

26 June 2020

Anna Rossington
Deputy Director, Future Consumers & Retail Price Protection
Ofgem
10 South Colonnade
London
E14 4PU

Email: BillBullen@utilita.co.uk

Dear Anna,

Re: Protecting energy consumers with prepayment meters: May 2020 Consultation

INTRODUCTION

1. PRELIMINARY POINTS

- 1.1 This is our non-confidential response to Ofgem's statutory consultation "Protecting energy consumers with prepayment meters: May 2020 consultation" dated 18 May 2020. It also constitutes representations in respect of the licence modifications proposed in the statutory notice of 18 May 2020 in order to introduce a new default tariff cap level for prepayment meter customers and, so far as relevant, our representations in respect of the other statutory consultations issued on the same date.¹
- 1.2 As requested, we are responding to the issues, options, and considerations in the consultations and provide our views on Ofgem's proposals to assist Ofgem to reach a rational and justifiable decision in line with its powers and duties and the relevant statutory objectives to which Ofgem is required to adhere and/or have regard.
- 1.3 As a preliminary point, we do not consider that in all the circumstances this consultation (or the others referred to above) has provided sufficient time to enable interested and affected parties to consider the proposals in full (including the confidential model and data provided separately pursuant to undertakings) and provide fully informed and considered responses. This is particularly the case for specialists in the prepayment meter sector like Utilita because at the time of

¹ i.e. the consultations entitled, "Reviewing smart metering costs in the default tariff cap: May 2020 statutory consultation"; "Reassessing the wholesale allowance in the first default cap period: May 2020 consultation"; and the statutory notice of proposed licence modifications (relating to the wholesale allowance adjustment) of 18 May 2020.

the design of the default tariff cap in 2018, prepayment meter customers were subject to a separate price cap and therefore Utilita was not significantly affected by the design of the default tariff cap, meaning that it was disproportionate to engage consultants to review the model and the data in 2018. You have requested feedback on the PPM consultation process in paragraph 1.50 of the consultation (and other consultations) and we provide it here.

- 1.4 The Government Consultation Principles 2018² require (at paragraph "E") that "Consultations should last for a proportionate amount of time", taking into account the nature and impact of the proposal. The nature of the proposal here is to cap the recoverable costs that PPM suppliers can levy to finance their businesses and make a fair return. It has the potential to have a fundamental impact on the businesses of suppliers affected by it. The proposals envisage that the cap for PPM customers should be incorporated into the Default Tariff Cap under the Domestic Gas and Electricity (Tariff Cap) Act 2018 and should be set at a lower level than is currently the case, continuing to reduce thereafter. This is based in part on the introduction of a new element to the cap mechanism (itself based on a detailed model and large quantities of data) which, only a year ago, the CMA determined should not be introduced into its revised PPM cap. The impact of the proposals is very significant and follows a period (1 April 2017 to 30 September 2019) in which suppliers have under-recovered their costs (£50 million in the case of Utilita alone). In the circumstances, Ofgem should have afforded significantly longer for respondents to respond in accordance with its own consultation policy that would require an eight- or twelve-week consultation period. In the time available, and taking into account the disruptive impact of Covid-19, we have done the best we can to understand and respond to these proposals (set across three separate consultations and proposed licence modifications in parallel), but note that we have not had adequate time to do so and reserve our position in that regard, including the right to provide further responses after Ofgem's stated deadline for doing so, including a supplemental annex containing the findings of our consultants when they have completed their review of the data and model provided by Ofgem.
- 1.5 We also note that the Department of Business, Energy and Industrial Strategy published its decision in respect of the Smart Meter Policy Framework Post-2020 on 18 June. In the time available we have not been able to consider what this new policy framework might mean for Ofgem's policy in respect of smart metering allowances for the price cap, but it is clearly a relevant factor that Ofgem will need to consider and consult on. That it is now available may be a good reason for Ofgem to reconsider its policy³ of only taking the new framework into account later (when the cap may not still be in place).

²https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/691383/Consultation_Principles_1.pdf

³ As set out in paragraph 4.37 of Ofgem's consultation "*Reviewing smart metering costs in the default tariff cap: May 2020 statutory consultation*" (for the purpose of the footnotes, the DTC SMNCC Consultation)

2. OFGEM'S PROPOSALS

- 2.1 Ofgem intends to incorporate prepayment meter ("PPM") customers within the Default Tariff Cap ("DTC") when (or before) the CMA's existing PPM price cap expires, rather than using its separate powers under the Gas Act 1986 and the Electricity Act 1989 to introduce a replacement PPM cap designed specifically for PPM. This is Ofgem's first proposal on which it consults.
- 2.2 Should it decide, following this consultation to implement this first proposal, Ofgem will modify the DTC tariff cap conditions under section 1(2) of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the "Act") in accordance with its powers and duties thereunder.
- 2.3 The second decision for Ofgem under the Act is therefore how to modify the DTC tariff cap conditions in order to ensure that they are appropriate for the PPM sector and in keeping with its duties and obligations and the purpose of the Act.
- 2.4 Ofgem appears to have approached this issue on the basis of the following pre-determinations on which Ofgem is not proposing to consult:
 - 2.4.1 The cap level for credit customers must not be reduced in comparison to the level set in 2018; and
 - 2.4.2 PPM customers are best protected by ensuring that their existing bills and existing tariff differential (as compared to credit customers) are not increased and are ideally reduced.
- 2.5 These pre-determinations have led Ofgem to consider that the following outcomes are acceptable, and thus form the basis of the proposals under consultation:
 - 2.5.1 That the CMA's flawed estimate of the additional costs involved in serving PPM customers (the "PPM Uplift") should not be substituted with Ofgem's own view of what those additional costs should be, in spite of: (i) Ofgem having identified what those costs should be; (ii) the many reasons for preferring Ofgem's own view; and (iii) Ofgem's duties as decision-maker.
 - 2.5.2 That a "non-pass-through SMNCC allowance" specifically for PPM customers should be introduced in order to reduce the level of the PPM cap over time. This is notwithstanding the history of the PPM cap failing to reflect an efficient supplier's costs from inception, with such failure being exacerbated and most extremely suffered by specialist suppliers with higher than average numbers of PPM customers.
 - 2.5.3 That the price cap for PPM customers should be below Ofgem's view of an efficient supplier's cost to serve PPM customers, notwithstanding the harmful impact of this on PPM customers, including as a result of there being no incentives for suppliers to serve such customers, no room for

competition in the PPM sector and the likely exit of specialist PPM suppliers who have transformed the PPM sector, but are unable to finance their licensed activities.

2.5.4 Consequently, that the price cap for non-PPM customers should include costs attributable to serving PPM customers, amounting to a cross-subsidy in the operating cost allowance enjoyed by such suppliers.

2.6 We consider that Ofgem's pre-determinations (as set out at paragraph 2.4 above) are misconceived and have led to proposals in these consultations that are fundamentally wrong and in breach of Ofgem's duties; indeed they are themselves unlawful decisions reached without consultation or independent justification. They have led Ofgem to disregard the legal framework within which it is required to take these decisions and the applicable statutory and other duties. If those pre-determinations are to prevail they require proper explanation and justification.

2.7 The pre-determinations have also led to numerous factual errors and inconsistencies and strained reasoning on Ofgem's behalf for the very reason that Ofgem's motive is to achieve those unjustified goals at any cost, in the face of any countervailing evidence or logic. There is no prospect of any consideration of alternative outcomes because Ofgem is intent on avoiding any reduction to the DTC and any increase in the PPM cap, regardless whether that is justified by the evidence available to it and to which it should have regard. The adoption of these pre-determinations illustrate that Ofgem has failed to approach the issues, specifically the nature of the steps it should take in light of the evidence and in keeping with its duties, with an open mind.

3. STRUCTURE OF OUR RESPONSE

3.1 We have structured the remainder of this response as follows:

Part One: Ofgem's pre-determinations in respect of the PPM Uplift

Part Two: Ofgem's failure to meet its legal duties or to explain how these proposals enable it to do so

Part Three: Ofgem's errors of reasoning

Part Four: Ofgem's flawed approach to the PPM SMNCC

Part Five: Other issues

Next Steps

3.2 In the interests of time and focus, we have not included any comments in this response about the lack of justification for the cap as a matter of principle, but our view remains that it is not justified and not effective in protecting PPM or other customers. We would welcome the opportunity to comment further in respect of these issues during Ofgem's review into whether conditions are in place for effective competition pursuant to section 7 of the Act and we believe that Ofgem must meaningfully consult on this question.

PART ONE: OFGEM'S PRE-DETERMINATIONS IN RESPECT OF THE PPM UPLIFT

4. OFGEM'S PROPOSALS ARE DRIVEN BY UNJUSTIFIED PREDETERMINATIONS

4.1 Whilst Ofgem does not explicitly say this, it appears clear from the consultation that Ofgem's considered view is that the CMA's calculation of efficient PPM costs was flawed. Ofgem does not give clear reasons for its own view and we do not know what evidence it is considering for reaching its conclusion, for example, whether it has other data on PPM costs that is inconsistent with the CMA's conclusions. We note though that Ofgem states that it calculates "*that the operating costs allowance already includes £4.16 of reported additional PPM costs*" and that if "*the PPM uplift accurately reflects efficient additional costs, then all of that £4.16 relates to inefficient PPM costs*"⁴. This indicates that Ofgem, in reaching its view that the CMA's calculation of efficient PPM costs was flawed, is not simply looking at the analysis done by the CMA in 2014, but also considering independent data that indicates that the operating cost allowance contains PPM costs. This is however not clear from the consultation and we believe it is important that Ofgem clarifies this so that stakeholders can understand the basis on which Ofgem is making its proposals.

4.2 There are however in any event clear reasons for doubting the CMA's analysis of the 2014 data:

4.2.1 The CMA took the difference between the lowest-available cost to serve PPM and direct debit customers for electricity customers. This approach maximises the chances of measurement error caused by different cost allocation processes in the sample: an industry-wide comparison reduces the risk that the PPM Uplift simply captures cost allocation practices. That the CMA rejected such top-down methods for gas illustrates the unreliability of its methods.

4.2.2 The CMA's measure did not control for the extent of the smart meter rollout in its comparators and therefore may already reflect the benefits of smart meters for operating costs, even though it is intended to reflect the differential cost to serve in respect of traditional meters.⁵

⁴ Paragraphs 4.17, 4.56 and 4.57 of Ofgem's "*Protecting energy consumers with prepayment meters: May 2020 consultation*" dated 18 May 2020 (for the purposes of the footnotes, the PPM Consultation)

⁵ Because the CMA's top-down method compares the lowest direct debit cost per customer with the lowest PPM cost per customer, it is based on the cost allocation approaches of just the two companies that set the benchmark in each payment type. It is therefore sensitive to any biases those companies have in their cost allocation approaches. Because PPM customers make up a minority of the customer base of the companies included in the sample, the decision to allocate £1 towards direct debit will reduce PPM costs per PPM customer by more than a £1 allocation towards PPM would reduce direct debit costs per direct debit customer. Therefore, any distribution around how to allocate indirect costs will tend to yield a wider distribution around costs per PPM customer than around costs per direct debit customer, hence understating the difference between the two minimum values.

- 4.3 We also consider that the vintage of the data that the CMA used (2014) means that the PPM Uplift is also likely to be too low, given that our experience is that the costs of traditional meters have increased since 2014.
- 4.4 Ofgem considers that efficient PPM costs in 2014 for dual fuel customers could in fact exceed the current PPM uplift by £0 to £17. We are not in a position to assess whether that is correct because Ofgem have not identified or shared their analysis with us, although there is good reason to doubt the CMA's analysis. However, without any clear explanation or reasoning, Ofgem proposes not to correct that calculation by substituting the CMA's flawed uplift approach with its own, notwithstanding its own more 'conservative' assessment is more consistent with the approach to the other elements of the DTC incorporated into the new proposed PPM cap. In doing so, Ofgem appears deliberately to incorporate a materially inaccurate and inconsistent element into the proposed PPM cap.
- 4.5 This appears to be because, at least in part, correcting the CMA's flawed PPM uplift allowance would require Ofgem at the same time to correct the equivalent inaccuracies in the operating cost allowance within the DTC (and read across to the proposed PPM cap). That such an equivalent correction may be necessary arises from the way that the operating cost allowance was calculated – namely by deducting the CMA's flawed PPM uplift calculation from total operating costs to arrive at the non-PPM operating cost allowance. Therefore, the difference is directly related; if the PPM uplift is understated the operating cost allowance is overstated.⁶⁷
- 4.6 Ofgem, however, considers its ability to correct for this error is constrained by the necessity not to reduce the cap level for credit customers: "*If either of the approaches above would result in reducing the cap level for credit customers, then we would not do so*".⁸ That is despite there being more scope to reduce the DTC than the PPM cap, given the different levels of price competition below the cap. No adequate justification is given for this decision.
- 4.7 Ofgem further constrains its options by determining that the short-term protection of PPM customers (by not increasing the PPM cap to accommodate a corrected and cost-reflective PPM uplift) is its primary focus in reaching its proposed decision, which is itself an unjustified decision. Under the heading, "*Considering protection*", Ofgem states:

"Before considering the impact of smart meters, we do not consider that the cost reflective approach would protect PPM customers, which is our primary focus under the Act. If efficient costs exceed the PPM uplift, then the cost reflective approach would increase the cap level for PPM customers compared with the current level of protection they receive (before considering the net impact of the smart meter rollout).

⁶ Paragraphs 4.60–61 of the PPM Consultation

⁷ We are not clear whether Ofgem is saying that the overstatement of the operating cost allowance would just relate to the understatement of efficient PPM costs or whether in fact there are further PPM costs in there.

⁸ Paragraph 4.30 of the PPM Consultation

*In the circumstance where the cost reflective approach would reduce the overall level of protection for PPM customers with traditional meters, we would adopt a tariff differential approach, restricting the PPM uplift so that the cap level for PPM customers did not increase. We would spread any excess efficient incremental costs across all default tariff customers."*⁹

4.8 No justification is given for this decision. It does not appear to have been based on any consideration of whether, in fact, bills would increase in light of current costs, nor is it explained why the net impact of the smart metering (which Ofgem has determined is negative – thus reducing bills) should not be taken into account.

4.9 Later in Chapter 4, under the heading "*Considering protecting customers*" and the sub-heading, "*Our considerations*", Ofgem further states:

"To the extent that true efficient incremental PPM costs exceed the PPM uplift, the tariff reference approach affords greater protection to PPM customers. We consider this appropriate.

*A cost reflective approach would increase prices for PPM customers (before considering the impact of the smart meter rollout). We do not consider it desirable to increase the tariffs for PPM customers, compared to the current tariff differential they already pay. In line with consumer groups' views, we consider that PPM customers are more likely to be vulnerable than direct debit customers. In line with the CMA's findings they also face additional barriers to switching, are [sic] likely able or likely to switch to cheaper tariffs independently."*¹⁰

4.10 Ofgem does not consider or explain why maintaining the existing tariff differential for PPM customers, irrespective of whether it is cost-reflective and irrespective of whether that would meet its statutory duties under the Act and any other duties, is the best way of protecting PPM customers – or indeed what the implications of adopting this approach might be.¹¹ Ofgem does not need to do so: Ofgem already knows that this approach is "*appropriate*".

4.11 It is clear from the consultation (indeed explicitly stated) that Ofgem is operating on the basis of the following two preconceived ideas or pre-determined requirements:

4.11.1 Ofgem cannot reduce the cap level for credit customers.

4.11.2 PPM customers are best protected by the cap level – and the existing tariff differential – not increasing.

⁹ Paragraphs 4.31 and 4.32 of the PPM Consultation

¹⁰ Paragraphs 4.73 and 4.74 of the PPM Consultation

¹¹ Ofgem does mention in paragraph 4.75 of the PPM Consultation that, given that there are fewer PPM customers than direct debit customers, the impact of spreading PPM costs across all payment methods decreases bills for PPM customers to a greater extent than it increases bills for direct debit customers. But this does not amount to consideration of the implications of this impact and its compliance with Ofgem's duties.

4.12 These predeterminations have not been consulted on or justified. In our view, they are wrong and contrary to Ofgem's duties.

5. PRECONCEIVED ASSUMPTION THAT PPM CUSTOMERS ARE BEST PROTECTED BY LOW PRICES, IRRESPECTIVE OF COST-REFLECTIVITY

5.1 As set out in paragraph 4 above, Ofgem is not intending to ensure that the cap level for PPM customers under the DTC is set at a cost-reflective level so that efficient suppliers can recover their efficient costs, finance their businesses or make a reasonable return. Ofgem says that these matters are not its primary focus. Yet they are matters to which Ofgem *must* have regard. Ofgem proposes to introduce a cap under which PPM customers, at least in the short term, would pay a price that is below an efficient supplier's cost to serve them and is content for credit customers under the DTC to be cross-subsidising PPM customers by paying a price that is above an efficient supplier's cost to serve them. In so doing, Ofgem proposes a mechanism that allows credit suppliers to over-charge and over-recover and PPM suppliers not to recover their efficient costs.

5.2 We consider that Ofgem is wrong to conclude that this protects the interests of current and future PPM customers or meets the objectives of the Act (which underpin its power to introduce the proposed cap). This has been recognised by many people including Ofgem. We would be happy to provide further information to Ofgem on the detrimental impact of unduly low prices on customers' interests if that would be useful to Ofgem, but in the meantime we would highlight the following:

5.2.1 ***Utilita's experience:*** Utilita knows from its own experience that subsidised tariffs are not in the best interests of its customers. As a new entrant supplier, Utilita transformed the PPM market, which has traditionally been poorly served, by offering customers cheaper sustainable prices, an innovative product and a flexible and high-quality service. Other suppliers followed Utilita's example, competition started to develop significantly, driving efficiencies, innovation and better service. This simply would not happen today, but this is what Ofgem should be looking to incentivise in the interests of consumers rather than a market involving unsustainable suppliers offering below-cost acquisition tariffs. The level of market exits in recent years supports this view. It is simply not in PPM customers' interests for suppliers to have no incentive to supply them: prepayment meters are a good choice for many customers and they should not be discouraged from choosing them.

5.2.2 ***Ofgem itself has previously recognised the dangers of this approach.*** Ofgem itself recognised the dangers of setting the cap level significantly and consistently below an efficient supplier's costs in its March 2020 consultation. In those circumstances, Ofgem did not consider that "*short-term price protection would protect PPM customers in the long term, as under-investment could affect customers. Neither would*

suppliers have enough incentive to compete for these customers, because few, or no, suppliers would be able to finance the efficient costs of serving these customers".¹² Taking that to its logical conclusion, it would not serve customers well to drive efficient suppliers out of business, thus reducing competition. Indeed, to do so would defeat the purpose of the cap, which is intended to be temporary until the conditions for effective competition are created, but where a cap is set on this basis it would have the effect of reducing competition, thus preventing the conditions for effective competition. As proposed, the cap itself will be a barrier to entry and an attack on the existence of PPM-focused suppliers, such as Utilita. Ofgem has previously recognised that customer protection is "*related to the extent to which the customers pay a price that fairly reflects efficient underlying costs*".¹³ We believe that this is a fundamental principle that should not be departed from.

5.2.3 ***The CMA recognised the same dangers in its July 2019 decision.*** The CMA stated its concerns about the level of the PPM cap as follows:

"Our specific concerns are that suppliers earning less than a normal rate of return would not be incentivised to provide a high level of service to consumers, or to compete on service and, given that we understand from prepayment suppliers that service is particularly important for prepayment customers, this may lead to longer-term consumer detriment as a result. Unduly low levels of the PCR¹⁴ may also lead to a reduction in competition on price, with little ability for efficient suppliers to compete below the level of the PCR.

In the longer term, maintaining the PCR at a level where suppliers would not be able to earn a normal return on capital may lead to efficient suppliers leaving the market. While entry and exit are normal features of competitive markets, it would be a case for concern if a remedy that was intended to work alongside competition was to lead to a reduction in the number of suppliers. In addition, exits of suppliers generate costs both directly in terms of customers who may be unsettled in being transferred through the supplier of last resort mechanism operated by Ofgem and the possible loss of any energy they have purchased on a prepayment basis, and indirectly given the costs of that system are ultimately borne by customers. As a result, any exit of suppliers caused by the level of the PCR

¹² Paragraph 2.15 of Ofgem's "*Protecting energy consumers with prepayment meters*" consultation dated 10 March 2020 (for the purposes of the footnotes, the March Consultation)

¹³ Paragraph 4.14 of Ofgem's "*Decision – Default tariff cap – Overview document*" dated 6 November 2018 (for the purposes of the footnotes, the DTC Decision)

¹⁴ The PCR was the defined term used by the CMA for referring to its price cap.

being set too low would be likely to reduce choice and increase costs for prepayment customers in the long-run.

Consequently, our view is that while the PCR at its current level is meeting the aim of reducing the detriment identified in the EMI Final Report, it is not currently at a level that allows efficient suppliers to earn a normal rate of return, to be incentivised to remain in the segments and to serve prepayment customers better and to allow for competition below the level of the cap. This does not serve the interests of prepayment customers.

While prepayment customers will have to pay for an increase in the level of the PCR through an increase in their bills, we consider that setting the PCR at a level that means it can meet all its aims will result in better market outcomes for prepayment customers, and we note that none of the respondents to our consultation on the provisional decision disagreed with this point.¹⁵ (emphasis added)

- 5.2.4 We would note that these concerns related to the risk of PPM suppliers earning less than a normal rate of return; Ofgem's current proposals would lead to suppliers failing even to cover their costs, such that they could not compete at the level of the price cap, never mind below it and this is not sustainable.
- 5.2.5 ***The danger was well understood by the Government and Parliament when drafting the Act.*** The recognition that customers are not served by tariffs that are set below efficient costs explains why Ofgem is required by the Act to have regard to the interests of future customers as well as existing customers and to each of the statutory needs set out in section 1(6) of the Act. It explains why Claire Perry reassured the House of Commons, in respect of the Act, that "*the powers given to Ofgem have to ensure that we do not disincentivise competition*".¹⁶ However, there is no evidence in the consultation that Ofgem has had regard to the interests of future customers in reaching these proposals. Before reaching a decision, it is incumbent on Ofgem to do so.
- 5.2.6 ***The danger has long been understood at EU-level and the European Commission has long imposed restrictions on price caps.*** Directive (EU) 2019/944 of the European Parliament and of the Council of 5 June 2019 (the "**Recast Electricity Directive**") only permits price caps if they are directed at energy poor or vulnerable customers or are required for the purpose of a transition period to establish effective competition (which is the purpose of the DTC, which Ofgem proposes to apply to PPM customers pursuant to this consultation). It is worth noting here that:

¹⁵ Paragraphs 3.20–3.22 of the CMA's "*Review of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016: Final Decision*" of July 2019 (for the purposes of the footnotes, the July Decision)

¹⁶ House of Commons (2018) March 18 debate (vol 637, col 275)

- (a) Price caps that are intended to facilitate a transition to effective competition are explicitly required to "*be set at a price that is above cost, at a level where effective price competition can occur*".¹⁷ The UK Government has confirmed that the DTC is such a price cap and meets these requirements.¹⁸ However, the proposed PPM cap does not.
- (b) Public interventions in price setting for the supply of electricity should not lead to direct cross-subsidisation between different categories of customer,¹⁹ nor result in additional costs for market participants in a discriminatory way.²⁰ In the context of Ofgem's proposed PPM cap, a cross-subsidy would by definition threaten the ability of PPM-focussed suppliers to finance their activities and would be discriminatory.

5.3 In this context, it is extraordinary that Ofgem, in the name of protecting PPM customers, is explicitly proposing to incorporate the PPM price cap into the DTC so that it is set at a level that it believes is below an efficient supplier's cost-to-serve and then, with the introduction of a negative PPM SMNCC further to reduce the amount PPM suppliers can charge for their services. Whilst Ofgem may say that the PPM SMNCC is tracking changes in efficient costs, it is a nonsense to do this in respect of one allowance within the price cap without seeking to ensure that the other allowances in fact track efficient costs. This approach can only be based on a failure to have regard to its duties under s.1(6) of the Act, including to "*exercise its functions... with a view to protecting existing and future domestic customers who pay standard variable and default rates*" (emphasis added).

5.4 It is not clear how Ofgem has concluded that this approach is in accordance with its legal duties; indeed, it appears that little consideration has been given to the legal framework within which Ofgem is taking (and is required to take) its decision. It is not a technicality that Ofgem has failed to mention the impact of its proposals on the interests of future as well as current customers, both of whom Ofgem is required to protect in accordance with section 1(6) of the Act. Ofgem has also failed to consider the matters to which it must have regard pursuant to section 1(6) of the Act (for which see paragraphs 8 to 12 below). If, contrary to our reading of the proposals, Ofgem has complied with these duties, it is incumbent on Ofgem to explain how it has determined that these proposals are compliant with them, before reaching any decision.

5.5 We also note here that, while the Act allows different provision to be made for different areas or different cases (section 2(1)(f)), it does not allow Ofgem to make decisions with a significant distributional effect and to "pick winners". Indeed, the Act envisages that, where necessary, vulnerable customers may be

¹⁷ Article 5(7) of the Recast Electricity Directive

¹⁸ Great Britain confirmed to the European Commission that the Default Tariff Cap "is consistent with the derogation in paragraph 6 [of Article 5]". The document can be accessed at this [link](#).

¹⁹ Recital 25 of the Recast Electricity Directive

²⁰ Article 5(4)(e) of the Recast Electricity Directive

subject to a separate price cap both during and after the expiry of the DTC, when it is envisaged Ofgem would use powers under the Electricity Act 1989 and the Gas Act 1986, which enable Ofgem to specifically consider the interests of vulnerable customer groups.²¹

5.6 This is consistent with the fact that the Government has stated that the DTC under the Act meets the derogation in the Recast Electricity Directive for price caps that are required for the purpose of a transition period to establish effective competition (as opposed to a derogation for price caps for energy poor or vulnerable customers). In focusing its determination on the protection of vulnerable customers (although it is unclear from the consultation if that is its focus, or rather just the protection of PPM customers more generally, regardless of whether they are in fact vulnerable), such that the tariff differential (and indeed the overall level) of the PPM cap should not increase, Ofgem has seemingly taken into account factors that are legally irrelevant or worse impermissible and any decision made on that basis would be unlawful. As noted above, and as confirmed to the European Commission by the Government, the purpose of the cap is to facilitate the transition to effective competition, not protect vulnerable customers. Indeed, at paragraph 2.30, Ofgem states that the purpose is to "*ensure that suppliers charge PPM default tariff customers a fair price, that reflects the underlying costs of serving PPM customers*". That purpose carries with it obligations which are seemingly (and explicitly) ignored in Ofgem's proposals. Before any decision is taken, Ofgem must correct this failing.

6. PRECONCEIVED ASSUMPTION THAT OFGEM CANNOT REDUCE THE CAP LEVEL FOR CREDIT CUSTOMERS

6.1 Ofgem considers its ability to correct the understated PPM Uplift is constrained by the necessity not to reduce the cap level for credit customers: "*If either of the approaches above would result in reducing the cap level for credit customers, then we would not do so*".²²

6.2 Ofgem goes on to say, that if it pursued a cost-reflective approach to the PPM Uplift it would need to remove the equivalent²³ PPM costs already socialised in the operating cost allowance, but that it would not do so "*in the circumstance in which doing so would reduce the current overall cap level for credit customers. In our 2018 decision, we set the headroom allowance so that the overall cap (a) allowed for the net long-run costs of uncertainty, above the level already covered by conservative assumptions in the other allowances and (b) protected customers and in doing so, had regard to the statutory needs in section 1(6) of the Act. Reducing the cap level would alter that decision which we do not propose to do*".²⁴

²¹ On the other hand, the Act does not do so.

²² Paragraph 4.30 of the PPM Consultation

²³ As noted above, we are not clear whether Ofgem is actually saying that the PPM costs contained within the operating cost allowance are greater than its views of the understated PPM Uplift

²⁴ Paragraph 4.58 of the PPM Consultation

- 6.3 Ofgem's logic is unclear:
- 6.3.1 Whilst we disagree in principle with reopening aspects of decisions previously made, we note that Ofgem does not consider that to be a constraint in respect of the PPM cap, where it is picking and choosing what to review only one year after it was reset by the CMA.
 - 6.3.2 On the assumption that Ofgem did not know at the time of its 2018 decision that the operating cost allowance under the DTC contained costs attributable to PPM customers, it would have set the headroom level based on a misunderstanding, of which it has now become aware and therefore an altered decision would better reflect more accurate information regarding costs.
 - 6.3.3 The impact on the *average supplier* of amending the cross-subsidy would be far less detrimental than the impact on a *PPM specialist supplier* of failing to rectify the position. Such rectification would benefit the far larger cohort of direct debit and standard credit customers in terms of reduced bills – and indeed PPM customers because they are best protected by prices that are cost-reflective for all the reasons set out in paragraph 4 above.
 - 6.3.4 The evidence from prices in the market indicates that there is much less scope to reduce the PPM cap than the DTC.
 - 6.3.5 Ofgem's existing analysis with respect to headroom can no longer apply in any event once it incorporates the PPM cap into the DTC: the "*conservative assumptions in the other allowances*"²⁵ it refers to as affecting its design of the headroom are not true with respect to the PPM Uplift or the PPM specific non-pass-through SMNCC it proposes to apply.
- 6.4 Therefore, whilst we would not advocate that Ofgem reopens its 2018 decision in respect of the DTC and we do not accept that doing so would be the necessary consequence of Ofgem rectifying the error in the existing PPM Uplift, it is clearly flawed to use this as a reason not to rectify the error when Ofgem is reaching its own decision on the setting of a PPM cap compliant with its duties and the statutory objectives of the Act to which Ofgem "must" have regard. It also calls into question the headroom allowance generally and more specifically as it relates to PPM suppliers under the proposed new cap.
- 6.5 Ofgem's single mindedness to protect the tariff differential for PPM customers has led it to disregard the interests of the far larger population of credit customers who by Ofgem's own reasoning are paying more than they should be. This would also be discriminatory because suppliers of credit customers are able to charge for costs not incurred in servicing such customers, while suppliers of PPM customers are prevented from recovering the full amount of their efficient

²⁵ Ibid

costs. There is an unlevel playing field created (inadvertently) by the CMA but now rubber-stamped and extended by Ofgem pursuant to these proposals.

- 6.6 We also note that Ofgem has failed to consider or explain how failing to rectify this cross-subsidy accords with its obligations under the Act, which are to protect the interests of existing and future domestic customers who pay standard variable and default rates. It is not, as Ofgem incorrectly state in the statutory notice, to protect PPM customers alone (whether or not vulnerable, which Ofgem has in any event not determined or consulted on). This error is not simply a technicality: Ofgem's misunderstanding has seemingly led it to disregard in its proposals the interests of domestic customers as a whole and whether it is in their interests to cross-subsidise other groups of customers.

PART TWO: FAILURE TO MEET LEGAL DUTIES

7. FAILURE TO CONSIDER DUTIES UNDER ELECTRICITY AND GAS ACTS

- 7.1 Ofgem appears not to have considered what functions it will be exercising when it makes its first decision, namely whether to proceed to introduce a PPM-specific cap using powers under the Electricity Act 1989 and the Gas Act 1986 or whether to proceed under the Act. We will scrutinise this aspect of the decision in due course.

8. FAILURE TO PROTECT EXISTING AND FUTURE DOMESTIC CUSTOMERS ON DEFAULT TARIFFS AND TO HAVE REGARD TO STATUTORY NEEDS

- 8.1 Ofgem is required to exercise its functions under section 1 of the Act with a view to protecting existing and future domestic customers who pay standard variable and default rates.
- 8.2 As explained above in paragraph 6, Ofgem appears not to have considered this statutory objective correctly. It has misstated this requirement in the statutory notice and has seemingly failed to consider the interests of future customers. Again, as explained in paragraph 6, we do not believe that Ofgem's proposals are in the interests of PPM customers or credit customers.

9. FAILURE TO HAVE REGARD TO NEED FOR SUPPLIERS TO FINANCE ACTIVITIES

- 9.1 Ofgem must have regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by their licence (s.1(6)(d) of the Act). Ofgem has not explained how it has done so and it does not appear to have done so.
- 9.2 Ofgem admits that "*the tariff differential approach would mean that suppliers will partially under-recover the efficient cost of each PPM customer with a traditional meter and over-recover for each direct debit customer. Suppliers with fewer PPM customers than average will be able to over-recover their costs.*

In practice, most non-specialist suppliers have customer mixes that allow them to recover their efficient PPM costs, or a substantial proportion of them."²⁶

9.3 Ofgem then states that: "*If we set the PPM uplift at a cost reflective level, that would allow specialist suppliers to recover their efficient costs in full. However, all PPM customers (whether they were served by a specialist supplier or not) would be charged substantially more (before considering the net impact of the smart meter rollout). We consider our proposal protects customers, which is our primary focus, and in doing so has regard to suppliers' efficient costs, which vary depending on suppliers' circumstances and business models*".²⁷

9.4 Ofgem's bare statement that it has regard to suppliers' efficient costs is nowhere explained or made out. It conspicuously fails to acknowledge, in contrast to non-specialist suppliers, that specialist PPM suppliers have customer mixes that would not allow them to recover their efficient PPM costs while acknowledging that some non-specialist suppliers may only be able recover "a substantial proportion" of their efficient PPM costs.

9.5 Ofgem comes back to this theme later in chapter 4 of the PPM consultation:

"In principle, we are not opposed to the effect created by allocating a portion of PPM costs to other customers and therefore we propose a tariff differential approach. We consider the impact for customers and suppliers to be consistent with section 1 of the Act, of which the primary objective is to protect customers. In our 2018 decision on the default tariff cap, we decided to set the uplift for standard credit customers using a tariff differential approach that was not fully cost reflective. We considered that this approach protected customers, and in doing so, we had regard to suppliers' finances, notwithstanding the potentially distorting impact the approach has on cost-recovery.

This approach has greater impact on suppliers with business models that specialise in serving customers with high costs traditional PPMs to recover their efficient costs. We do not consider that is a reason to increase tariffs and reduce protection for 4 million PPM customers, most of whom are not served by specialist suppliers."²⁸

9.6 While noting the greater impact on specialist suppliers, this does not acknowledge that such suppliers will not be able to recover their efficient costs and thus to finance their businesses. Ofgem makes no attempt to justify this approach by reference to their statutory obligations; it appears not to have considered the point, nor that suppliers have a licence obligation to supply PPM customers and therefore must be able to fund this. Indeed, Ofgem's only attempt to deal with these duties appear in section 2 of the SMNCC consultation and then only to underplay their importance.

²⁶ Paragraph 4.33 of the PPM Consultation

²⁷ Paragraph 4.34 of the PPM Consultation

²⁸ Paragraphs 4.84-85 of the PPM Consultation

- 9.7 The effect of Ofgem's proposed approach will be to drive even efficient specialist PPM suppliers out of business over time, thus reducing competition in the market, which is entirely against the justification and purpose of the Act. Such a decision would therefore require very clear and careful justification, but there is none.
- 9.8 This approach is also a clear departure from the way in which Ofgem considered its finance duty in November 2018, when Ofgem concluded that, "*Based on our analysis, we consider that efficient suppliers with a range of potential customer bases (including those matching the most disadvantageous customer base of the suppliers in our benchmarking sample) would be able to finance their activities under the cap*".²⁹
- 9.9 This conclusion is notably absent in the current consultation, presumably because Ofgem has either not considered it (a breach of duty), or has done so and recognised that some efficient suppliers would not be able to finance their activities under the cap (even before the impact of the PPM SMNCC).
- 9.10 Ofgem's limited attempt to justify its approach by reference to the approach it took to standard credit customers in 2018 suggests that Ofgem may not appreciate (or may not have considered) the very different impact that these proposals will have on PPM specialist suppliers. The impact of Ofgem's policy in respect of the standard credit uplift did not affect suppliers disproportionately to such a degree: Ofgem was still able to conclude in 2018 that efficient suppliers were able to finance their activities. Ofgem does not even consider whether efficient PPM suppliers will be able to do so in this consultation.
- 9.11 In terms of the impact, we note that PPM specialist suppliers would be unable to attract customers on default tariffs set at a level that allow them to cross-subsidise losses on PPM customers (both because, by Ofgem's own logic, such customers are disengaged from the market – and to the extent that they are engaged they are unlikely to switch to a tariff set at a level that allowed a cross-subsidy to other customer groups).
- 9.12 Ofgem has also not considered whether it should try to mitigate the impact of its proposals on affected suppliers, for example through some kind of levelisation mechanism, as commonly used in the industry, for example to distribute the impact of the feed-in-tariff scheme for small scale renewable generation. We would ask Ofgem to do so before reaching any decision on these matters.
- 9.13 We would be happy to provide Ofgem with evidence about the likely impact of its proposals on Utilita in line with Ofgem's duty to properly inform itself of relevant material facts and law, and to properly take them into account when making a decision. Ofgem should take the impact on Utilita very seriously due to its unique position in the market: as Utilita specialises in the prepayment sector, its costs provide the best evidence of the costs-to-serve of PPM customers. The estimated costs of PPM customers for suppliers with mixed portfolios depend on cost-allocation rules that may not reflect the true underlying economic costs of

²⁹ Paragraph 2.57 of DTC Decision

serving PPM customers. Utilita has repeatedly demonstrated its efficiency to the CMA and Ofgem. We would be happy to provide updated evidence of this if Ofgem would find it useful.

10. FAILURE TO HAVE REGARD TO THE NEED TO ENABLE COMPETITION

- 10.1 Ofgem must have regard to the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts (s.1(6)(b) of the Act). Ofgem has not explained how it has done so and it does not appear to have done so.
- 10.2 Ofgem includes the "*Impact on competition for default tariff customers*" as a sub-heading in the PPM consultation and concludes that overcharging direct debit DTC customers will not make a significant difference to the ability of suppliers to compete, or the likelihood that default tariff customers will switch to cheaper tariffs. Ofgem also notes that there is weak competition in the default tariff market anyway.
- 10.3 It may well be correct that the impact of this overcharge does not affect Ofgem's conclusion in 2018 that a range of different types of supplier will be able to compete effectively following the introduction of the DTC (notwithstanding its negative impact on incentivising efficiency and switching). But Ofgem has not considered the impact on competition in the PPM sector of setting a loss-making price cap, even though this consultation's purpose is to consider precisely what PPM cap to impose. It seems extremely unlikely that "*a range of different types of supplier will be able to compete effectively*"³⁰ in the PPM sector if Ofgem implements its proposals. Only suppliers with sufficient numbers of non-PPM customers that they are able to benefit from the cross-subsidy to such a level that they can either offset their under-recovery on PPM or over-recover by having disproportionately more non-PPM customers, will be able to compete in those circumstances. But that will stifle competition and will stifle different business models.
- 10.4 Ofgem's failure to consider the impact of its proposals on competition in the PPM sector is even more surprising given that the CMA recommended that in determining how to replace its PPM cap, Ofgem should review whether the headroom and approach to competition in the DTC would be effective in generating competition on price or service levels for PPM customers.³¹ Ofgem has failed to carry out this recommendation. It appears to justify this failure on the basis that there have been no significant changes in the market since July 2019³², while at the same time proposing to introduce a new PPM cap which will substantially reduce the ability of PPM suppliers to recover their costs and ultimately reduce charges. But of course, the fact that there have been no significant changes in the market is evidence that Ofgem *should* review the approach to competition in the PPM sector. It should consider why the number of

³⁰ Executive Summary, page 6, of the DTC Decision

³¹ Paragraph 5.10 of the July Decision

³² Paragraph 3.16 of the PPM Consultation

competitive PPM offers remains limited. In our view, it is not because PPM customers are disengaged: on the contrary, PPM customers tend to be engaged and acutely aware of what they spend. Rather, it is because suppliers cannot offer tariffs significantly below the cap because the level of the cap does not allow them to do so. As such, it is defective as against its purpose and is ripe for review and correction.

10.5 In our view, the effect of Ofgem's proposals would be to destroy competition in the PPM sector, leaving no supplier with an incentive to serve PPM customers well, leading to poorer service outcomes for PPM customers. Many suppliers would seek to retrench their PPM business. This means that competition will reduce even when the smart meter rollout is complete.

11. FAILURE TO HAVE REGARD TO THE NEED TO CREATE INCENTIVES FOR SUPPLIERS TO IMPROVE EFFICIENCY

11.1 Ofgem must have regard to the need to create incentives for holders of supply licences to improve their efficiency (s.1(6)(a) of the Act). Ofgem has not explained how it has done so and it does not appear to have done so in respect of the PPM cap.

11.2 It would be difficult for Ofgem to conclude that its proposals are consistent with this need: in practice, most efficiency improvements need up-front investment and suppliers will not make these investments if they see no prospect of making a return. The incentive created by setting a price cap too low for PPM customers is for suppliers to have as few PPM customers as possible.

12. FAILURE TO HAVE REGARD TO THE NEED TO MAINTAIN INCENTIVES TO SWITCH

12.1 Ofgem must have regard to the need to maintain incentives for domestic customers to switch to different domestic supply contracts (s.1(6)(c) of the Act). Ofgem has not explained how it has done so and it does not appear to have done so in respect of the PPM cap.

12.2 It would be difficult for Ofgem to conclude that its proposals are consistent with this need: suppliers will not be able to offer competitive tariffs below the level of the price cap if Ofgem's proposals are implemented, because suppliers will not even be able to recover their efficient costs, let alone any profit on the supply. Only those relying on cross-subsidies from other customers or pursuing a predatory pricing strategy would be able to do so.

PART THREE: ERRORS OF REASONING

13. IRRATIONAL AIM

- 13.1 The proposals are beset with error in terms of both fact and logic. This appears to be because Ofgem has immovably aligned itself to the pre-determinations, which then has skewed its reasoning throughout.
- 13.2 Ofgem's predetermination to maintain (or not increase) the existing price differential is illogical, given that the existing price differential is the product of price caps, rather than market forces, and the price differential has fluctuated significantly over time. Indeed, it was reset only in July 2019 (and with effect from 1 October 2019) when the CMA altered its approach to calculating the cap (once it had become clear that the previous formulation did not achieve its purpose and it was set at a level below the DTC). Therefore, there is no pedigree in, or comfort to be gained from maintaining, the existing price differential.
- 13.3 Further, Ofgem's desire to ensure that the price differential is maintained is expressly subject to the caveat of the non-pass-through SMNCC. This surely shows that there is no good reason for aiming to retain the existing tariff differential, irrespective of its relationship to costs.
- 13.4 The desire to retain a particular tariff-differential or even to avoid a bill increase or shock does not justify perpetuating errors in the cap methodology that allow suppliers to charge direct debit customers too much (and thus over-profit) and PPM customers too little (and thus under-recover). And given the expected reduction in the wholesale energy costs allowance with effect from 1 October 2020, Ofgem is able to avoid a bill shock for PPM customers in any event. There is no evidence that in making these proposals, Ofgem has modelled whether more accurately reflecting efficient costs will lead to higher charges in real terms for customers based on current costs. That is a relevant consideration to which Ofgem appear not to have had regard. Ofgem has failed to properly inform itself of relevant material facts and properly to take them into account.

14. PROTECTION IS NOT TARGETED OR PROPORTIONATE

- 14.1 Ofgem has not made the case for why it is seeking to provide additional "protection" for PPM customers. It has not sought to explain why this category of customers should receive subsidised bills (and why other customers should pay more as a result), save for mentioning that:
- 14.1.1 *"in line with consumer groups' views, we consider that PPM customers are more likely to be vulnerable than direct debit customers";* and
- 14.1.2 *"in line with the CMA's findings they [i.e. PPM customers] also face additional barriers to switching, are [sic] likely able or likely to switch to cheaper tariffs independently".³³*

³³ Paragraph 4.74 of the PPM Consultation

- 14.2 If Ofgem’s proposal is to “protect” PPM customers on the grounds of vulnerability, this would contradict its policy in 2018 when it decided that it would not be appropriate to subsidise standard credit customers on this basis. Ofgem explained then that “*while standard credit customers are twice as likely to be fuel poor, we consider that standard credit is a weak proxy for fuel poverty, especially as there are twice as many fuel poor customers paying by direct debit*”.³⁴ Given that PPM customers are less likely to be fuel poor than standard credit customers,³⁵ it is not clear why Ofgem proposes to apply a different policy to subsidising them and in fact proposes to deliberately perpetuate a cross-subsidy from standard credit customers to PPM customers, thereby creating inconsistencies in the underlying rationales for the approaches in the caps to different customer types.
- 14.3 If Ofgem’s proposal is to “protect” PPM customers on the basis that they face additional barriers to switching or are less able to do so, we note that Utilita’s own experience does not support this. Utilita’s rate of churn (annualized losses divided by supply point numbers) of prepayment customers over the past year is 28%. Over the past three years it has been 26% (i.e. it is high and increasing). Ofgem’s data on national domestic supplier switching³⁶ suggests a comparable churn rate, energy market wide, of around 20% (given there are 28.5m domestic electricity supply point and 23.6m domestic gas supply points). It is not clear from the consultation whether Ofgem agrees with the CMA’s findings or what data or analysis it has on the matter. Ofgem needs to ensure that it reviews (and collects if necessary) relevant information of this kind that is pertinent to its consultation.
- 14.4 Ofgem has also not explained why it considers that subsidising PPM customers by overcharging DTC customers is a proportionate way of providing this “protection”, nor what the overall effect of these proposals are on *all* customers of *all* payment types, current *and future*. Ofgem has simply stated that the impact of spreading PPM costs across all payment methods decreases bills for PPM customers to a greater extent than it increases bills for direct debit customers.³⁷ That is not a justification, but rather an economic fact.
- 14.5 As already noted above, Ofgem has not justified this as an objective in the first instance and, indeed, such an objective stands in contrast to its actual obligations under the Act. Regardless, Ofgem does not appear to have considered whether alternative ways of achieving its objective are available or whether the consequences of its intervention, including to specialist PPM suppliers, outweigh the perceived benefits of its measure – or indeed whether the consequences could be mitigated. Given the implications of the proposals for specialist suppliers, Ofgem must do so.

³⁴ Paragraph 3.28 of the Payment Uplift Annex to the DTC Decision

³⁵ <https://www.gov.uk/government/statistics/fuel-poverty-detailed-tables-2020>

³⁶ (<https://www.ofgem.gov.uk/data-portal/number-domestic-customers-switching-supplier-fuel-type-gb>)

³⁷ Paragraph 4.75 of the PPM Consultation

15. A SERIES OF FLAWED JUSTIFICATIONS FOR LEAVING THE PPM UPLIFT UNCORRECTED

- 15.1 As a preliminary point, Ofgem has not disclosed the data that would enable any consideration or review of its calculation of the understatement to the PPM uplift in the current PPM cap and/or the related cross-subsidy in the operating costs allowance. This is a material gap in the information required to enable a meaningful consultation process to be carried out. We would ask Ofgem to provide these calculations and the underlying data now, in order that affected parties may consider and respond to them. Without this information, it makes it difficult for us to determine whether Ofgem's analysis of the margin of error is correct.
- 15.2 Ofgem has tried to justify its failure to substitute its judgement for the CMA's on the PPM uplift on various grounds, all of which are flawed.
- First attempted justification: Consistency with the approach to the payment uplift for standard credit customers*
- 15.3 Ofgem has said that its approach is consistent with the approach it took to the payment uplift for standard credit customers in 2018, when it designed the DTC. Ofgem considers that it is using the "*approach as we decided to use for standard credit customers in our 2018 decision, setting the uplift below the efficient increment costs*".³⁸
- 15.4 This is wrong.
- 15.5 Ofgem was very clear in its decision on the DTC in 2018 that it did "*not consider there to be a strong argument to reduce the payment method differential in order to protect vulnerable customers*", spreading bad debt/related administrative costs was "*not a vulnerability argument*" and that "*while standard credit customers are twice as likely to be fuel poor, we consider that standard credit is a weak proxy for fuel poverty, especially as there are twice as many fuel poor customers paying by direct debit*".³⁹
- 15.6 In fact, in its decision on the DTC, Ofgem justified the allocation of some of the bad debt/admin costs to direct debit customers on the basis that this was cost reflective, saying that its approach "*acknowledges cost reflectivity can be considered in different and conflicting directions. At a group level, standard credit customers are more expensive, and it would be cost reflective to charge them for that. However, on an individual level it would not be cost reflective to charge a standard credit customer, who does not exhibit the characteristics of the group, the full cost to serve difference*".⁴⁰ Ofgem specifically did not allocate any of the additional working capital costs that come with standard credit customers to direct debit customers because doing so would not be cost-reflective.

³⁸ Paragraph 4.16 of the March Consultation

³⁹ Paragraph 3.28 of the Payment Uplift Annex to the DTC Decision

⁴⁰ Paragraph 3.48 of the Payment Uplift Annex to the DTC Decision

15.7 In any event, even if Ofgem's approach to setting the standard credit payment uplift was as Ofgem wrongly assumes, it would be inappropriate to rely on it to decide that its proposed approach to the PPM uplift is justified without further consideration of the particular circumstances relevant to PPM, including as to the impact on suppliers. Ofgem said in its November 2018 DTC decision that "*based on our analysis, we consider that efficient suppliers with a range of potential customer bases (including those matching the most disadvantageous customer base of the suppliers in our benchmarking sample) would be able to finance their activities under the cap*".⁴¹ Specialist PPM suppliers will by definition and in fact, not be in this position under its current proposals. This would be to the detriment of PPM customers: as explained in paragraph 5.2.1, specialist PPM suppliers like Utilita have transformed the market with competitive pricing, an innovative product and a flexible and high-quality service. PPM customers have specific needs and specialist suppliers have been able to win customers by understanding and responding to those needs. Some examples of the services we provide are as follows:

15.7.1 Utilita operates a no standing charge, two-rate tariff that has particular benefits for low income households using prepayment. This means that customers do not build up debt on a gas meter over the summer months. High Emergency Credit of £15 per meter is standard, and at least two days per week are Friendly Credit, so even if the customer runs out of credit the meters will not disconnect. Customers also have access to further credit via the PowerUp facility on the app which will provide a further week's worth of energy.

15.7.2 Hubs: While many companies in the energy sector have abandoned the high street, Utilita has gone in the other direction, and now has high street presence in six locations in GB with four more due to open in the next 12 months.

15.7.3 Awards: Utilita has won awards for both its service and its technology platform. Our app is consistently one of the best rated in the sector (over 4 stars), we consistently achieve over 4-stars on Trustpilot, Which? put us in the top five, uSwitch gave us best smart experience, and we recently won an award for best technology application in the Southern Tech awards.

15.7.4 Extra Care: Utilita has an award-winning Extra Care team, and during the COVID-19 crisis when many suppliers shut their call centres, we have been making outbound calls to those customers on our Priority Service Register.

Second attempted justification: The CMA accepted the impact on PPM suppliers

15.8 In respect of the requirements of Section 1(6) of the Act, Ofgem says that "*in practice, we would have regard to the efficient costs of suppliers with higher*

⁴¹ Paragraph 2.57 of the DTC Decision

than average proportions of PPM customers", and goes on to say immediately afterwards (as if it followed) that, "In its July 2019 review of the PPM cap, the CMA concluded that the impact of the revised PPM cap (the current approach) on suppliers with high proportions of PPM customers was reasonable in practice."⁴²

- 15.9 But that was because the CMA believed that it was creating a cost-reflective tariff that allowed PPM suppliers to receive a normal rate of return:

"Some suppliers indicated that the introduction of the DTC in addition to the PCR might restrict their ability to increase prices for their credit customers to mitigate the impact of the PCR on their businesses. In response we note that the PCR was designed to ensure that suppliers of prepayment customers could earn a normal rate of return without a need to cross-subsidise".⁴³ (emphasis added)

- 15.10 In light of evidence that the PCR was not allowing suppliers to earn a normal rate of return, the CMA decided to amend the PCR – i.e. to ensure that the PCR did what it was supposed to and ensured suppliers earned a normal rate of return (albeit that Ofgem now think that the CMA also got this calculation wrong). Therefore, the CMA's conclusion about the impact of the revised PPM cap being acceptable is not just irrelevant (given the CMA was intending to revise its cap so that it allowed suppliers to earn a normal rate of return); it should in fact cause Ofgem to consider why it is pursuing a policy that the CMA specifically rejected less than a year ago.

Third attempted justification: The CMA's recommendation was to review the PPM uplift only when the smart meter rollout has progressed significantly.

- 15.11 Ofgem says that "*In its 2019 review, the CMA considered that the PPM uplift would need review once the rollout of smart meters has progressed significantly, but until then it did not consider a review was necessary. We consider that the smart meter rollout has progressed since July 2019 but not significantly enough to conclude the CMA's assessment is no longer valid*".⁴⁴

- 15.12 But the CMA's recommendation was actually that Ofgem review whether "*the level of the payment method uplift for prepayment meter customers and the allowances for smart meter installation remain appropriate once the rollout of smart meters has progressed significantly as part of a broader consideration of the costs of the smart metering programme*".⁴⁵ [emphasis added]

- 15.13 The CMA's logic was that the PPM uplift and the smart meter allowances should be reviewed at the same time once the smart meter rollout had significantly progressed. That makes sense; they have a direct relationship.

- 15.14 Given that Ofgem has ignored the CMA's recommendation to review the smart meter allowances only when the smart meter rollout had progressed significantly and that the CMA's logic required the PPM uplift and smart metering allowances to be reviewed at the same time, it is illogical for Ofgem to try to justify its failure

⁴² Paragraph 2.22 of the PPM Consultation

⁴³ Paragraph 2.49 of the July Decision

⁴⁴ Paragraph 4.45 of the PPM Consultation

⁴⁵ Paragraph 5.10 of the July Decision

to review the PPM uplift (in the face of its own evidence that the uplift is too low) by reference to this recommendation. Ofgem is picking and choosing what to accept from the CMA to meet its own pre-determined outcome. We invite Ofgem to reconsider its approach.

16. OFGEM'S INCONSISTENT APPROACH TO SOCIALISATION OF COSTS

16.1 Ofgem's determination not to increase the existing tariff differential has led to it adopting a completely inconsistent approach to the issue of socialisation of costs.

Inconsistent approach to recovery of socialised costs – fairness and logic

16.2 Ofgem is proposing, on the basis that competitors in the fixed tariff market do not have socialised costs, that it would not be fair to expect suppliers to seek to recover socialised costs from fixed tariff customers:

"However, it is clear that suppliers price their FTs as part of competitive process, where competitors do not have socialised costs. On that basis, we err on the side of caution and assume that socialised costs cannot be recovered from FT customers. We propose to spread socialised costs across default tariff customers only."⁴⁶

16.3 Utilita agrees with the principle of not assuming that socialised costs can be recovered, but it is unclear how Ofgem can consider it fair to expect specialist PPM suppliers to seek to recover socialised costs from their non-existent standard default tariff customers (who, by Ofgem's own logic, are disengaged from the market and therefore PPM specialists would not be able to attract, let alone at a level that allows for cross-subsidy). To the extent average suppliers can cross-subsidise in the way that Ofgem envisage, this would not be fair to customers.

Inconsistent approach to socialisation of costs generally

16.4 Whilst Ofgem are content to socialise PPM customer costs onto DTC credit customers, Ofgem consider it unacceptable to socialise any DTC credit customer costs (i.e. those smart metering costs allegedly contained in the operating cost allowance that are in excess of the smart metering costs allegedly incurred in respect of the PPM sector) onto PPM customers.

16.5 Ofgem say that *"it would clearly not be appropriate to spread smart meter net costs from credit customers onto PPM customers. That would increase costs for those least able to bear them. Credit customers have lower tariffs and are less vulnerable on average"*.⁴⁷

16.6 But, as Ofgem pointed out in its November 2018 decision, there are more vulnerable customers amongst DTC credit customers (and indeed standard credit customers who are contributing to this cross-subsidy are more likely to be

⁴⁶ Paragraph 4.69 of the PPM Consultation

⁴⁷ Paragraph 5.36 of the PPM Consultation

vulnerable) and Ofgem is content for them to pay more than they should.

PART FOUR: OFGEM'S FLAWED APPROACH TO PPM SMNCC

17. OFGEM'S PROPOSALS

Ofgem argues that "*as the smart meter rollout continues, it will erode the additional costs of serving PPM customers with a traditional meter*" which "*means that the SMNCC allowance will grow increasingly large and negative, offsetting the PPM uplift, as the reasons for cost differences between credit and PPM customers reduce*".⁴⁸ On this basis, Ofgem proposes that, with effect from 1 October 2020, the non-pass-through SMNCC for PPM customers should reflect any difference in smart-metering costs in the relevant period in comparison to those assumed to be contained in the cap (subject to certain adjustments).

- 17.1 As an initial comment, whilst the smart meter rollout will reduce the reasons for cost differences between credit and PPM customers, there will still be a higher cost-to-serve for the latter group. We comment further on this point in paragraph 24 below.
- 17.2 More specifically, we note that the accuracy of the cap in reflecting the impact of the smart meter rollout relies on a consistent approach (both in terms of data and methodology) to determining:
- 17.2.1 the additional costs of serving PPM customers with a traditional meter;
 - 17.2.2 a PPM uplift that actually incorporates the relevant costs to be offset; and
 - 17.2.3 an accurate assessment of the particular costs that reduce following the introduction of smart meters.
- 17.3 Our consultants are reviewing the model and data made available by Ofgem to see if this is the case and we will provide a supplemental annex to this response to Ofgem as soon as possible once they have completed their review. We have asked our consultants to review, in particular:
- 17.3.1 **Cost reflectivity:** Whether the non-pass-through SMNCC reflects likely changes in the efficient operating costs of serving PPM customers.
 - 17.3.2 **Consistency with other cost allowances:** Whether the funding for the smart meter programme in the allowance for operating costs, the PPM uplift and the non-pass-through SMNCC is sufficient to cover its efficient costs for PPM customers, on a forward-looking basis.
 - 17.3.3 **Cost-recovery:** Whether the DTC for PPM customers provides sufficient funding for the smart meter programme over its duration.
- 17.4 More generally, in taking this as an opportunity to reduce the PPM cap, Ofgem fails to take into account a number of relevant matters:

⁴⁸ Paragraph 5.10 of the PPM Consultation

- 17.4.1 The PPM cap has only just been reviewed and reset with effect from 1 October 2019, following a significant period at which it was set below an efficient supplier's cost to serve. The CMA found that, in July 2019, the price cap methodology was resulting in an under-recovery of cost of around £45.80 for a typical customer.⁴⁹
- 17.4.2 Specifically, the CMA found that suppliers had under-recovered smart metering costs, with the CMA's original cap only taking account of £1.50 in smart metering costs per customer⁵⁰, meaning that suppliers have to date under-recovered the costs involved in the smart metering over the course of the cap.
- 17.4.3 Ofgem has specifically decided not to review an allowance – the PPM Uplift – which it believes to be set too low.

We expand on these points below.

18. CHERRY PICKING IN THE CONTEXT OF THE REST OF THE CAP

- 18.1 In 2019 the PPM Cap was reviewed by the CMA with effect from 1 October 2019 following a long period in which it failed to reflect suppliers' efficient costs. In its July 2019 report, the CMA found that the price cap methodology was resulting in an under-recovery of cost of around £45.80 for a typical customer.⁵¹ This is highly relevant context to whether it is now appropriate for Ofgem to seek to open-up one area of the cap where it believes that there may be savings to be found, while ignoring past losses caused by the cap methodology previously employed.
- 18.2 Ofgem's decision to proceed in this way is even harder to justify when one considers that Ofgem has decided against adjusting the PPM uplift to reflect its own view of the efficient costs of serving PPM customers.
- 18.3 Ofgem's decision to reopen the non-pass-through SMNCC alone, so soon after the CMA's review, is simply "cherry-picking".

19. PPM CAP DOES NOT TAKE INTO ACCOUNT THE ACCRUED COSTS OF THE PPM SMART METERING

- 19.1 In its *"Reviewing smart metering costs in the default tariff cap: May 2020 statutory consultation"*, Ofgem summarises its SMNCC proposals and policy aim as follows:

" We aim to set the SMNCC allowance so that, in aggregate and over all cap periods, default tariff customers pay an amount that reflects the

⁴⁹ Paragraph 3.11 of the July Decision

⁵⁰ Paragraph 2.72 of the July Decision

⁵¹ Paragraph 3.11 of the July Decision

impact of the smart meter rollout on the operating costs of an efficient supplier with an average rollout profile".⁵²

- 19.2 Ofgem goes on to explain that it set the SMNCC allowance too high in the initial cap periods for the DTC and that it would adjust future allowances to take account of those advance payments. It explains that its aim in doing so is to *"seek to ensure that the allowances a customer is charged over the lifetime of the cap reflect the efficient costs of an average supplier over that period of time"*.⁵³
- 19.3 Ofgem also proposes to introduce annual reviews and adjustments so that it does not double count the costs and benefits that have already been accounted for in past cap periods, deducting advance payments in previous periods from the allowance in future periods or, if suppliers' costs have been higher than the allowances since 1 October 2020, Ofgem would add that lagged payment to the allowances in future periods.⁵⁴
- 19.4 If Ofgem applied this policy consistently for PPM customers, it would need to include an adjustment to account for the under-recoveries in respect of non-pass through smart metering costs for the periods between 1 April 2017 and 30 September 2020, i.e. so that *the allowances a customer is charged over the lifetime of the cap reflect the efficient costs of an average supplier over that period of time*.
- 19.5 The logical corollary of Ofgem's policy in respect of non-pass-through smart metering costs is that Ofgem would also include an adjustment to account for the under-recoveries in respect of pass-through smart metering costs for the periods between 1 April 2017 and 30 September 2020. We can think of no good reason why Ofgem's policy in respect of under- or over-recoveries of non-pass-through smart metering costs should not apply to pass-through smart metering costs. The under-recovery of these costs is a serious and systematic error.
- 19.6 But Ofgem only proposes to reassess past cap periods for the purposes of the PPM cap with effect from 1 October 2020 and then only in relation to non-pass-through smart metering costs. Ofgem proposes to make no adjustment for any difference between suppliers' efficient operating costs prior to October 2020 and the allowance for the impact of the rollout on their costs in that period (i.e. the cap assumed no impact). This is on the spurious grounds that *"Before 1 October 2020, the PPM cap was not part of the default tariff cap, and was not intended to account for the impact of the smart meter rollout"*.⁵⁵

⁵² Paragraph 2.1 of the DTC SMNCC Consultation

⁵³ Paragraph 1.30 of the DTC SMNCC Consultation. We also note that Ofgem appears to concede, in response to comments from suppliers, that it may have created a legitimate expectation that it would not adjust allowances in respect of the DTC cap periods prior to 1 October 2019 and therefore only proposes to make adjustments in respect of periods from 1 October 2019. This should not detract from the fact that Ofgem's policy is otherwise that adjustments should be made to allowances to reflect the costs of the smart metering from 1 January 2019, i.e. the date on which the DTC commenced.

⁵⁴ Paragraph 3.3 of the DTC SMNCC Consultation

⁵⁵ Paragraph 7.4 of the PPM Consultation

19.7 This accrued under-recovery is clearly a highly relevant factor to a decision to seek to remove any perceived over-recovery in later periods. But Ofgem's failure to take it into account is stark in light of Ofgem's general policy in respect of the DTC to ensure that the smart metering roll out allowances a customer is charged over the lifetime of the cap reflect the efficient costs of an average supplier over that period of time.

Unfair and mistaken reasons for this differentiation

19.8 Ofgem's failure to apply its general policy with respect to the recovery of smart metering costs over the duration of the cap to the PPM sector is both inconsistent and unfair. It disproportionately harms specialist PPM suppliers and disproportionately benefits other supplier types, particularly those with fewer than average PPM customers.

19.9 Ofgem's first attempted justification of this approach is that prior to 1 October 2020, *"the PPM cap was not part of the default tariff cap"*.⁵⁶ Ofgem does not explain why it thinks that this is relevant to how it applies its current policy. The fact that the PPM cap was not part of the DTC prior to 1 October 2020 hardly creates a practical barrier to the application of this policy or to the correction of an inherent wrong or error within the cap. It is a relevant factor which Ofgem cannot simply ignore.

19.10 Ofgem's second attempted justification is that prior to 1 October 2020 the PPM cap *"was not intended to account for the impact of the smart meter rollout"*.⁵⁷

19.11 It is correct that, in its July 2019 decision, when the CMA decided to align the methodology for its cap to that of Ofgem's in most respects, the CMA decided not to include an allowance for non-pass-through SMNCC costs for PPM customers. The CMA did state that, *"As the PCR only applies to prepayment customer without an interoperable smart meter, we do not consider it appropriate for such costs to be borne by prepayment customers within the scope of the PCR"*.⁵⁸ But the CMA was not intending suppliers to be unable to recover those costs over time, including from prepayment meter customers. The CMA's (admittedly crude) reasoning was that the PPM Uplift allowed suppliers to offset the non-pass-through costs of the smart metering. The CMA stated that, *"if suppliers were able to recover under the PCR the pass-through costs (£21.80) as well as the non-pass-through costs of the smart metering programme (£19.72), while still benefitting from the existing prepayment uplift (set for customers with non-smart meters at £67 in the current charge restriction period), we consider this would involve an over-recovery of metering costs under the PCR...Essentially, the non-pass through smart metering costs are offset by the costs savings that can be achieved by serving prepayment customers with*

⁵⁶ Ibid

⁵⁷ Ibid

⁵⁸ Paragraph 2.77 of the July Decision

*smart meters (in prepayment mode) rather than with a traditional prepayment meter.*⁵⁹

- 19.12 It is correct that the CMA's cap failed to take into account pass-through smart metering costs, but this was a flaw that the CMA rectified in its 2019 review when it found that pass-through smart metering costs had changed such that they were at a level materially higher than the level allowed for in the price cap. This was therefore a reason for changing the price cap so that it met its original design aims and not an intentional design aim.
- 19.13 It is correct that the CMA did decide not to rectify this accrued under-recovery in its decision of July 2019. But we do not see the relevance of that to whether or not Ofgem should now apply its policy in respect of under- and over-recoveries of smart metering costs in a consistent and coherent way.
- 19.14 Therefore, we request that Ofgem should apply the logic of its policy on smart meter costs fairly to the PPM sector and reflect the accrued under-recovery of smart meter costs (both pass-through and non-pass-through) over the duration of the PPM cap. As things stand, once again, Ofgem's pre-determined outcome that the PPM cap cannot increase has driven a mistaken and inconsistent approach to PPM suppliers and customers.

Ofgem's disclaiming of responsibility for the CMA cap fails to acknowledge its own duties as the sector regulator and its own role in the CMA's cap review as well as its obligation as decision-maker now to take account of all relevant facts and matters and achieve an appropriate outcome

- 19.15 In its July 2019 decision, the CMA accepted that PPM suppliers were unable to earn a normal level of return under its then-existing price cap and attempted to rectify this. It attributed the issue principally to flaws in the price cap's methodology that meant the cap did not account for increases in policy costs and pass-through smart-metering costs.
- 19.16 It is clear, however, that the CMA did not realise that it had also set the PPM uplift at too low a level and that the design of the DTC was such that DTC customers were picking up PPM costs. The CMA specifically said that "*the DTC does not include prepayment metering costs*" and rejected the idea of a cross-subsidy.⁶⁰
- 19.17 It now appears to us that, at the time of the CMA's review, Ofgem must have known about the DTC containing PPM costs. It had collected data from suppliers in 2017 and had spent much of 2018 analysing the data in order to design the DTC. This current consultation suggests that Ofgem was aware of the PPM costs contained within the DTC because Ofgem appears to believe that there are PPM costs in the DTC operating cost allowance, irrespective of whether the CMA's PPM Uplift is accurate or inaccurate.⁶¹ This may also explain

⁵⁹ Paragraph 2.81 of the July Decision

⁶⁰ Paragraphs 4.27(c) and 2.49 of the July Decision

⁶¹ Paragraphs 4.17, 4.56 and 4.57 of the PPM Consultation

Ofgem's reluctance to interfere with the level of the DTC if the "cross-subsidy" was built into Ofgem's approach to the DTC headroom.

- 19.18 As we explained to Ofgem in our letter to Dermot Nolan of 21 December 2018, pursuant to section 47 of the Electricity Act 1989, Ofgem has a duty to keep under review, and collect information on, certain matters including prices for prepayment meters and any distortion or restriction of competition. Further, Ofgem has a specific duty, pursuant to section 47(3) of the Electricity Act 1989, where it considers it expedient to do so, to give information, advice and assistance to the CMA with respect to such matters. Similar duties apply pursuant to section 34 of the Gas Act 1986.
- 19.19 If Ofgem failed to provide this information to the CMA during its 2019 review of the PPM cap, it would have failed to carry out its duty lawfully in this regard, despite being alerted by us to those duties at the time and our continued representations to the CMA and Ofgem about the cross-subsidisation in the market that we knew must be happening, but which we – unlike Ofgem – were not in a position to evidence. We note that we specifically asked Ofgem in our letter of 8 October 2018 to use its models and updated data to assist the CMA in refreshing the calculation of the PPM uplift.
- 19.20 In this context, it is wholly inappropriate for Ofgem to be claiming that it does not need to consider past under-recoveries on the basis that they occurred on the CMA's watch: Ofgem was the expert sectoral regulator in possession of relevant data in respect of which it had a duty to advise the CMA. Much of the responsibility for the CMA's cap being set at a level that did not allow suppliers to recover smart metering costs therefore lies with Ofgem. It is therefore wrong for Ofgem to disclaim responsibility for rectifying this, especially when this goes against the logic of its own policy. It is also inconsistent with its decision to unpick certain elements of the CMA's decision that is not yet a year old and was designed to rectify the problems in its initial cap and provide incentives over time.⁶²

PART FIVE: OTHER ISSUES

20. WHOLESALE COST ALLOWANCE ADJUSTMENT

- 20.1 Whilst we appreciate the logic to Ofgem's decision to exclude PPM customers from the wholesale allowance adjustment (as the transitional issue for the first DTC period did not apply to PPM customers as they were already subject to the CMA's cap), we also note at the relevant point in time PPM suppliers were subject to a loss-making tariff that was much more onerous than the default tariff cap was to suppliers. Indeed, for a period of time, the PPM cap was set at a level below the DTC.
- 20.2 This decision therefore again reflects Ofgem's cherry-picking approach when it comes to the PPM sector.

⁶² Paragraph 2.81 of the July Decision

21. FAILURE TO PROVIDE COVID ALLOWANCE

- 21.1 Ofgem states that, at this stage, they cannot reliably estimate the scale of the impact of Covid on suppliers' costs and therefore propose to address the net cost impact in arrears, once the costs are known.
- 21.2 But Ofgem cannot expect suppliers to fund and support customers who cannot pay their bills or top up their meters when, by Ofgem's own view, they are under-recovering their costs. Suppliers simply cannot finance this without an allowance, even under the existing cap. It is Ofgem's job as regulator to estimate the impact, particularly in circumstances in which liquidity is a serious problem and Ofgem is about to impose further obligations on suppliers in respect of proactively identifying customers who are self-disconnecting and self-rationing.

22. HEADROOM

- 22.1 Ofgem justifies its decision not to review the headroom on the following basis: *"The adjustments to the payment method uplift and the non-pass through SMNCC which we propose relate to the different costs of serving PPM customers, and we have not identified any additional (or fewer) uncertainties in these costs than for other payment methods."*⁶³
- 22.2 This justification assumes that the payment method uplift and the non-pass through SMNCC are set on a cost-reflective basis and on the same "conservative" basis as Ofgem applied to the rest of the cap. It is now clear that they are not and therefore should theoretically affect the level of uncertainty and inaccuracy in the DTC and therefore the approach to headroom. Moreover, there are good reasons to believe that Ofgem is less able to identify efficient costs specific to the PPM sector than for the generality of consumers and therefore measurement error is greater: most suppliers offer tariffs to direct debit and standard credit customers. There are also some specific risks that PPM suppliers are more exposed to, for example, volumetric risk.
- 22.3 Clearly, our view is that DTC headroom should not be used to deal with the lack of cost-reflectivity in the PPM-specific elements of the PPM cap, but it should be set at an appropriate level and Ofgem should ensure that it is not used to cover an unreasonable number of risks. We also note that, because headroom is set as a percentage of the other cost elements, and because the PPM uplift does not reflect efficient costs for PPM suppliers, the headroom figure in the PPM cap will inevitably be lower than it should be and lower than the headroom available in respect of other customer types (and in respect of those types will in fact over-compensate for uncertainty due to the cross-subsidy).
- 22.4 Yet Ofgem has ignored the CMA's recommendation to review the headroom for the PPM cap. It should have considered whether further headroom was required for the PPM sector and reflected this in the PPM uplift or a specific headroom allowance for PPM customers. We would ask Ofgem to reconsider its approach.

⁶³ Paragraph 3.18 of the PPM Consultation

23. FUTURE REVIEWS

- 23.1 We do not agree with Ofgem's proposal to limit the scope of future reviews of the SMNCC on the basis of proportionality. It is crucial that industry is able to have the opportunity to review in detail the accuracy of Ofgem's proposals: whatever the outcome of this consultation is, there will be no leeway in the price cap to allow PPM suppliers to take a broad-brush approach to the accuracy of individual components of the cap. There is no reason for Ofgem not to provide full transparency and make available the relevant data to allow industry to take a view on whether it is proportionate for them to review it: Industry has no desire to spend unnecessary time and money on such matters, but experience supports the need for it to do so.
- 23.2 We also note that our consultants' findings in respect of the accuracy of Ofgem's approach to date will be relevant to this question and therefore we may follow-up with more specific comments on the scope of future reviews.

24. MISUNDERSTANDINGS

- 24.1 It is apparent from the consultation that Ofgem misunderstands the PPM sector in a number of ways. We have commented on many of these already elsewhere in our response, but we wish to note the following additional points.
- 24.2 ***Variable tariffs are not necessarily punitive tariffs.*** Some suppliers do their best to offer one main tariff to avoid confusing customers and abusing their trust by using the "tease and squeeze" strategy. This is a preferable outcome for many customers. We do not think it makes sense to assume that a customer choosing a fair, single variable tariff, which they can leave at any time, needs protection from a cap.
- 24.3 ***Lack of fixed price contracts is not an indication of a lack of customer engagement or competition.*** The reason that there are not many fixed price contracts offered in the PPM market is because the existing price cap applies to such contracts (which is not the case in the DTC), meaning that suppliers are actively disincentivised from offering them because the "fixed price" is only fixed if prices and costs go up (to the detriment of suppliers) and not if they (and the cap) go down (to the benefit of customers). Therefore, Ofgem must not view the lack of fixed price contracts as indicative of anything other than the skewed incentives produced by the existing price cap.
- 24.4 ***PPM Customers are not debt free.*** PPM customers may bring debt with them through the Debt Assignment Protocol, acquire debt due to having difficulty paying their bills and seeking discretionary credit, or move to prepay to pay off debt previously acquired as a credit customer. It is not tenable for Ofgem to consider that either prepay customers do not acquire debt, or that debt incurred under a different payment method is relevant only to that payment method. For example: a PPM supplier inheriting a prepay customer is compelled to take on their debt under the Debt Assignment Protocol (up to £500 per meter) and the outgoing supplier receives most of the debt under the Debt Assignment

Protocol. The inheriting PPM supplier may also have to provide the customer with further support and discretionary credit.

- 24.5 **ECO Scheme:** We note that Ofgem is considering recovering "*advanced payments*" it considers have been made in respect of the ECO scheme. Given that our experience is that the costs of the ECO scheme have increased significantly, if Ofgem determines in due course to carry out such a review, any such review must involve a reassessment of the costs of the scheme. In the meantime, we reserve all rights to comment on any proposals in respect of the ECO scheme that Ofgem brings forward in due course.
- 24.6 **Ongoing Cost-to-serve differential:** Ofgem make a number of statements that indicate its belief that once the smart meter rollout is complete, the difference between the costs of serving PPM customers and credit customers will be substantially reduced, or removed.⁶⁴ Whilst the costs will reduce, we envisage that there will still be a significant uplift required to cover the cost to serve PPM customers. One example is that a PPM customer with a smart meter can top up easily and wherever. They can therefore match size of top up to their budget and may choose to top up two or three times a week. Each top up has a cost to the supplier. If the customer had previously topped up once a month as the shop was five miles away, this will multiply the costs to the supplier of serving this customer.
- 24.7 We would be pleased to provide further information on this issue to Ofgem in due course. In the meantime, Ofgem should not act on the assumption that the need for a PPM Uplift will disappear once the smart meter rollout is complete.

25. FAILURE TO CARRY OUT AN IMPACT ASSESSMENT

- 25.1 Pursuant to Section 5A of the Utilities Act 2000, Ofgem is required to carry out an impact assessment where:
- 25.1.1 it is proposing to do anything for the purposes of, or in connection with, the carrying out of any function exercisable by it under or by virtue of Part 1 of the Gas Act 1986 or Part 1 of the Electricity Act 1989; and
- 25.1.2 it appears to it that the proposal is important, unless it appears to Ofgem that the urgency of the matter makes it impracticable or inappropriate for Ofgem to comply.
- 25.2 To date, we do not believe that Ofgem has published a draft impact assessment and so assume that Ofgem is not proposing to publish one when it makes its decision. But we are unclear why. Ofgem did so when designing the DTC.
- 25.2.1 Ofgem is exercising functions under Part 1 of the Gas Act 1986 and Part 1 of the Electricity Act 1989 when deciding how to proceed in respect of prepayment meter customers and is exercising functions in connection

⁶⁴ Paragraph 1.23 of the PPM Consultation

with those functions when modifying licence conditions pursuant to the Act.

- 25.2.2 The proposals are clearly important, given their impact on suppliers and the public.
- 25.2.3 The exemption cannot apply, given the need for Ofgem to take these decisions has been known since the CMA first introduced a time-limited price cap and there is no need for Ofgem to end the CMA's cap early.
- 25.3 A failure to carry out an impact assessment would not simply be a procedural failure. If Ofgem carried out an impact assessment, it would be self-evident that its proposals are ill-considered, disproportionate and discriminatory – and not in the interests of PPM customers or customers generally.

26. NEXT STEPS

- 26.1 We would welcome the opportunity to discuss Ofgem's proposals and our response to the consultation with Ofgem further. We are also available to provide any information that Ofgem would find useful in reaching its decision, for example any further information about Utilita's costs or efficiency, the likely impact on Utilita of Ofgem's current proposals or on the benefits that PPM specialist suppliers have brought to PPM customers.
- 26.2 We would also be happy to discuss with Ofgem alternative ways in which it could seek to achieve the legitimate objective (which we share) of keeping bills as low as possible for PPM customers. We think this objective can be achieved by measures that do not operate against the long-term interests of PPM customers. One example might be to look at the smart metering policy framework as it applies to PPM customers, in particular in relation to SMETS2 meters.
- 26.3 We intend to submit a supplemental annex to this response as soon as possible following our consultants completing their review of the data and model made available by Ofgem.
- 26.4 Alison Russell will be happy to act as our contact point for questions or to arrange a meeting, her email is alisonrussell@utilita.co.uk, and her phone number is 07711 900614.

Yours sincerely,



W. N. Bullen
CEO, Utilita