Peter Hill
Energy Prepayment Review
Competition & Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

By email to: Remedies.reviews@cma.gov.uk

Friday, 15 March 2019

Dear Peter

Review of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016 – response to issues statement

Further to our recent call, and previous submissions, Centrica welcomes the opportunity to respond to the issues statement published on 19 February.

Our overall position is as follows:

- As set out in our letters of 18 January and 22 February, there have been fundamental changes of circumstance since the Order was made that necessitate urgent review and revision to the present prepayment meter (PPM) price cap in time for the October cap period.
- As the issues statement notes, smart rollout is behind where it was expected to be at the time of the CMA's Energy Market Investigation (EMI); however, this is by no means the only relevant change of circumstance. The coexistence of the present PPM cap with Ofgem's wider default tariff cap (DTC) was not foreseen when the order was made but creates a substantial risk of unintended adverse consequences for competition and consumers.
- This risk has been clearly recognised by Ofgem in its submission of 18 January to the CMA. Ofgem's submission rightly draws attention to significant divergences between the CMA's PPM cap and Ofgem's wider DTC which cannot be objectively justified by differences between prepayment and credit payment methods, notably in relation to the treatment of wholesale and policy costs. The cumulative effect of these is a substantial shortfall in efficient cost recovery under the present PPM cap, as Centrica has previously advised.
- Divergence and inconsistency between the two caps is even more clearly apparent following recent confirmation of April 2019 cap values, with the headline level of the PPM cap below that of Ofgem's DTC despite the acknowledged higher costs associated with prepayment infrastructure.
- This results in distorted price signals to consumers which work against smart meter rollout; this problem is further compounded by the different way in which the two caps vary with energy consumption, which is confusing for consumers and likely to further inhibit smart meter adoption by PPM customers – contrary to the CMA's original intention.
- In the medium term we believe these inconsistencies can be most appropriately be resolved through a formal transfer of responsibility from the CMA to Ofgem. However,

in the short term the lead times necessary to confirm revised cap values for October by 7 August require the CMA itself to act directly through revisions to the Order.

- This is the course of action recommended by Ofgem, which we support. We set out in the attached appendix concrete proposals to give effect to the changes Ofgem proposes, highlighting material changes since the CMA established the PPM cap, together with further recommendations to address PPM specific issues, ensure that consumer price signals are consistent at all levels of consumption (so lines don't cross) and provide an appropriate allowance for smart meter costs which are not adequately reflected in the current PPM cap.
- The precise way in which smart costs are allowed for in the PPM cap will be for the CMA to determine but we think it should be anchored to the approach taken by Ofgem for the DTC, which provides a materially higher allowance more consistent with the programme's ambition. Suppliers will increasingly look to align their investment in smart with cap allowances in line with 'all reasonable steps' (ARS) licence obligations. There are lead times associated with programme adjustments so the sooner the CMA can provide certainty over future smart allowances for PPM, the better from a smart programme perspective.

We understand that the CMA timetable only allows for single round of consultation on a provisional decision. This is likely to issue in May to allow for a 30-day consultation and consideration of responses in time to confirm final decisions and cap values by 7 August. We further understand that CMA will be relying primarily on views and evidence provided in response to the issues statement to shape its provisional decision with no provision for further formal information gathering ahead of consultation on the provisional decision.

The appendix to this response therefore sets out how we believe the CMA should give practical effect to our recommendation to adopt Ofgem's 'bottom up' methodology and apply it to the circumstances of PPM for the cap period starting in October 2019. In summary, it does the following:

- Details the material changes since the PPM order was set that necessitate a change of approach to take account of more recent analysis and data
- Explains what replacing current PPM methodology with Ofgem DTC methodology means in practice for each cap component – consistent with Ofgem's own recommendation to CMA
- Identifies further adaptations the CMA will need to undertake to apply a bottom up cost methodology to PPM, notably
    - Treatment of smart costs
    - PPM uplift
    - Consistent price signals to consumers (ensuring lines don't cross)

For ease of reference, these proposals are summarised in Table 1 below.

As we have previously noted, while the 'mid-term' review of the PPM Order as originally conceived would have centred on smart meter roll out, this can no longer be the sole focus given wider changes of circumstance outlined above. While smart roll out does not have the same significance for the future of the PPM cap it might have done absent a wider DTC, there have undoubtedly been material changes not foreseen at the time of the order. By way of illustration and evidence to support the review, we enclose two confidential submissions to Ofgem detailing these changes and what they mean for the future:

- An extract from Centrica's response to Ofgem's May 2018 consultation on the proposed DTC;
- Our more recent forecasts submitted to Ofgem pursuant to ARS licence obligations.

I hope you will find these further submissions helpful in shaping the provisional decision for consultation. We should, of course, be very happy to discuss further or provide any clarification you might require so please do not hesitate to contact me if you have any immediate questions.

Yours sincerely

Don Wilson

Retail Market Policy

Table 1: Proposed approach to revised PPM cap components for October 2019 cap

Cap component	Data source	Justification
Wholesale	DTC cap value	The DTC cap is based on more recent data and uses a more sophisticated methodology. These costs apply equally to PPM customers as credit customers.
Policy costs	DTC cap value	The DTC cap is based on more recent data and also takes account of changes in eligible volumes. These costs apply equally to PPM customers as credit customers.
Network costs	DTC cap value	The DTC cap is based on more recent data for settlement year profile data and published loss factors than the PPM cap. These costs apply equally to PPM customers as credit customers.
Opex	DTC cap value	The DTC cap is based on more recent data and utilises a more robust methodology in its calculation. These costs apply equally to PPM customers as credit customers.
Smart meter costs	DTC cap value	There are different options that the CMA could choose, but adopting the DTC value is the most pragmatic. Whatever CMA decides, it will constrain the level of investment suppliers can make in the smart meter rollout.
Prepayment uplift	PPM cap value with PAP and PAAC set to zero in DTC	Existing PPM payment uplift can continue to be used – further supported by Ofgem's use of the estimate in its calculation of opex costs in the DTC. PAP and PAAC can be set to zero. The prepayment uplift should then be applied to standing charge/unit rate so as to ensure that the DTC and PPM caps do not cross.
EBIT and headroom	DTC cap percentages	A pragmatic approach given the use of Ofgem's DTC cap.