Invitation to Comment:
Energy Prepayment Review
Competition and Markets Authority
Victoria House (6th Floor South East)
37 Southampton Row
London
WC1B 4AD

18th January 2019

Dear Sir/Madam,

Proposed review of the Energy Market Investigation (Prepayment Charges Restriction) Order 2016

Thank you for the opportunity to respond.

npower's position to the CMA on price caps is a matter of public record[1] and has not changed. Our comments to the CMA on the level of the Prepayment (PPM) cap are also a matter of public record[2]. The UK requires a sensible regulatory framework to attract the investment required to transform our energy system and deliver positive outcomes for consumers. Poorly designed price caps adversely impact investor confidence and put excessive financial pressure on suppliers (noting recent failures), which helps neither consumers nor competition.

In our response to Ofgem's statutory consultation on the default tariff cap[3], we explained the potentially dramatic consequences of a cap set too low; the impact on the profitability and sustainability of suppliers and risk to the delivery of important government programmes, such as Smart. These risks are compounded by supplier failures and the mutualisation of unpaid obligations, with inadequate recovery mechanisms in the cap, which in practice fall to compliant suppliers and customers at the cap. These concerns also extend to the PPM cap.

We believe a review of the PPM cap is necessary and should be prioritised: in order to align with the default tariff cap methodology (as appropriate); facilitate cost recovery; support the roll out of smart meters; and ultimately pave the way for its removal. We believe that this needs to be concluded in time for the October 2019 cap updates. Appended to this letter, we expand on this in response to your specific questions.

Yours faithfully,

Paul Finch
Regulation

[1] RWE response to CMA's PROVISIONAL DECISION ON REMEDIES, dated 21 April 2016 https://assets.publishing.service.gov.uk/media/5728b4c3e5274a036a00001a/rwe-pdr-response.pdf

[2] npower's response to CMA's Prepayment Charge Restriction Order Consultation, dated 11 November 2016 https://assets.publishing.service.gov.uk/media/58347537e5274a5918000000/prepayment_price_cap_draft_order_response_RWE_npower.pdf

[3] https://www.ofgem.gov.uk/system/files/docs/2018/11/npower_-_response.pdf

1) **whether the CMA should prioritise the Order for review at this time**

Yes.

The regulatory and commercial landscape has moved on from a PPM cap baselined at 2015 prices. Suppliers' concerns with the setting of the PPM price cap are well documented, in particular the under-recovery of smart costs and the additional costs to serve PPM.

Despite our significant concerns with the level of the default tariff cap, the information gathered and bottom-up cost analysis undertaken by Ofgem provides a more recent view of suppliers' costs and risks. This would provide a more robust basis than a historic reference-price basis, for the remaining term of the PPM cap. Divergent price caps with inconsistent inputs and methodologies further distort the market and risks unintended consequences.

SMETS2 PPM customers are currently protected by the Direct Debit (DD) default tariff cap. Ofgem said that it will consider a specific payment method uplift when sufficient data is available. The CMA has acknowledged that traditional PPM costs are higher than smart meters[4]. Our most recent analysis indicates a PPM cost to serve differential of c£70 relative to Dual Fuel DD, placing a PPM cap in the same ballpark as the Standard Credit default tariff cap.

The different cap methodologies could result in a PPM cap below the DD cap when updated in April. It would be a perverse outcome if the PPM cap for higher cost to serve customers is lower than the DD cap that applies to SMETS2 PPM, potentially undermining smart take-up. A more cost-reflective PPM cap would avoid this.

2) **Whether it is appropriate for the scope of the review to consist of the assessment of the progress made concerning the rollout of smart meters, and the CMA's calculations underlying the initial benchmark figures set out in Annex 1 to the Gas Supply Licence Condition 28A and in Annex 1 to the Electricity Supply Licence Condition 28A concerning the 'policy cost allowance' and the DCC costs element of the 'indirect cost allowance'**

Yes (but see our answer to 3).

The policy cost allowance (baselined 2015 x CPI) should be updated to mirror the policy cost allowance in the default cap. For example, ECO costs under the default cap reflect the ECO3 Impact Assessment. Our experience is that smart costs continue to increase significantly above CPI.

We note Ofgem's statement that smart costs are implicitly included in the PPM cap based on the then DECC's input to the CMA[5]. However, it is unclear the extent to which the 2015 benchmark suppliers had priced smart or stranded asset costs from replacing traditional meters, into their tariffs. The current PPM cap will not include DCC overruns and increased costs, or the higher costs of a compressed roll-out. DCC costs and other smart related industry costs should be "pass through" based on actuals, in line with the default tariff cap methodology. The review should ensure that a PPM cap reflects the efficient costs of serving SMETS1 PPMs.

[4] CMA Energy Market Investigation Final Report 24 June 2016, para 9.469
[5] Ofgem "Providing financial protection to more vulnerable customers" 20 December 2017, para 3.63

3) **whether there is evidence that additional calculations of cost categories, or broader elements of the Order should also be subject to review**

Yes.

As indicated above, the CMA should work with Ofgem to align the PPM cap methodology and cost allowances with the default tariff cap to the extent appropriate. For example, the wholesale cost allowance under the latter includes an uplift for Unidentified Gas (albeit currently set at a level that is manifestly and knowingly understated). A bottom-up cost approach is also more transparent than a reference-price based cap. For example, the default tariff cap includes explicit allowances for wholesale shape, swing and imbalance costs.

The additional costs to serve PPM should also be reviewed and the cap updated accordingly. Price convergence around the PPM cap and reduced switching are observable consequences of a cap that does not cover the costs of supplying energy. Nevertheless, the PPM market share of new entrant suppliers indicates a healthy level of competition, which along with increasing smart PPM volumes, paves the way for the removal of the PPM cap by the end of 2020.

We also believe that the CMA and Ofgem should urgently assess the impact of the mutualisation of costs (primarily Renewables Obligation and Feed-in-Tariff) as a result of supplier failures. By supplier pricing taking inadequate account of the cost of obligations and then fulfilling the expectation of many defaulting against these expectations, CMA and Ofgem are forcing a regressive redistribution of costs to consumers. The case for a specific pass-through allowance in price caps has increased in the light of recent events and with further failures likely (heightened by the inability to recover such costs).