By email:

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

8th July 2019

Dear Sir/Madam,

Review of the Energy Market Investigation (Prepayment Charges Restriction) Order 2016

Thank you for the opportunity to respond.

We welcome the CMA's provisional decision to adopt Ofgem's Default Tariff Cap (DTC) methodology, in time for the October 2019 cap update. The CMA has correctly identified that the prepayment cap (PCR) is materially under-recovering the costs of efficient suppliers. We estimate that this amounts to c£300m across the industry (c£17m npower) from when the cap was introduced in 2017 to September 2019.

Notwithstanding our concerns about the level of the DTC, a PCR that is more cost reflective will better facilitate competition, innovation and good service standards

We have a number of specific comments.

Wholesale

The CMA states that the wholesale cost component in the PCR is £14 lower than Ofgem's DTC and this difference has been fairly stable over time. As this is material shortfall across the PCR customer base, we do not see how this can be considered an adequate reflection of wholesale costs. See also our comments on recovery.

The PCR assumes 63% of gas demand is in the winter, compared with 75% in the DTC. The industry is putting in place new End User Categories (EUCs; the gas equivalent of profile class) from October 2019, which will define how gas is allocated, both for domestic prepayment (72%) and non-prepayment (77%)[1]. If the DTC "bottom-up" methodology is adopted, it will be important to ensure that the correct/updated EUCs are applied in the PCR and DTC. Otherwise, the winter element of the wholesale index will be too low.

Capacity Market

Ofgem correctly allowed for Capacity Market (CM) costs within the DTC, driven by the Government's expectation that (subject to State Aid approval) payments suspended during the standstill period would be paid by suppliers. Ofgem has also proposed to include a full CM allowance in the third cap period.

[1] averaged across Local Distribution Zones, there will be regional variances.

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The current version of the PCR model uses a different source for the costs of the CM. The PCR model uses forecasts from the Office for Budget Responsibility (OBR). The latest OBR forecasts do not include CM costs, given the standstill period for the CM scheme. The PCR, using its current methodology, would therefore not include CM costs when indexing policy costs for the cap period starting in October 2019.

Adopting the DTC methodology for the PCR would ensure recovery of CM costs, which are material at c£15 per typical domestic customer.

Exclusion of non-pass through smart costs

We question why the CMA believes that it is not appropriate for customers with a SMETS1 prepayment meter to bear non-pass through costs. Suppliers who have invested in a SMETS1 prepayment solution will have stranded costs from procuring and installing a smart meter that will become interoperable once enrolled into the DCC. Exclusion of such costs would mean that such prepayment customers avoid their share of smart rollout costs. If the intent is that these costs are subsidised, this should be explicit.

SMETS2 PPM costs

These currently fall under the DTC for Direct Debit, with no uplift for additional costs. Ofgem stated that it would keep this under review as data emerged on whether there are any additional efficient costs above direct debit, with power under the licence condition to set a different SMETS2 tariff cap. Ofgem should address this as part of its review of the SMNCC and when reviewing whether to take appropriate action beyond the PCR.

npower (and we assume others) have incurred: i) higher costs relating to additional functionality in IT investments, and ii) additional testing of the national prepayment infrastructure for SMETS2 meters (in 2019 npower are forecasting a spend of £1.85m solely on prepayment testing).

The extent to which Ofgem included such costs in the overall assessment of smart costs for the DTC, remains unclear.

Headroom

The CMA allowed headroom for competition in the PCR, whereas Ofgem's lower headroom allowance is intended as an (insufficient) buffer for uncertainty and error. It is not clear why the CMA considers adopting the latter to be appropriate. It seems counter-intuitive given the CMA's concerns about the lack of competition in the prepayment segment. We note the recommendation that Ofgem assesses this in considering any future protection of prepayment customers.

Recovery

npower maintains that the lack of a recovery mechanism in price cap design is a fundamental error, out of keeping with standard regulatory practice in price control (for example in network regulation in Great Britain), and flowing a deadweight cost of risk into the economy. This is particularly pertinent in relation to wholesale, smart and other policy costs (as the CMA has highlighted here). It is also exacerbated by the mutualised costs of supplier failures.

Suppliers have and continue to materially under-recover costs under this licence condition, contrary to Ofgem's statutory duty to ensure that licensees can finance their activities. Both the CMA and Ofgem disagreed with us about the justification for a recovery mechanism in the PCR and DTC. On the evidence, the case is clear.

Yours faithfully,

[redacted]

Regulatory Advisor
[redacted]

Cc: Chris Harris, Head of Regulation and Compliance

Ofgem, Retail Price Regulation