

npower
Prepayment Charge Restriction Order Consultation
Response dated 11 November 2016

Requirement for recovery mechanism and/or change to 6-2-12 methodology

1. In npower's response to the PDR, we submitted that the price cap should include a mechanism for recovery of realised costs in excess of those built into the price cap. The CMA considered that as a result of enhancements to the remedy design, a recovery mechanism was not required. In our written response to the CMA's initial consultation on the Prepayment Price Cap Order and on a call with the CMA on 21 September 2016, we explained why we continue to consider that a recovery mechanism is necessary (both in respect of under- and over-recovery of costs). The draft Order now issued for consultation does not include such mechanism, the CMA having considered that this would be "very complex and unlikely to result in more equal treatment of suppliers."¹
2. We explain below, expanding on our written response to the initial consultation, why we continue to consider that a recovery mechanism is required. As an alternative, we explain how a simple change to the 6-2-12 methodology for calculating wholesale costs included within the price cap could reduce the risk on suppliers in respect of wholesale costs (though these are not the only element where suppliers face cost recovery risk).
3. As noted in our response to the initial consultation, even after the CMA's enhancements to the remedy design, there remains a significant risk that suppliers' realised costs over a given price cap period will not be equivalent to the costs included within the setting of the price cap. This is due to both additional costs not recognised by the mechanism and the fact that costs can change between the time of setting the price control and the point at which the costs are realised. This risk is largest for wholesale costs but also exists for policy costs and PPM specific costs.
4. As also noted in that response, the move by the CMA from an annual cap (at PDR stage) to a six monthly cap (in the Final Report) exacerbates the risk of mismatch between allowable and realised wholesale costs, and the CMA does not appear to have considered whether this change to the remedy design might necessitate a recovery mechanism. This risk arises from the fact that the period covered by forward looking wholesale prices (12 months) in the price observation period is not aligned with the price cap period (6 months). This risk can only be partly mitigated when purchasing energy on the wholesale market. The CMA has not assessed this cost risk on suppliers or, therefore, provided for it within the calculation of headroom.

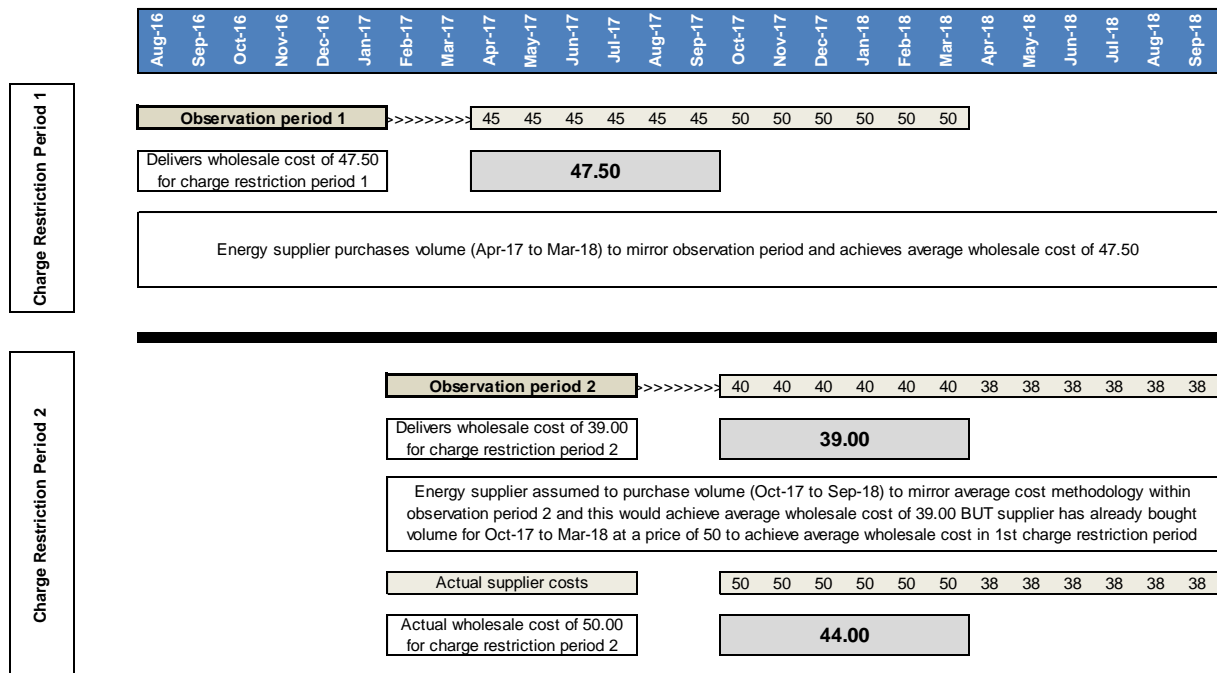
¹ CMA Notice of intention relating to the Prepayment Charge Restriction Order, paragraph 10

5. We highlighted to the CMA in our response to the initial consultation that, in order to implement the price cap in practice, it will be necessary to provide some costs information at an early stage before the supplier has its best view of those costs, which increases the risk that realised costs will differ to those included within the price cap. In the PDR and the Final Report, the CMA had not considered the timing of the provision of costs information, therefore had not yet considered whether this might give rise to a risk of mismatch between costs included within the price cap and costs actually realised.
6. As previously noted in our response to the PDR and our other responses, where price controls exist for networks and in retail markets, the regulatory standard is to recognise this risk in the recovery mechanism, i.e. where benchmark costs have risen after the price control is set then this increase is added onto the prices for the next price control, or if they have fallen the prices are reduced. We consider that including a recovery mechanism within the price cap is not contrary to any of the CMA's key findings in the Final Report. Indeed, it would make the remedy less onerous on suppliers and can benefit customers by potentially reducing the volatility of the price cap.

Wholesale costs

7. npower believes the CMA's methodology for calculating the wholesale cost component of the price cap results in suppliers facing unavoidable wholesale cost risks. Movements in the wholesale market may make it impossible for a supplier to achieve the average wholesale cost element of the price cap that is calculated via the CMA's adoption of the 6-2-12 wholesale cost design.
8. In the absence of a recovery mechanism, over the life of the cap, suppliers may be faced with wholesale costs that are not recoverable from their customers i.e. a supplier would be unable to match the wholesale cost element of the price cap despite following the implied hedging strategy.
9. Figure 1 illustrates the risk that suppliers would face under the CMA's 6-2-12 methodology. For simplicity, this example removes seasonal consumption variation but this does not impact the principle that is being illustrated.

Figure 1 Current price cap methodology

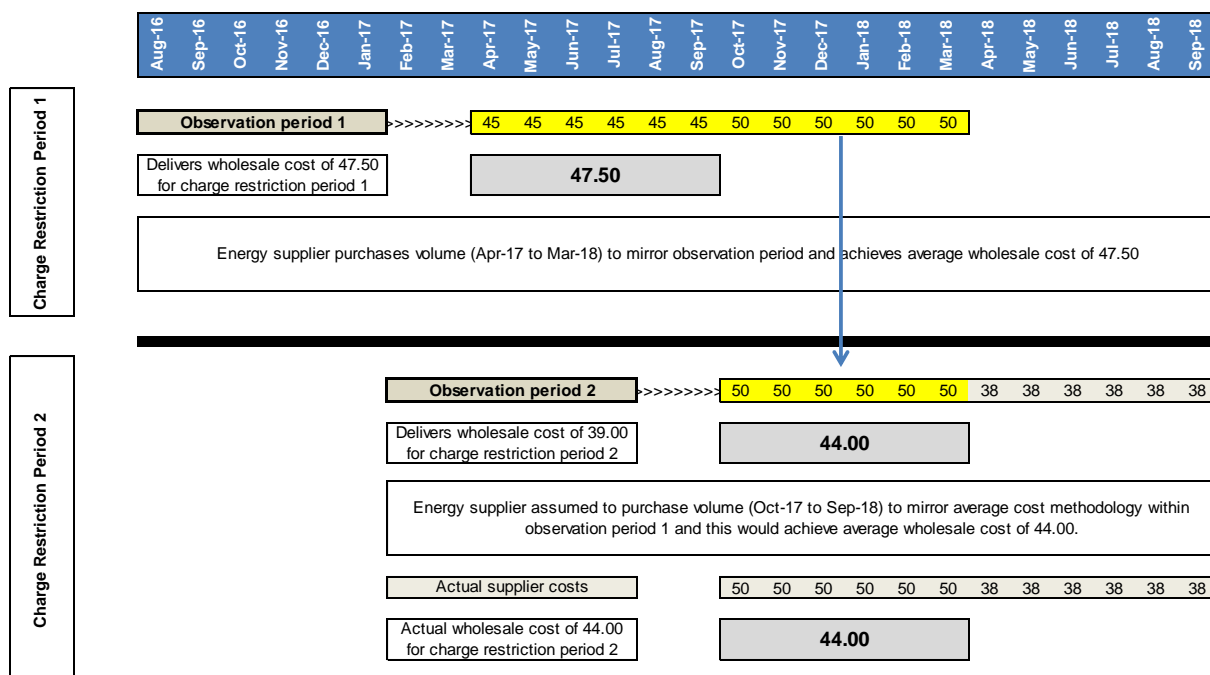


10. Initially, for the first charge restriction period a supplier is able to secure energy at a cost matching that within the price cap, as set by the 6-2-12 methodology. I.e. by purchasing energy for the 12 month period Apr-17 to Mar-18 over the observation period Aug-16 to Jan-17, an average price of 47.50 (in this example) is achieved.
11. However, if the wholesale market were to fall after the end of the first observation period, by following the implied hedging strategy, suppliers would be unable to match the wholesale price included within the price cap for the second charge restriction period. This is because, to achieve the average wholesale price included within the price cap in the first charge restriction period, suppliers would have purchased energy for a period of Apr-17 to Mar-18 – i.e. including Oct-17 to Mar-18 which falls within the second charge restriction period – at the prevailing price in observation period 1 (50); however the wholesale price included within the price cap for the second observation period includes the cost of energy (40) for this period (Oct-17 to Mar-18) observed over a different time period (Feb-17 to Jul-17), i.e. observed at a time when it is cheaper than the price already paid by the supplier.
12. The wholesale price of 39 included within the price cap for the second charge restriction period reflects the downwards movement in the wholesale market that has occurred after the end of the first observation period. But suppliers are faced with higher costs as energy for the period Oct-17 to Mar-18 has already been purchased during observation period 1 at a higher price.
13. In order to avoid this risk that suppliers face significant costs that they are unable to recover, the CMA would either need to revisit the 6-2-12 methodology

(to ensure that the wholesale cost component of the published price restriction is a cost that can be secured by suppliers) or include a recovery mechanism to allow suppliers to recover legitimately incurred unavoidable costs.

14. An example alternative methodology is provided below in Figure 2. Here the price cap in period 2 and subsequent periods reflects the overlap in the observed periods i.e. the wholesale cost in period 2 is made up of prices from the previous observation period for the first six months of the observed period. npower notes that whilst this methodology enables suppliers to better follow the wholesale cost component of the cap it does lead to a less accurate reflection of costs in the cap period. npower would urge the CMA to consider alternative methodologies (to the 6-2-12 approach) that strike a better balance between minimising risk to suppliers and being reflective of the costs within the cap period.

Figure 2 Alternative price cap methodology



Other supplier costs

15. npower agrees that, in the case of network costs, the model should be able to be changed if there is a material change in the relevant charging methodology. npower considers that any change to the charging structure should be reflected in the relevant Networks worksheets of the PPC model such that the actual change in network costs including those due to methodology/charging structure change are correctly reflected in the indexation of the price cap.
16. Some use of system charges are known in advance but the breakdown of costs (and hence total amounts payable by suppliers) are dependent on demand

profiles. Not all of these are known in advance (for example Balancing Services Use of System charges or Transmission Network Use of System “triad” charges, which depend on system demand in different periods). As already stated above, npower would urge the CMA to consult further on a suitable mechanism that would enable suppliers to recover such costs.

17. Policy costs are seasonal, inter-year (e.g. Energy Companies Obligation) and may have obligation setting and/or obligation delivery years that are out of phase with the price control years.
18. Similarly some costs (e.g. Capacity obligation costs) are currently not captured within the Office for Budget Responsibility (OBR) forecasts and as a result will not be captured in the current cap design. The CMA should consult on an appropriate method to reconcile such inconsistencies in approach.

Notification period

19. The CMA states that *‘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.’*² npower notes that this is an increase on the period included within the initial consultation but considers this minor change still does not allow suppliers adequate time to review and change their prepayment prices, particularly given that Supply Licence Condition 23 (SLC23) requires suppliers to notify customers in writing at least 30 calendar days in advance of a price increase.
20. These timings are likely to result in suppliers having approximately 25 calendar days to review and set prices, make changes within their systems, produce and mail highly-prescribed Price Change Notifications and provide the PPMIPs (Prepayment Meter Infrastructure Providers) with the separate 30 calendar days’ notice they require to upload the new prices to meters. npower continues to consider that a more realistic timeframe to enable suppliers to implement and compliantly inform customers of a price increase, as a result of a change in the price cap, would be [CONFIDENTIAL] calendar days.
21. As noted in our response to the initial consultation, an alternative would be to add a clause to SLC23, where the price control allows for a price increase, replacing the absolute requirement to notify 30 days in advance with an “all reasonable steps” requirement to notify price control changes 30 days in advance, recognising that “all reasonable steps” would permit, for example, deliberate delays in notification in order to minimise customer inconvenience from the contact centre congestion caused by concentrated notification. npower would urge the CMA to discuss with Ofgem how a workable remedy can be

² CMA Prepayment Charge Restriction Explanatory Note, page 10, paragraph 41

devised that both allows suppliers to make changes to their prices to reflect changes to the prepayment cap and provides customers with full information about changes to their prices.

22. npower recognises that a longer notice period is more likely to result in the PPM price control update relying upon estimated costs such as network operator recovery costs. This further reinforces the need for the CMA to consult on a suitable recovery mechanism.

Assessment of compliance with the Prepayment Charge Restriction

23. npower agrees with the CMA's proposed assessment of compliance in that a prepayment tariff needs to comply within the prepayment charge restriction during the charge restriction period at all consumption points. However, we explain below why providing data to evidence actual consumption within the price restriction period may be difficult in some instances within the proposed timeframe.
24. Additionally, within paragraph 47 of the 'Explanatory note for consultation' the Relevant Maximum Charges are defined as "*exclusive of Value Added Tax (VAT)*"; for completeness npower considers that this should also be reflected within the SLC definition which currently only refers to "*in pounds sterling*".

Calculation of Relevant Maximum Charges per fuel and Metering Arrangement

25. npower requests that in the new SLC, the CMA confirms that where a customer has two prepayment meters – one off peak (OP) and one on their related 24-hour tariff – supply charges under each tariff must comply with the respective cap. As drafted paragraph 52(c) within the explanatory note implies that in this scenario the OP metering would be treated as E7, despite the fact that there will be a 24 hour meter recording consumption concurrently with OP load, both charged at their respective unit rates. For E7, the meter records either peak or OP load at different unit rates. npower believes that the OP meter and the related MPAN 24-hour supply meter should be treated as two separate meters for the purposes of the cap since these customers do not have a 'Multi-Register Prepayment Tariff' and they have two distinct tariffs, one of which could be a single rate fixed term tariff and the other an evergreen off peak tariff.

Timetable overview

26. npower has no issues with the proposed timings in the table, however would suggest that the reporting deadline should be five working days rather than seven calendar days to allow for bank holidays.

Monitoring compliance and reporting

27. npower asks that the CMA clearly sets out a summary of the compliance monitoring and reporting requirements detailing the roles and requirements of each party i.e. which elements the CMA will monitor and what reporting they require, what Ofgem are doing and what reporting is going into them.

Annex 1 CMA's Baseline Values

28. npower sees no obvious issue with the TDCVs (Typical Domestic Consumption Values) based on those that applied January 2014 to August 2015 being constant throughout the Prepayment Charge Restriction period.

Updating the Baseline Values

Network costs

29. npower notes that the CMA is now proposing that actual outturn BSUoS costs are used in the calculation of the cost indexation, rather than the National Grid forecast. However, npower believes that the spreadsheet contained within Annex 3 cannot set the BSUoS element of the price cap in advance of the charge restriction period because it refers to the BSUoS charges over the same period that the cap would cover.
30. The indexation of the electricity standing charge does not take into account fixed charges i.e. the CMA has assumed nil consumption means zero network costs. This is not the case for Use of System Charges. The provision of the distribution infrastructure and the transmission and generation of energy capacity to a connected consumer has a cost even with no current consumption and this cost is recovered by suppliers via fixed cost charging. To improve the accuracy of the calculation, the indexation of the standing charge (nil consumption cap) should include the distribution and other standing charges.

Annex 2 – Charge Restriction Regions

31. With regard to gas charge restriction regions the approach to map the Gas Local Distribution Zones (LDZs) to the equivalent electricity distribution regions is consistent with npower's own gas regional pricing methodology, however npower notes that the CMA's mappings appear to be slightly inconsistent with our own mappings. npower notes that the CMA suggests visibility of the mapping methodology is contained within Annex 5. npower would ask that the CMA updates Annex 5 to present this information as it currently contains information relating to the Baseline Benchmark Maximum Charges and not mapping methodology.

Prepayment Charge Restriction Electricity Supply Licence Condition

32. Within paragraph 28A.19 it states that *"If, owing to a technical issue, the Authority is unable to publish the Benchmark Maximum Values or the values listed in paragraph 28A.17 within the timetable set out in paragraph 28A.16, it will publish such values without delay following resolution of the technical issue."* npower assumes that a delay in publication of the necessary data will result in a delay in the implementation of the charge restriction period, by at least the same number of days. This will also have a knock on impact on the reporting deadlines detailed in the table on page 22 of the consultation document and SLC 28A.29.
33. Within paragraph 28A.29 there is a requirement for licensees to provide the Authority with reporting within seven days. In line with our comments on the timings detailed in the table on page 22 of the explanatory notes npower considers five working days may be a more appropriate time period to allow for bank holidays. In addition, npower assumes if the Authority requires the 'other information' detailed in 28A.29(h) that there will be a consultation to ensure suppliers can provide this information within the timeframe.
34. npower believes that for completeness the 'Relevant Customer' definition³ should be expanded to include Fixed Term Contract customers so that it reads: *'Relevant Customer' means a Domestic Customer supplied via a Prepayment Meter, excluding those Domestic Customers supplied via an Excluded Smart Meter or supplied under a Fixed Term Supply Contract which was entered into on or before 24 June 2016.*
35. The 'Single-Rate Metering Arrangement' definition⁴ should be expanded to include customers with E7 who have elected to be billed on a single rate tariff to ensure they are not considered as having a restricted metering arrangement i.e. *'Single-Rate Metering Arrangement' means using an Electricity Meter for the purpose of a Prepayment Tariff whereby a Domestic Customer is charged on the basis of a single Unit Rate; this includes customers with Restricted Hours Metering who have opted to be billed on a single rate tariff.*
36. The illustrative model currently contains inconsistencies with values from the Annexes⁵ within the SLC. npower requests that the CMA issues an audited, signed off price cap model including baseline values so that suppliers can have confidence that they are projecting off a consistent baseline position. It is essential that the baseline values in the model and the SLC match if suppliers

³ Draft Prepayment Charge Restriction Electricity Supply Licence Condition, page 13

⁴ Draft Prepayment Charge Restriction Electricity Supply Licence Condition, page 13

⁵ For example, within Annex 5 the baseline maximum charges in the SLC are c 0.4% lower than in the model. This equates to between £1.56 to £1.78 lower than the model for single rate electricity and between £2.33 and £2.64 lower for E7.

are to use it to calculate prices in advance of notification of maximum charges by Ofgem. Otherwise suppliers will be entirely dependent on Ofgem announcing the maximum charges, and will not be able to carry out their own projections in advance, which will put pressure on the timelines for setting and implementing prices in time for the start of the next charge restriction period.

37. As discussed previously npower considers that the SLC should explicitly state that the values provided within the Annexes are exclusive of VAT.
38. Within article 28A.26 npower would suggest the wording for (b) is amended to provide clarity in respect of early *Charge Restriction Periods* from "*when historic data relating to two consecutive Charge Restriction Periods are not available in relation to a particular Prepayment Tariff, the licensee must...*" to "*when historic data relating to (i) initially, a recent 12 month period, and (ii) from 1 April 2018, two consecutive Charge Restriction Periods are not available in relation to a particular Prepayment Tariff, the licensee must...*"

Prepayment Charge Restriction Gas Supply Licence Condition

39. As discussed in our comments on the electricity SLC there are inconsistencies with the figures within the model and annexes.

The Energy Market Investigation (Prepayment Charge Restriction) Order 2016

40. npower would like to understand why within the draft SLC 28A it states that suppliers must ensure, up to 31/12/2020, that prices must comply with the cap - but SLC 28A.18 has a licence condition having effect until 30/6/2021.