SCOTTISHPOWER

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Invitation to Comment: Energy Prepayment Review
Competition and Markets Authority
Victoria House
37 Southampton Row
London
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18 January 2019

Dear Team,

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

Thank you for the opportunity to make representations on the CMA's proposed review of the above Order.

The CMA's invitation to comment of 21 December sets out three matters for consultation: whether the CMA should prioritise a review of the Order at this time, the appropriateness of the scope of the review as outlined by the CMA and whether additional calculations of cost categories or broader elements of the Order should be reviewed. Our views on each of these matters are set out in Annex 1.

In summary, we consider that:

- A review of the Order commencing January 2019 should be an administrative priority for the CMA.
- The scope of the review should include (but not be limited to) the two items suggested by the CMA: (i) smart meter rollout progress and (ii) the need to adjust the 'policy cost allowance' and DCC cost element of 'indirect cost allowance'.
- The scope of the review should be widened to include consideration of the case for:
    - amending the calculation of other cost categories in the cap, so as better to align with Ofgem's Default Tariff Cap;
    - revoking the Order, with a view to prepayment customers being protected instead by the Default Tariff Cap.

We would encourage the CMA to undertake its review on a timescale which would allow it to bring into effect any modifications in time for the October 2019 price cap period.

Should you wish to discuss any of our views or have any questions please contact me or James Soundraraju .

Yours sincerely

Richard Sweet
Head of Regulatory Policy

Annex 1

PROPOSED REVIEW OF THE ENERGY MARKET INVESTIGATION (PREPAYMENT CHARGES RESTRICTION) ORDER 2016 – SCOTTISHPOWER RESPONSE

1. Should the CMA prioritise the Order for review at this time?

Yes, we agree with the CMA's initial assessment that carrying out the proposed review should constitute an administrative priority, for the following reasons:

- The review would reflect the CMA's statutory duty to keep under review orders and undertakings.
- The review would have a direct impact on consumers in vulnerable circumstances. The energy market remains an important area for consumers and prepayment meters, in particular, are often used by vulnerable consumers. It is appropriate to ensure these customers continue to be protected in an effective and proportionate way, given the significant and unforeseen changes in supplier costs (notably smart meter rollout costs) and in legislation since the Order was introduced.
- Conducting a focused review would involve a modest amount of CMA resource. The CMA already has a baseline of knowledge of the prepayment sector, and there is now a volume of up-to-date detailed information and expertise available to the CMA from the NAO's audit of the Smart Meter Implementation Programme and Ofgem's implementation of the default tariff cap. Indeed, as set out below, we think the CMA should keep an open mind to allocating a modest amount of additional resource to undertake a broader review than is currently envisaged.

We consider it is highly likely that the CMA would find that there has been a change of circumstances which means that the Order is no longer appropriate and needs to be varied or revoked. Two key changes in circumstances are the unforeseen increases in smart rollout costs (see below) and the enactment of the Domestic Gas and Electricity (Tariff Cap) Act 2018.

Balancing the likelihood of a successful outcome for consumers against the likely CMA resource requirement we consider there is a strong case for a review of the Order to commence in January 2019.

2. Is it appropriate for the scope of the review to consist of the assessment of (i) the progress made concerning the rollout of smart meters, and (ii) the CMA's calculations underlying the initial benchmark figures set out in Annex 1 of SLC28A concerning the 'policy cost allowance' and the DCC costs element of the 'indirect cost allowance'?

Yes, we think it is appropriate for the review to consist of (but not be limited to) assessment of the items proposed by the CMA.

<u>Smart meter rollout progress</u>

It is important that the CMA includes an assessment of the progress made in the rollout of smart meters given the significance of smart meter rollout in the CMA's original assessment of the need for the cap. The CMA will be able to draw on the recent NAO review and without a significant additional resource requirement.

'Policy cost allowance' and DCC cost element of 'indirect cost allowance'

The re-assessment of supplier costs will be a vital feature of the proposed review and the CMA is correct to identify DCC cost elements as a key area where supplier costs have significantly exceeded expectations at the time the CMA's Order was designed. (Although the Order was published in 2016, its assessment of smart costs drew on DECC/BEIS documents published considerably earlier.) However, DCC costs are not the only aspect of smart rollout costs that have increased dramatically beyond original expectations. Delays in the smart rollout programme caused by delays to the DCC, and weak customer interest in having smart meters installed have both increased other cost categories[1]. The CMA can avoid significant resource implications in re-assessing these costs by seeking access to information on smart meter rollout costs gathered by Ofgem for its default tariff cap.

These unforeseen increases in smart rollout costs (together with other costs unaccounted for by the CMA methodology discussed below) mean that the CMA prepayment price cap is now substantially below the cost-reflective level, even including the headroom allowance. This can most obviously be seen by comparing the Default tariff cap level for dual fuel direct debit (DD) (£1,137) against the prepayment cap for dual fuel (£1,136) – as set out in Table 1 overleaf. The prepayment cap is £1 lower than the DD cap, despite the fact that there is a net payment method uplift of £55 (£67 less £12). In other words, the prepayment cap appears to be around £56 too low, in light of the more up to date information available to Ofgem when it set the default tariff cap. A discrepancy of this magnitude will create significant market distortions that will very likely have a significant adverse impact on consumers.

3. Is there evidence that additional calculations of cost categories, or broader elements of the Order should also be subject to review?

Yes, we believe the scope of the review should be extended to include consideration of: (i) other cost categories and (ii) the case for revoking the Order.

Other cost categories

As shown in Table 1 below, a comparison of components of the Prepayment Cap and the Default Tariff Cap reveals significant differences in the allowances for wholesale costs, indirect costs (which include smart meter rollout costs) and 'headroom'.

[1] The NAO's report highlights a number of aspects which have had an impact on most elements of Indirect Costs. For example, it notes that, 'most suppliers have found it harder and more expensive than expected to arrange installations with consumers'. Indeed, its conclusion on value for money states that *'The facts are that the programme is late, the costs are escalating, and in 2017 the cost of installing smart meters was 50% higher than the [Business, Energy and Industrial Strategy] Department assumed'*.

Table 1: Comparison of the Safeguard Prepayment Tariff Cap and Default Tariff Cap in Winter 2018/19.

Components (Winter 2018/19)	Pre-payment Cap	Default Tariff Cap		Difference: DTC DD vs PPM Cap
		Direct Debit	Standard Credit	
Wholesale costs	£421	£447	£447	£26
Network costs	£257	£258	£258	£1
Policy costs	£134	£137	£137	£3
Indirect costs (inc EBIT)	£172			£46
Operating costs		£198	£198	
EBIT		£20	£20	
Payment method uplift	£67	£12	£95	-£55
VAT 5%	£54	£54	£54	-
Headroom allowance	£31	£12	£12	-£19
Level of the cap	**£1,136**	**£1,137**	**£1,221**	**£1**

We do not think the co-existence of two price cap methodologies that lead to differing views on the same cost components is sustainable or efficient for the market. The review should consider ways to harmonise the methodology for the Prepayment Cap with Ofgem's Default Tariff Cap, extending the scope to include:

- wholesale costs allowance, including whether the PPM cap includes sufficient allowance for UIG, losses and other wholesale cost elements identified by Ofgem;

- all elements of smart meter rollout costs, not just the DCC;

- mutualisation costs resulting from supplier insolvencies (for which there is currently no allowance in the Ofgem DTC).

Although the headline dual fuel cap levels are very close for DD and PPM in the table above, this masks more significant variations at two levels:

- between electricity and gas;
- between standing charge and variable charge.

These variations mean that there is a risk of customer detriment whereby customers may in practice face significantly different charges on tariffs that are designed to comply with the two caps. If a customer does not know, for example, whether they are on a SMETS1 or SMETS2 prepayment meter[2], this could make it difficult to obtain an accurate price comparison from a price comparison website. This underscores the need for greater alignment between the two caps.

<u>Revoking the Order</u>

The Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act'), provides that if the Order is terminated early, and no standalone replacement PPM cap is implemented by Ofgem to provide an exemption under section 3(2)(a) of the Act, those currently covered by the cap would be protected by the default tariff cap as the exemption in section 3(1)(a) would cease to apply. This would also be the case if at the end of 2020 the default cap is extended, as per the process outlined within the Act, and the CMA does not implement a further PPM

[2] Tariffs for SMETS1 prepayment meters must comply with the CMA's prepayment price cap whilst tariffs for SMETS2 prepayment meters must comply with the Default Tariff Cap for DD.

Cap. Even if the Secretary of State were to lift the tariff cap at the end of 2020, Ofgem would retain powers to implement targeted price caps at certain customer groups under Section 9 of the Act. Ofgem would, therefore, have the power to retain protections for PPM customers passed the 2020 deadline if deemed necessary, which aligns with the option that the CMA outlined in its EMI final report.

In light of the above, we think the CMA should also give consideration to revoking the Order with a view to prepayment customers being protected instead under the Default Tariff Cap. This would require a degree of coordination with Ofgem so that Ofgem could consult on a modification to the methodology to provide for a new cap for customers with prepayment meters. This would have a number of potential advantages, including reduced CMA resource requirement going forward and no risk of divergence between CMA and Ofgem price caps, with consequential risk of market distortions.

ScottishPower
January 2019