

# Consultation

## Protecting energy consumers with prepayment meters

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We are consulting on initial policy options for protecting energy consumers with prepayment meters after the expiry of the prepayment charge restriction (“the PPM cap”). We would like views from people with an interest in energy tariffs for energy consumers with prepayment meters. We particularly welcome responses from energy suppliers, consumer groups, and charities. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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## Executive summary

The Competition and Markets Authority (“the CMA”) designed the Prepayment Charge Restriction (“PPM cap”) to protect energy consumers with prepayment meters (“PPM customers”) from weak competition and barriers to engagement. In July 2019, the CMA recommended that Ofgem consider whether and how to protect PPM customers after the PPM cap expires at the end of 2020.

This consultation seeks stakeholders’ views on the options, considerations, and our provisional proposals for protecting PPM customers. Stakeholders’ responses will inform a statutory consultation on our substantive proposals, which we intend to publish in **May 2020**.

### Protecting PPM customers

We have concluded that PPM customers will require protection after the PPM cap expires. Technical barriers continue to constrain competition and choice for PPM customers. On that basis, we could replace the PPM cap with another dedicated cap for those customers, or use the default tariff cap with adjustments so it is suitable for PPM customers. Provisionally, we propose to use the default tariff cap.

### Adjusting the default tariff cap for PPM customers

If we take this approach, then we would introduce a new default tariff cap level that is suitable for PPM customers. We propose that a new cap level would apply to all PPM customers with default tariffs.<sup>1</sup> A new cap level is necessary as existing arrangements would cap PPM tariffs at the level intended for customers paying by direct debit.<sup>2</sup>

Provisionally, we expect that a default tariff cap level for PPM customers would provide a similar level of protection as the existing PPM cap (or potentially, the same level). Few cost categories vary depending on a customer’s payment method or meter type, so we would expect these allowances to match the default tariff cap. The CMA has already aligned the PPM cap’s methodology with the default tariff cap methodology for common cost components. Where costs do depend on a customer’s payment method or meter type, we seek views on whether it is necessary and proportionate to change the relevant methodologies.

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<sup>1</sup> This would be regardless of their prepayment meter type (traditional, interoperable smart prepayment meter, or non-interoperable smart prepayment meter).

<sup>2</sup> Section 3 of the Domestic Gas and Electricity (Tariff Cap) Act 2018.  
<http://www.legislation.gov.uk/ukpga/2018/21/section/3/enacted>

### **Assessing suppliers' efficient operating costs of serving PPM customers**

We have considered how to assess and reflect the efficient costs of serving PPM customers. The PPM cap allows for these costs by combining the operating cost allowance (which applies to all customers in the default tariff cap regardless of their payment method) and a PPM uplift, calculated by the CMA. We propose to maintain that approach.

Provisionally, we propose to maintain the PPM uplift, rather than recalculate it. Consistent with our approach to standard credit customers, we seek to protect PPM customers from paying substantially higher price differentials than they currently do. The PPM uplift may not be fully cost reflective.

In maintaining the current PPM uplift, we should spread the proportion of PPM costs that exceed the PPM uplift onto other payment methods. In practice, the methodology we used to calculate the operating cost allowance already does this. All customers (regardless of payment method) pay a portion of efficient PPM costs. We propose to maintain that approach.

For an efficient supplier with an average proportion of PPM customers, our proposal would have the same impact as a fully cost reflective PPM uplift. Provisionally, we expect the different impacts on suppliers with more or fewer PPM customers than average to be acceptable.

### **Assessing the impact of the smart meter rollout on suppliers' PPM costs**

We have considered how to assess and reflect the impact of the smart meter rollout on an efficient supplier's PPM costs. In particular, whether we should include an allowance at all (the PPM cap does not), and if so, whether we should use the existing non-pass-through Smart Metering Net Cost Change ("SMNCC") allowance, or a new allowance specifically for PPM.

Provisionally, we propose to include an allowance, calculated specifically for PPM customers. Our preliminary analysis suggests that the benefits of replacing a traditional PPM with a smart meter are greater than they are for replacing a traditional credit meter (or put another way, the net costs are lower for PPM). So, we would expect an appropriate allowance for PPM customers to be lower than the non-pass-through SMNCC for credit customers.

We propose to estimate the impact of the rollout using the BEIS's smart metering implementation programme cost benefit analysis ("CBA") as a starting point. Our preliminary analysis suggests that suppliers incur net costs when replacing traditional PPMs with smart meters, but those costs appear to be lower than the costs already included in the operating cost allowance. On that basis, it is possible that the non-pass-through SMNCC for PPM could be negative.

## 1. Introduction

### What are we consulting on?

1.1. This consultation sets out our considerations about whether, and, if so, how, to provide price protection to energy consumers with prepayment meters (“PPM customers”) after the expiry of the prepayment charge restriction (“the PPM cap”).

1.2. We seek stakeholders’ views on the relevant issues, options, and our provisional proposals for protecting PPM customers. Stakeholders’ responses will inform a statutory consultation on our substantive proposals, which we intend to publish in May 2020.

1.3. In the consultation, we consider:

- whether or not PPM customers will require protection after the PPM cap expires;
- if we protect PPM customers, whether we would use a new PPM cap, or the default tariff cap (as it is, or adjusted so it is suitable for PPM customers);
- if we use the default tariff cap, adjusted for PPM customers, we consider how we would set the allowances in that cap; and
- in particular, we consider how we could ensure that the allowances for operating costs and the impact of the smart meter rollout are appropriate.

1.4. Provisionally, we propose to protect PPM customers on default tariffs after the PPM cap expires. We propose to do this using the default tariff cap, with a new cap level that is suitable for PPM customers.

## Context and related publications

### The price caps currently protecting customers

#### *The PPM cap*

1.5. The CMA designed and introduced the PPM cap as part of the package of remedies from the energy market investigation.<sup>3</sup> It found weak competition and barriers to engagement in the PPM segment of the retail energy market. It decided to protect PPM customers until the smart meter rollout was complete, which the CMA believed would remove technical barriers to engagement – a prerequisite for effective competition.

1.6. The PPM cap has been in place since April 2017, covering all PPM customers without an interoperable smart meter – approximately four million customers at the time. In practice, we allow suppliers to charge PPM customers with an interoperable smart meter at the level of the PPM cap.<sup>4</sup> The PPM cap protects default tariff customers and customers that have actively chosen Fixed Term tariffs (“FTs”).

#### *The default tariff cap*

1.7. We introduced the default tariff cap on 1 January 2019, protecting over 11 million customers on standard variable and default tariffs (which we refer to collectively as “default tariffs”).<sup>5</sup> The default tariff cap ensures default tariff customers pay a fair price for the energy they consume, reflecting its underlying costs. These underlying costs change over time, so we update the cap every six months to reflect this.

1.8. Currently, the default tariff cap does not apply to PPM customers. Section 3 of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (“the Act”) excludes PPM customers because they already benefit from the PPM cap. When the PPM cap expires this exemption will cease, unless we replace the PPM cap. Otherwise, the default tariff cap will apply to all

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<sup>3</sup> CMA (2016), Energy market investigation – Final report. <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

<sup>4</sup> Ofgem (2018), Default tariff cap – decision overview, paragraph 6.24. [https://www.ofgem.gov.uk/system/files/docs/2018/11/decision\\_-\\_default\\_tariff\\_cap\\_-\\_overview\\_document\\_0.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document_0.pdf)

<sup>5</sup> Ofgem (2018), Default tariff cap: decision – overview. <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

customers with default tariffs, including PPM customers. The default tariff cap has different cap levels for customers paying by standard credit and those with other payment methods. We could introduce a new cap level for PPM customers.

1.9. We are reviewing how we allow for the impact of the smart meter rollout on suppliers' operating costs-to-serve for customers with credit meters. In October 2019 we published a consultation on those proposals.<sup>6</sup> In response to suppliers' responses we are refining those proposals and will consult on them in mid-May.<sup>7</sup>

## **Reviewing the PPM cap**

### *Updating the methodology*

1.10. The CMA reviewed the PPM cap and published its decision in July 2019.<sup>8</sup> It found that the conditions of competition in the prepayment segments had not improved materially since the introduction of the PPM cap and levels of overall engagement among prepayment customers were still low.

1.11. The CMA reviewed whether the methodology accurately estimated the efficient costs of supplying PPM customers. It concluded that the PPM cap undervalued policy costs and smart meter industry charges.<sup>9</sup>

1.12. As a result, in June 2019, the CMA decided to change the methodology for calculating the PPM cap. It chose to adopt the methodology Ofgem developed to set the cap levels in the default tariff cap with two exceptions.

- Payment Method Uplift: The CMA removed the payment method uplifts in the default tariff cap, which account for the incremental efficient costs of standard credit, recovered mostly from standard credit tariffs and partly from direct debit

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<sup>6</sup> Ofgem (2019), Reviewing smart metering costs in the default tariff cap: October consultation <https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-october-consultation>

<sup>7</sup> Ofgem (2020), Reviewing smart metering costs in the default tariff cap: Update and response to the October 2019 consultation. <https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-update-and-response-october-2019-consultation>

<sup>8</sup> CMA (2019), Review of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016. <https://www.gov.uk/cma-cases/review-of-the-energy-market-investigation-prepayment-charge-restriction-order-2016>

<sup>9</sup> Smart costs related to charges from DCC, SEGB or SMICoP



tariffs. The CMA maintained the PPM uplift from its original methodology for the PPM cap.

- The non-pass-through SMNCC: the CMA excluded the allowance in the default tariff cap that accounts for the net change in operating costs since 2017 that result from replacing traditional credit meters with smart meters.

1.13. The new PPM cap methodology came into effect from October 2019. The CMA’s changes to the methodology increased the PPM cap by about £50 for dual fuel customers.<sup>10</sup>

Table 1.1 shows the allowances in the PPM cap for summer 2020.

**Table 1.1 The PPM cap allowances for April 2020 to September 2020**

Allowance	Electricity	Gas	Implied Dual fuel
Wholesale	202	206	408
Network	141	132	273
Policy	144	25	169
Operating cost	83	95	178
Payment method uplift for traditional PPM	26	42	68
Pass-through SMNCC	7	5	12
EBIT	12	10	21
Headroom	7	6	13
VAT	31	26	57
<b>Total</b>	<b>652</b>	<b>548</b>	<b>1,199</b>

Source: Ofgem (2020), Prepayment Meter Price Cap: 1 April 2020 to 30 September 2020.

<https://www.ofgem.gov.uk/publications-and-updates/prepayment-meter-price-cap-1-april-2020-30-september-2020>

#### *Arrangements for when the PPM cap expires*

1.14. In its review, the CMA also concluded that PPM customers would likely require continued protection after the PPM cap expires. It considered that PPM customers would still face barriers to engagement, as the smart meter rollout will continue beyond 2020.

1.15. The CMA recommended that Ofgem consider providing protection for PPM customers after the expiry of the CMA’s PPM cap in line with its objectives and duties. In that context,

<sup>10</sup> CMA (2019), Review of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016, paragraph 4.17. <https://www.gov.uk/cma-cases/review-of-the-energy-market-investigation-prepayment-charge-restriction-order-2016>

the CMA recommended we consider any future changes of circumstance in light of the original aims of the PPM cap when setting the level of any replacement charge restriction.<sup>11</sup>

1.16. The CMA stated that it is for Ofgem to decide whether and how to implement these recommendations in light of its own statutory objectives and duties. The CMA noted that one way to protect PPM customers would be to prepare the default tariff cap for all PPM customers on default tariffs, subject to adjustments to reflect underlying efficient costs of serving the prepayment segment.

1.17. In addition, the CMA recommended that Ofgem consider undertaking additional analysis in two areas in advance of any decision on how to protect PPM customers following the expiry of the PPM cap. These were:

- whether the headroom and approach to competition in the default tariff cap would be effective in generating competition on price or service levels for prepayment customers; and
- whether the level of the payment method uplift for PPM customers and the allowances for smart meter installation remain appropriate once the rollout of smart meters has progressed significantly as part of broader consideration of the costs of the smart metering programme.

## Consultation stages

1.18. This consultation will remain open for four weeks, closing on **Wednesday 8 April 2020**. Please provide responses by 11pm.

1.19. We intend to publish a statutory consultation in **mid-May 2020**. Responses to this policy consultation will inform the proposals we present in the statutory consultation.

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<sup>11</sup> CMA (2019), Review of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016. <https://www.gov.uk/cma-cases/review-of-the-energy-market-investigation-prepayment-charge-restriction-order-2016>

## How to respond

1.20. We want to hear from anyone interested in this consultation. Please send your response to [retailpriceregulation@ofgem.gov.uk](mailto:retailpriceregulation@ofgem.gov.uk).

1.21. Please respond to the issues, options, and considerations in this consultation as fully as you can. This is a policy consultation. It seeks stakeholders' views on the important issues, options, and considerations to inform and update our thinking. Where we have preferred options we propose them. However, in some places we discuss policy options without selecting a particular option as our proposal. We will present proposals in the statutory consultation, after considering stakeholders' views on the important issues set out in this policy consultation.

1.22. We will publish non-confidential responses on our website at [www.ofgem.gov.uk/consultations](http://www.ofgem.gov.uk/consultations).

## Your response, data and confidentiality

1.23. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.24. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.25. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

1.26. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

## General feedback

1.27. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

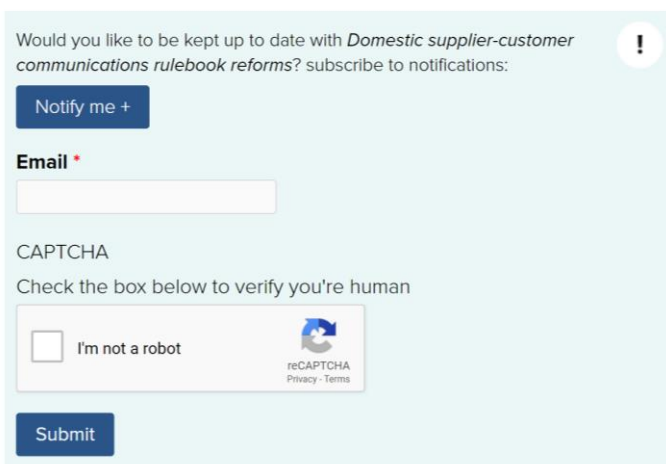
Please send any general feedback comments to [stakeholders@ofgem.gov.uk](mailto:stakeholders@ofgem.gov.uk)


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## 2. Considering protection for PPM customers

In this chapter we consider whether PPM customers will require protection after the PPM cap expires and how we might protect those customers, if required.

### **Input requested from stakeholders**

We seek stakeholders' view on the issues, options, and our provisional proposals set out in this chapter.

### **Summary of provisional proposals**

2.1. We conclude that PPM customers will require protection after the PPM cap expires. Technical barriers continue to reduce competition and choice for energy consumers with a traditional prepayment meter. PPM customers' engagement with the market remains limited.

2.2. We consider whether to replace the PPM cap, or include PPM customers in the default tariff cap. Provisionally, we propose to use the default tariff cap, with adjustments suitable for PPM customers.

### **Protection for PPM customers**

#### **Considerations**

2.3. As discussed in Chapter 1, the CMA found weak competition and barriers to engagement for PPM customers. It introduced the PPM cap to protect PPM customers until the smart meter rollout removed those barriers. In its review, the CMA recommended that we consider whether PPM customers would require protection after the expiry of the PPM cap.

2.4. We have considered developments since July 2019 and we conclude that PPM customers will continue to require protection after the expiry of the PPM cap.

### *Technical barriers*

2.5. Over the next few years, technical barriers are likely to remain in place for many PPM customers with traditional meters as the smart meter rollout continues. In September 2019, BEIS consulted on a policy framework for smart metering that would apply from 2021 to 2024, after the current obligation on energy suppliers ends.<sup>12</sup>

### *Market offers*

2.6. Cheaper tariffs are available to PPM customers who switch. Price dispersion between the PPM cap and cheaper FTs has increased since the CMA's July 2019 review. The difference between the cheapest tariff in the market and the cap level has increased from around £120 to £235. The difference between the PPM cap level and the average tariff has increased from £22 to £30. In part, this is because the CMA revised the PPM cap methodology, increasing the cap level by about £50 in like-for-like terms.

2.7. Choice for PPM customers, in terms of the number of competitive PPM offers, remains relatively limited. Most PPM tariffs are close to the PPM cap level. The number of PPM tariffs has slightly decreased between 2019 and 2020, largely due to some suppliers leaving the market. Controlling for that, the number of tariffs on offer has remained broadly stable.

### *Engagement*

2.8. Most PPM customers are also default tariff customers, and so may not be engaged in the market. Even if dispersion and choice had substantially increased, PPM customers (in the absence of a cap on their tariffs) might not take advantage of those choices. Nearly all PPM customers are on default tariffs. By comparison, credit customers have extensive choice of cheaper tariffs, yet many are still on default tariffs. This, in part, was why Parliament introduced the default tariff cap to protect customers on default tariffs regardless of their payment method or meter type.

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<sup>12</sup> BEIS (2019), Smart meter policy framework post 2020.  
<https://www.gov.uk/government/consultations/smart-meter-policy-framework-post-2020>

## How to protect PPM customers

### Options

2.9. We have considered three options for how we might best protect PPM customers after the PPM cap expires at the end of the year.

- Do nothing, allowing the default tariff cap to protect PPM customers with default tariffs at the level intended for direct debit customers.
- Replace the PPM cap with another dedicated cap for PPM customers.
- Use the default tariff cap, with adjustments so it is suitable for PPM customers.

### Provisional proposal

2.10. Provisionally, and for the reasons below, we propose to use the default tariff cap, with adjustments so it is suitable for PPM customers.

2.11. In Chapters 3, 4, and 5 we discuss how we might propose to assess and ensure that the default tariff cap is suitable for PPM customers.

### Considerations for option 1: Do nothing

2.12. If we did nothing, most PPM customers would roll on to the default tariff cap. Nearly all (98% of) PPM customers have default tariffs.<sup>13</sup> Allowing this to happen would protect PPM customers (cap their tariffs), but not necessarily at an appropriate level.

2.13. The default tariff cap already has different cap levels depending on a customer's payment method. Provisionally, we do not consider that either of the current levels would be appropriate for PPM customers.

- The standard credit cap level – this cap level is higher than we would expect a suitable PPM cap level to be. In particular, high bad debt and working capital

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<sup>13</sup> Ofgem analysis of October 2019 supplier customer accounts.

costs lead to high standard credit costs, which in our view, do not apply for PPM customers to the same extent.

- The non-standard credit level – we set this cap level with direct debit customers in mind. Provisionally we would expect this cap level to be lower than the efficient costs a supplier would incur serving PPM customers. In particular, we would expect the costs of the meter and associated infrastructure to be higher than for customers paying by direct debit.

2.14. If the PPM cap expired without a replacement, the non-standard credit cap level would apply to PPM customers. This level is about £50 lower than the existing PPM cap level, and so on that basis it would appear to be inappropriate.

2.15. Provisionally, we do not consider that this option would reasonably protect customers nor have regard to the statutory “needs” in section 1(6) of the Act.<sup>14</sup> If the cap level was significantly and consistently below an efficient supplier’s we do not consider that the short term price protection would protect PPM customers in the long term, as under-investment could affect customers. Neither would suppliers have enough incentive to compete for these customers, because few, or no, suppliers would be able to finance the efficient costs of serving these customers.

### **Considerations for options 2 and 3**

2.16. Provisionally, we consider there to be two reasonable options for protecting PPM customers following the expiry of the PPM cap: replacing the PPM cap, or adjusting the default tariff cap, so that it is suitable for PPM customers.

2.17. Below, we consider which option is preferable with the following issues in mind:

- the level of protection (the cap level);
- the scope of protection (which customers the cap applies to); and
- the period of protection (how long the cap would apply for).

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<sup>14</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1 (6)  
<http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted>



*The level of protection (the cap level)*

2.18. Our choice of approach should not affect the level we would set each of the allowances in the cap at (except for the headroom allowance). We would seek to provide a reasonable allowance for the costs of an efficient supplier in either case. This is one of the reasons why, in its review, the CMA adopted the methodology used in the default tariff cap and applied it to the PPM cap (on a like-for-like comparison of the allowances).

2.19. In principle, our choice of approach could affect the overall level of the cap (in practice, the amount of headroom we use to 'top up' the other allowances). Under the default tariff cap, we would be required to set the level of protection provided in line with section 1 (6) of the Act. A new PPM cap would not be restricted to those considerations.

2.20. In practice, we consider that section 1 (6) is compatible with the level of protection that we would seek to provide in either case.<sup>15</sup> The objective of the default tariff cap is to protect existing and future domestic customers who pay standard variable and default rates. In doing so, we must have regard to:

- the need to create incentives for holders of supply licences to improve their efficiency;
- the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- the need to maintain incentives for domestic customers to switch to different supply contracts; and
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

2.21. On that basis, we do not consider the desired level of protection affects our choice between these two options.

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<sup>15</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1 (6)  
<http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted>

*The scope of protection (which customers the cap applies to)*

2.22. Our choice does affect the scope of any resulting cap – ie which customers that cap would protect and which customers it would not protect. If we chose to replace the PPM cap, we could define the scope of its replacement. The existing cap applies to all PPM customers with non-interoperable meters.<sup>16</sup> If we wanted to replicate that, or provide protection to all PPM customers, then a new PPM cap could be preferable. If we use the default tariff cap, the only PPM customers that we could protect would be those with default tariffs.

2.23. In practice, there is little difference between the two options, as nearly all PPM customers are also default tariff customers. However, 2% of PPM customers actively choose Fixed Term tariffs (FTs).<sup>17</sup> Under the default tariff cap, these customers would no longer be protected by a cap.

2.24. We consider it appropriate to protect only default tariff customers. Firstly, customers choosing competitive tariffs are likely to pay less than the default tariff cap level in any case. The few competitive PPM FTs that are on offer would likely remain below the cap level for default tariffs. Most FTs on offer to direct debit customers are below the level of the default tariff cap, even though they are not price regulated. We would expect the PPM market to be broadly similar.

2.25. Secondly, so long as customers have made an informed choice to accept a tariff that is above the level of the cap, our provisional position is that it is unnecessary to cap those tariffs. In the absence of the PPM cap, it is possible that some non-default PPM tariffs may exceed the level of the cap. We expect that those customers can and will make an informed choice about paying more than they would pay on capped default tariff. On expiry of their FT, licence conditions require suppliers to inform customers of the default tariff they would otherwise pay.<sup>18</sup>

2.26. On that basis, we do not consider the desired scope of protection affects our choice between these two options.

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<sup>16</sup> In practice, we allow suppliers to charge all PPM customers at the PPM cap level.

<sup>17</sup> Ofgem analysis of October 2019 supplier customer accounts.

<sup>18</sup> See Condition 31I. Contract changes information (notifications of price increases, disadvantageous unilateral variations and end of fixed term contracts) in the Electricity Supply Standard Licence Conditions and Gas Supplier Standard Licence Conditions <https://www.ofgem.gov.uk/licences-industry-codes-and-standards/licences/licence-conditions>

*The period of protection (how long the cap would apply for)*

2.27. Our choice of approach affects how long the resulting cap would be in place for. If we replace the PPM cap, we could choose how long it should be in place for. The CMA intended for the PPM cap to protect PPM customers until the smart meter rollout removed barriers to competition. BEIS has consulted on the smart meter rollout policy framework, which aims to complete the rollout by the end of 2024.<sup>19</sup> On that basis, we would put a cap in place until the end of 2024.

2.28. We cannot choose how long the default tariff cap will be in place. The default tariff cap cannot be extended beyond 2023. Before that point, we must assess the conditions for effective competition each year, and recommend whether the default tariff cap should be extended by the Secretary of State for another 12 months.<sup>20</sup>

2.29. A new PPM cap might be preferable if we needed knew that PPM customers will continue to require protection after the default tariff cap expires. Provisionally, we do not consider this to be the case. We would expect that if default tariff customers (with credit meters) no longer required protection, then it is at least possible that default tariff customers with PPMs would not require protection either. Although the conditions for effective competition are not the same for PPM customers and customers with credit meters, there are common issues.

2.30. In any event, when the default tariff cap expires (in 2023 or before), we must consider whether there are categories of customers who may in future pay excessive charges.<sup>21</sup> If PPM customers require protection then we would consider the issue at that point. We do not need to anticipate whether PPM customers would require protection, or what form it should take.

2.31. On that basis, we consider that the default tariff cap is preferable. It has an existing timetable and framework for considering customers' ongoing needs. We consider it preferable and appropriate to align with that timetable and framework, rather than overlay a separate process for customers with similar issues and considerations.

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<sup>19</sup> BEIS (2019), Smart meter policy framework post 2020

<https://www.gov.uk/government/consultations/smart-meter-policy-framework-post-2020>

<sup>20</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, section 7

<http://www.legislation.gov.uk/ukpga/2018/21/section/7/enacted>

<sup>21</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, section 9

<http://www.legislation.gov.uk/ukpga/2018/21/section/9/enacted>

### 3. Adjusting the default tariff cap for PPM customers

In this chapter we describe how we propose to adjust the default tariff cap to protect PPM customers with default tariffs.

#### **Input requested from stakeholders**

We seek stakeholders' view on the issues, options, and our provisional proposals set out in this chapter.

#### **Summary of provisional proposals**

3.1. If we use the default tariff cap to protect PPM customers, then we would introduce a new cap level suitable for PPM customers. In that event, there would be different cap levels for customers paying by direct debit, by standard credit, and by PPM.

3.2. If we use the default tariff cap to protect PPM customers, we propose that the new cap level would apply to all PPM customers with default tariffs, regardless of their prepayment meter type (traditional, interoperable smart prepayment meter, or non-interoperable smart prepayment meter).

3.3. Provisionally, we expect that a default tariff cap level for PPM customers would provide a similar level of protection as the existing PPM cap (or potentially, the same level). Few cost categories vary depending on a customer's payment method or meter type. We would expect common cost components to match the default tariff cap. The CMA has already aligned the existing PPM cap's methodology with the default tariff cap methodology for common cost components.

3.4. Where costs do depend on a customer's payment method or meter type, consider whether it is necessary and proportionate to change the relevant methodologies. We discuss the main areas of assessment in Chapter 4 (operating costs for PPM customers with traditional meters) and Chapter 5 (the impact of the smart meter rollout on operating costs).

## How to set each allowance in the cap level

### Provisional proposal

3.5. If we created a new cap level in the default tariff cap, suitable for PPM customers, we consider that the majority of the allowances in the cap would not require reassessment or adjustment. Table 3.1 sets out our provisional proposals. In each case we have considered, whether to include an allowance at all, and whether to maintain the methodology that is already used in default tariff cap and/or the PPM cap.

**Table 3.1 – Proposed allowances for a PPM level in the default tariff cap**

Allowances	Description	Approach
Wholesale, Networks, and Policy	Allowances for purchasing energy, transporting energy, and funding social and environmental policies. These should not differ by payment method or meter type.	<b>No change.</b> The PPM cap already uses the default tariff cap methodology.
Operating cost	Allowance for operating costs. This applies to all payment methods, based on efficient costs in 2017 for direct debit customers.	<b>No change.</b> The PPM cap already uses the default tariff cap methodology.
Payment method uplift (PPM uplift)	Allowance for the additional costs of serving PPM customers compared with the operating cost allowance.	<b>Assess whether change is required.</b> In chapter 4, we consider options.
Pass-through SMNCC	Allowance for the change in smart meter industry charges. This should not differ by payment method or meter type.	<b>No change.</b> The PPM cap already uses the default tariff cap methodology.
Non-pass-through SMNCC	Allowance for the change in operating costs from replacing PPM with smart meters. This should differ by meter type.	<b>Assess whether change is required.</b> In chapter 5, we consider options.
EBIT	Allowance for a normal profit. This should not differ by payment method.	<b>No change.</b> The PPM cap already uses the default tariff cap methodology.
Headroom	An allowance that ‘tops up’ the cap level for the net impact of uncertainty and to achieve the object of the Act.	<b>No change.</b> The PPM cap already uses the default tariff cap methodology.

## Considerations

### *Wholesale, policy, and network costs*

3.6. We propose to maintain the current methodology for wholesale, policy, and network costs. We describe the relevant methodologies in our 2018 decision.<sup>22</sup> These allowances should be at the same level for all customers, regardless of their payment method. In July 2019 the CMA aligned the PPM cap's wholesale and policy costs methodology with the default tariff cap. The network costs methodologies have always been aligned.

3.7. We are currently reassessing the wholesale allowance in the first cap period of the default tariff cap, and may introduce an adjustment allowance in a limited number of future cap periods.<sup>23</sup> That adjustment should not apply to PPM customers, because it relates to the amount charged to default tariff cap customers in a previous period, when PPM customers were covered by the CMA's separate PPM cap.

### *EBIT and VAT*

3.8. As with wholesale, network and policy allowances, EBIT and VAT are common cap components. We propose to apply the same methodology. These components are set as percentages of other cost components and some of those other components will differ for PPM customers. On that basis, the absolute levels of EBIT and VAT will vary by payment method – as they do in the current default tariff cap levels for direct debit and standard credit.

### *Headroom*

3.9. Like EBIT and VAT, we set headroom using a standard percentage across payment methods. Headroom is a 'top-up' allowance serving two purposes. It allows for the net impact of uncertainty, not already accounted for in the other allowances. It also ensures that the

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<sup>22</sup> See Ofgem (2018), Default tariff cap: decision – overview, Appendix 4 – wholesale, and Ofgem (2018), Default tariff cap: decision – overview, Appendix 5 – policy and network costs. [https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix\\_4\\_-\\_wholesale\\_costs.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_4_-_wholesale_costs.pdf) and [https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix\\_5\\_-\\_policy\\_and\\_network\\_costs.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_5_-_policy_and_network_costs.pdf).

<sup>23</sup> Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation. <https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation>

overall cap level achieves the objective of the Act, and in doing so, has regard to the other statutory needs set out in section 1(6).<sup>24</sup>

3.10. Provisionally, we consider it unlikely that our proposals would alter our assessment of the net uncertainty in the combined allowances. Most allowances do not vary by payment method and we propose no change in the approach. For components that do vary with payment method we will reassess those allowances to consider whether changes are appropriate. Although we do not anticipate any such changes would impact the net uncertainty in the level of the PPM cap, it is possible theoretically. In those circumstances we would review the implications for the assessment of uncertainty we made when we set headroom allowance.

3.11. Additionally, in its July 2019 assessment, the CMA recommended that we consider whether headroom and the approach to competition in the default tariff cap would be effective in generating competition on price or service levels for prepayment customers. The CMA found that competition had not changed significantly since its original investigation, but it remained unclear how that would be affected by the future roll out of smart meters, and that should be assessed at the relevant time.

3.12. As discussed in Chapter 2, we do not consider that market conditions or technical barriers have changed significantly since July 2019. Therefore, we do not consider that changes in headroom would stimulate competition and lead to better outcomes for PPM customers at this stage. In line with the CMA recommendation, we may reassess this issue when the smart meter roll out is more advanced.

3.13. Provisionally, we would therefore expect to use the existing default tariff cap headroom allowance for the PPM level, unadjusted.

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<sup>24</sup> Ofgem (2018), Default Tariff Cap: Decision – overview, paragraph 2.4 ([https://www.ofgem.gov.uk/system/files/docs/2018/11/decision\\_-\\_default\\_tariff\\_cap\\_-\\_overview\\_document\\_0.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document_0.pdf)) and Appendix 2 – Cap level analysis and headroom. [https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix\\_2\\_-\\_cap\\_level\\_analysis\\_and\\_headroom.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_2_-_cap_level_analysis_and_headroom.pdf)

*Cost components that depend on payment method or meter type*

3.14. Suppliers' operating costs depend on the payment methods and meter types of their customers. We would propose to allow for the efficient costs of serving PPM customers by combining several allowances:

- the operating cost allowance;
- the PPM uplift, for the portion of additional costs of serving PPM customers that we choose to reflect in PPM tariffs; and
- the change in suppliers' operating costs due to the smart meter rollout.

3.15. We discuss our options and considerations for assessing these costs and how we might allow for them in Chapters 4 and 5.



## 4. Operating costs for customers with traditional meters

In this chapter, we consider whether it is necessary and proportionate to update the prepayment (PPM) uplift. We consider whether the PPM uplift should fully reflect the efficient incremental cost of serving PPM customers and whether to adjust the operating cost allowance to separately identify socialised efficient incremental PPM costs and remove inefficient incremental PPM costs.

### **Input requested from stakeholders**

We seek stakeholders' view on the issues, options, and our provisional proposals set out in this chapter.

### **Summary of provisional proposals**

4.1. We propose to maintain the current price differential between the cap levels for direct debit customers and PPM customers (not including the impact of the smart meter rollout). In practice, that means we propose to maintain the level of the PPM uplift used in the PPM cap, rather than conducting an updated assessment of efficient incremental costs of serving PPM versus direct debit customers.

4.2. In maintaining the current PPM uplift, we would spread the proportion of efficient PPM costs that exceed the PPM uplift onto other payment methods. The methodology we used to calculate the operating cost allowance for the default tariff cap means that any incremental PPM costs over and above the PPM uplift are already included in the operating cost allowance. We propose to maintain the operating cost allowance unadjusted, which we estimate contains about £5 of PPM costs already.

4.3. We do not propose to collect new data to reassess the PPM uplift or operating cost allowance. Collecting PPM data from 2017 would be consistent with the default tariff cap methodology, but analysing it would be redundant; the operating cost allowance in the default tariff cap already includes 2017 PPM costs. Latest data, on costs in 2019 or 2018, would be inconsistent with the default tariff cap methodology, which is based on data from 2017.

## The existing methodology

### The allowances

4.4. The current PPM cap provides for the efficient operating costs of serving PPM customers in two allowances: the PPM uplift; and the operating cost allowance.

**Table 4.1: relevant allowances already included in the PPM cap**

Allowance	Electricity	Gas	Implied Dual fuel
Operating cost	83	95	178
Payment method uplift for traditional PPM	26	42	68

Source: Ofgem (2020), Prepayment Meter Price Cap: 1 April 2020 to 30 September 2020.

<https://www.ofgem.gov.uk/publications-and-updates/prepayment-meter-price-cap-1-april-2020-30-september-2020>

### The PPM uplift

4.5. The PPM uplift is an additional allowance that applies only to PPM customers. It does not apply to customers with other payment methods. It increases tariffs for PPM customers to recognise, in part or in full, the additional costs suppliers incur in serving these customers compared with direct debit customers.

4.6. The CMA calculated the existing PPM uplift<sup>25</sup> considering two sets of data.

- The incremental costs of serving prepayment customers (compared with customers paying by direct debit) that suppliers reported for 2014.
- A supplementary 'bottom up' exercise, to assess the differential costs between customers who paid by direct debit and those customers who had a prepayment meter. For that analysis, the CMA considered each element of indirect costs that had been identified by suppliers and decided if a differential cost could be expected and, if so, what an efficient value might be.

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<sup>25</sup> CMA (2016), Energy market investigation. Appendix 9.8: Analysis of indirect costs by payment method. <https://www.gov.uk/cma-cases/energy-market-investigation>

4.7. The PPM uplift represented the CMA's view of efficient incremental costs at the time. It set the allowance at £63 (£24 for electricity and £39 for gas in 2014 prices). Broadly, that level reflected the midpoint of the range of estimates in its bottom up analysis. The estimate was broadly comparable average differential across the six largest supplier at the time.<sup>26</sup>

### **The operating cost allowance**

4.8. The operating cost allowance applies to all customers, regardless of their payment method.

4.9. We describe the full methodology for the operating cost allowance in Appendix 6 of 2018 decision.<sup>27</sup> The important points are:

- we analysed data on ten large suppliers' total operating costs per account in 2017;
- we adjusted each supplier's total operating costs per customer to account for the proportion of their customers that had a PPM or paid by standard credit;
- to set the operating cost allowance, we compared each supplier's operating costs per account after those adjustments for payment method; and
- we set the allowance at a level £5 below the dual fuel cost of the lower quartile supplier.

### **Interaction between the two allowances**

4.10. We have considered our methodology for the operating cost allowance and, for the reasons below, our preliminary analysis suggests that up to £5 of the allowance already accounts for the portion of incremental costs of serving PPM customers in 2017 that exceeds the CMA's assessment of efficient incremental PPM costs in 2014.

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<sup>26</sup> CMA (2016), Energy market investigation. Appendix 9.8: Analysis of indirect costs by payment method. Paragraphs 128, 147, and 164. <https://www.gov.uk/cma-cases/energy-market-investigation>

<sup>27</sup> Ofgem (2018), Default tariff cap: decision – overview, Appendix 6 - Operating costs. <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

4.11. We adjusted each supplier's total operating cost because customers paying by standard credit or PPM are, on average, more expensive to serve than those paying by direct debit. So, the proportion of a supplier's customer base using different payment methods was likely to have a material impact on their total reported operating costs per customer in 2017. That adjustment increased comparability of each supplier's costs. It reduced the risk that suppliers with the lowest total operating costs per account simply had fewer customers with expensive payment methods.

4.12. To adjust for the proportion of prepayment customers we subtracted from each supplier's total reported operating costs per account in 2017 a standardised estimate of the additional costs of supplying prepayment customers. We calculated that standardised estimate by combining the CMA's PPM uplift with the proportion of each supplier's domestic gas and electricity customers that pay by prepayment.<sup>28</sup> We made a similar adjustment relating to customers paying by standard credit.

4.13. The adjustment was conservative. Had we used a higher estimate of the additional costs of supplying PPM customers (ie an estimate of efficient costs higher than the PPM uplift), we would have made a greater downward adjustment to the operating costs per direct debit customer used in our benchmarking. Our benchmark would have therefore been lower. So, if the true efficient incremental PPM costs in 2017 were higher than the CMA's assessment (of 2014 costs), then the operating cost allowance would have been lower. The converse is also true.

4.14. The true efficient increment PPM costs in 2017 could differ from the CMA's assessment based on cost in 2014, but they could not exceed the actual incremental costs included in the total operating costs that suppliers reported for 2017. We estimate the amount of PPM costs included in the operating cost allowance is about £5 (before considering efficiency).

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Appendix 6 - Operating costs, paragraphs 2.4 to 2.8 <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

## Assessing the PPM uplift at typical consumption

### Options

4.15. We could maintain the current PPM uplift in the PPM cap, or we could reassess it and (potentially) set a new level. If we were to reassess the PPM uplift, we consider that there are two options in principle:

- A fully cost-reflective approach: we could make the PPM uplift fully reflective of the efficient incremental cost-to-serve for a PPM customer (compared with a direct debit customer). To do this, we would collect cost data, benchmark suppliers' incremental costs, and estimate an efficient level. We might analyse cost categories in aggregate, or consider each cost category separately (metering, customer service, etc.). Our considerations and options would be similar to those we discussed for estimating the efficient incremental costs of serving standard credit customers, which we set out in our 2018 decision.<sup>29</sup>
- A tariff-differential approach: we could restrict the PPM uplift to achieve a certain differential between PPM tariffs and direct debit tariffs. There are various ways we might do that (for example, with reference to the current difference between the cap levels, historical market prices, or some other reference). Where our preferred tariff differential is less than the efficient cost differential, we should spread those excess efficient costs across all payment methods.

### Provisional proposal

4.16. We propose a tariff-differential approach. We consider that even if the efficient incremental costs of serving PPM customers exceeded the current PPM uplift, we would seek to spread those excess costs across all payment methods. This is the approach we decided to use for standard credit customers in our 2018 decision, setting the uplift below the efficient incremental costs. In this case, we would maintain the current PPM uplift unadjusted in order to avoid increases in the current tariff differential between PPM and direct debit customers. We may consider alternative tariff differentials, if appropriate.

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<sup>29</sup> Ofgem (2020), Default tariff cap – decision, Appendix 8 – Payment method uplift.  
<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-overview-document>

4.17. In practice, that means we propose to maintain the current level of the PMU uplift, updating it each cap period by CPI(H). The level of the PPM cap in the default tariff cap would match the level of the current PPM cap, except for any changes as a result of the PPM SMNCC (which we discuss in the next chapter). This means that impact on customers and suppliers would remain at current levels.

### **Considerations**

4.18. We consider these options against section 1(6) of the Act. In particular:

- protection for customers of default tariffs; and
- an efficient supplier's ability to finance its activities.

#### *Protection for customers of default tariffs*

4.19. A fully cost reflective approach would set the PPM uplift at the level of efficient incremental cost of serving PPM customers. This approach would set tariffs in line with efficient costs, but preliminary analysis suggests that it would substantially increase tariffs for PPM customers and reduce tariffs for other customers to a lesser extent.

4.20. A fully cost reflective PPM uplift may be higher than the existing PPM uplift. Theoretically, it could be lower, but suppliers' representations have suggested it might be higher. In either case, both the PPM uplift and the operating cost allowance would change. The level of efficient costs in 2017 cannot be greater than the level of costs suppliers *actually incurred*, so the total operating costs we analysed when setting the operating cost allowance would be unchanged. Only the adjustment for the proportion of PPM customers would change. A higher estimate of the efficient incremental PPM costs would reduce the adjusted operating costs we analysed for each supplier. That would, under a fully cost reflective approach, increase the PPM uplift and reduce the operating cost allowance.

4.21. The impact on PPM customers and direct debit customers would differ. On average, suppliers have roughly five to six times as many direct debit customers than PPM customers. So, a relatively minor impact on each direct debit customer has a much larger impact on each PPM customer; as each £1 per PPM customer is spread between many more customers on other payment methods.

4.22. Relative to a fully cost-reflective approach, a tariff-differential approach would constrain the PPM uplift in order to protect PPM customers. The approach provides more protection for PPM customers than direct debit customers. It reduces PPM tariffs to a level *below* efficient costs and increases direct debit tariffs (relative to fully cost reflective approach) to a level *above* their efficient costs. To the extent that the PPM uplift is less than the true efficient costs in 2017, then the PPM uplift and operating cost allowance already have this relationship. If we maintain the current PPM uplift, the level of protection provided to each payment method would be unchanged.

4.23. We do not consider it desirable to significantly increase the tariffs for PPM customers, compared to the current tariff differential they already pay. We consider that PPM customers are more likely to be vulnerable than direct debit customers. In line with the CMA's findings, they also face additional barriers to switching.<sup>30</sup>

4.24. On that basis, we would prefer to set the PPM uplift using a tariff-differential approach to avoid reducing protection for PPM customers. That would constrain the maximum value of a newly assessed PPM uplift to its current level.

*An efficient supplier's ability to finance its activities*

4.25. Our approach makes no difference for an efficient supplier with market average proportions of direct debit, standard credit and PPM customers. They would fully recover the cost of their activities whether we set a fully cost reflective PPM uplift, or restrict it to achieve a lower tariff differential.

4.26. Under a fully cost reflective approach, an efficient supplier would recover its costs of serving each customer group from the customers in that group. Under a tariff-differential approach, an efficient supplier with an average proportion of PPM customers would partially

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<sup>30</sup> Citizens Advice found 41% of all PPM customers reported health issues, including 15% reporting mental health issues. Citizens Advice (2018) Switched On – Improving support for prepayment consumers who've self-disconnected.

[https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/PPM%20self-](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/PPM%20self-disconnection%20short%20report.pdf)

[disconnection%20short%20report.pdf](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/PPM%20self-disconnection%20short%20report.pdf). In England for both gas and electricity, a household is more likely to be fuel poor if paying via prepayment compared to direct debit or standard credit, with around 23% of households paying via PPM in fuel poverty in 2016. BEIS (2018) Annual Fuel Poverty Statistics Report.

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/829006/Annual Fuel Poverty Statistics Report 2019 2017 data .pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/829006/Annual_Fuel_Poverty_Statistics_Report_2019_2017_data_.pdf)

recover its PPM costs from PPM customers and recover the remaining costs from customers with other payment types.

4.27. Our choice of approach would affect an efficient supplier that did not have direct debit, standard credit, and PPM customers in the market average proportions.

4.28. Under a tariff-differential approach a supplier's ability to recover, or over-recover, its costs would depend on the proportion direct debit, standard credit, and PPM customers it has. Suppliers with more PPM customers than average would under-recover efficient costs to an extent (as they lack enough customers using other payment methods to recover the portion of efficient PPM costs spread to non-PPM customers). The inverse is true of suppliers with more direct debit customers than average – they could over-recover from direct debit customers and would not have a shortfall in PPM costs to offset. This is matter of degree: the more a supplier differs from the market average proportions, the greater the impact.

4.29. In principle, we are not opposed to the distortion created by allocating a portion of PPM costs to other customers. We consider the impact for customers and suppliers to be consistent with section 1 of the Act. In our 2018 decision on the default tariff cap, we decided to set the uplift for standard credit customers using a tariff-differential approach that was not fully cost reflective.<sup>31</sup> We set the standard credit uplift below our estimate of the efficient cost differential between standard credit and direct debit customers. We benchmarked the differential between the direct debit and standard credit tariffs to the average price differential in the market in 2017 (which was lower than suppliers' cost differential). We spread the additional efficient costs of serving standard credit customers across other payment types. We considered that this approach protected customers, and in doing so, we had regard to suppliers' finances, notwithstanding the distorting impact the approach has on cost-recovery.

4.30. In practice, we would have regard to the efficient costs of suppliers with higher than average proportions of PPM customers. In its July 2019 review of the PPM cap, the CMA concluded that the impact of the revised PPM cap (the current approach) on suppliers with high proportions of PPM customers was reasonable in practice.

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<sup>31</sup> The methodology is described in full in appendix 8 of Ofgem (2018), Default tariff cap: decision – overview, Appendix 8 – Payment method uplift. <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>



4.31. For the reasons above, our provisional view is that the impact of maintaining the level of the current PPM uplift is likely to be appropriate with regard to the statutory needs set out in section 1 of the Act.

## **Assessing the PPM uplift at nil consumption**

### **Provisional proposal**

4.32. In the PPM cap, the PPM uplift applies equally at typical and nil levels of consumption. We propose to take the same approach for a default tariff cap level for PPM customers.

### **Considerations**

4.33. In the default tariff cap, the differential between the standard credit tariffs and direct debit tariffs varies with consumption. This is because the underlying costs vary with consumption, largely due to bad debt and working capital. On that basis the standard credit uplift is smaller at nil consumption and it is at typical consumption. These variable cost categories are less significant for PPM customers. The cost differentials between those with credit meters and PPM customers mainly reflect assets and services that do not seem to vary with consumption. On that basis the PPM uplift at nil consumption should match the uplift at typical consumption. This proposal would maintain the current approach in the PPM cap.

## **Assessing the operating cost allowance**

### **Options**

4.34. Whichever approach we take when setting to the PPM uplift, it would have an impact on the operating cost allowance. Under a fully cost reflective approach, we would have to remove all PPM costs included in the operating cost allowance. Under a tariff-differential approach, we would need to consider how to treat the efficient and potentially inefficient PPM costs already included in the operating cost allowance.

4.35. For efficient costs in the operating cost allowance, we have two options. Neither of these options would change the cap levels. We could:

- leave the costs in the operating cost allowance – this is the current situation and would require no change; or

- remove the costs from the operating cost allowance, and reallocate those efficient costs to a Payment Method Uplift - this is the approach which we used for standard credit costs in our 2018 decision.

4.36. For apparently inefficient costs in the operating cost allowance, we could:

- leave the inefficient costs in the operating cost allowance;
- remove the inefficient costs from the operating cost allowance and make no other changes. This would reduce the cap levels for all customers; or
- remove the inefficient costs from the operating cost allowance, and consider the impact of that adjustment on how headroom accounts for net uncertainty and conservatism in the methodology.

### **Provisional proposals**

4.37. In each case, and for the following reasons, we propose to leave the operating cost allowance unadjusted.

### **Considerations**

#### *Spreading a portion of efficient PPM costs to all payment methods*

4.38. If we were to restrict the PPM uplift, we should spread the proportion of efficient PPM costs that exceed that the PPM uplift to other payment methods. Given our methodology for the operating cost allowance, if the efficient incremental PPM costs in 2017 exceeded the PPM uplift, then we will have left those additional costs in the operating cost allowance analysis. Currently, that portion is not separately identifiable.

4.39. For the efficient costs, this decision is cosmetic (whether to include these costs in the operating cost allowance or in a payment method uplift applied to all payment methods). The choice has no impact on the cap level, so it does not affect protection for customers or suppliers' finances and incentives to compete. Whether those costs are in a Payment Method Uplift (as they are for standard credit costs allocated to the direct debit) or in the operating cost allowance, the cap level is the same.

4.40. Provisionally, given the impact is nil or negligible, we do not consider it necessary or proportionate to collect data to reallocate costs from the operating cost allowance to an uplift.

*Apparently inefficient costs*

4.41. The true efficient incremental costs of serving PPM customers in 2017 may have been higher than the PPM uplift. But the true efficient costs in 2017 cannot have exceeded the actual incremental costs that suppliers included in their 2017 total operating costs. Any difference between the true efficient costs and the actual costs suppliers will have been included in the operating cost allowance. This difference reflects inefficient PPM costs.

4.42. The CMA's analysis of costs in 2014, suggests that most large suppliers had inefficient incremental PPM costs at that time. Based on that analysis, we estimate that the portion of costs that we might calculate as inefficient would be between £1 and £3. If we considered that the efficient cost in 2017 matched the PPM uplift, that would suggest all of the PPM costs included in the operating cost allowance are inefficient (about £5).

4.43. Provisionally, we do not think it appropriate to remove apparently inefficient costs from the operating cost allowance and reduce the cap levels. Any approach to estimating efficiency contains uncertainty and different degrees of conservatism in its assumptions. Our approach to analysing the total operating costs in our 2018 decision adjusted for PPM costs conservatively. Adjusting the allowance would change the level of conservatism.

4.44. Changing the level of conservatism matters because we set the default tariff cap level (ie the amount of headroom we used to top up the allowances) considering the amount of uncertainty and conservatism in the allowances. Calculating and removing the apparently inefficient PPM costs from the operating cost allowance costs reduces the conservatism in that methodology. It is at least possible that some or all of that conservatism should be allocated in headroom, if we were to remove it from the operating cost allowance.

4.45. If we were to reallocate conservatism from the operating cost allowance to headroom (in full or in part), then the impact on customers and suppliers may not differ much when compared with leaving the operating cost allowance as it is, unadjusted.

## Considering cost data

### Options

4.46. We have considered whether it is necessary and proportionate to collect updated data on the incremental costs of serving PPM customers. Given the considerations above, we do not consider it necessary, as the cap level could not change in any case.

4.47. However, we have considered two options for collecting data to reassess the efficient costs of serving PPM customers, were we to collect data.

- Data from 2017, which would be consistent with the analysis we conducted for the operating cost allowance.
- Latest data, from 2019 if available, or from 2018 if not.

### Considerations

#### *Option 1: 2017 data*

4.48. We could collect data that is consistent with the data we used to set the operating cost allowance – data from 2017. Analysis of these data would be redundant. The current caps already incorporate this data (as discussed above).

4.49. Taking our provisional position on the PPM uplift above – that we would use a tariff-differential approach and would not seek to remove apparently inefficient costs – any reassessment would lead to no adjustment to the cap levels (or only minor changes relating to reallocations between allowances within each cap level). Updated data could not amend the total operating costs reported by suppliers for 2017.

4.50. We could collect data to reallocate the PPM costs currently contained in the operating cost allowance to other allowances (either to a payment method uplift if they are efficient, or to headroom if there are inefficient). These changes would be cosmetic. They would not affect customers or suppliers. We do not consider this necessary.

*Option 2a: Latest data on total operating costs*

4.51. We could use cost data from 2019 for all payment types (or 2018, if that is the most recent data available). This would use the latest data on suppliers' total costs, consistent with the Consolidated Segmental Statements ("CSS"), breaking that data into costs for the three payment types, and again into the components of cost (metering, field force, customer services, debt etc.).<sup>32</sup> We could then benchmark suppliers to estimate the efficient cost for each payment method.

4.52. This approach should allow us to estimate the efficient PPM costs using latest data, in a way that is consistent with the assessment of operating costs for other payment methods.

4.53. However, in effect, this approach reopens the operating cost allowance for all payment methods, which is not the intention of assessing protection for PPM customers. The impact of any trend in efficient PPM costs could be overwhelmed by other factors. Provisionally, we do not consider this approach to be necessary, proportionate, or valid. Our reasons for this view are as follows:

- Supplier costs from 2019 have been subject to price caps whose purpose (in part) is to reduce those costs. We might expect supplier costs to have reduced since the implementation of the cap, and become more efficient. It would not improve incentives for suppliers to become more efficient if we re-set the benchmark for efficiency based on 2019 cost data, as this would move the definition of efficiency set in 2017.
- If it transpired that supplier costs had increased since 2017 (eg suppliers had become less efficient), we would not amend the benchmark for efficient costs, as this would undermine the purpose of setting efficient costs for suppliers in the first instance. Neither would we expect suppliers to have immediately rescaled their costs to account for changes in their customer bases or benefited from the cost of efficiency programmes yet. These factors would distort a revised benchmarking of operating cost per customer.

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<sup>32</sup> Ofgem (2019), Energy companies' Consolidated Segmental Statements [https://www.ofgem.gov.uk/system/files/docs/2019/09/energy\\_companies\\_individual\\_consolidated\\_segmental\\_statements\\_2018\\_v1.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/09/energy_companies_individual_consolidated_segmental_statements_2018_v1.pdf)

- Further, the basket of reference suppliers will have changed since 2017 as suppliers have gained and lost customers, and the market has had new entrants and consolidation. For instance, some suppliers that were small in 2017 have now reached a scale where we would include them in analysis. The changing composition of suppliers is likely to have had a greater effect on the assessment of operating costs than trends affecting the drivers of underlying costs to serve.

*Option 2a: Latest data on PPM costs only*

4.54. We could use data from 2019 for PPM costs (or for the difference in direct debit and PPM costs) only and append the resulting efficient cost benchmark to the existing operating cost allowance. This would maintain all existing analysis for the operating cost allowance and require new analysis to determine only the efficient incremental PPM costs.

4.55. This approach would not reopen the other payment methods, although it would face all the other difficulties of using later data described above. In addition, it faces other problems:

- In principle, applying costs for only one payment type from 2019 data on top of costs for another payment type from 2017 data is methodologically weaker, cost may be double counted or excluded, not only misallocated. It is stronger when the total costs reflected in the caps (across direct debit, standard credit and PPM) sum to the total operating cost of an efficient supplier in a given year, which is not possible to achieve with an amalgamation of reference years.
- In practice, changes in the basket of reference suppliers and their customer numbers will make the bases for the 2019 incremental costs different for the base to which the PPM uplift would be applied. Changes in the relative costs of PPM and direct debit may result in a PPM uplift that is incorrect (for example, if direct debit costs have risen faster than PPM costs since 2017, this would indicate a narrower gap between payment types than would be appropriate).
- Furthermore, the 2017 PPM costs that exceeded the PPM uplift would need removing from operating cost allowance, to avoid double counting of costs.

4.56. For these reasons, neither approaches for using recent data is necessary or preferable to using 2017 data.

## 5. Considering the impact of the smart meter roll out

In this chapter, we consider how to account for the impact of the smart meter rollout on costs relating to PPM customers.

### **Input requested from stakeholders**

We seek stakeholders' view on the issues, options, and our provisional proposals set out in this chapter.

### **Summary of provisional proposals**

5.1. In our October consultation we estimated the operating cost allowance within the default tariff cap already contains about £7 per fuel that relates to the smart meter rollout, before considering relevant IT costs.<sup>33</sup> As set out in Chapter 4, we do not propose to amend that operating cost allowance when setting the cap for PPM customers in the default tariff cap.

5.2. We propose to set the allowance for industry charges (the pass-through Smart Metering Net Cost Change ("SMNCC")) using the same methodology we use to set the default tariff cap for other payment methods. The PPM cap already includes this allowance (using the same methodology we use to set the cap for other payment methods), so there would be no change in terms of the impact on customers and suppliers.

5.3. Provisionally, we propose to include an allowance for the impact of replacing traditional PPM with smart meters (a non-pass-through SMNCC *specifically calculated for PPM*). This is not currently included in the PPM cap. The benefits of replacing a PPM with a smart meter are greater than they are for replacing traditional credit meters (or put another way, the net costs are lower). On that basis, we would expect an appropriate allowance for PPM customers

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<sup>33</sup> See table 4.4 in Ofgem (2019), Reviewing smart metering costs in the default tariff cap. [https://www.ofgem.gov.uk/system/files/docs/2019/10/smart\\_metering\\_review\\_in\\_the\\_default\\_tariff\\_cap\\_-\\_october\\_consultation.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/10/smart_metering_review_in_the_default_tariff_cap_-_october_consultation.pdf)

to be lower than the SMNCC for credit customers. Therefore, we propose a specific PPM allowance.

5.4. Our preliminary analysis suggests that suppliers incur net costs when replacing traditional PPM with smart meters, but those costs may be less than the costs already provided for in the operating cost allowance (using a market average rollout profile). On that basis, the non-pass-through SMNCC for PPM could be negative. If that was the case, it would not mean that there is no cost associated with the smart meter rollout to PPM customers. These preliminary figures are indicative only. We have collected data from suppliers on meter rental charges, but have not considered this information yet. Below we discuss cost and benefit drivers for suppliers to consider and scrutinise.

5.5. It is possible that we may need to amend our proposed methodology for calculating the non-pass-through SMNCC for PPM customers after the statutory consultation. However, we would still need to set a cap level for PPM customers in time for the end of the year. In that event, we would likely propose a contingency allowance for cap period five (October to March 2021). Based on the preliminary analysis we would likely set the non-pass-through SMNCC at zero – ie no net change to costs included in the operating cost allowance.<sup>34</sup> Given our preliminary consideration of costs and the allowances, this contingency position would be conservative.

## The existing methodology

### The allowances

5.6. If we applied the existing methodology for the PPM cap to the default tariff cap, there would be, effectively, three allowances reflecting the impact of the smart meter rollout on an efficient supplier's operating costs: operating cost allowance, the pass-through SMNCC for industry charges, and the non-pass-through SMNCC for the impact on suppliers' operating costs of replacing traditional meters. The PPM cap does not include the non-pass-through SMNCC. The non-pass-through SMNCC is a measure of the *change* in costs, not absolute costs, so in practice, that means the PPM cap assumes that the rollout does not change suppliers' costs.

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<sup>34</sup> Combined with the PPM uplift proposed in Chapter 4.



**Table 5.1: Relevant allowances in the PPM cap for the smart meter rollout**

Allowance	Electricity	Gas	Implied Dual fuel
Operating cost	83	95	178
Pass-through SMNCC	7	5	12
Non-pass-through SMNCC	Not included	Not included	0

Source: Ofgem (2020), Prepayment Meter Price Cap: 1 April 2020 to 30 September 2020.

<https://www.ofgem.gov.uk/publications-and-updates/prepayment-meter-price-cap-1-april-2020-30-september-2020>

### **The operating cost allowance**

5.7. The operating cost allowance in the default tariff cap includes costs relating to the smart metering rollout. We estimate the value of those costs to be about £7 per fuel before considering IT costs related to smart meters, using our SMNCC model (which is based on BEIS’s Smart Metering Implementation Programme cost benefit analysis (“CBA”) and cost data from 2017).<sup>35</sup> As discussed in chapter 4, we propose to maintain the operating cost allowance unadjusted.

### **The pass-through SMNCC**

5.8. As the smart meter rollout progresses, suppliers pay industry body charges. These cover the costs incurred by the Data Communications Company (“DCC”), Smart Energy GB (“SEGB”), The Alternative Home Area Network Company (“Alt Han Co”), and Smart Meter Installation Code of Practice Ltd (“SMICoP”).

5.9. The default tariff cap includes an allowance for the change in these costs since 2017: the pass-through SMNCC. We calculate the change using industry charging statements. In July 2019, the CMA decided to include the same allowance and methodology in the PPM cap.

### **The non-pass-through SMNCC**

5.10. Suppliers incur the costs and benefits of installing smart meters in their customers’ homes. This includes the costs of installing and maintaining smart meters, the benefit of no longer paying for the installation and maintenance of the traditional meter they replace, and the net impact on suppliers’ overheads (IT costs, call centres, and other activities).

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<sup>35</sup> See table 4.4 in Ofgem (2019), Reviewing smart metering costs in the default tariff cap. [https://www.ofgem.gov.uk/system/files/docs/2019/10/smart\\_metering\\_review\\_in\\_the\\_default\\_tariff\\_cap\\_-\\_october\\_consultation.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/10/smart_metering_review_in_the_default_tariff_cap_-_october_consultation.pdf)

5.11. We set the non-pass-through SMNCC in the default tariff cap to account for the net change in these costs considering traditional credit meters. Importantly, the non-pass-through SMNCC is not a measure of smart costs overall – it is a measure of the change in those costs, compared with costs included in the operating cost allowance.

5.12. We set the non-pass-through SMNCC for credit customers considering:

- the change in the rollout profile, the number of smart meters that have been installed compared with 2017;
- the change in the costs and benefits of replacing traditional credit meters with smart meters;
- the change in inflation since 2017; and
- an adjustment to account for the different definitions of 'efficiency' we used to assess total operating costs in 2017, and to assess smart metering costs in isolation.

5.13. The non-pass-through SMNCC is not currently included in the PPM cap.

## **Assessing the pass-through SMNCC**

### **Options**

5.14. To reflect the costs of industry charges we have considered:

- using the pass-through SMNCC already used in the default tariff cap and PPM cap; or
- developing a new methodology to calculate a value specifically for PPM customers.

## Provisional proposal

5.15. Provisionally, we propose to maintain the pass-through SMNCC allowance for PPM customers, using the same methodology we use for credit customers. This methodology is set out in our 2018 decision and was adopted by the CMA in their 2019 review of the cap.<sup>36</sup>

## Considerations

5.16. In principle, the impact of the industry bodies' activities<sup>37</sup> may not exactly reflect the market proportions of credit and PPM customers. For instance, marketing activities (SEGB) or those in premises that cannot connect to standard Home Area Networks (HAN) may or may not disproportionately affect PPM customers. We expect that impact to be difficult to estimate and the net impact, if any, to be minor.

5.17. In practice, these costs should not vary significantly by payment method. The majority of the costs are largely charged on a market share basis without a breakdown by payment method. To calculate the allowance for pass-through costs, we use the SEGB budget for SEGB costs and the DCC charging statement for the majority of the other costs (ie DCC and Alt Han Co).<sup>38</sup> In both of these cases, we either take total costs or unit costs then calculate the per meter cost. These costs are not separated by payment method in their respective sources and we do not assume a split by payment method when we calculate the allowance.

## Assessing the non-pass-through SMNCC

### Options

5.18. The smart meter rollout changes suppliers' operating costs as they replace traditional meters with smart meters. We have considered four options for how might account for this impact on supplier's costs:

- applying the non-pass-through SMNCC allowance for credit customers;

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<sup>36</sup> Ofgem (2018), Default tariff cap: decision – overview, Appendix 7 – Smart metering costs. [https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix\\_7\\_-\\_smart\\_metering\\_costs.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_7_-_smart_metering_costs.pdf)

<sup>37</sup> DCC, SEGB, Alt Han Co, and SMICoP

<sup>38</sup> We also calculate SMICoP costs but these have been immaterial so far. The increment for the April 2020 cap period is £0.01

- not including a non-pass-through SMNCC at all (the current PPM cap approach);
- applying a single non-pass-through SMNCC for both PPM and credit; and
- applying a non-pass-through SMNCC allowance specifically for PPM customers.

### **Provisional proposal**

5.19. We propose to introduce a non-pass-through SMNCC allowance specifically for PPM customers. Our preliminary consideration and analysis suggest that replacing PPMs with smart meters has greater benefits (or lower net costs) for suppliers than replacing credit meters. We should consider the particular impact on the smart meter rollout on PPM customers.

### **Considerations**

#### *Option 1: the non-pass-through SMNCC allowance for credit customers*

5.20. This allowance considers the net change in operating costs that comes from replacing traditional credit meters with smart meters. This is irrelevant to PPM customers, and would misstate the change in PPM costs. The credit SMNCC would overcharge PPM customers as the benefits of replacing traditional PPMs are greater than they are for replacing credit meters (or the net costs are lower).

#### *Option 2: Not including a non-pass-through SMNCC at all (the current approach)*

5.21. This option would assume that installing smart meters has no impact on suppliers' net costs. The smart meter rollout does affect costs, so this approach would be unlikely to be accurate. Our preliminary analysis suggests this option would overstate costs. The net costs of the rollout to PPM customers change over time, and eventually become net benefits, which should be reflected in a reduction in the customers' tariffs. Not including an SMNCC at all would mean we could not track the net change in costs. Using this fixed allowance (consistently set at no change) we would increasingly setting the cap too high.

#### *Option 3: a single non-pass-through SMNCC for both PPM and credit*

5.22. This option would recognise the PPM costs and benefits, but spread them across all customers in a single SMNCC. The net cost of replacing traditional PPM with smart meters appears to be less than it is for replacing traditional credit meters. We consider that choosing

this option would increase bills for PPM customers in order to decrease bills for direct debit customers. In addition, as there are far fewer PPM customers than there are credit customers, the increase for each PPM customer would be much more significant than the reduction for each credit customer. As stated in Chapter 4 (4.23), we seek to protect PPM customers.

*Option 4: a new non-pass-through SMNCC specifically for PPM customers*

5.23. Provisionally, we propose to include a non-pass-through SMNCC allowance for PPM customers. We would apply this allowance only to PPM customers in the default tariff cap. It would serve the same function as the non-pass-through SMNCC for credit customers: accounting for the change in costs compared with the level already accounted for in the operating cost allowance. However, this allowance would account for the difference in the costs and benefits to date from the smart rollout that are specific to PPM customers, as compared to the standard 2017 baseline (the amount included in the operating cost allowance).

## **Estimating an SMNCC for PPM customers**

### **Options**

5.24. To provide an SMNCC allowance for PPM customers, we need to estimate the impact of the smart meter rollout on an efficient supplier's operating costs. Conceptually, this issue is largely the same as the one we consider for credit meters. To estimate costs we could:

- use the CBA as a starting point, making modifications as required. This is the approach we already use for the impact of the smart meter rollout on credit meters; or
- create a new estimate of the costs and pace of the smart meter rollout.

## Provisional proposal

5.25. We propose to use the CBA as a starting point. For the reasons set out in our April and October consultations, we consider that the CBA remains the most robust and detailed assessment of the cost and benefits of the smart meter rollout.

5.26. We propose to build a SMNCC-PPM model to estimate the net change in costs that result from replacing traditional PPM with smart meters.<sup>39</sup> The SMNCC model for PPM customers would match the SMNCC model for credit customers in some respects and differ in other respects. We consider the main similarities and differences below, for stakeholders to consider the potential level of the SMNCC for PPM customers relative to the SMNCC for credit customers, and scrutinise our account of the costs and benefits drivers.

## Considerations

### *Summary of similarities and differences*

5.27. We believe the principal differences between the SMNCC model for credit customers and the SMNCC model for PPM customers would be the following components (which we describe in more detail later in this chapter).

- Amortised asset and installation costs for traditional meters: the SMNCC model includes these costs for traditional credit meters. As the smart meter rollout removes these costs, they are included as benefits in the model. Traditional PPMs are more expensive than traditional credit meters, so for the non-pass-through SMNCC for PPM customers, this benefit would be larger than for the non-pass-through SMNCC for credit customers.
- Premature Replacement Charges ("PRCs"): the SMNCC model includes the average cost charged by Meter Asset Providers ("MAPs") for removing a traditional credit meter before the end of its rental life. The PRCs for PPMs will differ from those for credit meters, due their higher cost and differences in the average remaining asset life.

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<sup>39</sup> In practice, this may not be a separate mode from the current SMNCC model. It could be an addition to that model.

- Smart PPM-specific benefits: Currently, we exclude from the SMNCC model any benefits in the CBA that relate only to PPM customers. We need to include these benefits in the SMNCC-PPM model.

5.28. Suppliers have rollout obligations. Those obligations, and the profile in the CBA, do not distinguish between smart meters replacing credit meters and those replacing PPMs.

However, in practice, progress against the expected profile differs by meter type.

5.29. We do not envisage significant differences relating to the following cost components.

- Smart meter asset and installation costs (including In-home displays costs): provisionally, we consider there would be limited differences in the asset and installation costs for smart meters operating in credit and in PPM mode. We may consider the impact of unique assets, such as the pre-payment metering interface device ("PPMID").
- Operational and maintenance costs: there should be no or negligible difference in the cost of operating and maintaining a smart meter dependent on the payment mode in which it operates. PPM Infrastructure Provider ("PPMIP") and National Payment Service ("NPS") costs are included in the PPM uplift, as they are required for both smart and non-smart customers.
- Supplier IT and DCC adaptor costs: suppliers' technology costs are not separated by meter payment mode.
- Organisational, advertising and other costs: costs in all other categories are independent of the payment mode that the meter is operating in, and therefore their treatment would not differ between a non-pass-through SMNCC for PPM customers and a non-pass-through SMNCC for credit customers.

#### *Amortised asset and installation costs for non-smart meters*

5.30. The SMNCC model includes the amortised asset and installation costs for traditional meters – modelling the economic cost which MAP charges should reflect. This recurring payment for asset and installation costs for a traditional meter is curtailed once it is replaced by a smart meter. Therefore this cost is avoided (not incurred) and is treated as a benefit in the SMNCC model.

5.31. Where a traditional meter is being replaced, the analogous incurred cost for the smart meter is higher than the avoided cost for the non-smart meter, resulting in a net cost in the model.

5.32. Traditional PPMs are more expensive than traditional credit meters. Therefore the annualised avoided cost for a PPM is higher than it is for a credit meter. On that basis, we would expect a non-pass-through SMNCC for PPM customers to be significantly lower than the non-pass-through SMNCC for credit meters with regard to this issue – the benefit of installing a smart meter is greater (or the net cost is lower) for PPMs than it is for credit meters.

5.33. We do not expect that the cost of smart meters differs substantially depending on payment method. However, SMETS1 and SMETS2 meters have different costs. So individual suppliers may see apparent variation in asset costs for each payment method depending on the proportion of SMETS1 and SMETS2 meters.

5.34. Suppliers provide the data for these costs and benefits in their annual supplier returns (“ASRs”).

#### *PRCs – traditional meters*

5.35. The PRC represents the charge incurred by a supplier when it removes a traditional meter before the end of its rental life. The PRC associated with a meter depends on its cost and its remaining life. The costs of meters, the length of the rental contracts (their economic lives), and the distribution of asset ages can differ between credit meters and PPMs.

5.36. We propose to set PRCs specifically for PPMs. This data comes from the ASRs and our Request For Information (“RFI”) relating to PRCs.

5.37. For PPMs, asset costs are higher than they are for credit meters; economic lives tend to be shorter; and the average age of replaced meter tends to be slightly younger. Therefore PRCs may be higher for PPM customers than for credit customers. On that basis we would expect PRCs to increase the non-pass-through SMNCC for PPM, compared with the non-pass-through SMNCC for credit customers.



### *PRCs – SMETS1*

5.38. There may also be PRCs for replacing SMETS1 smart meters with SMETS2 smart meters. There is no distinction in the physical asset between a SMETS1 meter in PPM mode and a SMETS1 meter in credit mode, thus the original cost of the asset being replaced should not differ with payment method.

5.39. However, smart meters used by PPM customers and credit customers may not have the same likelihood of being replaced. The average age of the smart meter being replaced may also vary by payment method. Either could mean that on average PRCs for SMETS1 meters are higher or lower for a PPM customer than they are an average credit customer.

### *Rollout numbers in aggregate*

5.40. For the non-pass-through SMNCC for credit customers, we use the aggregate rollout profile to estimate the number of credit meters that will be replaced by smart meters. We could maintain that approach when setting the non-pass-through SMNCC for PPM customers – taking the proportion of traditional PPMs replaced with a smart meter to be equal to the proportion of credit meters replaced.

5.41. For PPM, we are aware that this approach may overstate the rollout for two reasons.

- **Historically:** the number of PPMs actually replaced to-date would be lower than assumed in our model. This would overstate suppliers' costs, but our initial estimates suggest the impact is small.
- **Forecasts:** a number of factors mean that the PPM rollout in the coming months may be less than forecast using the profile in the CBA. The SMETS1 end-date for PPM has passed, which curtails the rollout of SMETS1 PPM devices. For PPM, there are residual technical challenges with SMETS2 in DCC and meter firmware that do not affect credit customers, and may mean the PPM rollout is below the general assumptions in the CBA. This would risk overstating suppliers' costs, if smart meters are not actually installed.

5.42. We expect that this means that the model would overstate the net costs of the smart meter rollout to date with regard to PPM customers. The rollout volumes in the non-pass-through SMNCC function as a multiplier: the net cost (or benefit) calculated for each meter is scaled up by the forecast installations in each period.<sup>40</sup> If replacing a traditional PPM with a smart meter is a net cost to suppliers, then overstating the progress of the rollout will overstate costs, and set the non-pass-through SMNCC too high. If replacing a traditional PPM with a smart meter is a net benefit to suppliers, then overstating the rollout would understate costs, and set the non-pass-through SMNCC too low. Based on suppliers' previous representations and our initial assessment, we expect replacing a PPM with a smart meter to be a net cost, so overstating the rollout profile would inflate the non-pass-through SMNCC for PPM customers.

5.43. Reducing the rollout profile would reduce the allowance. This might protect customers – by not allowing for smart meters that are not going to be installed until later – but it risks increasing the likelihood that installations are delayed, rather than anticipating that delay.

5.44. The pace of the rollout is uncertain in general and it may be more uncertain and challenging for PPM. In their responses to our October consultation on the non-pass-through SMNCC for credit meters, suppliers emphasised the uncertainty of the smart meter rollout, and that targets were challenging.<sup>41</sup> For the reasons above, the uncertainty regarding suppliers' rates of installation compared may be greater for PPM.

5.45. In their responses to our October consultation on the non-pass-through SMNCC for credit meters, suppliers emphasised that, in the face of that uncertainty, we should consider reviews. In our January response we agreed that reviews would likely be inevitable, to ensure that the allowance does not deviate too far from the actual number and costs of the smart meters suppliers will actually install.<sup>42</sup>

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<sup>40</sup> This mechanism is simplified for the sake of a clear argument. The SMNCC model has several other factors included such that the rollout volume does not operate strictly as a linear multiplier. Cost and benefits are not solely or simplistically variable.

<sup>41</sup> Ofgem (2019), Reviewing smart metering costs in the default tariff cap: October consultation (<https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-october-consultation>) and Ofgem (2020), Reviewing smart metering costs in the default tariff cap: Update and response to the October 2019 consultation (<https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-update-and-response-october-2019-consultation>)

<sup>42</sup> Ofgem (2020), Reviewing smart metering costs in the default tariff cap: Update and response to the

5.46. For the non-pass-through SMNCC for PPM, we provisionally consider that it is prudent and reasonable to use the CBA rollout profile (which will likely be higher than the rollout for smart meters to PPM customers) with regular updates of the expected rollout profile to mitigate the risk of misstating costs.

*Variation in rollout numbers between suppliers*

5.47. Rollout profiles vary between suppliers. That means different suppliers have different efficient costs. However, we can only set one allowance. As with the non-pass-through SMNCC for credit customers we propose to set a single allowance based on the aggregate rollout profile in the CBA. This means that the impact on individual suppliers will vary, as the timing of their costs (based on their own installation rate) and revenue (based on the market wide historical installation rate, and notional forecast) will differ.

5.48. The range in suppliers' progress installing smart meters in PPM customers' homes could be greater than it is for credit meters. Some suppliers are well advanced with their smart meter rollout to PPM customers. Others are not.

*Preliminary analysis*

5.49. We are seeking suppliers' views on how replacing PPMs with smart meters affects their net operating costs.

5.50. Taking together the changes for PPM outlined above and, assuming no changes to the rollout profile, we would expect the overall net cost for smart PPM to be lower than that for credit, as there are more benefits from smart PPM than there are for smart credit.

5.51. Our initial estimates suggest that this net cost is less than the amount already accounted for in the operating cost allowance. On that basis, the non-pass-through SMNCC for PPM customers would be likely be slightly negative in cap period five (October 2020 to

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March 2021) – suggesting that the current PPM cap is overstated as it does not include a non-pass-through SMNCC at all.

5.52. This analysis is preliminary. Our estimates may vary as we scrutinise and adjust the assumptions. We also intend to update the SMNCC model with the latest ASR submissions, if available with sufficient time. However, this first approximation of the impact allows us to consider and discuss the principal drivers of the cost and benefits of replacing traditional PPMs with smart meters, and their potential impact on net costs. We have set them out in this consultation for suppliers to consider and indicate where they are incomplete or vary from their expectations.

## **Contingency arrangements for cap period five**

5.53. We intend to set out our proposed non-pass-through SMNCC for PPM customers in a statutory consultation in mid-May. Alongside our proposals we will disclose the SMNCC model.

5.54. It is possible that we need to revise our proposals for the non-pass-through SMNCC for PPM customers and consult on those revisions. However, the PPM cap will expire at the end of 2020 regardless, and all PPM customers with default tariffs will be capped at the direct debit level if we do not implement changes.

5.55. On that basis, we propose contingency arrangements in the statutory consultation in the event that we need to consult on revisions. Given the analysis above, we expect that to mean we would set the non-pass-through SMNCC for PPM customers to zero – no net change in costs compared with the operating cost allowances' baseline. We would apply that contingency allowance to the agreed PPM uplift, or current PPM uplift if no approach is agreed (as discussed in Chapter 4). That is likely conservative and maintains continuity with current PPM cap, preventing disruption for customers and suppliers.

## 6. Other considerations

In this chapter we consider the timing of the transition and whether there are potential implementation issues that could affect customer or suppliers.

### **Input requested from stakeholders**

We seek stakeholders' view on the issues, options, and our provisional proposals set out in this chapter.

## **Timing of expiry**

### **Options:**

6.1. The transition from the PPM cap to the default tariff cap may not cause any disruption for customers or suppliers, if for example the cap levels are the same. However, if the cap level in the default tariff cap differs from the PPM cap, we may wish to manage the timing of that transition.

6.2. We have considered three ways we might manage the timing of when customers and suppliers move from one set of arrangements to the other.

- Introduce changes to the default tariff cap with effect from 1 January 2021. We could introduce the allowances that apply to PPM customers, and/or the levels for those allowances, mid-way through the cap period. The cap levels for other payment methods would be unaffected.
- Introduce changes to the default tariff cap with effect from 1 October 2020. In effect, the default tariff cap would be ready before the PPM cap expires.
- Introduce changes to the default tariff cap with effect from 1 October 2020 and end the PPM cap for PPM customers on default tariffs early.

## Considerations

6.3. In its July 2019 review of the PPM cap, the CMA introduced a direction process to SLC 28A for cap period beginning 1 October 2020.<sup>43</sup> It allows Ofgem to apply for a direction to release suppliers from its obligation to comply with the PPM cap between 1 October 2020 and the PPM cap expiry at 31 December 2020. This applies for PPM customers that will be appropriately protected by another charge restriction imposed by Ofgem. It is then the CMA's decision on whether to grant the direction.

6.4. If the PPM cap level changed, then an extraordinary update in the middle of winter may not be preferable to either suppliers or consumers.<sup>44</sup> Suppliers would have an additional price update process and must notify their customers of any changes. Customers would be disrupted with additional price changes on top of what they are used to (that update may reduce prices, rather than increase them).

## Implementation issues

### Considerations

6.5. We seek to limit implementation issues for customers and suppliers that could result from the transition between the PPM cap and the subsequent arrangements.

6.6. We believe that the impact of moving from the PPM cap to the default tariff cap would be no more complex than arrangements for a standard cap update – and may have no impact at all if the cap levels are the same. If the cap levels differ, the variable charge and standing charge would need updating (as with a normal cap update), but we do not think changes to any of the methodologies we use to set the cap would affect suppliers' systems or communication processes.

6.7. Changes in scope (who the cap applies to) may require suppliers to change their systems. Based on our current proposals, we do not consider the impact of changes in scope would be disruptive.

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<sup>43</sup> CMA (2019) Review of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016, paragraph 4.30.

[https://assets.publishing.service.gov.uk/media/5d405962e5274a4016893bd0/Final\\_Decision\\_PPPC.pdf](https://assets.publishing.service.gov.uk/media/5d405962e5274a4016893bd0/Final_Decision_PPPC.pdf)

<sup>44</sup> This assumes that the Secretary of State chooses to extend the default tariff cap, which we have not pre-judged.

- We have proposed to introduce PPM customers with an interoperable smart meter into the cap level for PPM customers. In practice we allowed suppliers to charge these customers at the PPM cap level, so the impact of this proposal on suppliers should be minimal.
- We have proposed not to apply the cap to actively chosen FTs. As these customers are on separate tariffs, it should not in our view be difficult for suppliers to adjust their processes from their arrangements for the PPM cap.

6.8. There may be other transitional issues we have not considered and we seek suppliers' views on any such issues as part of this consultation.

## Appendix 1

### Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

#### **1. The identity of the controller and contact details of our Data Protection Officer**

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at [dpo@ofgem.gov.uk](mailto:dpo@ofgem.gov.uk)

#### **2. Why we are collecting your personal data**

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

#### **3. Our legal basis for processing your personal data**

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. ie a consultation.

#### **3. With whom we will be sharing your personal data**

We may share consultation responses with the CMA and BEIS.

#### **4. For how long we will keep your personal data, or criteria used to determine the retention period.**

Your personal data will be held for six months after the project, including subsequent projects, is closed. Subsequent projects legal proceedings regarding a decision based on this consultation.

#### **5. Your rights**

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:



- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3<sup>rd</sup> parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

**6. Your personal data will not be sent overseas**

**7. Your personal data will not be used for any automated decision making.**

**8. Your personal data will be stored in a secure government IT system.**

**9. More information** For more information on how Ofgem processes your data, click on the link to our "[Ofgem privacy promise](#)".