads for example, unless all comply, those who do submit reads will bear costs more appropriately attributable to those who do not. Under a price cap, this is an unacceptable level of financial risk.

We propose that rather than a fixed allowance of 0.96%, the allowance for UIG should be a parameter, updated with the cap. This will still provide an incentive to reduce UIG but will avoid penalising those shippers who act to reduce UIG.

The second important area Ofgem's change in approach highlights is the risk of gaming between caps. The differing methodologies may provide incentives for inappropriate switching between payment methods. If caps are to be applied, they must be consistently constructed and accurate for all types of customers affected. Ofgem has addressed this where it is within their control, by incorporating the Safeguard Tariff within the DTC.

The DTC as designed can accommodate variation. This is demonstrated by the inclusion of two different payment methods. Ofgem should raise these issues and advantages with the CMA, who are due to commence a review into the PPM cap in January 2019.

We can see no logic to the CMA maintaining a different cap structure or undertaking further extensive work. Operating two different structures will only create additional complexity for Ofgem to monitor and bring no benefit. Ofgem's analysis for the DTC has been extensive, and used data more current to the cap setting than the CMA used for the PPM Cap.

The CMA undertook limited analysis to calculate a PPM uplift as part of the implementation of the PPM Cap, and Ofgem used the final figure as a proxy to normalise the Credit/Direct Debit

calculations. While utilising the CMA figures for this purpose, Ofgem notes that it has not completed full PPM modelling.

However, in calculating the PPM uplift, the CMA failed to adequately substantiate their reason for selecting an increment of £63 (£66.50, indexed), rather than figure which more accurately reflected general PPM costs. This would have been at the higher end of the range, given the identified cost differential of £76¹. The range in the EMI Final Report was £50.49-£80.60 (£53.30-£85.08, indexed).

We believe that Ofgem should use their models, and updated data, to assist the CMA in refreshing the calculation of the PPM Uplift. The PPM Cap should then be incorporated within the structure of the DTC and the updated uplift applied. This would produce a consistent approach for customers, reducing the risk of cross subsidy and customer detriment.

In addition, Ofgem should use their understanding of PPM and vulnerable customer requirements as specified in the supply licence, to help the CMA identify deficiencies in the PPM Uplift. While the CMA recognised serving PPM customers is higher cost, we believe the analysis to be incomplete. The CMA did not accommodate a number of factors in their methodology, so the uplift figure chosen (nearer the lower bound) did not reflect actual costs to serve. The figure calculated by the CMA for the SLEFs would better reflect the generality of PPM customers. Many are vulnerable, needing extra help and support – others will simply contact their supplier more frequently for help, especially when newly installed.

The CMA also dismissed the relevance of PPM debt, asserting the supplier had previously received the benefit of additional revenue from the customer while in credit mode. This is only true where the customer has previously been a credit customer, on a more expensive tariff, with the same supplier.

This is often not the case. PPM customers may have acquired debt due to a variety of reasons, the most common are:

- paying off discretionary credits provided to PPM customers on customer (or Citizens Advice) request due to self-disconnection; and
- Debt up to £500 per meter brought with the customer under the Debt Assignment Protocol

In both cases, the supplier has licence obligations which mean these activities are rarely elective. Even where the customer has previously paid by credit, they may not have paid a higher rate to cover the bad debt expense. For example, Utilita operates a simple, fair charging policy, which is not differentiated by payment method.

¹ EMI, Final Report. Appendix 9.8, Para 162. "Our analysis has provided a number of potential estimates of an efficient differential in the costs of serving PPM as opposed to DD customers: (a) Under the approach put forward by SSE to identifying the cost differential for the efficient supplier (i.e. identifying the most efficient DD supplier for each fuel and comparing these costs with those of the most efficient PPM provider for each fuel), this gives a DD-PPM cost differential of £60 (£26 for electricity, £34 for gas). We also considered what the differentials would be if Utility Warehouse were excluded from the comparison set, i.e. only the cost data of the Six Large Energy Firms were considered. This generated a cost differential of £76 (£22 for electricity and £54 for gas);"

While many of these issues may appear to relate mainly to the PPM Cap, they are equally important for the DTC: SMETS2 PPM customers will be subject to the DTC. This is a strong argument for consistency of approach between the caps to avoid customer confusion.

We have set out in the following appendix a number of more specific observations relating to the consultation.

In conclusion, while we do not support the implementation of the DTC, we believe that the approach taken by Ofgem addresses some of the most significant deficiencies in the PPM Cap. The analysis is more robust, in particular the bottom up approach applied and the recognition that the Smart Metering costs must be accommodated.

On that basis, we believe that Ofgem should engage robustly with the CMA to ensure that following the required review of the PPM Cap in January 2019, that Cap is rolled into the DTC. This would be an efficient and economic approach, with the main requirement being for the PPM Uplift to be appropriately updated to ensure that the operating costs associated with all required licence conditions are incorporated.

We would welcome an opportunity to discuss these issues with the team in detail and would be happy to contribute to the necessary analysis.

Yours sincerely,

By email

Alison Russell
Director of Policy and Regulatory Affairs

Appendix 1 – Questions for clarification and issues on the Main Document and Appendices

Under each sub heading, we have described the issue or concern and located the document reference to which it applies.

Main document

Page 9

It is unclear whether the proposal to move Warm Home Discount Safeguard Tariff customers to the DTC applies only to Credit and Direct Debit Customers, or whether this would also apply to Prepayment customers. We would appreciate clarification.

Para 2.17

In respect of Unidentified Gas (UIG) we note the extensive work being undertaken by Xoserve at present and believe the DTC must be designed to accommodate ongoing developments. At present, shippers are recipients of the impact of UIG, and while to some extent they can assist in resolution by submission of data, they are financially exposed to the failures of other shippers who may not have submitted data. A shipper acting efficiently and submitting meter readings for all its sites will still be affected by the performance of other shippers that do not do so. This acts as a disincentive and unfairly applies additional risk to compliant shippers.

The costs associated with the current levels of UIG are not adequately covered by the proposed approach in the consultation. The minimal proposed allowance does not reflect the external nature of the risk and the lack of control available to shippers.

Activities are underway to improve these issues, but Xoserve has identified that currently UIG is much higher than the 0.96% proposed. As this is a factor external to shippers we believe that rather than 0.96% being a fixed number, it should be a parameter, which can be supplied by Xoserve and updated at appropriate intervals.

Para 2.23

This paragraph may be contradictory. The document asserts that the approach of the DTC to hedging is not intended to be an instruction to follow. However, the paragraph also states that Ofgem expects suppliers to change strategy to reflect the allowance. This dictates the risk mitigation strategies suppliers may wish to use and may result in Ofgem actually shaping the market.

Para 2.63

In this paragraph Ofgem confirms the selection of the lower quartile supplier as the efficiency “frontier” and confirms an additional £5 per dual fuel customer is to be deducted to sharpen incentives to improve efficiency.

Ofgem does not provide analysis or substantiation for this figure, and so it should be excluded. While £5 dual fuel sounds a small sum, when operating under very tight margins, this is a significant impact, which should not be applied on a purely arbitrary basis. This means that the Dual Fuel cap should be increased by £5.

Appendix 1 – Benchmark Methodology

No additional comments

Appendix 2 – Cap Level Analysis and Headroom

Para 2.13-2.14

Please see section on the main document, para 2.63 above. We do not support the additional arbitrary reduction of £5 from the efficient costs.

TDCVs for gas single rate and electricity multi-rate on page 5 footnote 2 are incorrect. These are stated as 4,100 and 4,600, rather than 12,000 and 4,200 for gas single rate and electricity multi-rate respectively.

Para 4.34

We note that Ofgem does not consider the DTC (or by inference, the PPM Cap) to be a barrier to innovation. We fundamentally disagree.

Currently, in the industry, there are a series of major development programmes, these include half hourly settlement, faster switching and review of customer communications. This is in addition to innovations in their tariffs or services, which suppliers may wish to develop to achieve differentiation and improved customer service. All these activities will require investment by suppliers – some major, some minor – over and above the business as usual costs considered in the development of the caps.

It is important to note that the periods of the caps coincide with the mandated major developments and these must be funded within cap allowances.

Where caps are applied across the market, with assumed minimal returns such as 1.25% and 1.9%, this will act as a constraint both on resources and investment. Suppliers will have to prioritise regulator mandated developments over independent innovation, leading to a stagnating industry over time.

The approach proposed only allows for fixed not variable tariffs to be innovative – and over time will reduce the flexible variable offerings some customers will prefer.

Para 4.64

Ofgem notes that Last Resort supply payments are managed through network charges and so accommodated by the cap. Ofgem also correctly identifies this would not address bad debts which are applied to the industry through an alternative mechanism, and that these may need to be absorbed by headroom.

We do not support this approach. Ofgem proposes that headroom should be severely limited, and it will not be sufficient to cover such bad debts. These debts may well have been incurred due to a supplier inability to operate within the cap. Ofgem acknowledges that suppliers may fail as a result of the cap.

This is a clear recognition of the fact that the proposed DTC is extremely testing on suppliers.

Expecting those suppliers who can manage to operate within the cap to have sufficient leeway to accommodate the bad debts of those who cannot is manifestly unreasonable.

We suggest that Headroom should be a parameter within the DTC so that where bad debts of this type are quantified, an appropriate increment can be applied to the headroom. This would be a better approach than simply increasing headroom as it will only be used if required.

Appendix 3 – Updating the Cap Methodology

Para 3.20

Ofgem confirms in this paragraph that retrospectivity will not apply. While we generally support this approach, noting its consistency with historic industry decisions, we consider that a test of scale may be needed.

We propose that where massive shifts occur mid period - for example due to external factors – either retrospection to the prior period may be needed or an emergency re-opener. The most likely justification would be movements in the wholesale market, which affect all suppliers.

We do not anticipate that this would be used often, but the provision should be available.

Appendix 4 – Wholesale Costs

Para 2.39

We dispute the accuracy of this paragraph. The approach set out does not enable the supplier to choose to manage their risk, it just requires them to accept the level of risk assessed as part of the DTC.

Para 2.50

We do not agree with Ofgem’s approach of 70:30 base/peak split. We modelled the default period profile class coefficients (DPPC) from the industry-standard market domain data (MDD), for the last complete financial year (2017/18). Actual losses (i.e. line-loss factors (LLF), GSP group correction factors (GCF), and transmission loss multipliers (TLM)) were applied, to adjust from meter-level demand to allocation.

The data used for the submission were limited to a single GSP (Midlands_E) for simplicity; Midlands was chosen as being reasonably representative, with loss factors showing greatest variability from the GB average, furthest North or South.

Assuming an aim to initially shape to provide the least variance between initial hedge and final position, an average of the off-peak demand was taken to give a standard baseload forecast. The average peak load position, minus the baseload forecast, provided the standard peak load forecast. In combination, this gave the following outcome:

PC	TYPE	SPLIT
1	BASE	87%
1	PEAK	13%
2	BASE	124%
2	PEAK	-24%

On this basis, demonstrated that standard, actual industry data (DPPCs, LLFs, GCFs, TLMs) produced an 87-13 split for PC01 customers.

For PC02 customers, as off-peak night-time demand exceeds peak day-time demand, the best shaped position would be a baseload hedge greater than peak load, requiring a volume of peak load to be resold, following the baseload purchase. This is impractical for the calculation, so we suggest a 100-0 split would be most appropriate for PC02 customers.

Para 3.15

Please note that we believe sub-point 3 to be incorrect. The data used is single year, not seasonal normal. The data from 2017/2018 as a single year is unsuitable given factors such as the “Beast from the East”.

Para 3.42

Please see previous sections and main letter in respect of our proposals for UIG.

Appendix 5 – Policy and Network Costs

Table 5.2

Please note that there is an error in the table. Warm Home Discount is incorrectly attributed. It should be applied to Electricity only, as this is the basis upon which it is levied. If this is not the case, then if a supplier has an electricity only customer, they will under-recover.

Para 2.40

This paragraph implies imposition by Ofgem of an unlevel threshold and lower opex where suppliers are not obligated. It further assumes that smaller suppliers may enjoy other cost advantages. We do not agree that this reasoning is sufficient. Our analysis has identified that in meeting obligation costs, smaller suppliers who are fully obligated are most frequently at a disadvantage compared to both SLEFs and non-obligated suppliers.

This approach of penalising medium sized suppliers is not productive, these are the suppliers who are most likely to challenge SLEFs to the benefit of consumers. It is therefore essential that Ofgem avoids actively disadvantaging them.

Appendix 6 – Operating costs

Para 2.60

We dispute the approach promulgated in this paragraph. Ofgem clearly agrees that certain suppliers faced different costs due to the customer segments served.

While we agree costs may vary, there is the clear potential for customer benefit, where customers are served by suppliers who are expert in their needs. This needs to be addressed within the DTC rather than being disregarded.

Para 4.1

We support Ofgem’s move to CPIH for the DTC. This should also be applied for consistency to the PPM cap.

Appendix 7 – Smart Metering Costs

We have one key concern over the updating of SMNCC beyond October 2019: Table A7.2 of Appendix 7 assumes roll out rates of smart meters are consistent across suppliers, which is not the case. This underestimates the cap with respect to suppliers who have been installing large numbers of smart meters already. These suppliers will incur costs within the cap period but that can't be recovered until after the cap.

Appendix 8 – Payment Method Uplift

Para 2.18

We note the points in relation to the extra costs of debt collection and increased propensity to call associated with Credit Customers. We agree that this is the case relative to Direct Debit customers. However, PPM customers also have and bring debt which must be managed and have an even higher propensity to contact. There are also extensive administrative costs applicable to PPM customers.

Para 2.55

This paragraph contains inaccuracies. As we identified in our covering letter, PPM customers (including smart PPM customers) can acquire debt while using a PPM meter. This may relate to use of emergency or friendly credit, tends to reduce self-disconnection etc. Ofgem requires suppliers to adopt a constructive and sympathetic approach to such customers. It is therefore only reasonable to acknowledge the consequence of such processes is debt that the customer needs to repay.

It is also essential that Ofgem recognises the impact of the Debt Assignment Protocol (DAP). Suppliers can refuse to transfer credit or DD with debt but must accept PPM customers in accordance with the supplier licence. This means suppliers may be compelled to accept customers with debt up to £500 per meter, where the debt will not have arisen with that supplier. However, the incoming supplier will have the operational costs, including bad debt expense, of managing that debt.

This will be equally true for SMETS2 PPM customers as it is for SMETS1 and traditional meters. It is likely that the costs of managing DAP debt may in fact rise under SMETS2 given the reduction in PPM functionality which will be imposed.

Appendix 9 - EBIT

We dispute that 1.9% is appropriately considered a normal profit for a supplier organisation. The assumption underlying such a conclusion is the same as that of the CMA, that capital employed in a supplier business can be appropriately modelled and costed using the Capital Asset Pricing Model. This is not the case. Suppliers are privately run businesses, facing substantial risks and exposures in the market that network organisations do not. The appropriate return must therefore be considered against competitive companies not against monopoly organisations.

The Weighted Average Cost of Capital quoted also continues to assume an unreflective 10% cost of capital, which is not the case.