Appendix: Updating the PPM cap

1 Much has changed since the CMA designed the PPM cap. These changes mean that there is a need for the CMA to make adjustments to it for implementation in October 2019. Given that the CMA has limited time to undertake this task, we support Ofgem's proposal that the CMA should update the cap, using the DTC cap as the basis for this. Although Ofgem's DTC methodology is not perfect, it reflects more up to date information as well as benefiting from the additional time available to Ofgem to set its cap and the fact it could also learn from the operation of the PPM cap. The difference between these two cap levels (once the payment differential uplifts are removed) shows that a number of costs are now materially understated in the PPM cap, largely for reasons that would not have been known at the time when the CMA originally set the cap.

2 Following our conversation with the CMA on 8th March 2019, we provide additional evidence that we hope will assist the CMA in its review. This covers:

- what has changed since the CMA set the original PPM cap;
- where (and why) Ofgem's DTC cap would provide a better alternative;
- solutions for those areas where Ofgem's DTC cap does not provide an obvious solution; and
- how these can be combined to ensure that the resulting cap does not run the risk of the caps crossing (providing confusing signals to consumers that may further inhibit adoption of smart meters as explained in previous submissions).

3 While the CMA set the cap using a top-down method based on the tariffs of First Utility and Ovo in 2015, Ofgem used a bottom-up methodology, largely using 2017 data. We therefore describe each cost element in Ofgem's methodology and assess whether it should be adopted by the CMA.

Wholesale

4 In determining the wholesale allowance for the Default Tariff Cap (DTC), Ofgem undertook a detailed bottom up assessment of wholesale costs of suppliers. This included explicit consideration of the additional costs of wholesale beyond the direct fuel cost component. Specifically, Ofgem considered:

- shaping costs;
- rehedging day ahead costs;
- imbalance costs;
- transaction costs; and
- unidentified gas.

6. Ofgem also included a specific risk and uncertainty allowance to reflect the inherent volatility and uncertainty of future wholesale prices and customer's energy demand. Ofgem used 2017-18 data to estimate all of the additional allowances and then converted these into percentage uplifts to the direct fuel costs.

7. This more sophisticated approach to cost assessment provides a better basis for estimation of wholesale costs than that undertaken by the CMA. This is because, in the time available, the CMA did not directly calculate wholesale costs for the PPM cap. Instead it derived them

through apportioning its benchmark bill (adjusted for profitability and network charges) based on the average share of "wholesale", "policy" and "other" costs reported in the consolidated segmental statements. We have already provided evidence to the CMA in previous correspondence that this methodology is flawed and risked resulting in the underestimation of the true costs to suppliers as a result of transitory wholesale cost advantages of FU and OVO being hardwired into the PPM cap.[1]

8. The wholesale allowance in the PPM cap is more than £13 lower per dual fuel customer than in the DTC.[2] There is no reason that the costs of purchasing wholesale energy for price capped default tariff customers should be any different from the costs of purchasing wholesale energy for price capped PPM customers. Instead, the difference is driven by the differences in methodology and data used for the base period rather than any true difference in costs to suppliers.

9. While we continue to believe that Ofgem's methodology could itself be improved, we recognise that it provides a better reflection of the true wholesale costs than the current PPM cap. We therefore recommend that it is adopted.

10. In either case, both use the same indexation approach (the 6-2-12 index), which could continue to be used. This shows that Ofgem adopted the CMA's methodology where it proved to be fit for purpose on an ongoing basis.

Policy Costs (including capacity market costs)

11. The CMA's approach for estimating policy costs was conceptually the same as for wholesale costs (a top-down approach), as described above.[3] These baseline costs are then indexed by reference to OBR forecasts of aggregate policy costs. By indexing policy costs based on forecast scheme costs only, the cap implicitly holds supply volumes constant over time. While this may have been a reasonable expectation at the time, it has not been the case in practice. This has led to a failure in the PPM cap tracking the increases in policy costs that suppliers have been facing. We don't believe this was the CMA's intention.

12. By way of example, the RO scheme costs (£) have increased by 58% from 2015/16. However, due to a declining charging base, the £/MWh to suppliers (given by the RO obligation x buyout price) has increased by 84%. While a small (c.4% by 2019/20) part of the difference is explained by the Energy Intensive Industry exemption, the majority of the difference is driven

[1] Letter from Raj Roy to Sarah Cardell 25 January 2018
[2] This has been estimated for the summer 2019 cap period.
[3] In addition, because the benchmark suppliers were growing, this meant that the baseline costs would have beer lower than they would have been for a supplier that faced constant or declining volumes.

by underlying changes in supply volumes. The scale of reduction in volumes was not recognised when the CMA set the PPM cap.

	2015/16	2016/17	2017/18	2018/19	2019/20
RO buyout price (nominal)	£44.33	£44.77	£45.58	£47.22	£48.78
RO (%)	29%	35%	41%	47%	48%
RO (£ / MWh) (nominal)	**£12.86**	**£15.58**	**£18.64**	**£22.10**	**£23.61**
Vs 2015		21%	45%	72%	84%

	2015/16	2016/17	2017/18	2018/19	2019/20
OBR – RO costs	3.9	4.7	5.4	6.1	6.1
Vs 2015		20%	40%	58%	58%

13. As part of the DTC, Ofgem undertook a review of actual policy costs using scheme administration data from 2017. Ofgem directly estimated policy costs for a fully obligated supplier operating in a steady state that was neither gaining or losing customers.

14. To update the policy cost allowance in the DTC cap, Ofgem updates the bottom up calculations each 6 months based on the same scheme data but also accounts for changes in eligible volumes. This means that the allowance reflects the changes to suppliers' costs per customer or per kWh due to reductions in the scope of energy supply over which some of the schemes recover their costs.

15. There is no reason why the policy costs of supplying customers should vary between credit and PPM customers. However, for the summer cap period the DTC policy cost allowance is more than £22 higher than the same allowance in the PPM cap.[4] This differential is likely to increase further in future, absent intervention. The CMA should therefore adopt Ofgem's methodology for policy costs (including the capacity market).

Network costs

16. Even though network charges are treated as essentially pass-through charges in both the PPM and the DTC controls, there are some minor discrepancies between the two that come from Ofgem using more up to date data than the CMA, that make little sense to continue.

- Loss Factors (TNUoS & BSUoS): In the DTC cap, Ofgem applies the published loss factors to profile data from the latest available settlement year, which is currently 2017/18, to get the losses uplift for TNUoS and BSUoS. In contrast for the PPM cap, the loss factors that are being applied are though that were based on 2014/15 settlement year.

[4]The difference in the GB average cap is £22.43 at TDCV for the Summer 2019 cap period. This estimation includes capacity market costs, which Ofgem treats as wholesale costs in the DTC but the CMA treated as policy costs.

- 4pm - 7pm share of demand (TNUoS): Similarly, the DTC cap, Ofgem uses the latest settlement year profile data to get the portion of total units that occur between 4-7pm for TNUoS charges, whilst in the PPM cap these are still based on the 2014/15 settlement year:
    - Default: 17.65% (SR) & 14.01% (E7)
    - PPM: 17.72% (SR) & 14.45% (E7)

17. Rather than to continue these minor discrepancies which do not reflect any differences in the network charges faced by PPM customers, we believe that the CMA should adopt Ofgem's network cost allowance given that it is based on more up to date data.

Operating costs

18. As part of its review, Ofgem gathered evidence on the operational costs of a wide range of market participants from 2017 to come up with its estimate of the efficient opex costs of a supplier. As well as being based on more up to date data than the CMA had available to it, it also encompassed a wider range of market participants.

19. The one area that Ofgem did not seek any up to date information was to assess the payment method uplift. Instead it used the CMA's estimate of this to net off the cost to serve prepayment meter customers before it estimated the opex costs of credit customers. We assume that this was because it felt that costs had not materially changed since the CMA collected its data. Given this link between the two caps, should the CMA wish to revisit the additional costs of prepayment meter customers using more up to date data, Ofgem will need to reflect any change in its calculation of opex costs within the DTC cap.

20. Since both the CMA's and Ofgem's methodologies are seeking to estimate the operating costs of a direct debit customer, in the overall context of setting a consistent cap, use of Ofgem's more up to date analysis would make sense in this context. Given the links to smart meter costs (discussed in the next section) it will also need to be used to maintain consistency if the CMA is to adopt Ofgem's smart meter allowances.

Smart meter costs

21. Sufficient provision for the smart meter rollout is vital, to ensure that the smart programme progresses to conclusion and is not inadvertently slowed down. We have been at the forefront of installing smart meters to prepayment customers. The number of prepayment customers, and the number of those that have a smart meter, are provided in the following Table.

    ✂

22. We have also provided the CMA with additional documentation that provides further detail about the smart meter rollout. This shows quite how much has changed since the CMA originally set the cap. These changes have invariably had an impact on the net costs that suppliers face, and the PPM cap has failed to keep track of them.

23. Assuming that the CMA does include Ofgem's estimate of opex, this will include the 2017 smart meter costs of ScottishPower (since this company set the benchmark lower quartile cost that Ofgem used in the DTC). Based on the approach Ofgem took, it is our understanding that

the smart costs that are included within this baseline will be a blend of both the credit and PPM net smart meter costs of ScottishPower in 2017, and therefore is as relevant to the PPM cap as it is to the DTC cap.

24. To that can be added the calculation of the pass through SMNCC costs that are used in the DTC cap, as these costs are the same for both credit and PPM customers. It is instructive to see how much these costs have grown since the CMA undertook its research, and in a way that could not have reasonably been known at the time and was not reflected in the costs of First Utility, the company on which the smart meter costs were based, nor in the indexation method chosen (CPI). The table below shows the change to the level of DCC costs that were forecast in 2015, compared with what has out-turned, or is now forecast in 2019.

DCC Total Revenue (£m)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
As at 1st April 2015	115	200	182	185	232	261
As at 7th Jan 2019	115	247	292	432	586	663
Difference	**-**	**48**	**110**	**247**	**354**	**401**

25. In addition to the net smart meter costs included in the opex baseline and allowed through in the pass through SMNCC, Ofgem has also calculated the additional net smart meter costs faced by suppliers of credit customers (called non-pass through SMNCC). To date, these have been estimated solely for credit meters. Even though the DTC cap will also cover SMETS2 PPM meters, given the small number of these meters, Ofgem has not yet undertaken the work to understand what the costs associated with these customers will be, nor included any such costs within the DTC cap.

26. By setting this cap, the CMA will be determining the level of the smart meter costs of an efficient operator as they relate to customers covered by this cap. Given the "All Reasonable Steps" (ARS) framework, suppliers will be constrained necessarily by the allowance embedded within the price cap in terms of the scale of activities that can be undertaken.

27. British Gas is fully committed to the rollout of smart meters and we would like the cap to include an allowance to cover these costs for PPM customers as we believe continuing with the rollout is in the best interests of our customers. ✂

28. For this reason, although there are different options that the CMA could take to determine this allowance, we would suggest that as an interim measure, the CMA adopts Ofgem's non-passthrough SMNCC for credit. While we recognise that this may underestimate the benefits associated with smart prepayment meters (which, at least for meter rental costs) may be higher than for credit, it will under-estimate some of the additional costs associated with these meters, particularly the one-off costs that suppliers incur immediately a smart meter is installed (such as the stranding of the old prepayment meter). Given that one-off costs dominate the calculation of non-pass through SMNCC costs for periods where installations are high, this effect may dominate.

29. Ofgem has recently released its timetable for setting the level of SMNCC for the cap periods starting in October 2019 and April 2020. The April 2019 review is intended to be relatively light touch, with a more detailed review ahead of April 2020. A pragmatic solution would therefore be to use the SMNCC allowance that will be set by Ofgem for the DTC in October 2019, and

recommend that Ofgem then includes an assessment of PPM smart meter costs as part of its more detailed review ahead of April 2020.

30. If the CMA is unable to adopt an SMNCC figure that Ofgem will not finalise until August 2019, then an alternative would be to adopt the figure that is already announced for April 2019. However, if this is done, a further adjustment would need to be made to ensure that the DTC and PPM cap lines do not cross (see next section).

The PPM uplift and Opex PAP and PAAC

31. As we have set out in the section on opex above, Ofgem chose to adopt the CMA's PPM uplift when it calculated the opex costs that are included within the DTC. Continuing with the PPM uplift that the CMA is currently using will avoid Ofgem needing to revisit the estimation of opex it is using within the DTC control.

32. In setting the DTC cap, Ofgem chose to socialise some of the additional costs associated with cash cheque customers across direct debit customers. The cap therefore includes two allowances (known as Opex PAP and Opex PAAC) that recover these costs. These costs relate to:

    - Additional working capital
    - Additional bad debt costs
    - Additional administrative costs:
        - bill printing
        - additional call propensity
        - administration costs of debt collection.

33. Since the additional costs of serving standard credit customers are designed to be fully recovered from standard credit and direct debit customers, there is no need for such socialisation to be included in any PPM cap. This means that PAP and PAAC should be set to zero for PPM customers.

34. However, PAP and PAAC do affect the slope of the DTC cap line (as PAP applies to the unit rate and PAAC applies to the standing charge). As we have said in previous correspondence, we believe that it is important that the DTC and the PPM caps do not cross. For this reason, we would propose that the structure of the PPM uplift is amended to mirror exactly the overall structure of the DTC cap.

35. The PPM uplift in the PPM cap is currently all included in the standing charge. This is reflective of the types of additional costs that suppliers face to serve PPM customers, much of which relates to meter rentals. However, for other reasons we would recommend that the CMA adopts a pragmatic approach and instead of having all the PPM uplift on the standing charge, adapts the structure to match that generated by the PAAC and PAP in the direct debit DTC. In the event that the CMA does not adopt the October 2019 SMNCC non-pass through cost for credit customers, a further adjustment may be required to reflect the impact this will also have on the slope of the DTC. The important point is that the application of the PPM payment uplift is made in such a way that the two caps remain parallel (rather than risk crossing).

36. We accept that this would be a move away from cost reflectivity. However, we believe this is important for the smart meter roll out to PPM customers such that the PPM cap (which applies to traditional meter PPM customers and SMETS1 PPM customers) and the DD DTC (which

applies to fully interoperable PPM smart meter customers) maintain a positive differential for all levels of consumption.

37. This addresses a key problem that is created by the current two cap structure.

EBIT and headroom

38. Ofgem has adopted the CMA's assumptions on EBIT, using the level of 1.9% to reflect that it doesn't assume intermediary trading arrangements. It then chose to apply a much lower level of headroom than the CMA used in the PPM cap.

39. While we continue to consider that there are flaws in the way that EBIT was calculated, and consider that Ofgem's approach to providing headroom is wholly inadequate, we can see that the pragmatic approach for the CMA is to adopt Ofgem's proposals to stay in line with the DTC cap.