

11 November 2016

David Fowles  
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Competition and Markets Authority  
Victoria House  
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By email only

Dear David,

**Re: EMI Formal Consultation: The Energy Market Investigation (Prepayment Charge Restriction) Order 2016**

Thank you for the formal draft of The Energy Market Investigation (Prepayment Charge Restriction) Order 2016 (the Order) and draft Supply Licence Conditions (SLCs). This letter forms Utilita Energy Ltd's (Utilita's) response.

For clarity, Utilita does not support the implementation of a prepayment price cap. If a cap is to be implemented, it should protect all those customers deemed to be in need of such protection, which this does not do by leaving credit customers exposed. We continue to believe there are other ways to address the Prepayment AEC which the CMA has failed to explore. We also consider that there are aspects of the Prepayment AEC which the CMA remedies fail to address.

Moving to the consultation, we have reviewed the documents carefully. The form of the Order, explanatory note and draft SLCs is generally clear and we consider consistent between the documents.

However, following our review of the documents there are a number of points which need to be addressed. We are also disappointed that the CMA, in drafting the Order has not taken account of the numerous points raised by Utilita and other parties during the consultation process and the energy market investigation.

We continue to believe that the approach of a cap is flawed and will have adverse unintended consequences for consumers and competition more generally.

These are grouped for convenience, but should be considered against all relevant parts of the consultation materials.

## Net Margin

The approach set out in the CMA report and proposed to be implemented by this Order is not robust. An EBIT margin of 1.25% as contemplated by the report is inadequate, providing insufficient incentive to compete in the prepayment market, failing to provide for necessary investment and reducing competition for those customers who most need it. The cap is essentially a profits cap, which resulted from a flawed assessment of the cost of capital in energy supply.

The CMA used the capital asset pricing model (CAPM) to determine a cost of capital for energy suppliers, and it made a number of questionable assumptions. However, the fundamental flaw is the inappropriateness of CAPM for the energy retail sector. CAPM evaluates the return of a sector relative to returns of the market as a whole, and gives a value for the sector's relative risk. The problem with applying this to the energy sector is that the underlying driver of variability of returns is not related to returns of the market, but unpredictable things like the weather. In the long run, therefore, the beta value is likely to be close to zero, not because the sector is low risk, but because there is very little causal correlation between the returns of the energy supply sector and the economy as a whole.

The CMA acknowledges this in the final report, stating *'there can be significant volatility in the profits of a retail supply business due to weather-related demand fluctuations, government scheme costs and input price changes, we note that these would only have an effect on beta to the extent that the volatility is correlated with overall market returns. Neither volumetric risk arising from fluctuations in the weather, nor changes in government scheme costs, exhibit this correlation'*.

This is correct. However, the CMA failed to follow through to the natural conclusion which is that since there is no causal correlation the CAPM model is inappropriate. The CAPM model is designed to determine cost of equity in circumstances where 'unsystematic' risk, such as those in energy supply, can be diversified away through portfolio selection. CAPM does NOT provide a cost of equity for an asset outside a portfolio, and is consequently entirely inappropriate for privately owned new entrant energy suppliers.

A further issue with the approach is that the CMA evaluated returns over such a short period (five years), that its calculated value for beta cannot be considered reliable, and could have been any number depending (for example) on how well weather conditions correlated with returns of the market as a whole.

Using the returns of the Big Six energy suppliers only, the CMA has calculated a beta value of 0.7 – 0.8, which being less than 1 and above zero suggests energy is a normal good, with a lower risk than the market in general. This is in line with the CMA's view of energy suppliers, which it considers to be 'regulated utilities' with a low underlying risk profile. While this may be a reasonable approach when considering network businesses, it is not so for suppliers. Energy supply is far from being a regulated utility, and is subject to active competition and substantial risks. A primary activity of an energy supplier is managing wholesale risk on behalf of its customers. Weather has a large impact on both demand and marginal wholesale prices, and hence on the returns of an energy supplier. During colder than seasonal normal conditions an energy supplier is likely to be in a short position and have to buy additional volume from the system at a high marginal price, as the system as a whole is short. This form of multiplicative price and volumetric risk cannot be hedged with standard derivative products and is well documented in academic literature. In general, warmer conditions will also

reduce energy suppliers' profits because they are likely to be long and selling back into flooded market. Suppliers must either have significant capital employed to cover weather risk, or demand a much higher return on capital than the 10% calculated by the CMA.

For new entrants, the very companies providing the competitive pressure, the situation is even worse. The CMA failed to consider or properly quantify the price of risk on wholesale volume for new customer acquisitions. As the price cap will be fixed for periods of six months, two months in advance, a supplier seeking to win new customers must accept the risk of wholesale price movements between the setting of the cap and product delivery. Using the Black-Scholes model, Utilita priced this risk relating to new customers at approximately £10 for each new dual fuel customer acquired after the setting of the price cap. While the value may seem small, an EBIT margin of 1.25% equates to £10 - £15 per dual fuel customer, and therefore this alone wipes out the margin the CMA has allowed.

By regulating prices so tightly and, by its own admission, considering gas and electricity to be 'entirely homogenous products' the CMA is in effect mandating a cost leadership strategy in the pre-pay sector, and is sending a signal to energy suppliers to cut costs in order to improve profitability. This not only may result in some suppliers compromising the level of service offered to pre-pay customers, but it also precludes pre-pay customers from choosing to participate in any value adding services that would fall foul of the price cap (completely missing the fact that the pre-pay sector has seen a greater level of innovation than the rest of the market, in particular through much higher penetration of smart meters providing a massively improved service).

In addition to the points above, other CMA and Ofgem proposals currently under consideration will create greater levels of exposure for smaller players with significant prepayment portfolios. There are several relevant examples, the two most current are:

- a) In parallel to this consultation, Ofgem is consulting on capping warrant cost charges for the installation of prepayment meters. The proposed level is at £100-150 and is deliberately set below supplier cost (which can be anywhere from £300-600 or more depending on individual circumstances). Ofgem consider the unrecovered amount will be socialised across the supplier's remaining customers, but do not consider how this is to be achieved within the prepayment cap.
- b) Ofgem has issued the statutory licence consultation for requiring suppliers to participate in randomised controlled trials. In a workshop, it was made clear that Ofgem expected suppliers to absorb these costs, including where the trial required the supplier to commission extra resource to support the work. In the covering letter for selection criteria, specific reference was made to testing prompts etc. for prepayment customers due to the prepayment AEC. Again, no consideration was given to how this would be addressed in the context of a prepayment cap.

As set out previously, proposing a prepayment cap with so little headroom that such proposals become matters for concern is perverse and counterproductive. An adjustment of approach is required either to provide greater leeway on the headroom, or an acknowledgement that costs resulting from any regulatory change affecting prepayment customers should be subject to a cost pass through.

### Perverse incentives

The approach set out in the documents of removing only customers who have SMETS2 meters from the price cap protection creates a perverse incentive on customers to reject SMETS2 meters. This is in direct opposition to government policy that suppliers should move to installing SMETS2 meters from SMETS1 meters. The approach renders SMETS2 customers unprotected in the same way that credit customers are unprotected.

Suppliers were specifically encouraged to roll out smart meters to prepayment customers during the foundation phase, bringing the benefits (including savings) of smart to those most in need earlier than would be the case for SMETS2. This meant, by definition, installing SMETS1 meters for those customers.

It is perverse to penalise suppliers who acted to support these customers in accordance with government policy, especially as the SMETS1 design provides for interoperability. It is also notable that given the DCC deferments, there are now millions of SMETS1 meters on the wall, and these numbers will increase significantly by the SMETS1 end date. Current forecasts indicate numbers of the order of 9-10m meters or more are expected to be *in situ*, and these meters will clearly remain on the wall for their operable life well beyond 2020.

We note that CMA has set out scope for SMETS1 meters to be placed out of scope once considered fully interoperable in the CMA's view. Given the position now and work being undertaken to facilitate further interoperability, there is no need for a bureaucratic process.

However, as previously stated, the current proposals create a range of problems. We remain concerned that after the SMETS1 end date, the incentive on customers may be to reject smart meters completely pending the end of the price cap. It is not clear how suppliers can efficiently and economically overcome this issue given that the cap is set at a level where suppliers can already make only minimal returns. In the FDR, the CMA opined that a return of 1.25% is appropriate, which leaves little or no room for competition to overcome such a perverse incentive.

One of the issues facing the smart programme is safety due to rapid deployment of smart. By capping returns in this way, the CMA is further pressurising suppliers to compromise safety, especially for prepay customers (the ones most in need of smart benefits and whom government has previously encouraged suppliers to prioritise). The government must prioritise safety, and the tight timetable to 2020 and restricted profits due to the cap are not consistent with a prudent approach to safety.

### Timing of the announcements of the new Charge Restriction

In the FDR, CMA envisaged that suppliers would be given two months' notice of the new Charge Restriction. In the draft Order this has been amended to 45 days. This is not practical.

Changes to the Charge Restriction will generally require suppliers to consider price changes in order to remain in compliance with the cap. It is essential to recognise that even if the overall effect is to reduce maximum revenue, either the standing charge or a unit rate may need to be increased as part of the supplier rebalancing of their tariff across consumption levels.

The operation of SLC 23 requires the customer is given 30 days' notice of such changes. This may require a full mailing to the supplier's prepayment base for adverse change depending on the new cap – for example, even if the cap is reduced overall, charges may require rebalancing and hence SLC23 may still kick in. However the nature of the mailing will not be clear until the cap is published. While we note that as part of the process, CMA has taken some account of representations on the timing of publication of the benchmark restrictions by GEMA, we believe that this still presents suppliers with significant difficulties in respect of the notice periods required under the supply licence condition 23.

We believe there are two relatively simple options:

- i) Give suppliers the originally proposed 60 days' notice of the price cap change
- ii) Amend the SLC23 requirement such that where the change results from a price cap change, only 2 weeks' notice needs to be given to customers. As such changes will be within cap, we cannot see any customer is unduly impacted by this proposal.

Supplier risk could also be reduced by application of SLC23 at a cap level rather than a charge level, this would in any case align better with an annual cap.

#### Policy costs

The consultation sets out that these will be currently indexed to national changes using OBR reports. This is inconsistent with the methodology used for wholesale and network costs and introduces risk that the cap will not move in line with underlying costs of sale. Policy costs should be calculated on the basis of a domestic customer's policy costs and indexed accordingly.

We do not oppose removal of the CRC from policy costs as we agree it does not apply to domestic customers, however this removal strengthens our argument previously put forward that the costs should move in line with domestic costs.

#### Wholesale & Market costs

##### **a) Six monthly indexation**

As we have identified previously, this period exposes suppliers to wholesale price risk for new customers. While clearly the effect of this could be positive or negative, the increase to the variability of returns will increase the cost of capital associated with new customers and therefore discourage competition in the prepayment sector.

We set out in our submission and hearing our view that for quarterly indexation would reduce the risk. We continue to believe that this is a particular vulnerability for new entrant and smaller suppliers, and that in failing to address this point the CMA risks favouring the interests of larger players at the expense of smaller new entrants.

If CMA and Ofgem wish to stimulate competition, they should seek to reduce such risks for smaller players and index quarterly. If suppliers do not wish to respond quarterly, they are clearly at liberty to address this in their pricing, but the arrangements should allow the flexibility of supplier choice.

## b) Costs of shaping

As well as wholesale price risk, which is partly accounted for in the price cap calculation, energy suppliers are exposed to price and volume risk on the spot market. Forward products are 'flat', in that the same volume is contracted for period of time, for example a month or a season. Forward products do not, therefore, reflect the actual volume a supplier ultimately has to buy, as electricity is settled half hourly and gas daily.

Energy suppliers must 'shape' the forward products to the final allocated volume by buying and selling half-hours or days on the spot market to match the final allocation. Energy suppliers must accept price risk on the spot market, as the price of volume sold is likely to be different to the price of volume purchased.

Suppliers must also accept volume risk, in that customers may use more or less energy than seasonal normal. Furthermore, as well as being uncertain, price and volume risk are often correlated and are multiplicative – in colder than seasonal normal conditions the system as a whole is likely to be short and the marginal price high, and the supplier, which is likely to be in a short position, must buy additional volume at a high price. In warmer than seasonal normal conditions the system as a whole is likely to be long and the marginal price therefore will be low, while the supplier is likely to be long and have to sell volume back to the system at a low price.

While not explicitly recognized in the CMA's assessment of costs of supply, the cost of shaping the forward positions is implicit in the 'other' costs of an energy supplier. Shaping costs are volatile and some periods will be much more expensive than others, depending on weather conditions and system margin. No consideration has been given by the CMA to the costs of shaping implicit in the baseline tariffs used for cap setting and how this cost will change over time. This introduces additional risk to an energy supplier, which cannot be absorbed by the low profit margin and headroom allowed in the cap.

We have also previously identified that these costs will have a greater impact on smaller players – their portfolios are often less diversified and hence impacts can be more extreme.

## c) Headroom

We note that for electricity single rate, the headroom is proposed to be 4.23%. However, for gas, which is also single rate, this is proposed to be 0.75% less at 3.48%. The reason for this is not explained, and given the volatility of gas heating loads in winter, we believe this reduction is unjustified.

### Indirect costs

Meter rental costs are not currently explicitly recognised and we therefore assume that they are included as part of indirect costs, which will be indexed with CPI.

However, meter rental costs as a whole are likely to increase during the smart meter roll-out, not least due to increased demand for installation capacity as a result of the Government's 2020 deadline.

We suggest that this expected increase should be reflected in the cap as without it, the cost of sale change will not be accurately reflected in the cap. While this might be reasonably attributed as a

SMETS2 issue, as we argue above, removing SMETS2 meters from the cap creates a perverse incentive. We consider it would be better to address the issue of meter costs within the cap.

### Multi-tier tariffs

We note that CMA has amended the section on assessment of multi-tier tariffs in line with our recommendations. We welcome this approach as we believe that this will enable appropriate assessment of such tariffs.

### Monitoring and reporting

We note there are two aspects of reporting required:

- i) A compliance declaration to the CMA that the supplier is in compliance with the Order
- ii) Reporting to Ofgem for monitoring purposes

As suppliers are required to be in compliance with the Order, we do not believe that requiring a document to be submitted to the CMA to state that they are in compliance provides any additional assurance.

We also note in the licence drafting that licensees are required to retain records and produce to the CMA. As this is a specific point, this should also include the period for which CMA expects suppliers to retain such records. CMA should also confirm that electronic records will be considered to be 'writing' for this purpose.

The drafting in 28A also notes something called the 'Prepayment Tariff availability criteria' however this term is not defined. Please clarify what these criteria are intended to capture.

### Duration

We understood from the CMA FDR that the intention was the cap would operate until 31 December 2020 unless shortened or extended in response to the mid period review. We would therefore like to understand why in the draft Order, this period is extended until June 2021, which is not only six months beyond the previously proposed end date, but necessitates a three month cap period at the end of the term.

It is not clear what additional benefits are expected from this arrangement.

If you would like to discuss any points in more detail, in particular, the areas around multi-tier tariffs, we would be happy to help.

Yours sincerely,

*By email*

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