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Dear Peter

**SSE response to CMA invitation to comment on a proposed review of the Energy Market Investigation (Prepayment Charges Restriction) Order 2016**

SSE welcomes the opportunity to provide views on the scope of this important review and looks forward to continued engagement with CMA as it progresses.

We have set out our responses to the three parts of the consultation within Annex 1 and have supplied supporting evidence in Appendix 1. As discussed previously, SSE would very much welcome the opportunity to hold a more in-depth discussion around our submission (in particular to walk through the content of Appendix 1) and take any feedback on areas of analysis that might support the CMA further in their review.

**Summary of SSE's key considerations**

We believe that a timely variation or revocation of the Order is warranted, without diluting the protections afforded to PPM customers, on the basis that:

- there is new evidence, analysis, and conclusions available in respect of setting price protection that have led to the development of a methodology that more accurately reflects costs than the PPM Cap;
- the introduction of the Default Tariff Cap means there are now two price caps in operation that interpret and track costs differently, which may create customer confusion and could discourage the uptake of SMETS2 PPM meters;



- changes in the regulatory framework since the PPM Order was introduced would allow the ongoing protection of this customer group in the event that the PPM Order is revoked early; and
- there are ongoing indexation errors with the PPM Cap methodology that are leading to supplier's **suffering financial losses**. These errors require correction if this cap is to continue to be in place.

SSE's view is that the most practical options would either be to align the PPM methodology to that of the Default Tariff Cap, or to revoke the PPM Order altogether.

In both cases PPM customers would remain protected, but at a level and under a mechanism that is consistent with other domestic supply customers. Added benefits would also be realised in simplifying the overall approach to price protections – both from a customer and administrative perspective – and avoiding the risk of discouraging the uptake of SMETS2 meters. We would of course recommend that in either case, a cost-reflective allowance is built into the Cap – using the Default Tariff Cap methodology – to account for the payment uplift associated with the cost to serve PPM customers.

We hope that this response is useful and constructive and would welcome the opportunity to follow up the points made in more depth with CMA in due course.

Yours sincerely

Patricia Hall  
Regulation Manager



## **Annex 1: SSE response to CMA invitation to comment on a proposed review of the Energy Market Investigation (Prepayment Charges Restriction) Order 2016**

### **1 Whether the CMA should prioritise the Order for review at this time**

SSE is supportive of the CMA prioritising the Order for review at this time. We note that paragraph 14 of the explanatory note to the CMA Order explains that in certain circumstances and from time to time the Order should be subject to a review to determine whether a variation or revocation is required.

We believe that a timely variation or revocation of the Order is warranted on the basis that:

- there is new evidence, analysis, and conclusions available in respect of setting price protection that has led to the development of a methodology that more accurately reflects costs than the PPM Cap;
- the introduction of the Default Tariff Cap means there are now two price caps in operation that interpret and track costs differently, which creates customer confusion and could discourage the uptake of SMETS2 PPM meters;
- changes in the regulatory framework since the PPM Order was introduced would offer default price protection for this customer group in the event that the PPM Order is revoked early; and
- there are ongoing indexation errors with the PPM Cap methodology that are leading to supplier's suffering financial losses. These errors require correction if this cap is to continue to be in place;

We have explored these points in Section 3.

### **2 Whether it is 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 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'**

SSE agrees that it is appropriate for the scope of the review to consist of an assessment of the progress made concerning the rollout of smart and the calculations underlying the initial benchmark figures set out in Annex 1 of the Supply Licence Conditions.

As noted in the consultation document, on 23 November 2018, the National Audit Office published its report into the rolling out of smart meters, in which it highlighted that, "the



number of smart meters installed by 2020 will fall materially short of the [Business, Energy and Industrial Strategy] Department’s original ambitions”. The explanatory note for the PPM Order explains that in the event that the smart rollout was progressing slower than anticipated, the mid-term review would consider requesting that Ofgem introduce new protections for PPM customers to ensure they are protected until the rollout is substantially completed. We take this latter part to mean that the new protections would take effect once the PPM Order is removed at the end of 2020. We would argue that those protections are already in place and as such, the regulatory landscape is now prepared for the removal of the Order. Therefore, we believe that there is an opportunity to remove the Order early and relinquish the CMA, Ofgem and suppliers of the administrative cost and burden associated with the PPM Cap.

In terms of the calculations underlying the initial benchmark, we would point the CMA to the work undertaken by Ofgem for the Default Tariff Cap, which provides a framework through which the costs of the smart meter rollout can be recovered under a price cap. Currently, the PPM Cap has no mechanism to recover smart costs and given this is one of the most high priority Government policies for the transformation of the energy network – and comes at an extensive industry cost – it is imperative that those costs are built into the PPM Cap.

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

For the reasons listed in our response to Section 1, we believe that a broader review of the Order is warranted. These points are explored below.

#### **3.1 There is new evidence, analysis, and conclusions available in respect of setting price protection that has led to the creation of a more comprehensive methodology that better reflects the costs of supplying energy**

The development of the PPM Cap by the CMA in 2016, and analysis of its performance once implemented provided a substantial body of evidence and analysis upon which Ofgem could build and refer to when designing their methodology for default price protection across the whole market, for all customers and meter types.

Following an extensive industry consultation process, during which Ofgem sought to establish a methodology that would best serve the interests of current and future consumers, as well as have regard to the matters within the Default Tariff Cap Act, Ofgem took forward aspects of the CMA’s methodology that performed well and amended aspects that warranted revision. Ofgem gathered new data to produce an up-to-date and





comprehensive view of the costs borne by an efficient supplier and sought to formulate a methodology that best ensures the price cap accurately reflects those costs.

SSE has explored the differences between the construct of the two caps and, using historical data made available by Ofgem via the Default Tariff Cap consultation process to project how the Default Tariff Cap would have performed, we show how the different methodologies interpret costs over the four cap restriction periods from Summer 2017 to Winter 2018. This analysis reveals important inconsistencies in a number of areas (at TDCV<sup>1</sup>):

- Wholesale costs: while baselined to the same data, there are a number of differences between the methodologies which we believe should be aligned e.g. the interpretation of wholesale costs in the Default Tariff Cap includes a fuller measure of shape costs than the PPM Cap, and includes an allowance for UIG unlike the PPM cap methodology;
- Policy costs: there are significant differences in granularity of application with the caps which produces differing indexation changes year-on-year e.g. the Default Tariff Cap takes a scheme specific approach to Policy Costs and accounts for changes in qualifying demand, which causes the relative levels of policy costs to diverge between the caps;
- Operating costs: different methodologies to assess operating costs across the two caps (i.e. top-down vs. bottom-up); the PPM Cap is baselined on two suppliers who have since shifted their market positioning; the PPM Cap does not include an adjustment for smart, and is baselined to 2015 data as opposed to 2017 data;
- Smart costs: the treatment of smart differs between the caps with the inclusion of a dedicated Smart Metering Net Cost Change model in the Default Tariff Cap. This leads to increasing price divergence over time as smart rollout cost increases are reflected in the Default Tariff Cap but not the PPM Cap.
- Other cost elements: the payment uplift within the Default Tariff Cap as a proportion of the bill varies by consumption, whereas it is a fixed amount in the PPM Cap.

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<sup>1</sup> Ofgem's Typical Domestic Consumption Value for a medium user: 3,100 kWh electricity and 12,000 kWh gas; Economy 7 ;4,200 kWh electricity.



These issues are expanded upon in slides 7-13 of Appendix 1. This demonstrates that the work undertaken to develop Default Tariff Cap methodology offers a number of learnings that could be used to strengthen the PPM Cap methodology by correcting errors and better ensuring costs are reflected accurately.

SSE believes that if the PPM Cap remains in place, the methodology should be aligned to the Default Tariff Cap and that the payment method uplift mechanism in the Default Tariff Cap methodology is extended to include PPM costs. Indeed, failure to improve alignment is likely to lead to significant consumer confusion over time.

### **3.2 There are now two separate price caps methodologies in operation which set prices at different levels for the same payment method**

We believe that the existence of two separate caps protecting a single meter category, and the divergence of those prices, was not the CMA or Ofgem's intended outcome. While we are now at a point in time when the caps are relatively aligned (at least for TDCV), as time goes on we expect that significant divergence will occur. We have illustrated in slides 4 - 5 the price trends of the two caps taking a retrospective view – using historical data made available by Ofgem via the Default Tariff Cap consultation process – on how the Default Tariff Cap would have performed had it been in place at the same time as the PPM Cap.

Our analysis shows how the price levels of the PPM Cap and the Default Tariff Cap track differently over time and that the relationship between them varies at different points in time. For example, a dual fuel Economy 7 PPM customer with Typical Domestic Consumption Values (TDCV) would have paid slightly more than the same customer paying by Direct Debit during Summer 2017 (£7.21 more); however, in Winter 2018 they would have paid significantly less than that same customer paying by Direct Debit (£56.76 less). The same trend is visible in the case of a single fuel electricity customer at TDCV: the PPM customer would have paid more in Summer 2017 but less in Winter 2018. Please refer to slides 4 – 5 of Appendix 1 for the supporting analysis across all applicable tariff types.

Similarly, using the same historical data made available by Ofgem, we have conducted an analysis to track how the relativity of standing charges changes over time at nil consumption. As shown in slide 6, in the case of single fuel gas tariffs the standing charge for a PPM customer is higher than that of a Standard Credit customer in Summer 2017, but lower in Winter 2018.

The divergence of prices across the two caps and the very changeable relationship in how they track in relation to each other creates an unpredictable, inconsistent and extremely difficult landscape around which customers must navigate, budget and make informed



choices. This situation could promote disengagement at a time when customers seek price transparency and stability. Furthermore, it introduces complications for customers seeking to take advantage of the functionality offered by their smart meter to change payment mode to suit their circumstances, as switching from SMETS1 PPM mode to credit mode and *vice versa* would result in a switch of price cap.

Having two separate caps for the same meter group that offer different levels of price protection, but which change over time in terms of which cap offers a higher or lower level of price protection is extremely confusing for customers, and commercially irrational for suppliers. We do not believe that this was the intention of either the CMA or Ofgem and from a policy perspective we do not believe there is any logic to support the continuation of such a position.

### **3.2.1 Potential impact on smart meter rollout**

As the CMA may be aware, low customer appetite for the uptake of smart metering is presenting significant challenges to suppliers seeking to rollout smart meters across their customer base. SSE tracks a survey conducted via the YouGov Utilities Tracker, which investigates the experience, usage, attitudes and future intentions of a representative sample of UK consumers relating to gas and electricity supply and includes questions on smart metering. The most recent wave of YouGov research in October 2018 shows that customers who 'actively don't want one' and are 'not really interested' in getting a smart meter now account for 50% of customers surveyed (up from 27% in October 2016). In contrast, only 23% of customers are 'very' or 'quite' interested in getting a smart meter (down from 37% in October 2016).

Suppliers are also battling with the impact of negative media on customer appetite. The same YouGov Utilities Tracker reports that of those consumers who were not interested in having a smart meter installed, 40% cited 'negative stories on smart meters in the media' as the key rationale for their decision.

We are concerned that in addition to general disinterest in smart and the impact of negative media, the risk of the PPM cap tracking higher than the Default Tariff Cap at any point in time (due to differences in the way costs are interpreted) could create a further barrier to the smart rollout by discouraging the uptake of SMETS2 meters, or worse still, incentivising SMETS2 customers to go back to heritage PPM meters. We believe that this introduces the risk of an additional barrier in an already very challenging environment within which suppliers are trying to achieve smart rollout targets.

We believe that whether the CMA opts to revoke or vary the PPM Order, it is important that prices for PPM customers are aligned to avoid confusion, disengagement, promote





interchangeability across meter types, and avoid creating barriers to the uptake of SMETS2 meters.

**3.3 Changes in the regulatory framework since the PPM Order was introduced would ensure that the objectives of the Order would still be met if the Order was revoked early**

The CMA Order sought to protect the prices of PPM customers on the basis that until PPM SMETS2 meters were available to these customers, they were less able to engage with the market to shop around for competitive tariffs. We consider that two key changes in the regulatory framework since the PPM Order was first introduced would ensure PPM customers continue to receive price protection and benefit from policy developments aimed at improving customer engagement, even in the event of the PPM Order being revoked.

Firstly, Ofgem has been progressing various initiatives aimed at increasing engagement across all customer types. These initiatives are ongoing and include Cheapest Market Offer Letter, Cheapest Market Offer Communication, Collective Switches, and the CMA Disengaged Database. Secondly, the Default Tariff Cap Act has been introduced, which offers price protection to all customers on default tariffs not subject to the PPM Cap. As such, if the PPM Order was revoked PPM customers would then be protected under the Default Tariff Cap and over time benefit from additional measures introduced by Ofgem aimed at increasing engagement in the market.

**3.4 There are ongoing indexation errors with the current PPM Cap methodology that are leading to supplier losses and price convergence**



SSE is among other suppliers who have highlighted concerns with the accuracy of the cap. When consulting on extending the PPM Cap to include more vulnerable customers Ofgem sought views on amending the CMA PPM methodology. Ofgem state – in their summary of





responses document<sup>2</sup> - that “most respondents also highlighted a number of concerns with the accuracy of the existing benchmark. Most respondents, including the vast majority of suppliers, highlighted that it was essential to consider whether the methodology should be at least modified, and ideally recalculated, to ensure it is cost-reflective.”

We believe that the errors within the PPM Cap methodology, the lack of inclusion of smart costs, and the inappropriate indexation, are leading to price convergence at the top end of the cap<sup>3</sup> as suppliers are forced to use the allowable headroom to recover costs or minimise losses.

Table 1 below shows analysis we carried out last year to compare the costs allowed for under the CMA Cap compared to SSE costs in the financial year 2017 -2018, as well as the forecast costs up to the end of the financial year 2018-2019 adopting the same 6-2-12 energy hedging approach.



The negative impact of post-cap price convergence on consumer engagement must be taken into account when considering the scope of the PPM Order review. The research to support the importance of price divergence in driving customer engagement is compelling and was used to inform the CMA’s Energy Market Investigation. The CMA point to research conducted as part of the investigation which explored the attitudes of consumers to switching. This research found that consumers require a minimum saving per annum of £158 (on average) to encourage them to switch. The median saving value was £114 per annum<sup>4</sup>. We note that similar trends were reported in the YouGov Survey (October 2017, Wave 12, YouGov Utilities Tracker), made available by YouGov and subscribed to by Utilities companies.

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<sup>2</sup>[https://www.ofgem.gov.uk/system/files/docs/2018/03/providing\\_financial\\_protection\\_to\\_more\\_vulnerable\\_consumers\\_-\\_summary\\_of\\_consultation\\_responses\\_0.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/03/providing_financial_protection_to_more_vulnerable_consumers_-_summary_of_consultation_responses_0.pdf)

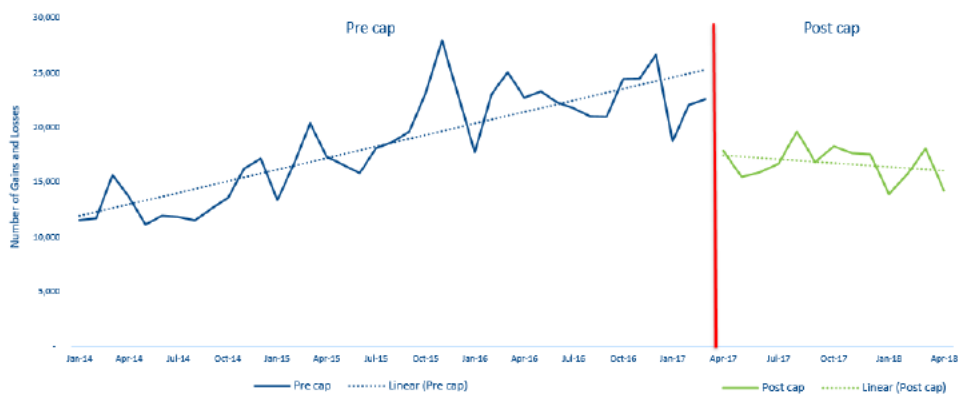
<sup>3</sup> Impact of Safeguard Tariff for PPM prices; Figure 2.13; Ofgem State of the Energy Market, 2017. This clearly illustrates the post-cap price convergence under the PPM Cap

<sup>4</sup> Energy Market Investigation Report for CMA, completed by GfK NOP, Feb 2015, Para 149



We believe there is a risk that the level of the PPM Cap – which is not cost-reflective and is likely to be leading to price convergence around the cap level – is also leading to a reduction in switching activity. SSE has evidence of a marked reduction in switching activity in the PPM market since the introduction of the cap. In Figure 1 below, we have provided data charting the total gains and losses on a quarterly basis of PPM customers since 2014. The total volume of switches among SSE’s PPM customer base in the 12 months to 31<sup>st</sup> March 2018 was 25% lower than in the 12 months to 31<sup>st</sup> March 2017 (the period immediately before implementation of the PPM cap) and 20% lower than in 2015/16. Thus, while there are various factors that might affect switching activity in this segment it is clear to see that there has been a marked decline in switching since the cap was introduced. Looking at the trend of PPM switching activity, we can see that prior to the cap’s introduction it had been on an upward trend, increasing in line with general industry movements, but then drops once the cap is introduced.

**Figure 1: Total PPM gains and losses 2014 - 2017**



We believe there is compelling evidence on the loss-making nature of the cap, post-cap price convergence, and post-cap reduction in switching activity to warrant an examination of the PPM Cap methodology with a view to correcting the errors within it, addressing the current trends in the market, and ensuring suppliers can operate sustainably and compete for customers.