

Energy Prepayment Review  
Competition and Markets Authority  
Victoria House (6th Floor South East)  
37 Southampton Row  
London  
WC1B 4AD

15 March 2019

### **Decision to launch a review of the Energy Market Investigation (Prepayment Charges Restriction) Order 2016**

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, storage and energy supply to end users. We have around five million electricity and gas customer accounts in the UK, including residential and business users.

We recommend that the CMA varies the Energy Market Investigation (Prepayment Charges Restriction) Order 2016 'the Order' to address the changes in circumstances since the Order was made. In our attachment we provide evidence that:

- Fitting smart PPM meters would make PPM customers an attractive prospect for suppliers, but the lower cap for PPM creates a complication in the installation process and a disincentive for customers to have a smart PPM fitted.
- As was recognised by the CMA the installation of smart PPM will overcome the lack of competition for PPM customers (due to technical restrictions). Therefore, to ensure there is effective competition for these customers it is essential that they are not disincentivised to install smart meters.
- Weaknesses in the prepayment meter (PPM) methodology have also become evident in the years since it was introduced. In several respects actual costs have diverged materially from allowed costs.

Our detailed responses are set out in the attachment. To discuss any of the issues raised in our response or have any queries, please contact Kevin Hammond on 07875 113467, or myself. The content of this response may be published on the CMA website.

Yours sincerely,

**John Mason, Senior Manager of Customers Policy and Regulation**

## Attachment

### Decision to launch a review of the Energy Market Investigation (Prepayment Charges Restriction) Order 2016 - EDF Energy's response

#### Weaknesses in the PPM Methodology

In our original response to the CMA on the PPM Cap methodology we highlighted weaknesses which resulted in the initial level of allowed costs being set too low and anticipated that this divergence between allowed and actual costs would increase over time. This has now occurred. The weaknesses we identified were:

**1. The approach used by the CMA to calculate the energy/non-energy costs split in the benchmark**

In particular, the split of energy/non-energy costs for Profile Class 2 (PC2) customers was not accurate. The PPM Cap methodology assumes policy and other costs for PC2 meters are the same as for a single rate meter, despite PC2 customers' higher typical consumption. This results in too large a proportion of a PC2 bill being allocated to energy costs in the baseline figures (which are then updated over time). The price cap mechanism updates for changes in costs, but by applying the resulting delta to an incorrect starting point actual means that allowed costs increasingly diverge over time.

**2. Use of Office for Budget Responsibility (OBR) projections as the basis for policy cost adjustments**

We support this approach, however there are other aspects that need to be updated:

- The methodology only observes the increase in total costs and not how these have been applied to the cap level. As the demand for both electricity and gas has been declining in recent years then even this means the unit cost needs to increase to ensure the total policy costs can be recovered from a lower level of consumption.
- In addition, Energy Intensive Industries (EIs) can now claim exemptions – meaning that non-EI customers will pick up an increased proportion of the total charge, but this is again not reflected in the cost calculation. The current PPM methodology does not capture these changes.

**3. Smart Costs have increased**

The exclusion of smart costs from the update mechanism of the PPM Cap means that a substantial element of costs has not be updated. The CMA stated in its final report that smart costs appear to be stable. This was clearly an incorrect assumption given the very substantial increases in costs in the years since, which Ofgem has reflected in their Default Tariff Cap calculation.

#### 4. The benchmark wholesale costs were incorrect and did not allow for associated shape, transaction, losses and uncertainty costs

The original baseline for wholesale costs in the PPM cap did not match our own calculations and so has been a source of divergence between allowed and actual costs since. The calculation also did not separately identify any allowance for the elements of cost incurred, over time, which are inherent in forecasting wholesale costs due to weather and other variables such as losses. The difference in allowed wholesale costs between the PPM cap and Default Tariff Cap, which was calculated by Ofgem on a bottom-up basis based on the same hedging period and approach, clearly illustrate this inaccuracy in the PPM cap methodology.

**Table 1.** Comparison of Default Tariff Cap and PPM Cap illustrating divergence of costs

<b>Price Cap Comparison from 1 April 2019 £ at Ofgem Typical Consumption</b>	<b>SVT DD Dual Fuel</b>	<b>PPM Dual Fuel</b>	<b>Variance</b>
<b>Wholesale</b>	506	493	-13
<b>Policy Costs (Capacity Market + Other Policy)</b>	166	144	-22
<b>Network Costs</b>	270	271	0
<b>Operating Costs (Inc. Smart)</b>	204	174	-30
<b>Payment Uplift</b>	12	67	55
<b>EBIT/Headroom</b>	36	34	-2
<b>VAT</b>	60	59	-1
<b>Total</b>	<b>£1,254</b>	<b>£1,242</b>	<b>-£12</b>

#### Distortion of the Market

At the time of the CMA investigation outcome only PPM customers were subject to a cap and therefore a relatively small proportion of the overall market was impacted. Whilst we did have concerns with the PPM Cap methodology we viewed the overall package of measures as broadly positive for the market. Now that around half the market is subject to price caps the weaknesses in the PPM cap methodology has resulted in some unintended consequences and a material market distortion. This is because the PPM Cap is set at a lower level than the Default Tariff Cap, despite the cost to serve legacy PPM customers being significantly higher. This difference is represented in Table 2.

The Default Tariff Cap only allows costs relating to non-PPM default tariff customers to be recovered, plus a small margin if benchmark efficiency is achieved. In calculating the Default Tariff Cap benchmark cost level Ofgem excluded the additional cost of PPM meter customers. They used the PPM cap uplift for this adjustment, so that only costs associated with non-PPM customers were considered.

**Table 2.** Estimated difference between Default Tariff Cap and PPM Cap levels

	<b>SVT DD Elec £</b>	<b>PPM Elec £</b>	<b>Variance Elec £</b>
<b>Wholesale</b>	<redacted>	<redacted>	<redacted>
<b>Policy Costs (Capacity Market + Other Policy)</b>	<redacted>	<redacted>	<redacted>
<b>Network Costs</b>	<redacted>	<redacted>	<redacted>
<b>Operating Costs (Inc. Smart)</b>	<redacted>	<redacted>	<redacted>
<b>Payment Uplift</b>	<redacted>	<redacted>	<redacted>
<b>EBIT/Headroom</b>	<redacted>	<redacted>	<redacted>
<b>VAT</b>	<redacted>	<redacted>	<redacted>
<b>Total</b>	<redacted>	<redacted>	<redacted>

### **A standardised estimate of the additional costs of supplying prepayment customers**

This is calculated by combining the CMA's estimate of the prepayment uplift, as calculated for inclusion in the prepayment meter price cap as of 1 April 2017 (£24.41 for electricity, £39.66 for gas), with the proportion of each supplier's domestic gas and electricity customers that pay via prepayment<sup>1</sup>.

This adjustment to the Default Tariff Cap means that the additional costs associated with serving PPM customers cannot be recovered from customers on the Default Tariff Cap even if suppliers are at the benchmark cost level. Intense competition in the market for fixed customers including from suppliers who do not offer legacy PPM tariffs means that, in effect, the additional costs of serving PPM customers cannot be recovered in the market and impacts upon supplier profitability. The unintended consequence is to make legacy PPM customers have a lower commercial value, which is not in the interests of suppliers or PPM customers. The combination of price caps and intense competition has already resulted in the failure of many suppliers, including Economy Energy, one of the specialist PPM suppliers the CMA consulted with when creating the PPM Cap.

### **A disincentive for customers to fit Smart Meters**

EDF Energy has reported to Ofgem its challenging delivery targets for 2019 smart meter installation and the percentage of meters expected to be smart by the end of 2020. Our level of ambition is based heavily on the availability of SMETS2 meters that operate in prepayment mode. This is because there will be a strong incentive for prepayment customers to install smart meters as they have more to gain than credit customers from the additional convenience they offer e.g. remote charging. The Customer journey for having a smart PPM meter fitted should be a positive one, but a financial penalty to accept the offer of a smart meter would have a very negative impact for those customers on

<sup>1</sup> Ofgem Default Tariff Cap Decision Appendix 6

default prices. The already challenging media coverage of the smart meter programme would likely highlight any issue of an increase in charges for PPM customers who install a smart meter, exacerbating the problem of persuading already disengaged customers to adopt smart meters.

### The solution

When the CMA created the PPM Cap we recognised that a balance was being sought to keep the cap cost-reflective without introducing onerous processes for Ofgem and suppliers. It was for this reason that aspects of the methodology was developed taking a pragmatic approach only appropriate for a limited proportion of the market. The introduction of the Default Tariff Cap has introduced new and more robust methodologies for calculating the same costs as those in the PPM Cap.

To resolve the market distortions created by the operation of two price caps at different levels and to reduce the burden on Ofgem and suppliers the PPM Cap should be calculated using the Default Tariff Cap Methodology. This will result in a single methodology for both caps.

The one area where an adjustment to the existing Default Tariff Cap is needed is in calculating the PPM uplift, to allow recovery of the additional costs associated with serving legacy PPM customers. As highlighted above, Ofgem removed the costs associated with legacy PPM customers from the Default Tariff Cap benchmark, using the PPM uplift from the PPM cap to make the adjustment. Therefore, the PPM cap uplift should be applied to the Default Tariff Cap level so that these costs can be recovered from PPM customers. Our internal analysis, shown in Table 3, demonstrates that the cost to serve of PPM customers is a <redacted> PPM Uplift of £67 per dual fuel customer, as used by Ofgem in the Default Tariff Cap. Table 4 shows a comparison of Default Tariff Cap and PPM Cap showing effect of PPM uplift.

**Table 3.** EDF Energy estimate of additional PPM costs

<b>Additional Cost of PPM Customers compared to DD</b>	<b>£ per account</b>
<b>Cost to Serve</b>	<redacted>
<b>Debt costs</b>	<redacted>
<b>Metering Costs</b>	<redacted>
<b>Acquisition costs</b>	<redacted>
<b>Total</b>	<redacted>

The PPM uplift will need to be kept under review going forward as the number of customers with legacy PPM meters reduces and the costs of the PPM infrastructure is borne by a diminishing number of customers, thereby increasing the cost per customer.

Ofgem should carry out such work in the future. However, this should not be placed as a requirement on Ofgem to take forward prior to the setting of the April 2020 Default Price Cap. Ofgem should also ensure that any change to the uplift applied to the PPM cap should also be consistently reflected in any reduction to the Default Price Cap for non-PPM customers moving forward.

**Table 4.** Comparison of Default Tariff Cap and PPM Cap showing effect of PPM uplift

<b>Price Cap Comparison from 1 April 2019 £ at Ofgem Typical Consumption</b>	<b>SVT DD Dual Fuel</b>	<b>Current PPM Cap Dual Fuel</b>	<b>SVT DD including PPM Uplift</b>
<b>Wholesale</b>	506	493	506
<b>Policy Costs (Capacity Market + Other Policy)</b>	166	144	166
<b>Network Costs</b>	270	271	270
<b>Operating Costs (Inc. Smart)</b>	204	174	204
<b>Payment Uplift</b>	12	67	67
<b>EBIT/Headroom</b>	36	34	38
<b>VAT</b>	60	59	63
<b>Total</b>	<b>£1,254</b>	<b>£1,242</b>	<b>£1,314</b>

EDF Energy, March 2019