utilita
life with power

13 November 2023

Price Protection Policy
Ofgem
10 South Colonnade,
Canary Wharf,
London,
E14 4PU

Email: regulatoryaffairs@utilita.co.uk

By email only

Dear Price Protection Policy,

Re: Energy price cap operating cost review benchmarking working paper.

We write in reply to the above Working Paper. We set out our responses to Ofgem's questions in Appendix 1.

We are generally agreeable that the average weighted benchmark option delivers positive customer outcomes.

We support the weighted average approach. It is our view that this approach also enables higher supplier efficiency and achieves all four outcomes, (in Table 2) in a more sustainable manner. A lower quartile benchmark does not suddenly create efficiency and will make investment in the energy sector, and investment in innovation more difficult.

We agree with Ofgem's assumption that EGP will not be in place or will remain above the cap. It is not clear however, if Ofgem has assumed that the PPM cap will be levelized. This is a key assumption in supporting PPM customers, historically Ofgem has not allowed full cost recovery and has chosen to create payment type cross subsidies to protect this customer segment from the price differential compared with direct debit customers. This is no longer needed and the benefits of reflecting the true cost within the Cap will ensure that these customers receive the level of support and innovation they deserve.

The benchmark must be directly linked to the granularity of costs in which Ofgem applies a benchmark to. The more Ofgem segments cost elements the greater risk there is of creating an unrealistic notional supplier (as assessing cost categories separately fails to reflect the different specialisms of different suppliers, each of which will be more efficient in its area of focus). This risk is mitigated with a weighted average benchmark.

Since the implementation of the price cap, customer switching has reduced dramatically, with prices for SVT tariffs converging at or close to the cap. Indicating that the cap has been set too stringently in the past. The cap should protect vulnerable customers who do not engage with the market, it should not set prices.

The last few years have highlighted the risks of understating the price cap. When considering its approach Ofgem should recognise that there is greater risk in undersetting allowances than oversetting them. Competitive, naturally occurring, forces will keep pressure on lower prices, only where allowances are overstated. However if they are set too low, customer outcomes will be poorer, with lower customer service levels, less innovation and overall reduced financial resilience.

Yours sincerely

Robert Cameron-Higgs
Director of Regulatory Affairs (Designate)

Appendix 1

We set out our responses to Ofgem's questions below:

1. **What is your view on how benchmarking options will lead to different outcomes?**

It is evident that the current approach to the benchmark has not led to good customer outcomes. A lower quartile benchmark creates an unrealistic notional supplier, leading to unsuitable business practices or a higher level of capital adequacy.

The benchmark applied needs to be considered in line with how it is applied to costs. The more the granular costs are analysed, and the benchmark applied to individual cost items, the more unrealistic the overall allowance will be.

A weighted benchmark for the total cost to serve will most accurately reflect a notional supplier, rewarding suppliers whose overall business model is more efficient than average and will incentivise those who are below average to invest in efficiencies. Leading to a sustainable, competitive market where suppliers can innovate and deliver real savings to customers, while protecting all customers from *excessive* prices, as intended in the Tariff Cap Act.

Within a highly competitive sector, the risk of understating the allowance has greater overall detriment to the industry than overstating the allowance.

2. **In terms of achieving these overarching objectives, what outcomes should we focus on through the operating cost review?**

Positive customer outcomes should be the overarching objective(s) for Ofgem and suppliers, which set the primary parameters of any operating cost review. The industry is a month away from a new set of Licence Requirements for improved Customer Standards which narrowly avoided a price cap adjustment. This set of licence changes is being implemented alongside the Voluntary Ofgem/Supplier/Citizen Advice sponsored winter initiative to assist customers in the short and medium term and withhold specific debt-related activities this winter. Yet, suppliers are still being expected to go above and beyond Licence obligations in other areas. With Suppliers operating wafer-thin margins, Ofgem must continue to adjust the price cap with these incremental regulatory changes otherwise it leaves no room for supplier innovation.

It is Ofgem's goal to promote sustainable competition, therefore it must create a market where new entrants can, not only enter the retail industry, but make and retain a reasonable profit. Existing suppliers must also be able to make and retain reasonable profits. This will in turn attract investment into the market, ensure supplier resilience against future shocks, organically drive-up customer standards and further drive *real* innovation.

Therefore, Ofgem should allow an upward correction on the cap to take account of current and future regulatory changes. The notion that Ofgem can protect consumer interests by keeping prices artificially low is not sustainable and would further lead to key supplier exits (see Shell, for example). Actual customer Price Protection can only be effectively managed by good competition and not through well-intentioned but ultimately self-defeating interventions in the energy market.

3. Are there any other outcomes that we should consider achieving through the choice of benchmarking options?

The benchmark needs to allow for at least the average supplier to recover its costs. Ofgem should consider the investability of the sector and allow for good competition under the price cap. The price cap was never meant to set the price of energy, but to operate as a cap to protect consumers who do not engage with the market and stick on standard variable prices for years.

4. Are there groups of costs captured within the operating cost review that are cross correlated and therefore those costs should be considered and benchmarked together?

As stated above, the more granular the costs are grouped and a benchmark applied, the higher the benchmark must be set. But all costs are inextricably linked, with the move to a smarter energy supply sector imminent, it would be irrational to believe that this will be more cost effective for suppliers in the short term.

The benefits of Smart in Prepay, for example, enable suppliers to monitor customers in real time, and provide immediate proactive support. This is additional support that is not available for non-smart customers and while in the short term, it will lead to an increase in suppliers' costs, this will result in more positive customer outcomes in the longer term.

Ofgem must therefore remove the separate SMNCC allowance and cover this within Technology and Communication costs.

5. How should we treat costs (ie debt-related costs) that may be more uncertain than other costs?

A separate benchmark may be needed for the underlying economic situation which undoubtedly will become the new norm for the foreseeable medium-term future. This is combined with the suspension of debt recovery activity since February 2023 (the PPM moratorium), the new Licence conditions on Involuntary PPM installation, supplier winter commitments on debt pauses and increased write off, and the £150 warrant cap which is not linked to inflation. All of which will lead to more bad debt costs which must be considered.

This requires a degree of future-proofing future debt related costs, which is as yet not quantified or incurred. Suppliers can estimate the volumes for yet-to-be incurred costs which should also be considered.

6. Are there any other costs that we should isolate from the total core operating costs?

Isolating specific costs will increase the risk of incorrectly setting the allowance. Ofgem must take all costs into account including the inefficiency that results from major industry initiatives in the short term and other industry costs relating to adoption and enrolment.

7. What are your views on setting separate core operating cost allowances for smart meter and traditional meter customers, given the risks we discussed in this section?

We do not support separate core operating cost allowances for smart and traditional meter customers.

The increased capability enabled by smart prepay leads to much better customer outcomes but potentially at a higher cost. This may not be true for traditional and smart credit customers. For example suppliers can monitor meter information in real time, and provide immediate proactive support when customers face difficulties such as issues topping up, help to restore supply following disconnection, provide additional support credit or schedule an engineer visit. This is additional support that is not available for non-smart prepay customers. This capability clearly has a better customer outcome but comes at a cost to suppliers.

Traditional meter customers must continue to bear the cost of the smart meter rollout to incentivise them to upgrade their meter infrastructure and to encourage their respective energy supplier to install smart meters. The difficulties with the smart meter rollout are that it sets targets for suppliers to meet, but it does not mandate consumers to have them installed in their property. Innovative suppliers like Utilita that put the installation of smart meters as part of their USP should not have to subsidise suppliers who fail to adhere to smart meter rollout targets or for consumers who refuse a smart meter.

By splitting the price cap between traditional and smart meters, it would perversely incentivise traditional customers to not accept a smart meter because the costs may potentially be more expensive to have a smart meter.

Utilita's view is that all customers should pay the same, with traditional customers paying for Smart, they will be incentivised to receive the benefits at no additional cost.

On top of the above there is an additional cost in managing more tariffs because of potentially separate caps and ensuring compliance with multiple price caps.

8. What other benchmarking parameters do you think we should consider setting separate allowance for?

We do not consider that the industry would benefit from setting separate allowances. The costs are all inter-linked. All costs should be considered in their totality.

9. What analysis do you think we should carry out in assessing the materiality of nonefficiency factors using the RFI data?

Please see our response to Question 10.

10. What other approach do you think we should take in how we account for nonefficiency factors?

We do not believe Ofgem should be too concerned by “nonefficiency”, different business models will have different efficiencies and non-efficiencies. As in response to other questions in this consultation, Ofgem should consider costs in total and look at a weighted average.

The more granular Ofgem considers the cost stack the greater risk there is of creating “nonefficiency” which is then offset elsewhere.

For example, it could be viewed that Utilita’s customer mix is “nonefficient”, however this nonefficiency is only created by setting benchmarks at more granular cost items.

For example, a higher-than-average proportion of PPM customers is efficient from a bad debt perspective. Ofgem recognises this and adjust this cost item within the PPM cost stack meaning that a PPM specialist supplier does not benefit from these efficiencies. These efficiencies come at a higher operating cost, therefore Ofgem must allow the full recovery of these costs.

11. What is your view on the proxy for suppliers’ proportion of high-cost-to-serve vulnerable customers? Would you suggest an alternative approach?

In the case of Utilita with a high proportion of smart prepay and PSR customers, this should not be treated as an inefficiency. We must be allowed to recover our costs to support these customers. As for our response to Question 10, a high proportion of vulnerable customers is not an inefficiency, and to imply it is, is to assume an inherent cross subsidy between customers.

12. What level of stringency of the cap do you think we should consider?

Ofgem must consider that the risk of setting the allowance too low is greater than that of setting it too high. Energy supply is a competitive sector, naturally occurring competitive forces will reduce prices if Ofgem sets them too high but if set too low there is no way for the sector to recover these costs and this could lead to greater risk taking, for example a higher risk hedging strategy to make up the difference.

13. How should we account for the impact of the expected regulatory changes mentioned above?

The recent changes to Involuntary PPM, Additional Support Credits and self-disconnection regulations need to be considered, these well-intentioned interventions will drive up consumer debt and reduce a customer’s incentive to become energy efficient. Costs to serve will increase as more customers realise they are subsidising customers who refuse to pay through higher energy bills and simply begin to follow suit.

Ofgem’s current expectation of suppliers is that meeting licence obligations in customer experience should be predicated on upholding minimum standards. Considering that and the fact that regulatory changes will evolve (almost certainly continuously raising the bar for energy suppliers) it should demand a looser cap to account for these uncertainties.

14. Which option of accounting for the uncertainties in costs driven by upcoming regulatory changes do you agree with? What other options do you think we should use to account for these costs?

We agree with option three: setting a looser cap.

15. How should we account for the limitations in our methodology and the associated uncertainty?

The Quarterly price cap review allows Ofgem to make more targeted adjustments for unexpected costs. We would support an annual RFI on the same basis, so Ofgem can monitor operating costs, and where it deems material, adjust the operating costs accordingly, allowing suppliers to recover such costs and thus ensuring customers benefit from continued innovation and supplier efficiency on an enduring basis. Ofgem should not rely on headroom indefinitely which has been the current approach to costs.

In achieving the four outcomes Ofgem has identified, the risk of overstating the allowance is less than understanding it. Any overstatement of the cap in its totality will have an advantage of being subject to competitive forces.

16. What approach do you think we should take to set the benchmarks for different operating cost allowances?

The difficulty in operating under a price cap is that each energy company has its own unique business model, with differing customer demographics and pricing structures, so it is problematic to take account of the different operating cost allowances or anticipate future economic shocks.

Benchmarks should allow for a looser cap and consider all reasonable costs rather than an allowance that understates efficient retail prices to the detriment of both suppliers and, in the long run, customers.

Ofgem must create a market where new entrants can not only enter the retail industry, but make and retain a reasonable profit. Existing suppliers must also be able to make and retain reasonable profits. This will in turn attract investment into the market, ensure supplier resilience against future shocks, organically drive-up customer standards and further drive *real* innovation.