



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

SSE
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Sent by email: Remedies.reviews@cma.gov.uk

15 March 2019

Dear Peter

SSE response to CMA Statement of Issues on the review of the Energy Market Investigation (Prepayment Charges Restriction) Order 2016

SSE welcomes the opportunity to provide evidence and views on the statement of issues to be considered in the review of the Order and looks forward to continued engagement with the CMA as it progresses.

This response builds on the information already provided in our original submission and addresses the question of how the Order should be reformed or revoked in light of those changes.

Summary Recommendation

SSE recommends the CMA adopt the Default Tariff Cap (“DTC”) methodology for the Prepayment Meter (“PPM”) price cap, with an additional PPM uplift element. SSE believes the change should be made in a timely manner, to limit the increasing risk of unintended consequences and customer confusion as the rollout of SMETS2 PPM accelerates, and to ensure that there is appropriate price protection for all PPM customers. SSE recommends the CMA should implement a new PPM cap methodology in time for the October revision of the price cap.

Key SSE Points

The introduction of the Default Tariff Cap (“DTC”) means there are now two retail energy price caps in operation that interpret and track costs differently. SSE understands that whilst the CMA is not obliged to act consistently on comparable matters relative to other

authorities, it does seek to act in a manner which secures consistent outcomes¹. Irrespective of the merits of the PPM and DTC approaches, the co-existence of these different methods means that consumers of equal standing are currently treated differently (on a like for like basis) as a result of their chosen metering technology. We are not aware of any regulatory rationale for this.

Absent a change in PPM methodology, SSE believes this inconsistency raises issues of equity between consumer groups and introduces unnecessary distortions in the marketplace which are to the detriment of other energy market policy market objectives. In particular, SSE believes that:

- the difference between PPM and DTC price cap methodologies means that customers may be financially better off under different caps at varying levels of consumption; and
- the PPM price cap methodology may result in a lower price for heritage PPM meter users relative to SMETS2 users which will cause customer confusion and discourage the uptake of SMETS2 PPM meters. PPM users switching to SMETS2 meters may face a price increase when the DTC is higher.

Tariff cap levels should only vary in respect to payment methods (i.e. to the extent necessary to allow for recovery of differing levels of costs to serve).

For reasons we have described in our first submission (SSE 18/01/19 Para 3.1, p 4-6) and stated in more detail in Annex 1 of this submission, SSE also believes the DTC methodology is more robust to that currently used to calculate the PPM price cap. The DTC method not only builds on the CMA methodology in relation to the PPM price cap but benefits from a substantial additional and more recent body of evidence and analysis which Ofgem was able to draw upon and was not previously available to the CMA. This has resulted in a DTC which SSE considers more accurately reflects the costs to serve customers, whereas the PPM price cap does not and is causing efficient suppliers to operate at a loss.

In addition, the introduction of the DTC has reduced the ability of some suppliers to absorb under-recovered costs from PPM customers. This means suppliers may be less able to compete through other customer tariffs and may negatively affect their ability to offer customers incentives to switch from heritage to SMETS2 meters. As it stands, therefore, the PPM price cap methodology risks lessening competitive pressure.

¹ Guidance on CMA's approach to use of its consumer powers:
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/288624/CMA7_Consumer_Protection_guidance.pdf



Next Steps

We have commented on the Issues Statement in more detail in Annexes 1 and 2 to this document. We have also provided a separate document, **(Appendix 1)**, which provides further supporting analysis.

We hope that this response is useful and constructive and look forward to working with the CMA to help inform any changes. Should you have any questions or if we can provide you with any further information please do not hesitate to contact me.

Yours sincerely

Louise Murphy
Interim Head of Retail Regulation

Annex 1: Potential changes of circumstances

1 Rollout of smart meters

Evidence from the National Audit Office shows that the rollout of smart meters is taking place at a slower rate than anticipated in 2016.

During the course of this review, we will seek views and evidence from interested parties in relation to the following matters:

- *the speed of rollout of smart meters to date, including both SMETS1 and SMETS2;*
- *the expectations for the speed of rollout of both SMETS1 and SMETS2 meters in the future, including the extent to which these will be rolled out by the end of 2020, (including plans for interoperability of SMETS1 meters), when the CMA's charge restriction expires;*
- *where appropriate, the causes of slower rollout of smart meters and action that is and could be taken to increase this, and its likely impact; and*

Evidence in relation to the speed of smart roll across the industry will be best addressed by Ofgem and BEIS as they will have the most accurate, up to date and comprehensive information. In January 2019, all suppliers submitted a progress report, setting out details of the number of smart meter installations completed in 2018. In addition, many suppliers will have also resubmitted their roll out plans to Ofgem in January 2019, with revised 2020 targets for approval.

- *any other relevant evidence related to the rollout of smart meters that interested parties consider the CMA should take into account.*

Smart metering brings important benefits to prepayment and vulnerable customers, from better access to tariff choice to improved control over consumption which helps reduce the likelihood of self-disconnection.

The key message underpinning the marketing of smart metering is that they can help reduce costs by allowing consumers to see their consumption, take control, and become more efficient. To date, however, uptake of smart meters has been lower than expected and customer interest in smart metering has been decreasing (YouGov research 2016 – 2018). With the installation of SMETS2 PPM meters expected to commence in September 2019, the current differences in cap methodology will mean there is potential for an increase in price when moving from a Heritage meter to a SMETS2 meter. This price differential introduces a risk that customers' willingness to move to SMETS2 meters will be compromised. The risk of a possible price increase associated with getting a SMETS2 meter could exacerbate low customer demand for smart.

Since the introduction of the PPM Order, the industry has gathered several years' data on customer appetite and attitudes to smart metering. Customers are sceptical that a smart meter can actually help manage energy usage (YouGov 2018). The importance of cost has also been highlighted in wider research e.g. GfK report for the CMA (2015) on customer engagement in the energy market.

It is vital, therefore, as an industry, we remove and minimise any barriers to the uptake of smart metering. We explain, below, that the current differences in cap methodology (Appendix 1 p9-14) will mean there is potential for a paradoxical increase in price when moving from a heritage meter to a SMETS2 meter. This will dampen customers' willingness to move to SMETS2 meters, exacerbating already low customer demand.

Aligning the methodology for the PPM cap with the default tariff cap would, therefore, remove a potential barrier to the industry's smart meter rollout targets whilst ensuring that PPM customers are still provided with appropriate price protection.

2 GEMA's charge restriction on default tariffs

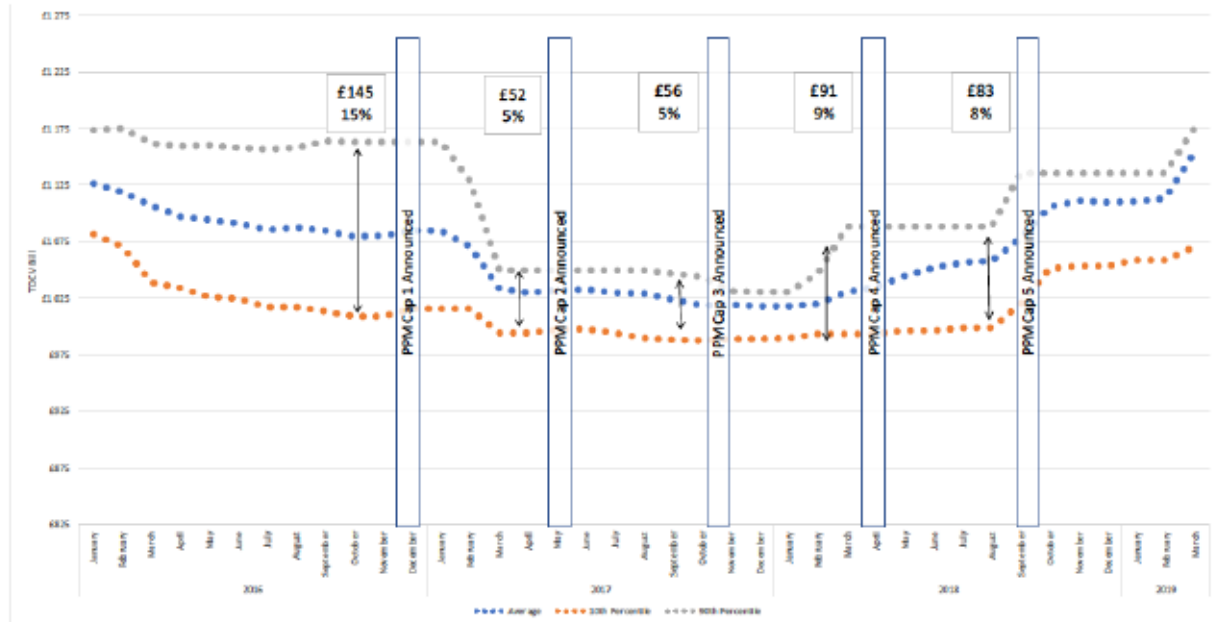
The CMA has concerns that the coexistence of the Order (which covers prepayment customers) with GEMA's charge restriction (which covers standard meter customers with standard variable and default tariffs) creates a risk of unintended consequences. During the course of this review, we will seek views and evidence relating to the following matters related to the two charge restrictions:

- *the impact of the CMA's ongoing charge restriction for prepayment meter customers*

SSE's analysis shows two important trends since the introduction of the PPM price cap:

- Prices for PPM customers have converged; and
- Churn in PPM customers has declined

Since the PPM cap was introduced in 2017 there has been a decline in the variance of PPM tariffs offered for this customer group. The potential benefits which customers can obtain from switching has consequently reduced. SSE's market monitoring indicates a decrease in the spread between highest and lowest PPM tariffs from 19% to 12%. When considering only nationally available tariffs, Graph 1 shows that prior to the introduction of the cap there was £145 difference between the 90th and 10th percentiles of tariffs. This fell to £52 (an 5% spread) after the implementation of the cap. This difference in March 2019 is £83 (an 8% spread).



Graph 1 Price variance across the PPM the market since the introduction of the PPM cap.



• the difference in methodology and underlying data used by GEMA in its charge restriction when compared to that used by the CMA;

As we highlighted in our previous response, SSE has explored the differences between the construct of the two caps and, using historical data made available by Ofgem via the Default Tariff Cap consultation process to project how the Default Tariff Cap would have performed, we have now updated the information on how the different methodologies interpret costs over the five cap restriction periods from Summer 2017 to Summer 2019. This analysis reveals important inconsistencies in a number of areas (at TDCV) and we can see the differences increasing even in this short period of time since our last submission:

- Wholesale costs: while baselined to the same data, there are a number of differences between the methodologies which we believe should be aligned e.g. the interpretation of wholesale costs in the Default Tariff Cap includes a fuller measure of shape costs than the PPM Cap, and includes an allowance for UIG unlike the PPM cap methodology;
- Policy costs: there are significant differences in granularity of application with the caps which produces differing indexation changes year-on-year e.g. the Default Tariff Cap takes a scheme specific approach to Policy Costs and accounts for changes in qualifying demand, which causes the relative levels of policy costs to diverge between the caps;

- Operating costs: different methodologies to assess operating costs across the two caps (i.e. top-down vs. bottom-up); the PPM Cap is baselined on two suppliers who have since shifted their market positioning; the PPM Cap does not include an adjustment for smart, and is baselined to 2015 data as opposed to 2017 data;
- Smart costs: the treatment of smart differs between the caps with the inclusion of a dedicated Smart Metering Net Cost Change model in the Default Tariff Cap. This leads to increasing price divergence over time as smart rollout cost increases are reflected in the Default Tariff Cap but not the PPM Cap.
- Other cost elements: the payment uplift within the Default Tariff Cap as a proportion of the bill varies by consumption, whereas it is a fixed amount in the PPM Cap.

These issues are expanded upon in slides 8- 14 of Appendix 1. This demonstrates that the work undertaken to develop Default Tariff Cap methodology offers a number of learnings that could be used to strengthen the PPM Cap methodology by correcting errors and better ensuring costs are reflected accurately.

• the scope for unintended consequences arising from there now being two charge restrictions in the energy market, including: the impact of these two charge restrictions on smart meter rollout and customer incentives to request smart meters; the incentives on suppliers and competition;

As a result of the discrepancies noted above, SSE observes two sets of unintended consequences emerging from the deployment of the current PPM price cap method:

- Price protection afforded by the different tariff levels arising from the PPM price cap and the DTC is inconsistent; and
- The PPM price cap does not allow for cost recovery.

Unintended Consequences for Tariff Levels

There are two key issues:

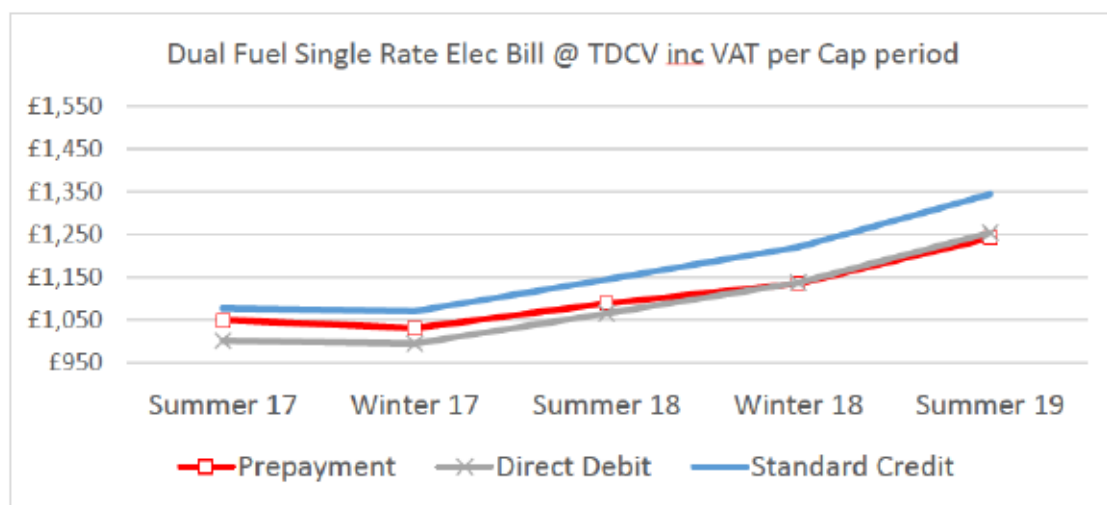
Increasing divergence between cap levels

SSE has compared the evolution of DTC and PPM price cap levels over time. Our analysis highlights that for Typical Domestic Consumption Values (“TDCV”), energy bills for the dual fuel and Economy 7 customers have diverged, over the past two years, for customers subject to the DTC and the PPM price cap.

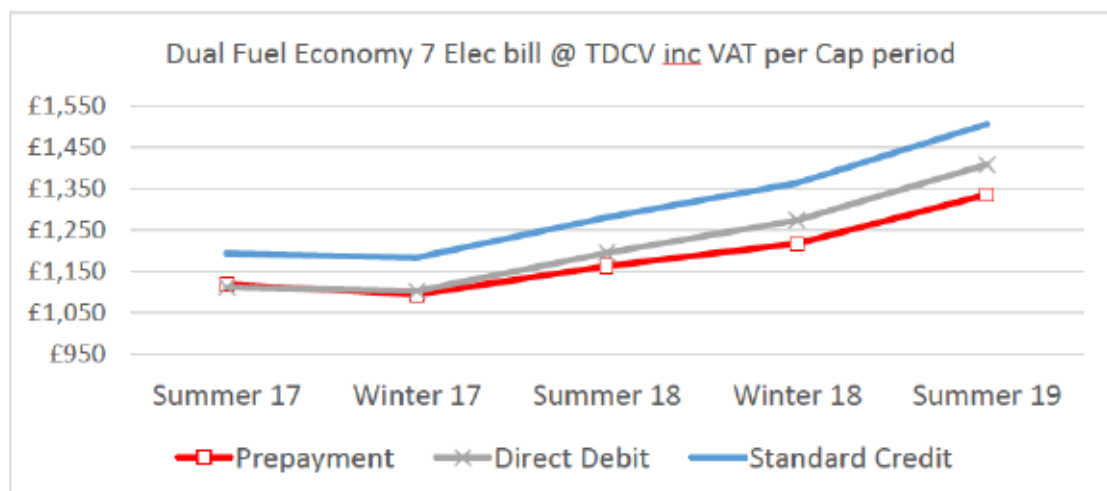
For example, Graphs 3 and 4 show that at TDCV, single rate electricity PPM customers could pay £25 per annum less than direct debit customers that are subject to the DTC. For Economy

7, the difference is £87. This is a level of variance close to the level research² suggests customers will consider moving tariff. Should rates be priced in line with the cap level it will therefore act as a disincentive to switch from Heritage PPM to SMETS2. Further analysis is included in (Appendix 1, p 4-7).

The divergence of prices for PPM may cause customers confusion, disengagement, promote interchangeability across meter types, and create barriers to the uptake of SMETS2 meters.



Graph 3 Dual Fuel (single rate electricity) caps over time

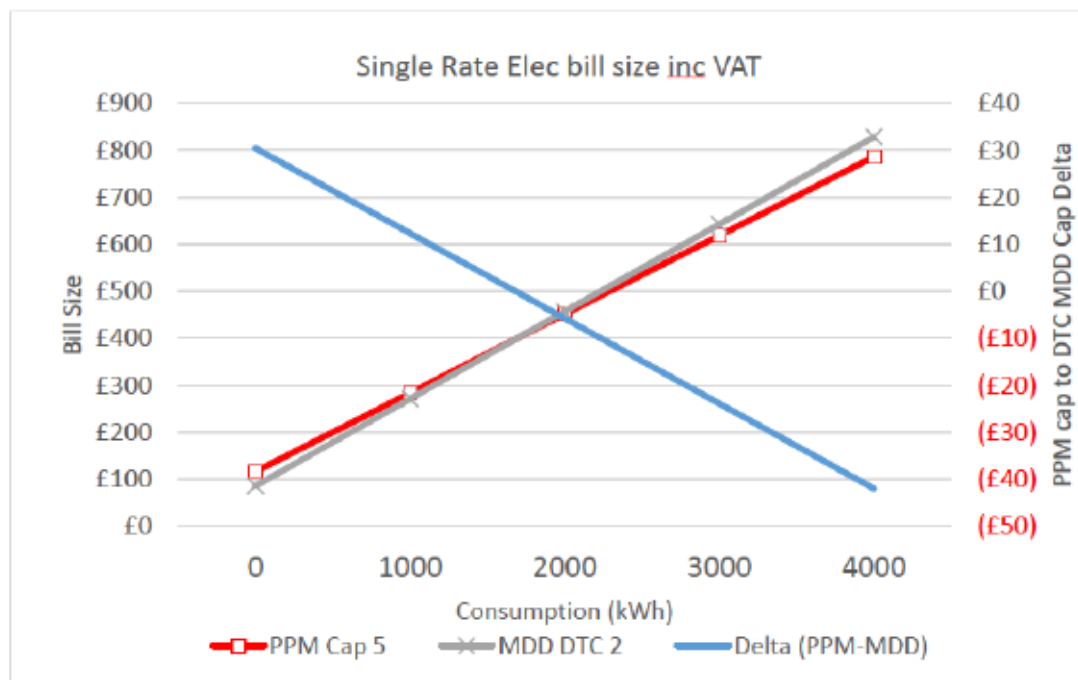


² YouGov tracker Oct 17

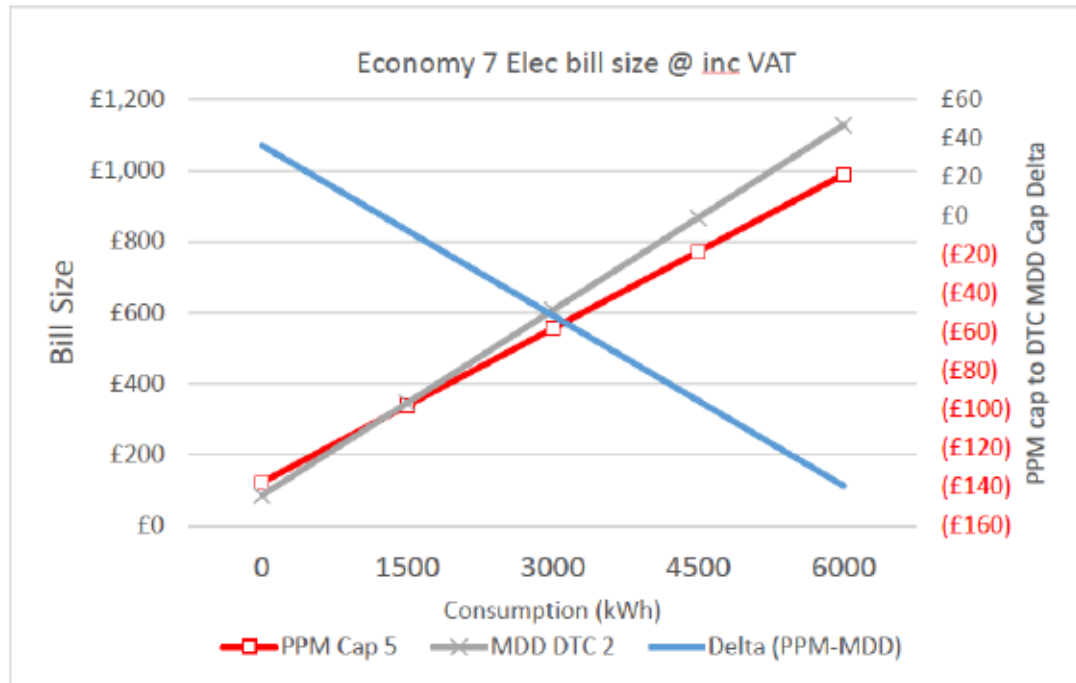
Graph 4 Dual fuel (Economy 7) caps over time

Furthermore, customers are currently financially better off under different caps at varying consumption. Graphs 5 and 6 compare the customer bill for single rate and Economy 7 electricity customers at differing levels of consumption with the equivalent were they to be subject to the DTC. For both customer classes, the PPM price cap results in an increasingly lower customer bill for PPM customers relative to the equivalent DTC as consumption increases.

We are not aware of any regulatory rationale which justifies this and think it is unnecessarily confusing for both customers and suppliers. As most tariff decisions are made on the basis of cost/usage projections, this discrepancy can result in customers discovering after the event that they would have been better off benefitting from a different metering and cap arrangement if their usage habits change. Whilst we acknowledge that this may be the case when customers are offered a choice between different commercial offerings by their suppliers, we are not in a position to explain to customers why two related regulatory caps should drive this outcome. This also seems to contradict the general policy objective to make customer engagement with tariff choice simple. This confusion increases the risk of these customers disengaging from the energy market and raises significant issues of equity between customer classes, as customers of equal standing risk being protected inconsistently as a result of regulatory process.



Graph 5 PPM vs DTC for single rate customers as of summer 2019 caps



Graph 6 PPM vs DTC for Economy 7 customers as of Summer 19 caps

Unintended Consequences on Cost Recovery

As we highlighted in our previous response there are ongoing indexing errors with the PPM Cap methodology that are leading to suppliers suffering financial losses.



In addition, Ofgem highlighted in its response to the CMA concerns that the PPM price cap is not cost reflective. Since the introduction of the DTC any ability for suppliers to absorb unintended losses resulting from the PPM Cap's indexation is no longer available. As such, much more severe unintended market consequences could materialise

Table 1 below shows our analysis to compare the costs allowed for under the CMA PPM price cap compared to SSE costs in the financial years 2017 -2018 and 2018- 2019. We draw several conclusions from this analysis:



- The difference between SSE policy costs and the CMA policy costs is increasing. This divergence is accounted for by the approach to indexation which does not effectively tracking qualifying demand (**Appendix 1, p11**);

- The large differential in 'other costs' is evidence of higher baseline costs and increasing smart metering costs that the PPM price cap method does not allow for. (Appendix 1, P12).

SSE utilises a cost allocation model to allocate the costs to serve across the different payment methods. The costs incurred by SSE are captured initially within cost centres which are each based on activity rather than at a customer account level. For example, a general customer enquiries cost centre will manage queries from all customers regardless of payment method. When we review each cost centre, the costs are allocated across the payment methods using a methodology appropriate for each cost centre. An appropriate methodology for a cost centre can be based on management information such as a breakdown of transactions processed, resource allocations or by consulting with the relevant cost centre manager. However, in many instances, there will not be a differential in the allocation of costs between the different payment methods as a payment method may not have a direct link to costs incurred.

We can confirm our cost allocation model is reviewed periodically to update our assumptions based on the current data and customer behaviour. This review is typically undertaken on an annual basis. The data used for this analysis is used to retrospectively review the costs incurred in the previous financial year. This data is then used to ensure that our assumptions are broadly in line with the cost to serve differentials used in our current prices charged on Direct Debit and Standard Credit. As one measure is retrospective, and the other measure is future focussed, we expect the price differentials between different payment methods within our cost to serve to be within a reasonable tolerance level.



SSE believes that the costs associated with Wholesale Energy and Network are broadly aligned with the calculations used within the PPM Cap. However, the costs associated with Policy and Other categories are diverging. A more detailed view of this can be found in Slides 8 to 14 within the Appendix. Combined with the lower view of payment method uplift this means that PPM is becoming more loss making over time.

SSE believes that the methodology used with the DTC to determine payment method uplifts is in line with our cost allocations and so are confident that our view of PPM uplift is in line with actual realised costs.





Ofgem sought views on amending the CMA PPM methodology during the development of the DTC cap methodology. Ofgem states – in its summary of responses document³ - that “most respondents also highlighted a number of concerns with the accuracy of the existing benchmark. Most respondents, including the vast majority of suppliers, highlighted that it was essential to consider whether the methodology should be at least modified, and ideally recalculated, to ensure it is cost-reflective.”

If suppliers are unable to operate heritage meters in line with costs then there will be no opportunity to offer additional incentives to customers to switch from heritage to SMETS2 meters. Furthermore, the continuation of two caps at different levels will further undermine the confidence of those customers who do take a SMETS2 meter, who may feel disadvantaged by lower capped prices remaining available in respect of their previous meter type.

³https://www.ofgem.gov.uk/system/files/docs/2018/03/providing_financial_protection_to_more_vulnerable_consumers_-_summary_of_consultation_responses_0.pdf

Annex 2 Potential outcomes of the review

Should the CMA conclude that, by reason of any change of circumstances, the Order is no longer appropriate and needs to be varied or revoked, the CMA would need to consider the following matters, on which it will seek views and evidence from interested parties:

- *how to ensure continued protection for prepayment meter customers until the rollout of smart meters has concluded; and specifically*
- *whether it would be more appropriate to vary the CMA's Order or to revoke it and, linked to this matter,*
- *whether to recommend:*
- *an extension of GEMA's charge restriction to cover prepayment meter customers, or*
- *that GEMA introduce a new charge restriction covering prepayment meter customers.*

Taking account of the evidence presented above and our earlier submission on the proposed review of the prepayment charges restriction, SSE is strongly of the opinion that the Order is no longer appropriate and needs to be varied or revoked. Should the CMA agree, it should ensure that the discrepancies, we have highlighted between the PPM and DTC price cap, are addressed as early as possible. We believe a change should be implemented prior to the setting of the winter 2019 caps to avoid additional customer confusion going into winter.

To ensure the continued protection for prepayment meter customers, SSE recommends that either the CMA varies the Order, adopting the default tariff cap methodology for the PPM cap and includes a PPM uplift element in place of the default tariff cap's method uplift or PPM customers are adopted by Ofgem into the DTC with an appropriate cost to serve uplift.