Appendix 9.6: Prepayment

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Introduction

1. In this appendix we set out in more detail analysis and evidence supporting findings related to the prepayment segments. In particular, in Section 9 we look at the extent to which prepayment customers may be less engaged than direct debit customers and possible supply-side constraints on competition in the prepayment segments.

2. Here we set out additional evidence in relation to these points. In particular, we first set out the demographic characteristics of prepayment customers. Second we set out additional evidence in relation to:

   (a) technical constraints in the prepayment infrastructure for 'dumb' prepayment meters that limit prepayment tariff offerings;

   (b) Softer incentives on suppliers to compete to acquire prepayment customers such as:

      (i) higher acquisition and service costs of prepayment customers, capital and other growth constraints on independent suppliers; and

      (ii) the complexities involved in the assignment of customer debt in some prepayment meter switches; and

   (c) regulatory constraints.

Demographic characteristics of prepayment customers

3. In Section 9 we consider the demographic characteristics of prepayment customers in relation to direct debit and standard credit customers.

4. Table 1 shows respondents' highest qualification by payment type. We find that, when compared with both direct debit and standard credit customers, prepayment customers are significantly: less likely to have a degree as their highest qualification; and more likely to have a GCSE as their highest

qualification. Further, when compared with direct debit customers, prepayment customers are significantly more likely to have no qualifications.

Table 1: Highest qualification by payment type

%

	Prepayment customers	*Direct debit customers*	*Standard credit customers*
Degree	17	47	41
A Levels	20	19	16
GCSE	33	19	19
None	30	15	23

Source: CMA analysis of survey data.
Notes:
1. Bases differ for customer group. Prepayment customer base = 605, direct debit customer base = 4,902 and standard credit customer base = 914.
2. Respondents are categorised based on their payment method. In particular, respondents are only included if they have the same payment method for all fuel types (that is, including those with only one fuel type).

5. Table 2 shows respondents' income by payment type. We find that, when compared with both direct debit and standard credit customers, prepayment customers are significantly: less likely to have an income of over £36,000; and more likely to have an income below £18,000.

Table 2: Income by payment type

%

	Prepayment customers	*Direct debit customers*	*Standard credit customers*
<£18k	48	16	25
£18k - £36k	16	21	17
>36k	6	29	18
Don't know/Refused	31	35	41

Source: CMA analysis of survey data.
Notes:
1. Bases differ for customer group. Prepayment customer base = 646, direct debit customer base = 5,121 and standard credit customer base = 973.
2. Respondents are categorised based on their payment method. In particular, respondents are only included if they have the same payment method for all fuel types (that is, including those with only one fuel type).

6. Table 3 shows respondents' age by payment type. We find that, when compared with direct debit customers, prepayment customers are significantly: less likely to be aged over 65; and more likely to be aged between 18 and 35. Further, when compared with standard credit customers, prepayment customers are significantly: less likely to be aged over 65; and more likely to be aged between 35 and 44 or 45 and 54.

Table 3: Age by payment type

%

	Prepayment customers	*Direct debit customers*	*Standard credit customers*
18-35	27	15	23
35-44	22	18	14
45-54	24	20	16
55-64	14	15	13
65+	13	32	34

Source: CMA analysis of survey data.
Notes:
1. Bases differ for customer group. Prepayment customer base = 639, direct debit customer base = 5,050 and standard credit customer base = 959.
2. Respondents are categorised based on their payment method. In particular, respondents are only included if they have the same payment method for all fuel types (that is, including those with only one fuel type).

7. Table 4 shows respondents' status by payment type. We find that, when compared with both direct debit and standard credit customers, prepayment customers are significantly more likely to: be disabled; be a single parent; or be more than one of disabled, single parent and carer.

Table 4: Status by payment type

%

	Prepayment customers	*Direct debit customers*	*Standard credit customers*
Carer	6	6	7
Disabled	23	10	11
Single Parent	18	5	8
Multiple	10	3	4
No/DK/Refused	43	76	70

Source: CMA analysis of survey data.
Notes:
1. Bases differ for customer group. Prepayment customer base = 646, direct debit customer base = 5,121 and standard credit customer base = 973.
2. Respondents are categorised based on their payment method. In particular, respondents are only included if they have the same payment method for all fuel types (that is, including those with only one fuel type).

8. Table 5 shows respondents' tenure type by payment type. We find that, when compared with direct debit customers, prepayment customers are significantly: less likely to live in a property they own; and more likely to live in rented housing, both social and private, and other. In addition when compared with standard credit customers, prepayment customers are significantly less likely to live in a property they own outright; and more likely to live in rented social housing and other.

Table 5: Type of tenure by payment type

%

	Prepayment customers	*Direct debit customers*	*Standard credit customers*
Own – outright	5	41	35
Own – mortgage	14	38	20
Rent – private	23	11	21
Rent – social	46	6	17
Other	12	4	7

Source: CMA analysis of survey data.
Notes:
1. Bases differ for customer group. Prepayment customer base = 646, direct debit customer base = 5,121 and standard credit customer base = 973.
2. Respondents are categorised based on their payment method. In particular, respondents are only included if they have the same payment method for all fuel types (that is, including those with only one fuel type).

Supply side barriers to entry and expansion in prepayment

9. In Section 9 we consider whether there may be supply-side constraints on competition in the prepayment segments which might explain the absence of the cheapest tariffs in the prepayment segments when compared with those offered in the direct debit segments (even accounting for differentials in the costs to serve).

10. In this section we outline additional information in relation to those supply-side constraints. In particular, these supply-side constraints are:

    (a) technical constraints in the prepayment infrastructure for 'dumb' prepayment meters that limit prepayment tariff offerings;

    (b) Softer incentives on suppliers to compete to acquire prepayment customers (and in particular concerning new entrants for which the technical constraints are greater, see below) such as:

        (i) higher acquisition costs of prepayment customers, capital and other growth constraints on independent suppliers; and

        (ii) the complexities involved in the assignment of customer debt in some prepayment meter switches; and

    (c) regulatory constraints.

Technical constraints

11. Below we outline additional evidence in relation to the allocation of gas tariff codes and the extent to which smart meters are a solution to the technical constraints present in the dumb prepayment infrastructure. In Annex A we also set out a potential workaround to the technical constraints that we considered.

Allocation of gas tariff pages

12. In Section 9 we outline that there does not appear to be a clear mechanism for allocating gas tariff codes.

13. For example, E.ON stated that Siemens managed all the gas tariff code allocations. E.ON set out that it recently returned four unused tariff pages to Siemens, [✂], suggesting that there is a mechanism for reallocating tariff codes. However, it is not clear that this is transparent and visible to all suppliers that may wish to acquire further tariff codes.

14. Further, several independent suppliers have given us examples of the difficulties that they encountered when they tried to secure a gas tariff page in order to enter or expand their offering in the prepayment segments. In particular:

    (a) Robin Hood Energy told us that it signed a contract with Siemens in May 2015 but this contract could not be fulfilled due to a lack of slot availability. Robin Hood Energy contacted Ofgem in September of the same year, complaining that this was a barrier to entry, and a few weeks later it eventually received a slot from Siemens which had been returned by a party that was not using it.

    (b) Ovo Energy explained that it had not had difficulty in acquiring one gas tariff page from Siemens in May 2013. However, Ovo Energy explained that in order to offer fixed-rate tariffs, as well as an SVT, one gas tariff page was not enough and therefore it had requested an additional tariff page from the Supply Point Administration Agreement forum.[1] Ovo Energy told us that although it had received a gas tariff page in September 2015 it had experienced difficulty in doing so. In particular, it had tried to engage with the Supply Point Administration Agreement forum first through Siemens in July 2015 and subsequently directly at the Supply Point Administration Agreement's September 2015 meeting. Ovo Energy told us that after its experience at the September 2015 meeting it had not expected to find a resolution to its problem at the Supply Point Administration Agreement forum and had raised the issue with Ofgem. Ovo Energy explained that [✂].

[1] Supply Point Administration Agreement forum is the industry forum in which suppliers discuss a range of issues relating to gas.

(c) First Utility has [✂] gas tariff [✂], which [✂] assigned to it in April 2015. It has asked Siemens [✂]. Siemens has told [✂]. First Utility also noted that the prepayment segments are not considered to be [✂].

15. We note that Economy Energy told us that it had started selling in the prepayment segments in Q3 2012 and had no problems procuring the required electricity or gas tariff pages necessary to enter. It currently offered a one-year fixed tariff and an SVT to prepayment customers.

Smart metering as a solution to these technical constraints

16. In Section 9 we identify that there are technical constraints that limit the ability of suppliers to reproduce the same structure and type of acquisition tariffs available in the direct debit segments in the prepayment segments. Here we look at the evidence received in relation to smart meters and technical constraints.

17. Smart prepayment meters operate independently of the current dumb prepayment infrastructure. Therefore from a technical point of view, a smart prepayment meter – whether SMETS 1 or SMETS 2 – can side-step all aspects of the dumb prepayment infrastructure, including the payment system. This means smart prepayment meters increase the ability of suppliers to offer tariffs to prepayment customers on those meters by avoiding the tariff code slot constraints identified in Section 9.

18. For example, E.ON started rolling out SMART PAYG meters to its eligible customers during Q1 2016. These smart prepayment meters will allow those prepayment customers to access exactly the same E.ON tariffs as customers on credit meters. E.ON told us that this was a competitive acquisition play in the market.[2]

19. Utilita, an entrant, has an offering that is focused entirely on the smart prepayment segments. Utilita told us that it had found that the prepayment segments was profitable even when the cost of renting smart meters was included. Moreover, we were told by Utilita that it found that any new prepayment account was cheaper to serve with a smart prepayment meter than a dumb prepayment meter. Although the capital cost of keeping a customer on a dumb prepayment meter might be lower compared with installing a smart prepayment meter, a dumb prepayment meter need to be replaced by a smart meter before 2020 as per the gas and electricity SLCs.

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[2] See E.ON's response to the provisional decision on remedies, p10-12 and E.ON's website: 'Smart Pay As You Go is coming'.

20. We believe therefore that suppliers ought to be able to profitably offer smart prepayment meter tariffs that are lower than the current prepayment tariffs based on dumb prepayment infrastructure, both because of lower costs to serve and because of the currently high margins available in the prepayment segments.[3] We understand that some of the cheapest prepayment offerings include the installation cost (if not already installed) of a smart prepayment meter.[4]

21. We note that, although it is possible to circumvent the technical constraints of the prepayment infrastructure through smart meters, only very few suppliers (and only E.ON of the Six Large Energy Firms) have focused their strategy in the prepayment segments on installing smart meters with a view to offering cheaper tariffs. In particular, only two independent suppliers – Ovo Energy and Utilita – offer smart meters as an acquisition strategy on a nationwide basis.[5] This is reflected in that the penetration of smart prepayment meters is low, at around 8% for dual fuel customers in the prepayment segments.[6]

22. Further, even where an independent supplier has pursued a strategy based on smart prepayment meters, this strategy has not been underpinned by prepayment tariffs that are comparable with the cheapest tariffs in the direct debit segments (even accounting for differentials in the costs to serve), as shown in Section 8.[7]

23. In relation to this we note that two mid-tier suppliers, Ovo Energy and First Utility told us that currently their smart prepayment offering is constrained by their dumb prepayment offering. [✂]. First Utility told us that its offering on smart prepayment meters, which it installed for its existing customers who were in debt, was constrained by its offering to customers who switched to First Utility on dumb prepayment meters. We note however that another (smaller) supplier with a smart offering told us that this was not a material issue.

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[3] Our reasoning is that tariffs based on dumb prepayment infrastructure currently appear to have relatively high margins, margins that could profitably accommodate the rental cost of a new smart A1PP meter.
[4] For example, in our PCW analysis set out in Section 8 Utilita had the cheapest prepayment tariff in three regions and that tariffs is a smart prepayment tariff, see Figure [8.x] in Section 8.
[5] Economy Energy is planning to make smart meters available to all prepayment customers during 2016. This is made possible in part due to an arrangement with its meter asset provider which is covering capital and installation costs of meters. We understand that Robin Hood Energy is also planning to make smart meters available to its existing and new customers, however, we note that as at 28 February 2015 it had [✂] prepayment customers on supply and therefore we do not expect this to have a significant impact on the market.
[6] This is based on dual fuel customers as at Q4 2015. CMA analysis based on data from the Six Large Energy Firms, the Mid-tier Suppliers, Economy Energy and Utilita.
[7] RWE Npower said that given the constraints arising from the RMR four-tariff rule, in particular, the disincentive to target niche customer groups, and the low level of smart meter penetration it was perhaps not surprising that smart metering had not led to significant reductions in price whilst it remained small scale. See RWE Npower's response to the provisional decision on remedies, p48.

24. Therefore at present the vast majority of customers on smart prepayment meters do not have materially different prepayment options to customers on dumb prepayment meters except those existing E.ON customers for whom SMART PAYG meters have been installed (see paragraph 18).

Interoperability of smart prepayment meters

25. In general suppliers have agreed that smart meters will circumvent the technical constraints that arise from the current prepayment infrastructure.[8] However, EDF Energy told us that although technical constraints were likely to be addressed by the roll-out of SMETS 2 this was not the case in relation to SMETS 1. In particular, EDF Energy told us that SMETS 1, unless and until adopted by the Data Communications Company,[9] would not be fully interoperable between suppliers such that a customer with a SMETS 1 meter who switched supplier was likely to lose the smart functionality. Therefore customers with SMETS 1 prepayment meters would face a barrier to switching.[10]

26. We understand that SMETS 2 meters will operate by sending or receiving information through the Data Communications Company to/from customers' current suppliers (and/or network operators or authorised third parties). While currently SMETS 1 meters are not able to function via the Data Communications Company in this way we understand that, although the timing is uncertain, a project is currently underway to assess how SMETS 1 meters could be 'enrolled' into the Data Communications Company.

27. However, Utilita and E.ON have told us that a SMETS 1 prepayment meter can be interoperable between suppliers if suppliers have agreements with the relevant Smart Meter System Operator (SMSO) for that smart meter.

28. We understand that Secure are the SMSO for both E.ON's SMART PAYG meters and the smart meters that Utilita install. When a customer with one of these meters switches supplier there is a requirement for the meter to be switched to credit mode. However, if the gaining supplier, or their appointed

[8] For example, see Centrica's response to the addendum, EDF Energy's response to the addendum, E.ON's response to the addendum, Scottish Power's response to the Second Supplemental Remedies Notice, para 22.5, SSE's response to the addendum and Robin Hood Energy's response to the addendum.
[9] First Utility also told us that currently there was uncertainty around the adoption of SMETS 1 meters by the Data Communications Company.
[10] EDF Energy response to addendum to provisional findings (13 January 2016), paragraph 1.6. Centrica also noted that not all smart meters installed by Utilita were SMETS compatible.

Smart Meter System Operator, have an agreement in place with Secure then the meter can continue to be operated as smart prepayment meters.[11]

29. E.ON noted that competitors, including Ovo Energy and Utilita, had agreements with Secure while Utilita told us that Secure had advised it that Secure have agreements with 14 suppliers

30. Therefore, at least some smart meters are interoperable between suppliers subject to those suppliers having agreements in place with relevant SMSO and the incentive to operate those smart meters.

Softer incentives to compete to acquire prepayment customers

31. In Section 9 we consider whether there are softened incentives for all suppliers, and in particular new entrants, to compete to acquire prepayment customers such as:

    (a) higher costs of acquiring and serving customers in the prepayment segments, and especially so for new entrants, compared with direct debit segments; and

    (b) the complexities involved in the assignment of customer debt in some prepayment meter switches.

32. Here we look at additional evidence in relation to these factors.

Higher acquisition and service costs of prepayment customers and independent suppliers' constraints on growth rates

33. In Section 9 we identified that new entrants may incur higher metering costs than the incumbent suppliers in relation to the current prepayment infrastructure.

34. In addition to those outlined in Section 9 we note that First Utility told us that there are [✂] changing prepayment tariffs within the current dumb infrastructure [✂]. First in relation to both the electricity and gas prepayment infrastructure [✂]. [✂]. In addition First Utility noted that in relation to the electricity prepayment infrastructure if it wants to change an electricity prepayment tariff in any way[12] [✂].

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[11] Where these agreements are not in place the meter would become dumb in relation to the new supplier or the new supplier would have to replace the meter. Further, some prepayment customers with SMETS 1 meters may be unable to use the prepayment setting on their meter if they switch. As a result, such customers may have to change their meter in order to switch supplier.

[12] First Utility noted that the charge would be the same even if it updated one unit rate in one region.

35. In Section 9 we also identified that there are costs to serve that are higher for the Six Large Energy Firms and the independent suppliers in the prepayment segments, relative to the equivalent cost to serve in the rest of the domestic retail energy markets, but we expect those costs to adversely affect the incentives of the independent suppliers somewhat more so that they do for the Six Large Energy Firms. The two specific examples of differences in cost identified in Section 9 are: the costs involved in administrating the Debt Assignment Protocol; and the need to use more expensive external telesales and face to face marketing channels in order to reach prepayment customers. In relation to the Debt Assignment Protocol see paragraphs 45 to 48 below.

36. In relation to marketing channels we have received some evidence on the extent to which prepayment customers are acquired through more expensive marketing channels relative to direct debit customers, and therefore on the extent to which this reduces suppliers' current incentives to compete to acquire prepayment customers.

37. In particular, Scottish Power told us that as few as [✂]% of its prepayment customers had been acquired through PCWs. The rest were acquired through more expensive channels, including external sales ([✂]%) and face to face ([✂]%). For Scottish Power's direct debit customers, in contrast, just under half were acquired through PCWs, with the rest being accounted for by a mixture of internal and external telesales. Only [✂]% were recruited face to face.

38. Similarly:

    (a) EDF Energy said that prepayment customers are generally harder to access and less responsive to approaches by suppliers and so cost more to acquire per account.[13]

    (b) RWE Npower said that any supplier wishing to target its tariffs at prepayment customers would be subject to the costlier acquisition channels associated with acquiring those customers.[14]

    (c) Economy Energy told us [✂].[15]

[13] See EDF Energy response to addendum 26 January 2016.
[14] See RWE Npower's response to the provisional decision on remedies.
[15] See Economy Energy's response to the provisional decision on remedies.

39. Although we note that while Utilita told us that around [✂] of its customer acquisitions are face to face and that the out-of-pocket commission paid per customer is [✂] the commission on PCWs.[16]

40. Finally our review of parties' responses to our information requests also suggests that prepayment customers, in particular when currently using a dumb meter, may be more expensive to acquire (in particular through a smart prepayment tariff) to the extent that more capital is required upfront. This can be due, for instance, to the need to install a smart prepayment meter in order to circumvent the technical constraints noted above, or because of the additional costs of (and low prospect of successfully) acquiring customers with an outstanding debt (as discussed below).

Additional barriers to acquiring indebted prepayment customers

41. In Section 9 we consider whether the Debt Assignment Protocol (DAP), the industry process used to assign debt when indebted prepayment customers try to switch supplier, may soften incentives to compete by limiting the prospect of successfully acquiring customers with existing debt.

42. Here we provide more detail on the DAP and how the DAP process has changed over time. In particular, we outlined work by Ofgem in relation to the DAP and the recent Point of Acquisition (POA) model which has been adopted by eleven suppliers in total, including all of the Six Large Energy Firms.

Process for switching indebted prepayment customers

43. Our understanding of the procedure with regards to switching indebted customers, outside of the POA model which is discussed below, is the following:

    (a) The indebted customer might or might not have told the acquiring supplier that they are in debt.

    (b) The acquiring supplier makes a change of supplier request to the incumbent supplier.

    (c) The incumbent supplier raises an objection to the switch on the grounds of the debt owed; there are then outcomes depending on whether the debt is less than £500 or more than £500 per fuel:

[16] Utilita told us that there were other acquisition costs but said that out-of-pocket commission is the key cost. Hearing with Utilita dated 27 April 2016.

(i) If the debt is less than £500 per fuel, the customer is informed of this objection by mail, and if the customer responds to the objection by mail and appeals under the DAP, then the customer's debt is automatically (and entirely) assigned to the acquiring supplier (which must pay within 28 days 90% of the debt to the incumbent supplier as full settlement)[17] and the switch completes.[18] The customer is also informed that they need to give the incumbent supplier permission under the Data Protection Act 1998 to share debt details with the acquiring supplier.[19]

(ii) If the debt is more than £500 per fuel, the incumbent supplier has the right to refuse the transfer.

44. From the point of view of an **acquiring** prepayment supplier, this does not appear to be excessively onerous. In particular:

(a) there is no prohibition on charging interest on the acquired debt;

(b) prepayment customers are dependable payers – they incur debt before they are on prepayment meters, not after (and start to pay back the debt in order to purchase energy[20]); and

(c) the customer still owes the entirety of the sum, but it is purchased by the new supplier at a 10% discount, providing a positive incentive to acquire such customers.

45. However, in response to the addendum some suppliers have explained that this process adds to supplier's costs. In particular, Centrica told us that there were a number of process and procedural issues which made it difficult and costly to administer, including that the DAP remained very manual, time consuming, and costly to operate. Similarly Robin Hood Energy told us that there a number of manual steps that the acquiring supplier must take.

46. Utilita told us that the Debt Assignment Protocol was currently manually intensive and onerous for suppliers. In addition, Utilita told us that it had

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[17] Note that the level of indebtedness of the customer is not adjusted downwards by 10%.
[18] We are not clear why there needs to be a pre-agreed level of debt reduction for switching to occur; it is not clear what is the impact of this requirement, combined with parties' obligations set out in SLC 14, on (incumbent and new) suppliers' incentives within the context of the switching process. EDF Energy said that while the reduction may be an incentive for incumbent suppliers to retain customers, as outlined at Section 9, it could also act as an incentive for suppliers to acquire customers, as outlined at paragraph 44. See EDF Energy's response to the addendum, paragraph 3.1(d).
[19] Ofgem notes that it does not believe that this is actually mandated by the Data Protection Act and asked the industry to waive this requirement in September 2014. Ofgem open letter (22 September 2014), Reforming the switching process for indebted prepayment meter customers – the Debt Assignment Protocol.
[20] Each time a customer makes a payment to top up their prepayment meter electricity key or gas card, a percentage is used to repay the outstanding debt according to the existing repayment plan. The remainder is used to purchase energy.

filtering mechanisms in accordance with the supply licence in its sales process aimed at minimising the time spent by face to face agents on prospects with low-probability success because of debt issues. Utilita explained that face to face agents might not sign up customers with debt above £500, as these customers had to be managed through a different process, including its credit control team.

47. Further, some independent suppliers' also suggested that their growth rate in the prepayment segments may be constrained by capex (and its impact on cost of capital) required to take on customers with debt. In particular:

(a) Robin Hood Energy told us that it was concerned about the cost of capital associated with taking a large number of customers under the DAP. It suggested that this might be a constraint on the rate of growth that could be achieved in the prepayment segments. Specifically, the transfer of debt via the DAP required the payment of 90% of the debt with 28 days whereas it took a lot longer for a supplier to recover that debt (approximately two years).[21] However, Robin Hood Energy had not found this to be a problem so far.[22]

(b) Our Power Energy Supply also told us that the DAP had had a negative impact on new entrants due to the cost of capital it entailed. In particular, the transfer of debt required scarce working capital, involved a significant 'buy-out' rate (90%), made it more difficult for new entrants to raise further working capital and took a long time to recover.[23]

48. Therefore, the DAP is likely to contribute to the higher acquisition costs identified above and in Section 9.

Ofgem work in relation to the DAP

49. Ofgem reviewed the DAP in 2012 and suppliers committed[24] to improve it through various initiatives, such as generating greater awareness and increasing the debt threshold necessary in order to qualify for a switch – from £200 to £500.

[21] According to Robin Hood Energy, Ofgem's Social Obligation Report 2014 shows that on average it takes 112 weeks to recover debt from a prepayment customer.
[22] In relation to this we note that as of 28 February 2015 Robin Hood Energy had [✂] prepayment customers.
[23] The set maximum recovery rate for debt of £5 per week means that a customer with £500 debt would take a minimum of two years to repay that debt.
[24] See Ofgem's open letter (24 September 20102). Debt Assignment Protocol Review: the process for prepayment meter customers switching with a debt.

50. Ofgem again reviewed the DAP in 2014 to assess these commitments made by suppliers in 2012, evaluate the impact of any changes, and ascertain whether more needed to be done.

51. While Ofgem welcomed the progress by suppliers in increasing awareness about the DAP and increasing the switching threshold to £500, it concluded that indebted prepayment customers still face unnecessary barriers to switching and complexity in the switching process, which could explain the small number of indebted prepayment customers completing a switch For instance, Ofgem found that not all independent suppliers were honouring the £500 threshold and may be preventing their customers from switching in circumstances below this amount. Additionally, Ofgem found that the 'objection letter' sent by incumbent suppliers to their customers stated that customers may still switch if their new supplier was willing to assume the debt, but that customer consent was required in order for the former supplier to share details of the debt with the new supplier. Unless customers provided this consent, switches were stopped. This was despite the fact that such consent was, in Ofgem's view, not required under the Data Protection Act 1998.

52. Ofgem has already taken some steps to address these barriers to switching. It has amended SLC 14.6[25] to reflect the threshold of £500 under which suppliers have the obligation to facilitate a customer's switch. It has also identified in an open letter published on 22 September 2014[26] areas for improvement that required actions by Ofgem and the industry:[27]

(a) The 'objection letter' sent by an incumbent supplier should not confuse customers as to their right to switch, making clear that the switch will continue; further 'objection letters' should only be sent to customers who are unable to switch.

(b) The 'complex debt' aspect of the DAP should be revisited in order to diminish the instances in which the switch in disallowed.

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[25] Ofgem (12 May 2015), *Decision to make modifications to the gas and electricity supply licences to reform the switching process for indebted prepayment meter customers – the Debt Assignment Protocol*.
[26] Ofgem open letter (22 September 2014), Reforming the switching process for indebted prepayment meter customers – the Debt Assignment Protocol.
[27] Ofgem asked the industry to revisit its procedures in 2014 and to have a new DAP by April 2015. Ofgem noted that suppliers were largely in agreement with Ofgem's proposal but raised concerns that amending the DAP in this respect would require significant system and processing changes. We understand that the industry has not approved the changes suggested by Ofgem yet.

(c) Issues relating to multiple registrations should be addressed in order to avoid multiple objection letters being sent to the customers, causing unnecessary confusion for them and adding cost.

53. In its Forward Work Programme 2015-16,[28] Ofgem indicated that it would put in place a new regime for the DAP to reduce barriers to switching for indebted prepayment customers. In order to ensure 'safe and efficient switching', it also noted that a key consideration in reviewing the arrangements by which suppliers may object to customers switching would be whether current arrangements are conducive to customers in debt being able to get the best deal, while simultaneously ensuring that suppliers are able to take appropriate steps to have debt repaid.

54. In the course of 2015, Ofgem collected evidence relating to the supplier objections mechanism. It is currently in the process of analysing the information received, and has also commissioned external experts to examine the costs and benefits in more detail as input to its wider consideration of the issue. Ofgem expects to issue a further update in early 2016.[29]

POA Model

55. In April 2015 ten suppliers, including all of the Six Large Energy Firms, adopted the POA model with an additional supplier adopting the POA model in July 2015. This model is aimed at simplifying the switching process for customers.

56. In particular, the POA model builds the provision of information about the DAP and customer agreement to debt assignment in the event of a debt objection into suppliers' sales channels for all prepayment customers. Therefore, for those prepayment customers with a debt of £500 or less per fuel who are looking to switch to a supplier operating the POA model, and who give their consent at the point of acquisition, the model removes the need for that prepayment customer to take action (as set out at 43(c)(i) above) to complete the switching process under the DAP in the event of an objection being raised.[30]

57. In addition those suppliers who signed up to the POA model also updated their debt 'objection letters' such that the letter sets out:

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[28] Ofgem, *Forward Work Programme 2015-16*, Section 2.14 and 3.10.
[29] See Ofgem's website: Suppliers' objections.
[30] See Energy UK response to the addendum.

(a) For those who have not previously agreed to the DAP, the steps necessary to complete their switch through the DAP.

(b) For those who have previously agreed to the DAP, that their switch will continue and that debt information will be shared with, and debt assigned, to the acquiring supplier to facilitate the DAP.

58. Initial evidence suggests that the POA model has increased the number of successful switches. In particular, Ofgem said that in Q3 2015 the proportion of attempted switches by prepayment customers being completed through the DAP was 3.4% for electricity and 4.2% for gas compared to figures of 0.3% for electricity and 0.4% for gas at Q3 2014.[31]

59. Energy UK said that around a third[32] of switches attempted by prepayment customers with less than £500 of debt were successful by the end of the quarter where an objection was raised.[33] Ofgem told us that it understands that the differences between these numbers could be explained by different methodologies and coverage. For example, Energy UK include switches where an objection was raised, but the switch occurred outside the DAP because the customer cleared their debt with their existing supplier and Energy UK's figures are only based on eight electricity and seven gas suppliers operating the POA model.

60. We note that although initial evidence suggests that successful switching has increased the figures above still mean that the majority of switches attempted by prepayment customers with a debt under £500 fail.

61. Further, Ofgem said that although the POA model addresses one significant process issue the industry believes that a number of other technical issues are causing attempted switches to fail partway through the switching process. Ofgem said that suppliers told them that a large proportion of attempted switches fail because the two suppliers involved in the switch hold differing records of the name of the customer which leads to uncertainty and confusion as to whom the debt should be assigned.[34]

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[31] This is based to information provided by suppliers to Ofgem as part of Social Obligations reporting. See Ofgem's response to the addendum.
[32] We note that this is based on only eight electricity and seven gas suppliers operating the POA model. See Energy UK response to addendum and SSE's response to the addendum p27. SSE also said that its total customer gains and losses through the DAP have more than doubled in 2015 from 2014 levels.
[33] These switches were completed either through the DAP or because the customer cleared their debt with their existing supplier removing the objection.
[34] See Ofgem's response to the addendum.

Possible regulatory barriers to competition in the prepayment segments

62. In Section 9 we consider whether there are any parts of the 'simpler choices' component of the Retail Market Review (RMR) rules which may hamper competition for reasons that are specific to the prepayment segments. Here we set out in more detail our consideration of the 'four-tariff rule'.

Four-tariff rule

63. In our view, the maximum number of tariffs that a supplier may offer to customers at any one time under the 'four-tariff rule', which applies to both credit meters and prepayment meters, may make it more costly to offer a tariff aimed specifically at the prepayment segments in the sense that such a tariff could take up one of a supplier's four slots.

64. We have analysed the tariff choices (as of October 2015) that suppliers have made available with a particular focus on how they fit offers to the prepayment segments within their four-tariff offering (see Section 8).

65. The question we ask is whether this configuration of four-tariff choices suggests that a normal competitive process has been impeded by the existence of the four-tariff constraint.

66. First, we note that there is no evidence that suppliers offered greater tariff choice in the prepayment segments before the RMR rules. In Q1 2012, before the introduction of the RMR rules, there were no fixed and 15 SVT prepayment tariffs on offer. By Q2 2015, there were three fixed and over 17 variable prepayment tariffs on offer. The evidence we have is that tariff choice in the prepayment segments has been increasing, not falling, over the period of investigation (although at a very slow pace compared with the direct debit segment). It seems likely, therefore, that even if the RMR rules constrain the number of tariffs on offer in the prepayment segments, they are not the principal cause of prepayment customers facing prepayment tariffs that are materially more expensive than the cheapest direct debit tariffs.

67. That said, the four-tariff rule does introduce some additional costs to prospecting in particular niches, though this is a general issue we have observed with the RMR rules rather than anything specific to the prepayment segments (and has been identified as an AEC see Section 9).

68. Parties have confirmed that they were able in principle to offer the same tariffs to prepayment customers as to other customers. However, some parties noted that designing a tariff specifically for prepayment customers had an opportunity cost by taking up one of the four slots of the four-tariff rule

(therefore reducing the number of tariffs that may be offered to non-prepayment customers).

69. This is therefore consistent with the AEC we have found with respect to the simpler choices component of the RMR rules, and suggests that innovation in the prepayment segments may be restricted by the choice of suppliers not to dedicate a tariff slot specifically to this segment.

70. We have then considered whether, as a result, the four-tariff rule had a stronger impact in the prepayment segments to the extent that it would constitute an absolute barrier to competition. If we focus on Scottish Power and EDF Energy, because these are two of the Six Large Energy Firms offering non-SVT dumb prepayment meter tariffs, it seems clear that the four-tariff rule does not constitute an absolute barrier to competition between the two of them (although, as noted above, it may restrict the parties' ability to compete through innovation). A process of successive undercutting could occur as follows: EDF Energy could lower the price on its prepayment-only tariff to attract customers; Scottish Power could either lower the prepayment uplift on the 'charity fixed'[35] prepayment tariff, or switch its prepayment offering to its lower-priced fixed acquisition tariff (with relevant cost-to-serve adjustment) in order to engage in competition with EDF Energy's undercutting.

71. Therefore in relation to the 'four-tariff rule' we have considered the degree to which it might impose an opportunity cost to the offering, in the prepayment segments, of competitively priced acquisition tariffs (compared with the direct debit segments). While we believe that there is such a cost, we do not conclude that this is an absolute constraint on competition in the prepayment segment. Moreover, we consider that it is not specific to the prepayment segment and is common to the issues we have already raised in relation to the 'simpler choices' component of the RMR rules in Section 9.

Parties comments

72. [✂].

73. Similarly Centrica and RWE npower told us that the four-tariff rule acted as a constraint in relation to the prepayment segments. In particular, they told us that a prepayment meter specific tariff would take up a slot under the four-tariff rule that could otherwise be used for a tariff targeted at a larger customer base.

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[35] The non-SVT tariff that Scottish Power currently offers in a prepayment version is the Help Beat Cancer tariff.

74. RWE npower told us that we underestimated the extent to which, along with technical constraints, the RMR simpler choices rules, including the prohibition on cashback and other non-cash incentives, account for the differences in competition between the prepayment segments and the credit segments.

75. Similarly SSE noted that we understated the impact of the RMR rules, and technical constraints, on the ability of suppliers to engage with customers and tailor commercially-attractive offerings.

76. We note that in relation to these points none of the parties provided evidence on why, in and of itself, the impact of the 'four-tariff rule' on prepayment went beyond the issues we have already raised in relation to the 'simpler choices' component of the RMR rules in Section 9.

77. Although, we note that First Utility told us that the four-tariff rule did not adversely impact the prepayment segments as the rule was on a per meter type basis.

78. EDF Energy noted that, while it agreed that the simpler choices component of the RMR has reduced the incentives for suppliers to design more prepayment-specific tariffs, its view was that the main issues were the technical constraints arising from the prepayment infrastructure.

79. Scottish Power told us that the removal of the 'simpler choices' component of the RMR rules would relax the technical constraints arising from tariff codes. In particular, Scottish Power told us that if a supplier had an SVT for credit meters that varied by PES region then the 'simpler choices' component of the RMR rules required the same regional variation for the prepayment SVT and this took up 14 prepayment tariff codes, we understand this component to be SLC 22B.7(b). Given the existence of the four-tariff rule, suppliers that wanted to offer a prepayment meter fixed-term tariff had to offer a prepayment meter version of a credit meter fixed-term tariff, which, if there was regional variation, would require another 14 prepayment meter tariff codes, or use one of the scarce four-tariff slots. Absent these two rules suppliers could offer prepayment meter tariffs with more limited regional variation and therefore reduce the number of prepayment meter tariff codes needed for each separate tariff. This would increase the number of prepayment meter tariffs that could be offered within the current system.[36]

80. Our consideration of the constraints arising from the four-tariff rule and SLC 22B.7(b) are set out in Section 9.

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[36] Scottish Power's response to the addendum, p21, paragraphs 23.4 & 23.5.

Annex A: Prepayment infrastructure

1. In Section 9 we outline our understanding of the current prepayment infrastructure for dumb prepayment meters and the constraints it places on suppliers' tariff offerings.

2. Based on this understanding of the constraints, we were concerned that the limited availability of tariff codes could restrict firms' ability to offer competitive acquisition tariffs – especially those based on the currently popular one-year fixed structure. As a result, we engaged further with suppliers to understand better the nature of these constraints, and whether there are potential workarounds that could mitigate the effect of these technical barriers.

3. In this section we set out a potential workaround we considered, and parties' responses to it.

4. In forming our understanding of these issues, we met with Itron and Siemens, the prepayment meter infrastructure providers (PPMIP) for electricity and gas respectively. In addition, we sent two rounds of information requests to the Six Large Energy Firms and the mid-tier suppliers to understand better the extent to which they faced technical constraints in offering tariffs to customers with prepayment meters.

Potential workaround

5. Based on our understanding of the technical constraints arising from the prepayment infrastructure we considered it possible that suppliers could offer prepayment tariffs without the need to have a tariff code for each tariff they offered.

6. This potential workaround and the suppliers' responses are set out below. Having considered suppliers' responses to this potential workaround for the tariff code issue, we consider it unlikely that there is a solution to the tariff code issue that would not require reasonably large system changes. Suppliers also noted that smart meters would remove tariff code issues and the payment infrastructure limitations, affecting the proportionality and cost-effectiveness of any remedy in this area. As a result, we do not think that this proposed workaround is a solution to the tariff code issue that would be both timely and proportionate.

Our proposed workaround

7. The purpose of the tariff code is to communicate to the meter the rate at which it should decrement the customer's balance. One of the infrastructure

providers pointed out that the purpose of the prepayment tariff on the meter was to decrement credit, not to try to recreate the accuracy of the billing engine on the meter. Any number of tariffs can be applied at the billing engine and can be reconciled with the customer against any payments made, as per the normal credit customer process. We were interested in understanding whether a customer could be placed on a tariff code that does not match their actual tariff details (meaning that the balance on their meter would be decremented at the 'wrong' rate), but then for there to be a 'truing up' process subsequently to ensure that the customer ends up paying the correct amount.

8. For example, a supplier could offer its customers a competitively priced fixed tariff, but use its SVT tariff code. The customer's meter would decrement their balance based on the SVT tariff code (and therefore in line with the SVT standing charge and unit rate(s)), but the customer would be refunded the difference at a later date.

9. The prepayment infrastructure enables suppliers to receive meter readings when a customer tops up, meaning that the supplier would be able to calculate how much the customer should have paid over a given period (eg between top-ups). The supplier would therefore be able to calculate how much a customer's balance needed to be adjusted (either up or down).

10. The prepayment infrastructure also has a credit-adjustment function that allows suppliers to adjust individual customers' balances (ie add or remove credit from their balance) when they top up. That is, the supplier can send a message to a payment terminal, and when the customer inserts their key/ card, their balance is adjusted, based on the supplier's instructions. This feature is in regular use by suppliers in the ordinary course of operation of the system, whether it be to manage a debt agreement or to make adjustments to payments against actual meter readings.

11. As a result, under the workaround we proposed to suppliers, suppliers would be able to offer tariffs to customers for which they did not have tariff codes. While customers' meters would decrement at a rate that is not perfectly in line with their tariff, there would be a mechanism through which suppliers could remotely adjust their customers' balances (eg at each top-up) to reflect any over- or under-payment.

Suppliers' responses to the proposed workaround

12. We received a range of responses from suppliers, with all suppliers considering our proposed workaround to be infeasible in practice. Below we set out the main barriers identified by parties.

Technical barriers

13. A number of suppliers told us that the messaging service for crediting or debiting balances on the prepayment infrastructure would not be able to handle the increased volume of messages that would be needed to adjust customers' balances on a regular basis.

14. Suppliers set out that the messaging service had limitations on the volume of messages it could send to customers' accounts. Under the current infra-structure, messages have to be sent to individual payment terminals and are picked up by the customer's key/card when they top up.[37] As a result, a customer will pick up a message only when they top up at the 'correct' terminal; if the supplier sends a message to one terminal, but the customer tops up elsewhere, the customer may not pick up the message during that top-up. When sending messages to customers, suppliers therefore try to send them to the terminals they consider the customer is likely to use for its next top up.

15. Suppliers told us that each terminal had a fixed capacity of messages.[38] If a supplier sends a message to a terminal that has reached its capacity of messages, the message is not stored on the terminal, and does not reach the customer (even if they top up at that terminal subsequently). These messages are queued, and reach the terminal only when space becomes available (ie when other messages have successfully been picked up by other customers, and are therefore removed from the terminal). Suppliers also told us that if a message is waiting for a space on a payment terminal to become free for more than a certain amount of time, it is cancelled, and the message would have to be resent.

16. In addition, Centrica noted that a recent exercise that required sending messages to approximately 1.6 million customers had already taken over 12 months, and had so far reached only 89% of the target customers. Given these difficulties with the messaging system, suppliers considered that it was not feasible to use it to adjust customers' balances on a very frequent basis (eg each time they top up).

Financial barriers

17. A number of suppliers explained that introducing such a system would be costly for them. Centrica, E.ON, RWE and SSE explained that they would face considerable costs in adjusting their systems to enable them to calculate

[37] It is not possible to send messages to a customer that can be picked up at any terminal.
[38] For example, SSE set out that each Paypoint terminal could hold a maximum of 250 messages.

and execute the required adjustments to customers' balances. EDF Energy, E.ON, RWE, SSE, Co-operative Energy and Ovo Energy highlighted their concerns regarding the likely increased costs of sending the required messages.

18. In addition, suppliers also set out that this proposed system would likely result in considerable confusion, as customers' meters would decrement at the 'wrong' rate, leading to a greater volume of calls to their customer service advisers, further increasing costs. More generally, suppliers raised their concerns that customers' experience would be negatively affected by such a system, noting that many of their customers with prepayment meters were in financial difficulty, and monitored their expenditure closely. As a result, they considered that a system where the balance reported on the customer's meter did not reflect their actual balance would cause problems for those customers.

Regulatory barriers

19. We did not receive consistent responses on whether or not there would likely be regulatory barriers to implementing such a system. However, EDF Energy and SSE questioned whether this would be counter to Supplier Licence Condition (SLC) 22B, which prohibited cash discounts. SSE also questioned whether this would be contrary to the Treating Customers Fairly licence condition (SLC 25C) due to the potential for customer confusion, and the potential for the customer to be charged the incorrect rate until they receive the message through the terminal. In addition, E.ON and Co-operative Energy considered that unilateral contract variation rules would apply if the supplier changed the rate at which the customer's meter decremented, even if the customer was on a fixed tariff.