

ENERGY MARKET INVESTIGATION

Summary of hearing with Utilita on 27 April 2016

Introduction

1. Utilita believed there were two types of supply companies in the energy market, the Six Large Energy Firms and the main new entrants. The Six Large Energy Firms were described by Utilita as profitable but shrinking. Some of the new entrants had achieved rapid growth, but in Utilita's view they were either losing money or did not make sustainable profits.
2. Utilita believed it was an exception to the above as it had both grown rapidly and operated profitably, which made it a sustainable, competitive threat to the Six Large Energy Firms.
3. Utilita's success was achieved in the prepayment market, where it had 99% of its customer base. Utilita noted that this success was achieved in a market that the CMA had identified as suffering from under-engagement and high acquisition costs.
4. Utilita's business model was underpinned by the utilisation of its smart prepayment offering and it had installed smart meters at over 90% of its customer base, which was more like the business model for the future. Utilita had innovated with its smart prepayment offering and ever since it launched its smart prepayment product in 2008, it had operated at a price point below the level of the Six Large Energy Firms for standard variable prepayment on a like-for-like basis.
5. Utilita had roughly 330,000 customers, most of whom were dual fuel, which equated to about 7% of the prepay market. Utilita was currently growing its business as quickly it had ever done, acquiring around [redacted] households a week, in a prepayment market which was increasing by up to approximately 250,000 households annually.
6. Utilita believed its supply point ratio, the number of supply-points divided by the number of full-time equivalent employees, demonstrated that it operated a very efficiently. Utilita currently had around [redacted] supply points per full-time equivalent employee, while, to the best of its knowledge, the Six Large Energy Firms had around [redacted] supply points per employee. Even though Utilita did not

have the benefit of the economies of scale enjoyed by the Six Large Energy Firms, its business was more efficient.

7. While Utilita was currently a successful business, this had not always been the case. Its smart prepayment product began development in 2006, but it was not until 2014 that Utilita broke even financially, having overcome many obstacles, the majority of which were regulatory in nature rather than technological.

Price cap

8. Utilita was fundamentally opposed to a price cap. It believed it was bad for consumers and damaged the development of a competitive market. Utilita believed that there were facets of the price cap, such as the dual-fuel option and the annual indexation which did not work. As currently envisaged, the price cap would damage Utilita's ability to grow its prepay business, whereas Utilita's innovations in the market had enabled it to outperform other new entrants financially. It was essential that a company could enter the market and trade profitably in a sustainable way.
9. The prepay market had attracted a number of new entrants. Utilita cited Economy Energy, which focused purely on prepay. OVO Energy, E.ON and British Gas had all launched a smart prepay product in the last 12 months. Utilita noted that the prepay market enjoyed high levels of switching, with levels comparable to those in the credit sector. The customer sector suffering in the energy market were those who were paying by cash or cheque.
10. Utilita was also concerned because the price cap would only cover a proportion of the market, which would lead to unintended consequences. The Six Large Energy Firms would be incentivised to stop switching customers to prepay as the price cap would make it more profitable to keep people on standard variable tariffs (SVTs). As the price cap would hit profits in the prepay sector, companies would also have an incentive not to install prepay meters, which would not be in the interests of consumers for whom prepay is appropriate.
11. Utilita had modelled potential changes to its tariff structure if a price cap were implemented and found that additional revenue could be recovered by increasing standing charges, while staying within the cap. This would have a detrimental effect on a number of consumers, who would see prices rise, this might particularly impact low user customers.
12. Utilita believed it was inappropriate, discriminatory and illogical to only target the prepay sector with a price cap as it was highly competitive. There was

more differential pricing in the credit market (cash/cheque), where there were more vulnerable and fuel-poor households.

Utilita's business

13. Utilita had targeted the prepay market as it believed it was a sector that was poorly served by the Six Large Energy Firms. Technological advances had also made it possible to improve the service delivered to customers and address cost-to-serve issues.
14. Over [X]% of Utilita's customer acquisitions came from door-to-door selling and this was probably the least expensive method of obtaining new customers. Its other sales channels included partnerships with social housing providers. Utilita made only a small proportion of customer acquisitions through price comparison websites as it believed this was an expensive way of acquiring customers.

Smart and dumb prepayment meters

15. Compared to dumb prepay meters, smart prepayment meters offered convenience for customers, enabling them to top-up their meters via a smart phone or online. Smart meters could also be programmed so that they would not disconnect at inconvenient times, such as weekends or Christmas Day. Customers could also reconnect immediately, without the need to go to a shop to top up. This functionality reduced Utilita's cost to serve as it did not need to operate a call centre 24/7.
16. Utilita's smart prepay technology helped it to avoid the expense involved in dispatching an engineer to add credit to meters for those customers with special needs. Utilita's smart meters could do this remotely.
17. Utilita did not believe that SMETS 2 meters were designed for prepayment customers. The functionality to support prepay customers would not be available until release 1.3, and there was still confusion as to when they would go live.
18. SMETS 1 meters offered a better solution for prepay customers, as evidenced by the number of these meters purchased in the prepay sector. SMETS 1 meters offered a more flexible use of vend codes, which could be inputted into a meter to allow credit to be added and also used to change tariffs, functionality which was ruled out for SMETS 2.

19. The functionality of smart meters was important because unlike credit customers, disruption to prepay customers would likely lead to a loss of power and it was important that the means existed to get them back on supply. Unlike SMETS 2, SMETS 1 meters offered this functionality via vend codes.
20. In terms of interoperability of SMETS 1 meters, Utilita exchanged SMETS1 metered customers with other suppliers on a regular basis and it believed that within the next six months, 90% of SMETS 1 meters would potentially be interoperable. Utilita was also installing the only meters that had 100% of the functionality of the original specification for SMETS 1 meters.
21. There would be a regulatory requirement to install SMETS 2 meters if Utilita's business kept growing.¹ Utilita's preference was to continue with SMETS 1 meters, which had lower costs, more flexibility and offered the ability to add greater functionality in the future.
22. Utilita did not believe that the target date of 2020 for the installation of SMETS 2 meters would be met. As well as there being no SMETS 2 meters installed for testing, the manufacturing or installation capacity did not exist to meet this target date. Utilita said it would be helpful for the industry if there were more sensible proposals for how to install smart meters for the benefit of customers rather than an ongoing discussion about the SMETS 2 meter programme which was not going to work.
23. Utilita was concerned that there would be a situation post the SMETS 1 end date, and pre adoption and enrolment by the DCC where a perfectly good SMETS 1 meter was removed by another supplier for some reason and it could not reinstall it. Utilita believed the communications system for SMETS 1 meters was better than for SMETS 2 because it had more technical flexibility in covering the country and could use a roaming SIM. It was not possible to have a roaming SIM with a SMETS 2 meter.
24. Utilita did not know what the incremental costs of switching to SMETS 2 meters would be because there were not any meters to buy and it did not know about all aspects of the charging structure. There was also evidence that SMETS 2 meters would take longer to install. The ideal situation for Utilita would be to carry on being able to roll out SMETS 1 meters.
25. In relation to its future business strategy, [X].
26. Utilita felt it would not make a difference if the proposed price cap was just for dumb prepayment meters rather than for smart meters. Part of Utilita's sales

¹ This is because after the SMETS 1 end date, SMETS 1 meters will no longer meet the supplier obligation.

proposition was that customers would not pay more with a smart prepay product. In Utilita's view, in order to avoid perverse incentives, the price cap needed to be broadened and not narrowed.

27. In relation to its 'premium' tariff for people who did not want a smart meter, Utilita advised that it sold a smart prepay product, but some customers later actively refused to have the smart meter installed (which was a principal term of the contract), so would be transferred to the dumb prepay product. The cost to serve these customers was different. Utilita said around 3 to 4% of its customers refused to have a meter installed, and it charged them about 10% extra. Utilita said it was difficult to specify the exact difference in the cost to serve these customers.
28. Utilita was not convinced that prepay customers would at some point become credit customers. The difference between its customers and other credit customers was that its customers had visibility of exactly how much money they were in credit, whereas credit customers very often do not. Utilita said a smart prepay product was not necessarily desirable but the undesirable element of prepay (walking into a shop to top it up) had been taken away and smart prepay could be topped up online or via a phone app, reducing stigma and inconvenience.
29. Utilita agreed that smart prepay tariffs were more expensive than a credit or direct debit acquisition tariff, but it considered that many of these acquisition tariffs were not sustainable, even if the company offering them was sustainable in the longer term. Utilita's pricing message to its customers was a longer term price promise and some customers preferred this to lower, fixed-term prices, with no indication what will happen to that product at the end of the fixed term or that it will be competitive during the term.

Unintended consequences

30. Utilita said one unintended consequence of the price cap could be to incentivise the Six Large Energy Firms to stop promoting prepay. These suppliers would want to keep customers on standard credit tariffs as they could charge them a higher price for these tariffs.
31. Utilita thought the price cap could have a very significant adverse impact on its business. If the price cap was introduced, the only companies which could continue to operate in the prepay sector would either be companies that chose to accept a loss or those that could cross-subsidise such as the Six Large Energy Firms. Another unintended consequence of the price cap would therefore be a prepay sector limited to the Six Large Energy Firms and any firm that wanted to commit commercial suicide.

32. Utilita's own analysis showed that if a price cap had been in place as of June 2015 [✂].
33. Utilita believed another critical unintended consequence of a price cap was a detrimental impact on smaller consumers. Utilita's typical average consumption level for electricity was in excess of Ofgem's medium customer, but its typical average gas consumption was significantly below Ofgem's medium customer. Utilita's tariff levels reflected these consumption levels but the proposed price cap was quite flat across a range of consumptions, whereas in actual fact there would be a three dimensional surface of customers using all combinations of consumptions for each fuel, making a dual fuel cap unworkable. Utilita would therefore have to restructure its tariffs to remain under the price cap, including doubling its standing charge and making heavy cuts to its unit rate. Such changes would benefit higher energy users but not lower user customers. Utilita assumed other suppliers would face the same situation. Utilita said that the customers of OVO and First Utility had generally higher consumption and that their tariffs would be likely to reflect this.
34. Utilita thought a dual-fuel price cap would not work because of the differences in consumption levels. Utilita thought a single-fuel price cap should be considered instead.

Price cap methodology

35. Utilita said smart meter roll-out to 80% of customers would happen by 2024/2025 at the earliest. There was insufficient gas meter manufacturing capacity to deliver the planned number of smart meters in the next four years. Utilita was trying to install smart meters to all its customers but only 90% had them, which demonstrated there would always be difficulties in ensuring all customers had smart meters.
36. When asked, Utilita said that in its view, it was too late to amend the smart meter roll-out programme to speed up installation enough to meet 2020. There were significant issues moving from SMETS 1 to SMETS 2 meters and, in any event, the number of SMETS 1 meters installed was below the level forecast by the Government a year ago. Utilita thought the focus should be on roll-out of smart meters to prepayment customers because it was the one sector of the market where there was an unequivocal commercial case for installing smart meters.
37. Utilita was most concerned about the infrequency of the escalator mechanism in relation to cost shocks within the price-cap mechanism. Wholesale costs

would be a big issue but also policy costs and how these were defined. Indexation (frequency) would be critical for Utilita.

38. Utilita said the frequency of its price changes depended on underlying cost-of-sale movements. Utilita had made a price change roughly every quarter in the last year, including two price cuts of around 5% in October and April. [X]. Utilita's price cuts were intended to support customer acquisition and Utilita assumed that it would continue to see more price competition in future, particularly with [X].
39. Utilita said there was a risk of wholesale price movements between the date of setting the price cap and the date of acquiring the customer. Utilita said there were various options in relation to such risk but this remained a cost, which it had priced in its written submission to the CMA.
40. Utilita said its current hedging strategy was to hedge for its existing customer base, incrementally over time. If the price cap was implemented, it would have to change its hedging strategy as it would be exposed to much greater risk. The natural hedge would be to hedge out 12 months but that would be more expensive. Utilita said it might be difficult in general for smaller suppliers to hedge a full year's worth of volume for their customer base.
41. Utilita said its systems could cope with monthly price changes but there could be a problem for customers with dumb prepay meters. In addition, there would be a need to communicate price-change messages to customers. Nevertheless, if the price cap was set at such a low level that it was 'biting all of the time', then monthly pricing changes might be a consequence.
42. Utilita believed that if, as a consequence of the price cap, all dumb tariffs were changed on the same day, the system would potentially not be able to cope. This would be an industry-wide problem, and it has already happened when there were clusters of price-change messages for prepayment customers using dumb meters. Such messages were sent to particular local terminals with a certain shelf-life which meant they could block out other messages.
43. In relation to indexation of the wholesale costs for the price cap, Utilita was also concerned about the single point in time used for the year-ahead prices to determine the weighted annual cost. There could be quite dramatic changes in prices; recently there had been very volatile price movements. Utilita proposed an alternative methodology that would result in the underlying weighted costs not being directly linked to any particular monthly price. Utilita said whatever decision was made as to the weighting of forward prices, suppliers would mimic that in how they hedged.

44. Utilita would find a 'ratchet mechanism' more acceptable than the proposed price cap. The mechanism could involve bringing in a price cap across the entire customer base (not just the prepay market) at a higher level and then ratcheting it down. This would give a clear message to the market on the direction of travel and it would give Utilita, and other suppliers, the opportunity to adjust their business in a sensible time frame.
45. Utilita said the CMA's estimate of £54 as the extra cost to serve prepayment customers was an underestimate. Utilita thought there were aspects that had not been considered for the cost-to-serve estimate. Given Utilita's portfolio, the data gave a very pure cost to serve with prepayment customers. If these (prepay) customers were off supply, their general reaction would be to telephone their supplier (ie not to 'self-serve') and that carried costs, not least because many of these customers were very vulnerable, and often had no money at all resulting in longer telephone calls. Utilita said the CMA's analysis of cost to serve contained no difference in the call centre costs between credit and prepayment customers.
46. Utilita said there were different costs associated with its very small number of credit customers. There were billing costs and extra data costs, where these customers were not on smart meters. However, the majority of its customers were on smart prepay products and its analysis of costs to serve was based on these customers. Utilita thought the cost-to-serve differential with respect to metering costs would disappear if everyone was on smart meters.
47. In relation to its proposed alternative remedies to the price cap, Utilita said there could be potential to influence the smart meter roll-out programme. Utilita would find it helpful if the current rule that enabled a supplier to remove a smart prepay meter and replace it with a dumb prepay meter was removed. In addition, the adoption of SMETS 1 meters could be brought forward and there could be greater recognition of their interoperability. These would be matters for DECC to address or Ofgem through changes to suppliers licence conditions.
48. Another alternative remedy proposed for consideration by Utilita was relative pricing for all suppliers, with, for example a percentage maximum differential in pricing across all a supplier's tariffs including acquisition tariffs. Utilita said this proposal sought to address the huge price variations from the Six Large Energy Firms which were essentially the result of inefficient businesses.
49. A further alternative remedy for consideration was a restriction on the incumbent supplier from competing for customers. In effect, when a customer sought to move supplier, the transfer was non-competed. Utilita said this had

been done before with a restriction placed on British Gas in the 1990s, which had worked quite well.

Project Nexus

50. Utilita said Project Nexus was particularly bad for suppliers with a high proportion of prepayment customers on their portfolio. The project was intended to put settlement in the gas industry on a similar basis to the electricity industry but Project Nexus was now around eight years old and had yet to deliver anything.
51. Utilita thought there were three issues with Project Nexus. First, considerable de-scoping over time so it was not as good as it should be. Second, the initial allocation for prepayment customers was based on a credit customer profile. Utilita said this failed to take account of the differences in customers' consumption and would undoubtedly add to prepayment customer costs. Third, a problem of large differences for prepayment customers between initial allocation costs and reconciliation. There would be overestimates in winter and underestimates during summer. Utilita was frustrated with the approach taken to reconciliation which did not follow the model for the electricity market.
52. Utilita said the structures that Ofgem was putting in place would improve the governance of Project Nexus. These had already resulted in Xoserve producing additional information and improved clarity, however Utilita did not feel that given the time, they would deliver enough improvements for the project to go live on 1 October. Utilita did not want to see Project Nexus go live on 1 October as there were still elements to be tested. Utilita thought it was more important that the project was implemented right and for the benefit of consumers.
53. Utilita fully supported the idea of the gas market working on the basis of daily meter readings for all customers. However, Project Nexus discriminated against prepayment customers because of the pricing and initial allocation issues mentioned. Utilita had 300,000 daily metered residential gas customers spread across the country; more than the number of profiles that Xoserve had used to decide the gas profiles for Project Nexus. Utilita's large customer base could massively improve the profile, and if Project Nexus went in on 1 October the profile would be wrong.