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

Executive Summary

1. In its Energy Market Investigation ("**Investigation**"), the Competition & Markets Authority ("**CMA**") considered that a cap on prepayment ("**PPM**") prices was necessary to provide immediate assistance for PPM customers, as it would take until the end of 2020 for some of the other remedies it had proposed to become effective.

2. Many of those remedies are now operational. Other solutions are expected to deliver during 2019, and there are commercial solutions that we also anticipate will significantly improve consumer engagement in the near future, including in the PPM market, so that Ofgem will be able to recommend to the Secretary of State that there is no need for the default tariff cap to continue beyond the end of 2020. These solutions include:

    - Ofgem's disengaged database;
    - engagement prompts such as the cheaper market offer letters being trialled by Ofgem;
    - other Ofgem consumer engagement trials, such as collective switching for consumers who have been on a supplier's standard variable for three years or more; this has resulted in switching rates for some collective programmes of 15-20%;
    - delivery of midata in energy, an open data standard that will allow consumers to authorise their energy supplier(s) to share a consistent set of data with third parties to make switching easier and ensure quotes are more reliable;
    - further development of auto-switching facilities, whereby a third party contracts with energy consumers to automatically switch them to the cheapest tariff for them.

3. There are two remedies that are not likely to deliver results by the end of 2020: substantial completion of the smart rollout programme and mandatory half-hour settlement – although it is not clear what the CMA means by 'substantial'. The latter has been delayed until 2023 and, as the CMA has noted, the former is not likely to meet its expected deadline.

4. Delivery of half hourly settlement is linked closely to the smart rollout; more granular settlements requires more granular data. A critical mass of smart meters will be needed to realise the full benefits. Ofgem is due to make its final decision on market-wide half hourly settlement in the second half of 2019. It will then take some time to deliver due to the complexity and extent of change required. We do not see half hourly settlement, however, as particularly significant in terms of delivering improved competition, and it is unlikely to deliver innovation beyond what will already be possible via smart meters.

5. We accept that, at the current time, relatively few smart PPM meters have been installed and most of these are first generation meters ("**SMETS1**"). This is due to a number of reasons which we will explain later in our response, but includes late delivery of the infrastructure to enable smart metering, a number of technical issues still to be resolved and consumer resistance;

research carried out by Smart Energy GB ("**SEGB**") shows that around 30% of consumers will decline a smart meter when offered.

6. As part of this review, the CMA needs to consider the unintended consequences of the PPM cap; in particular, it has resulted in a reduction in switching levels, a decline in the number of fixed term tariffs in the PPM market and inhibitions on innovation:

    - the pricing differential between the cheapest and most expensive PPM tariffs on the market is insufficient to drive most consumers to switch; E.ON's analysis of its own losses shows that switching tails off where savings are less than £75 per year. Other consumer research indicates that customers need to save £100 or more before they will consider changing their tariff. Until recently, where we have seen a sustained downward movement in wholesale prices, the differential between PPM prices and the level of cap level was not significantly greater than £75.

    - the nature of the cap, where prices are likely to change every six months, makes offering fixed term tariffs unattractive. Suppliers are generally able to offer cheaper prices for fixed term tariffs due to greater certainty that a customer will remain with them for a particular period of time. Ofgem rules around fixed term tariffs make offering them problematic for suppliers and potentially could result in them making a loss; further information on this is provided below;

    - standard time of use prices under the cap are based on Economy 7 tariffs, and were based on prices offered by First Utility and Ovo during the benchmark period which were not cost reflective, and hence resulted in a cap level that does not include a number of obligation costs. Suppliers must make an application to Ofgem for each charge restriction period if they wish to use alternative consumption splits, which is both onerous and uncertain. The cap therefore also discourages suppliers from offering time of use tariffs.

7. Until the cap is removed, these restrictions will continue to have a significant impact in the PPM market, restricting the ability of consumers to capitalise on some of the expected benefits of smart metering and suppressing switching rates.

8. The price caps have also reduced the ability of suppliers to innovate, not only due to the nature of the cap but also because the level it is set at is insufficient to allow an efficient supplier to make a reasonable profit, let alone finance research and development of new ideas.

9. It took years to develop a level of switching in the energy industry that well exceeds the level of switching seen in other industries, such as banking, insurance and broadband. The introduction of caps has been a retrograde step, providing consumers who are unable or disinclined to engage in competition a false sense that PPM and default tariffs offer them the best deal they can get, whereas in fact cheaper prices are available in the fixed term market. The caps also deny larger suppliers the ability to make a reasonable profit and thus reduce investment capability, stifling innovation. The sooner the cap is removed, the quicker competition can deliver on innovative tariffs to encourage switching and provide an incentive for consumers to take up the offer of a smart meter.

10. Of course, PPM customers should not receive less support than those on default tariffs; PPM customers are, on average, more likely to be vulnerable than other customer groups and therefore may find it more difficult to engage in the energy market. Our proposal, therefore, is that the PPM cap should be combined with the default tariff cap:

    - it should use the same methodology;
    - it should only apply to PPM customers on default tariffs;
    - it should end along with the default tariff cap at the end of 2020, unless the Secretary of State publishes a statement to extend it in accordance with Section 8 of the Domestic Gas and Electricity (Tariff Cap) Act 2018.

11. It is our opinion that the default tariff cap similarly has significant unintended consequences, and we shall raise these with Ofgem at the appropriate time to justify a recommendation to the Secretary of State that both caps should cease to have effect at the end of 2020.

Domestic Weak Customer Response adverse effects on competition – progress

12. The CMA identified a number of features giving rise to a Domestic Weak Customer Response adverse effect on competition ("**AEC**"), and we discuss some of these below.

Decline in switching in the PPM market

13. Switching trends in the wider domestic market had been on an upward trend over a number of years even prior to introduction of the PPM cap[1]; the CMA acknowledged this in its final report: *"There has been a rapid expansion in the market shares of suppliers outside of the Six Large Energy Firms, from less than 1% at the beginning of the period [Q2 2011] to 13% in gas and electricity in the first quarter of 2016."*[2]. This share is now 27%. In 2015, the domestic switching rate averaged 11%[3]; by June 2018, rolling annual household switching rates reached 18.4%[4].

14. These switching rates compare very favourably with other industries. For example, Ofcom reports that between 7 and 12 months prior to 30 September 2019, 6% of consumers switched broadband provider[5]. In the year to 30 June 2018, 6% of consumers switched bank[6].

15. It should also be acknowledged that there are a significant number of customers who switch tariff but remain with the same supplier; around a third of customers supplied by the largest six suppliers actively switch tariff each year[7].

[1] Ofgem Retail Market Indicators, https://www.ofgem.gov.uk/data-portal/retail-market-indicators
[2] Energy Market Investigation Final Report, Competition and Markets Authority, 24 June 2016, para 8.154
[3] Retail Energy Markets in 2016, Ofgem, 3 August 2016, page 2
[4] State of the energy market report 2018, Ofgem, 11 October 2018, page 4
[5] https://www.ofcom.org.uk/__data/assets/pdf_file/0014/125024/switching-tracker-2018-data-tables.pdf, Table 114
[6] What would it take for you to switch bank? Financial Times online, 27 July 2018 https://www.ft.com/content/02ca58c6-917f-11e8-bb8f-a6a2f7bca546
[7] Providing for a transition back to a competitive retail energy market: A response to the CMA's Invitation to comment on its proposed view of the Prepayment Charges Restriction Order 2016, Stephen Littlechild, 17 January 2019, section 7

16. As we stated in our response to the CMA's decision to launch a review of the PPM cap[8], competition levels as measured by the Herfindahl-Hirschman Index ("**HHI**") demonstrate the significant improvement in overall switching rates.

Year	HHI gas (approximate)	HHI electricity (approximate)
2011	2,450	1,800
2015	1,900	1,450*
2018	1,250	1,000

**EMI Final Report suggest this value is for 2016*

Sources: Energy Market Investigation Final Report, Competition & Markets Authority, 24 June 2016; State of the Market Report 2018, Ofgem; Providing for a transition back to a competitive retail energy market: A response to the CMA's Invitation to Comment on its proposed review of the Prepayment Charges Restriction Order 2016, Stephen Littlechild, 17 January 2019

17. The fact that the CMA concluded, in its recent appraisal of the proposed SSE-npower merger[9], that *"the proposed Merger may not be expected to result in a substantial lessening of competition"*, despite the fact that the merged company would be the second-largest domestic supplier with an initial share of about 19% of the gas market and 23% of the electricity market, suggests that the CMA agrees that the domestic retail market is very competitive and that concentration is no longer a problem.

18. Unfortunately, the introduction of the PPM cap in 2017 reversed some of the hard-won positive trends in switching in the PPM market, as the evidence shows that switching away from the largest suppliers has slowed down[10]. In our opinion, competition in the PPM market would have been even worse had non-obligated suppliers not aggressively marketed their tariffs and offered unsustainable prices to help them achieve economies of scale.

19. There are two factors we believe have led to lower switching in the PPM market. Firstly, the fact that prices are capped has, we believe, led to a complacency amongst PPM consumers who may now believe that, because they are getting a capped price from their existing supplier, there is little to be gained from making the effort to switch.

20. Secondly, and in support of the first point, prices for PPM tariffs from larger, obligated suppliers[11] have generally clustered around the level of the cap; only smaller, non-obligated suppliers can afford to offer lower prices, and trust in these suppliers, who do not have household names, is lower than for more established suppliers[12]. Indeed, the recent spate of market exits (12 in 2018, a further three in the first two months of 2019) may have served to increase this distrust.

[8] Decision to launch a review of the Energy Market Investigation (Prepayment Charges Restriction) Order 2016, E.ON response

[9] SSE Retail and Npower: The anticipated merger between the retail energy business of SSE plc and Npower Group Limited, Competition & Markets Authority, 10 October 2018

[10] Ibid., page 34

[11] Suppliers who are obligated under certain social and environmental schemes to provide assistance to vulnerable consumers due to having reached a certain level of customers.

[12] State of the energy market report 2018, Ofgem, page 22

21. Many studies have been undertaken on the level of savings consumers need to make to encourage them to switch supplier; analysis undertaken by GfK in 2015[13] reported that, of those who knew it was possible to change supplier or were not sure, the average saving they considered was necessary to encourage them to switch was £158; the mean was £114. Only 18% said they would switch for less than £100. Our own analysis of 250,000 losses experienced in 2015 indicated that switching tailed off considerably below £75. As at 17 January 2019, the differential between the cheaper PPM price and the level of the PPM cap was £77. The gap is now wider as a result of the sustained downward movement in wholesale prices; some suppliers are able to react more quickly to such changes depending on their hedging strategy.

22. Even though switching levels in the energy market grew to 18.4% in 2018 (before the implementation of the default tariff cap), we acknowledge there is no need for complacency. However, there is already considerable support for consumers to engage in the energy market, and more support will become available over the next year or so:

    - price comparison websites ("**PCW**") offer easy tariff comparison, and the Midata programme, which will allow sharing of accurate consumer data between accredited parties, will make it even easier for consumers to get an accurate quote;
    - some PCWs also offer a telephone switching service;
    - PCWs and other third parties are providing auto-switching apps, where a consumer can contract with a third party to do all the comparison and switching work for them;
    - collective switches have been popular and successful for a number of years, and Ofgem has also been carrying out some of its own collective switching trials with disengaged consumers;
    - other trials being carried out by Ofgem include a disengaged customer database to help engage consumers who have not switched for three years or more, and communications offering cheaper tariffs and inviting consumers to switch (such as the Cheaper Market Offer Letter trial[14]).

23. In the PPM market, however, innovation has stagnated somewhat. Since the introduction of the PPM cap there has been a decline in the number of fixed term tariffs offered: in December 2017, 32% of PPM tariffs were fixed; by February 2019 this had declined to 14%. At E.ON, we had been offering all of our fixed term tariffs to smart PPM customers; with the introduction of the PPM cap this was no longer commercially viable, as the cap applies to all PPM customers, even if they have chosen a fixed term tariff. As a result, we would have had to reduce fixed term prices mid-contract but been unable to increase them had the level of the cap increased under supply licence rules. We believe that removal of the PPM cap will allow suppliers to create new and innovative tariffs for this group of customers.

Homogenous nature of gas and electricity

[13] Energy Market Investigation, a report for the Competition and Markets Authority by GfK NOP, February 2015 https://assets.publishing.service.gov.uk/media/54e75c53ed915d0cf700000d/CMA_customer_survey_-_energy_investigation_-_GfK_Report.pdf

[14] https://www.ofgem.gov.uk/publications-and-updates/qualitative-findings-cheaper-market-offers-letter-trial

24. The CMA considered that gas and electricity are homogenous products and therefore reliant almost entirely on price for competition. We have always disagreed with this; there are a number of innovative ways energy is being or has been packaged:

    - green energy tariffs;
    - bundling energy with other items such as smart thermostats, boiler servicing or cinema tickets;
    - tariffs that track the wholesale energy market;
    - fixed bill tariffs, so customers pay exactly the same amount in each month of their tariff term even where they consume more than anticipated at the start of the tariff (this is different to payment by fixed monthly Direct Debit, where changes in consumption can result in variations in monthly bills);
    - tariffs that offer cheaper energy at off-peak times;
    - longer term fixed tariffs, up to five years;
    - tariffs that offer 'free days';
    - tariffs that offer customers with storage heating energy at 0p per kWh at night.

25. In addition, some consumers select their tariff on the reputation of a supplier or online reviews of customer service. Therefore; we disagree with the CMA's conclusion of homogeneity; factors other than price also have a significant role to play in consumer choice.

Lack of confidence in/access to price comparison websites

26. The CMA required that Ofgem should remove certain simpler choices including the four-tariff rule introduced as part of Ofgem's Retail Market Review. It also required removal of the 'whole of the market' requirement from the Confidence Code to promote competition between price comparison websites ("**PCW**").

27. PCWs can therefore display as a default a smaller range of tariffs (those from suppliers with whom the PCW has a contractual relationship), which may be less daunting for consumers and encourage them to engage. For those tariffs, the PCW is likely to be able to offer to undertake the switch on behalf of the customer, instead of the customer having to apply through the relevant supplier's website, which allows for a simpler switching experience.

28. The changes Ofgem has made have also allowed suppliers to offer a wider range of tariffs, including exclusive tariffs with PCWs, giving consumers greater choice, although of course, as we explain elsewhere, the PPM cap has actually resulted in a significant decline in number of fixed tariffs in this part of the market. In addition, collective switch schemes have continued to flourish; consumers who do not feel confident to engage in the energy market alone have confidence in doing so with others via a trusted third party.

Access to ECOES and SCOGES databases for PCWs

29. The CMA recommended that Gemserve and Xoserve provide access to PCWs to their databases, ECOES and SCOGES which maintain a record of the energy supplier relevant to each meter. These

databases are already used by suppliers and it was considered that if they were used by PCWs, the level of erroneous transfers would be significantly reduced.

30. Whilst PCWs can now request access to ECOES and SCOGES, the brief enquiries we have made suggests that few have done so to date. One PCW that is making use of ECOES reported that it had not had a significant impact on erroneous transfers; customers appeared to be changing the pre-selection away from the industry data rather than using the addresses as provided in industry data. The same PCW reported that it had had contractual difficulties in respect of the gas databases and had therefore halted the process.

Prepayment adverse effects on competition – progress

31. The CMA also identified a number of features giving rise to a prepayment AEC. Progress made on some of these is reviewed below.

Technical constraints

32. This issue related to the limited number of tariff pages available for classic PPM meters and the consequent restriction on the number of different price configurations that can be offered by a supplier to its PPM customers. The tariff pages available are now shared more equally between suppliers; consequently, many smaller suppliers are now able to offer PPM to their customers.

33. The CMA recommended that Ofgem make other changes to the supply licence, specifically to allow suppliers to set prices to for prepayment customers with no obligation to apply the regional cost variations applied to other payment methods with the same core tariff, in order that better use could be made of tariff pages. Ofgem made this change after consultation; it was effective from 28 November 2016[15].

Debt Assignment Protocol

34. The CMA also recommended that Ofgem undertake a number of changes to its Debt Assignment Protocol ("**DAP**"). Ofgem confirmed in February 2017[16] the actions it had taken in this respect.

Speed and scale of smart meter roll-out

Delays in delivery

35. As noted by the National Audit Office[17], in the early days of rollout of smart meters there was no common standard specification, meaning that in most cases, if a customer switched supplier they lost smart functionality. To ensure that meters could be interoperable between energy suppliers the government set minimum standards, with the intention that all smart meters should be connected to a central data and communications infrastructure, known now as the Data Communications Company ("**DCC**"). In 2012, the government encouraged suppliers to accelerate the rollout before the new infrastructure was built and therefore before final specifications for

[15] Modification of electricity and gas supply licences to remove certain RMR Simpler Tariff Choices rules, Ofgem open letter, 29 September 2016
[16] Debt Assignment Protocol: Remedy Implementation, Ofgem open letter, 20 February 2017
[17] Rolling out smart meters, National Audit Office, 23 November 2018

smart meters was settled. It also obligated suppliers to take all reasonable steps to install smart meters in all homes in Great Britain by 2019; a year later, this was pushed back to 2020.

36. The meters available for installation in 2012 were the first generation of the Smart Metering Equipment Technical Specifications ("**SMETS1**"); energy suppliers had to commission individual communications structures, with the intention that they would later be enrolled into the DCC or replaced with a second generation meter. The expectation was that a relatively small number of SMETS1 meters would be installed, as the second generation ("**SMETS2**") was expected to be available in June 2014. In fact, technical constraints meant that the first SMETS2 meter was not installed until July 2017. SMETS1 meters must therefore be upgraded to a DCC-compliant version of firmware or a further meter switch must be arranged with the customer to upgrade it to SMETS2.

37. There are still significant issues with smart meters for particular scenarios: SMETS2 PPM meters are not expected to be available until the end of March 2019; there are issues with connecting in-home displays ("**IHD**"), with improvements expected in spring 2019; however, solutions are still being developed for some types of property (the NAO estimates this at 3.5%-5%[18]; E.ON's own estimate is that around 8% of properties will still not have a technical solution by the end of 2020); issues have been experienced with integrating meters into the DCC in the North of England and Scotland, due to lower than expected WAN coverage and some SMETS2 meters not meeting floor noise specifications.

38. To date, the focus has been on ensuring that SMETS2 meters can satisfactorily operate in credit mode, and development of asset variants and firmware has been delayed as a result. This includes to delays to delivering PPM solutions. This issue also results in delays to training of meter technicians.

39. At E.ON, we have experienced other issues which are delaying progress in installing SMETS2 meters. We had originally assumed that installations times for SMETS2 would be similar to those for SMETS1; in fact, SMETS2 meters are taking 10% longer. We are looking into ways of improving this.

40. We have also had issues with lack of space where we have to install a separate comms hub alongside a SMETS2 meter. This can give rise to a need for alterations or damage to consumers' properties and may result in the consumer rejecting the installation.

41. It is anticipated that a significant number of premises will still have classic meters by the end of 2020, for the following reasons:

    - research carried out by SEGB shows that around 30% of consumers will decline a smart meter when offered;
    - this is, to some extent, due to or exacerbated by the negative media surrounding smart meters and, recently, we are aware that anti-smart campaigners have been delivering door drops to discourage consumers from taking up a smart meter. There is also a lot of disinformation; for example, a recent YouTube video, which went viral,

[18] Ibid., para 12

falsely claimed that smart meters emit harmful levels of radiation. As a result, we were asked by a number of consumers to remove their smart meters;

- our own research shows that a large proportion of consumers have a very low propensity to respond to smart meter communications;
- the recent imposition of price caps has reduced the investment capabilities of energy suppliers. This has been exacerbated by the ever-growing costs of the programme; compared to the Licence Application Business Plan[19], the cost incurred by industry to date is already £0.6 billion higher than initially forecast. Forecast costs for the next three regulatory years is £1.3 billion higher than originally forecast. This is due to a number of factors, not least the delay to SMETS2 programme delivery, also the introduction of new programmes of work such as Alternative HAN and SMETS1 enrolment and adoption.

Expectations for the speed of rollout in future

42. Some of the delays detailed above are still continuing; it will not be possible to offer some customers a smart meter until these issues are fully resolved.

43. At E.ON, we are aiming to have installed DCC-compliant meters at around 50% of our customer's properties by the end of 2020, subject to the DCC delivering on its obligations and delivering a fit-for-purpose system. We believe this is a realistic and achievable estimate and, while we continually look to ways we can speed up the installation rate, we do not anticipate that there is any way the 2020 deadline can be achieved.

44. We will also continue to lobby for ways in which the number of DCC-enrolled meters can be increased. For example, the deadline for ceasing installation of SMETS1 meters is 15 March 2019. We strongly believe that, until sufficient SMETS2 meters are available, suppliers should be able to continue installing SMETS1 meters that are capable of becoming DCC-compliant by means of over-the-air upgrades, and that the deadline for such upgrades should also be extended to avoid unnecessary costs for suppliers and inconvenience for consumers: currently, a SMETS1 meter that is not upgraded by the deadline must be replaced by a SMETS2 meter.

45. Even if all technical issues were resolved and suppliers had been taking all reasonable steps to install smart meters at all properties by the end of 2020, actual installations are likely to be 70% at best, unless more can be done to counteract the negative perceptions of smart metering by the media and certain activists.

46. The timescale, however, is impracticable, given that a large number of consumers are disengaged with the market in general, and others who are engaged in the switching market are disengaged as far as smart meters are concerned. Responses to our campaigns offering smart metering to customers realised just 7.5% success in 2018 (all customer groups). In an attempt to improve uptake of smart metering, we have included a term in most of the fixed tariffs available directly from us that a customer must agree to be contacted about smart metering and, where they are eligible, have a smart meter fitted during the life of the tariff. We also have plans to offer incentives to encourage existing customers to book an appointment to have a smart meter

[19] Smart DCC Ltd Licence Application Business Plan, Data Communications Company, 30 April 2014

installed, for example Taste Cards (50% discount or 2 for 1 offers at various popular restaurant chains) or entry into a prize draw. We will monitor the success rates of these trials and adapt our engagement strategy accordingly.

47. The initial spate of smart meter installations has been largely with consumers who are 'early adopters'. Suppliers are now finding it harder to encourage consumers to switch their meter; it is expected that, as time moves on, this situation can only worsen. Not only does this impact the 2020 deadline, it also means that costs of the smart programme will increase, with suppliers having to make multiple contact attempts and find innovative ways to engage those who are disinclined to participate. Given the restrictions on revenue due to the imposition of price caps, this could result in even more suppliers exiting the market; in 2018 alone, 12 suppliers went out of business.

Unintended consequences of the coexistence of GEMA's charge restriction on default tariffs and *the PPM cap*

Impacts on switching

48. We have discussed the impacts on switching since the introduction of the PPM cap in detail above.

49. The PPM cap has limited the ability of many suppliers to make a reasonable profit from PPM tariffs; this is indicated by the bunching of prices around the level of the cap. Smaller suppliers have been able to offer lower prices, but this is largely because they have an advantage over larger suppliers who are obligated under certain social and environmental schemes; this advantage translates into additional headroom of around £40. Where prices have been offered that are significantly more than £40 below the level of the cap, we believe these suppliers are offering unsustainably low prices in order to gain a foothold in the market and thereby make economies of scale.

50. There is thus a chicken and egg situation: the CMA and Ofgem want to see that the conditions for effective competition are in place before they remove the caps; effective competition is much more difficult while there are price caps in place.

Price divergence

51. So far, prices on the two caps have not significantly diverged; if they do, consumers may come to distrust all price caps as they will not understand how both can be considered 'fair' if prices are appreciably different.

52. Any errors in the CMA's methodology are likely to have magnified over time as the cap has been updated. We have recently noted an error impacting the PPM cap update for April 2019. The error comes from the Office for Budget Responsibility ("**OBR**")'s Levy Control Framework ("**LCF**"); in earlier versions of the LCF, Renewables Obligation ("**RO**") costs were forecast to increase, but in the version used for the April 2019 PPM cap, RO costs were shown as flat. This is at odds with the market's expectations as well as with treatment within the default tariff cap calculations, where the RO element has increased. We intend to pursue this issue with the OBR, but it will be too late to be reflected in the April 2019 PPM cap.

53. The greater the divergence, the more risk there is that consumers may prefer to remain with a PPM rather than switch to a credit meter, as PPM prices are likely to be cheaper. The low number of fixed term tariffs available in the PPM market whilst the PPM cap remains in place leaves consumers with little choice while they have a PPM, and they may be discouraged from arranging to switch to a credit meter if it means they will pay a higher price, despite the fact that a credit meter could give them access to a number of cheaper, fixed term tariffs. It could also lead to more customers wanting to switch to PPM from credit meters to benefit from the lower prices.

Impact on smart metering take up

54. Smart Energy GB indicates a number of benefits[20] for having a smart meter:

    - being able to see what you are spending: consumers with a PPM will see less benefit from this than those with a credit meter, as they will generally be able to tell, from frequency of top ups, what uses the most energy;
    - good energy habits: again, the nature of PPMs already encourages careful use of energy to minimise the frequency and value of top ups;
    - no more manual readings: PPMs immediately convert consumption into pounds and pence, therefore PPM consumers are less aware of and rely less on meter readings.

55. The main benefits of smart meters for PPM consumers, then, will be lower costs through fixed term tariffs and time of use tariffs. As outlined earlier, the restrictions of the PPM cap make it unattractive to offer fixed term tariffs to PPM consumers; the same is true for time of use tariffs.

56. Suppliers are generally able to offer cheaper prices for fixed term tariffs due to greater certainty that a customer will remain with them for a particular period of time. Ofgem rules around fixed term tariffs mean that suppliers would have to reduce prices if the level of the cap was lowered, despite the original fixed term price being calculated on the basis of wholesale energy prices at the time the contract was entered into, thus potentially making a loss on the contract. If the level of the cap subsequently increased, suppliers would be prohibited from increasing fixed term prices in accordance with the rules of the supply licence. This is demonstrated by the number of fixed tariffs having reduced since the introduction of the PPM cap as stated above, from 32% of PPM tariffs to 14%.

57. While there is provision for time of use tariffs based on the Economy 7 tariff within the PPM cap rules, any other permutations of consumption split can only be applied with Ofgem approval; this process has to be repeated for each charge restriction period, making the process onerous and uncertain for suppliers, particularly for time of use tariffs offered as part of a fixed term tariff.

58. A further unintended consequence lies in the fact that consumers with a SMETS1 PPM are subject to the PPM cap, whereas those with a SMETS2 PPM are subject to the default tariff cap. Consumers generally have little or no comprehension of the difference between these two meter types and are unlikely to be aware of which type they have. Actual information as to the type of SMETS meter a consumer has will not be available to a supplier until registration is confirmed; at

[20] https://www.smartenergygb.org/en/smart-meter-benefits/benefits-for-you?gclid=EAIaIQobChMItM2X9OTg4AIVBoXVCh1SWQ_eEAAYASAAEgJmnvD_BwE

that stage, a contract with a customer will already have been agreed, and potentially those prices could breach the relevant cap.

Impact on growth of smaller suppliers

59. As we have stated above, a decline has been seen in switching rates since the PPM cap was introduced. It is too early yet to see if this will be replicated for the default tariff cap; the majority of the switching, however, is likely to be to smaller, non-obligated suppliers who have an advantage of around £40 due to not having to pay for some social and environmental obligations. This differential may result in new entrants maintaining growth to below the thresholds where they start to become obligated.

Differences in methodologies and underlying data between the two caps

60. The CMA will be aware that E.ON has always had significant concerns about the methodology used for the PPM cap. We consider the use of two post-privatisation market entrants (Ovo and First Utility) as a benchmark was flawed on a number of counts.

61. Ovo and Firstly Utility both made losses for a number of years following introduction of the PPM cap and could not therefore be said to be offering sustainable prices. We contend that Ovo and First Utility did not represent efficient suppliers in a steady state.

62. In its Investigation, the CMA considered that the sales and marketing costs for these two suppliers were higher than for established suppliers, and that this therefore balanced the additional costs that ex-incumbents faced due to having a greater proportion of vulnerable customers, who have a higher cost to serve[21]. We have always disagreed with this. The number of suppliers in the energy market has increased significantly over the years; new entrants have the benefit of lower costs due to not being subject to certain social and environmental schemes, therefore can attract customers away from obligated suppliers with lower prices. In order to try to maintain market share, larger suppliers must therefore invest considerably in sales and marketing to try and compete on factors other than price; their sales and marketing costs are therefore unlikely to be very different from new entrants'.

63. In our response to the CMA's decision to launch a review of the Energy Market Investigation (Prepayment Charges Restriction) Order 2016, we mentioned our concerns about the forecast costs for the Renewables Obligation ("**RO**") which were used to calculate the April 2019 PPM cap. These costs come from the Office for Budget Responsibility ("**OBR**")'s Levy Control Framework ("**LCF**") which showed RO costs to be flat. This is at odds with market expectations and with the treatment of RO in the default tariff cap. We have now queried this with the OBR, who have advised that their forecasts are based on total receipts/costs of the RO scheme under the LCF for the relevant year. For the year 2019/20 total receipts are broadly flat, with increasing underlying costs per MWh being offset by an expected reduction in overall demand. As a result, the level of the April PPM cap has not increased in respect of rising RO costs, and suppliers are unable to recover these additional costs through higher prices.

[21] Energy Market Investigation: Provisional decision on remedies, Competition & Markets Authority, 17 March 2016, para 3.176

64. This is a further indication of flaws in the CMA's methodology and puts the outcome of the PPM cap calculations in direct conflict with the more robust default tariff cap methodology, which assesses costs at a per MWh basis. The default tariff cap therefore more accurately reflects the increasing costs that suppliers will face and increases the level of the cap accordingly, allowing suppliers to maintain margins.

65. In considering an appropriate methodology for the default tariff cap, Ofgem initially considered four options:

    - a basket of market tariffs
    - the existing CMA benchmark
    - an updated competitive reference price with cost adjustments
    - a bottom-up cost assessment

    We strongly supported the last option, a bottom-up cost assessment. We considered that, along with a correction mechanism to allow for inaccuracies in forecasting, this would represent actual costs as closely as it was possible to do. Ofgem decided not to include a correction mechanism but made some allowance for inaccuracies in costs, as well as a headroom allowance (albeit one that, in our opinion, is inadequate). Operating costs still needed to be calculated on the basis of a benchmark, but we recommended that the supplier(s) used for this should represent an efficient supplier in a steady state, rather than one that was willing to operate at a loss while it grew its customer base. Ofgem selected the largest supplier with the lowest costs and deducted a £5 'efficiency factor'[22] per dual fuel customer – an amount that was plucked out of the air – based on the assumption that a large supplier could not be efficient.

66. Nevertheless, the differences in the two methodologies are, therefore, quite significant. We acknowledge that some of the difference in prices is accounted for by the different costs to serve of different payment methods; nevertheless, whilst there is currently only a minimal divergence between the prices for the two caps, there is the potential for this to become much more significant over time. It will then become more noticeable to consumers and may be the cause of media discussion: how can two capped prices be so different?

67. As mentioned above, consumers with smart PPM meters may be on either the PPM cap or default tariff cap, depending on which type of meter is installed (SMETS1 or SMETS2). This is very confusing for consumers, who are unlikely to know the difference between the two types of meter, and causes significant issues when switching supplier, as a new supplier will be unable to tell which type of smart meter the customer has until the registration is complete.

68. We therefore strongly recommend that the Energy Market Investigation (Prepayment Charge Restriction) Order 2016 (the "**Order**") should be revoked and the default tariff cap should be extended to include PPM consumers.

69. Not only that, we believe that, to allow competition to flourish within the fixed tariff market, the PPM element of the default tariff cap should only apply to PPM consumers on a default tariff.

22

70. At the point where Ofgem reviews whether conditions are in place to remove the default tariff cap at the end of 2020 in order to provide a recommendation to the Secretary of State, the PPM element of that cap could be reviewed simultaneously.

71. For reasons outlined in this response, we believe it is important that both caps do not continue beyond the end of 2020; we shall therefore be making strong representations to Ofgem on the reasons why the caps should not be extended.

Continued protection for PPM customers

72. There has been a significant improvement in the availability of tariff pages for classic PPM customers since the PPM cap was introduced; there is now no reason why a smaller supplier or new entrant is not able to set its own prices when offering PPM tariffs.

73. At the present time there is no stable SMETS2 PPM solution, and we do not anticipate one being ready and fully tested by 15 March 2019, which is the end date for installation of SMETS1 meters. This could bring a complete halt to the installation of smart metering for PPM customers. We are seeking support from Ofgem and BEIS to allow us to continue to install SMETS1 PPM meters beyond the current end date. These meters should be eligible for enrolment to the DCC with the appropriate over-the-air upgrade to avoid further meter exchanges to SMETS2, which would not only incur additional unnecessary costs, it would also be inconvenient for consumers.

74. If, as we propose, the default tariff cap is extended to cover PPM consumers and the Order is revoked, then PPM consumers would still be afforded the protection deemed necessary following the outcome of the CMA's Investigation. The two caps are currently priced very similarly, with some PPM consumers (SMETS1) on the PPM cap, and others (SMETS2) already on the default tariff cap.

75. As discussed above, a wider range of tariffs, including fixed term tariffs, is unlikely to materialise until the PPM cap is removed. The number of fixed term tariffs available to smart PPM consumers was higher before the cap was introduced than it is now. The sooner full competition is resumed, the quicker the market can react to reintroduce more fixed term tariffs and other innovations.

76. We do not believe it is necessary for the smart meter rollout to be complete before the PPM cap is removed. In fact, the more consumers who have a SMETS2 PPM installed as the rollout progresses, especially where it replaces a classic PPM, the more confusion there is likely to be for consumers who will be moved from one cap to another.

77. Assistance is already provided to vulnerable consumers, many of whom will have PPMs. Customers who are fuel poor are generally likely to be in receipt of government benefits, which should cover normal energy costs. Those who have higher consumption due to inadequate housing or health issues, for example, may require additional assistance. Many suppliers, including E.ON, also offer an energy fund to provide financial assistance to the most vulnerable consumers. In addition, the Warm Home Discount scheme, which larger suppliers are obligated to provide and some others voluntarily provide, can also help these consumers.

78. Customers who are struggling to pay their bills already receive a great deal of assistance from energy suppliers, including access to discretionary credit, breathing space, energy efficiency advice and signposting to consumer or debt advice organisations.

79. A PPM consumer can change supplier even where they have a debt that does not exceed £500, providing both suppliers and the consumer agree to transfer of the debt using the Debt Assignment Protocol.

80. PPM customers will also be able to take advantage of auto-switching schemes, which will switch customers to the cheapest price available to them without them having to do anything.

Potential outcomes of the review

Revocation

81. We believe a considerable amount of damage has been done to the competitive energy market due to the imposition of price caps. Switching has declined, suppliers have removed fixed term tariffs from the PPM market, consumers have been given the impression that they are protected and on a fair price, whereas switching tariff or supplier may be a better option for them.

82. It would be unrealistic to suggest that the PPM cap could be removed before the default tariff cap, and that cap cannot be removed until Ofgem recommends to the Secretary of State that the right conditions are in place for effective competition; the earliest opportunity for this is the end of 2020. We do not believe it would be appropriate, therefore, for the CMA to revoke the Order at present unless there were alternative remedies available for PPM customers equivalent to those provided by the default tariff cap.

Extension

83. The CMA may consider that the delays to the smart meter rollout warrant an extension of the PPM cap beyond the end of 2020. We believe this is not an appropriate response. As we have explained above, the caps are already having a number of detrimental impacts, and the longer they are in place the harder we believe it will be to recover to the levels of switching that were seen prior to the cap being introduced.

84. Ofgem is due to consult later in 2019 on the conditions it believes need to be in place to recommend removal of the default tariff cap, but has indicated that it *"will take a higher level view of the market structure by assessing the wider market developments and the trends in competition."*[23]

85. We believe that, because of the unintended consequences of the PPM cap and also the default tariff cap, both caps should end at the earliest possible opportunity, i.e. the end of 2020.

Revocation and combining the PPM cap with the default tariff cap

86. It would seem appropriate, therefore, that the two caps should be aligned more closely; indeed that PPM customers become subject to the default tariff cap under the same licence conditions. It is important, however, that amendments are made to allow for a separate payment uplift for

[23] Decision – Default tariff cao – Overview document, Ofgem, 6 November 2018

PPM consumers, for whom the cost to serve, as observed by the CMA in the Investigation, differs from the cost to serve of Direct Debit and on demand payment methods.

87. This review presents an ideal opportunity to revoke the Order now and instead make changes to the default tariff cap licence conditions to include PPM consumers.

88. A further benefit of aligning the two caps would be that PPM SMETS1 and SMETS2 customers would be treated the same, avoiding the confusion we have explained above.

89. We would also recommend that, in aligning the two caps, the PPM cap should apply only to PPM customers on a default tariff. Those on a fixed tariff have made an active choice to switch in the recent past and are likely to be on a price that is lower than their supplier's default tariff. This recommendation also has the benefit of encouraging greater competition in the fixed term PPM market.