

18 January 2019

Energy Prepayment Review  
Competition and Markets Authority  
Victoria House (6<sup>th</sup> Floor South East)  
37 Southampton Row  
London WC1B 4AD

Email:

By email

Dear Sirs,

**Invitation to comment (ITC) on a proposed review of the Energy Market Investigation (Prepayment Charges Restriction) Order 2016**

Thank you for the opportunity to comment on the above proposed review into the Energy Market Investigation (Prepayment Charges Restriction) Order 2016 (the 'PPM Cap').

While welcoming the review, we believe that the scope of the review is too narrow, and does not have the required sense of urgency to address the perilous state of many small suppliers, which has been exacerbated by the fundamental flaws with the current PPM Cap. It is critical to appreciate that the PPM Cap continues significantly to damage to the market and must be addressed as soon as possible.

There are two big risks to the review as currently proposed:

- (1) That the scope is inadequate to address the fundamental flaws inherent in the PPM cap; and
- (2) That the lack of urgency expressed by the CMA in the ITC means action is unlikely to be taken quickly enough to stem the serious and potentially irreparable damage the PPM cap is doing to the market.

Unless both risks are properly addressed in the review, we see the CMA as failing in its statutory duties to monitor remedies to ensure they are remain effective and proportionate.

With the introduction of the Default Tariff Cap (the 'DTC'), we believe it is simply not sustainable for the PPM Cap to continue to be based on the flawed methodology adopted during the Energy Market Investigation (the 'EMI'). The PPM Cap must as a matter of urgency be aligned to the more robust methodology and set of assumptions on which the DTC has

been introduced. Further, we believe that the CMA should also give serious consideration as to whether the separate PPM Cap can now be revoked completely, and PPM customers adequately protected under the DTC. This would address the distortion of having two different caps, operating on different methodologies, being imposed by two different regulators, operating in the same market.

The CMA should also be giving serious consideration as to whether the PPM Cap as currently operating is lawful under EU law and whether, in continuing to apply it, the CMA is having sufficient regard to the duties of Ofgem to ensure that efficient suppliers are able to finance activities under their licences.

As we have said consistently, the PPM Cap has fundamentally damaged switching. An imposed and inadequate cap is not a substitute for healthy competition in the market. Ofgem has noted the reduced range of offers available to PPM customers and the reduced range of prices, as well as the fall in switching numbers, but has not yet sought to act. While prices under the cap have displayed convergence, we strongly believe this is not a symptom of suppliers overcharging the PPM customers on their portfolio, but of simply attempting to survive. The CMA also needs to understand the relative positions of the larger SLEF suppliers, (who have been able to cross-subsidise losses in the PPM segment of the market), as against suppliers such as Utilita, whose principal focus is on bringing effective competition and innovation to better service PPM customers. Put bluntly, the current PPM Cap is not in the best interests of the customers it was intended to protect - and is damaging the structure of the market.

A poorly executed market intervention such as the PPM Cap not only damages the competitive market, but also destroys significant shareholder value and investor confidence. When an efficient supplier struggles to meet costs because of fundamental flaws in the regulatory regime, it is the duty of responsible regulators to acknowledge the error and remediate it promptly.

Utilita is a smart energy supplier, with a portfolio of nearly 700,000 customers, around 95% of whom are prepay. We specialise in providing flexible and high-quality services to a sector of the market traditionally poorly served. We have been installing and operating smart prepay meters since 2009 and SMETS meters since 2013. Around 90% of our prepay customers benefit from having smart meters installed, with more getting their smart meters all the time. We are the largest supplier of smart prepay customers, and our customers enjoy the quality service we provide.

We are uniquely positioned to understand the requirements of smart prepay customers. This unparalleled experience in the prepay sector means that Utilita has the expertise to manage such customers efficiently and economically. The nature of our portfolio also evidences a very clear view of the impact of the PPM Cap, without any of the muddying of waters created by cross subsidy into credit customers, such as that by the SLEFs.

Since the implementation of the PPM Cap Utilita has pared its already efficient organisation wherever possible and continues to do so. However, what is clear is that the margins assessed as present in the PPM Cap by the CMA in the EMI were never there.

The PPM Cap contains a number of fundamental flaws which must all be corrected in this review. In addition, the implementation of a DTC on Standard Variable Tariffs ('SVTs'), which has been calculated using a significantly more robust, bottom up methodology, throws into even sharper relief the problems with the PPM Cap.

In the EMI, the CMA acknowledged that it had identified the higher costs associated with supporting PPM customers. We now find ourselves, as an industry, in the anomalous position that there is a very real risk that PPM customers will pay less than DD customers under the two caps. This is a fundamental inconsistency and needs to be addressed.

It should also be recognised that Ofgem has significantly greater expertise than the CMA in creating robust price and revenue restrictions, given it is the expert sectoral economic regulator. In preparing for the DTC as explicitly charged by Parliament, Ofgem carried out a much more thorough process than the CMA, it collected much additional data from suppliers, which it analysed carefully before constructing a robust, bottom up methodology. It also consulted on its emerging thinking at intervals to inform its development activity using industry expertise and consulted again on the result.

The situation is sufficiently serious that if the CMA is unable to execute a timely review, we believe that the PPM Cap must be suspended. The ITC implies a lengthy - possibly six months - process of review which cannot be justified. There are a range of simple options available to the CMA which could be executed far more quickly than is implied by the ITC. Specifically, these should include:

- 1) Varying the PPM Cap to mirror the provisions of the DTC methodology, while applying an uplift to accommodate PPM;
- 2) Revoking the PPM Cap and requesting Ofgem to update the DTC with an uplift to reflect the difference between Direct Debit and PPM costs of supply and create a PPM cap within the DTC (though parallel CMA and Ofgem processes would need to run concurrently in order to ensure this could be achieved as quickly as possible);
- 3) Considering some alternative or interim arrangement if such either of the above cannot be achieved by April 2019.

Utilita has made significant sacrifices in its' business in order to accommodate the damaging impact of the three cap periods so far, but this cannot continue. We believe this impact will be exacerbated for us and other suppliers by the implementation of the DTC.

Turning to the specific questions in the ITC, we have addressed each below.

**1) *Should the CMA prioritise the Order for review at this time?***

Yes, for the reasons we have already set out the CMA needs urgently to prioritise the review of the Order. This means prioritising the review to ensure that the current issues with the PPM Cap are addressed by April 2019.

While we are reassured that the CMA does consider a review appropriate, it is overdue in the context of the PPM Cap. The CMA prioritisation principles seek to assess whether the CMA should allocate resource to the review, which they must. However, the prioritisation being proposed does not adequately address the necessary sense of urgency of action where the review has a fundamental impact on other parties. The CMA should not just allocate resource but do so in a sufficient and timely manner to ensure that the review is concluded at the earliest opportunity. Late summer 2019 is not going to be good enough.

Put bluntly, if the PPM Cap is not reviewed as a matter of urgency, there are likely to be further supplier exits. Clearly, this has serious implications for competition in the supply market. It is important also to understand the costs incurred as a result of a Supplier of Last Resort being appointed and the mutualisation obligations being triggered as a result of defaults under the Renewables Obligation and the Feed-in Tariff scheme.

***2) Should the scope of the review consist of the (i) progress made concerning the rollout of smart meters, and (ii) the CMA's calculations underlying the initial benchmark figures concerning the "policy cost allowance" and the DCC costs element of the "indirect cost allowance". .***

As already set out above, Utilita firmly believes that the review must not be limited to these two areas. They are both important and must be included, but they are not the only problems and addressing these alone will not address the fundamental problems with the PPM Cap.

It is now beyond doubt that the methodology underlying the PPM Cap was deeply flawed, and based on the unsustainable prices of two unrepresentative suppliers, in very different market conditions from those operating today. Ofgem rightly rejected the CMA's methodology when designing the DTC, and following a thorough review. It is very difficult to see how the CMA could conclude that it would be appropriate to continue with its methodology, when there is a much more up-to-date and robust methodology available that could be easily adopted. Further, that the updated methodology was designed by the expert sectoral regulator, following a thorough review undertaken by Ofgem of most aspects of the DTC building blocks.

Further, as result of the work done by Ofgem in designing the DTC, the CMA is now in a position to obtain evidence that the PPM Cap does not allow suppliers to finance their activities, in respect of the supply of energy to PPM customers. We have repeatedly made representations to the CMA to this effect. However, our ability to evidence this has been limited by the fact that other suppliers supply a wider pool of customers, and therefore their losses from PPM customers have been hidden by cross-subsidies from other customer groups. We believe that the CMA should request advice and information from Ofgem on this point. In light of the CMA's obligation to have regard to Ofgem's statutory duties, it must consider as part of this review whether the PPM Cap enables a licensee to finance its activities and it must obtain evidence from Ofgem on this point.

The CMA must have regard to Ofgem's statutory duties including in respect of regulatory best practice, which include a requirement for consistency. It is wholly inconsistent for there to be

two different methodologies for establishing the same cost benchmark, before the different costs of different payment methods are considered.

To be effective and meet the CMA's own statutory duties, the review must not be limited to these two areas alone. The proposed, very limited scope is wholly inadequate to address the continuing issues under the PPM Cap. Addressing only those issues would mean that the PPM Cap would continue to be inappropriate, and would continue to be disproportionate and therefore, in our view, in breach of EU law.

However, as we have identified at the start of this letter, the requirement to consider broader points does not mean the CMA should have to carry out its own detailed work. Ofgem has already completed almost all the data gathering and analysis necessary. The CMA should simply be adopting and building on the work already done by Ofgem as the expert sectoral economic regulator.

In summary, it is clear that there have been significant changes of circumstance since the CMA designed the PPM Cap:

- The market has dramatically changed, with the number of supplier exits and regulatory investigations showing the unsustainability of certain supplier business models;
- There has been a major change with the introduction of the DTC, meaning that a separate methodology for the PPM Cap is wholly inappropriate; and
- Ofgem must now be aware and hold evidence to the effect that the PPM Cap does not allow suppliers to finance the supply of energy to PPM customers.

In light of the above, it would be wholly wrong for the CMA to restrict the scope of its review to the roll-out of smart meters and policy and DCC costs.

A fundamental and ongoing issue with the PPM Cap has been the underestimation by the CMA of the impact on suppliers. When discussing an EBIT of 1.25%, the tiniest of miscalculated allowances has a wide-ranging impact. Utilita has also supplied a confidential submission to the CMA, which must be read in conjunction with this letter. This data includes detailed analysis of policy cost impacts; DCC costs and other relevant variables such as UIG, mutualisation, unforeseen supplier failure impacts and the issues around the Capacity Market. In each case it is essential to ensure that where supplier may be required to meet such costs, they can collect appropriate revenues in the same period to allow for robust accrual.

The answer to this question should be read with the answer to question 3, as the points made there are also relevant to this section.

***3) Whether there is evidence that additional calculations of cost categories, or broader elements of the Order should also be a subject for review?***

As set out in our response to the previous question, there is clear evidence that a broader review is not just desirable but essential to the health and functioning of the competitive market.

As part of their work on the DTC, Ofgem conducted extensive and robust analysis of the requirements and developed a bottom up methodology. This included broad data gathering and assessment. The outcome of this work is to place the Direct Debit Cap at around the same level as the PPM Cap, when even the CMA acknowledged the additional costs of supplying PPM customers.

The difference between the two sets of calculations supports the extensive analysis Utilita has conducted. We believe that applying the methodology used for the DTC to prepay, with an additional allowance to reflect the costs of prepay customers would provide a robust and equitable PPM cap, which allowed efficient prepay suppliers to make a modest profit and still compete.

We therefore believe that the first stage of the review should be to consider replacing the PPM cap methodology with the DTC methodology and simply using the CMA resource to update the assessment of the necessary uplift.

Further support for this approach is that customers will then receive consistently calculated protection. At present, the confusion from multiple caps will be further exacerbated by having two methods, the output from which is very likely to be counter-intuitive.

There are a number of areas within the DTC which demonstrate incontrovertibly the flaws in the PPM Cap. Each of these areas must be fully addressed in order to remediate. The extensive nature of the adjustments needed further supports our view that duplicating the very recent work undertaken by Ofgem cannot be justified. It would be a complete waste of time, resource and money.

We set out in brief below a few of the main areas which must be considered:

- The DCC and other smart roll out costs are specifically accounted for in the DTC and almost entirely omitted from the PPM Cap;
- Policy costs in the DTC are estimated using actual and estimated costs borne by suppliers, rather than OBR estimates of total scheme costs (this is a far superior methodology to that used in the PPM Cap, that removes the risk of over or under recovery of such costs, as the proportion borne by suppliers changes over time);
- DTC operating costs have been estimated using a bottom up assessment of a large number of suppliers, with the lower quartile being taken as efficient (having a far more robust approach than estimating such costs by adjusting the retail prices or two suppliers, which was the approach used by the CMA when setting the PPM Cap); and
- Ofgem includes an “uncertainty allowance” in the DTC for wholesale costs to cover weather and spot price variability (this accounts for the return on the additional requirement for economic capital to cover this variability and, although this risk is idiosyncratic, economic capital must still be available to cover periods of losses), including:
  - Usage and associated spot price risk are significant for all energy suppliers, even those that hedge forward in an optimal way, and a 1 in 4 event on this risk alone would wipe out the 1.25% EBIT expected by the CMA, even if this were achievable;

- A 1 in 20 event would create a negative EBIT approaching -1.5% (at a not unreasonable level of confidence of continued operation over a one-year period of 99%, an energy supplier of Utilita's size requires something in the order of £25m + of economic capital in additional to regular capital employed to cover this risk alone, which is not provided for by the CMA);
- These numbers relate to a static portfolio, meaning that the volumetric risk associated with uncertain customer acquisition is in addition to this (previously Utilita estimated this cost risk on new customers to be £20.43 - i.e. nearly double the intended EBIT - in the first year of supply only and with no effect after that).

To conclude, our strong belief is that the PPM Cap should be varied to align it with the methodology and assumptions developed by Ofgem to support, making an appropriate allowance for a PPM uplift. It should be possible to do this as part of an expedited review process, using the work already done by Ofgem in respect of the DTC.

We believe the CMA should also give serious consideration as whether it is appropriate at this stage to go one step further and to revoke the PPM Cap, and for Ofgem to accommodate PPM customers within the DTC. However, if this is the preferred approach it needs to be done as part of an expedited parallel process with Ofgem to ensure it concludes as quickly as possible so as not to cause further potentially irreparable damage to the market.

At a minimum, this means that the scope must be wider and the review executed much more quickly than usual for the CMA. There must be at least a definite interim solution for 1 April 2019 and clearly defined final outcome by the beginning of August 2019 to allow for contractual and licence notifications to customers for 1 October 2019.

We would welcome the opportunity to meet with you and discuss this submission in detail.

Yours faithfully,

*By email only*

Alison Russell  
Director of Policy and Regulatory Affairs