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By email

Dear Anna,

Re: Working Paper #1: setting the default tariff cap

Thank you for the opportunity to comment on the working paper. The timeline was short for responses, but we agree that it is helpful for Ofgem to share its evolving thinking in this area through the route of working papers.

Utilita is primarily a smart prepayment supplier, and has carefully considered the paper in the context of our experience under the CMA prepayment charge restriction (PPM Cap). This is relevant to the working paper and the development of the tariff cap and both the PPM cap and the CMA process for implementation offer valuable insights and lessons to be learned.

The working paper does not pose specific consultation questions, we therefore offer both general views and more specific points.

Utilita does not support the implementation of a default tariff cap in the form proposed. We have raised a number of concerns throughout the process, and continue to believe that a general cap is not the right solution. The approach of a default tariff cap risks significant damage to the competitive market. It is essential to consider the damage risks in detail, to ensure that the approach to creating the tariff cap mitigates such issues as far as possible.

The drafting in the Bill implicitly recognises these risks by requiring Ofgem to have regard to the following matters:

a) *The need to create incentives for holders of supply licences to improve their efficiency*
b) *The need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts*
c) *The need to maintain incentives for domestic customers to switch to different domestic supply contracts*

d) *The need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.*

The challenges posed fall into a number of categories.

The risk to switching

The implementation of a default tariff cap risks customers failing to switch, and relying on the existence of a cap to protect them. In the domestic supply market, supplier profits are low, there are significant numbers of challenger organisations and around 20% customers are now with independents.

The implementation of the PPM cap, by failing to adhere to the clear principles laid out in the draft Bill, has led to reduced switching and a reduced choice of offers available to PPM customers.

Implementing a default tariff cap risks the same effects being replicated into the rest of the market. The approach to the cap development must consider how to mitigate this risk.

A relative cap

Utilita and others have highlighted that the application of a default tariff cap does not address the fundamental issue of differential pricing: that acquisition tariffs are supported by large numbers of 'sticky' customers on standard variable tariffs.

A default tariff cap is a very blunt instrument. A relative cap, applied specifically to the SLEFs would be a solution properly tailored to the issue identified.

Combined impacts of policy actions

While not specific to this Working Paper, it will be important to consider throughout the process of development the combined effect of policy actions.

Currently, there is a PPM Cap which has also been extended to the customers benefitting from the Warm Home Discount Scheme (WHD). This doubles up policy impacts with consequential impacts on supplier costs, but only where suppliers are required to participate in the scheme. The outcome is that customers in need receive a variable experience, with some receiving an unsustainable level of double benefit, and some receiving nothing.

We believe that the WHD should not co-exist with tariff caps. The purpose of the WHD when implemented was to reduce the cost of energy for the lowest income households from the very high pre-pay and SVT (non-direct debit) prices being charged by the Big Six. Through the scheme, these low-income households were effectively being given the benefit of lower prices without switching. Eligible customers are now much more widely distributed.

It is also clear that the PPM Cap does not include sufficient margin to give back £140 per customer. Failure to consider the cost of WHD in the default tariff cap risks further embedding the principle of cross subsidy, which is not beneficial for competition in the long run.

Setting a Default Tariff Cap

There are a number of key elements which we believe must be applied in taking interventionist actions such as setting a tariff cap where this is taken forward to mitigate the impacts.

1) As referenced above, the action should be as tailored and accurately targeted as possible. In our view, a generalised cap does not do this.

2) Suppliers must be held neutral to costs they cannot control. This has been established in principle in the PPM cap, but has been poorly implemented. For example, the CMA set out its intention that network costs should be pass through and appropriately indexed. However, the CMA did not take account of DCC costs, which suppliers cannot control, and which are set by Ofgem via the DCC price control. Ofgem must take into account all relevant costs which a supplier cannot control and implement a full pass through arrangement. This would include costs such as DCC or industry change costs as identified in the working paper.

   We also note that there have been recent changes to these indexed costs that need to be reflected in any cap calculation going forward, including in the current safeguard tariffs of PPM and WHD:
   - EII exclusion from the Renewable Obligation cost: The calculation of RO costs is based on market share of demand; the recent exclusion of Energy Intensive Industries means the remaining parties will have a bigger share of the pot to pay for. This will increase supplier costs materially and needs to be indexed accurately.
   - Capacity market: In response to the PPM cap, we previously commented on the omission of the capacity market in the cap calculation. This will need to be addressed as part of the arrangements.

3) The arrangements must be flexible so that providing suppliers comply, they can choose how to deliver compliance. For example, if Ofgem were to implement a standing change and unit rate cap, the compliance test should be on the annual cost, to allow suppliers to choose a full range of tariff structures if they wish.

4) Indexation and the data used must be of sufficient frequency to closely match the costs suppliers face. Setting indexation rates and intervals is notoriously difficult to get right, and mismatches have the potential for serious impacts (please see section below on wholesale costs). The quality and accuracy of indexation will also be affected by the baseline to which it is applied, if this is poor, indexation will not resolve the issue. For example, under the PPM Cap, indexation was weighted using changes in costs of a typical bill, but this did not reflect that PPM customers on average use less energy, particularly gas and hence bill proportions were atypical.

5) Delivery of items such as headroom and margin must be carefully tested in a range of scenarios. This is particularly important where the cap has been set using a small or extreme subset of data as the competitive benchmark. This will be key in ensuring that the matters in the draft bill, such as the ability to compete, incentives and financeability are maintained.

6) The ability to update the methodology. The current drafting in the bill requires that the level of the cap is reviewed at intervals. However, specific provision is not made for a review of the methodology. This is essential, there must be the ability for those

impacted to request review of the cap if necessary. A reasonable hurdle for review would be needed, but if an error in the cap is identified, or an exogenous change occurs which means an update is needed (for example the EII change and alterations to DCC charges), there must be simple and efficient provisions for this to happen without recourse to legislation, the CMA or Judicial Review.

Wholesale costs

The indexation of the price cap has an implicit forward purchasing and risk hedging strategy, as indexation will be based on forward prices at a specific point in time. We identified in our submissions to the CMA that smaller suppliers may struggle to hedge out for a 12 month period as originally proposed, or even the six months of the final proposals. They may also struggle to fund the associated collateral requirements.

In the long run it is unlikely that expected value of returns can be increased by diverging from this implicit forward purchasing strategy, but as retail prices are fixed for a defined period, divergence from this forward purchasing strategy will increase the variability of returns (and therefore costs of capital) without increasing long run expected value. A rational, risk minimizing, approach would therefore be to buy all anticipated volume for prepayment customers for the period ahead at the date used for price cap determination. As a result of the CMA's hedging strategy, energy suppliers attempting to compete for new prepayment customers are exposed to additional risk, as retail prices are limited for the defined period. It will also be relevant to consider timing in terms of when in the year people are most inclined to switch and whether this varies by customer type. More frequent indexation mitigates this exposure.

An energy supplier competing to gain prepayment customers could buy forward contracts for anticipated customer growth and accept the risk that growth targets may not be met, or not hedge price risk and accept greater variability of gross profit. As part of our CMA submission, using the Black Scholes formula, we estimated this risk in the form of an option for a typical customer. We calculated the premium for an Ofgem defined medium user (assuming a frictionless and perfectly liquid market, and therefore an underestimate of the true cost) and compared it to the premium under normal circumstances, assuming prices could not be increased without 30 days' notice.

We found that the additional risk premium imposed by an annual price cap would be extremely significant, but reduced by around three quarters if the cap could be varied quarterly. We continue to believe that more frequent indexation for wholesale prices would be beneficial, acting to reduce risk for smaller and new entrant suppliers and supporting competition.

If suppliers do not wish to respond quarterly, they are clearly at liberty to address this in their retail pricing, but the arrangements should allow the flexibility of supplier choice. This would also support the principles laid down in the draft Bill.

We have not specifically commented on the four methodologies in this submission, but will comment shortly on working paper #2.

We hope these comments have been helpful and would be happy to discuss any points in more detail.

Yours sincerely,

By email

Alison Russell
Director of Policy and Regulatory Affairs