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Friday, 18 January 2019

Dear Ms Gomes da Silva

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

Centrica welcomes the opportunity to comment on the CMA's proposed review of the PPM cap.

We strongly agree with the CMA's provisional view that such a review is necessary and should be regarded as an administrative priority. A 'mid-term' review of the cap in the light of progress with smart meter roll out was always envisaged. But fundamental changes of circumstance since the conclusion of the CMA's Energy Market Investigation (EMI) underline the need for more fundamental urgent review.

In summary, we believe that:

- with the introduction of default tariff cap by Ofgem, there is now a very strong case for review of the PPM cap that goes beyond the narrow scope being proposed in the consultation document;
- specifically, inconsistencies have arisen between key aspects of the PPM cap methodology and the default tariff cap, for understandable reasons, which need to be addressed through this review;
- consistency of methodologies can be achieved relatively simply by the CMA revoking the PPM cap order, which would leave Ofgem free to set a single PPM cap; and
- a failure to do so would lead to continued and material inconsistencies between the two methodologies – most notably with respect to smart metering cost allowances – which can be expected to distort supplier behaviour and adversely impact the pace of smart meter rollout amongst PPM customers and the overall smart meter penetration rate if these inconsistencies are allowed to persist.

The CMA's invitation to comment correctly identifies the recent NAO report and Ofgem's introduction of a wider default tariff cap as material changes of circumstance requiring consideration in accordance with Section 162 of the Enterprise Act 2002 (the 2002 Act).¹ It also notes² that Section 162 (2) of the

¹ Invitation to comment at paragraphs 10 and 11

² Ibid at paragraph 3

2002 Act requires the CMA to consider “*whether, by reason of any change of circumstances, an enforcement order is no longer appropriate and needs to be varied or revoked*”³ (emphasis added).

The Domestic Gas and Electricity (Tariff Cap) Act 2018 (the 2018 Act) and Ofgem’s introduction of a wider default tariff cap effective from 1 January 2019 completely changes the counterfactual against which the separate PPM cap now needs to be assessed.

- Price caps are no longer a limited intervention for a discrete segment of an otherwise unregulated market. SMETS2 PPM meters which the CMA deliberately excluded from the PPM cap are now subject to a default tariff cap set on a different basis.⁴ This creates unnecessary complexity for suppliers and confusion for customers which threatens to exacerbate barriers to smart meter adoption. However, it also means that were the PPM cap to be revoked, rather than being left unregulated default PPM tariffs for all meter types would be subject to regulation by Ofgem in any event.
- Ofgem’s bottom up cost modelling also exposes serious shortcomings in the PPM cap methodology, particularly in relation to treatment of smart costs which Ofgem is set to review further for the cap period commencing 1 October 2019. For example, we estimate a shortfall of over £12 for pass through smart metering costs implicit in the PPM cap compared to the £17.27 per dual fuel customer value yielded by Ofgem’s modelled result for winter 2018/19. But the work already undertaken by Ofgem, and the further work it has committed to, also provides a resource to remedy such discrepancies.

The adverse implications of these fundamental changes, in particular for the rollout of smart meters, and the appropriate course of remedial action now are explained more fully in the attached appendix.

In short, we believe there is a compelling case for a single PPM cap covering all PPM meter types and that the CMA should, in fact, revoke the PPM cap order. This would leave Ofgem free to set a single PPM cap, if appropriate, in a manner consistent with its wider default cap methodology and relieve the CMA of burden of maintaining a separate PPM cap.

At present, the CMA has proposed a scope that entails only (a) the progress on the rollout of smart meters, (b) the policy cost allowance and (c) the DCC costs element of the indirect cost allowance.

While we welcome the CMA’s apparent readiness to consider changes to elements of the present cap, the scope remains too narrow to enable proper consideration of the implications of and interactions with the default tariff cap, and must be extended. This extended scope should therefore include the option of revocation, which would allow Ofgem to design and administer an appropriate single PPM cap. This is not only the correct approach from a policy perspective; it is also **required** by section 162(2)(c) of the 2002 Act, as explained above.

While this requires the scope of the review to be broader than currently proposed, we believe such a review can and must be accomplished expeditiously so that a single PPM cap can be in place by the cap period commencing 1 October 2019 at the latest.

This matters because smart meter roll-out forecasts for 2019 and supporting plans are currently being locked down based on the limited allowance made for smart costs within existing price caps. There

³ Enterprise Act 2002 Section 162 (2) (c)

⁴ Ofgem has committed to keep its approach to SMETS2 PPM meters under review and stated that it plans to work with the CMA in the context of the mid-term review of the prepayment meter cap to ensure approach and thinking is aligned.



are long lead times associated with any change to programme delivery in the light of any change to the allowance made for smart programme costs within the price caps that now apply.⁵ Therefore, any slippage in confirming smart allowances for price cap periods from 1 October onwards will have knock-on adverse consequences for programme delivery in 2020. Given the importance the CMA has previously placed on smart roll out in view of the customer benefits expected to result, we hope you will agree that achieving certainty on future smart allowances by early August is imperative.

We look forward to engaging with your team further as the review unfolds. If you have any immediate questions, please contact [redacted] who will be coordinating our response.

Yours sincerely

Raj Roy
General Counsel, UK & Ireland

cc: Mary Starks, Ofgem

⁵ For example, the lead time for recruiting and training engineers is approximately nine months, similarly for ordering meter assets, and for changing operational resourcing

Appendix

Centrica has previously called upon the CMA to review the methodology used to set the PPM cap in the light of evidence that it fails to allow appropriate recovery of suppliers' efficiently incurred costs, contrary to the CMA's legislative intention.⁶ The CMA did not reach a firm conclusion on this matter, but indicated that it was not, at that time, persuaded that the evidence presented amounted to a *prima facie* change of circumstance. Moreover, it indicated that even if it were persuaded that there had been a material change, it might still decline to conduct a review on the grounds of administrative priority.⁷

While Centrica continues to disagree with this view⁸, we discuss in turn below:

1. The further fundamental changes that have taken place since the start of 2018
2. Why resource and priority considerations support the case for a wider review now

We conclude by outlining an appropriate way forward, enabling the CMA to withdraw its own PPM cap while leaving Ofgem free to apply an appropriate replacement to the extent continuing price protection remains necessary.

1. Fundamental changes in circumstance the CMA must now consider

Change in circumstance #1: The PPM cap is no-longer an isolated intervention – much wider intervention through a default tariff cap (explicitly rejected by the CMA) is now a reality

In January 2018, the CMA's PPM cap was the only retail tariff price cap operating in the GB energy market, covering an estimated 4.5 million electricity accounts and 3.5 million gas accounts representing 17% of all electricity accounts and 15% of gas accounts. Ofgem decided in December 2017 to extend price protection to an additional 1 million customers currently or previously in receipt of the Warm Home Discount rebate, with effect from 2 February 2018. Nevertheless, price protection remained the exception rather than the rule with most prices, including for default tariffs, competitively determined not capped by regulation.

This situation changed fundamentally with the passage of Domestic Gas and Electricity (Tariff Cap) Act 2018 (the 2018 Act) in July 2018 and Ofgem's subsequent decision of 6 November 2018 to implement a wider default tariff cap with effect from 1 January 2019.

The 2018 Act provides for the PPM cap to continue by carving it out from the application of the wider default cap.⁹ However, it equally provides for the cap to be replaced.¹⁰ As explained further below, this is what we believe should now happen.

⁶ Letter from Raj Roy to Sarah Cardell 25 January 2018

⁷ Letter from Andrea Gomes da Silva to Raj Roy, 7 February 2018

⁸ For the record, Centrica maintains that the evidence previously provided did and still does demonstrate a *prima facie* change of circumstance pursuant to section 162 (2) of the Enterprise Act 2002 and remains of the view that that administrative priority cannot justify refusal to undertake a review in such circumstances. However, given the ample and indisputable evidence that circumstances have further changed since February 2018, we focus here on those more recent changes, the evidence supporting them and the implications for the future of the PPM cap.

⁹ Section 3(1)(a)

¹⁰ Section 3(1)(b)

Change in circumstance #2: default tariffs for prepayment customers are now capped irrespective of meter type, contrary to CMA's intention when the PPM cap was established

The 2018 Act also requires that any default tariff not specifically excluded under section 3 must be covered under section 1. It is this provision that has led Ofgem to set a default cap for SMETS2/excluded smart meters that fall outside the terms of the pre-existing PPM cap mandated by the CMA.

The requirement for Ofgem to include SMETS2/excluded smart meters within a cap is not in dispute. However, Ofgem's decision to apply a cap that functions differently from the existing PPM cap introduces unnecessary complexity and confusion that threaten to undermine smart meter take up by PPM customers if not addressed.¹¹ Customers with traditional PPM meters currently protected under the PPM cap may be more or less protected under an alternative cap depending on their consumption profile, and face additional uncertainty about future change if/when the status of a SMETS1 meter changes. If this situation is allowed to persist it is likely to retard smart meter take up in the PPM segment. This would be contrary to the CMA's intention to incentivise the transition to fully interoperable smart meters. As well as being a material change in circumstance, therefore, this factor falls full square within the scope of the mid-term review in any event.

Change in circumstance #3: Ofgem has considered and rejected use of the PPM methodology for the wider cap because it does not appropriately reflect efficiently incurred costs

At the time it designed the PPM cap, the CMA recognised that a methodology it considered could be put in place quickly to protect a limited catchment of PPM customers on a strictly temporary basis might not be appropriate for any wider or more enduring cap.¹² While the wider default cap is also intended to be temporary, the extension provisions found in section 8 of the 2018 Act anticipate a cap that might last until the end of 2023, substantially longer than currently envisaged for the PPM cap.¹³

Before reaching its final decision, Ofgem considered various candidate methodologies for setting a general default cap, including: the PPM methodology; an alternative updated 'top down' competitive benchmark approach; a 'market basket' approach and a 'bottom up' methodology. Ofgem's eventual choice of bottom up approach and the detailed methodology for determining components parts of the overall cap differ in important respects from the PPM methodology. Indeed, Ofgem's decision to undertake a more detailed estimation of individual cost line items exposes deficiencies with the PPM methodology. We describe this in detail below with respect to smart meter costs. However, there is a similar issue with respect to policy costs, where the current PPM methodology results in a less accurate estimation of these costs than the default tariff cap. This must also be addressed as part of this review.

Ofgem's cost modelling takes account of more recent data than was available to the CMA when it established the current PPM cap, and is already being used as the basis for the SMETS2 default tariff cap. Ofgem has committed to liaising with the CMA in the context of its review and Ofgem's

¹¹ See Centrica's response to Ofgem's September default tariff consultation for further details. Ofgem's proposals are discussed at Appendix 8 on payment methods.

¹² CMA explicitly considered and rejected wider default caps as discussed at paragraphs 11.86–11.97 of EMI final report

¹³ Further provisions at section 9 require Ofgem to consider whether enduring protection may be required for particular classes of customer beyond termination of the general default cap by the exercise of its functions under the Gas Act 1986 and Electricity Act 1989

methodology is already in the public domain. Allowing Ofgem to refine and build on this analysis to support a single PPM cap would be administratively efficient and address CMA concerns about administrative priority within its own resources.

Change in circumstance #4: Ofgem has recognised the need to benchmark and index smart costs differently from other indirect costs

As previously noted by Frontier Economics, there is strong prima facie reason to believe the initial quantum of net smart costs implicit within the PPM cap materially understates the appropriate benchmark for an efficient supplier. This concern is compounded by the fact that the underlying drivers of net smart costs will not be captured by a general CPI index.

Ofgem has recognised this weakness by rejecting the PPM methodology as a suitable basis for the wider default cap. There is now a specific index applied to the costs of smart meters to reflect the specific evolution of these costs. Further, the bottom up approach Ofgem has adopted distinguishes between pass through costs associated with smart (including DCC costs) and other drivers of net cost over which suppliers in principle have more control.

It is instructive to compare the evolution of these costs over time, with the indexation provided within the PPM cap. According to Ofgem's modelling, pass through smart metering costs in winter 2018-19 were £17.27 per dual fuel customer. Applying the same methodology to calculate these costs in 2015, the baseline that was used by the CMA when setting the PPM cap, the equivalent costs would have been £4.61. Applying the PPM indexation methodology (CPIH) to this would result in an allowance of £4.88 in the cap in winter 2018-19 – a material shortfall of £12.39 relative to the costs that Ofgem has identified.¹⁴ This clearly demonstrates that the PPM methodology does not have the capability to account for the substantial changes in the pass-through costs associated with smart meters. In contrast, Ofgem's methodology and calculations can easily be applied to the PPM cap to consider these changes in an administratively efficient manner.

Change in circumstance #5: Ofgem has recognised the need to further review smart costs given material risk that such costs may change in ways that are difficult to accurately model far in advance

Ofgem has had to take a view on smart costs for the purposes of setting the initial level of the cap. It proposes to maintain this initial approach also for the cap period from April to September 2019 given limited time to complete more fundamental review before confirming April prices in early February.

However, the need for timely review underlines the importance of getting the smart allowance right given that suppliers cannot spend more on smart than the cap allows and the importance attached to smart roll out by the CMA in the context of PPM and by Parliament in the context of the wider default cap.

While commitment to review is welcome, it could lead to further divergence between the caps applied to PPM meters subject to the existing PPM cap and SMETS2/Excluded smart meters covered by the wider default cap, potentially exacerbating barriers to smart take up by PPM customers. However,

¹⁴ Calculated based on SEGB 2015 budget and calendar year 2015 DCC average costs being in the baseline. 2015 average costs for DCC are based on a time weighted average of the charges for 2014/15 and 2015/16. If 2015/16 costs only are used then the shortfall is still £11.69.

this problem – which Ofgem has acknowledged¹⁵ - could be addressed efficiently by enabling Ofgem to consider smart costs in relation to credit and PPM payment types at the same time, with minimal administrative burden on the CMA.

2. Resource and priority considerations support the case for review

As noted above, the CMA previously indicated that even if it were satisfied there had been a material change of circumstance, it might still decline to embark on a review on grounds of administrative priority.

Centrica maintains its previous view that the deficiencies of the PPM cap methodology and clear evidence of price convergence dampening competition are, in themselves, sufficiently serious to warrant further investigation by the CMA. Nevertheless, given the CMA's previous stance we explain below how subsequent changes in circumstance, if anything, further reinforce the case for a prompt review.

- **Changed circumstances include abundant new evidence and ready-made analysis**

The changes of circumstances identified above do more than establish that sufficient change has occurred to justify a fresh look. They also provide a ready-made evidence base on which the CMA can draw, substantially reducing the burden of fresh evidence gathering and analysis that might otherwise have been necessary.

The fruits of this evidence gathering and analysis are to be found in Ofgem's November decision, and are available as necessary to support its review. If the review concludes that the CMA can leave future PPM caps entirely to Ofgem, there will be no ongoing call on CMA resource or overhead of ensuring co-ordination with Ofgem.

- **The CMA is committed to the mid-term review in any event**

Even if there had been no change in circumstance whatsoever, the CMA must have allocated appropriate resource to support its own long-planned review. For reasons outlined above, changed circumstances bear directly on that review as originally conceived. In particular, a review focussed narrowly on smart roll-out would have to consider the impact of subjecting SMETS2/excluded smart meters to a separate and divergent cap set by Ofgem.

There is no reason for the CMA to have considered this eventuality at the time it concluded the EMI because it explicitly considered the appropriate scope of interim price protection and consciously excluded SMETS2. The change is not due to a lack of forethought on the CMA's part but to the fundamental change of circumstance brought about by subsequent decisions to impose a wider default cap.

This is the first opportunity the CMA will have to consider its PPM cap in these fundamentally changed circumstances. It is a timely opportunity which the CMA must now take.

¹⁵ See e.g. Ofgem overview document discussion beginning at paragraph 6.19
<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

- **The CMA always envisaged inviting Ofgem to intervene if roll-out appeared behind schedule**

The mid-term review was originally conceived principally in terms of reviewing progress with smart roll-out, with the key question as to whether roll-out was ahead of schedule, on schedule or behind schedule. In the latter case, the possibility of Ofgem taking action directly was clearly foreseen as an option.¹⁶

Clearly the CMA may wish to review and form a view on smart roll-out as part of its mid-term review. The burden of this task will be much reduced by the timely availability of the NAO's recent report, which concluded that the programme is late, the costs are escalating, and in 2017 the cost of installing smart meters was 50% higher than the Department initially assumed.¹⁷ There is thus strong prima facie evidence that the contingency of considering action by Ofgem, already provided for, is engaged.

- **The 2018 Act poses no barrier to Ofgem taking responsibility for a replacement cap**

The 2018 Act does more than carve out the PPM cap from the wider default cap. Section 1 (1) positively requires Ofgem to apply a default tariff cap, subject only to the exemptions provided for under Section 3.

(1) As soon as practicable after this Act is passed, the Gas and Electricity Markets Authority ("the Authority") must modify the standard supply licence conditions so that they include conditions ("tariff cap conditions") that impose a cap on all standard variable and default rates that may be charged by the holders of supply licences for the supply of gas or electricity under domestic supply contracts.

But this is subject to section 3 (exemptions from the cap).

Section 3 itself is framed in the following terms.

(1) Tariff cap conditions do not apply in relation to domestic customers who—

(a) benefit from the cap on rates or amounts charged for, or in relation to, the supply of gas or electricity provided for by the Energy Market Investigation (Prepayment Charge Restriction) Order 2016, made by the Competition and Markets Authority, or

(b) benefit from a cap on such rates or amounts that is a replacement for the cap provided for by that Order.

(2) Tariff cap conditions may provide for the conditions not to apply in relation to—

(a) domestic customers who benefit from a cap imposed by the Authority on rates or amounts charged for, or in relation to, the supply of gas or electricity to customers who appear to the Authority to be vulnerable by reason of their financial or other circumstances;

¹⁶ CMA Explanatory Note at paragraph 75 c) *"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)."*

¹⁷ <https://www.nao.org.uk/wp-content/uploads/2018/11/Rolling-out-smart-meters.pdf>

(b) standard variable rates which apply only if chosen by domestic customers if, or to the extent that, the rates in question appear to the Authority to support the production of gas, or the generation of electricity, from renewable sources.

Section 3(1)(b) provides on its face for a cap that is a replacement for the present PPM cap, without specifying that such a cap must be made directly by the CMA. But if neither Section 3(1)(a) or (b) apply the requirement to impose a default cap will be engaged subject to Section 3(2).

Section 3(2)(a) expressly provides for Ofgem to disapply a default tariff cap in the event that it applies an alternative cap benefiting customers who appear to it to be vulnerable by reason of their financial or other circumstances. This would be a cap under Ofgem's pre-existing powers, such as that applied to customers in receipt of Warm Home Discount from February 2018 until superseded the default tariff cap on 1 January 2019.

Any cap introduced by Ofgem under its pre-existing powers would be subject to whatever expiry Ofgem determined, rather than by the review and expiry provisions in Sections 7 and 8 of the 2018 Act. Alternatively, if Ofgem does not initially make express provision for a separate PPM cap under pre-existing powers, Section 9 would require it to consider doing so before the tariff cap conditions have ceased to have effect (Section 9 reproduced in full below for reference).

(1) Before the tariff cap conditions have ceased to have effect as provided by section 8, and afterwards at such intervals as the Authority considers appropriate, the Authority must carry out a review into—

(a) the pricing practices of holders of supply licences for the supply of gas and electricity under domestic supply contracts, and

(b) whether there are categories of domestic customers paying, or who may in the future pay, standard variable and default rates for whom protection against excessive charges should be provided.

(2) Such a review must, among other things, consider—

(a) whether there are domestic customers who the Authority considers will suffer an excessive tariff differential where on the termination of fixed rates the customers move to standard variable or default rates, and

(b) whether customers who appear to the Authority to be vulnerable by reason of their financial or other circumstances are in need of protection.

(3) If the review concludes that protection should be provided, the Authority must take such steps as it considers appropriate by the exercise of its functions under the Gas Act 1986 and the Electricity Act 1989.

This being the case, any concern the CMA may have about possible continuing need for a PPM cap to apply for any particular category of PPM customers beyond the expiry of any default tariff cap that applied to PPM is clearly capable of being addressed, if appropriate, directly by Ofgem.

If it were simply the case that smart roll-out was identified as being behind schedule, but Ofgem was not already committed to maintaining price caps on a broader front, there might be an argument for CMA retaining responsibility until the end of 2020 and transferring responsibility to Ofgem beyond that date. However, that is not the present situation. Ofgem is already committed to maintain a price

cap in place for an increasing volume of PPM customers until the end of 2020 at the earliest and possibly beyond.¹⁸

In the changed circumstances where progress on the deployment of fully interoperable smart meters will no longer determine whether continuing protection applies (because SMETS2 PPM meters fall under Ofgem's default tariff cap in any event) the case for accelerating the point at which Ofgem takes sole responsibility for PPM price caps is compelling.

Conclusion

We have demonstrated that

- Fundamental changes in circumstance necessitate a fundamental review of the PPM cap considering the intervening impact of the wider default cap; and
- Administrative priority cannot justify refusal to undertake such a fundamental review but points strongly to an exit strategy from the CMA whereby Ofgem takes over responsibility for the PPM cap.

We strongly urge the CMA and Ofgem to work together on the forthcoming review with a view Ofgem assuming responsibility for a single cap covering all PPM meters as soon as possible.

¹⁸ The proportion of PPM meters subject to Ofgem's cap rather than the CMA's will increase as SMETS2 meters replace traditional meters and as SMETS1 meters become interoperable and fall out of the PPM cap.