

## **ENERGY MARKET INVESTIGATION**

### **DRAFT EXPLANATORY NOTE – CONSULTATION**

#### **The Energy Market Investigation (Prepayment Charge Restriction) Order 2016**

*This note is not a part of the Order*

#### **Introduction**

1. The Competition and Markets Authority (CMA) published its findings in a report under section 136 of the Enterprise Act 2002 (the Act) entitled Energy market investigation: Final Report on 24 June 2016 (the Report).
2. The Report set out the CMA's findings that there are features of the markets for the domestic retail supply of gas and electricity in Great Britain which, alone or in combination, give rise to adverse effects on competition (AECs).
3. The CMA decided on a package of remedies to be implemented by it in order to remedy, mitigate or prevent the AECs (and associated detriment) that it found.
4. The Energy Market Investigation (Prepayment Charge Restriction) Order 2016 (the Order) gives effect to one of these remedies, namely the requirement on suppliers to ensure that the annual bills paid by prepayment customers do not exceed a specified cap for a period until the end of 2020 (see paragraph 20.24(k) of the Report).
5. Section 15 of the Electricity Act 1989 (EA89) and section 27 of the Gas Act 1986 (GA86) provide that where the CMA makes an order under section 161 of the Act, such order may also provide for the modification<sup>1</sup> of the conditions of a particular licence, or the standard conditions of licences of any type (including supply licences for gas and electricity) to such extent as may

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<sup>1</sup> The term 'modification' includes additions, alterations and omissions.

appear to the CMA to be requisite or expedient for the purpose of giving effect to, or taking account of, any provision made by the order.

6. The Order introduces a new electricity supply licence condition 28A, and a new gas supply licence condition 28A (the Electricity Licence Condition and the Gas Licence Condition, together the Licence Conditions).
7. This Explanatory Note applies to the Order and the Licence Conditions.
8. Nothing in this Explanatory Note is legally binding.
9. Terms defined in the Order, the Electricity Supply Licence or the Gas Supply Licence (including in the Licence Conditions) have the same meaning in the Explanatory Note. In the event of a conflict between this Explanatory Note and any provision of the Order or the Licence Conditions, the Order and Licence Conditions shall prevail.

### **Possible consequences for non-compliance**

10. Section 167 of the Act places a duty on any person to whom the Order applies to comply with it. Any person who suffers loss or damage due to a breach of this duty may bring an action.
11. The CMA has power under the Order to give directions, including directions to a person in their capacity as an office holder, for the purpose of carrying out, or ensuring compliance with, the Order.
12. Section 167 of the Act also provides that the CMA can seek to enforce the Order by civil proceedings for an injunction or for any other appropriate relief or remedy.
13. The obligations set out in Article 3 of the Order will be introduced, pursuant to Article 4 and Schedules 1 and 2, into the Electricity Supply Licence and Gas Supply Licence. To the extent that the obligations set out in the Order have been introduced into the Electricity Supply Licence and Gas Supply Licence, GEMA has a duty to monitor compliance and, where appropriate, to use its powers under sections 25 to 28 EA89 and 28 to 30F GA86, including where appropriate by imposing on the licensee a penalty of such amount as is reasonable in all the circumstances of the case. The CMA intends to collaborate with GEMA so as to put in place processes to monitor and ensure compliance with the obligations set out in the Order and the Licence Conditions, where appropriate, through enforcement measures.

## **Review of the Order**

14. The CMA has a duty under section 162 of the Act to monitor the operation of the Order. This includes a duty to consider, from time to time, whether the Order should be varied or revoked in the light of a change of circumstances. Suppliers may apply for a variation or cancellation of all or part of the Order on the basis of a change of circumstances, or recommend that the CMA reviews the need for the Order or part of it.
15. GEMA has a general duty, under section 47 of the EA89 and section 34 of the GA86, to monitor activities connected with regulated energy activities (including supply of electricity and gas), as well as provide advice, information and assistance to the CMA (on its own initiative or where expressly requested).
16. As set out in paragraph 28A.1 of both Licence Conditions, the Prepayment Charge Restriction (ie the price cap) will apply from 1 April 2017 until 31 December 2020. Pursuant to the Report, the Prepayment Charge Restriction will be subject to a mid-term review commencing in January 2019 of the progress that has been made concerning the roll-out of smart meters (including SMETS 2 smart meters). In the event that such roll-out were materially ahead of (or behind) schedule, the CMA will consider whether to revoke the Order early (or recommend that GEMA consider introducing further measure to protect prepayment customers until the roll-out is substantially completed) in light of such a change of circumstances.

## **Structure of the Order**

17. The Order is divided into 3 Parts and has 3 Schedules:
  - (a) Part 1 contains general provisions which include specifying when the Order comes into force, the scope of the Order, and the definitions that are used throughout the Order (and which are also used in this Explanatory Note).
  - (b) Part 2 contains an obligation on suppliers to comply with the Prepayment Charge Restriction.
  - (c) Part 3 contains provisions for monitoring compliance, including provisions allowing the CMA to give directions as to compliance with the Order and to require the supply of information for the purposes of monitoring compliance with the Order and reviewing its operation.
  - (d) Schedule 1 contains the new Condition 28A of the Electricity Supply Licence.

- (e) Schedule 2 contains the new Condition 28A of the Gas Supply Licence.
  - (f) Schedule 3 contains a Template Prepayment Charge Restriction Compliance Statement.
18. Schedules 1 and 2 incorporate by reference two calculation models (in .xls format) which are used for assessing the wholesale costs and network costs assumed within the price cap, respectively. These are Annexes 2 and 3 of the Licence Conditions. In addition, the CMA published on 24 June 2016 an illustrative model that shows how the Relevant Maximum Charges are to be calculated and updated for each fuel in each Charge Restriction Period, Charge Restriction Region, and (for electricity) for each Metering Arrangement.<sup>2</sup> As discussed in paragraphs 18 and 23 of Annex 1 to this Explanatory Note, we have:
- (a) changed one of the assumptions within the illustrative model, which is to exclude the Carbon Reduction Commitment from electricity policy costs; and
  - (b) Updated the calculation of network cost allowances in order to be more accurate.
19. Updated versions of the illustrative model<sup>3</sup> and the network cost allowance calculations are published as part of this consultation.

### ***Part 1 – General and Interpretation***

20. Article 1 provides that the Order applies to suppliers, defined as any person authorised to supply gas by virtue of a Gas Supply Licence and any person authorised to supply electricity by virtue of an Electricity Supply Licence (referred to as Retail Energy Suppliers in the Order and licensees in the Licence Conditions). It provides that the Order shall come into force on [date after the Order] December 2016, except Article 3, which shall come into force on 1 April 2017.
21. Article 1.4 provides that the Order shall continue to be into force until 30 June 2021, or until such time (before this date) as it is varied or revoked under the Act. For the avoidance of doubt, the obligation on suppliers to comply with the

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<sup>2</sup> The illustrative model does not form part of the Final Report, Order or Licence Conditions. In the event that there is any inconsistency between any of these documents and the illustrative model, then the Order and Licence Conditions shall prevail.

<sup>3</sup> The policy cost amendment relates to row 35 of the 'Inputs' sheet within the model. The OBR projections for all factors other than the CRC are: £5.6bn for the base year, and for indicative purposes only, £6.6bn for 2016-17, £8.0bn for 2017-18, £9.9bn for 2018-19, £11.4bn for 2019-20 and £12.3bn for 2020-21. These are available on the [budget responsibility webpage](#) supplementary fiscal table 2.7.

Prepayment Charge Restriction shall be in force between 1 April 2017 and 31 December 2020 (subject to any variation of the Order).

22. Article 2 includes definitions of various terms used in the Order and in a limited number of instances cross-refers to terms defined in the Licence Conditions or defined elsewhere in the Electricity Supply Licence or Gas Supply Licence. To the extent possible, the terms used in the Order have been defined to have the same meaning as in the Electricity Supply Licence and the Gas Supply Licence (as applicable). For the avoidance of doubt, when a word or expression has been expressly defined in the Order, the definition set out in the Order shall prevail over other definitions.

### ***Part 2 – Prepayment Charge Restriction***

23. Articles 3.1 and 3.2 (and paragraph 28A.1 of both Licence Conditions) contain an obligation on Retail Electricity Suppliers and Retail Gas Suppliers to comply with the Prepayment Charge Restriction between 1 April 2017 and 31 December 2020.
24. The Prepayment Charge Restriction is implemented through the calculation of a Relevant Maximum Charge so that the total supply charges for any level of consumption over the Charge Restriction Period, ie as a pound sterling amount, will be lower than the Relevant Maximum Charge at that level of consumption.
25. As a result, suppliers must ensure that the aggregate amount of all Charges for Electricity Supply Activities and Charges for Gas Supply Activities to each Relevant Customer do not exceed the Relevant Maximum Charges (ie the level of the price cap which is applicable in a given Charge Restriction Period with respect to Relevant Customers, depending on their location and (for electricity) whether their tariff uses a Multi-Register Metering Arrangement (eg for restricted meters or a time of use arrangement) or uses a Single-Rate Metering Arrangement (ie single and multi-tier tariffs which do not vary by time of use). The Relevant Maximum Charges will vary regionally to reflect differences in network costs in each Charge Restriction Region, and will vary per fuel. With respect to the Supply of Electricity, there are two separate Relevant Maximum Charges in each Charge Restriction Region to reflect differences in costs between the two Benchmark Metering Arrangements:
  - (a) Single-Rate Metering Arrangements (calculated on the basis of Prepayment Tariffs where a customer is charged on the basis of a single unit rate); and

(b) Economy 7 Metering Arrangements (calculated on the basis of Prepayment Tariffs where a customer uses a meter for the purpose of an Economy 7 tariff<sup>4</sup>).

26. We discuss below the scope of the Order (see paragraphs 27 to 35), how the Relevant Maximum Charge is calculated (see paragraphs 37 to 44 and Annex 1) and how compliance with the Prepayment Charge Restriction must be assessed (see paragraphs 45 to 73).

### *Scope of the price cap*

27. In each applicable Charge Restriction Period, the Prepayment Charge Restriction (ie the price cap) will apply to (a) all single fuel gas and electricity tariffs made available to new domestic prepayment customers (ie through pre-contractual offer or invitation to treat, and whether made available directly or indirectly by a supplier<sup>5</sup>), and (b) to all the single fuel gas and electricity tariffs that are in place through existing contracts with Relevant Customers. Suppliers will also have to ensure that each single fuel component made available or applied within a dual fuel component during the period of application of the Prepayment Charge Restriction complies with the Relevant Maximum Charge for each fuel.
28. There are two exceptions to suppliers needing to comply with the Prepayment Charge Restriction:
- (a) Fixed Term Supply Contracts entered into prior to the publication on 24 June 2016 of the Final Report (until expiry of the original term of the contract, regardless of any subsequent renewal or extension of the original term) (see paragraphs 30 below); and
  - (b) Customers with Excluded Smart Meters, eg those meeting the SMETS 2 technical specification or otherwise being fully interoperable (see paragraphs 31 and 35 below).
29. All other tariffs made available to, or in place with, prepayment customers are within the scope of the Prepayment Charge Restriction and must be set in order to comply with it. In principle, Prepayment Tariffs must comply with the Prepayment Charge Restriction at all levels of consumption. As discussed below, we recognise that tariffs with low standing charges may theoretically breach the cap at certain (high) levels of consumption, but in practice will not

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<sup>4</sup> ie where, in each period of 24 hours, the peak electricity consumption for a customer is recorded during 17 'day/normal' hours and the off-peak electricity consumption level is recorded during seven 'night/low' hours.

<sup>5</sup> eg through a third party intermediary or white label partnerships.

breach the Prepayment Charge Restriction (because all Relevant Customers on such tariffs in practice have low levels of consumption). With respect to such tariffs, suppliers will need to seek a direction from GEMA to allow compliance of such Prepayment Tariffs to be assessed on an ex post basis (see paragraphs 65 to 73).

30. As regards Fixed Term Supply Contracts entered into by a customer before 24 June 2016, the agreed price will not be constrained by the Order until the expiry of the original term of the contract. For instance, in relation to a 12 month contract entered into with a Relevant Customer on 1 June 2016, the Prepayment Charge Restriction will not apply as regards supply to that Relevant Customer until 30 May 2017 (unless the customer switches supplier or tariff before the expiry of the original term of the contract). Once the original term of a Fixed Term Supply Contract between a supplier and a customer expires, the Prepayment Charge Restriction will apply as from the commencement of any contract extension period, roll-over period or renewal contract (as applicable).
31. The Prepayment Charge Restriction will not apply in respect of any Relevant Customer with an Excluded Smart Meter.
32. For the avoidance of doubt, the price cap shall apply solely to the supply of energy to the premises of Relevant Customers where no Excluded Smart Meter has been installed. Any Relevant Customer who is not supplied, for any reason, through an Excluded Smart Meter will remain protected by the Prepayment Charge Restriction until an Excluded Smart Meter has been effectively installed at their premises.
33. Excluded Smart Meters are defined to include SMETS 2 smart meters (ie versions of the SME Technical Specification other than the first version). As explained in the Report, SMETS 2 is being designed such that applicable smart meters can communicate with any supplier via the data and communications company (the DCC). As a result, the implementation of SMETS 2 smart meters will eliminate the technical constraints on suppliers' ability to offer prepayment customers a wider range of tariffs, including tariffs that are equivalent to those on offer to customers on direct debit. It will also make it possible to switch customers with a SMETS 2 smart meter remotely (at little or no cost) to a credit tariff.
34. The infrastructure needed to allow communication with the DCC is not currently in place and there are currently no SMETS 2 smart meters installed. However, SMETS 2 smart meters are likely to be installed during the life of the Order and the Licence Conditions. Accordingly, there will be a gradual

process of customers falling outside the scope of the Prepayment Charge Restriction as the smart meter roll-out progresses.

35. In addition to SMETS 2 smart meters, the definition of Excluded Smart Meters also includes any other type of smart meters identified by the CMA (by way of a direction) as being fully interoperable, in terms of providing functional interoperability, technical interoperability and commercial interoperability. This definition relies on the three forms of interoperability that the UK Government is aspiring to achieve with SMETS 2.<sup>6</sup> Currently no SMETS 1 smart meter satisfies this definition. Accordingly, as the starting position, the Prepayment Charge Restriction will apply to all prepayment customers on SMETS 1 smart meters. At any point when the CMA considers that a particular category of SMETS 1 smart meter satisfies this definition, it will issue a direction identifying any such category of meter, and Relevant Customers on these meters will be excluded from the Prepayment Charge Restriction<sup>7</sup>. Suppliers are at liberty to submit evidence to the CMA in support of a claim that a particular category of smart metering system satisfies the definition of Excluded Smart Meter. The CMA will consider any such evidence received and respond with one of the following:
- (a) A direction that the smart metering system in question is an Excluded Smart Meter;
  - (b) A statement that the smart metering system in question is not an Excluded Smart Meter or the CMA has been provided with insufficient evidence to be able to determine that the smart metering system in question is not an Excluded Smart Meter; or
  - (c) A request for further evidence in order to be able to reach a conclusion.
36. For the avoidance of doubt, where a supplier installs a smart meter at a prepayment customer's premises that belongs to a category of smart meters that falls within the meaning of Excluded Smart Meter (ie a SMETS 2 smart meter or a category of smart meters which has already been identified by the CMA, through a direction, as an Excluded Smart Meter), there is no need for the supplier to obtain a new direction under the terms of Article 6.2. However, suppliers may instead choose to liaise with the CMA to clarify whether one or

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<sup>6</sup> See page 17 of DECC's Consultation on the second version of the Smart Metering Equipment Technical Specifications, dated 13 August 2012: [Smart Metering Implementation Programme](#).

<sup>7</sup> The CMA expects that once a SMETS 1 smart meter has been enrolled with the DCC it will meet the definition of Excluded Smart Meter. At the time of this explanatory note, however, the process and conditions for enrolment of SMETS 1 smart meters have not been finalised by the DCC. Therefore, we have not drafted the definition of Excluded Smart Meter to specifically include SMETS 1 meters enrolled with the DCC since this would either be unnecessary (if the enrolment with the DCC necessarily implies that the interoperability criteria are met) or inappropriate (if enrolment with the DCC does not guarantee that the interoperability criteria are met).



more smart meters it is planning to install belong to a category of smart meters that falls within the meaning of Excluded Smart Meters.

### *Calculation of the level of the price cap*

37. The Licence Conditions (paragraphs 28A.6 of the Electricity Licence Condition 28A and paragraph 28A.4 of the Gas Licence Condition) include the formula under which the relevant levels of the price cap (defined as the Relevant Maximum Charges) will be calculated. As noted above, the same core approach is followed for each fuel (save that two separate caps are generated as regards electricity supply in each Charge Restriction Region; one based on Single-Rate Metering Arrangements and one based on Economy 7 Metering Arrangements). The formula reflects the three benchmark tariffs explained in detail in the Report (defined, for electricity, as the Benchmark Metering Arrangements). It is also consistent with the illustrative model published by the CMA.<sup>8</sup> The approach that will be taken to the calculation of each aspect of the price cap is consistent with the Report and is summarised in Annex 1 to this Explanatory Note. For the two most complex aspects of the formula, wholesale costs and network costs, the calculation is to be performed within models which are incorporated by reference into the Licence Conditions. These models are included as Annexes 2 and 3 to the Licence Conditions.
38. The price cap period from 1 April 2017 to 31 December 2020 will be split into six monthly Charge Restriction Periods, other than a three-month final period (ie eight Charge Restriction Periods in total). Prior to each Charge Restriction Period, GEMA will, where possible, publish details of the price cap within that period. The values of the price cap are based on a pre-defined set of formulae and assumptions, and in principle suppliers can perform their own calculations in advance of GEMA's publication. In the case of any disagreement, all suppliers will be required to comply with the price cap based on the Benchmark Maximum Charges published by GEMA.
39. The formula requires GEMA to calculate, as components of the price cap:
  - (a) Wholesale costs for gas and electricity, using a model to assess benchmark costs for the relevant period derived from market indices;
  - (b) Network costs based on network company charging statements, using a model to convert charging data to network costs per Relevant Customer;

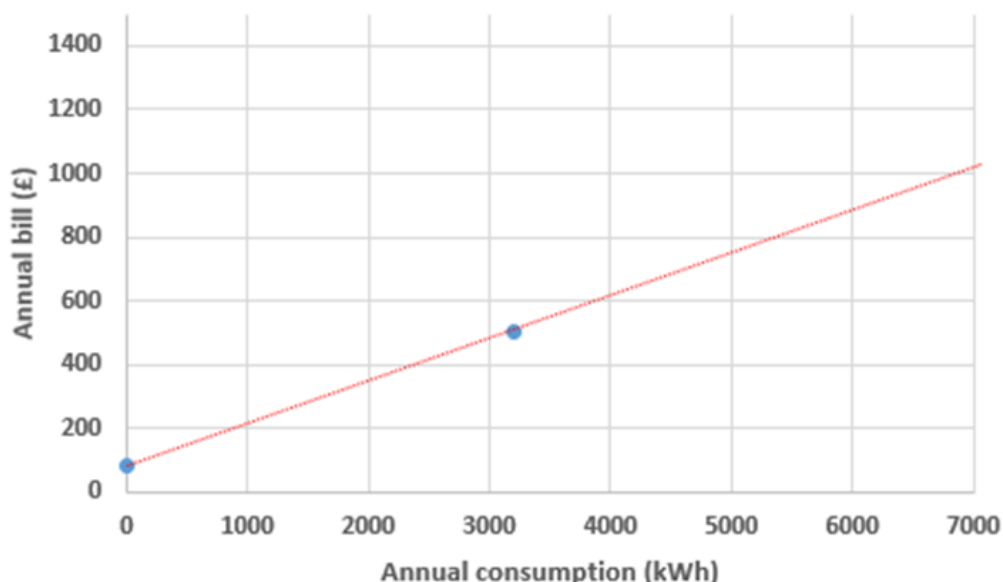
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<sup>8</sup> See [energy market investigation case page](#). Save for minor adjustments concerning policy costs and network costs; see further paragraph 23.

- (c) Policy costs;
  - (d) Operating costs (termed 'indirect cost allowance');
  - (e) Prepayment Meter costs (termed 'prepayment meter uplift allowance') ;  
and
  - (f) Headroom.
40. Using the process set out in the Licence Conditions (and further described in Annex 1 to this Explanatory Note), GEMA will calculate and publish the following 84 Benchmark Maximum Charges prior to each Charge Restriction Period:
- (a) for each of nil consumption (standing charge) and medium TDCV;
  - (b) for each of the 14 Charge Restriction Regions (equivalent to electricity distribution regions);
  - (c) for each of Gas, Electricity (Single-Rate Metering Arrangements) and Electricity (Economy 7 Metering Arrangements).
41. GEMA will publish on its website the 84 Benchmark Maximum Charges no later than the fifth Working Day of February in relation to a Charge Restriction Period starting on 1 April and no later than the fifth Working Day of August in relation to a Charge Restriction Period starting on 1 October. These updated Benchmark Maximum Charges will be published in the format specified in annex 4 to the Licence Conditions.
42. The two consumption levels, ie nil and medium TDCV, are used as the basis for calculating the Relevant Maximum Charge for each Relevant Customer for any consumption level. The Relevant Maximum Charge at other consumption levels will be determined assuming a single unit tariff for all levels of consumption (with an assumed consumption split for Economy 7 Metering Arrangements to give an effective single unit tariff). The Relevant Maximum Charge thereby sets a cap on the total bill for each level of consumption. For the avoidance of doubt, it does not set a cap on the unit rate or require suppliers to offer a single unit tariff for all levels of consumption. Suppliers' tariffs must be assessed against the Relevant Maximum Charge, and the Licence Conditions provide for how more complex tariffs, such as those providing for more than a single unit rate for different consumption windows, must be assessed for compliance with the Prepayment Charge Restriction (see further paragraphs 45 to 73).

43. Using this approach, Relevant Maximum Charges are calculated by using linear interpolation between the Prepayment Charge Restriction at each Benchmark Annual Consumption Level (ie nil and the medium TDCV that applied for the period January 2014 to August 2015) extrapolated across all consumptions (ie a straight line between these two points extended for any consumption) in accordance with a formula set out in paragraph 28A.6 of the Electricity Licence Condition and paragraph 28A.4 of the Gas Licence Condition.
44. This is illustrated in the chart below, where the blue dots indicate the Relevant Maximum Charge for Single Rate Metering Arrangements at the Benchmark Annual Consumption Levels (ie nil and medium TDCV) in a given Charge Restriction Period and Charge Restriction Region, whilst the red line indicates the level of the Relevant Maximum Charge for all other consumption levels.

**Figure 1: Determination of a Relevant Maximum Charge based on two Benchmark Annual Consumption Levels**



The above chart shows the methodology for calculating the Relevant Maximum Charge for all consumption levels up to 7,000 kWh, based on illustrative benchmark annual consumption levels for Single-Rate Metering Arrangements. This approach will extend in this manner for all consumptions exceeding 7,000 kWh.

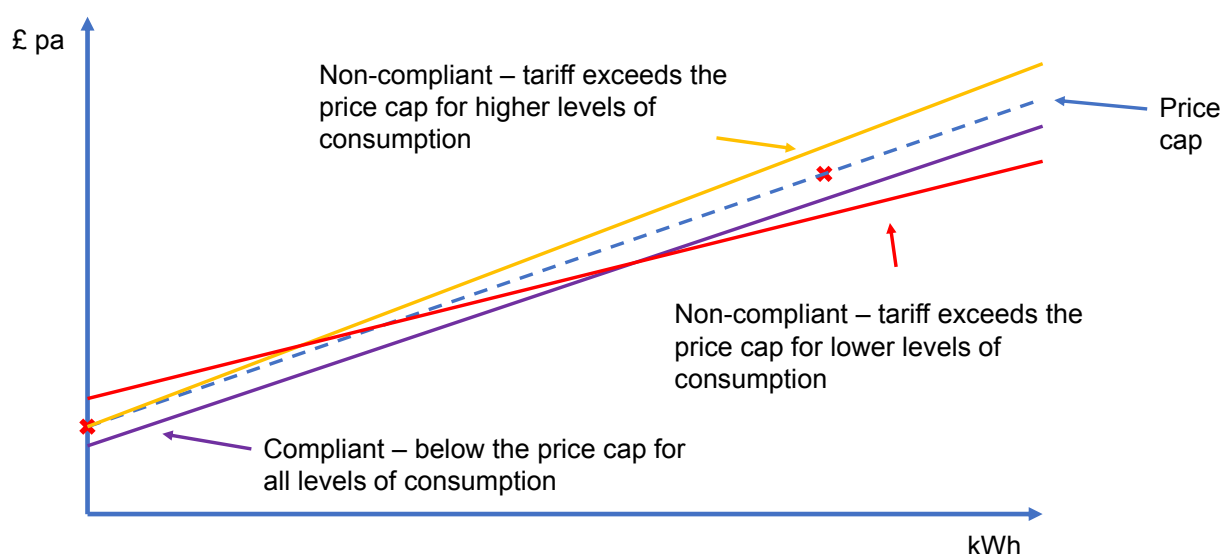
### *Assessment of compliance with the Prepayment Charge Restriction*

45. Compliance of any individual Prepayment Tariff with the Prepayment Charge Restriction will normally be assessed on an *ex ante* basis by suppliers. A Prepayment Tariff is compliant with the Prepayment Charge Restriction if at any point during a Charge Restriction Period, at all consumption levels (subject to the possibility of assessing compliance on an alternative basis pursuant to paragraphs 28A.19 and 28A.20 of the Electricity Licence Condition and paragraphs 28A.17 and 28A.18 of the Gas Licence Condition - see

paragraphs 65 to 71), such tariff is below the level of the prevailing Relevant Maximum Charge for the relevant Charge Restriction Region and (for electricity) Metering Arrangement (see paragraph 28A.2 of the Electricity Licence Condition and of the Gas Licence Condition).

46. Suppliers are responsible for ensuring such *ex ante* compliance of Prepayment Tariffs with the Prepayment Charge Restriction, including following each update of the Prepayment Charge Restriction, unless GEMA has directed that a particular tariff will be assessed on an *ex post* basis (in which case the supplier must adhere to the terms of the direction and relevant paragraphs of the Licence Conditions).
47. For the purpose of this requirement, a Prepayment Tariff is considered to be compliant with the Prepayment Charge Restriction if the aggregate Charges for Supply Activities under the Prepayment Tariff would be lower than the aggregate Charges defined by the Relevant Maximum Charge at all levels of consumption, as illustrated in figure 2 below. Both the aggregate charges under the tariff and the Relevant Maximum Charges are defined exclusive of Value Added Tax (VAT).

**Figure 2: Prepayment Charge Restriction compliance example**



48. When the level of the Relevant Maximum Charges are updated, this may result in the need for available and existing Prepayment Tariffs to be reviewed to remain compliant with the Prepayment Charge Restriction. It may be that for a short period following 1 April or 1 October some customers still consume energy at the rates prevailing prior to 1 April or 1 October as they are yet to top up. However, for the purpose of the assessment of compliance, it should be assumed that the energy purchased within a Charge Restriction Period is consumed within the same Charge Restriction Period.

49. With respect to Multi-Register Prepayment Tariffs, for the purpose of the assessment of compliance (whether *ex ante* or *ex post*), it should be assumed that all Relevant Customers consume energy in line with the Assumed Consumption Split applicable to Multi-Register Prepayment Tariff.

#### *Calculation of Relevant Maximum Charges per fuel and Metering Arrangement*

50. For each Charge Restriction Period, ie in every six months period during the period of the price cap<sup>9</sup>, GEMA will calculate three Relevant Maximum Charges for each region and consumption level: two for electricity and one for gas.
51. With respect to the supply of gas, assessment of compliance will not vary by Metering Arrangement, ie all tariffs will need to comply with the same Payment Charge Restriction as illustrated in Figure 2 above.
52. As noted in paragraph 25 there are two different Relevant Maximum Charges, one calculated on the basis of tariffs relying on Single-Rate Metering Arrangements, and the other on the basis of tariffs relying on Economy 7 Metering Arrangements. Prepayment Tariffs will be assessed for compliance by comparison with the most relevant of these two Relevant Maximum Charges. So, for example:
- (a) Where a customer is charged on the basis of a Single-Register Prepayment Tariff<sup>10</sup> (ie single rate or non-time-of-use multi-tier), compliance of that the applicable tariff will be assessed against the Relevant Maximum Charge for Single-Rate Metering Arrangements. Note that this is the case even if the physical metering equipment used to record the customer's usage is capable of recording consumption on the basis of time of use.
- (b) For Multi-Register Prepayment Tariffs<sup>11</sup>, compliance will be assessed against the Relevant Maximum Charge for Economy 7 Metering

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<sup>9</sup> Save for the last Charge Restriction Period which would be three months in duration.

<sup>10</sup> Single-Register Prepayment Tariffs are defined to mean a Prepayment Tariff whereby a customer is charged for electricity supply on the basis of a Single-Register Metering Arrangement (ie any Metering Arrangement that is not a Multi-Register Metering Arrangement (see below)). The definition of Single-Register Metering Arrangement includes a Single-Rate Metering Arrangement (regardless of the metering equipment employed) and a Multi-Tier Metering Arrangement in which the unit rate does not vary according to the time of use.

<sup>11</sup> Multi-Register Prepayment Tariffs are defined to mean a Prepayment Tariff whereby a customer is charged for electricity supply on the basis of a Multi-Register Metering Arrangement (whereby one or more meters is used for the purposes of a prepayment tariff whereby a customer's electricity consumption at certain times or for certain purposes is separately recorded on one or more registers). The definition of Multi-Register Metering Arrangements includes any contractual arrangement whereby the customer is charged on the basis of a time of use tariff (regardless of the metering equipment employed). For the avoidance of doubt, the definition of Multi-Register Metering Arrangements therefore includes any time of use tariff recorded on a single register (and would, therefore, include any smart metering arrangement that applies a time of use tariff).

Arrangements. The bill applying over the Charge Restriction Period will be calculated using an Assumed Consumption Split, ie the assumed consumption split between each rate (ie peak and off peak) supported by the relevant Metering Arrangement.

- (c) Where a customer has two (or more) single-rate meters for the same fuel, and these meters operate as a single metering system for the purpose of a Multi-Register Prepayment Tariff (eg for a time-of-use tariff), then that tariff will be assessed against the Relevant Maximum Charge for Economy 7 Metering Arrangements.
53. One supplier has suggested that Multi-Register Prepayment Tariffs other than Economy 7 Tariffs should be assessed against the Relevant Maximum Charge for Single-Rate Metering Arrangements. This argument was based on data indicating that some customers with Multi-Register Prepayment Tariffs other than Economy 7 Tariffs have consumption profiles more akin to customers with Single-Register Prepayment Tariffs than to customers with Economy 7 meters.
54. We note that, whilst informative, consumption profiles do not give the whole picture. In particular, any customer billed on the basis of multiple registers can expect to benefit from lower rates when consuming electricity off-peak and therefore a price cap which does not reflect this saving is less relevant.
55. Following the approach set out in the Final Report, all Multi-Register Prepayment Tariffs will be assessed against the Relevant Maximum Charge for Economy 7 Metering Arrangements using Assumed Consumption Splits as described in Electricity Supply Licence below.
56. For Economy 7 Tariffs, the Electricity Licence Condition assumes that a consumption split of 38:62 between off-peak and peak will remain appropriate for all tariffs and throughout the life of the price cap.<sup>12</sup> GEMA will have the ability to direct an alternative split, should evidence indicate that it would be more appropriate. Where a licensee submits evidence in support of an alternative split for Economy 7 Tariffs, we expect that GEMA will review this evidence and consult prior to directing an alternative split.<sup>13</sup> There are Multi-

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<sup>12</sup> We note that the 38:62 split is an average derived from actual consumption data. The population from which this average was drawn includes both customers with storage heating and customers without storage heating. These two groups of customers are likely to have materially different consumption patterns. We received a suggestion that the split ought to reflect the consumption profile of only customers with storage heating. To the extent that population of customers without storage heaters but who nonetheless have Economy 7 meters were to reduce materially then it may be appropriate to revisit the 38:62 split.

<sup>13</sup> A single Assumed Consumption Split for Economy 7 will be applied for all regions and for all suppliers. Whilst suppliers may present evidence in relation to their own customer base they may not have data applicable to all customers. In considering whether to direct a revised Assumed Consumption Split Ofgem shall consider data relating to all affected customers.

Register Prepayment Tariffs other than Economy 7 Tariffs include for instance time-of-use tariffs or tariffs where different rates apply to different consumption purposes (but exclude Multi-tier Arrangements). In this case, the Assumed Consumption Split of 38:62 off-peak:peak used for Economy 7 Metering Arrangements may not be appropriate in projecting the mix of consumption at the different charging levels.

57. For instance, if a supplier offers a Prepayment Tariff (eg Economy 10) with a greater proportion of the day than Economy 7 being at the lower off-peak rate, this supplier may need to use a different Assumed Consumption Split if a greater proportion of overall consumption is charged at the cheaper off-peak rate over the Charge Restriction Period.
58. Therefore, for the purpose of assessing compliance with the Relevant Maximum Charges, an alternative Assumed Consumption Split may need to be determined by each supplier for each tariff.<sup>14</sup> In assessing compliance, suppliers will be required to use historic data relating to that particular tariff to calculate the relevant Assumed Consumption Split (when available, over at least 24 consecutive months). In the absence of such historic data, for instance for new tariffs, a supplier will need to provide a forecast of the Assumed Consumption Split, as well as evidence supporting such forecast. In addition, the supplier must provide to Ofgem, after the end of the relevant Charge Restriction Period, data on actual consumption to allow an assessment of whether its forecasts were reasonable. Where there is a particularly small number of customers with a given Metering Arrangement it will be for suppliers to identify suitable data and submit this to Ofgem.<sup>15</sup>
59. For the avoidance of doubt, the compliance of a Prepayment Tariff is to be assessed on the basis of the Metering Arrangement on which it relies for charging Relevant Customers. For example, if a customer has its consumption recorded by an Economy 7 meter but is purchasing electricity on the basis of a Single-Rate Metering Arrangement (where the same rates apply to both night and day consumption), then that tariff will be assessed against the Relevant Maximum Charge for Single-rate Metering Arrangements.
60. Where projections have been made by a supplier, and there is a material discrepancy between forecast and actual consumption taking place in the peak period such that Relevant Customers on a given tariff have incurred charges materially in excess of the Relevant Maximum Charge, GEMA may

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<sup>14</sup> Note that any Assumed Consumption Split would apply across all regions, and would reflect annual consumption patterns.

<sup>15</sup> Such data may, for example, include data from customers with the same Metering Arrangement but a different payment method. However, it will be for suppliers to make the case that any such data is appropriate and relevant.

direct the supplier to pay a rebate to such Relevant Customers. We expect GEMA will only give such a direction when the discrepancy (and the detriment per customer arising from it) is substantial. For the avoidance of doubt:

- (a) the potential for payment of rebates exists for both Economy 7 Tariffs as well as other Multi-Register Prepayment Tariffs;
- (b) where a customer has left supply or changed suppliers during the Charge Restriction Period to which a rebate relates, suppliers should make reasonable endeavours to pay any rebate owed.

#### *Treatment of white meters*

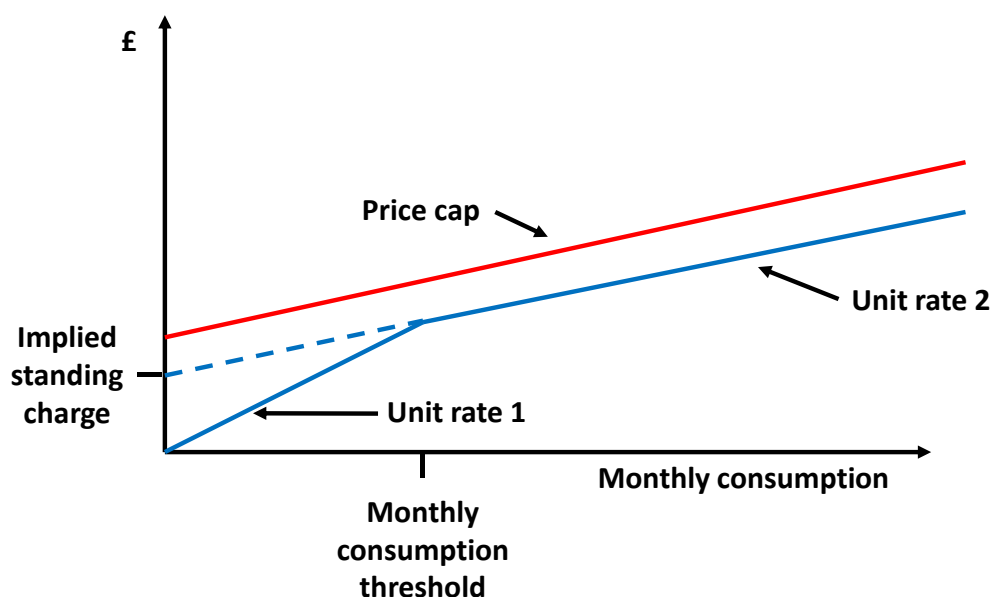
- 61. Some suppliers have suggested that tariffs based on white meters should be included within the definition of Economy 7 Tariffs for the purposes of assessing compliance with the Order. We note that white meters are in many cases similar to Economy 7 meters and to a large extent are used in lieu of Economy 7 meters in Scotland.
- 62. However, we also note that there are different sorts of white meters (including some with three registers) such that it would be difficult to construct a definition of 'white meter arrangements' which includes only those white meters which are used for the purpose of Prepayment Tariffs which are sufficiently similar to Economy 7 Tariffs. Further, we note that the approach to compliance we have set out for Multi-Register Prepayment Tariffs other than Economy 7 Tariffs provides a means of assessing compliance for each metering arrangement type which can cater for each different metering arrangement type.

#### *Treatment of Multi-tier Arrangements*

- 63. Certain suppliers are currently offering tariffs with no standing charge but two or more unit rates. Consumption up to a specified threshold in each month is charged at the first, higher rate, with all consumption above such threshold charged at the second, lower rate. For such a tariff, consumption above the threshold can be modelled as being driven by a standing charge and a single unit rate (where the unit rate is equal to the second rate specified in the tariff). In order to assess compliance of such tariffs with the Order this model of the tariff will be used since it provides a simple way to apply the price cap which ensures customers are protected. This approach is illustrated in figure 3 below:



Figure 3: Illustration of assessing compliance for Multi-tier Arrangements



Source: CMA.

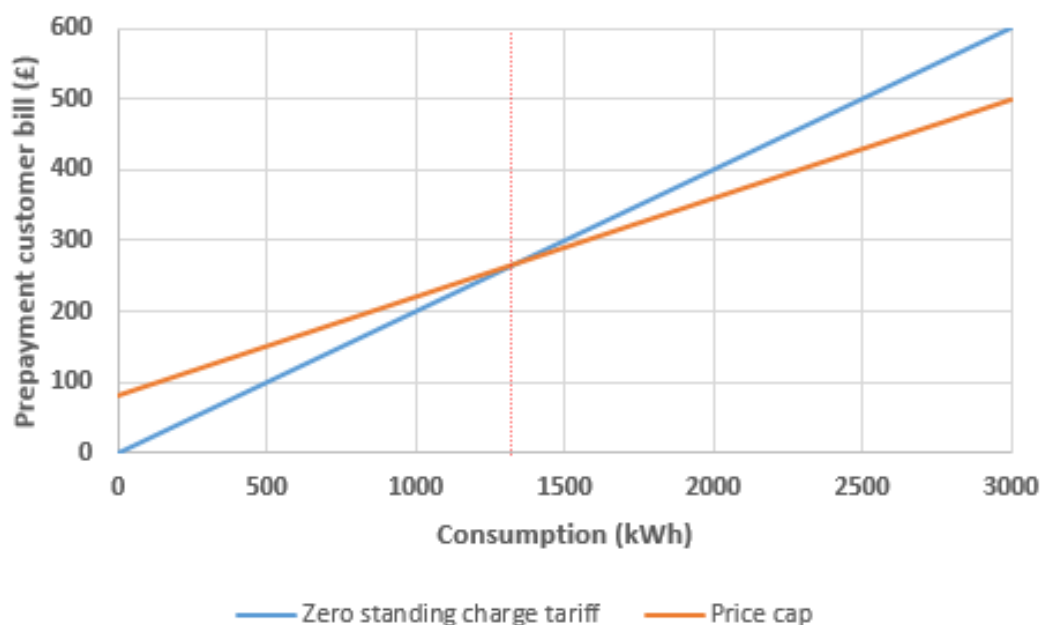
64. In the case of Single-Rate Prepayment Tariffs relying on Multi-tier Arrangements, our understanding is that these do not normally vary by time of day, and in that context appear to be more comparable to a standard tariff, with different unit rates for different levels of consumption. These tariffs are therefore to be assessed against the Relevant Maximum Charge for Single-Rate Metering Arrangements (unless they vary by time of day).

#### *Treatment of Prepayment Tariffs with low standing charges*

65. As explained above, compliance with the Prepayment Charge Restriction will normally be established by assessing each Prepayment Tariff on an ex ante basis. This means that suppliers will assess compliance based on the aggregate amount of charges projected to apply over the Charge Restriction Period. If a Prepayment Tariff is compliant at all consumption levels, no further step (eg an *ex post* assessment) is required.
66. Most Prepayment Tariffs are based on a similar pricing structure, with a (positive) standing charge and unit rate, which broadly reflects the structure of the Relevant Maximum Charges. However, there are a limited number of Prepayment Tariffs which historically have had a different approach, and which might not be compliant with the Prepayment Charge Restriction below or above certain levels of consumption. Such Prepayment Tariffs might however, in practice, be compliant with the Prepayment Charge Restriction for all Relevant Customers because, at the actual level of consumption of each customer on such Prepayment Tariffs, the charges incurred by customers are lower than the Relevant Maximum Charges.

67. An example of such a Prepayment Tariff is a zero standing charge tariff. Generally a consequence of having a zero or low standing charge is that the unit rate is higher. This in turn means that these Prepayment Tariffs are below the Relevant Maximum Charge cap at a low consumption level, but may be above the Relevant Maximum Charge at higher consumption levels.
68. For instance, the zero standing charge tariff illustrated in the chart below is lower than the Relevant Maximum Charge for all consumption levels up to ~1,300 kWh, however the Prepayment Tariff is not compliant with the Relevant Maximum Charge above this level.

**Figure 4: Prepayment Charge Restriction compliance example – zero standing charge tariff**



69. In order to allow tariffs targeted at Relevant Customers of a specific consumption profile (eg low consumption customers) that may genuinely benefit these customers, suppliers can seek a direction from GEMA that will provide for the supplier to be able to offer and enter into such tariffs, subject to satisfying certain additional requirements. The supplier will still be required to comply with the cap at all levels which are considered likely to occur in practice, ie those below 1,300 kWh in Figure 4 above. In addition, the supplier will need to provide satisfactory evidence that:
- (a) it is unlikely that Relevant Customers on this Prepayment Tariff will have an annual level of consumption where the Prepayment Tariff is in excess of Relevant Maximum Charge; and
  - (b) it would not be practical to offer a Multi-tier Arrangement which would be compliant at all levels of consumption in lieu of the proposed tariff.

70. If such a direction is given, the supplier will also be required to assess compliance with the Prepayment Charge Restriction at all actual consumption levels (ie at the consumption levels of all Relevant Customers who were on that Prepayment Tariff in the relevant Charge Restriction Period) on an ex post basis. If the ex post compliance assessment were to show that any Relevant Customer on this Prepayment Tariff has incurred charges higher than the Relevant Maximum Benchmark, the supplier must:
- (a) inform Ofgem in writing of such event and relevant Electricity Licence Condition or Gas Licence Condition (or both) without delay; and
  - (b) pay a rebate to such customers equal to the difference between the charges incurred by these customers and the charges that these customers would have paid if the supplier had complied with the Prepayment Charge Restriction.<sup>16</sup>
71. Given the potential for seasonality to result in high consumption during one Charge Restriction Period to be followed by lower consumption during the next period, for the purpose of assessing compliance on an ex post basis, consumption levels should be projected over a 12-month period.
72. Compliance must be assessed every six months based on actual consumption in the Charge Restriction Period that has just ended. The consumption in that Charge Restriction Period would be projected forwards using historic data on seasonal variation in consumption to derive an annualised figure which must then be assessed against the Relevant Maximum Charge.
73. Using the example set out in the chart above (paragraph 68), if all Relevant Customers on that Prepayment Tariff had a projected annual consumption level below or equal to ~1,300 kWh, no rebate will be needed. If some Relevant Customers were projected to reach levels of consumption that over a 12-month period, would exceed ~1,300 kWh, a rebate would be due to these customers.

#### *Fully interoperable smart meters*

74. The licence condition refers to Excluded Smart Meters and notes that Smart Metering Systems which are 'fully interoperable' will be defined as Excluded Smart Meters. Such meters will be identified by the CMA (through a direction given under the Energy Market Investigation (Prepayment Charge Restriction))

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<sup>16</sup> In relation to Multi-Register Prepayment Tariffs, assuming consumption in line with the Assumed Consumption Split.

Order 2016). We expect that Smart Metering Systems which meet the following interoperability criteria will result in the Smart Metering System being fully interoperable:

- (a) 'Commercial Interoperability' means that licensees are capable of operating Metering Equipment installed by another licensee without the need to replace any equipment in the Domestic Premises.
- (b) 'Functional Interoperability' means that functional requirements are required to be delivered in a consistent, defined way, such that any licensee will be capable of operating any Electricity Meter with a clear understanding of the processing the equipment will undertake and the outputs they, and their customers, will receive;
- (c) 'Technical Interoperability' means that a licensee Metering Equipment is interchangeable and inter-connectable with that of any other licensee's in any particular Domestic Premises.

#### *Mid-term review*

- 75. The Report also provided for the Prepayment Charge Restriction to be subject to a focused mid-term review commencing in January 2019<sup>17</sup> of the progress that has been made concerning the roll-out of Smart meters (including SMETS 2 smart meters). This mid-term review may have the following potential outcomes:
- 76. In the event that the roll-out of smart meters was materially ahead of schedule, the CMA will consider whether to terminate the Prepayment Charge Restriction early.
- 77. In the event that the roll-out of smart meters was broadly on schedule, the CMA is likely to decide to take no further action.
- 78. In the event that the roll-out of smart meters does not appear likely to be completed by 31 December 2020, the CMA will consider whether to encourage GEMA to review the situation and take whatever action it considers appropriate (including whether to introduce a similarly structured Prepayment Charge Restriction in the prepayment segments as from the start of 2021).

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<sup>17</sup> The mid-term review will be conducted in January 2019 as this is the approximate mid-point between the commencement of the Prepayment Charge Restriction in April 2017 and its termination in December 2020.

*Timetable overview*

79. The table below provides an overview of the effective dates for the Prepayment Charge Restriction, including index observation dates and reporting requirements:

<b>Charge Period</b>	<b>Effective dates</b>	<b>Wholesale index observation period (ICIS standard products)</b>	<b>Network index observation date (Network Company Charging Statements)</b>	<b>Electricity policy cost index observation date (Economic and Fiscal Outlook Tables)</b>	<b>Gas policy / indirect / prepayment cost index observation date (CPI)</b>	<b>GEMA notification to suppliers</b>	<b>Supplier reporting to GEMA under SLC 28A.29<sup>18</sup></b>
1	01/04/2017 – 30/09/2017	01/08/2016 – 31/01/2017	GEMA to determine based on Network Company charging statements published at least two months prior to the start of the relevant Charge Restriction Period.	Will be based on the most recent Economic and Fiscal Outlook published by the Office of Budgetary Responsibility. This is currently expected to be the Autumn Statement in the preceding year for charge restriction periods commencing in April and the current year Main Budget (in March)	December 2016	7 February 2017	7 April 2017
2	01/10/2017 – 31/03/2018	01/02/2017 – 31/07/2017			June 2017	7 August 2017	7 October 2017
3	01/04/2018 – 30/09/2018	01/08/2017 – 31/01/2018			December 2017	7 February 2018	7 April 2018
4	01/10/2018 – 31/03/2019	01/02/2018 – 31/07/2018			June 2018	7 August 2018	7 October 2018
5	01/04/2019 – 30/09/2019	01/08/2018 – 31/01/2019			December 2018	7 February 2019	7 April 2019
6	01/10/2019 – 31/03/2020	01/02/2019 – 31/07/2019			June 2019	7 August 2019	7 October 2019

<sup>18</sup> Note that other reporting may be required if, for example, a supplier makes use of Assumed Consumption Splits when assessing compliance.

7	01/04/2020 – 30/09/2020	01/08/2019 – 31/01/2020		for charge restriction periods commencing in October.	December 2019	7 February 2020	7 April 2020
8	01/10/2020 – 31/12/2020	01/02/2020 – 31/07/2020			June 2020	7 August 2020	7 October 2020

### ***Part 3 – Monitoring compliance and reporting***

80. Article 5 of the Order requires suppliers to submit a report to the CMA in the format specified in Schedule 3 to the Order. Compliance statements must be submitted to the CMA no more than 30 days after the end of each Charge Restriction Period.
81. Paragraphs 28A.26 to 28A.29 of the Electricity Licence Condition and paragraphs 28A.19 to 28A.22 of the Gas Licence Condition set out the detailed reporting requirements. These reports must be submitted to GEMA no more than three working days after the start of each Charge Restriction Period. While we have decided not to prescribe the format for this reporting, we expect this to be similar to the format that is included in Annex 3 to this Explanatory Note. GEMA may publish guidance on how this reporting is to be completed and may update the format of the reporting from time to time. Suppliers are required to inform GEMA, in writing or in any other the format specified by GEMA, of any subsequent changes to the information included in the report as soon as it is reasonably practicable.
82. These compliance statements and reports are required to assist the CMA and GEMA in complying with their statutory duties to monitor compliance with the Order and Licence Conditions, respectively.
83. GEMA is also expected to inform the CMA of any breach of the Prepayment Charge Restriction by any supplier. In addition, GEMA is expected to take such enforcement action as it believes is appropriate in the event of non-compliance with the applicable Electricity Licence Condition or Gas Licence Condition (for instance failure to pay a rebate where appropriate). The CMA will also monitor the Order in accordance with its statutory duty.
84. Article 6 provides that the CMA may give directions as to compliance with the Order. Article 7 provides for any person to whom this Order applies to provide information required by the CMA to allow it to monitor and review compliance with and operation of the Order. GEMA has similar powers under the Electricity Supply Licence and Gas Supply Licence, including in the Licence Conditions.



## Annex 1: Calculation of the price cap

1. Prior to each Charge Restriction Period, GEMA will calculate the Relevant Maximum Charges for each Charge Restriction Region<sup>19</sup>, Benchmark Annual Consumption Level (ie nil and the medium TDCV that applied for the period from January 2014 to August 2015) and (for electricity) Benchmark Metering Arrangement (ie single-rate and Economy 7<sup>20</sup>) in accordance with the formulae set out in paragraph 28A.7 of the Electricity Supply Licence Condition and paragraph 28A.5 of the Gas Supply Licence. These formulae take account of the values of a number of inputs, ie wholesale costs, network costs, policy costs, other indirect costs, the prepayment cost differential, and headroom.

### CMA's Baseline Values

2. The CMA has calculated the Baseline Values, as at 30 June 2015, for each of the relevant inputs for calculating the Relevant Maximum Charges (ie wholesale costs, network costs, policy costs, other indirect cost allowance, the prepayment uplift allowance, and headroom). These Baseline Values are included in Annex 1 of the Licence Conditions.
3. The CMA has also used these Baseline Values to calculate the Baseline Benchmark Maximum Charge (ie the hypothetical baseline Relevant Maximum Charge as at 30 June 2015) for each relevant Charge Restriction Region, Benchmark Annual Consumption Level and (for electricity) Benchmark Metering Arrangement. The Baseline Benchmark Maximum Charges are included in Annex 5 of the Licence Conditions.
4. As further explained below, the Baseline Values will be updated by GEMA to determine the appropriate level of the Relevant Maximum Charges prior to each Charge Restriction Period in the manner set out in the Licence Conditions.
5. The Baseline Values and, accordingly, the Baseline Benchmark Maximum Charges, are based on the medium TDCVs that applied for the period January 2014 to August 2015, ie:

(a) Single-rate Metering Arrangements – 3,200 kWh per annum;

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<sup>19</sup> The 14 Charge Restriction Regions are set out in annex 2 to this Explanatory Note.

<sup>20</sup> As it is further explained in paragraphs 50 to 60, compliance with the Prepayment Charge Restriction for Multi-Register Prepayment Tariffs will be assessed against the Relevant Maximum Charge for Economy 7 Metering Arrangements.

(b) Economy 7 Metering Arrangements – 4,600 kWh per annum; and

(c) Gas consumption – 13,500 kWh per annum.

6. Ofgem regularly re-assesses TDCVs and, therefore, these values may be amended throughout the duration of the Order. As the Relevant Maximum Charges are defined by a straight line between zero consumption and the TDCV consumption levels outlined above, it is not considered necessary to adjust the medium TDCV for the purposes of determining the Relevant Maximum Charges when GEMA amends the TDCV values. In calculating the Benchmark Maximum Charges, GEMA will, throughout the duration of the Order, use the TDCVs that applied for the period January 2014 to August 2015, as set out above.
7. This approach to determining the Relevant Maximum Charges in line with the medium TDCVs prevailing during January 2014 to August 2015 is a minor departure from the Report, where we set out that the network cost allowance would be calculated using the TDCVs prevailing two months before the start of a Charge Restriction Period. This departure will not impact the overall level of the Relevant Maximum Charge, but will simplify the calculation and provide consistency across the Charge Restriction Periods.

### **Updating the Baseline Values**

8. As indicated above, the Baseline Values for wholesale costs, network costs, policy costs, indirect cost allowance, the prepayment uplift allowance, and headroom will be updated by GEMA to determine the appropriate level of the Relevant Maximum Charge for each Charge Restriction Period in the manner set out in the Licence Conditions.
9. The Charge Restriction Periods are set out in the table included in paragraph 79 of this Explanatory Note.
10. The values for wholesale costs, policy costs, indirect cost allowance, prepayment uplift allowance and headroom will be consistent across Charge Restriction Regions for each Charge Restriction Period. The values for network costs may vary dependent on regional variations in network costs.
11. Some general guidance on how the wholesale costs, network costs, policy costs, indirect cost allowance, the prepayment uplift allowance, and headroom will be updated by GEMA is provided below.

## **Wholesale costs**

12. The values for wholesale costs will be updated using a formula set out in paragraph 28A.8 of the Electricity Licence Condition 28A and paragraph 28A.6 of the Gas Licence Condition 28A. This formula takes into account an index constructed by the CMA which tracks the movement in wholesale costs according to the 6-2-12 design noted in the Report.
13. The index will be calculated using information available from ICIS<sup>21</sup> on market prices for standard wholesale products (forward prices for energy delivered over a 12-month period), save where such data source is no longer available, in which case GEMA may replace the data source with any suitable successor data source or where such successor cannot be identified, following consultation, GEMA may replace the data with an alternative data source or amend the model. This index will measure movements since the end of June 2015 in the cost of delivering gas and electricity to domestic customers.
14. For Charge Restriction Periods starting 1 April, the wholesale index value will be the average of the daily prices for standard wholesale products for the six months starting 1 August in the previous calendar year and ending on 31 January. For Charge Restriction Periods starting 1 October the wholesale index values will be the average of the daily prices for standard wholesale products for the six months starting 1 February and ending on 31 July of the same calendar year.
15. The detailed methodology to calculate the wholesale index values is set out in Annex 2 to the Licence Conditions.

## **Network costs**

16. Network costs are the costs of transferring energy from the producer to the end user. Network costs refer to the cost of building, maintaining and operating the energy network and system infrastructure to deliver energy to the customer. These are split between the transmission companies (who take the energy from the producers and deliver it to the different areas of the country) and distribution companies (who arrange for the energy to be transported from the transmission end point to the final users).
17. The values for network costs will be updated (for each Charge Restriction Region) by GEMA on the basis of the most recent published network company charging statements as at:

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<sup>21</sup> ICIS is a market information provider.

- (a) 1 February for Charge Restriction Periods starting 1 April; and
  - (b) 1 August for Charge Restriction Periods starting 1 October.
- 18. Network cost allowances will be calculated in accordance with the methodology and data sources set out in Annex 3 to the Licence Conditions, save where such data source is no longer available, in which case GEMA may replace the data source with any suitable successor data source or where such successor cannot be identified, following consultation, GEMA may replace the data with an alternative data source or amend the model. These calculations have been updated from the version published on 24 June 2016 to take account of comments received since that publication that suggested how the network cost calculations could be more accurate. The specific changes are:
  - (a) Gas exit capacity charges now use the ECN charges levied by gas distribution networks and the value used for an LDZ is now a weighted average rather than a simple average of the values of charges for each exit zone in the LDZ.
  - (b) BSUOS charges are now calculated on a half hourly basis and are applied to demand figures as uplifted by both transmission and distribution losses.
- 19. GEMA may, following consultation, amend the methodology set out in Annex 3 to calculate the network cost allowance, where changes in charging methodology result in the network cost allowance diverging materially from the calculation of actual network costs for some or all Relevant Customers.

### ***Policy costs***

- 20. Policy costs are becoming an increasingly large component of the overall costs borne by suppliers.<sup>22</sup> The costs of complying with various social and environmental schemes are recovered through electricity and gas bills. The level of the Relevant Maximum Charges will be updated to recognise changes in the costs of complying with these schemes. The approach adopted for updating policy costs varies between electricity and gas.
- 21. The values for electricity policy costs will be updated according to the formula set out in paragraph 28A.12 of the Electricity Supply Licence Condition 28A. This formula takes into account the projections for the total costs arising from

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<sup>22</sup> Ofgem's analysis of the components of a typical customer's bill estimates that environmental and social costs will have increased from £62 in the year to 31 December 2014 to £71 in the year to 31 March 2016. Source: Ofgem, breakdown of an electricity bill over time.

social and environmental policies from the Office for Budget Responsibility (OBR). In the event that this data is not available GEMA will, following consultation, identify an alternative data source.

22. The value of this term in each Charge Restriction Period is defined as the sum of the values relating to environmental levies for any forthcoming Charge Restriction Period, as included in the forecast of current receipts presented in the most recent Economic and Fiscal Outlook published by the OBR, before the relevant Charge Restriction Period.
23. Within the illustrative model published on the [energy market investigation case page](#) alongside the Report, we outlined that the baseline value for the electricity policy index was ca. £6.2 billion,<sup>23</sup> however this included ca. £0.7 billion relating to the Carbon Reduction Commitment, which does not apply to Domestic Customers and accordingly should not be reflected in the index. The Baseline Value for the electricity policy index will therefore be £5.6 billion and the Carbon Reduction Commitment will not be included within future policy cost index values. Because costs relating to the Carbon Reduction Commitment have been excluded from both from the baseline value and from the actual data used within the price cap calculation to determine the future level of policy costs, this amendment has had an immaterial effect on the expected level of the Relevant Maximum Charges.
24. The values for gas policy costs will be updated based on the formula set out in paragraph 28A.10 of Gas Supply Licence Condition 28A. This formula relies on the value of the Consumer Prices Index (CPI) published by the Office for National Statistics. If the CPI were to be discontinued, this formula would rely on the successor to such series as may be identified by the Monetary Policy Committee of the Bank of England for the purposes of targeting inflation, or any other relevant benchmark index identified by GEMA.
25. For a Charge Restriction Period starting 1 April, the index shall be updated based on CPI for the month of December preceding the start of this Charge Restriction Period. For a Charge Restriction Period starting 1 October, the index shall be updated based on CPI for the month of June preceding the start of this Charge Restriction Period.

### ***Indirect cost allowance***

26. The values for indirect cost allowance will be updated based on the formula set out in paragraph 28A.13 of the Electricity Licence Condition 28A and

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<sup>23</sup> This £6.2 billion was based on 2015-16 environmental levies outlined within Table 2.7 of the [March 2016 Economic and Fiscal Outlook](#).

paragraph 28A.11 of the Gas Licence Condition 28A. This formula relies on the value of the CPI, which will be updated as per paragraphs 24 and 25 above.

### ***Prepayment uplift allowance***

27. The values for the prepayment uplift allowance (ie the additional costs of supplying gas or electricity to prepayment customers compared to direct debit customers) will be updated based on the formula set out in paragraph 28A.14 of the Electricity Supply Licence Condition 28A and paragraph 28A.12 of the Gas Supply Licence Condition 28A. This formula relies on the value of the CPI, which will be updated as per paragraphs 24 and 25 above.

### ***Headroom***

28. Headroom is defined as a percentage of the sum of the values for wholesale costs, policy costs, indirect cost allowance and prepayment uplift allowance. With respect to electricity, the headroom percentage will be 4.23% for the Relevant Maximum Charges applicable to Single-Rate Metering Arrangements and 3.41% for the Relevant Maximum Charges applicable to Economy 7 Metering Arrangements. With respect to gas, the headroom percentage will be 3.48%. The headroom percentage will remain constant for each Charge Restriction Period. However, the value (in pounds) of the headroom will be updated based on the updated values for wholesale costs, policy costs, indirect cost allowance and prepayment uplift allowance for the respective Charge Restriction Period. The updated value for headroom will be determined based on the formulae set out in paragraph 28A.15 of the Electricity Licence Condition 28A and paragraph 28A.13 of the Gas Licence Condition 28A.

## Annex 2: Charge Restriction Regions

1. The Charge Restriction Regions equate to the distribution service areas of the 14 electricity distribution network operators listed in the first column of the table, as specified in their respective distribution licences and described in the second column:

<b>Electricity Distribution Network Operator</b>	<b>Region</b>
Electricity North West Limited	North West England
Northern Powergrid (Northeast) Limited	North East England
Northern Powergrid (Yorkshire) plc	Yorkshire & North Lincolnshire
Scottish Hydro Electric Power Distribution plc	North Scotland
Southern Electric Power Distribution plc	Southern England
SP Distribution Ltd	Southern Scotland
SP Manweb plc	North Wales and Mersey
London Power Networks plc	London
South Eastern Power Networks plc	South East England
Eastern Power Networks plc	East England
Western Power Distribution (East Midlands) plc	East Midlands
Western Power Distribution (West Midlands) plc	West Midlands
Western Power Distribution (South West) plc	South West England
Western Power Distribution (South Wales) plc.	South Wales

2. The approach to mapping Gas Local Distribution Zones (LDZs) to the respective Charge Restriction Regions is set out in Annex 5 to the Gas Licence Condition.

## **Annex 3: Format of the report (reporting obligation)**

See separate excel file: [Annex 3 reporting template.xlsx]