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By email to: Remedies.reviews@cma.gov.uk

Dear Peter

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

Centrica welcomes the opportunity to comment on the provisional decision.

In summary

- We strongly agree with the CMA's provisional conclusion that the Prepayment Charge Restriction (PCR) is no longer effective in meeting all its aims due to materially underestimating the costs incurred by efficient suppliers, and therefore needs to be varied.[1]
- We endorse the CMA's finding that it is not in the interests of prepayment customers for the PCR to be maintained at an artificially low level; as the CMA notes this may simply lead to suppliers cutting costs with less competition and lower service standards resulting.[2]
- We therefore welcome the CMA's provisional decision to revise the PCR methodology in line with Ofgem's Default Tariff Cap (DTC) methodology in time for the cap period commencing 1 October 2019 as we have previously recommended.[3]
- Our main reservation concerns the CMA's proposal to disallow full recovery of non-pass-through smart costs from prepayment customers. Our concern is that this will inevitably constrain investment in smart roll-out for prepayment customers, further delaying the

[1] Provisional decision Executive Summary paragraph 5
[2] Provisional decision paragraph 6.6
[3] See, for example, Centrica's response to the issues statement https://assets.publishing.service.gov.uk/media/5cf680a7ed915d097f9f8dcc/Centrica_response_to_CMA_issues_statement_on_PPM_cap_review.pdf

resulting consumer benefits and unduly prolonging continued price protection the CMA believes is necessary.[4]

- Should the final decision mirror the provisional decision not to provide fully for the costs of smart roll-out to prepayment customers within the PCR, Ofgem will need to address this risk by ensuring that it will allow recovery of resulting cost shortfalls when it reviews the application of its DTC to fully interoperable smart prepayment meters.[5] We discuss this issue further in the attached appendix.

Given the overwhelming need to ensure that the provisional decision is confirmed in time to enable Ofgem to notify revised cap values by 7 August, we do not seek to comment extensively on all aspects of the CMA's analysis in the present response. In the main, disagreement over aspects of the CMA's analysis is not material to the provisional decision itself.[6] We therefore confine wider comment to the following short points:

- We disagree with the CMA's apparent view that the coexistence of the PCR and DTC does not amount to a change of circumstance. However, in view of the provisional decision to nevertheless recognise the relevance of the DTC in other respects and substantially adopt its methodology, this is of little immediate consequence.
- We disagree that the current PCR methodology provides an adequate reflection of wholesale costs[7] and that differences in this regard between PCR and DTC are not in themselves material. We stand by our previous critique in this respect.
- More generally, we disagree that that the £3.20 difference the CMA calculates between a hybrid option and the DTC option is 'small'.[8] Whether or not a difference of this magnitude might be regarded as small for an individual customer, the cumulative effect across millions of prepayment meter customers is large and likely to remain so well into 2020 given the current DCC enrolment schedule.[9]
- The CMA's provisional recommendation that Ofgem should provide protection to prepayment customers when the PCR expires until the roll-out of smart meters is substantially complete is premature, inconsistent with the Energy Market Investigation (EMI) final report, and risks pre-empting reviews Ofgem is required to undertake in any event under the terms of the Domestic Gas and Electricity (Tariff Cap) Act 2018.[10] The CMA should instead recommend that Ofgem undertakes a review in good time ahead of the cap period commencing October 2020, but without pre-determining the outcome.[11]

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[4] Paragraph 5.5 of the provisional decision states that *"the CMA considers it appropriate for prepayment customers to continue to be protected following the expiry of the PCR and until the completion of the roll-out of smart meters to the large majority of prepayment meter customers." (Emphasis added)*

[5] To date, Ofgem has not conducted a full review of how the DTC should apply to fully interoperable smart PPM meters falling outside the scope of the PCR but has stated that it will consider and consult on this when sufficient data is available. See November Decision Overview at 5.23 https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document_0.pdf

[6] It may, however, be relevant in other contexts. To avoid any misunderstanding, where we do not comment expressly this does not imply complete agreement with the analysis or provisional conclusions presented. We reserve all rights to make further representations to the Ofgem or the CMA as may be appropriate in due course.

[7] Provisional decision paragraph 2.76

[8] Provisional decision paragraph 4.15, for example

[9] We also note that DCC enrolment is a necessary but not sufficient condition for SMETS1 meters to be excluded from the PCR. Fully interoperable smart meters are not excluded from the PCR until the CMA gives specific direction to that effect.

[10] For further discussion see https://www.eprg.group.cam.ac.uk/wp-content/uploads/2019/06/S.-Littlechild_Energy-Prepayment-Review-submission-to-CMA_1Jul19.pdf

[11] We do not object to the CMA's proposal to vary the order to allow the PCR to end on 30 September 2020 in the event that Ofgem plans to introduce separate protection from 1 October 2020 i.e. on a contingent basis. It is the outcome of Ofgem's review, including the scope and duration of any enduring price protection for prepayment customers that requires further consideration and consultation.

As with previous submissions, given the complex interactions between the PCR and the DTC, this response is copied to Ofgem. If you have any questions about this response, or if we can assist the Panel further, please contact me or don.wilson@centrica.com.

Yours sincerely

[redacted]

Tim Dewhurst
Head of Regulatory Affairs, UK & Ireland

Appendix – Treatment of smart metering costs in the PCR and implications for DTC

We welcome the CMA's recognition that smart metering costs have increased far beyond the initial Government estimates considered by the CMA at the time it designed the PCR methodology.[12]

We have previously acknowledged that there are various approaches the CMA could potentially take to determine the smart allowance within a revised PCR. We previously proposed that, as an interim measure, the CMA should adopt Ofgem's non-pass-through SMNCC for credit. This is not the approach proposed in the provisional decision. While the overall approach to smart allowance proposed represents an improvement on the current position, it appears that the CMA's intention is that the PCR should <u>not</u> allow full recovery of smart costs from prepayment customers within the scope of the PCR. It is important that the implications of this policy decision are fully understood.

We appreciate that the CMA may be concerned to limit the extent of any increase in costs to be borne by prepayment customers within the scope of the PCR. However, we remain concerned that this will have the unfortunate consequence of constraining investment in smart conversion for prepayment customers. This will limit the benefits customers can derive in the short term and delay the point at which roll-out of smart meters to the large majority of prepayment customers may be considered complete.

To the extent the CMA maintains its current approach in the final decision, Ofgem must address the need to allow for full recovery of smart costs incurred in relation to prepayment customers when it revisits its approach to fully interoperable smart meters within scope of the DTC.

This is the logical corollary of the CMA's provisional decision not to allow full recovery of non-pass-through smart costs within the PCR. To do otherwise would not be consistent with Ofgem's statutory duties to ensure that suppliers can finance the regulatory obligations placed upon them as part of their licensed activities.[13]

CMA proposes only partial recovery of smart costs under the PCR

At 2.64 to 2.71 of the provisional decision, the CMA seeks to distinguish between pass-through costs - which it considers should be recovered from prepayment customers subject to the PCR, and non-pass-through costs – which it does not consider it appropriate for prepayment customers within the scope of the PCR to bear.

The CMA does not elaborate on why it considers it inappropriate for non-pass-through costs to be borne by prepayment customers within the scope of the PCR, beyond stating at 2.69

> *"In relation to non-pass-through cost, which relate to the roll-out and installation of actual smart meters, <u>we note that the PCR only applies to prepayment meters without an interoperable smart meter</u>. We therefore do not consider it appropriate for such costs to be borne by prepayment customers within the scope of the PCR." (emphasis added)*

[12] Provisional decision paragraph 2.65
[13] As the CMA notes at paragraph 10 of the Executive Summary, since the proposed variation to the PCR involves amending standard licence conditions, the CMA is required to have regard to GEMA's statutory functions.

Given the need to have regard to suppliers' ability to finance their regulatory obligations, the implication of this statement would appear to be that non-pass-through costs should be borne instead by prepayment customers with an interoperable smart meter.

Charges for prepayment customers on default tariffs with an interoperable smart meter that falls outside the scope of the PCR fall under Ofgem's DTC. Initially, Ofgem has set the cap for SMETS2 prepayment customers at the same level as applies to credit customers paying by direct debit, with no prepayment uplift.[14]

Ofgem's policy is to socialise installation and other smart costs widely

The CMA's intention to exempt prepayment customers who do not yet have a fully interoperable smart meter from contributing to non-pass-through costs contrasts with the approach Ofgem has taken to cost recovery through the standard licence conditions imposed on suppliers. Ofgem's open letter of 27 July 2017[15] states:

> *"Standard condition 22A of the gas and electricity supply licences require that any charges for supply activities (including the charges for the provision of a meter), must be incorporated within a supplier's standing charge and or unit rate. However these restrictions do not apply to a prescribed list of additional charges, which include the removal, installation, testing or repairing of a meter.*
>
> *Gas SLC 35 and Electricity SLC 41 set out the framework and objectives of the SMICoP (Smart Metering Installation Code of Practice)2 for domestic consumers. The code must at all times comply with the content requirements specified in the licence. These licence conditions set out that costs in relation to the provision, configuration, installation, operation, replacement and modification of a smart meter cannot be recovered from an individual customer, and should instead be borne by a supplier's domestic customers more generally as an increment of the charges for energy supplied to them."* (Emphasis added)

Disallowing non-pass-through SMNCC leaves smart PPM underfunded and will constrain smart rollout

As Centrica has previously advised, by setting the PCR the CMA will be determining the level of smart costs of an efficient operator as they relate to customers covered by the cap.[16] Given the "All Reasonable Steps" (ARS) licence framework, suppliers will be constrained necessarily by the allowance embedded within the price cap in terms of the scale of activities that can be undertaken.

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[14] While Ofgem's DTC does include and allowance for non-pass-through SMNCC, this is based on the smart costs credit customers so cannot be assumed to include smart costs associated with prepayment.

[15] https://www.ofgem.gov.uk/system/files/docs/2017/07/2017.07_revised_installation_cost_restrictions_final.pdf (Note, this letter updates an earlier letter from August 2015)

[16] https://assets.publishing.service.gov.uk/media/5cf680e0ed915d097c71c99c/Centrica_Appendix_PPM_price_cap.pdf

It is therefore concerning that one of the specific adjustments proposed to Ofgem's DTC methodology is to exclude non-pass-through SMNCC.[17][18]

The effect of this is that while a small element of non-pass-through embedded within the Opex component of Ofgem's DTC methodology will remain, and be indexed forward by CPIH, the substantial incremental net increase in non-pass-through costs compared to Ofgem's 2017 baseline will not be recoverable from prepayment customers within scope of the PCR. Since non-pass through costs associated with smart meters for prepayment customers are also not provided for within Ofgem's DTC for credit meter customers, there remains a clear funding shortfall against smart meter roll-out ambitions.

Adopting credit non-pass-through SMNCC in the PRC (as we proposed as an interim measure) would address this issue and allow the funding to be provided from 1 October 2019. If this isn't implemented, then the earliest it can be addressed is as part of Ofgem's review of smart meter costs in the DTC, to be implemented in time for the subsequent tariff change on 1 April 2020.

Future review by Ofgem should include the continued smart funding deficit

The CMA has proposed that Ofgem continue to provide price protection to prepayment meter customers after the expiry of the PCR until the roll-out of smart meters is substantially complete.[19] As noted in the covering letter, we consider this recommendation to be too prescriptive, inconsistent with the EMI final report, and in any event premature although we do agree that Ofgem should conduct a review ahead of the cap period commencing October 2020. The CMA also recommends that Ofgem consider future changes of circumstance in light of the original aims of the PCR when setting the level of any replacement charge restriction.

The latter recommendation clearly encompasses the two areas signalled by the CMA at paragraph 5.8, namely:

- whether the headroom currently within the DTC will be effective in generating competition on price or service levels for prepayment customers;
- whether the level of the prepayment meter method uplift and the allowances for installation remain appropriate once the roll-out of smart meters has progressed significantly.

We agree that Ofgem should consider both these matters, and additionally note that the review of prepayment method uplift must take account of the deployment costs of SMETS1 prepayment meters already incurred, as well as further costs associated with programme delays on DCC enrolment and transition to full interoperability.

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[17] Currently non-pass-through SMNCC in the DTC is £9.02 for electricity and £10.70 for gas. Note, however, that this is the increment on top of whatever non-pass-through costs may be included in the 2017 Opex benchmark as explained in the appendix to our response to the issues paper https://assets.publishing.service.gov.uk/media/5cf680e0ed915d097c71c99c/Centrica_Appendix_PPM_price_cap.pdf

[18] The CMA's commentary at 2.67 and footnote 73 implies that pass-through-costs are set directly using BEIS CBA model, and that this model is published. This is not correct. In fact, pass-through SMNCC has been set using an Ofgem SMNCC model based on BEIS wider CBA model. However, neither BEIS CBA model nor Ofgem's SMNCC model have been published. This lack of transparency remains a serious concern.

[19] Provisional decision paragraph 5.9