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Project Manager
Energy Market Investigation
Victoria House, Southampton Row
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Dear Sirs

re: Energy Market Investigation - Initial Submission

Introduction to Utilita

Utilita is an independent supplier of gas and electricity to the residential market in Great Britain focused on delivering a pre-pay service using smart meters. Utilita launched its product in 2009, and now has 130,000 dual fuel customers, of which nearly 100,000 have smart meters installed. Over the last five years we have maintained a price point below the lowest price of the Big Six, whilst at the same time delivering a higher quality of service, both in terms of convenience and reliability.

More than 4.5 million homes in GB have prepayment gas and/or electricity services. According to Consumer Futures the majority of these households are within the 3 lowest income deciles and have a higher proportion of people with special needs and a greater propensity to suffer from Fuel Poverty (under the government's 'high cost low income definition'). These customers are, in our opinion, poorly served by the Big Six who typically charge higher prices, driven in part by their continued use of out-dated technology and inefficient systems. This market sector is probably the most in need of the benefits that innovative competitive suppliers can bring.

Utilita's unique and innovative business model is not only delivering better value to its customers now, it is also a demonstration of how supply operations can be run more efficiently. Smart meters, a more expensive asset compared to conventional pre-pay meters, have allowed us high productivity levels and a low cost to serve to serve as a result we can offer customers a price point lower than the Big Six. With 99% of our customers pre-paying we have minimal bad debt. We have already surpassed 1,000 supply points per employee. We consistently settle 90% of our wholesale electricity requirements within 2 months (industry average less than 40%). These performance figures, added to the price point we have achieved, and the high percentage of our customers that are already benefiting from the convenience offered by smart meters, show that better business performance is possible at the same time as giving a better service to customers.

We have faced a number of barriers to growth that have caused us to carry additional costs and risks. These have arisen from a wide range of regulatory and/or industry systems and governance arrangements, rather than such things as wholesale market liquidity or vertical integration. The devil has been very much in the detail. We believe neither Ofgem nor the government have given sufficient assistance to small suppliers to help overcome these barriers.

During the financial year 2012/13 we estimate that deficiencies in the detailed operation of the gas and electricity supply industry cost Utilita in excess of 5% of its revenue. Energy supply is by nature a high turnover/low margin business, and it should be immediately obvious that a 5% loss of revenue, which effectively ended up in various pockets of the Big Six, is unsustainable, and has a serious impact on the ability of innovative new entrants to compete with established players.

Legally the maximum fine that Ofgem can apply is 10% of turnover, although this has never happened – the biggest fine to date was less than 2%. We, however, were effectively “fined” half of the maximum penalty simply for trying to deliver a better and cheaper energy service to those that are most in need.

CMA Energy Market Investigation

Retail profits in energy supply are low in percentage terms, and probably lower than industries serving equally vital goods and services such as housing and food. However, a simple percentage profit comparison fails to recognise the much greater risks faced by energy suppliers due to the capital intensity of the industry and the huge variations in demand. The risk/reward ratio in energy retailing is clearly not that attractive to established retail brands. Supermarkets have started phone services, petrol retailing, various financial services, but have NOT entered the energy market other than as sales agents with white label products. Even big energy brands such as Shell and BP have chosen not to enter the residential energy supply market despite having significant up stream activity and strong consumer brands.

The level of competition in terms of numbers of companies is not significantly different from other sectors of the economy. Food retailing, petrol retailing, and retail banking, all have around six large companies serving the bulk of the market. In recent years the number of residential energy customers that are supplied by new entrants has risen to over 5%, and is still rising, but this ignores the huge in roads new entrants have made in the business market.

Energy still represents a relatively small part of household expenditure for most customers at around 5% compared with 20% spent on food and other groceries, and over 40% on housing. Indeed published government statistics don't even show the cost of energy supplies as a separate item.

In summary retail energy supply is:

- not that profitable compared to the risks it carries;
- at least as competitive as other sectors of the economy; and
- not that important in terms of the overall cost of living for the majority of consumers.

Nonetheless, the energy market is a key area of political and regulatory activity. Since privatisation of the electricity industry in 1990 there has been an almost constant stream of interventions, so much so that the industry has never had a meaningful period of stability to allow competition to flourish, drive down prices and improve services. In recent years the rate of new interventions has accelerated, often with overlapping or conflicting objectives, many with no overall benefit to consumers.

Whilst there has been criticism about the prices and profits of energy suppliers, the government has introduced mechanisms that improve the profitability of electricity generators and that will tend to raise wholesale prices (and hence retail prices). The view that profits are

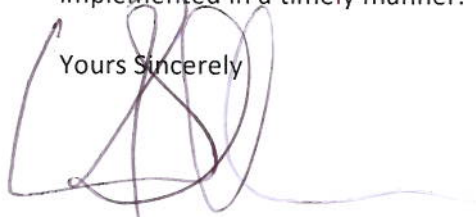
too high in energy retailing but not high enough in generation doesn't fit well with the concept of too much vertical integration whereby vertically integrated companies make their profits upstream, and thus stifle competition downstream.

None of this is to say that there are no problems with the energy retail industry, indeed there are many as we have stated earlier. Energy markets are complicated and the processes that support them are intricate, frequently opaque, rooted in the past and hard to change. We believe their ability to manage change to industry processes is one of the key ways the Big Six have exploited their market power. Furthermore, we believe that Ofgem has acquiesced in that it has failed to make changes that would bring simplicity and clarity to the market, or has adopted a one-size-fits-all policy that essentially maintains the market power of the incumbent players.

Although we acknowledge the theories of harm raised in the Statement of Issues, we do not believe these address all of the problems faced by new entrants. In particular we believe the issues of: (i) regulatory risk; (ii) political intervention; and (iii) industry governance, must form part of the investigation. They have an impact on investment, the propensity of companies to compete in the market, the costs they impose on existing companies (including the cost of capital), and thereby reduce the value competing suppliers can deliver to consumers. We raise some of the detailed issues in the attached appendix.

The main benefit, in our opinion, to be derived from the CMA investigation would be a clear, accurate and authoritative statement on the supply of energy, and how it should be regulated. We therefore fully support the CMA in its work and look forward to seeing the benefits implemented in a timely manner.

Yours Sincerely



William Bullen
Managing Director, Utilita

Appendix to Initial Submissions

Gas allocation

The gas market is cleared on a daily basis, but it is currently not possible to read all domestic gas meters that frequently, and consequently the industry has a set of rules for estimating the amount of gas a supplier takes from the system. Unlike in the electricity market there is no subsequent reconciliation of the estimated consumption to actual meter readings, and therefore any error becomes a hard cost (or benefit) to the supplier.

The accuracy of the estimation process is critical to the success of the gas market since it is impossible to say we even have a market if what the supplier is allocated by the estimation rules has no relation to the amount of gas it sold to its customers. However, the estimation process is based the consumption profile of a typical credit metered customer, and it is clear that pre-pay customers not only have a different profile of consumption, but a very different response to variations in temperature.

The effect of this was to dramatically over estimate the amount of gas that was allocated to Utilita's account during the FY 2012/13, costing an additional £1.5 million. In some months the estimation error was in excess of 25% - higher than our gross margin. Since the total amount of gas is fixed, any over allocation to Utilita means that larger suppliers were under-allocated, albeit by a minute amount in comparison to their total consumption.

During our subsequent discussion with Ofgem it became clear that this was a problem that they were aware of but had done nothing about. Furthermore it was clear that the largest supplier in the market was also well aware of the problem, but had chosen to do nothing about it. Despite the large negative impact this error had on a new entrant Ofgem decided it was unfair on the larger suppliers to ask them to re-pay the subsidy they took from Utilita, and Ofgem took no action to help Utilita recover its loss.

This is an example of governance, and subsequently regulatory, failure.

Electricity Prepayment Infrastructure

The infrastructure behind most electricity pre-pay meters was not originally designed for a competitive market, furthermore when competition was introduced to the retail market in 1998 there were no accreditation standards for operators of prepayment infrastructure (despite the fact that accreditation was introduced for most other critical systems). The consequence of this is that payments made by consumers to top-up their key meters are sometimes sent to the wrong supplier and in some cases are sent to no supplier at all. These are referred to in the industry as mis-directed payments and unallocated payments respectively.

Between them the Big Six are currently holding around £25 million in cash for which their systems cannot identify the correct supplier, i.e. unallocated payments. However, we estimate that this is dwarfed by the amount of cash that they have sent to the wrong supplier, i.e. mis-directed payments. They all still resist any attempt to introduce accreditation of their pre-pay infrastructure systems.

Furthermore the industry has been unable to agree a protocol for the transfer of credit on pre-pay meters when there is a change of supplier. The result of this is that the old supplier retains the customer's cash, whilst it is the new supplier that has to absorb the cost of energy being consumed. Clearly incumbent suppliers will be net winners from this, whilst new entrants will

be net losers. This inability to agree a protocol needs to be compared to speed in agreeing a debt transfer protocol for pre-pay customers, i.e. where the new supplier has to send them cash.

The combination of these failings in electricity pre-pay processes cost Utilita over £1.0 million during 2012/13.

This is an example of governance, and subsequently regulatory, failure.

Allocation of Unidentified Gas

Due to inaccuracies and failing processes in the gas industry, residential customers have been systematically subsidising the gas consumption of commercial customers. This has primarily due to two reasons: (i) an inaccurate estimate of how to allocate losses from the gas distribution network; and (ii) an inappropriate allocation of the gas consumed at premises that did not have a gas supplier registered to them.

This is an example of governance failure.

Gas Network Charges

Unlike electricity, gas network charges result in largely fixed monthly costs. This means that suppliers (with a relatively high cost of capital) subsidise network operators (who have a relatively low cost of capital) during the summer months when gas demand is low. This will increase consumers' bills.

Utilita has previously lobbied to have the structure of gas network charges changed to make them more related to the level of consumption. The monopoly network operators rejected the change and Ofgem agreed with them.

This is an example of governance and regulatory failure.

Collateral

We currently have over £7 M in collateral placed with a variety of counterparties to cover energy and networks liabilities. This is a significant burden, and the requirement to place more collateral is a key constraint to growth. Collateral requirements are due to get worse rather than better, since suppliers are being asked to provide guarantees to the government to cover the liabilities it has incurred in agreeing subsidies to various generators.

The electricity and gas industries have a number of natural monopolies and it would seem sensible to have similar collateral rules, and also to ensure that these monopolies manage risk in the most efficient manner. However, this is not the case, collateral rules vary and in general there is no incentive on the service provider to manage risk other than simply passing it on to the supplier. As mentioned elsewhere, suppliers generally have a higher cost of capital than regulated monopolies so asking them to cover the risk adds more cost to consumer bills.

This is an example of governance failure.

Gas Meter Provision

In both the gas and electricity markets the provision of meters has been opened to competition. In fact this is split into two activities: (i) the provision of the meter; and (ii) the

maintenance of the meter (i.e. the removal or exchange). All industry systems and processes have been amended to enable this change to happen, and for suppliers to thereby manage the provision of meter services for their customers in the most efficient manner possible. In Utilita's case, because its proposition is based on the installation of a set of smart meters, these provisions are vital in allowing us to minimise the cost of our services.

In a previous investigation carried out by the predecessor to the CMA, the Competition Commission, it was found that NGC was a dominant player in the market for the provision of gas meters. The report from that inquiry raised a question about whether or not NGC was further damaging the market because it was foreclosing the meter management market by insisting it be appointed as the meter manager for its assets.

Contrary to the industry norm, NGC insists on carrying out the maintenance activity for its meters. This not only imposes excess costs on suppliers, but it also frustrates any attempt to efficiently exchange a dumb gas meter during the installation of a dual fuel set of smart meters. Utilita raised a complaint with Ofgem regarding the actions of NGC, but Ofgem refused to look into the case on the basis that it did not have sufficient resource.

This is an example of governance and regulatory failure.

Incumbent Suppliers and Differential Pricing

Each of the Big Six suppliers has an incumbent market sector that is derived from their acquisition of old state owned monopoly suppliers. It is quite clear that they derive higher margins from their incumbent "areas" than they do "out of area". The "areas" are defined by the regional distribution companies that have been amalgamated into the organisations we see today, and in the case of British Gas its incumbent market is gas throughout the country and electricity is "out of area". These regions are:

Eon – Eastern, East Midlands, Norweb

EdF – SWEB, Seeboard, London

RWE – Midlands, Yorkshire, Northern

ScottishPower – South of Scotland, Manweb

SSE – Southern, Swalec, North of Scotland

BG – Gas throughout GB

Differential pricing has been a key feature of the pricing strategies of the Big Six, all have maintained higher prices "in area", and offered lower prices "out of area" where they want to gain more customers. The most stark example of this is BG, according to Ofgem's segmental analysis of 2012, BG enjoyed a clear 0.5 p/kWh premium in the gas market c/w other Big Six operators, and at the same time offered competitive electricity retail prices.

Clearly new entrants have to compete against the lowest price offerings (often unsustainable acquisition products) in all areas of the country, so this pricing strategy from the Big Six would tend to form a cartel.

This is an example of regulatory failure.

RMR

The RMR initiative was started because of: (i) apparent consumer confusion over tariffs; (ii) differential pricing by the Big Six to extract higher margins from inert customers; and (iii) the

attempts by Big Six to exclude new entrants from the market by dominating price comparison websites with a multitude of very similar tariffs. It may have addressed some of these issues, but so far it is not at all clear that it has resulted in less confusion or lower prices. At the same time RMR is stifling the ability of suppliers to innovate, and if they have a different business model to the standard assumed by RMR, the new rules are potentially quite damaging.

We would question whether customers are really that confused about energy prices relative other goods and services they buy. Energy bills are certainly no more complicated than a supermarket bill, and energy tariffs are considerably simpler than phone tariffs. It is doubtful that RMR will prevent differential pricing. As discussed above the main way in which Big Six operators do this is on a regional basis and RMR doesn't address that.

RMR is an incredibly detailed set of rules, which essentially mean that all suppliers have to offer the same limited set of products and present them in precisely the same way. This is a massive restriction on the ability of suppliers to innovate, and is far more intrusive than regulations covering pricing in any other sector of the economy. One example of this is that refer-a-friend type programmes, which are common in many sectors of the economy, are banned under RMR. This is a cost effective way, particularly for independent suppliers, by which word of mouth can deliver a supplier new customers and at the same time share some of that benefit by rewarding the original customer.

Utilita has always had a fair pricing policy. Old and new customers are all on the same prices; prices that were constantly pegged at below the level of the cheapest of the Big Six. We have gained 130,000 pre-pay customers all of whom had other options but chose Utilita as their supplier because of our simple tariff message, no standing charge, and trust that we were not misleading them. By giving customers what they say they wanted, i.e. no standing charge - we thought Utilita was part of the solution, not part of the problem. 130,000 customers have not been confused about our pricing message; we don't have a large inert customer base giving us super profits; we did not present a multitude of tariffs to confuse customers; and we were not profiteering from unjustifiable differential pricing. Nonetheless, RMR rules meant that Utilita's tariff was illegal, and have forced Utilita to change its tariff, indeed to introduce more than one tariff, clearly complicating our price message to customers, and forcing us to go back on a promise we made to our customers not to introduce a standing charge.

Having reviewed what evidence Ofgem collected for RMR it is quite clear that there was not a particularly strong message from customers about tariff structures, they did not ask pre-pay customers whether or not they preferred to have a standing charge, and that Ofgem did not consider the impact of its policy on an innovative supplier offering smart pre-pay, in particular taking into account the capital investment that implies.

In a statement to the House of Commons Select Committee, Dermot Nolan said "...for a tariff that has social purposes or is going to affect more vulnerable customers, I will approve that tariff. I will give them an exemption. I want to be clear about that." Apparently, Utilita's smart pre-pay service that is targeted at providing a more convenient and low cost option to low income households and those with special needs doesn't meet these criteria since Utilita's application for a derogation was rejected by Ofgem.

This is an example of regulatory failure.

Increasing Cashout Prices

Ofgem has recently carried out a significant code review that resulted in some change proposals for the electricity market. The first of these is to change the formula for calculating cashout prices so as to create greater penalties for imbalance. No independent suppliers were

involved in the process, and Ofgem is now seeking to rush through a change to the cashout price before winter 2014/15. This will have the effect of putting upward pressure on prices at a time when most people are seeking to reduce prices.

Smaller suppliers will naturally have greater proportional exposure to balancing prices than larger suppliers. This is firstly a result of the accuracy with which they can forecast, and secondly because of the standard contract size in the forward market. More extreme balancing prices also favour vertically integrated players. The proposed changes will therefore penalise smaller players and tend to push the industry towards a cartel of large vertically integrated players.

Ofgem's proposals appear to be based on a rather simplistic implementation of marginal cost pricing theory without any consideration for transaction costs that mean this is inappropriate. Market participants cannot see the price signal ahead of time and therefore cannot respond. Furthermore, even if they were in a position to take action suppliers of non-half hourly metered customers are not in control of the half hourly allocation of energy (which is based on a fixed profile).

This is an example of regulatory failure.

Feed-in-Tariffs

We understand the government's desire to reduce CO2 emissions, however we believe this should be done in the most cost effective way possible. In other words we should have a clear assessment of the relative costs of reducing CO2 emissions by the various mechanisms available to us, and focus policy decisions on encouraging the most cost effective measures.

The Feed-in-Tariff (FiT) scheme does not do this. During the development of this policy we asked DECC for an assessment of the most cost effective measures for reducing CO2 emissions and did not receive a reply. FiTs not only subsidises the production of energy from relatively expensive producers, but also the administration costs of the supplier that manages the relationship with the consumer. There are further administration costs incurred at Ofgem to manage the process.

In summary: (i) this is a significant and growing tax; (ii) an expensive way to collect a tax; and (iii) it's an expensive way to reduce CO2 emissions (if at all). By promoting non-cost effective emission abatement strategies and asking all consumers to pick up the bill not only is this unnecessarily increasing energy prices, but is contrary to the government's stated intention to reduce fuel poverty.

This is an example of political failure, and subsequently regulatory and governance failure.

Smart Meter Programme

From the outset the smart meter project, run initially by Ofgem and subsequently by DECC, undermined the commercial proposition that Utilita brought to the market. By creating uncertainty over the longevity of the meters that Utilita was installing, and then taking several years to remove that uncertainty, the programme placed significant additional costs and risks on Utilita.

The main effect of this was to make investment in new smart metering assets difficult and expensive until compliant meters were available. Due to more onerous financing costs, smart meter rentals were nearly double where they should have been (i.e. political and regulatory intervention increased the cost of capital).

The DECC programme for smart meters introduces yet another regulated monopoly service provider (the DCC). This will add cost and reduce benefits compared to more flexible and innovative options. Consumers are already paying for the DCC service even though it is not yet operational (and will not be for another 12 months). The government has once again created a high cost IT programme that is failing to deliver to time.

EMR

Later this year the government is due to implement the new capacity mechanism which has the specific aim of increasing revenues for generators, and will therefore increase wholesale costs for suppliers. It is not at all clear to us why this market is needed and how it will interact with the existing energy market. Furthermore, it appears to be addressing the same issue as Ofgem's cashout proposals.

We understand the desire to clean up electricity supply and in particular the removal of old, dirty, coal fired plants, but nearly 7 GW of relatively modern, clean and efficient gas fired plants has also been removed from the system in recent years. Consequently capacity margins have tightened. Some of the plants will return to take advantage of the EMR rules.

This is a fundamental change to the electricity market, and it is therefore essential that this new subsidy mechanism is investigated by the CMA, and that it reports on the benefits or otherwise of this change.

Re-Nationalisation

In recent months there has been a number of supply licences issued to local authority organisations. It is far from clear how this will benefit consumers, or help to drive down costs. It is also unclear how the full cost of operating an energy supply company, including staff, IT investment and managing wholesale risk, will be ring fenced from the other activities of a local authority, and therefore what future impact there may be on council tax payers.

Given the potentially much lower cost of capital that local authority owned organisations will have compared to a private new entrant, they will have a competitive advantage. The CMA must consider the likely impact of this development.

Price Intervention and Government Energy Rebate

Last year Labour announced a proposed price freeze because their research identified that as a policy that will swing voters in key seats. In response the government announced a rebate in order to diffuse the issue.

Neither of these policies are in the best interest of consumers in either the long or the short term. The price freeze policy is the most extreme example of political risk and is already having upward pressure on prices. The energy rebate is a waste of time and money, since the cost of implementing it is higher than the value of the rebate, but will leave less lasting damage.