8 July 2019

Mr Peter Hill
Competition and Markets Authority
Victoria House,
Southampton Row,
London WC1B 4AD

Email: [redacted]

Dear Peter,

Energy Market Investigation (Prepayment Charge Restriction) Order 2016 (the "PCR") – Provisional Decision

Thank you for the opportunity to comment on the above consultation document. Utilita is pleased that CMA has recognised a number of the fundamental issues with the PCR which was implemented in April 2017. The CMA recognised that the PCR is no longer meeting its aims for a number of reasons, these include:

- Efficient suppliers should be able to earn a normal rate of return without a need to cross subsidise and that the PCR was not set appropriately
- Inherent and continuing downward bias in the calculation of Policy costs
- Major understatement of Smart Metering costs (almost twice the allowed EBIT)
- Need to act urgently, changes to take effect from October 2019
- Recognition that keeping the cap artificially below the efficient costs of supplier is not in customers' best interests
- Recognition that the PCR is so tight that market exit is a significant risk
- PCR constraint meant consumer service quality may be materially affected
- Hybrid reference price/cost index approach used by CMA is much less accurate than the bottom up approach employed by Ofgem, which could not have been developed by the CMA in time for the original implementation

We support the CMA's points above and are pleased they are generally addressed. We are also in broad agreement on the main areas which constitute relevant changes of circumstance. However, we note that in at least one case – the finding that prepay market conditions have not improved significantly – the main reason is that the PCR (as implemented) was and remains fundamentally wrong.

The CMA does recognise, as does Ofgem, that SMETS2 prepay meters have only recently become available, and are still not yet operating reliably at scale. SMETS1 prepay meters continue to function well, and our level of expertise in this sector is unique.

This allows us to highlight an area of continuing misunderstanding by the CMA. CMA makes the assumption that once enrolled, a prepay customer becomes like any other for a supplier to support. This is a fundamental misconception which must be changed. Prepayment customers are different. They cost more to manage and support. While smart meters make a big difference both to customer experience and supplier management, we can categorically state they do not place prepay customers on a level playing field with direct debit customers to service.

Utilita is demonstrably an efficient supplier in providing services to prepay customers, the fact we are still here under the PCR proves that. However, even with a smart meter, prepay customers have a higher propensity to contact their supplier, and are more likely to experience disability or be otherwise vulnerable. They are also very likely to be cash poor and to have difficulty in topping up their meters and repaying debt. CMA has tended to view prepay customers as always paying in advance, which is frequently not the case. Prepay customers may bring debt with them through the Debt Assignment Protocol, acquire debt due to having difficulty paying their bills and seeking discretionary credit, or move to prepay to pay off debt previously acquired as a credit customer.

CMA (and Ofgem in future) must recognise this cost to serve differential exists. CMA must ensure that going forward, whether prepay meters are smart/traditional and enrolled in the DCC or not, any PCR or other protection addresses this.

We welcome the clarification in the Explanatory Note on Excluded Meters, in particular, that DCC enrolment is a necessary, but of itself not a sufficient condition for definition as an Excluded Meter. This transition must be carefully managed, and any Direction reviewed for broader impact before implementation. This will be particularly relevant when ensuring that prepayment customers continue to be appropriately viewed as prepay in terms of any future protection provided.

There are also a number of other areas which have not been adequately addressed, and hence must be considered failings of the review:

- 1.25% EBIT is not adequate to support a normal rate of return
  This is not enough to allow suppliers to compete and innovate, while still meeting all licence requirements (especially for vulnerable customers) and industry investment programmes as well.

  At present, unless suppliers use different contract types in order to benefit from differential pricing, compliance with licence and industry programmes will come at the expense of investment in innovation and the future customer.

- Competition for customers
  We believe that the PCR significantly reduced competition in the prepayment market because of low/negative margins. The level at which the PCR was set also contributed to the degree of price convergence which has been observed. Nonetheless prepayment switching is still healthy and smart meter penetration is

higher than for credit customers. On this basis, we must question the continuing need for a PCR.

In addition, the CMA is still targeting steady state costs. For competition to flourish and the market to thrive, suppliers must be able to make economic choices about profit, growth and investment strategies. The proposals will not allow for such choices, and so will not allow suppliers to compete for prepay customers – the group that most need competition.

- No acceptance that the underlying opex allowance was insufficient
  The review does not consider or recognise that the underlying opex allowance to manage and support prepay customers was completely inadequate. As a specialist, we believe Utilita is the most efficient smart prepay supplier, and we cannot achieve the allowed opex. CMA states in the review that cross subsidy should not be required to enable suppliers to finance their business, this was not the case.

  The CMA implicitly reviewed the opex allowance by adopting the Ofgem methodology, but the error is not explicitly recognised.

- Size of prepayment customer
  Utilita has highlighted a number of times that a prepayment customer generally consumes less than the equivalent credit customer. This has direct relevance to the calculation of the PCR. Given the elapsed time, it is extremely disappointing that the CMA has not addressed this matter.

- Cost under-recovery
  CMA has rightly acknowledged that there has been significant under-recovery of costs due to the poorly calculated PCR. There were significant errors in the PCR methodology, which have now been acknowledged, and plans made to improve (if not fully correct) the issues by moving to the Default Tariff Cap (DTC).

  In carrying out the analysis for the provisional decision, the CMA highlights a number of different areas where supplier under-recovery has occurred. Adding these areas together, the CMA has set out that the increased would be approximately £46 at Ofgem medium consumption. The difference is even greater if actual average prepay consumption is used. This would equate to an adverse impact on a supplier of approximately £4.6m for every 100,000 customers.

  The document completely fails to address that over the last two and a half years, suppliers such as Utilita and their shareholders have suffered fundamental, and business threatening, detriment due to the inappropriate calculations implemented by the CMA. This was the case even where there was an overestimate in the first PCR period, as the overestimate simply reduced the level of detriment. CMA should consider how best such impacts could be remediated, for example by aligning the restriction to the credit cap, as below.

As an interim measure, we support the approach set out of aligning the calculation of the PCR to the DTC. This is a sensible and pragmatic approach to address the worst aspects of the PCR as soon as possible.

The short-term ambition should be that as an industry, we move towards a wholly integrated cap. There are more vulnerable customers of all types who are on Pay on Receipt of Bill (PORB) credit terms than are on prepayment, and probably on direct debit. This means that the backstop 'cap' must be the one for PORB customers. A single 'safeguard' cap, set at the level for PORB allowing suppliers to compete robustly - and profitably – below that level must be the right objective for the short and medium term.

There is already healthy competition and switching for Direct Debit customers below the level of the cap, and prepayment customers also continue to switch. A backstop cap aimed at preventing the kind of problematic differential pricing previously noted should be sufficient. This approach would remove the perverse incentives currently existing between the caps.

The single cap described above would also allow for the development of a framework, and the necessary data collection, to support robust analysis of the competitive framework by Ofgem. This will allow timely evaluation to consider the removal of caps completely in due course.

The rollout of SMETS2 meters is behind schedule and in reality is likely to remain so. However, prepayment has a high penetration of interoperable SMETS1 meters, where customers switching retain their smart services. The tariff table issue previously identified is not relevant since competitors to SLEFs are based on SMETS1 meters, this therefore removes the link to roll out.

Finally, we do not support the proposal by CMA that prepayment customers should be protected until after the end of the smart roll out. This is not because we oppose the cap in principle, rather we support the integration of the PCR with the DTC. As a result, we believe that when Ofgem carries out the review of the DTC, it should be Ofgem, and not the CMA, who makes the recommendation on whether further protection for prepayment customers is required.

We hope this submission has been helpful and would be happy to discuss any points in more detail.

Yours sincerely,

By email

Alison Russell
Director of Policy and Regulatory Affairs