London Office
4th Floor,
1 Tudor Street,
London EC4Y 0AH
Tel: +44 (0)141 614 7501

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

8 July 2019

Dear Team,

Provisional Decision – Review of Energy Market Investigation (Prepayment Charge Restriction) Order 2016

Thank you for the opportunity to provide views on this provisional decision. We agree with the CMA's provisional conclusion that there have been changes in circumstances such that the Prepayment Charge Restriction (PCR) is no longer effective in meeting all of its aims and that the Order is no longer appropriate and needs to be varied.

We have consistently raised concerns that the level of the prepayment price cap is significantly too low and has not kept pace with increasing policy, wholesale and operational costs. We therefore welcome the CMA's intention to adopt the more up to date methodology developed by Ofgem for the purpose of the Default Tariff Cap (DTC) with adjustments specific to the prepayment sector. Given the magnitude of the gap that has opened up between actual costs faced by suppliers and allowances in the PCR, it is vitally important that the level of the cap is increased in time for 1 October 2019, as the CMA proposes.

We do however remain concerned that the proposed new methodology will still not fully reflect costs efficiently incurred in the supply of energy to prepayment customers plus the headroom deemed appropriate by the CMA to provide scope for competition under the cap. As set out in Annex 1, we believe the CMA is wrong to disallow the fixed element of non-pass-through smart metering net costs (NPT SMNCC) and would encourage it to make an adjustment to the cap to correct for this, if it can be done in time for the 7 August deadline. We also believe the original CMA allowance for the DD-PPM cost uplift was too low and agree that this should be revisited by Ofgem. We would also encourage the CMA to reconsider its decision to reduce the headroom allowance, for which it gives no explanation.

The CMA also proposes that responsibility for the cap should transfer to Ofgem from 1 October 2020, with a recommendation to Ofgem to continue the protection beyond December 2020. We believe there would be advantages to transferring this responsibility sooner, with discretion for Ofgem to make further adjustments to the methodology if required. We believe this should be done with effect from 1 April 2020.

Finally, we are concerned that the CMA is proposing to recommend that Ofgem should provide protection to prepayment customers after the PCR expires until the rollout of smart meters is substantially complete. This recommendation runs contrary to the decision in the CMA EMI Final Report, which was that if smart meter rollout was delayed, the CMA should consider encouraging Ofgem to review the situation and take whatever action it considered appropriate, ie to give discretion to Ofgem. This option was considered carefully by the CMA in its Final Report, and considered to be the most appropriate, and it appears that the CMA is now rejecting the previous arguments with no explanation. We can see substantial risks to consumers from fettering Ofgem's discretion in this way and no obvious advantages.

We elaborate on these views further and provide supporting data in Annex 1. Please do not hesitate to contact me or James Soundraraju [redacted] if you have any questions arising from this response.

Yours sincerely,

[redacted]

Richard Sweet
Head of Regulatory Policy

Annex 1

PROVISIONAL DECISION – REVIEW OF ENERGY MARKET INVESTIGATION (PREPAYMENT CHARGE RESTRICTION) ORDER 2016 – SCOTTISHPOWER RESPONSE

1. Introduction

We have consistently raised concerns that the level of the prepayment price cap is significantly too low and has not kept pace with increasing policy, wholesale and operational costs. We therefore welcome the CMA's intention to adopt the more up to date methodology developed by Ofgem for the purpose of the Default Tariff Cap (DTC) with adjustments specific to the prepayment sector.

In addition to the reasons identified by the CMA for favouring Ofgem's methodology, we would note that if the CMA's methodology was retained for the next price control period, suppliers would no longer be able to recover the costs of CM levy payments which have temporarily been suspended but are expected to be resumed later in the year (subject to State Aid re-approval). This is because the CMA's methodology bases the allowance for policy costs on OBR forecasts, which now exclude CM levy costs on the basis that the CM has been suspended. If suppliers were unable to recover these costs, this would run contrary to Government expectations that suppliers will be in a position to pay accumulated CM levies soon after State Aid approval is confirmed.

Given the magnitude of the gap that has opened up between actual costs faced by suppliers and allowances in the PCR, and the length of time this gap has already been in place, it is vitally important that the level of the cap is increased in time for 1 October 2019, as the CMA proposes. We therefore recognise that there is limited time for the CMA to take into account new evidence and undertake further analysis. However we think that it should be possible to correct an issue relating to the fixed element of NPT SMNCC costs (see section 2 below) in time for the 7 August deadline for publishing cap levels.

Other points covered in the sections below include:

- our concern that the original CMA estimate of the DD-PPM cost to serve differential was too low (section 3)
- the lack of any rationale for the CMA's proposed reduction in the headroom allowance (see section 4);
- the case for bringing forward the hand-over to Ofgem from 1 October 2020 to 1 April 2020 (section 5);
- our concerns over the CMA's proposed recommendation to Ofgem (section 6);
- a minor correction to the CMA spreadsheet (section 7).

2. Non pass-through smart metering costs

We agree with the CMA's rationale that it is appropriate for the pass-through element of Ofgem's smart meter net cost change (SMNCC) allowance to be included in the prepayment cap. This relates to costs of supplier contributions to DCC, SEGB and AltHanCo relating to establishing, marketing and operating the smart metering system. These costs are levied on suppliers in proportion to their total number of meter points, and the allowance in the Ofgem's DTC methodology is derived by calculating the per-meter cost. If this per-meter cost were not included in the PCR, suppliers would not be able to recover the portion of these costs relating to non-smart prepayment meters.

By the same rationale, the CMA should also include the *fixed* component of the non pass-through (NPT) SMNCC[1], ie the component of NPT SMNCC which suppliers incur regardless of the number of meters they install, for example programme management costs and industry subscriptions. Ofgem's allowance for these costs is based on its modified version of the BEIS cost benefit analysis model. Fixed costs such as these would be converted into a per-meter cost in this model in the same way as the pass-through costs referred to above. Hence, these costs will not be fully recovered via the DTC and an allowance needs to be included in the PCR if they are to be fully recovered.

We list in Table 2 below cost categories, drawn from the list of SMNCC cost categories in Ofgem's DTC consultation[2], that we believe are relevant to NPT SMNCC. It is inevitable that there are fixed cost elements in this list that do not scale with the rollout of smart meters. For instance, 'organisational' costs such as legal, institutional and organisational set up costs will be incurred irrespective of rollout volumes, similarly for supplier capex and opex costs.

Table 2 - Costs categories relating to NPT SMNCC

In premise costs
- Meters and IHDs
- Installation of meters
- Operation and maintenance of meters
- Communications equipment in premise

Suppliers' and other participants' system costs
- Supplier capex
- Supplier opex

Other costs
- Disposal
- Pavement reading inefficiency
- Organisational

In Table 3 below, we provide a breakdown of our organisational and internal programme costs (excluding Pass-Through) that relate to fixed costs, and how much that amount has increased since 2017 (the baseline year for SMNCC). As shown in the table, we believe the shortfall in the PCR allowance in respect of fixed NPT SMNCC costs is circa £[✂] per dual fuel customer.

We would encourage the CMA to adjust the final level of the cap to correct for this omission if it can be done in time for the 7 August deadline. We would expect that the relevant quantity could be inferred from Ofgem's NPT SMNCC model and that this could be provided to the CMA by Ofgem on request.

[1] NPT SMNCC include costs of the metering assets, installation, In Home Display (IHD) and smart-related system changes

[2] Appendix 10 - Smart metering costs (page 21) : https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-policy-consultation-overview

Table 3 - Fixed elements of ScottishPower's NPT SMNCC in 2019

	2017 (£m) (Half-Year)	2019 (£m) (Oct 19 - Mar 20)	Fixed element of NPT SMNCC (£m)
P&C - Legal Costs	[✂]	[✂]	[✂]
P&C - MGT & Business Support	[✂]	[✂]	[✂]
P&C - Salary Costs	[✂]	[✂]	[✂]
P&C - Secondment Expenses	[✂]	[✂]	[✂]
P&C - Travel & Accommodation	[✂]	[✂]	[✂]
PIR - ISO 27001	[✂]	[✂]	[✂]
IT - Change Management	[✂]	[✂]	[✂]
SUK - Support Costs	[✂]	[✂]	[✂]

Total Fixed NPT SMNCC in 2019 (£m)	[✂]
Multiplied by 2 to give full year equivalent value (£m)	[✂]
ScottishPower dual fuel customers (millions)	[✂]
Fixed NPT SMNCC per DF customer (£/customer)	[✂]

3. Prepayment meter (PPM) cost differential

In our response to the CMA's Energy Market Investigation in 2016, we provided evidence to suggest that, based on ScottishPower's costs, the CMA had significantly underestimated the cost to serve differential[3] between PPM and direct debit (DD) customers. Whilst the CMA estimated the difference at £63 per year per dual fuel customer for the first charge restriction period in April 2017, the corresponding actual cost difference faced by ScottishPower for these cost items was circa £[✂].

There are two possible explanations for the difference between the CMA's estimate and ScottishPower's estimate of the DD-PPM cost differential. Either ScottishPower's PPM costs were higher than the industry benchmark estimated by the CMA or ScottishPower's DD costs were lower. Ofgem's identification of ScottishPower as the efficient benchmark for setting the operating cost allowance in the DTC suggests the latter is at least part of the explanation. Therefore, to the extent that the difference is due to ScottishPower's low DD costs, the CMA should be giving greater weight to ScottishPower's estimate of the differential.

We note that the CMA has provisionally decided to maintain the PPM uplift at £67 but recommends that Ofgem considers undertaking additional analysis on the 'prepayment meter payment method uplift' in advance of any decision on how to protect prepayment customers. We agree with this recommendation.

[3] The costs-to-serve differential between those customers on direct debit and those on prepayment is used by the CMA as the prepayment meter payment method uplift element in the PCR.

4. Headroom

The CMA's rationale for including a headroom allowance in the PCR was to provide additional scope and incentive for suppliers to compete underneath the level of the cap, bearing in mind the particular constraints on competition (relating to availability of 'tariff codes') in the traditional prepayment meter market:

> "Even with a price cap design that accurately tracks costs we consider it is appropriate to include a headroom allowance so that suppliers are able to compete to offer a range of profitable tariffs at different levels".[4]

This rationale is distinct from Ofgem's rationale in including a headroom allowance in the DTC, which was to cater for uncertainties and unforeseen cost increases:

> "We include an additional component (headroom), which 'tops-up' the cap to ensure we give due regard to the net cost of residual risk and uncertainty not already compensated by our efficient cost estimates".[5]

In its provisional decision the CMA is proposing to reduce the headroom in the PCR from £34 per dual fuel customer (the level originally deemed appropriate by the CMA for competitive headroom) to £14 (the allowance set by Ofgem for uncertainty in the DTC). This represents a fundamental change in the methodology for which the CMA gives no explanation.[6] In order to justify such a change, the CMA would either need to have reconsidered the purpose of the headroom (and consulted accordingly on the reason for changing the purpose) or would need to have reassessed the competitive conditions in the prepayment segment and concluded that a smaller allowance would be sufficient for the original purpose (and consulted accordingly). As far as we can see, the CMA has done neither, and it should therefore retain the previous value of the headroom allowance.

Indeed, we would note that there is little evidence of price competition under the current prepayment cap, which is understandable given that the intended competitive headroom allowance has been entirely swallowed up by the shortfall in other costs allowances. The fact that there is currently a significant level of competition under the DTC for credit meter customers is not directly relevant, since as noted above, there are separate constraints in the prepayment market, and the current levels of price dispersion under the DTC can largely be attributed to recent volatility in the wholesale energy market.[7]

5. Timing of implementation

The CMA is proposing that responsibility for protecting PPM customers could transfer to Ofgem from 1 October 2020 (thereby ending the CMA's PCR on 30 September 2020) if, by that point, Ofgem is ready with its own PPM price protection.

4 Energy Market Investigation Final Report, paragraph 14.118
5 Default Tariff Cap Decision – Overview Document, paragraph 2.4
6 Although the CMA offers some comments at para 4.20(b) regarding headroom, we do not think these comments are relevant to this particular decision. The CMA is making two separate decisions relating to headroom: (i) to replace the CMA's previous headroom estimate with Ofgem's DTC headroom in the PCR with effect from 1 October 2019; and (ii) to specify the new PCR headroom calculation in the licence in such a way that it does not automatically vary if Ofgem subsequently varies its DTC headroom approach. Our reading of para 4.20(b) is that it refers to the latter not the former.
7 At a point in time when wholesale prices have sharply reduced, the energy cost of acquiring a new customer on a fixed term product is much less than the cost of energy for an existing customer on a default tariff whose energy has been purchased in line with price cap hedging assumptions.

We believe there would be advantages to transferring this responsibility sooner (we would suggest with effect from 1 April 2020), by ending the PCR on 31 March 2020, and giving discretion to Ofgem to make further adjustments to the methodology if required. This would give Ofgem greater flexibility to make further adjustments to the relative levels of the smart and non-smart prepayment cap (and the allocation of costs between them) should this prove desirable. It would also provide an opportunity for Ofgem to gather additional evidence to review whether the CMA's original estimate of the DD-PPM cost differential remains appropriate.

An earlier transition to ownership by Ofgem may also deliver benefits in terms of consistency and efficiency of processes, information provision, data management and use of resources from a single regulatory interface.

6. Recommendation to Ofgem

Finally, we are concerned that the CMA has provisionally decided to recommend that Ofgem provide protection to prepayment customers until the rollout of smart meters is substantially complete as follows:

> "The CMA recommends that GEMA should provide protection for prepayment meter energy customers after the expiry of the CMA's prepayment meter charge restriction until the roll-out of smart meters is substantially complete in line with its objectives and duties."[8]

This proposed recommendation runs contrary to the decision of the CMA's Energy Market Investigation, and the CMA offers no explanation as to why it has reversed the previous decision. The final decision of the EMI was that if smart meter rollout was delayed, the CMA should leave it to Ofgem's discretion to determine what form of protection might be most appropriate. For example (emphasis added):

> "In the event that, at the date of the mid-term review, the roll-out of smart meters does not appear likely to be completed by 31 December 2020, we would consider whether to **encourage Ofgem to review the situation and take whatever action it considers appropriate** (including whether to introduce a similarly structured price cap in the prepayment segments as from the start of 2021). We believe that this approach is more proportionate than extending the PPM Price Cap Remedy for a further specified period. While this creates some uncertainty about the possibility of a price cap being in place beyond 2020, this uncertainty is narrowed to the issue of the extent of roll-out."[9]
>
> *"If the roll-out of smart meters did not appear likely to be completed by 31December 2020, the CMA would consider whether to **encourage GEMA to review the situation and take whatever action it considered appropriate**."*[10]

This recommendation was considered carefully by the CMA in the Final Report and felt to be more proportionate than other options, but it now appears that the CMA is minded to reverse its previous decision with no explanation as to why it is appropriate to do so.

[8] Provisional Decision, para 5.9
[9] CMA EMI Final Report, para 14.338
[10] Explanatory Note to the Order, paragraph 75 (as quoted in the Provisional Decision, para 5.2(c)

By making a recommendation in the terms proposed, the CMA will be tying Ofgem's hands to retain a price cap for potentially many years after the planned expiry of the PCR (depending on the interpretation of 'substantially complete'). Much can potentially change in the intervening time period, and there are various scenarios in which this recommendation could unnecessarily constrain Ofgem's ability to implement the most effective overall solution. For example Ofgem might (in the absence of this recommendation)

- decide to implement an alternative protection, such as a price cap targeted at financially vulnerable consumers, which would not necessarily include all consumers with prepayment meters;

- conclude that conditions have changed sufficiently (even without complete smart meter rollout) that no further protection is required;

- implement some other form of protection (other than a price cap).

From a consumer protection perspective, we can see no disadvantage in the CMA sticking to its previous decision and encouraging Ofgem to review the situation and take whatever action it considers appropriate. If Ofgem considers a continuing price cap to be appropriate, it has the necessary powers to implement it, without needing a CMA recommendation. If Ofgem does not consider it to be appropriate, this will be for good reason, and consumers' interests would be better served if Ofgem is left free to act accordingly.

7. Correction to CMA spreadsheet

We note that Tab '1b_Historical_level_tables' omits 'Network Costs' in cells X16:AB16.

ScottishPower
July 2019