SCOTTISHPOWER

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Energy Prepayment Review
Competition and Markets Authority
Victoria House (6th Floor South East)
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15 March 2019

Dear Team,

Issues Statement – Review of Energy Market Investigation (Prepayment Charge Restriction) Order 2016

Thank you for the opportunity to comment on the main issues the CMA expects to consider as part of this review and in reaching its conclusions.

We believe that the changes in circumstances identified by the CMA (smart meter rollout delays and introduction of the default tariff cap) are such as to necessitate a review or revocation of the Order.

In particular, the misalignment between the Prepayment Cap and Default Tariff Cap (DTC) is distorting price signals and risks causing customer confusion. We believe the most appropriate outcome from the review would be for the CMA to revoke the PPM price cap order, with prepayment customers being protected instead by Ofgem's DTC.

Given the risk of further divergence between the levels of the two price caps, we believe prompt action is essential and we would encourage the CMA to conclude its review by 7 August, in time to align the caps in October 2019.

We provide our views in Annex 1 on matters related to the two overarching factors in the Issues Statement - *Rollout of smart meters* and *GEMA's charge restriction on default tariffs* – and suggest a way forward for a handover from the CMA to Ofgem.

Please do not hesitate to contact me or James Soundraraju (tel
) if you have any questions arising from this response.

Yours sincerely,

Richard Sweet
Head of Regulatory Policy

Annex 1

ISSUES STATEMENT – REVIEW OF ENERGY MARKET INVESTIGATION (PREPAYMENT CHARGE RESTRICTION) ORDER 2016 – SCOTTISHPOWER COMMENTS

1. Introduction

Our comments on the Issues Statement are organised as follows:

- rollout of smart meters
- level of the Prepayment Price Cap
- misalignment of the Prepayment and Default Tariff Caps
- the DD-Prepayment differential
- suggested way forward.

2. Rollout of smart meters

We broadly agree with the findings of the NAO's report on its investigation of smart meter rollout,[1] including its conclusion that there is no realistic prospect of installing smart meters in all eligible premises covered by the rollout obligation by 2020. As the NAO notes, the schedule for the programme set in 2011 and 2014 has proven over-optimistic.[2] The pace of rollout has been slower than anticipated because of significant challenges, including weaker than expected consumer demand, difficulties in implementing dual band communication hubs and Alternate Home Area Networks, and delays to the DCC.

Rollout to date has clearly fallen short of the widespread adoption of smart meters that the CMA believed would eliminate the adverse effect on competition (AEC) impacting the prepayment segment, and does not therefore provide grounds, in terms of the CMA's AEC, for revoking the Prepayment Cap early.

We note that the NAO report does not distinguish in its findings on the rollout of smart meters between credit and prepayment meters. Given the limited information in the public domain on the replacement of traditional PPMs with smart meters, and the importance of this information to the review, we encourage the CMA to obtain more evidence on the rollout of smart meters to PPM customers.

3. Level of the prepayment price cap

We recognise that the CMA designed the PPM cap with the purpose of protecting the prepayment meter segment from an AEC. The Domestic Gas and Electricity (Tariff Cap) Act has now imposed the DTC on all standard variable and default tariffs with effect from 1 January 2019. This is a change of circumstance that could not have been envisaged at the time of the CMA's Final Report in 2016.

Ofgem's use of a bottom-up approach to set the benchmark in the DTC consisted of calculating the cost elements separately using supplier and industry data from 2017. It also adopts a scheme-specific view of policy costs, allows for pass through of smart related costs

[1] https://www.nao.org.uk/report/rolling-out-smart-meters/
[2] Figure 8, Part 1 NAO Report

outside the control of suppliers, includes an annual adjustment for smart meter rollout costs and takes a broad assessment of wholesale costs which accounts for shaping.

This approach is in contrast to the CMA's methodology for the PPM cap which uses a price reference approach to set the benchmark, is based on 2015 data and uses segmental statements to establish the relative proportion of cost elements in the cap.

Ofgem's decision to use a bottom-up methodology references[3] the rationale it outlined in its statutory consultation[4] which notes that, "Having considered the merits of the different approaches and stakeholder responses to our consultation, we propose to use a bottom-up assessment of costs as our primary method of estimating what would be an efficient level of costs associated with supplying a customer with typical consumption".

The more recent price cap methodology developed by Ofgem suggests that the CMA Prepayment Cap has failed to keep pace with increasing costs and is now at a level which is significantly too low, relative to the CMA's original objectives in setting the cap. This is consistent with the observed price convergence around the level of the cap[5] as suppliers are forced to use up headroom in the cap (intended to allow competition) to recover costs. As a result, there is limited scope for suppliers to price prepayment products below the level of the cap to encourage engagement by prepayment customers.

The effect of the Prepayment Cap being too low would be expected to be most pronounced for suppliers with a high proportion of prepayment customers. In this context we note that Our Power ceased trading in January 2019 and Utilita has warned that, 'it has made significant sacrifices in its' business in order to accommodate the damaging impact of the three cap periods so far, but this cannot continue' and 'if the PPM Cap is not reviewed as a matter of urgency, there are likely to be further supplier exits'.[6]

4. Misalignment of the Prepayment and Default Tariff Caps

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

[3] Ofgem (2018), Default Tariff Cap: Decision Appendix 1 – Benchmark methodology, paragraph 3.7 https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_1_-_benchmark_methodology.pdf
[4] Ofgem (2018), Default Tariff Cap: Statutory Consultation. Appendix 1, paragraph 2.16. https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_1_-_benchmark_methodology.pdf
[5] Ofgem State of the Market Report 2017, Figure 2.13
[6] Utilita response to the Invitation to Comment on CMA's review of the PPM Charge Restriction Order: https://assets.publishing.service.gov.uk/media/5c6be03040f0b61a16070819/190118_Utilita_Response_to_ITC_Redacted.pdf

Table 1: Comparison of Dual Fuel Prepayment Cap and DTC in the current and previous charge restriction periods

	Oct 18 - Mar 19				Apr 19 - Sep 19			
Components	**PPM**	**DTC**		**DD vs PPM**	**PPM**	**DTC**		**DD vs PPM**
		DD	**SC**			**DD**	**SC**	
Wholesale costs	£421	£447	£447	£26	£493	£521	521	£28
Network costs	£257	£258	£258	£1	£271	£270	270	-£1
Policy costs	£134	£137	£137	£3	£144	£151	151	£7
Indirect costs (inc EBIT)	£172			£46	£174			£52
Operating costs		£198	£198			£204	204	
EBIT		£20	£20			£22	24	
Payment method uplift	£67	£12	£95	-£55	£67	£12	95	-£55
VAT 5%	£54	£54	£54	£0	£59	£60	£64	£1
Headroom allowance	£31	£12	£12	-£19	£34	£13	15	-£21
Level of the cap	**£1,136**	**£1,138**	**£1,221**	£2	**£1,242**	**£1,254**	**£1,344**	£12

Source: ScottishPower analysis of CMA and Ofgem price cap data

If the Prepayment and DTC are to co-exist in the interim, it is detrimental to have allowances for the same price cap components in Prepayment Cap lower than in the DTC, with those gaps expected to increase over time[7]. This divergence between the caps risks causing consumer confusion and creating unhelpful distortions to incentives.

Confusing price signals

A comparison of the maximum charges under the Prepayment Cap and DTC at three consumption levels (Nil, TDCV Medium and TDCV High) is shown in Table 2 below.

Table 2: Comparison of Prepayment cap and DTC at different consumption levels[8] for April – September 2019 period

Prepayment

	Nil	Medium	High
Electricity (single rate)	£116	£635	£887
Gas	£105	£607	£816
Dual Fuel	£221	£1,242	£1,702

DTC DD

	Nil	Medium	High
Electricity (single rate)	£85	£661	£939
Gas	£97	£593	£800
Dual Fuel	£182	£1,254	£1,740

Difference between DTC DD and Prepayment

	Nil	Medium	High
Electricity (single rate)	-£30	£26	£53
Gas	-£9	-£14	-£16
Dual Fuel	-£39	£12	£37

The scale of the difference between the Prepayment Cap and the DTC for DD customers is currently relatively small (£12 for DF at TDCV Medium), but it has increased since the previous price cap period. However, the difference is greater for customers at different consumption levels (eg it is £37 for DF at High consumption) and for individual fuels (where

[7] For instance, the PPM cap does not include an adjustment for smart meter costs whereas the DTC includes SMNCC which is measured against a 2017 baseline and increases year-on-year.
[8] TDCV medium: E:3,100 kWh; G:12,000 kWh; TDCV High E:4,600 kWh; G:17,000kWh

the Prepayment Cap is lower in electricity but higher in gas when compared with the DTC). These differences, which are not cost-reflective are likely to send confusing price signals to consumers, particularly those with high or low consumption, or purchasing a single fuel.

Ofgem's response to the CMA's call for evidence argued that aligning the two methodologies should reduce customer confusion around the two cap levels. We support these views and agree with the risk Ofgem is highlighting around the coexistence of the two misaligned caps.

5. The DD-Prepayment differential

In its Final Report the CMA concluded that an appropriate point estimate for the additional cost of serving prepayment customers at typical consumption relative to Direct Debit in 2015 was £63 (£24 for Electricity + £39 for Gas). The uplift is indexed by CPI and is currently £67. Table 3 shows how the CMA estimate breaks down between different cost elements.

Table 3: Breakdown of CMA prepayment uplift in 2015

	Prepayment cost uplift relative to DD (in 2015) (£ per customer per year)		
Metering	**E**	**G**	**DF**
Rentals	9.03	18.53	27.56
Maintenance	3.36	3.17	6.52
Installation	1.08	1.11	2.20
Removal	0.73	0.82	1.55
Reading	0.00	0.00	0.00
	14.20	**23.63**	**37.83**
Cost to pay			
Paypoint / Payzone charges	4.98	6.04	11.02
Itron & Siemens charges	3.66	5.56	9.22
	8.64	**11.6**	**20.24**
Other servicing costs			
Bad debt	-0.95	-1.06	-2.01
Call centre	2.26	4.99	7.25
Other costs	-0.15	-0.16	-0.31
	1.16	**3.77**	**4.93**
Total	**24.00**	**39.00**	**63.00**

We believe the current value of the uplift would remain broadly appropriate as an uplift to the DTC DD cap level for the October 2019-March 2020 price cap period, despite increased penetration of smart prepayment meters, for the following reasons:

- Ofgem's methodology for setting the DTC included an adjustment whereby it subtracted an estimate of the additional costs of prepayment customers from the operating costs of suppliers based on the CMA's prepayment uplift.[9]. On that basis, any changes in the cost uplift between 2015 (when the CMA estimated it) and 2017 (the base year for Ofgem's calculations) would already be implicitly adjusted for.

- A significant proportion of the cost uplift relates to payment infrastructure costs, which do not scale with numbers of traditional smart meters; indeed, while smart prepayment customers still wish to have the option of paying by cash, there is a continuing need for the Paypoint/Payzone charges.

[9] Default Tariff Cap – Statutory Consultation; Appendix 6 – Operating costs

- Although the metering cost element would be expected to reduce with increased penetration of smart prepayment meters, some of this reduction (between 2015 and 2017) will already have been captured by Ofgem's adjustment (see above). Furthermore, to be consistent with Ofgem's methodology, any subsequent reduction since 2017 would need to be estimated on the basis of smart prepayment meter penetration amongst typical larger suppliers (ie excluding penetration for smaller specialist prepayment suppliers).

6. Suggested way forward

Given the risk of further divergence between the levels of caps, we believe prompt action is essential and we would encourage the CMA to conclude its review by 7 August, in time to align the cap methodologies in October 2019. We would note that the risk of any price increase for prepayment customers resulting from the realignment would be mitigated if (as is currently expected) the allowance for wholesale costs is reduced in the October price cap.

We think it would make sense for the Order to be revoked so that Ofgem takes ownership of the Prepayment Cap from the CMA. Ideally, the handover from the CMA to Ofgem should take place in time for the next charge restriction period commencing in October 2019. This would call for close coordination between the CMA and Ofgem so that Ofgem is ready with an appropriate PPM uplift by 7 August 2019. Failing that, we suggest the Order be revoked in time for Ofgem to take over with effect from April 2020.

If the CMA and Ofgem conclude there is insufficient time for a handover in October, we believe the CMA should review the Order so as to align the Prepayment and DTC price cap methodologies for the October period. The alignment of the methodologies could be approached in two ways. The CMA could adjust individual components of the prepayment cost stack where they clearly diverge with the DTC or it could adopt Ofgem's cost stack in its entirety and apply the existing prepayment uplift on top of that. We believe the latter approach is preferable as it is more transparent and would ensure that the caps were aligned for individual fuels and for different consumption levels, removing the anomalies highlighted in Table 2 above.

For the reasons set out above, we believe the current prepayment cost uplift is likely to remain broadly appropriate, at least for an interim 6 month period, and the CMA could simply add this to the DD price cap calculated by Ofgem (minus the allowance for socialisation of bad debt costs). If Ofgem were to take on responsibility for the cap for the period starting April 2020, it would have time to conduct any additional information gathering and consultation required to refine and update the value of the uplift.

ScottishPower
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