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Dear Anna,

Protecting energy consumers with prepayment meters

Thank you for the opportunity to comment on this consultation. Under the Domestic Gas and Electricity (Tariff Cap) Act 2018, customers who are currently protected by the CMA's Prepayment Charge Restriction will automatically be covered by the Default Tariff Cap if it is extended into 2021 (except for circa 2% of prepayment customers who are not on default tariffs). Unless Ofgem amends SLC28AD (or introduces a new replacement PPM cap) these customers will be subject to the same cap level as direct debit customers, (a £38 reduction in the level of the cap relative to the prepayment cap in Period 4), making provision of prepayment services unsustainable. It is essential that Ofgem takes steps to address this, and we agree that the most pragmatic approach is to introduce a new default tariff cap (DTC) level that is suitable for PPM customers.

Our comments in the proposals in Ofgem's consultation are in Annex 1. We agree that the very small proportion of prepayment customers on non-default tariffs should not be included in the cap, and we agree with Ofgem's proposed contingency approach. Our main points are:

1. **Competitive distortion:** Ofgem's decision to smear costs between different payment methods has resulted in a significant distortion of competition between suppliers with different mixes of customers. Ofgem should take the opportunity presented by this review to reallocate back to prepayment the £5 of PPM-DD cost differential which it considers is included in opex (and hence smeared across all payment methods). The distortion resulting from smearing of standard credit costs would remain, but this would reduce the overall distortion by ~1/3. (The distortion resulting from smearing of PPM costs is particularly acute given the presence in the market of 'pure-play' PPM providers).

2. **Under-recovery:** In the interim, if Ofgem is unable to remove this competitive distortion, it should take steps to correct the shortfall in cost recovery that results from smearing of PPM costs. The shortfall arises because suppliers are unable to recover smeared prepayment costs from customers with credit meters in the

competitive product market (who account for circa 42.5% of the overall market). Based on Ofgem's estimate of £5 of smearing, and 17% overall market share of PPM, the PPM cap level would need to be uplifted by £5*42.5%/17% = £12.50 to make up for this. This would be consistent with the approach Ofgem adopted for smearing of standard credit costs.

3. **Smart cost differential:** In order to develop a separate NPT-SMNCC model for prepayment, Ofgem will need to determine the DD-PPM cost differential for *smart* meters. The additional 'benefit' (avoided cost) that will need to be factored into Ofgem's NPT-SMNCC model for prepayment is not simply the traditional DD-PPM cost differential (currently £68), but rather the *difference* between traditional and smart differentials. The smart differential will include *inter alia* higher metering costs (eg due to stranding and replacement), higher call centre costs and higher payment system costs. We suggest that Ofgem will need to issue an RFI to obtain robust data on these costs.

4. **Rollout profile:** We disagree with Ofgem's proposal to use the generic rollout profile in the BEIS CBA for calculating the NPT SMNCC for prepayment meters. Deployment of smart prepayment meters has significantly lagged smart credit meters, and this would not be a reasonable assumption.

5. **Warm Home Discount**: We assume it is not Ofgem's intention for PPM customers who were on Warm Home Discount up to the end of Scheme Year 8 to be capped at the DD level instead of the new prepayment level. Ofgem will need to amend the payment method definitions in SLC28AD to avoid unintended consequences.

6. **Timing of implementation**: In view of the uncertainty around future smart meter rollout profiles resulting from COVID-19 (and the potential consequential delay in BEIS' policy decision on a framework for smart meters post 2020), we believe it will be necessary for Ofgem to undertake a further reappraisal of the NPT SMNCC model (for both credit and prepayment meters) in due course, with appropriate levels of disclosure and external scrutiny. In the meantime, we think the only realistic option for Ofgem is to revert to its contingency plan of creating a new prepayment level in the DTC based on the same methodology as the PPM price cap. It would be more straightforward for this to take effect on 1 October 2020 than on 1 January 2021.

Should you have any questions on this response, please do not hesitate to contact James Soundraraju (Tel: 014 1614 2421, jsoundraraju@scottishpower.com) in the first instance.

Yours sincerely,

Richard Sweet
Head of Regulatory Policy

Annex 1

OFGEM CONSULTATION ON PROTECTING ENERGY CONSUMERS WITH PREPAYMENT METERS – SCOTTISHPOWER RESPONSE

1. Competitive distortion resulting from smearing

Ofgem's decision to smear costs between different payment methods has resulted in a significant distortion of competition between suppliers with different mixes of customers.

Ofgem's November 2018 decision on the DTC explained that standard credit costs had been smeared over SC and DD payment methods. Ofgem now says that its preliminary analysis suggests there is up to £5 of additional smearing of prepayment costs across other payment methods. This £5 represents the portion of incremental costs of serving PPM customers in 2017 that exceeds the CMA's assessment of efficient incremental PPM costs in 2014.[1]

In other words, the opex allowance (which applies to all payment methods) contains up to £5 which should properly be included in the DD-PPM uplift. In order to mitigate the resulting competitive distortion Ofgem should take the opportunity presented by this review to reduce the opex allowance by up to £5 and increase the DD-PPM uplift by the corresponding amount, which based on the overall PPM market share of 17%[2], would be circa £5/17% = £29.

The extent of the competitive distortion resulting from smearing of standard credit and PPM costs is illustrated in Tables 1 and 2 for Supplier A with a mix of payment methods typical of a large supplier, and Supplier B with a mix typical of a small or mid-tier supplier. (Values are for a dual fuel customer at typical consumption, price cap period 4, exclusive of EBIT and VAT).

Table 1 - Competitive distortion with smearing of SC and PPM costs

	Actual cost		Allowance			Supplier A		Supplier B		Competitive advantage B vs A
	SC-DD uplift	PPM-DD uplift	SC-DD uplift	PPM-DD uplift	Surplus/ deficit in allowance	Capped customer mix	Weighted surplus/ deficit	Capped customer mix	Weighted surplus/ deficit	
PPM		£97	£0	£73	-£24.4	30%	-£7.28	5%	-£1.22	£6.06
SC	£132		£80	£5	-£47.0	24%	-£11.48	5%	-£2.35	£9.13
DD			£12	£5	£16.8	46%	£7.70	90%	£15.14	£7.45
						100%	-£11.07	100%	£11.57	**£22.64**

Table 2 - Competitive distortion with smearing of SC costs only

	Actual cost		Allowance			Supplier A		Supplier B		Competitive advantage B vs A
	SC-DD uplift	PPM-DD uplift	SC-DD uplift	PPM-DD uplift	Surplus/ deficit in allowance	Capped customer mix	Weighted surplus/ deficit	Capped customer mix	Weighted surplus/ deficit	
PPM		£97		£97	£0	30%	£0.00	5%	£0.00	£0.00
SC	£132		£80		-£52	24%	-£12.71	5%	-£2.60	£10.10
DD			£12		£12	46%	£5.41	90%	£10.64	£5.23
						100%	-£7.29	100%	£8.04	**£15.34**

[1] Ofgem 'Protecting energy consumers with prepayment meters', 10 March 2020, para 4.10

[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/875750/table_242.xlsx and https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/875754/table_252.xlsx

If Ofgem were to reverse the smearing of PPM costs, the competitive distortion (for the illustrative example shown in the tables) would reduce from £23 to £15, a reduction of a third. The competitive distortion resulting from smearing of PPM costs is particularly acute given the presence in the market of 'pure-play' PPM providers (not modelled in the tables above) – making it even more necessary for Ofgem to remove this distortion.

2. Under-recovery of PPM costs

In the interim, if Ofgem is unable to remove this competitive distortion, it should take steps to correct the shortfall in cost recovery that results from smearing of PPM costs.

As noted above, Ofgem says its preliminary analysis suggests that up to £5 of prepayment costs are smeared across other payment methods via the opex allowance.[3] The shortfall arises because suppliers are unlikely to be able to recover smeared prepayment costs from customers with credit meters who are not on default tariffs (who account for circa 42.5% of the overall market).[4] In the fixed term product market prices are subject to intense competition and suppliers with a small share of prepayment customers (of which there are many) will be able to set the price at a level which does not reflect any recovery of prepayment costs. Hence £5*42.5% = £2.13 of the PPM costs smeared to opex will not be recoverable.

A similar situation arises with the smearing of standard credit costs to DD. Suppliers with a small proportion of standard credit customers will be able to set a competitive price for fixed term DD products which does not include any recovery of smeared SC costs. Ofgem recognised this issue when it determined the tariff cap methodology in November 2018, where it smeared SC costs using the percentage of non-prepayment *default tariff* customers paying by each payment method.[5]

Based on the above estimate of up to £2.13 of unrecoverable PPM costs and 17% overall market share of PPM, the PPM cap level would need to be uplifted by £2.13/17% = £12.50 to make up for this, and to bring the treatment of PPM cost smearing in line with standard credit cost smearing. (Alternatively, if Ofgem wishes to continue smearing PPM costs across all payment methods, it should increase the opex allowance by £2.13/57.5% = £3.70 to allow for full recovery).

3. Smart DD-PPM cost differential

In order to develop a separate NPT-SMNCC model for prepayment, Ofgem will need to determine the DD-PPM cost differential for *smart* prepayment meters. The additional 'benefit' (avoided cost) that will need to be factored into Ofgem's NPT-SMNCC model for prepayment is not simply the traditional DD-PPM cost differential (currently £68), but rather the *difference* between traditional and smart differentials.

The smart DD-PPM cost differential will potentially include the following ongoing costs:

- **More calls to call centres**: Even with smart meters in prepayment mode, we would expect PPM customers to generate more (and more complex) calls as a result of the practicalities of this payment method. Compared with DD smart meter customers, there is more scope

[3] Ofgem 'Protecting energy consumers with prepayment meters', 10 March 2020, para 4.10
[4] The proportion customer accounts on all payment methods who were on default tariffs in October 2019, excluding Bulb, was 59% (electricity) and 56% (gas) – see https://www.ofgem.gov.uk/data-portal/retail-market-indicators.
[5] Ofgem Default Tariff Cap: Decision, November 2018, Appendix 8 – Payment Method Uplift, paragraph 2.41.

for things to go wrong, and when they do go wrong, customers need more urgent support, making it more likely that they will call their supplier (rather than, say, emailing, visiting the website or using mobile applications). Even where the matter is not urgent, we find that prepayment customers are more likely to call us than DD customers. We anticipate that reasons customers with smart PPMs will continue to call us (that would not generally apply to DD smart meter customers) include:

a) vending issues such as credit not added to meter;
b) issues relating to the customer's financial circumstances and any associated vulnerability;
c) behavioural preferences;
d) potential lack of experience with website or application-based support mechanisms; and
e) urgency (customers who have dipped into the emergency credit on a prepayment meter are building up daily standing charges for however long the emergency credit is in effect)

- **Payment infrastructure charges**: Customers with smart meters operating in PPM mode will continue to have the option of topping up at a shop, online, with a mobile app or via text message. There will continue to be some services and infrastructure costs for smart PPM customers who choose to vend at outlets (eg Paypoint/Payzone service charges).

- **'Safe and reasonably practicable' compliance:** Suppliers are required under SLC28.1A to take appropriate steps if they become aware or have reason to believe that it is no longer safe and reasonably practicable for a customer to operate a smart meter in prepayment mode. Suppliers will continue to incur the costs of complying with this obligation, which in some cases may involve visits to the customer's premises. This is not an obligation that applies to DD or SC customers

In addition, the NPT SMNCC model will need to take account of one-off costs associated with smart meter installation which are higher when replacing prepayment meters:

- **ERCs:** Early replacement costs associated with traditional prepayment meters are likely to be higher than for traditional credit meters.

- **SMETS1 meter stranding costs:** When a supplier gains a SMETS1 meter operating in prepayment mode it will not be able to continue operating the meter in prepayment mode unless it has an agreement with the smart meter's head end provider (Secure, CGI, Morrison Data Services, etc). If it does not have such an agreement, the gaining supplier may have to replace the SMETS1 meter with one that it is able to support. The removed SMETS1 meter is returned to the Meter Asset Provider who may then attempt to recover the cost of that stranded asset in one of two ways (both of which result in costs to suppliers):
    - as an Early Replacement Charge (ERC) to the gaining supplier if that supplier has a churn agreement with the MAP business; or
    - as an ERC to the supplier that installed the SMETS1 meter (if the original purchase agreement provides for this).

We encourage Ofgem to gather information on the above costs through an RFI to suppliers, as part of this review of the PPM price cap level.

4. Rollout profile

For the purpose of calculating the NPT SMNCC for PPM, Ofgem proposes to use the BEIS CBA smart meter rollout profile, which will likely be higher than the rollout to PPM customers, with regular updates of the expected rollout profile to mitigate the risk of misstating costs.[6] Ofgem says it expects that replacing a PPM with a smart meter will involve a net cost to the supplier, so overstating the rollout profile would likely inflate the PPM NPT SMNCC. However, it considers that the amount would be small, and it would be prudent to err on the side of over-stating so as not to risk increasing the likelihood that installations are delayed.

In our experience rollout of smart prepayment meters has very significantly lagged rollout of smart credit meters and we consider that Ofgem's proposal risks introducing unnecessary inaccuracies into the calculation of NPT SMNCC for PPMs. We suggest Ofgem should use a rollout profile that is consistent with the profile used for the credit meter NPT SMNCC, but adjusted to reflect the estimated lag in rollout.

5. Warm Home Discount

The protection that currently exists for standard credit customers in receipt of the WHD (ie being capped at the DTC DD level) applies only to customers who qualified for those protections by end of March 2019 (WHD Scheme year 8).

It was a transitional position taken as the WHD Safeguard Tariff did not have different cap levels for DD and SC. The move ensured that SC customers already protected by the WHD Safeguard tariff would not experience an increase in prices on 1 January 2019 (when the WHD Safeguard Tariff transitioned to the DTC) due to the SC DTC cap level being higher than the DD DTC cap.

Licence conditions are drafted such that any customers eligible for WHD after the end of March 2019 when Scheme Year 8 ended are not eligible for the specific provisions of SC WHD customers being capped at DD.

We assume it is not Ofgem's intention that PPM customers who were on WHD up to the end of Scheme Year 8 would be capped at the DD level instead of the new prepayment level. If so, Ofgem will need to find a way of amending the definition of 'Payment Method' in SLC 28AD (shown below) so that Relevant 28AD Warm Home Discount Customers who are paying by prepayment are caught by limb (a) but not limb (b).

> '**Payment Method**' means:
> (a) in relation to any Relevant 28AD Customer that is not a Relevant 28AD Warm Home Discount Customer, the method by which that Relevant 28AD Customer pays for Charges for Supply Activities, being either Standard Credit, Fully-Interoperable Smart Prepayment or Other Payment Method; or
> (b) in relation to a Relevant 28AD Warm Home Discount Customer, Other Payment Method;

If it is Ofgem's intention that PPM WHD customers should be on the DD cap, this would need to be expressly consulted on.

[6] Ofgem 'Protecting energy consumers with prepayment meters', para 5.46

6. Timing of implementation

In view of the uncertainty around future smart meter rollout profiles resulting from COVID-19 (and the potential consequential delay in BEIS' policy decision on a framework for smart meters post 2020), we believe it will be necessary for Ofgem to undertake a further reappraisal of the NPT SMNCC model (for both credit and prepayment meters) in due course, with appropriate levels of disclosure and external scrutiny.

In the meantime, we think the only realistic option for Ofgem is to revert to its contingency plan of creating a new prepayment level in the DTC based on the same methodology as the PPM price cap. It would be more straightforward for this to take effect on 1 October 2020 than on 1 January 2021.

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