Making a positive difference
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Response to CMA's proposed review of Energy Market Investigation Order 2016

Thank you for the opportunity to comment on the prepayment (PPM) price cap mid-term review and scope.

The CMA is consulting on whether to launch a review of certain aspects of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016 and the appropriate scope of the review. It proposes the review should cover: the progress made on the rollout of smart meters, the calculations underlying the initial benchmark figures concerning the policy cost allowance and the Data Communications Company (DCC) cost element of indirect costs, and whether additional costs or broader elements of the Order should be subject to review.

We believe there should be a broader review of the PPM cap, including its methodology. As mentioned in the CMA's consultation, there have been significant changes in the market, including the introduction of the default tariff cap.

We suggest the CMA adopts the same methodology as the default tariff cap and believe this is best achieved through a change in the Order. While we agree the CMA should review policy and DCC costs, we consider it valuable to consider all cost components of PPM consumers' bills. When designing the default tariff cap, we built on the experience of the CMA in designing the PPM cap and took account of recent data and developments in the market. It is important to understand the key differences between the PPM cap's and the default tariff cap's estimates of each cost component and to align them where appropriate. We believe the default tariff cap methodology would reflect current market conditions more closely.

We consider it important that the PPM cap is cost reflective and suppliers remain incentivised to supply these customers. A review is especially important as the introduction of the default tariff cap reduces scope for suppliers to recover any potential shortfall in PPM revenues from customers with other payment methods. As the CMA is aware, a number of companies have approached us regarding the cost reflectivity of the PPM cap. Given the nature of these concerns, the CMA may wish to consider what timeframe would be appropriate to sufficiently understand and address any potential issue.

For further information on the rationale for our recommendation, please refer to Annex 1 below.

If the CMA would find it helpful, we are happy to explain our thinking in designing the default tariff cap further, and to discuss any options for assessing and implementing potential changes to the PPM cap.

Yours faithfully,

Anna Rossington
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Annex 1 – Ofgem's views

Background

As part of the energy market investigation in 2014-2016, the CMA found that there were actual and perceived barriers to engagement for PPM customers. It decided to provide price protection to PPM customers and introduced the Order in 2016.

Based on the CMA's Order, Ofgem implemented the PPM cap in April 2017 and updates it every six months. Since the introduction of the PPM cap, the retail energy market has changed significantly. As the CMA mentions in its consultation, the National Audit Office (NAO) has published an update on the smart meter rollout which the CMA could take into account while reviewing the PPM cap.

The default tariff cap is one of the biggest changes to the retail energy market in recent times. The Domestic Gas and Electricity (Tariff Cap) Act 2018 passed through Parliament in July 2018 and Ofgem introduced the default tariff cap on 1 January 2019.

Methodologies for estimating and updating costs

The PPM cap and the default tariff cap protect different groups of consumers and were set using different methodologies. Despite these differences, most of the cost components within the caps are the same. We suggest that the CMA considers the value of aligning the caps' estimates of common cost components.

Cost components of the PPM cap and the default tariff cap

For both price caps, an initial benchmark was set based on supplier data, and also external non-supplier data in the case of the default tariff cap. Those benchmarks are split into different cost components reflecting an efficient supplier's wholesale, policy, network and indirect costs; they also include allowances for headroom and payment method.

For both caps, Ofgem updates each cost component separately to reflect changes in those costs. Ofgem updates the cost components every six months (announced in February and in August) using published non-supplier industry data.

Key differences in methodology and purpose

Setting the benchmark

The main difference between the caps' methodologies is in how the initial benchmark was set. For the PPM cap, the CMA used a price reference approach to set the initial benchmark. This consisted of calculating a benchmark from the average of a set of tariffs from First Utility and Ovo Energy as they represented efficient suppliers. The CMA split that overall benchmark into different cost components, so that each component could be updated in the relevant scale and direction of change. The CMA split the benchmark into separate cost components using other data.

In comparison, we used a bottom up cost assessment approach to set the benchmark in the default tariff cap. This consisted of calculating the cost elements separately using supplier and industry data. We then update the cap using a combination of the changes in the values calculated through the bottom up cost assessment and indexation.

The other main difference in the benchmarks is the data used to set them. For the PPM cap, the CMA used 2015 data, whereas we used 2017 data for the default tariff cap.

Purpose of the price caps

We recognise that the CMA and the government had different purposes for the PPM cap and default tariff cap respectively. These differences helped to determine the scope of each cap.

The CMA found that there were barriers to engagement for PPM customers and therefore introduced a cap applying to that payment type, not one restricted to certain tariff types. The default tariff cap applies only to default tariff customers (those on standard variable tariffs and any fixed tariffs that consumers default onto at the end of their fixed term deal) who are not already covered by other caps (including the PPM cap). This was because the government concluded that competition was not working for default customers.

These differences in purpose and scope do not mean that we would expect common cost components within each cap to differ. For instance, the wholesale costs incurred serving PPM customers would likely be similar to those incurred serving default tariff customers.

However, there are relevant cost differences between the two groups. Operating costs, for example, are higher for prepayment customers than for direct debit customers. The differences in these costs are accounted for in the payment method uplift components of the respective caps.

Rationale for our recommendation

We suggest the CMA adopts the default tariff cap methodology for the PPM cap and includes a PPM uplift element in the place of the default tariff cap's payment method uplift. The CMA could do this, for instance, by amending the Order. In designing the default tariff cap, we have considered the lessons from the PPM cap. We consider the default tariff cap methodology to be robust and based on recent data.

There are some differences between the estimates of common cost components in the two caps due to differences in the methodologies they use, which do not relate to differences in substance. These include: the allocation of cost components within the cap levels, the updating of wholesale costs, the updating of policy costs, the calculation of operating costs and the treatment of smart metering costs. We explain these points in more detail below.

Differences in methodologies between the two caps mean that the cap levels would likely diverge over time. For consumers with typical consumption levels, the scale of the difference between the PPM cap and the default tariff cap for direct debit customers is currently relatively small, but this may vary over time. It already varies for customers with different consumption levels.

Aligning the two methodologies should reduce customer confusion around the two cap levels. Common cost elements would be valued at the same level. Differences between the cap levels would relate to differences that are relevant to the respective payment methods.

<u>Key areas for methodology alignment</u>

Below, we consider the main reasons for aligning the PPM cap to the default tariff cap methodology. These issues are what we believe to be the major differences. This list is not exhaustive.

Allocations of cost components

As mentioned previously, the CMA used other data to split the PPM cap benchmark into separate cost components (termed 'weightings') for updating the cap.

Using a bottom up cost assessment for the default tariff cap meant that we calculated the cost components for the benchmark, and then summed them up to identify our benchmark level. This approach did not require us to make any assumptions on how to split an overall benchmark figure.

Although allocating weightings to different cost components does not affect the overall value of the original benchmark any misallocations would affect the level of the cap over time, as each cost component is updated separately. Our assessments of each component

were separate, using recent data on each component. This reduces uncertainty in the estimates.

Updating wholesale costs

Common cost components differ between the PPM cap and default tariff cap, even controlling for some methodological differences.

We consider wholesale costs to be a specific example of this issue. Even absent capacity market costs (which we include in wholesale costs but PPM cap includes in policy costs), there is a difference between the wholesale costs in the default tariff cap and PPM cap. This is despite the fact that the model for wholesale prices used to update the direct fuel part of the wholesale components is largely the same in the two methodologies.

Policy cost update

The PPM cap methodology uses the Office for Budget Responsibility's (OBR) forecast for the cost of environmental levies from its fiscal report to update policy costs. There is an approximate four month lag between the OBR publishing the report and Ofgem using it to update the PPM cap.

For the default tariff cap, we decided to use data mainly from the scheme administrators to estimate and update policy costs.

We considered both options when designing the default tariff cap and opted to use the scheme administrator data. We found that data from scheme administrators was more accurate and had a smaller lag time when compared to the OBR estimates.

Although the values are the same between both caps, they include different schemes under the policy costs component. For example, the CMA includes capacity market costs under policy costs whereas in the default tariff cap, we include capacity market costs in the wholesale component. When comparing like for like policy costs, there is a difference in the level of policy costs between the two caps.

Operating costs

The CMA based the PPM cap benchmark on First Utility's and Ovo Energy's tariffs to reflect the costs of an efficient supplier. When considering the operating cost component, it made adjustments based on their future expectation of the costs for these companies. The adjustments were reasonable and based on appropriate and relevant information available at the time (in 2015). In developing the default tariff cap, we had the benefit of hindsight, and consider that the CMA would find it valuable to assess whether the assumptions and allowance remain appropriate.

To set the operating cost allowance in the default tariff cap we analysed a sample of ten suppliers. We decided to set the operating cost allowance with reference to the lower quartile supplier. We then subtracted an efficiency factor.

The differences in approach to operating costs may interact with the approaches taken to the headroom allowances. For the default tariff cap, we set the allowance higher than the frontier costs in our sample. This judgement allowed for differences in suppliers' customer bases that may result in higher efficient costs for some suppliers. Having made this choice, we did not need to provide additional headroom for variation in efficient operating costs. The PPM cap benchmarked to operating costs that were closer to the frontier, but it includes more headroom. These methodological differences may net each other out, to some extent.

We believe the operating costs in the default tariff cap reflect the wider market, given we calculated them using a supplier at scale and used more recent (2017) cost data.

Smart metering costs

In setting the PPM cap, the CMA assumed that the tariffs used to calculate the benchmark included the costs of smart metering for those suppliers in 2015. Therefore, the implicit allowance for smart metering costs as part of the operating costs component and therefore updated in line with inflation (CPI).

For the default tariff cap, we also included smart costs incurred up to 2017 in our operating costs sample. However, to update these costs we recognised that smart metering costs would not change in line with inflation as suppliers proceed with the rollout. We decided to have a separate smart metering increment, which would enable us, when updating the cap, to recognise changes in the net cost and benefits to suppliers of introducing smart meters.

We recognise that the CMA and Ofgem may have had different policy intents with respect to smart metering costs. Since PPM customers with interoperable smart meters are exempt from the PPM cap, the CMA might not intend for smart metering costs to be recovered from customers protected by the PPM cap. In the default tariff cap, we do not have any specific exemptions for default customers with a smart meter and therefore we consider the cost across all consumers under the default tariff cap.

In both cases, we consider it important that any charges applied to all suppliers, regardless of their progress in the rollout ("pass through costs" - eg DCC costs) are included in the cap level and updated as necessary. Whereas, the inclusion of costs applied to suppliers specific to their rollout operations ("non-pass-through costs" – eg installation) is a policy decision for the CMA to make. Any policy decisions should consider both cost recovery from smart meter customers and any disincentives for customers to adopt a smart meter.

Alternative option

Rather than adopt the default tariff cap methodology, the CMA may wish to assess and adjust components of the PPM cap on a case by case basis. We consider this may be a workable solution to address some of the key issues. However, we suggest using the entire default tariff cap methodology as a simple and practical approach. Each incremental adjustment to the original price reference methodology may dilute its original rationale (reducing the remaining price signal it actually contains), but fewer adjustments could leave potential issues unresolved.