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By email

Dear Anna,

Re: Working Paper #3: Approach to headroom

Thank you for the opportunity to comment on the working paper. 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.

As stated in our previous submissions, we do not support the implementation of a general cap across all standard variable tariffs, as we believe that the issues which it seeks to address would be better managed by the imposition of a relative price cap.

However, if a general cap is to be imposed, in a structure which applies to the whole market, it will be essential to include an appropriately derived amount of headroom. This is required to allow room for incentives and competition to continue. We address the more specific questions raised in the working paper below.

We are also seriously concerned by the assumption in the working paper that fixed tariffs are the only appropriate alternative to default tariffs. There is no reason why this should be the case.

As has been previously identified, while there may be problems with the default standard variable tariffs provided by big six suppliers, non-default standard variable tariffs, such as those offered by challenger companies can provide an attractive, flexible choice for customers. Where the tariff is competitive, and there is no termination fee, this can be equally good (if not better) for customers than a fixed tariff.

Some suppliers offer only a very small number of tariffs, usually variable, in some cases as few as one or two. It is important not to treat these variable tariffs in the same way as the default standard variable tariffs described above.

It is clear under the Prepayment Charge Restriction (PPM Cap), that setting an appropriate tariff cap is extremely difficult and complicated. The costs faced by suppliers are more complex than is often realised, costs of the same type can vary significantly by supplier, and there is a high probability of error.

As accepted by the CMA, the chances of error in setting the PPM Cap are high, and the headroom allowed in the CMA methodology is there (at least in part) to compensate for such error. Even with this allowance, we do not believe that the headroom is sufficient to cover the issues identified with the PPM Cap. If these types of issues were to be repeated, but without an appropriate headroom allowance, the consequences could be significant.

In the working paper, Ofgem notes a risk of headroom causing suppliers to price at the cap, reducing competition and switching rates. This risk would be best addressed by ensuring the headroom allows sufficient room for competition, with costs based on consolidated segmental statements and evidence from other suppliers, appropriately adjusted for one-off events.

The experience of the PPM Cap is that all large prepayment suppliers have priced at or near to the PPM Cap since inception, as the level of headroom is insufficient to generate real competitive pressure. This is further supported by the second tier grouping of suppliers pricing more than £50 below the PPM Cap. These suppliers are of a size where they are not obligated with respect to Warm Home Discount and ECO, and hence do not bear the same levels of policy costs as the larger suppliers. Consumers may not be clear on these differences and be disadvantaged as a result.

We believe that if a cap is created without headroom, switching rates will fall significantly as suppliers will have no room or incentive to compete, while customers will assume the cap provides all the protection they need. This is based on the expectation that if only the efficient level of costs is considered, the expected price difference between an inefficient level of costs and an efficient level may not provide a significant enough incentive for consumers to switch. This also does not account for the difficulty in establishing the efficient level of costs for all suppliers, without creating an artificially tiered market of the type described above.

We are generally supportive of the approach in Table 1, but note the difficulty in establishing the necessary data. The detail of costs, revenue and profit should come from the Consolidated Segmental Statements, this should ensure the cap plus headroom will allow for effective competition to the benefit of customers. The data collection would be much simpler should the relative cap route be taken.

The area of consumer engagement is crucial. Ofgem has already noted the impact on consumer switching under the PPM cap. The PPM Cap has also had impacts on supplier cost of acquisition. Prepayment switch rates and price dispersion under the cap provide evidence of reducing competition due to less price differentiation, and the importance of this issue on a broader scale should not be underestimated.

Finally, in terms of incentives in Table 1, the PPM Cap experience shows that not providing enough headroom can result price convergence at the cap, leading to a lack of competition.

We are encouraged by the recognition of the benefits of addressing the price differential between cheapest and most expensive tariffs, even though this is only presented as a way to engage small suppliers. The proposal does not acknowledge the fundamental issue that we have referenced above, that the biggest issue with price differentials has been seen with the big 6, rather than the smaller suppliers.

We continue to believe that the most appropriate route to address the difficulty is a relative price cap applied to the tariffs of the big six suppliers.

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