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Dear Dan,

Re: Review of additional wholesale costs in the default tariff cap: Update

Thank you for the opportunity to comment on the above update. We welcome the approach by Ofgem of sharing early thinking. We have set out below our brief views in respect of each of the questions posed by Ofgem.

5.1 To what extent do you agree or disagree with the overarching principles we have set out? Are there any additional principles you think we should consider when making a decision?

Utilita agrees with the general principles, especially that Ofgem should discount commercial decisions in any adjustment it makes, as any profits or losses resulting from these decisions are not a consequence of price cap allowances.

Utilita would also welcome Ofgem applying this overarching principle more broadly and so applying retrospective corrections to other elements of the price cap that are manifestly divergent from actual supplier costs, such as the operating cost allowance within the price cap. Utilita has previously set out its detailed views on those issues, though we have not restated here. We would, of course, be happy to discuss these points in more detail with Ofgem colleagues.

5.2 Given that Ofgem must exercise its functions under the Act with a view to protecting existing and future customers on standard variable and default tariffs, to what extent should suppliers be able to retain benefits or bear costs from (relating to principles 1 and 3):

> *a) overall market movements (eg in SVT demand or price driven demand destruction), that are outside of their control?*
> *b) commercial decisions (eg hedging strategies), that deviate from the assumed behaviour in the price cap? Does your answer differ whether the impact is a cost or a benefit to suppliers? If so, why?*

Overall market movements that are outside a supplier's control must be reflected in price cap allowances, as the price cap is intended to allow the recovery of the efficient costs of energy suppliers and further limits retail prices to these unavoidable costs; hence when the unavoidable costs change, the price cap must also change.

Suppliers may choose to deviate from any implicit behavioural assumptions within the price cap for legitimate reasons and must neither be compensated for risky behaviour resulting in losses, e.g., failing to price in the risk of a fixed term contract customer defaulting onto the default tariff cap when wholesale prices rise, nor penalized for sensible decisions that improve its financial position. The price cap is not intended to set a fixed profit or loss per customer, but to limit retail prices to protect the interests of customers while encouraging suppliers to make a profit, and as such Ofgem must not discourage efficient operation and incentives to increase efficiency; either compensating suppliers for poor decisions that result in losses or disallowing the profits from efficient behaviour will encourage inefficiency in the energy supply market.

5.3 To what extent should we align to the approach taken for previous wholesale decisions? Has suppliers' ability to mitigate risks changed over time, or are there other relevant changes in circumstances which would impact suppliers' ability to mitigate risks?

Where costs are unavoidable, such as high shaping costs, there is no case for expecting suppliers to be able to adjust their behaviour to mitigate the resulting costs.

Unexpected SVT demand, on the other hand, can no longer, if indeed it ever could be, described as 'unexpected', as any supplier previously ignorant of the risk of a fixed term tariff customer electing to receive price capped prices at the end of a fixed term contract can no longer be so.

5.4 Are there other considerations we should have when differentiating between an overall market movement (eg customers remaining on SVT tariffs), as opposed to an individual supplier's risk management strategy (ie between systemic and idiosyncratic risks)? To what extent should this include consideration of the number of suppliers who adopted a particular strategy?

Ofgem must be consistent in its approach; if it considers that many suppliers acted in a way that was different to the implicit assumptions within the price cap about efficient operation, and this difference in behaviour resulted in a gain to suppliers that Ofgem wishes to adjust for, Ofgem must also adjust for the losses suppliers incur due to inadequate provision for operating costs within the price cap since its inception.

Unless Ofgem is going to compensate suppliers for its repeated inadequate provision for operating costs spanning previous price cap periods, evidenced by the near universal losses of suppliers since its implementation, it must also disregard patterns of supplier behaviour that differ from those assumed within the price cap, where the result is a benefit to suppliers.

5.5 Do you agree with our high-level approach to differentiating between impacts caused by commercial decisions and external events? Where we see discrepancies between costs and allowances, what evidence should be considered to distinguish between the impact of commercial choices versus the impact of market movements outside of a supplier's control?

Utilita agrees with Ofgem's approach, but cannot comment on what would constitute admissible evidence, other than the explanation given by the supplier of why costs differ from allowances.

5.6 Given the variability in supplier approaches, and that Ofgem can only set one price cap level, how should we weight the commercial decisions made by some, but not all, suppliers? For example, if all suppliers benefited from market movements outside their control but only some suppliers also took commercial decisions which created further benefit.

We consider our answer is the same as that for question 5.4. However, to restate to avoid any doubt - Ofgem must be consistent in its approach.

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5.7 Before adjusting for any gains or losses, are there any particular factors that we should consider offsetting through other allowances (eg headroom)? If suggesting an offsetting allowance, please explain why.

No additional comment.

5.8 What benchmark approaches should we consider and why? Should the approach differ based on the direction of a potential adjustment?

Utilita sees no reason why the approach ought to differ by the direction of a potential adjustment. Given costs due to market movements are unavoidable, a mean of supplier costs for these variances would be the most appropriate benchmark. As described above, variances due to commercial decisions ought to be excluded from any adjustment.

We hope these comments have been helpful, and as we have stressed previously, we should be happy to discuss in more detail if Ofgem colleagues would find this helpful.

Yours sincerely,

By email only

Alison Russell
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