

UTILITA RESPONSE TO PRICE CAP: FINAL CONSULTATION ON UPDATING THE PREPAYMENT SMNCC ALLOWANCE

APPENDIX A: CONSULTATION RESPONSE

1. OFGEM'S PROPOSALS

- 1.1 On 29 April 2021, Ofgem issued a statutory consultation (the "**PPM SMNCC Consultation**")¹ setting out its proposals for setting the Smart Metering Net Cost Change ("**SMNCC**") allowance for customers with a prepayment meter ("**PPM**"), for the purpose of the cap on supplier charges pursuant to the Domestic Gas and Electricity (Tariff Cap) Act 2018 from cap period seven onwards.² The SMNCC is intended to take account of changes in operating costs due to smart meter rollout by suppliers compared to the baseline smart meter rollout costs in 2017. The PPM SMNCC Consultation was accompanied by a confidential model, accessible in full only to authorised advisers bound by confidentiality undertakings.
- 1.2 On 1 June 2021, Ofgem also published an addendum to the PPM SMNCC Consultation (the "**Addendum**")³. The Addendum sets out Ofgem's updated proposal, as a result of the Government's decision to extend the 'all reasonable steps' framework for the smart meter rollout for six months, to adopt a contingency allowance based on the SMNCC model for cap period seven and then to reconsult (on a narrow basis) in Autumn 2021 on the allowance for cap period eight onwards.
- 1.3 In the PPM SMNCC Consultation, Ofgem proposes to calculate the core SMNCC allowance for each cap period by calculating the expected difference in non-pass through ("**NPT**") smart meter rollout costs for the relevant cap period compared to a 2017 baseline.
- 1.4 Ofgem then proposes to apply three adjustments to the core SMNCC to establish the final SMNCC allowance:
- 1.4.1 First, Ofgem proposes to make certain adjustments to account for sunk costs associated with COVID-19.
- 1.4.2 Second, Ofgem proposes to offset the amount by which Ofgem considers the PPM Uplift underestimates the efficient cost differential between prepayment and direct debit customers. Ofgem proposes to apply this PPM cost offset on a cap period basis rather than cumulatively. This means that for a given cap period, any under-recovered PPM costs in a given cap period that cannot be offset against the negative SMNCC allowance (due to other elements of Ofgem's SMNCC proposals discussed below) will not be carried over to the next cap period.
- 1.4.3 Third, Ofgem proposes to apply an "advanced payments adjustment" ("**APA**") in respect of "advanced payments" from 1 January 2021 onwards, but only where the APA is negative (i.e. a "clawback"). Where the APA would

¹ Namely the consultation entitled "Price Cap: final consultation on updating the prepayment SMNCC allowance" and, so far as relevant to issues read across into the PPM SMNCC Consultation, the parallel consultation published on the same day in respect of the credit SMNCC allowance, namely a consultation entitled "Price cap - final consultation on updating the credit SMNCC allowance" (the "**Credit SMNCC Consultation**").

² As of 1 January 2021, Ofgem extended the cap to PPM customers.

³ The addendum is entitled "Price Cap – addendum to consultations on reviewing the credit and PPM SMNCC allowances".

otherwise be positive, i.e. a further allowance, no adjustment is made to account for this.

- 1.5 Subject to contingency arrangements, the outcome of the above proposals would be that a negative-only non-zero value for the final SMNCC allowance will take effect from cap period seven (October 2021–March 2022). As summarised below, and considered at length in the accompanying NERA report at **Confidential Appendix B (in full)** and **Appendix C (a non-confidential version)**, Ofgem’s decision on the core SMNCC is compromised by errors of approach and methodological flaws, which materially overstate the savings derived from the smart meter roll-out and do not reflect the costs that an efficient supplier would incur from the smart meter rollout.
- 1.6 Ofgem’s further decisions, to:
 - 1.6.1 prevent the SMNCC from becoming positive even where the model and data demonstrates that would be appropriate and cost reflective;
 - 1.6.2 apply the PPM cost offset only on a per cap period (rather than cumulative) basis; and
 - 1.6.3 to apply an APA only from a point in time (1 January 2021) when suppliers will have started to enjoy net cost benefits from the smart meter rollout (having suffered substantial unrecovered costs in prior periods which Ofgem have not seen fit similarly retrospectively to look to correct)are arbitrary, inconsistent with Ofgem’s approach to the credit SMNCC, apparently calculated to achieve an end result not supported by Ofgem’s model, data or duties and, ultimately, not cost reflective either on a per cap period basis nor on a whole life basis.
- 1.7 Accordingly, Ofgem’s proposals are not consistent with the legal framework Ofgem must operate within.
- 1.8 If Ofgem implements the SMNCC as proposed, it will fail to protect existing and future domestic customers who pay standard variable and default rates, as its proposals:
 - 1.8.1 will prevent efficient PPM suppliers from being able to finance their businesses, thereby preventing them from being able to compete effectively and disincentivising efficiency improvements, resulting in a reduction in competition;
 - 1.8.2 do not enable (or incentivise) suppliers to grow (or retain) their PPM customer bases (as the DTC would be set beneath the efficient costs of supplying a PPM customer). This will tend to ensure that tariff offerings converge very near the level of the cap and could result in higher tariffs upon expiry of the DTC; and
 - 1.8.3 accordingly, will not encourage customers to switch.
- 1.9 As such, these proposals will fail to facilitate a move to a more competitive market, thus breaching the purpose for which the legislation was introduced.

2. OFGEM'S ERRORS

The calculation of the core SMNCC is inaccurate and overstates the costs savings of the smart meter rollout

- 2.1 The calculation of the core SMNCC is inaccurate, relies on unjustified assumptions which are without evidential foundation and overstates cost savings as a result of the smart meter rollout compared to the 2017 baseline. It also reflects Ofgem's cherry-picking and selective approach when it comes to the PPM sector. Full details of the errors in the calculation are set out in the NERA report at Chapter 3. However, as NERA notes⁴:
- 2.1.1 It is unlikely to have identified all of the material errors and logical inconsistencies owing to the unnecessary complexity of the model. The model has not materially been simplified since the consultation conducted in 2020 which resulted in Ofgem's decision to reconsider its model and the SMNCC;⁵ and
- 2.1.2 Ofgem needs to provide further explanations to enable more meaningful review of certain elements that NERA has been unable to access further. It is frustrating that notwithstanding the feedback received to date on the model (and the fact that Ofgem spent almost an additional year reviewing the model and methodology before re-consulting on the proposed SMNCC), it remains opaque and relatively unchanged and unimproved.
- 2.2 We highlight below only the most significant and concerning errors but rely on the full analysis conducted by NERA.
- 2.3 The NERA report shows⁶ that in premise costs are overstated in Ofgem's model. For example:
- 2.3.1 Ofgem underestimates the age profile for traditional PPMs, a factor which it has acknowledged to be a key driver for the level of the SMNCC.⁷ Ofgem assumes an asset life of 14 years for electricity PPMs and 12 years for gas PPMs.⁸ NERA's analysis of supplier data shows that this is an underestimate and sets out what a minimum reasonable asset life assumption would be based on the data)⁹. Ofgem's approach to selecting an asset life assumption based on the supplier data is ad hoc at best and exhibits inconsistencies between electricity and gas. The main impact of underestimating the age profile of traditional meters is to make the counterfactual more expensive than it ought to be (because suppliers have to replace meters more frequently, and meter replacement is costly). Since the counterfactual is more expensive than it ought to be, the estimated

⁴ See paragraph 3.1 of the NERA report at Appendix B. All paragraph references to the NERA report at Appendix B can also be read across to the non-confidential version of the NERA report at Appendix C.

⁵ The model still contains 58 separate worksheets, and the roll-out profile is calculated over four separate sheets containing roughly 2,000 rows of calculations.

⁶ See paragraph 3.2 of the NERA report at Appendix B.

⁷ At paragraph 4.2 of the PPM SMNCC Consultation, Ofgem notes: "*The traditional meter asset life is a key driver of both costs and benefits in the SMNCC model, whilst the age after which PRCs for traditional meters expire will affect costs incurred of replacing these meters early*".

⁸ See paragraph 4.13 of the PPM SMNCC Consultation.

⁹ See paragraph 3.2.1 of the NERA report at Appendix B.

savings from smart metering are higher than they ought to be and so the SMNCC will be lower (or more negative) than it ought to be.

- 2.3.2 Ofgem underestimates the period of liability for rent and premature replacement charges ("**PRC**") on traditional PPMs.¹⁰ Ofgem assumes that suppliers are liable for rent and premature replacement charge payments on both gas and electricity traditional PPMs until they are ten years old. NERA's analysis of the supplier data shows that the term of PRC and rent liability on traditional meters is significantly longer than that assumed by Ofgem. This under-estimation has a variety of effects on the core SMNCC, running in both directions. The combined impact of these effects is that Ofgem's estimate of the core SMNCC is too negative.
 - 2.3.3 Ofgem overestimates the level of PRC payments for gas PPMs¹¹. NERA's analysis of the supplier data on PRCs shows that the average level of PRC payments for traditional gas PPMs at age zero is significantly lower than the level assumed by Ofgem.
 - 2.3.4 Ofgem assumes unjustified productivity improvements that cause it to underestimate the total cost of smart meter installation.¹² Ofgem assumes that there will be productivity improvements in smart meter installations from 2019 onwards, which reduce the cost of smart meter installations. The assumed productivity improvements are poorly explained and inconsistent with existing supplier data. In other words, they are not supported by the evidence Ofgem itself relies on to justify the SMNCC. Ofgem itself notes that *"One supplier anticipated that under the new BEIS smart meter policy framework the incremental cost of installations is likely to increase... due to suppliers looking to adopt additional measures to address customer engagement challenges"*.¹³
 - 2.3.5 Ofgem's assumed replacement rate for expiring in-home displays ("**IHD**") is unjustified¹⁴. Ofgem assumes that only a low proportion of expiring IHDs are replaced, and by implication assumes that many homes would instead have no IHD. This is inconsistent with the latest BEIS analysis and is a gross underestimate of replacement requirements and costs, causing Ofgem to underestimate the cost of the policy scenario, and thereby to over-estimate the benefits of the smart-meter rollout in terms of cost-savings. Again, this leads Ofgem to calculate the SMNCC as being lower (or more negative) than it ought to be.
- 2.4 In addition, the NERA report shows that operational (cost-to-serve) savings are overstated¹⁵. Ofgem's approach is flawed and inconsistent and reflects a selective approach when it comes to the PPM sector:
- 2.4.1 It assumes, without justification, that suppliers' average cost-to-serve ("**CTS**") per customer of each type is representative of the CTS that could

¹⁰ See paragraph 3.2.2.1 of the NERA report at Appendix B.

¹¹ See paragraph 3.2.2.2 of the NERA report at Appendix B.

¹² See paragraph 3.2.3 of the NERA report at Appendix B.

¹³ Paragraph 6.79 of the PPM SMNCC Consultation.

¹⁴ See paragraph 3.2.4 of the NERA report at Appendix B.

¹⁵ See paragraph 3.3 of the NERA report at Appendix B.

be saved by switching one customer from a traditional meter to a smart meter.¹⁶

- 2.4.2 It combines the supplier data in a way that places excessive importance on small customer groups with under-representative costs.¹⁷ The incorrect ordering of Ofgem's arithmetic causes a material upward bias in the CTS benefit, such that Ofgem's estimate of the average CTS benefit is larger than the CTS benefit across the industry as a whole.
- 2.4.3 It includes data from Utilita whose CTS traditional customers are not reflective of what the industry could save relative to the costs embedded in the operating cost allowance.¹⁸ Companies with a lower share of traditional PPM customers relative to total PPM customers tend to have a higher CTS per traditional customer. This is particularly true for Utilita, which is an outlier in terms of the degree of its rollout, and whose traditional CTS is among the highest in the industry. Ofgem's inclusion of Utilita for this purpose is inconsistent with its approach elsewhere in the application of the model (e.g. Utilita is excluded from the historical rollout profile). It should be excluded also from this aspect of the analysis.
- 2.5 Ofgem's method of calculating the CTS benefit is highly sensitive to its incorrect order of operations and its inconsistent choice to include and overweight Utilita's traditional customer base. As a result of these errors, Ofgem's resulting CTS benefit materially overstates the avoided CTS that an efficient supplier could actually achieve on each customer.¹⁹ Again, this results in the SMNCC being lower (or more negative) than it ought to be.
- 2.6 Lastly, Ofgem has overestimated the level of smart meter costs embedded in the operating cost allowance.²⁰ Ofgem assumes that the costs included in the operating cost allowance are equal to the net costs in 2017 of a notional "lower quartile" supplier with an industry-average rollout profile. This notional supplier does not exist in reality and has no impact on the operating cost allowance.
- 2.7 Taken together, it is clear that the core SMNCC calculations contain numerous clear and demonstrable errors that must be corrected regardless of any other issues raised in respect of Ofgem's proposals concerning the SMNCC.
- 2.8 Indeed, the core SMNCC calculations may contain more inconsistencies and errors which NERA has not been able to separately identify due to Ofgem's failure to provide complete information on which it relied in producing its proposals).²¹
- 2.9 NERA estimates that Ofgem's proposed core SMNCC is significantly overstated by at least £5.43–£7.68 per customer per year for electricity and £9.35–£12.41 per customer per year for gas. NERA also finds that the electricity SMNCC is *positive* in all periods, meaning that the smart meter rollout has increased the efficient costs of

¹⁶ See paragraph 3.3.1 of the NERA report at Appendix B.

¹⁷ See paragraph 3.3.2 of the NERA report at Appendix B.

¹⁸ See paragraph 3.3.3 of the NERA report at Appendix B.

¹⁹ See paragraph 3.3.4 of the NERA report at Appendix B.

²⁰ See paragraph 3.4 of the NERA report at Appendix B.

²¹ See paragraph 3.5 of the NERA report at Appendix B

a PPM supplier relative to the level embedded in the operating cost allowance and PPM uplift.

Other errors

(a) Ofgem's failure to offset the "under-recovered PPM costs" fully

- 2.10 Ofgem's view is that the PPM uplift was set too low and results in an under-recovery of the efficient cost to serve PPM customers. However, because of the way in which Ofgem designed the Default Tariff Cap originally in 2018, this under-recovery by PPM suppliers leads to over-recovery by credit suppliers.
- 2.11 Ofgem proposes to deal with the under-recovery by PPM suppliers by setting this off against the SMNCC. However:
- 2.11.1 Ofgem will not allow the net position to become positive, i.e. such that the final SMNCC is a positive amount (as it will be for the credit cap) even where that reflects Ofgem's own estimate of the efficient cost of supplying PPM customers;
- 2.11.2 Ofgem will not roll forward any "under-recovery" that has not been offset in a cap period. Rather, Ofgem proposes to apply the offsetting on a "per cap" basis rather than a "cumulative" basis; and
- 2.11.3 Ofgem will only apply its APA if it is a negative amount. This further erodes PPM suppliers' ability to recover their efficient costs, as Ofgem arbitrarily chooses to apply its APA only if it would further reduce the level of the cap, regardless of whether the data supports such an outcome.
- 2.12 These decisions are arbitrary. There is no legitimate justification for them – and Ofgem's only justification appears to be that they have pre-determined that the cap should not increase as a result of the final SMNCC and are adjusting the model to achieve that particular end. For example, Ofgem aims: *"to maintain the cost differential between cap levels for PPM and DD customers. This means that we would not set the net SMNCC [for PPM] above £0, to maintain the differential and the level of protection PPM customers currently have"*.²² Similarly, Ofgem notes that it considers: *"that there is a risk that any offset could be too generous to suppliers. A per cap period offset would be less risky on this basis"*,²³ with Ofgem preferring to err on the side of a *"slightly greater risk of under-compensating suppliers because of the overriding need to protect consumers"*.²⁴
- 2.13 However, that approach is inconsistent with the basis on which any cap is to be set – i.e. *"protecting existing and future domestic customers who pay standard variable and default rates"*, where protecting customers means ensuring that prices are cost reflective (see paragraph 3.14 below). It also wrongly assumes that there is a risk that the PPM cost offset may be overstated because Ofgem state that it is an upper bound limit for that offset. However, as demonstrated by NERA, the PPM cost

²² Paragraph 7.21 of the PPM SMNCC Consultation. In any event, this is no answer as that differential is not being maintained because the credit SMNCC is increasingly positive and the PPM SMNCC is increasingly negative.

²³ Paragraph 4.79 of the PPM SMNCC Consultation.

²⁴ Paragraph 4.80 of the PPM SMNCC Consultation.

offset is in fact a reasonable central estimate and the true value could be higher as well as lower.²⁵

- 2.14 The result is a failure to ensure that the cap is set in an accurate and cost-reflective way, based on Ofgem's assessment of the evidence. The justification based on maintaining the cost differential between PPM and DD customers also fails from the outset, as that differential will actually increase as a result of the arbitrary way that Ofgem ensures that the PPM SMNCC is always negative (or zero) while the credit SMNCC is allowed to be (and will be ever more) positive. Thus, Ofgem's SMNCC design will not only fail to allow PPM suppliers to recover their acknowledged under-recovered costs (which Ofgem has previously decided should be recovered through an adjustment to the SMNCC), but will allow the suppliers of credit customers (who already benefit from a cross-subsidy) to increase their charges and increase the differential between credit and PPM prices.
- 2.15 Ofgem's inaccurate calculation of the core SMNCC appears to have given it the wrong impression that the SMNCC would otherwise (i.e. without correcting for the PPM cost offset) be negative. This may have given Ofgem comfort for its proposal to prevent the SMNCC from becoming positive. However, as NERA has demonstrated, Ofgem's calculation of the core SMNCC is wrong and the PPM SMNCC for electricity will always be positive, regardless of the PPM cost offset. Ofgem will therefore need to reconsider its position on capping the SMNCC at zero.
- 2.16 Regardless, it is wrong for Ofgem artificially to refuse to allow the PPM SMNCC to become positive in circumstances here: (a) electricity PPM suppliers have under-recovered on Ofgem's view of efficient NPT smart metering costs in every single period since the prepayment charge restriction (the "PCR") was first introduced in 2017 (with the PPM cost offset); and (b) Ofgem does not propose to correct for that through an APA in a similar manner to the correction it proposes for gas from 1 January 2021
- 2.17 Allowing the PPM SMNCC to become positive – as it would be if Ofgem did not artificially prevent it from doing so – would better reflect Ofgem's stated desire to maintain the cost differential between credit and PPM (given that Ofgem has allowed the credit SMNCC to be positive).
- 2.18 In light of the evidence presented here and in NERA's report, Ofgem must reconsider its position to ensure that the PPM cap is lawful following 1 October 2021. Where cost-reflectivity would lead to a positive SMNCC, Ofgem should not artificially (and inconsistently with the approach to credit suppliers) prevent that outcome.
- (b) Ofgem applies an arbitrary cut-off date for the application of the SMNCC, meaning that it does not reflect the net costs of the smart meter rollout*
- 2.19 The application of the SMNCC with an effective date of 1 January 2021 is arbitrary and highly selective.
- 2.20 Applying an APA for the PPM SMNCC with effect from 1 January 2021:
- 2.20.1 Ignores the fact that suppliers have borne the very significant net costs of the smart metering rollout for years without being allowed to recover them. Ofgem now proposes only to apply the effect of the SMNCC rollout

²⁵ See paragraph 4.2.1 of the NERA report at Appendix B.

arbitrarily from a point in time when those costs have reduced to their lowest level or become savings – but where the overall position is still substantially one of under-recovery for PPM suppliers.

- 2.20.2 Also ignores the fact that there has been a huge under-recovery of pass-through smart metering costs for the earlier period of the cap.²⁶
- 2.21 Ofgem offers no credible explanation or justification for disregarding the fact that the PPM cap has failed to reflect the net costs of the smart meter rollout from inception. Plainly, any accrued under-recovery is a highly relevant factor to a decision to seek to remove any perceived over-recovery in later periods. Where the effect of the rollout and the cap will differ over time, and where imposing a cap that introduces an SMNCC into the calculation only at a point where the benefits of the rollout may begin to become positive (but where suppliers have suffered enormous under-recovery in prior periods), Ofgem risks exacerbating historical errors and failures to breaking point. That should be seen also in the context of Ofgem imposing additional obligations on suppliers without additional recompense (see paragraphs 2.25 to 2.28 below). Ofgem has wider obligations as the energy regulator than simply preventing certain customers from paying more over time for their energy needs. When making its decision on the PPM SMNCC, Ofgem should be mindful of its role in delivering an ecosystem that both prevents customers being over-charged for energy supply while ensuring suppliers can provide for customers' needs, including as to service quality, and that suppliers can meet their licence obligations. Years of under-funding coupled with new and arbitrary additional limitations on supply costs is risking the ability of suppliers to comply with their obligations and should they be unable to do so, that will have been caused by Ofgem.
- 2.22 If there must be an adjustment to take into account any perceived over-recovery now, it should start from the beginning of price capping – not from an arbitrary date (that also happens to fall after a period of significant under-recovery). Ofgem in properly complying with its duties in respect of the cap and applying best regulatory practice cannot act capriciously. Its decisions should be consistent, transparent, proportionate and fair. Its proposal to impose an SMNCC only when the effect will be to reduce charges (ignoring the fact that any earlier introduction would have increased them) risks breaching those obligations. Adopting this approach will result in suppliers substantially under-recovering the costs of historical under-provision for smart metering costs.
- 2.23 Ofgem's attempt to justify its selective approach on the grounds that the CMA (in different circumstances and for its own reasons) did not consider it appropriate to allow for an ex-post recovery mechanism for acknowledged under-recoveries by PPM suppliers is misconceived and irrelevant.²⁷ It is Ofgem's proposed decision to reopen and reset aspects of the CMA's redesigned cap on a selective basis that is

²⁶ Ofgem has previously acknowledged that, based on Ofgem's calculation of efficient costs, PPM suppliers have under-recovered by up to £17 per dual fuel PPM customer per year. This under-recovery continued even after the CMA's methodological review, which increased the PPM Cap by around £50 per year (such that prior to that review, under-recoveries were in the magnitude of £67 per year). See paragraph 4.70 of the PPM SMNCC Consultation. In the period 1 April 2017 to date, we estimate that Utilita's under recovery of costs was in the region of a £90 million reduction in EBIT.

²⁷ Ofgem notes at paragraph 7.20 of the PPM SMNCC Consultation that: "*The CMA did not consider it to be within the scope of their review to give consideration to including an ex-post recovery mechanism when this was not provided for in the original PPM cap. We do not consider it is our role to reopen a decision that the CMA has already considered and made*".

the issue, including by the application of an arbitrary start date that does not reflect the cumulative position. It is also Ofgem's proposed decision that breaches Ofgem's obligation to conscientiously have regard to the need for suppliers who operate efficiently to finance their activities, and which is irrational when considered in light of Ofgem's stated general policy:

"The upcoming cap periods therefore do not exist in isolation. The additional revenue that suppliers require in future depends on the allowances that they have already received through the cap and the costs that they have already incurred. As set out in our August 2020 decision, we are considering the cumulative costs and cumulative allowances".²⁸

(emphasis added)

"In each case, adjusting for advanced payments would ensure that suppliers are able to recover revenue which reflects the efficient costs of their smart meter rollout".²⁹

- 2.24 Ultimately, Ofgem had the ability to adjust the SMNCC to account for the known systemic under-recovery but has chosen not to do so. In making this decision, Ofgem is arbitrarily shutting its eyes to an issue that prevents proper achievements of its stated goal and risks harmful knock-on effects to the ability of suppliers to deliver on service quality and licence obligations. There is no legitimate justification for Ofgem taking this approach.

(c) Ofgem has failed to adjust the cap's methodology to reflect additional costs incurred by PPM suppliers

- 2.25 Ofgem has failed to adjust the cap's methodology to reflect significant additional costs incurred by PPM suppliers, as a result of additional obligations imposed on them since the cap was set.
- 2.26 A significant number of additional obligations have been imposed on PPM suppliers during 2020-2021. They include, but are not limited to, the following:
- 2.26.1 an obligation to provide more reporting during Covid-19;
 - 2.26.2 an obligation to identify & support customers at risk of self-disconnection;
 - 2.26.3 an obligation to provide adequate information on understanding emergency credit, friendly credit and additional support credit facilities;
 - 2.26.4 an obligation to provide additional support for vulnerable persons who have self-disconnected or are at risk of self-disconnection;
 - 2.26.5 for customers interacting with administrators, an obligation to update the terms and conditions of their domestic supply contracts to reflect specified licence conditions around the treatment of customers in payment difficulty;
 - 2.26.6 an obligation to ensure that their deemed contract terms and conditions reflect their obligations around deemed contracts; and

²⁸ Appendix 7, paragraph 1.4 of the Credit SMNCC Consultation.

²⁹ Appendix 7, paragraph 1.6 of the Credit SMNCC Consultation.

- 2.26.7 an obligation to document, and keep up to date, their strategy for safeguarding the continuity of supply for customers should the supplier exit the market.
- 2.27 In addition, we note that Ofgem has recently published its initial proposals for the commitments they would like suppliers voluntarily to make to protect consumers for Winter 2021/22. Again, these proposed voluntary commitments are extensive and there is no suggestion of additional funding being provided in the price cap in relation to these.
- 2.28 It is wrong for Ofgem to have completely ignored these additional obligations and increased burdens – imposed by both the obligations and additional information demands being made – in its proposals and not provide additional allowances to reflect the inevitable further costs they will entail. In addition, it further demonstrates how selective Ofgem’s approach is to the NPT SMNCC.

(d) Ofgem’s approach is not in customers’ interests

- 2.29 An approach of artificially reducing prices is widely understood to be detrimental to customers’ interests, but Ofgem is pursuing this policy for PPM customers.
- 2.30 In the words of the CMA:

"It is not in the interests of prepayment customers for the PCR to be maintained at an artificially low level, as this may lead to suppliers cutting costs, with less competition and lower service standards".³⁰

"[The PCR] is not currently at a level that allows efficient suppliers to earn a normal rate of return, to be incentivised to remain in the segments and to serve prepayment customers better and to allow for competition below the level of the cap. This does not serve the interests of prepayment customers. While prepayment customers will have to pay for an increase in the level of the PCR through an increase in their bills, we consider that setting the PCR at a level that means it can meet all its aims will result in better market outcomes for prepayment customers, and we note that none of the respondents to our consultation on the provisional decision disagreed with this point."³¹

3. OFGEM’S LEGAL ERRORS

- 3.1 Ofgem appears to be operating as if it is free to design the cap as it wishes and to pick winners and losers by preferring certain business models (i.e. those with below average levels of PPM customers, notwithstanding the relative inefficiency of such suppliers compared to new entrants such as Utilita), allowing cross-subsidies between different groups of customers on no verifiable or legitimate basis, artificially lowering prices for certain groups of customers (thereby increasing prices for others) and fudging outcomes.³²

³⁰ Paragraph 6.8 of the CMA’s final decision dated 31 July 2019: “*Review of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016*” (the “**July 2019 Decision**”).

³¹ Paragraph 3.22 of the July 2019 Decision.

³² To take one example, Ofgem’s statement at paragraph 6.45 of the PPM SMNCC Consultation that “*Most of the suppliers who would be underfunded by the weighted average rollout profile in PPM would be overfunded in credit. Therefore, across both credit and PPM, most suppliers are likely to receive enough funding to cover the efficient costs of delivering their obligations*” ignores the fact that – as Ofgem is well aware – not all PPM suppliers will over-recover on credit. It also highlights how Ofgem have taken

- 3.2 In fact, Ofgem is bound by the confines of the legislation under which it is operating and public law principles. In particular:
- 3.2.1 Ofgem must act consistently with the statutory purpose of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the "**Default Tariff Cap Act**").
 - 3.2.2 Ofgem must conscientiously and properly have regard to the statutory duties prescribed for it under the Default Tariff Cap Act.
 - 3.2.3 Ofgem must ensure that the cap it sets is consistent with the requirements of the Trade and Cooperation Agreement (the "**TCA**"), as implemented by the European Union (Future Relationship) Act 2020 (the "**EUFR 2020**").
 - 3.2.4 Ofgem must ensure that the cap it sets is consistent with the requirements of Directive 2019/944 on common rules for the internal market for electricity and amending Directive 2012/27/EU (the "**Recast Electricity Directive**") and Directive 2009/73/EC of the European Parliament and of the Council (the "**Gas Directive**") as the Default Tariff Cap Act was designed and confirmed by the Government to be.
 - 3.2.5 Ofgem must act in accordance with its public law duties.
- 3.3 Ofgem's proposals are not consistent with the legal framework Ofgem must operate within. Ofgem is far exceeding any regulatory discretion permitted to it as the economic regulator by Parliament within that legal framework.

Purpose of the Default Tariff Cap Act

- 3.4 Ofgem is proposing to exercise functions under the Default Tariff Cap Act to modify the cap it must impose on all standard and default rates which may be charged by suppliers to domestic customers.
- 3.5 Parliament has set out how Ofgem must exercise these functions, namely, with a view to protecting existing and future domestic customers who pay standard variable and default rates, and in so doing it must have regard to four matters:
- (a) the need to create incentives for holders of supply licences to improve their efficiency;
 - (b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
 - (c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
 - (d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence. *[Emphasis added]*³³
- 3.6 Ofgem appears to consider it is free to ignore the statutory purpose of the Default Tariff Cap Act to protect all default customers. Instead it has decided that it can set the PPM price cap via the SMNCC at an artificially low and non-cost reflective level because it considers this would better protect a particular category of

decisions in setting up the PPM SMNCC that is deliberately anti-competitive by minimising the potential for competition for PPM suppliers (particularly specialist PPM suppliers) but improving the prospect of competition on credit because there is headroom for that competition to take place for those with more efficient practices and costs (and/or with fewer than average PPM customers).

³³ Section 1(6) of the Default Tariff Cap Act.

customers. Ofgem equates protection for PPM customers with protecting PPM customers from an increase in prices (on the basis that such customers are vulnerable – without ever demonstrating that they are, even assuming such vulnerability was a relevant basis for setting the cap, which it is not), irrespective of whether any increase in prices is justified and reflects efficient costs.³⁴

- 3.7 This is obviously not what Parliament intended. It represents either a misunderstanding of or a disregard for the statutory purpose of the Default Tariff Cap Act. In fact, such an approach frustrates the purpose of the Default Tariff Cap Act, which is to provide time-limited protection against excessive prices whilst ensuring that customers continue to benefit from competition – and in the long-term facilitate a move to a market where more customers are able to benefit from competition. Indeed, the Government has confirmed to the European Commission that the intention of the default tariff cap is to protect customers from excessive prices until the conditions for effective competition are in place, consistent with the derogation in Article 5(6) of the Recast Electricity Directive.³⁵ The default tariff cap is not a vulnerable customer protection mechanism and Ofgem does not have power to apply it to that purpose.
- 3.8 This intention is also clear from statements of Ministers in Parliament, as well as the statutory needs set out on the face of the Default Tariff Cap Act.
- 3.9 Hansard records that on 26 February 2018, Claire Perry (then Minister for Energy and Clean Growth) stated that the "*Domestic Gas and Electricity (Tariff Cap) Bill will, subject to parliamentary approval, put in place a requirement on the independent regulator, Ofgem, to cap domestic energy tariffs until at least 2020. Currently, some consumers are paying up to £300 more than they need to – this cap will help bring this overcharging under control*."³⁶ [Emphasis added.]
- 3.10 In a statement on 6 March 2018, Claire Perry explained that "*The Bill is a time-limited, intelligent intervention that will help to accelerate the transition to a more competitive market. The powers given to Ofgem have to ensure that we do not disincentivise competition, while ensuring that companies have an incentive to improve the efficiency of their operations*".³⁷ [Emphasis added.]
- 3.11 This is consistent with the statement to Parliament made by the then Secretary of State for Business, Energy and Industrial Strategy, Greg Clark, that: "*The Government want the market to thrive. We continue to promote competition as the best driver of value and services for consumers*."³⁸
- 3.12 Further, in her written statement of 26 February 2018, Claire Perry made clear how important the statutory duties imposed on Ofgem under the Default Tariff Cap Act were:

In setting the cap, Ofgem must protect existing and future domestic customers, but must do so in a way that creates incentives for suppliers to improve efficiency, sets the cap at a level that enables suppliers to

³⁴ See for example paragraphs 4.5 and 4.68 of the PPM SMNCC Consultation.

³⁵ See page 31 of the Department for Business, Energy & Industrial Strategy's "GB Implementation Plan" dated July 2020.

³⁶ [Energy - Monday 26 February 2018 - Hansard - UK Parliament](#)

³⁷ [Domestic Gas and Electricity \(Tariff Cap\) Bill - Tuesday 6 March 2018 - Hansard - UK Parliament](#)

³⁸ [Domestic Gas and Electricity \(Tariff Cap\) Bill - Tuesday 6 March 2018 - Hansard - UK Parliament](#)

*compete effectively for supply contracts, maintains incentives for customers to switch and ensures that efficient suppliers are able to finance their businesses.*³⁹ [Emphasis added.]

- 3.13 This emphasis on the importance of setting the cap at a level that means that the cap can coexist with competition is not surprising as it is fundamental to the design of the cap.
- 3.13.1 **It is consistent with Professor Martin Cave's original vision on which the legislation was founded:** In his statement in the final report of the CMA's Energy Market Investigation, Professor Martin Cave said that in his view (in contrast to the view of the rest of the CMA group appointed to the investigation) there was not necessarily an irreconcilable conflict between competition and regulatory measures. He proposed a price cap across the market that attempted to achieve the goal of interim protection and promotion of engagement. One of the aspects that he emphasised would help to achieve this was a "*safe-guard (above-cost) element [that] enables the designer of the cap to be confident in achieving a desired level of detriment reduction, but also allows variation in the intrusiveness of the cap, and permits its level to be set to provide appropriate incentives to switch to a cheaper tariff*".⁴⁰ It was this idea that a price cap could coexist with competition and allow suppliers to make reasonable profits that the Government ultimately endorsed when introducing the Default Tariff Cap Act, approved by Parliament.⁴¹
- 3.13.2 **It is consistent with the "mischief" which the legislation was introduced to deal with:** The Default Tariff Cap Act was introduced as a response to the CMA's finding that there was an adverse effect on competition as a result of disengaged "sticky" customers, such that suppliers were able to charge excessive prices that did not reflect underlying costs.⁴² This was confirmed in the debates leading up to the passing of the Default Tariff Cap Act, where Claire Perry confirmed that "*the problem, and the reason for the Bill, is that there is a very large group of customers who are sticky—who stay on expensive standard variable and default tariffs because they do not know how to switch, or they are not aware that they can*".⁴³ It was not introduced for the purposes of providing artificially low prices for one particular group of customers: on the contrary, it was introduced with the purpose of ensuring cost-reflective pricing. Indeed, elsewhere Ofgem recognises this: "*We consider protecting customers to mean that prices reflect underlying efficient costs*".⁴⁴
- 3.13.3 **It is consistent with the provisions of the Recast Electricity Directive for "transition to effective competition" price caps which the legislation was carefully designed to comply with:** As a result of the harm that price caps

³⁹ [Written statements - 26 February 2018 - Written questions, answers and statements - UK Parliament](#)

⁴⁰ CMA Final Report on Energy Market Investigation (24 June 2016), Statement of dissent of Professor Martin Cave, paragraph 8, Page 1416.

⁴¹ See page 2 of the Government's response to the Competition & Markets Authority Energy Market Investigation dated February 2018, available [here](#).

⁴² CMA Final Report on Energy Market Investigation (24 June 2016), paragraph 20.5.

⁴³ [Domestic Gas and Electricity \(Tariff Cap\) Bill - Wednesday 18 July 2018 - Hansard - UK Parliament](#).

⁴⁴ Paragraph 1.6 of Ofgem's Decision on the potential impact of COVID-19 on the default tariff cap (2 February 2021)

can cause to consumers in the long term, the Recast Electricity Directive only permits two kinds of price caps: the first aimed at customers that are vulnerable or fuel poor for the purposes of the Directive and which must meet the conditions laid out in Article 5(3); and the second aimed at customers during a transition to effective competition, which must meet the conditions laid out in Article 5(6). Notably, the latter include the requirement that the price cap is set at a price that is above cost, at a level where effective price competition can occur, in order to ensure that the price cap does not itself hinder the achievement of effective competition. The Government has confirmed that the default tariff cap is a "*transition to effective competition*" cap and Ofgem has confirmed that neither the CMA PPM cap nor the Default Tariff Cap are aimed specifically at vulnerable customers.⁴⁵ The distinction between the two types of cap – and the fact that any "vulnerable customer" cap would need to be implemented through Ofgem's powers under the Electricity Act 1989 and Gas Act 1986 – is clear from the face of the Default Tariff Cap Act (see sections 3(2) and 9(2)) and from Ministerial statements in Parliament.⁴⁶

- 3.14 Ofgem appears to have misunderstood the statutory purpose of the Default Tariff Cap Act and decided that it is open to it to apply a price cap that elevates the short-term price protection of PPM customers (who it considers to be vulnerable by comparison to other customer groups and who it has determined are more worthy of price protection than vulnerable credit customers who Ofgem appears happy to see subsidising other customer groups). This conflicts with the aims of Parliament for the Default Tariff Cap Act to ensure that, whilst protecting customers against excessive charges, the cap coexists with competition and is cost-reflective.⁴⁷ Applying an artificially low cap is fundamentally contrary to the temporary nature of the cap as it hinders the aim of Parliament in introducing the legislation allowing for the cap, namely to achieve effective competition – and of course would be to the detriment of customers, given that customers are reliant on competition once the cap ends in 2023.
- 3.15 Of course, the Government may decide to introduce further price cap legislation in due course or Ofgem may decide to introduce a price cap under other powers,

⁴⁵ See BEIS's GB Implementation Plan (31 July 2020), page 31, where the Government confirmed that the Default Tariff Cap Act "*is consistent with the derogation in paragraph 6 [of Article 5]*" (i.e. the conditions that apply to "transition to effective competition caps"). Similarly, at paragraph 4.12 of its own [Consumer Vulnerability Strategy 2025 \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/publications/consumer-vulnerability-strategy-2025) published in October 2019, Ofgem stated in respect of the CMA PPM cap and its own default tariff cap: "*Both of these price caps cover a range of customers in vulnerable situations, but are not specifically aimed at consumers in vulnerable situations*".

⁴⁶ See for example Rebecca Pow's statements in the 30 April 2018 House of Commons Debate where she noted that the Bill "*places a new set of duties and powers on Ofgem to protect consumers on variable and default tariffs, and Ofgem already has a duty under the electricity and gas Acts to have regard to the need to protect vulnerable customers*" (link [here](#)). In response to proposed amendments that would have introduced vulnerability considerations into the Bill (but were not adopted), Claire Perry also confirmed that "*the Bill is in addition to and does not replace or replicate those [existing duties]*", which are under separate legislation (link [here](#)).

⁴⁷ It also conflicts with Ofgem's own statements as to the nature and purpose of the Default Tariff Cap Act. For example, paragraph 2.1 of the PPM SMNCC Consultation states that the purpose of the cap is to ensure that customers "*pay a fair price for their energy, reflecting its underlying costs*." This reflects Ofgem's decision dated 6 November 2018 on the [default tariff cap design](#), which noted that: "*This cap will protect default tariff and Standard Variable Tariff (SVT) customers from being overcharged for the energy they use*" (i.e. cost-reflectivity) and "*We have designed a cap that will provide a high level of protection – preventing unjustified price increases and ensuring default tariffs reflect more closely the underlying costs of supplying energy.*" [Emphasis added]

namely the Gas Act 1986 or Electricity Act 1989.⁴⁸ However, it would be a clear error for Ofgem to prejudge this outcome and decide on this basis to ignore Parliament's clear intention that caps under the Default Tariff Cap Act are temporary in nature, with the legislation only contemplating that Ofgem considers further price caps following the expiry of the Default Tariff Cap Act for the most vulnerable customers under existing powers. Any such price caps would need to be clearly targeted at energy poor or vulnerable household customers and the prospect of such caps cannot be a valid reason for Ofgem ignoring the purpose of the Default Tariff Cap Act under which it is currently operating.

- 3.16 In misunderstanding the purpose of the Default Tariff Cap Act and proposing a cap that is not cost-reflective, does not allow PPM suppliers to recover their costs and focuses attention on benefiting vulnerable customers over all else, Ofgem would be acting ultra vires were it to proceed with these proposals.

Compliance with statutory duties

- 3.17 As explained above, Parliament carefully set out the design criteria for Ofgem when developing price caps under the Default Tariff Cap Act. As part of this, the Default Tariff Cap Act sets out four "statutory needs" that Ofgem is required to have regard to (see paragraph **Error! Reference source not found.**3.5 above).
- 3.18 Ofgem seeks to explain the fact that it has not complied with these statutory duties as follows:

The requirement to have regard to the four matters identified in section 1(6) of the Act does not mean that we must achieve all of these...In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgement. Often, a balance must be struck by competing considerations.⁴⁹

...

We must set a single cap level, so there may be differences between the allowances we set and individual suppliers' efficient costs. This is an unavoidable consequence of setting a single allowance that protects customers, in accordance with Section 1(6) of the Act.⁵⁰

- 3.19 However, these justifications are at best irrelevant to the approach Ofgem is taking to the PPM cap. Ofgem is not balancing "competing considerations" or setting an allowance that unavoidably differs from an individual supplier's efficient costs: Ofgem is deliberately pursuing a policy that under-remunerates the efficient costs of supplying PPM customers, justifying it on the basis that the majority of suppliers are able to rely on Ofgem's price cap for credit customers overfunding the efficient costs of supply.⁵¹ In other words, Ofgem justifies under-funding (and under-charging) PPM customers on the basis that suppliers can over-charge credit

⁴⁸ Indeed, the Default Tariff Cap Act contemplates that Ofgem might not apply tariff cap conditions to customers who appear to Ofgem to be vulnerable by reason of their financial or other circumstances (section 3(2) of the Default Tariff Cap Act). The Default Tariff Cap Act also requires Ofgem, when the cap comes to an end, to assess whether there are categories of consumer still in need of protection, including customers who appear to Ofgem to be vulnerable by reason of their financial or other circumstances (section 9(2) of the Default Tariff Cap Act). If so, they may be protected via Ofgem's alternative statutory powers.

⁴⁹ Paragraph 2.17 of the PPM SMNCC Consultation.

⁵⁰ Paragraph 6.48 of the PPM SMNCC Consultation.

⁵¹ See paragraphs 6.45 to 6.48 of the PPM SMNCC Consultation.

customers (who may also be vulnerable and unable to afford covering those additional costs) to recover the difference. There is no authority in the Default Tariff Cap Act for such a policy and no justification for ignoring the statutory needs set out in the Default Tariff Cap Act on such a basis.

- 3.20 Ofgem appears to be using the fact that in certain circumstances there is a need to exercise judgement in determining the weight to apply to each statutory need to give itself *carte blanche* to disregard the design criteria laid down by Parliament. This is an error of law: *R (Hurst) v London Northern District Coroner* [2007] UKHL.
- 3.21 If the effect of Ofgem's judgment-calls is to produce an outcome that fails to meet the stated matters to which Ofgem must have regard, this cannot be a proper exercise of judgement as to the appropriate weighting of those considerations.
- 3.22 In fact, Ofgem's proposals fail to meet *any* of the four matters to which it is required to have regard.
 - 3.22.1 There is no incentive for holders of supply licences to improve their efficiency in circumstances where even the most efficient supplier cannot recover their efficient costs, let alone make any (or any reasonable) profit. In practice, most efficiency improvements need up-front investment and suppliers will not be able to raise funds to make these investments if they see no prospect of making a recovery and/or return. The incentive created by setting a price cap too low for PPM customers is for suppliers to have as few PPM customers as possible and provide the minimum service possible to mitigate costs.
 - 3.22.2 Holders of supply licences have not been enabled to compete effectively for domestic supply contracts, in circumstances where some suppliers, because of their mix of customers, are able to charge more than is fair because of the cross-subsidy and because of differences in the way that credit and PPM caps work and are set. Only suppliers with sufficient numbers of non-PPM customers are able to benefit from the cross-subsidy to such a level that they can either offset their under-recovery on PPM or over-recover by having disproportionately more non-PPM customers. Accordingly, only those suppliers will be able to compete in these circumstances. This will hinder competition and will stifle different business models. In our view, the effect of Ofgem's proposals would be to destroy competition in the PPM sector, leaving no supplier with an incentive to serve PPM customers well, leading to poorer service outcomes for PPM customers (who Ofgem considers to be the most vulnerable and needing protection). Effective competition is not merely about delivering differentiated or lower pricing. It also involves offering different services or qualities of service to meet differing customers priorities. Ofgem appears not to have taken any account of this and to have developed an SMNCC proposal that will force a race to the bottom in terms of quality and a focus on achieving the bare minimum of licence obligations, not because that is what suppliers want to do, but because the economic signals from the regulator mandate that outcome as necessary for any chance of survival. Many suppliers would seek to retrench their PPM business. This means that competition will reduce

even when the smart meter rollout is complete. That is also the opposite outcome intended by Parliament through the introduction of this cap.

- 3.22.3 There is no incentive for domestic customers to switch to different domestic supply contracts in circumstances where the PPM cap does not allow an efficient supplier to recover its costs because there will be no effective price competition (everyone will supply at the level of the cap given even this price is too low to recover costs). Consequently, there will be fewer suppliers for customers to choose from as Ofgem – by preventing the recovery of efficient costs – is effectively sending exit signals to suppliers serving the PPM market. Any further price incentives would therefore lead to a further under-recovery for suppliers. Only those relying on cross-subsidies from other customers or pursuing a predatory pricing strategy would be able to do so.
- 3.22.4 The need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence is clearly not being met in circumstances where Ofgem seeks to reduce the PPM Cap to a level that is below its view of the efficient cost to serve PPM customers and fails to allow any return on costs incurred in the past without any remuneration. .

The TCA Requirements

- 3.23 The TCA between the UK and the EU provides⁵², that if the UK decides to regulate the price of the domestic supply to consumers of electricity or natural gas, it may do so only to achieve a public policy objective, and only by imposing a regulated price that is clearly defined, transparent, non-discriminatory and proportionate. This is given effect in domestic law by section 29 of the EUFRA 2020, which provides that existing domestic law has effect with such modifications as are required for the purposes of implementing the TCA so far as it is not otherwise so implemented and so far as such implementation is necessary for the purposes of complying with the international obligations of the UK under the agreement.
- 3.24 Accordingly, the Default Tariff Cap Act, which must be interpreted in accordance with section 29 of the EUFRA 2020, requires that any price cap imposed by Ofgem under it must be clearly defined, transparent, non-discriminatory and proportionate. Proportionality in turn requires that that the measure in question is suitable or appropriate to achieve the objective pursued; and secondly, that the measure is necessary to achieve that objective (including considering whether it can be attained by a less onerous method).⁵³
- 3.25 The price cap proposed by Ofgem cannot be considered to comply with any of these criteria. In particular, it discriminates against all PPM suppliers (and especially those with a lower than average credit customer mix) as it is designed for suppliers that are able to cross-subsidise losses on PPM customers with over-charging customers using other payment methods. No consideration appears to have been given to treating those subsidising credit customers fairly. It is clearly not proportionate, and we note that the European Commission has already invited the UK to reconsider whether the default price cap is proportionate, i.e. there were

⁵² Article 326 of the [TCA](#).

⁵³ *R (Lumsdon) v Legal Services Board* [2015] UKSC 41.

already serious doubts that Ofgem's price cap was proportionate even before Ofgem's proposals to amend the price cap to perpetuate cross-subsidies and artificially reduce prices for one group of customers based on payment method.

Recast Electricity Directive and Gas Directive

- 3.26 Ofgem must ensure that the electricity cap it sets is consistent with the requirements of the Recast Electricity Directive, because, as a result of the 2018 Withdrawal Act, the Default Tariff Cap Act must be interpreted in accordance with EU law as it applied immediately before the end of the Brexit implementation period.⁵⁴ Ofgem must ensure that the gas cap is consistent with the requirements of the 2009 Gas Directive.
- 3.27 As a result, the gas cap must be clearly defined, transparent, non-discriminatory, verifiable and guarantee equality of access to consumers and in the case of electricity, being a "transition to effective competition" cap, set at a price that is above cost, at a level where effective price competition can occur. Yet, as noted above, PPM suppliers have under-recovered for electricity supply in every single cap period since the first cap was introduced in 2017.

Public Law Duties

- 3.28 Even if it were the case that Ofgem was entitled to design the cap as it wished, for example, by implementing an artificially low price cap on the basis of the vulnerable customer derogation, its proposed approach would be irrational due to (i) the inconsistencies in its approach, both internally within the SMNCC model and as between PPM and credit customers and (ii) the arbitrary nature of some of Ofgem's decisions in designing the SMNCC. It would also be based on a number of errors of fact and law. By way of example, Ofgem has a duty when it exercises its functions under the Default Tariff Act to have regard to the need to ensure the financeability of efficient suppliers. Suppliers' financeability is not to be judged on a snapshot basis but to be assessed and assured in the round and over time. The view taken by Ofgem that historical under-recovery under the CMA price cap is not its concern when it is exercising functions under the Default Tariff Act is therefore wrong and Ofgem has misdirected itself as to its legal duties.
- 3.29 Unfortunately, Ofgem appear to have lost sight of this principle of both economics and law.

4. NEXT STEPS

- 4.1 It is vital, in order for the PPM price cap to protect customers in accordance with the legal framework, for Ofgem to make the following changes to its proposals:
- 4.1.1 Recalculate the core SMNCC as per NERA's recommendations. This is a bare minimum and reflects merely corrections of Ofgem's errors in their application of their own proposals.
- 4.1.2 Acknowledge and accept that the SMNCC can and should be positive (in the same way as for credit customers) where that is the out-turn of the application of the data to the model and where cost-reflectivity so

⁵⁴ The Recast Electricity Directive was implemented by the UK for GB on 31 December 2020. In any event, legislation such as the Default Tariff Cap Act that pre-dates the coming into force of a European Directive must be interpreted consistently with the Directive from the date on which that Directive enters force – see *Mangold v Helm* (2005) C144/04 and other cases.

requires. This will correct Ofgem's failing to ensure full recovery of the PPM cost offset.

- 4.1.3 Refine the approach so that the core SMNCC (as recalculated) is applied so that it reflects the net costs or benefits of the entire smart metering rollout over the whole of the PPM cap life, starting from 1 April 2017, including both non-pass through and pass through smart metering costs, and thus abandon the arbitrary application of the APA from 1 January 2021 only.
- 4.1.4 Review the cap to take into account the additional costs imposed on PPM suppliers, as a result of additional obligations imposed on them since the cap was set.
- 4.2 Once this has been done correctly, it is vital that Ofgem focus on ensuring the regulatory framework is stable and predictable and conducive to investment. New entrants such as Utilita have transformed the PPM customer experience for the better and reduced prices; they should be encouraged rather than discouraged by an arbitrary and uncertain regulatory regime.
- 4.3 We are available to provide any information that Ofgem would find useful in reaching its decision. We would also be happy to discuss the points raised in this response and the accompanying NERA report with Ofgem.