

ENERGY MARKET INVESTIGATION

The Energy Market Investigation (Prepayment Charge Restriction) Order 2016

Notice of intention to make an Order under section 165 of, and Schedule 10 to, the Enterprise Act 2002 and public consultation on the proposed Order

Background

1. On 26 June 2014, the Gas and Electricity Markets Authority, in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002 (the Act) (as provided for by section 36A of the Gas Act 1986 (GA86) and section 43 of the Electricity Act 1989 (EA89)), made an ordinary reference to the Chair of the Competition and Markets Authority (CMA) for the constitution of a group under Schedule 4 to the Enterprise and Regulatory Reform Act 2013 for an investigation into the supply and acquisition of energy in Great Britain.¹
2. The CMA investigated the matters referred to it pursuant to sections 131 and 133 of the Act and concluded (a) in accordance with section 134(1) of the Act that there are features of the markets for the supply and acquisition of energy in Great Britain which, either alone or in combination, prevent, restrict or distort competition; and (b) in accordance with section 134(2) of the Act, that there are adverse effects on competition (AECs). The CMA published its findings in a report under section 136 of the Act entitled *Energy market investigation: Final report* published on 24 June 2016 (the Report).
3. Two of the AECs identified by the CMA were the Domestic Weak Customer Response AEC and the Prepayment AEC.
4. The features identified by the CMA as giving rise to the Domestic Weak Customer Response AEC were the following:
 - (a) Customers have limited awareness of, and interest in, their ability to switch energy supplier, which arises in particular from the following fundamental characteristics of the domestic retail gas and electricity

¹ [Energy market investigation terms of reference.](#)

supply markets: (i) the homogeneous nature of gas and electricity; and (ii) the role of traditional meters and bills.

- (b) Customers face actual and perceived barriers to accessing and assessing information arising, in particular, from the following aspects of the domestic retail gas and electricity markets: (i) the complex information provided in bills and the structure of tariffs; and (ii) a lack of confidence in, and access to, price comparison websites (PCWs) by certain categories of customers, including the less well-educated and the less well-off.
- (c) Customers face actual and perceived barriers to switching, such as where they experience erroneous transfers which have the potential to cause material detriment to those who suffer from them.

5. In addition, the CMA found that there are additional aspects of the prepayment meter segments that contribute to the features of the Domestic Weak Customer Response AEC. In particular, the CMA found that prepayment customers face:

- (a) higher actual and perceived barriers to accessing and assessing information about switching arising, in particular, from relatively low access to the internet and confidence in using PCWs; and
- (b) higher actual and perceived barriers to switching arising, in particular, from: (i) the need to change meter to switch to a wider range of tariffs (and the obstacles associated with this requirement such as perceptions of the complexity of the meter replacement process); and (ii) restrictions arising from the Debt Assignment Protocol hindering indebted prepayment customers' ability to switch supplier.

6. The features identified by the CMA as giving rise to the Prepayment AEC were the following:

- (a) technical constraints that limit the ability of all suppliers, and in particular new entrants, to compete to acquire prepayment customers, and to innovate by offering tariff structures that meet demand from prepayment customers who do not have a smart meter; and
- (b) softened incentives on all suppliers, and in particular new entrants, to compete to acquire prepayment customers due to: (i) actual and perceived higher costs to engage with, and acquire, prepayment customers compared with other customers; and (ii) a low prospect of successfully completing the switch of indebted customers, who represent about 7 to 10% of prepayment customers.

7. The CMA considered, in accordance with section 134(4) of the Act,
 - (a) whether action should be taken by it for the purpose of remedying, mitigating or preventing the AECs or any detrimental effect on consumers;
 - (b) whether it should recommend the taking of action by others for the purpose of remedying, mitigating or preventing the AECs or any detrimental effect on consumers; and
 - (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.
8. In the Report, the CMA decided on a package of remedies to remedy, mitigate or prevent the AECs and/or associated detriment that it found. The CMA decided to implement (through an Order) a prepayment charge restriction for the tariffs made available (either directly or indirectly) or applied to domestic customers on prepayment meters by energy suppliers.
9. By virtue of section 138(3) of the Act, the remedies implemented by the CMA must be consistent with the findings in the Report unless there has been a 'material change of circumstances' since preparation of the Report or the CMA otherwise has a 'special reason' for deciding differently.
10. In this regard, since publication of the Final Report, the CMA has received a number of submissions from parties relating to the implementation of this prepayment charge restriction, which it has considered:
 - (i) **BSUOS allowances**² – the Final Report set out that, for the purposes of determining the prepayment charge restriction, BSUOS allowances would be set using the out-turn BSUOS unit costs³ from the prior period. Several suppliers have submitted written correspondence suggesting or commenting on an alternative approach to setting the BSUOS allowance – namely, using forecast BSUOS unit costs.

We note that the approach set out in the Final Report introduces a lag between the period in which BSUOS costs are incurred and the period in which they are recovered and introduces potential for variability in cost recovery as a result of changes in the volume of electricity supplied. However, we note that using average projected prior period out turn values does ensure that over time costs are recovered (subject to differences in BSUOS unit cost between the first and last period and the issue of volume driven variability).

However, we also note that historically BSUOS unit costs have been higher than the forecasts presented by National Grid in its monthly

² Balancing system use of system.

³ The approach modelled for the Final Report used average out-turn BSUOS unit rates as projected by National Grid.

balancing system summary reports. We note therefore that using forecasts would result in under recovery of costs if future forecasts were again to be too low.

For this reason, having considered the arguments submitted to it to use an alternative approach, the Group has concluded that these do not give rise to a special reason to depart from the approach taken in the Final Report.

- (ii) **Correction factor** – Correction factors are a mechanism found in many price controls as a way of adjusting revenue allowances in subsequent periods for over- or under-recovery of allowed revenues in prior periods. The Final Report did not include a correction factor in the prepayment charge restriction. One supplier has submitted that a correction factor should be included.

For example, there is the possibility that a supplier may face costs different to those included within the price cap calculations in the event that they adopted a wholesale purchasing strategy that was different to the one implied by the price cap. We note that similar cost differences may arise to the extent there is volume variation, eg driven by customer churn, and therefore suppliers would be unable perfectly to replicate the wholesale purchasing strategy implied by any price cap. Additionally, suppliers may choose to adopt alternative strategies for other reasons such as to innovate or to manage their risks on a portfolio basis.

Moreover, constructing a correction factor to track over- or under-recovery of costs arising from different wholesale purchasing strategies would be very complex and unlikely to result in more equal treatment of suppliers.⁴ For this reason, having considered the arguments submitted to it to use an alternative approach, the Group has concluded that these do not give rise to a special reason to depart from the approach taken in the Final Report.

11. In accordance with section 165 and paragraph 2(1)(a) of Schedule 10 of the Act, the CMA hereby gives notice of its intention to make an Order on the terms attached to this Notice (the Draft Order) and invites representations on the Draft Order from any interested person or persons.

⁴ Since the correction factor would essentially need to establish an alternative implicit purchasing strategy or allow each supplier to pass through their own costs to tariff prices – each of these approaches would likely result in the price cap being more generous for some suppliers than others.

12. The Draft Order includes associated modifications to standard licence conditions mentioned in section 6(1) of the Electricity Act 1989 and in section 7A of the Gas Act 1986.
13. A draft Explanatory Note accompanying the Draft Order provides an explanation of how the Draft Order and the associated licence conditions are expected to operate.
14. This Notice and the Draft Order, including the associated modifications to relevant licence conditions, together with the draft Explanatory Note, have been published on the CMA website.
15. The CMA invites written representations on the proposed Order from any interested person or persons. The CMA will have regard to any representations made in response to this Notice. The CMA may also make modifications to the proposed Order as a result of any representations. If the CMA considers that any representation necessitates a material change to the proposed Order, the CMA will give notice of the proposed modifications.
16. Representations should reach the CMA by 5pm on 11 November 2016. Representations should be made in writing and should be addressed to:

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(signed) ROGER WITCOMB
Group Chair
11 October 2016