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Decision

Protecting energy consumers with prepayment meters: August 2020 decision

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Contact: Anna Rossington

Team: Retail Price Regulation

Email: retailpriceregulation@ofgem.gov.uk

We have consulted on our proposals to protect energy consumers with prepayment meters after the expiry of the prepayment charge restriction ("the PPM cap"). We have decided to protect customers with prepayment meters and default tariffs using the default tariff cap. This document explains our decision and the reasons for it.

Contents

Executive summary

Protecting energy consumers with prepayment meters

Extending protection for PPM customers

The prepayment meter cap (PPM cap) protects about four million energy consumers with prepayment meters (PPM customers). At the end of this year, the PPM cap is due to expire. We are extending protection for PPM customers with default tariffs by including a new cap level within the default tariff cap specifically for PPM customers. This decision explains our approach and our methodology for setting that cap level.

Setting the cap level

For cap periods 5 and 6 (1 October 2020 to 31 March 2021 and 1 April 2021 to 30 September 2021 respectively) we will set the PPM cap at the same level that would have been calculated by the current PPM cap methodology. The existing PPM cap will expire on 31 December 2020, at which point PPM customers with default tariffs will be protected by the default tariff cap at the same level.

We will calculate the new cap level by setting allowances for different cost categories. Most costs, such as wholesale and network costs, do not vary with payment method. So we will set those allowances using the same methodology that we use to set the current PPM cap and other payment methods in the default tariff cap. Suppliers incur additional operating costs when serving PPM customers with traditional meters, but installing smart meters reduces those additional costs over time. We include two allowances to recognise this: the PPM uplift, and the non-pass-through Smart Metering Net Cost Change (SMNCC) for PPM customers.

We have set the PPM uplift at the same level as the existing PPM cap and we have frozen the SMNCC at £0 until 30 September 2021. This allows us time to consider the new smart meter rollout framework and update our SMNCC proposals to better reflect the average reduction in suppliers' costs due to smart meters.

Future reviews of the impact of smart meters and adjustments

We will review the impact of the smart meter rollout on suppliers' operating costs every 12 months. The pace and cost of the rollout is uncertain, not least because social distancing arrangements to mitigate the impact of the coronavirus (COVID-19) pandemic have substantially reduced the number of installations in 2020. When setting the PPM SMNCC allowance for future periods, we will take into account any difference between the amounts suppliers charge customers (from 1 January 2021) and an updated assessment of the impact that the smart meter rollout has had on their efficient costs in that time.

1. Introduction

Context and related publications

This decision

1.1. This document sets out our decision to provide price protection to energy consumers with prepayment meters ("PPM customers") after the expiry of the prepayment charge restriction ("the PPM cap") and explains the reasons for our approach. We consider and take into account stakeholders' views on the proposals we set out in our May 2020 consultation.[1]

1.2. In this decision, we discuss:

- the context to protecting prepayment customers (Chapter 1, this chapter);
- our decision to continue protecting prepayment customers after the PPM cap expires, using the default tariff cap (Chapter 2);
- our decisions on setting each allowance in a default tariff cap level for PPM customers (Chapter 3);
- the reasons for our decision to set a PPM uplift, which recognises that suppliers' efficient costs are higher when serving prepayment customers compared with customers paying by direct debit, and the level we will set it at (Chapter 4);
- the reasons for our proposals to include a Smart Metering Net Cost Change (SMNCC) allowance for PPM, which we will initially set to zero, and from 1 October 2021 will set to a level which accounts for the net impact of replacing expensive traditional prepayment meters with cheaper smart meters on suppliers' efficient operating costs (Chapter 5);
- our next steps (Chapter 6).

[1] Ofgem (2020), Protecting energy consumers with prepayment meters: May 2020 Consultation. https://www.ofgem.gov.uk/system/files/docs/2020/05/protecting_energy_consumers_with_prepayment_meters_may_2020_consultation.pdf

1.3. Alongside this document, we have published:

- **notice of modification to the licence conditions** – the changes to the standard licence condition (SLC) 28AD of the gas and electricity supply licences that implement our decision.

- **notice of Baseline Values and Initial Values of the CPIH Index** – the baseline values of the default tariff cap. They are largely the same as our 2018 decision. The main difference is we have removed "fully interoperable prepayment" as a Payment Method and added "Prepayment" as a Payment method. We set the PPM level of Payment Method Uplift baseline values in the notice.

- **note of combined changes to the licence conditions** – the consolidated changes to SLC 28AD that implement our decisions on protecting energy consumers with PPM meters and reassessing wholesale costs in the first default tariff cap period.[2]

- **updated default tariff cap model** – an updated version of the default tariff cap model that reflects our decision.

- **updated Annex 5 model** – an updated version of the Annex 5 – Smart metering net cost change methodology model that reflects our decision.[3]

The price caps currently protecting customers

The PPM cap

1.4. The Competition and Markets Authority (the CMA) designed and introduced the PPM cap as part of the package of remedies resulting from the energy market investigation.[4] It found weak competition and barriers to engagement in the PPM

[2] Decision on reassessing the wholesale allowance in the first default tariff cap period https://www.ofgem.gov.uk/publications-and-updates/decision-reassessing-wholesale-allowance-first-default-tariff-cap-period
[3] Changes outlined in our decision on minor changes to 'Annex 5 – Methodology to calculate the Smart Metering Net Cost Change' https://www.ofgem.gov.uk/publications-and-updates/decision-minor-changes-annex-5-methodology-determining-smart-metering-net-cost-change
[4] CMA (2016), Energy market investigation – Final report. https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf

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.

1.5. The PPM cap has been in place since April 2017, protecting all PPM customers without an interoperable smart meter – approximately four million customers at the time. In practice, under the default tariff cap we allow suppliers to charge PPM customers with an interoperable smart meter at the level as the PPM cap.[5] The PPM cap protects default tariff customers and customers that have actively chosen fixed term tariffs (FTs).

The default tariff cap

1.6. 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").[6] 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 in line with the requirements of the Domestic Gas and Electricity (Tariff Cap) Act 2018 ("the Act") and SLC 28AD of the electricity and gas supply licence conditions we update the cap every six months to reflect this.

1.7. Currently, the default tariff cap does not apply to PPM customers.[7] Section 3 of 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 by introducing a separate PPM cap. Otherwise, the default tariff cap will apply to all customers with default tariffs, including PPM customers.

[5] 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
[6] Ofgem (2018), Default tariff cap: decision – overview. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview
[7] The existing PPM cap does not cover PPM customers with an interoperable smart meter, who are therefore covered by the default tariff cap. In practice, we allow suppliers to charge all PPM customers at the level of the PPM cap (see paragraph 1.5).

1.8. The default tariff cap has different cap levels for customers paying by standard credit and those with other payment methods.[8] We set the cap levels for each payment method by:

- Setting the same level of allowance for common cost components. These are the allowances for wholesale costs, network charges, policy costs of environmental and social obligations, common operating costs, and headroom. These costs do not vary by payment method. We also include a common allowance to account for the net impact on operating costs of replacing traditional credit meters with smart meters (the SMNCC allowance).

- Setting a Payment Method Uplift, to account for the additional costs of serving standard credit customers, for whom suppliers incur additional bad debt, working capital, and administrative costs. We also include a smaller Payment Method Uplift in the cap level for other payment methods (predominantly direct debit customers), as we recover a portion of the additional efficient operating costs of serving standard credit customers from all customers.

1.9. Alongside this decision, we have also published decisions to (a) adjust the cap level for an error in the wholesale allowance of the first cap period, and (b) update the non-pass-through SMNCC allowance for credit customers.

Protecting PPM customers

The CMA's July 2019 review of the PPM cap

1.10. The CMA consulted on its proposals to amend its existing PPM cap to much more closely align to the default tariff cap methodology, and published its decision in July 2019.[9] As part of its consultation process, it found that the conditions for competition in the prepayment market had not improved materially since the CMA introduced the PPM cap and that levels of overall engagement among prepayment customers were still

[8] In practice, the overwhelming majority of customers charged at the level for "other payment methods" pay by direct debit.
[9] 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

low. It concluded that protection for PPM customers should remain in place and continue after the PPM cap was due to expire.

1.11. The CMA reviewed whether its methodology for calculating the PPM cap level reflected the efficient costs of supplying PPM customers. Following two rounds of consultation (in response to its issues statement and provisional decision), it concluded that the PPM cap undervalued policy costs and smart meter industry charges.[10] As a result, in June 2019, the CMA decided to change the methodology for calculating the PPM cap.

1.12. The CMA adopted the methodology we 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.[11] The CMA replaced the uplifts with the "PPM uplift" allowance, from its original methodology for the PPM cap.[12]

- **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 CMA's changes to the methodology increased the PPM cap by about £50 for dual fuel customers.[13] The new PPM cap methodology came into effect from October 2019.

Arrangements for when the PPM cap expires

1.14. The PPM cap is due to expire at the end of 2020. In its review, the CMA concluded that PPM customers would require continued protection after the PPM cap expires. It

[10] Smart costs related to charges from DCC, SEGB or SMICoP
[11] The default tariff cap recovers some of this cost from direct debit customers, and so there is a payment method uplift for both direct debit and standard credit customers. The CMA removed both payment method uplifts.
[12]The CMA amended the pricing index it used to update the PPM uplift, adopting the Consumer Price Index including Housing (CPIH) for consistency with the default tariff cap).
[13] 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

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, 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.[14]

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*.

Ofgem consultations

1.18. On 10 March 2020 we published our initial consultation on protecting consumers with prepayment meters (March 2020 consultation).[15]

[14] 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
[15] Ofgem (2020), Policy consultation for protecting energy consumers with prepayment meters.

1.19. On 18 May 2020 we published our statutory consultation on protecting consumers with prepayment meters (May 2020 consultation).[16]

Understanding how costs differ between PPM and credit customers

1.20. Most cost categories do not depend on a customers' payment method or meter type. For example, the price of gas does not change if a customer pays by direct debit rather than prepayment. For that reason, many of the allowances in the PPM cap are the same as the allowance in the default tariff cap (which currently includes only direct debit and standard credit customers). We discuss common allowances in Chapter 3.

1.21. PPM customers with a traditional meter cost more to serve than customers with a credit meter. Primarily, this is because a traditional prepayment meter (and the accompanying infrastructure) is more expensive than a credit meter. The PPM cap has an allowance that seeks to recognise those additional costs, above the level of operating costs that direct debit customers incur: the PPM uplift. The default tariff cap does not currently include a PPM uplift but it does include an analogous payment method uplift relating to the additional costs of serving customers paying by standard credit. We discuss the PPM uplift in Chapter 4.

1.22. Suppliers must install smart meters, which has an impact on their operating costs. The gross cost of purchasing and installing smart meters is similar when serving PPM and credit customers. However, the impact on operating costs of replacing an expensive traditional prepayment meter with a smart meter is very different to the impact on suppliers' costs when replacing a traditional credit meter. Replacing a traditional prepayment meter with a cheaper smart meter reduces a supplier's operating costs, eroding the additional costs of serving PPM customers. Once the smart meter rollout is complete, the difference between the costs of serving PPM customers and credit customers will be substantially reduced, as the main reason for cost differentials will

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https://www.ofgem.gov.uk/publications-and-updates/policy-consultation-protecting-energy-consumers-prepayment-meters

[16] Ofgem (2020), Protecting energy consumers with prepayment meters: May 2020 Consultation. https://www.ofgem.gov.uk/system/files/docs/2020/05/protecting_energy_consumers_with_prepayment_meters_may_2020_consultation.pdf

have been removed (though some cost differences may remain).[17] We discuss the impact of installing smart meters in Chapter 5.

Typical Domestic Consumption Values

1.23. We designed the default tariff cap using the Typical Domestic Consumption Values (TDCVs) in use at the time (2018) and set the values in the licence condition to a Benchmark Annual Consumption Level which matched the 2018 TDCVs.[18] The TDCVs have since been updated to reflect changing consumption patterns.[19]

1.24. All values presented in this decision are stated in terms of the 2018 TDCVs, as are the values used in the modifications to the licence conditions. This is because it would make it difficult for stakeholders to follow the actual changes in methodology and values resulting from our decisions if we simultaneously changed the way we present results in our detailed publications. The changes to the TDCV do not affect the calculation of the maximum charges.

1.25. For the press release accompanying the cap updates (each August and February) we state the cap level using the latest TDCVs for presentational purposes only.[20] To avoid confusion, we refer to old TDCVs as "benchmark consumption" in this decision document, which is 3,100 kWh for electricity and 12,000 kWh for gas.

The Domestic Gas and Electricity (Tariff Cap) Act 2018 ("the Act")

1.26. We designed the default tariff cap in accordance with the Act. Section 1(6) states that we must protect existing and future domestic customers who pay standard variable and default rates.[21] In doing so, we must have regard to the following matters:

[17] For example, the costs incurred by supplied from prepayment customers topping up their account, which they may do more frequently as a smart meter allows them to top up from anywhere.
[18] Medium consumption values of 3,100KWh per annum for electricity profile class 1 and 12,000 kWh for gas
[19] 12,000 kWh gas medium consumption and 2,900 KWh electricity profile class 1 medium consumption, set out in Decision for Typical Domestic Consumption Values, January 2020 https://www.ofgem.gov.uk/publications-and-updates/decision-typical-domestic-consumption-values-2020
[20] We will announce the cap level for the fifth cap period on Friday 7 August 2020, effective on 1 October.
[21] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6).

- 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 domestic supply contracts; and

- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

1.27. The requirement to have regard to the four matters identified in section 1(6) of the Act does not mean that Ofgem must achieve all of these at all times. In setting the cap, Ofgem's primary consideration is the protection of existing and future consumers who pay standard variable and default rates, but Ofgem is also required to have regard to the four "needs" identified in section 1(6). In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often, a balance must be struck between competing considerations.

1.28. In setting the default tariff cap, we may not exempt holders of supply licences from their application, or make different provision for different holders of supply licences.[22] This means that in practice, we must continue to set a cap level for the duration of the cap and we cannot set a separate higher cap level for suppliers with higher costs.

Stakeholders' views

1.29. Two suppliers argued that we had not had appropriate regard to the financial performance of individual suppliers or the market as a whole, including consideration of COVID-19 impacts and suppliers' financial results. One of these suppliers also

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http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[22] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 2(2).
http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted

argued we had not had appropriate regard to the other three 'needs' (set out in Section 1(6)).

1.30. One stakeholder considered that we should undertake a formal Impact Assessment prior to making this decision. Impact Assessments are legally required by section 5A of the Utilities Act 2000 where (a) we are proposing to do something for the purposes of, or in connection with, the carrying out of any function exercisable by us under or by virtue of Part 1 of the Gas Act 1986 or Part 1 of the Electricity Act 1989; and (b) it appears to us that the proposal is important (within the meaning of section 5A (2)).

Our consideration

1.31. We do not consider that it is necessary to carry out an Impact Assessment under the Utilities Act before making this decision. As explained above, the expiry of the CMA's PPM cap means that (unless a different form of cap were set) PPM customers will come within the scope of the Act, and we have decided to protect those customers by using powers under the Act to set a cap level appropriate to them. Using our powers to set cap levels under the Act does not amount to doing something for the purposes of, or in connection with the carrying out of our functions under Part 1 of the Gas Act 1986 or Part 1 of the Electricity Act 1989. Therefore, the requirements of the Utilities Act are not applicable here since the modification of SLC 28AD falls outside the scope of exercising our functions under the Electricity and Gas Acts.

1.32. Nonetheless, we published an Impact Assessment of the default tariff cap alongside our 2018 decision. We considered the impact of the price cap, and its combination with competitive tariffs set below suppliers' costs, in the Impact Assessment. We concluded that the methodology we use to set the default tariff cap achieves the objective of the Act, and in doing, we had regard to the statutory needs in Section 1(6).

1.33. In formulating our proposals to extend the cap to PPM customers we have considered the impact of our proposals on default tariff customers and suppliers. These considerations are set out in detail in Chapters 3 to 5 in this document.

1.34. For most allowances, this is an application of our 2018 methodology, which matches the methodology used to set the current PPM cap (Chapter 3). We have considered the impact on customers and suppliers of adjusting the allowances that do relate specifically to PPM costs (see Chapters 4 and 5). We have concluded that our approach

does not change our overall assessment of the cap level in achieving the objective of the Act, which we set out in 2018 in our consultations and decision document.

1.35. In Chapter 6, we consider suppliers' views that we should review and potentially adjust the level of the cap as a whole (specifically the level of headroom, which sits on top of the cost allowances). We note the combined pressure of price protection for default tariff customers and suppliers offering less profitable competitive tariffs set below the level of the cap is proving a significant challenge, as we expected it would be in our 2018 Impact Assessment. This issue is broader than the price cap alone, and we continue to monitor it closely.

Related publications

1.36. The related publications are:

- The CMA's energy market investigation; The CMA (2016), Energy market investigation. https://www.gov.uk/cma-cases/energy-market-investigation
- The CMA's July 2019 review of the PPM cap. The 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
- Our March 2020 consultation: Ofgem (2020), Policy consultation for protecting energy consumers with prepayment meters. https://www.ofgem.gov.uk/publications-and-updates/policy-consultation-protecting-energy-consumers-prepayment-meters
- Our May 2020 consultation: Ofgem (2020), Statutory consultation for protecting energy consumers with prepayment meters. https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-protecting-energy-consumers-prepayment-meters

Your feedback

General feedback

1.37. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
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. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments?

Please send any general feedback comments to retailpriceregulation@ofgem.gov.uk.

2. Considering protection for PPM customers

Section summary

In this chapter, we conclude that PPM customers on default tariffs will require protection after the PPM cap expires. We will protect them under the default tariff cap.

Summary of our decision

2.1. We have decided to protect PPM customers on default tariffs after the PPM cap expires, as barriers to competition and engagement remain. We will provide this protection using a new cap level within the default tariff cap, for PPM customers.

Protection for PPM customers

Issue

2.2. In our May 2020 consultation we considered whether PPM customers require protection upon the expiry of the existing PPM cap.

Our decision

2.3. We have considered developments in the retail energy market since July 2019 and we conclude that PPM customers on default tariffs will continue to require protection when the PPM cap expires.

Rationale

2.4. The CMA's 2016 Energy Market Investigation found weak competition and barriers to engagement for PPM customers. Its 2019 review concluded that technical barriers remained and market conditions have not improved. The CMA recommended we consider whether PPM customers would require protection after the PPM cap expires.

2.5. We will apply the framework of the Act to provide protection for PPM customers on default tariffs for three main reasons (which are the same as those we consulted on in March and May 2020).

2.6. First, technical barriers remain 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.[23] In June 2020 BEIS published its response to the consultation,[24] which stated that government has decided to extend the 'all reasonable steps' framework to 30 June 2021, and implement a new four-year Framework to achieve market-wide rollout by mid-2025.

2.7. Second, the choice for PPM customers remains limited, in terms of the number of competitively priced PPM tariffs on offer. The number of PPM tariffs has slightly decreased between 2019 and 2020, largely due to some suppliers leaving the market.

2.8. Third, there is low engagement among PPM customers. Most PPM customers (98%) are on default tariffs and may not be engaged in the market, and so they are unable to take advantage of competitively priced tariffs and choice even if the number of those tariffs did increase. Even if there were a marked increase in PPM customers' engagement, this may be insufficient given the high proportion of default tariff customers. By comparison, credit customers have extensive choice of cheaper tariffs and more credit customers are engaged in the market. However, even then, many are still on default tariffs and require protection. 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.

Considering stakeholders' views

2.9. In response to our March 2020 consultation, all stakeholders who commented on this issue were supportive of extending protection for PPM customers upon expiry of the PPM cap. Several consumer groups noted that the reasons for the PPM cap's introduction have not gone away, including technical and engagement barriers.

2.10. In response to our May 2020 consultation, several consumer bodies and industry groups continued to support prepayment price protection through a price cap. Two

[23] BEIS (2019), Smart meter policy framework post 2020. https://www.gov.uk/government/consultations/smart-meter-policy-framework-post-2020
[24] BEIS (2020), Delivering s Smart System. Response to a Consultation on Smart Meter Policy Framework Post-2020 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/893124/delivering-smart-system-post-2020-govt-response-consultation.pdf

suppliers supported prepayment price protection through a price cap, though did not fully agree on our detailed rationale for this protection. One supplier stated a cap is not justified and does not protect prepayment customers, though its arguments related to the level of the cap and its impacts (which we discuss in Chapters 3, 4 and 5) rather than the use of a cap per se.

How to protect PPM customers

Issue

2.11. In our March 2020 and May 2020 consultations we considered how to protect PPM customers. We set out two options in our May 2020 consultation.

- Including PPM customers within the default tariff cap. This would apply to PPM customers with default tariffs only (98% of all PPM customers).
- Creating a new independent PPM cap, under separate powers. This approach would include all PPM customers.

2.12. In their responses, most stakeholders supported our proposal to protect PPM customers on default tariffs using the default tariff cap. We consider specific issues raised by stakeholders below.

Our decision

2.13. We have decided to use the default tariff cap to provide protection to all PPM customers with a default tariff. This excludes around 2% of PPM customers who have actively chosen a fixed term tariff ("FT").

Rationale

2.14. The vast majority of PPM customers (98%) are on default tariffs. Both options allow us to protect PPM customers on default tariffs.

2.15. We cannot use the default tariff cap to protect PPM customers that actively chose an FT. That would require an independent PPM cap.

2.16. We consider it appropriate to protect 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. We also note that most FTs on offer to direct debit customers are below the level of the default tariff cap, even though they are not price regulated.

2.17. Secondly, so long as customers have made an informed choice to accept a tariff that is above the level of the cap, we consider it unnecessary to cap those tariffs. In the absence of the current 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 a customer's FT, licence conditions require suppliers to inform customers of the default tariff they would otherwise pay.[25]

Considering stakeholders' views

FT customers

2.18. In response to our March 2020 consultation, most stakeholders were supportive of limiting the scope to default tariff customers. The main rationale provided by stakeholders was that FT customers are actively engaged with the market and so do not require protection. In addition, if any such customers became disengaged in the future, then they will default onto a default tariff and so the default tariff cap will protect them in any case.

2.19. In response to our May 2020 consultation, few stakeholders commented on this issue. The two stakeholders who commented were supportive of our proposals.

Active SVT customers

2.20. One supplier proposed a narrower scope in its response to both our March 2020 and May 2020 consultations. It argued that some customers choose to move to a variable

[25] 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

tariff, so are actively engaged and should be excluded from the cap. It also argued that offering a single variable tariff to customers is less confusing and does not penalise loyalty compared to some alternative tariff structures.

2.21. The Act requires that the default tariff cap applies to all SVTs; we cannot exclude sub-groups of SVTs or SVT customers. Furthermore, we do not propose to create a new PPM cap to adopt this approach. SVTs do not require customers to renew their choice when prices change, so customers can become disengaged following their initial switch and would subsequently have no protection if they were excluded from the cap. In its investigation into the energy market, the CMA concluded that suppliers had market power over disengaged customers, charging them more than they would be able to in a competitive market. The majority of those disengaged customers had SVTs.

Expiry of the default tariff cap

2.22. In response to our March 2020 consultation three consumer groups disagreed with our proposal. They considered the expiry of the PPM and default tariff caps should not be aligned and so advocated for a new PPM cap.

2.23. In response to our May 2020 consultation one consumer group reiterated its concerns, arguing that the conditions for ending the prepayment and credit customer caps are different, with the former linked to smart meter rollout (which BEIS expects to continue until mid-2025) and the latter to effective competition (until 2023 at the latest), and so the natural end points are not aligned.

2.24. We do not consider that the expiry of the default tariff cap is a risk for PPM customers. We agree that a significant proportion of PPM customers may have traditional meters when the default tariff cap expires in 2023 or before. However, Section 9 of the Act requires that, before the tariff cap conditions have ceased to have effect (whether in 2023, or before), we must review whether there are categories of domestic customers who may in the future pay standard variable and default rates for whom protection against excessive charges should be provided. Section 9 of the Act specifies that, if our review concludes that protection should be provided, we must take steps to ensure ongoing protection.

2.25. So, upon expiry of the default tariff cap, if PPM customers still require protection, then we can either (a) put in place a new PPM cap of the kind we have considered as part of

this consultation process, or (b) take an alternative approach that is not currently available, but would serve those customers more effectively.

2.26. On that basis, we do not need to anticipate now whether PPM customers will require protection at the end of the default tariff cap, or what form that protection should take. Our approach gives us more flexibility to respond to PPM customers' needs than mandating a new PPM cap until the smart meter rollout is complete.

2.27. Therefore, we consider that using 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 broadly similar issues and considerations.

Suitability of the default tariff cap

2.28. In response to our May 2020 consultation several suppliers expressed support for the default tariff cap being the appropriate mechanism for the prepayment cap. Two consumer groups argue that the PPM cap was brought in for different reasons to the default tariff cap, that PPM customers are very different to other customers, with 'materially worse' competition and engagement, that the natural end points of caps are not aligned, and that the cost make-ups are different.

2.29. The default tariff cap was introduced for different reasons to the PPM cap. However, in its July 2019 review the CMA chose to adopt the same methodology as the default tariff cap (expect for the PPM uplift and SMNCC, see Chapter 1). The *outcome* for PPM customers is the same. We consider this demonstrates that the methodology of the default tariff cap can achieve both sets of aims.

2.30. As we discuss above, PPM customers face greater barriers to competition and engagement. This is borne out in the fact that 98% of PPM customers are default tariff customers – unlike direct debit and standard credit customers, there is not a large group of PPM customers on tariffs materially beneath the price cap level. On that basis, a much greater proportion of PPM customers would be protected by the default tariff cap than credit customers are. However, that does not mean that, *for the customers that are protected by the cap*, the default tariff cap would not protect them adequately.

2.31. PPM customers face different costs from credit customers. However, we can account for that within the default tariff cap by setting a separate cap level for PPM customers, using a payment method uplift. We already adopt this approach for customers paying by standard credit (see Chapter 1).

How to protect PPM customers within the default tariff cap

Issue

2.32. The default tariff cap will apply to PPM customers with SVTs or other default tariffs from 1 January 2021, whether we adjust the default tariff cap or not. The issue is whether it would provide an appropriate level of protection. Without modification, PPM customers would be capped at the same level intended for customers paying by direct debit, which we consider to be too low.

2.33. In our May 2020 consultation we considered two options for how we could protect PPM customers after the PPM cap expires:

- do nothing, allowing the default tariff cap to protect PPM customers with default tariffs at the level intended for direct debit customers; or
- set a specific default tariff cap level of PPM customers, with adjustments to our methodology for other payment levels.

Our decision

2.34. We will set a specific default tariff cap level for PPM customers, with adjustments to our methodology for other payment levels.

2.35. In Chapters 3, 4, and 5 we discuss how we adjust the default tariff cap methodology so that it is suitable for PPM customers.

2.36. We have decided that all relevant PPM customers who receive the Warm Home Discount will be covered by the new PPM default tariff cap.

Rationale

2.37. Doing nothing means PPM customers would be covered automatically by the default tariff cap at the direct debit level. This cap level is materially below the efficient cost of serving PPM customers – see Chapters 4 and 5 for details of cost differentials. We do not consider that this option would be in customers' or suppliers' interests.

2.38. In setting a new cap level within the default tariff cap for PPM customers we can ensure that suppliers charge PPM default tariff customers a fair price. In Chapters 3, 4 and 5 of this document we explain which costs are the same across payment methods and which differ, and how and why we adjust the default tariff cap to account for these differences.

Considering stakeholders' views

2.39. In response to both the March 2020 and May 2020 consultations, most stakeholders were supportive of using an adjusted version of the default tariff cap. No stakeholder was supportive of PPM customers defaulting on to the non-standard credit default tariff cap (option 1).

Considering warm home discount customers

2.40. We received no comments in response to our May 2020 consultation regarding our proposals on how warm home discount customers are accounted for in the prepayment cap.

2.41. We have decided that all PPM customers who receive (or received) the Warm Home Discount will be covered by the PPM default tariff cap. The current licence conditions mean that any customer eligible for the Warm Home Discount up to the end of Scheme Year 8 would be capped at the direct debit cap level, rather than the cap level for the payment method they actually use. The intent was to prevent customers that benefited from the safeguard tariff (in place before we introduced the default tariff cap) from

experiencing a substantial increase in their bills, once we introduced the default tariff cap.[26]

2.42. No PPM customers benefited from the safeguard tariff, as they were already protected by the PPM cap. So the issue (of continuity with the level of protection the safeguard tariff provided) does not arise. We have amended the licence to ensure PPM customers receiving Warm Home Discount are charged in line with other PPM customers.

[26] Not all Warm Home Discount recipients were beneficiaries of the safeguard tariff customers. Customers who came into the Warm Home Discount scheme after March 2019 (Scheme Year 8) were not eligible.

3. Adjusting the default tariff cap for PPM customers

Section summary

In this chapter, we describe how we have adjusted the default tariff cap to protect PPM customers on default tariffs.

Summary of our decision

3.1. We have decided to set a new PPM cap level in the default tariff cap that will apply to all PPM customers with default tariffs, regardless of their meter type.

3.2. We will calculate all the cost components identically to the existing default tariff cap methodology, except for:

- the payment method uplift, and
- a new non-pass-through Smart Metering Net Cost Change allowance specifically for PPM.

3.3. For the fifth and sixth cap period (1 October 2021 and 30 September) we have decided to set the default tariff cap for PPM customers using our contingency proposal, which sets the payment method uplift using the current methodology used in the PPM cap and sets the SMNCC at £0. We discuss these two cost components in Chapters 4 (additional operating costs for PPM customers with traditional meters) and 5 (the net impact of the smart meter rollout on PPM operating costs).

Single cap level for all PPM default tariff customers

Issue

3.4. The underlying costs associated with PPM customers vary depending on their circumstances. In particular, costs vary depending on a customer's meter type. Generally speaking, traditional PPMs cost more than smart meters in prepayment mode. Smart meter costs also vary depending on an individual supplier's approach.

3.5. In our May 2020 consultation we proposed to set a single PPM default tariff cap level that would apply to all PPM customers with default tariffs, regardless of their meter type (traditional, interoperable smart meter in prepayment mode, or non-interoperable smart meter in prepayment mode). We discussed, and proposed rejecting, an alternative option to set multiple cap levels set at different prices, one for each type of meter.

Our decision

3.6. We have decided that the new PPM default tariff cap level will apply to all PPM customers with default tariffs, regardless of their meter type.

Rationale

3.7. A single cap for all PPM customers reduces complexity and reduces the risk of customer confusion. The main significant and substantial difference in costs between different groups of PPM customers is between customers with traditional PPMs and customers with smart meters in prepayment mode. As set out in our 2018 default tariff cap final decision, we consider that the costs and benefits of the smart meter rollout should be borne by all customers, since all customers will incur these once the smart meter rollout is complete.

3.8. In addition, traditional prepayment meters are significantly more expensive than smart meters, so the rollout should reduce costs for suppliers and prices for PPM customers. We consider those benefits should be shared across all PPM customers, otherwise those who are least engaged, or able to engage, would be left behind.

Considering stakeholders' views

3.9. In response to our March 2020 consultation, all stakeholders who commented on this point were supportive of a single PPM cap level.

3.10. In response to our May 2020 consultation, the two suppliers who commented were supportive of our proposals. Two consumer bodies argued we should not place the costs of the smart meter rollout on to customers who have not benefited yet.

How to set each allowance in the cap level

Issue

3.11. In our May 2020 consultation we proposed to set the cap level using the same methodology that we use for other payment methods, except for two elements: the PPM uplift and the non-pass-through SMNCC.

Our decision

3.12. We will set the PPM cap level in the default cap tariff using a 'bottom-up' approach, using the same methodology that we use for other payment methods, except for the PPM uplift and non-pass-through SMNCC (which are discussed in Chapters 4 and 5 respectively). See Table 3.1. This is unchanged from our consultation proposals.

Rationale

3.13. We will maintain the current methodology for wholesale, policy, and network costs – as these costs should not differ between payment methods and the PPM cap and default tariff caps already use the same methodologies.

3.14. We have reassessed the wholesale allowance in the first cap period of the default tariff cap, and have introduced an adjustment allowance in cap period five.[27] We have not applied this adjustment 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.

[27] Decision on reassessing the wholesale allowance in the first default tariff cap period https://www.ofgem.gov.uk/publications-and-updates/decision-reassessing-wholesale-allowance-first-default-tariff-cap-period

Table 3.1: 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.	**No change.** 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.	**No change.** The PPM cap already uses the default tariff cap methodology.
Payment method uplift (PPM uplift)	Allowance for the additional operating costs of serving PPM customers with traditional meters.	**No change.** In Chapter 4, we explain our reasons.
Pass-through SMNCC	Allowance for the change in smart meter industry charges. This should not differ by payment method or meter type.	**No change.** The PPM cap already uses the default tariff cap methodology.
Non-pass-through SMNCC	Allowance for the net change in operating costs from replacing PPM with smart meters. This should differ by meter type.	**Include in cap.** In Chapter 5 we our reasons for introducing this allowance.
EBIT	Allowance for a normal profit. This should not differ by payment method.	**No change.** 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.	**No change.** The PPM cap already uses the default tariff cap methodology.

3.15. We use the EBIT, VAT and headroom percentage figures from the default tariff cap, to which the PPM cap is already aligned. As these are set as percentages the absolute values may differ between payment methods.

3.16. We have not amended the operating cost allowance from the default cap tariff methodology, to which the PPM cap is already aligned. We discuss the interaction between operating costs, the payment method uplift and the SMNCC in Chapters 4 and 5.

Considering stakeholders' views

3.17. In response to both our March 2020 and May 2020 consultations, stakeholders were generally supportive of our approach not to change most cost components. Every stakeholder who commented was supportive of unchanged allowances for wholesale, policy, networks, EBIT and VAT.

3.18. We address stakeholders' comments on operating costs, payment method uplifts and the SMNCC allowance in Chapters 4 and 5 respectively.

Pre-determined conclusions

3.19. One supplier argued in response to our May 2020 consultation that our proposals for protecting PPM customers were flawed, because we had 'pre-determined' that a) the default tariff cap for credit customers must not fall, and b) the PPM cap level (and the tariff differential to the direct debit default tariff cap) must not increase.

3.20. This is a mischaracterisation of our consultation. These were not pre-determined decisions. We proposed views subject to consultation. Stakeholders could, and did, comment on these proposals in response to both our March 2020 and May 2020 consultations. The credit default tariff cap is outside the scope of this PPM consultation process, but is subject to its own review procedures.

3.21. In both our March and May 2020 consultations regarding PPM customers, we presented alternative approaches to our proposal and their impact on customers and suppliers. We explained our view that those alternatives had outcomes we considered less favourable than our proposal. If, following consideration of consultation responses, our analysis had resulted in different values, it is possible our decision would have been different to our proposals. We discuss the specific detail of this issue in Chapter 4.

Headroom for encouraging competition

3.22. One consumer group argued in response to both our March 2020 and May 2020 consultations that headroom is unnecessary for PPM – reasoning that the PPM cap is linked to the smart meter rollout, not effective competition, and so headroom to encourage competition is not needed. One supplier argued we should review (and increase) the headroom allowance.

3.23. Headroom is a 'top-up' allowance serving two purposes. It ensures that the 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).[28] Those "needs" include ensuring incentives for suppliers to compete for customers, but headroom is not exclusively for that purpose. Headroom also allows for the net impact of uncertainty, not already accounted for in the other allowances (i.e. the risk that our allowances are too low (or too high)).

3.24. 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.

3.25. 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.

Headroom for the net impact of uncertainty

3.26. In response to our March 2020 consultation, a consumer group argued that, given the uncertainty resulting from COVID-19, there is no need to adjust headroom. One supplier argued that the impact of COVID-19 requires an increase to the headroom allowance.

3.27. In response to our May 2020 consultation three suppliers argued for a need to review headroom, in light of our policy proposals, COVID-19, and other factors.

[28] 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) 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

3.28. We do not consider that our decision alters the net uncertainty in the combined allowances, so headroom does not require adjustment. Most allowances do not vary by payment method and we will not change our approach to setting most allowances. We will adjust the payment method uplift and introduce a non-pass through SMNCC for PPM customers (initially set to zero). However, we address uncertainty relating to these allowances within the allowances; additional headroom is not required.

3.29. In our May 2020 consultation we stated that it would better protect customers to assess the impact of COVID-19 on net costs in arrears, once they are known, and if necessary recognise any additional costs incurred by suppliers since the introduction of the new PPM cap level. Stakeholders who commented supported a review of COVID-19 impacts, not limited to smart costs. We will undertake this assessment in a separate process.

3.30. We therefore use the existing default tariff cap headroom allowance for the PPM level, unadjusted.

4. Additional efficient operating costs for PPM customers with traditional meters

Section summary

In this chapter, we provide our decisions on setting the PPM payment method uplift in the default tariff cap.

Summary of decision

4.1. We have decided to set the payment method uplift for PPM at the level of the PPM uplift in the current PPM cap (£24.41 electricity and £39.66 gas in the 2017 baseline year). We have set the PPM uplift using a tariff differential approach, seeking to maintain the current difference between the cap levels for direct debit customers and PPM customers. This ensures that, before considering the net impact of the smart meter rollout on the cap levels for each payment method, we do not reduce the level of protection PPM customers currently receive.[29]

4.2. We consider that efficient incremental PPM costs could exceed the PPM uplift by up to £17 (£7.95 electricity and £8.97 gas) per dual fuel PPM customer. This equates to £4.08 when recovered across all default tariff customers.

4.3. We have decided not to increase the PPM uplift to reflect those potentially additional costs. Firstly, to avoid a price increase for PPM customers, who are disproportionately likely to be vulnerable.[30] Secondly, the operating cost allowance already contains £4.16 (£2.07 electricity and £2.09 gas) of incremental PPM costs, due to the way we set the

[29] We discuss the impact of the smart meter rollout in Chapter 5, and below we discuss the interaction between the PPM uplift and the SMNCC.
[30] 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%20selfdisconnection%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

operating cost allowance for the default tariff cap. For suppliers serving 80% of PPM customers, this offsets the potential under-recovery of the PPM uplift.[31]

4.4. We recognise that the present position as described above may have a negative impact on PPM specialists, who serve approximately 20% of PPM customers and whose efficient additional PPM costs may not be fully covered. We shall seek to mitigate that effect over time, alleviating its impact on specialists, while also preventing price increases for customers. On that basis, we have decided to take steps to counter-act the effect over the medium term. Smart meters erode the additional costs of serving PPM customers as suppliers replace expensive traditional meters with cheaper smart meters. So, to mitigate the effect described above, we shall not reduce the PPM cap level to reflect the impact of smart meters until those benefits exceed the excess PPM costs (of up to £7.95 electricity and up to £8.97 gas).

The current PPM cap methodology

4.5. 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.

The PPM uplift

4.6. The PPM uplift is an allowance that applies only to PPM customers. It increases tariffs for PPM customers to reflect, in part or in full, the additional cost suppliers incur in serving PPM customers with traditional meters compared with direct debit customers.

4.7. The CMA set the existing PPM uplift considering the results of two sets of analyses.

- A benchmarking exercise, using supplier reported data on the costs to serve direct debit and the costs to serve PPM customers in 2014, from which the CMA calculated the cost differential per each supplier.

- A 'bottom up' exercise, to assess the differential costs between customers who paid by direct debit and those who had a prepayment meter. For that analysis,

[31] The £4.16 of costs already in the operating cost allowance offsets the additional £4.08 resulting from recovering the additional PPM costs over all default tariff PPM customers.

the CMA considered each element of indirect costs that had been identified by suppliers and calculated what the cost difference might be for an efficient supplier.

4.8. Any analysis of efficient costs requires a degree of judgement. The CMA judged that it should set the PPM uplift by combining the results of both approaches. They set the allowance at £64 (2017 prices).

Operating cost allowance

4.9. There is one level for the operating cost allowance and it applies to all customers, regardless of their payment method. It represents the efficient operating costs to serve direct debit customers. For other payment methods, the relevant payment method uplift 'tops-up' the operating cost allowance. Taken together, the operating cost allowance and the relevant uplift set the appropriate charge for customers using that payment method.

4.10. We describe the full methodology for the operating cost allowance in Appendix 6 of the 2018 decision.[32] The important points are:

- we analysed data on the ten largest suppliers' total operating costs per account in 2017;
- to calculate the direct debit level, 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 direct debit 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.

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

Interaction between the PPM uplift and operating cost allowance

4.11. The values of the operating cost allowance and the PPM uplift are interdependent. That is because when we adjusted each supplier's total operating costs per customer to account for the proportion of their customers that had a PPM, we used the CMA's PPM uplift to do so. The significance of that adjustment is that if we changed the value of the PPM uplift (e.g. if we thought the efficient additional PPM costs exceeded the PPM uplift), that change would affect the allocation of costs between the PPM uplift and the operating cost allowance, but it would not change the total costs that we allocated.

4.12. To set the operating cost allowance, we adjusted each supplier's total operating cost in 2017 using the PPM uplift. We did this because customers paying by standard credit or PPM are, on average, more expensive to serve than those paying by direct debit. Therefore, 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, such as PPM.

4.13. To adjust and remove the proportion of PPM costs from the total operating costs, we calculated the weighted PPM costs for each supplier. We used the £64 CMA PPM uplift (£24.41 for electricity and £39.66 for gas in 2017 prices) multiplied by the supplier's PPM customers as a proportion of their domestic portfolio. We then subtracted that adjustment from the total operating costs per customer. We made a similar adjustment relating to customers paying by standard credit.[33]

Estimating the efficient cost differential

Our decision

4.14. We have reassessed the cost to serve PPM customers, and decided that the cost differential between direct debit and PPM could be up to £81 (£32.36 electricity and

[33] Ofgem (2018), Default tariff cap: decision – overview. Appendix 6 – Operating costs (https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_6_-_operating_costs.pdf)

£48.63 gas) based on our judgement of efficiency. Our estimate is £17 (£7.95 electricity and £8.97 gas) higher than the CMA's PPM uplift.

May 2020 consultation options

4.15. In our May 2020 consultation, we considered whether the PPM uplift was accurate. We concluded that it was uncertain, and that the CMA's PPM uplift (£64) was an appropriate lower bound estimate. We estimated the upper bound efficient PPM cost differential to be £81.

4.16. We considered it likely that the efficient PPM cost differential could be between those two limits, i.e. between £0 and £17 higher than the current PPM uplift.[34]

Rationale

Assessing different judgements on efficient costs

4.17. We have assessed the same data that the CMA considered when it set the PPM uplift – suppliers' evidence on their operating costs per PPM and direct debit customers in 2014. This allows us to assess the PPM uplift using our own judgement about the level of efficient costs.[35]

4.18. In considering different efficient benchmarks, we do not conclude or imply that the CMA's judgement was inaccurate. Any assessment of efficiency contains a degree of uncertainty. Different analyses come to different conclusions depending on their approach and purpose. Given some suppliers' concerns, we deliberately compare the CMA's benchmark to more conservative analytic approaches to understand the potential impact on customers and suppliers.

[34] Ofgem (2020), Protecting energy consumers with prepayment meters: May 2020 consultation, paragraphs 4.42-4.47 (https://www.ofgem.gov.uk/system/files/docs/2020/05/protecting_energy_consumers_with_prepayment_meters_may_2020_consultation.pdf)

[35] Benchmarking costs requires a degree of judgment on what is efficient. For example, in our 2017 operating cost benchmarking exercise, we set the operating cost benchmark to the lower quartile. Alternatively, we could have been more aggressive with our definition of efficiency and set the benchmark to the frontier (lowest cost) supplier.

4.19. We consider the CMA's estimate (and therefore the PPM uplift) a reasonable estimate of efficient costs for a specific judgement on efficiency (i.e. the CMA set efficient costs close to the frontier level, noting that it considered all suppliers to have inefficient operating costs due to their market power over less-engaged and/or PPM customers): £64.07 in 2017 prices (£24.41 for electricity and £39.66 for gas).

4.20. We consider it possible that the PPM uplift accurately reflects the efficient incremental PPM costs. The CMA analysed data from 2014, taking its decision in 2016. The CMA conducted two sets of analysis. Firstly, it benchmarked suppliers' costs. It recognised that providing data was not a simple exercise for suppliers and it had concerns about data quality.[36] To verify the results of its benchmarking analysis, it also carried out a bottom-up analysis to assess efficient costs. The CMA considered and responded to suppliers' concerns that the PPM uplift might be too low, adjusting its analysis where necessary. The PPM cap was in place from 2017, with the PPM uplift a constituent part of it.

4.21. In its 2019 consultation and review, the CMA considered that the PPM uplift would need review once the rollout of smart meters has progressed significantly, but until then it did not consider a review was necessary.[37] We consider that the smart meter rollout has progressed since July 2019 but not significantly enough to conclude the CMA's assessment is no longer valid.

4.22. Assessing the same data as the CMA, we have estimated a higher level of efficient costs, £81 in 2017 prices (£32.36 for electricity and £48.63 for gas). We calculate this benchmark by taking the difference between (a) the weighted average costs to serve direct debit customers reported by the six largest suppliers and (b) the weighted average costs to serve PPM customers. We analyse each fuel separately.

4.23. Our estimate is deliberately conservative in comparison to the CMA estimate. The additional conservatism allows for the possibility that true efficient costs changed

[36] CMA (2015), Paragraph 49
https://assets.publishing.service.gov.uk/media/576bcc08ed915d3cfd0000b9/appendix-9-8-analysis-of-costs-by-payment-method-fr.pdf
[37] CMA (2019), Para 5.10 (b)
https://assets.publishing.service.gov.uk/media/5d405962e5274a4016893bd0/Final_Decision_PPPC.pdf

between 2014 and 2017, or the possibility that the CMA's assessment was stricter than we would judge.

Our consideration of stakeholder views

4.24. In response to our May 2020 consultation, one supplier stated our position of considering the CMA PPM uplift as the lower bound was incorrect. It believed the CMA PPM uplift underestimates the efficient cost differential.

4.25. The same supplier questioned our use of the 2014 data collected by the CMA. It claimed that PPM costs had increased since 2014 (but did not provide evidence). In response to our March 2020 consultation, another supplier claimed that we should collect additional data on PPM costs.

The consequence of reassessing efficient incremental PPM costs in 2017

4.26. As we discussed in our May 2020 consultation, it is possible the true efficient incremental PPM costs in 2017 could differ from the CMA's assessment based on costs in 2014 (either because costs have changed, or because the CMA's judgement on efficient costs was more aggressive than we would have judged in its place). But efficient PPM costs in 2017 could not exceed the actual PPM costs included in the total operating costs that suppliers reported for 2017. On that basis, no reassessment of the efficient incremental PPM costs in 2017 could increase the total operating costs in 2017. It could only (a) reallocate costs between PPM customers and direct debit customers and (b) identify inefficient costs included in the operating cost allowance.

4.27. As we considered in our March 2020 and May 2020 consultations, we could assess the risk of misallocation by undertaking a substantial new data exercise examining suppliers' PPM costs in 2017.[38] Alternatively, we could assess the risk of misallocation using the original data and we have done so.

[38] Ofgem (2020) – Protecting energy consumers with prepayment meters: March 2020 consultation, paragraphs 4.46 – 4.56.(https://www.ofgem.gov.uk/system/files/docs/2020/03/protecting_energy_consumers_with_prepayment_meters.pdf)

4.28. We consider that the latter approach is effective and proportionate given: (a) reassessing the operating costs would be a large data exercise for suppliers; (b) that we can assess the CMA's approach and judgement; and (c) as we had proposed and have now decided to, we would cover additional PPM costs in the operating cost allowance of the default tariff cap where they turned out to be higher than the CMA PPM uplift so it is unlikely to make a large difference to the current decision.

4.29. As discussed above, we have reviewed the data used to set the PPM uplift and consider the CMA's judgement of efficient costs reasonable. However, we consider it is possible that the uplift could underestimate efficient costs. We consider we would likely have adopted a more conservative approach.

4.30. For the purposes of our decision, we have decided to take the conservative approach and consider that the true efficient costs could be up to £17 higher than the CMA estimate. We therefore assess our proposals *on the assumption that* an efficient supplier's incremental PPM costs are £17 higher than the PPM uplift. While some suppliers perceive errors in the CMA's analysis,[39] this does not affect our consideration of suppliers' efficient costs.

Treatment of the efficient cost differential

Our decision

4.31. We have decided to use a tariff differential approach, in order to maintain the current differential between the direct debit and PPM cap levels, before considering the net impact of smart meters. In practice, this means that we maintain the existing PPM differential (£64.07 dual fuel, £24.41 electricity, and £39.66 gas in 2017 prices).

4.32. That means that the PPM uplift could under-recover true efficient costs for customers with traditional meters by up to £17 (£7.95 electricity and £8.97 gas). We have decided to recover additional PPM costs over all default tariff customers.

[39] As discussed in Chapter 1, the CMA's decision was consulted on. We have reviewed its analysis and consider it appropriate, even if we would have made a more conservative judgement.

4.33. We have decided to leave the operating cost allowance unchanged. There is already £4.16 of PPM cost in the operating cost allowance. For suppliers with an average proportion of PPM customers, this is sufficient to cover the amount that may not be recovered from PPM customers by the PPM uplift (the maximum amount required to cover excess PPM costs operating cost allowance is £4.08).[40] For non-specialists suppliers, who serve the majority (80%) of PPM customers, this approach allows them to recover their efficient costs.

4.34. We have decided to mitigate the effect of the cost differential described above by using the SMNCC. Replacing expensive traditional meters with cheaper smart meters reduce suppliers' operating costs, eroding the incremental cost of serving PPM customers. We have decided that we will not reduce the PPM SMNCC in line with the benefit of installing smart meters, until those benefits outweigh the potential excess PPM costs (£7.95 for electricity and £8.97 for gas). This alleviates the impact of the tariff differential approach on specialist PPM suppliers over the medium term.

May 2020 consultation options

4.35. In our May 2020 consultation, we considered two options for treating the efficient PPM cost differential:

- a cost reflective approach; and
- a tariff differential approach.

4.36. We stated that where the efficient PPM cost differential is higher than the CMA's PPM uplift, a cost reflective approach would increase PPM customers' prices. In comparison, a tariff differential approach would maintain the current differential for PPM customers.

[40] This is the maximum amount required for an efficient supplier with a market average proportion of default tariff PPM customers to recover its costs.

Rationale

Setting the PPM uplift

4.37. As we stated in our May 2020 consultation, we believe that the tariff differential approach protects PPM customers (a particularly vulnerable group), which is consistent with our primary obligation of consumer protection. This is because a cost reflective approach would increase the PPM cap level and therefore reduce the overall level of protection for PPM customers with traditional meters. By adopting a tariff differential approach we restrict the PPM uplift so that the cap level for PPM customers does not increase compared to the current level under the PPM cap. This means that PPM customers do not experience a sudden and sharp increase in prices (relative to customers on other payment methods).

Considering the operating cost allowance

4.38. Restricting the PPM uplift to the current tariff differential (before considering the impact of smart meters) means suppliers could under-recover their efficient costs by up to £17 (£7.95 for electricity and £8.97 for gas) from PPM customers subject to the cap. In our May 2020 proposal we proposed to recover those costs across all payment methods to mitigate the impact on PPM consumers. We calculate that £4.08 (£1.91 electricity and £2.17 gas) should be recovered from all default tariff customers for an efficient supplier with an average proportion of default PPM customers to recover its PPM costs. This is calculated by multiplying the additional £17 (£7.95 electricity and £8.97 gas) by the market average proportion of default tariff customers paying by PPM.

4.39. We estimate that the operating cost allowance already includes approximately £4.16 (£2.07 electricity and £2.09 gas) of PPM costs. The level reflects the difference in additional PPM costs between the CMA estimate and the lower quartile benchmark supplier recovered across the benchmark supplier's customer base. In other words, had we used suppliers' actual costs for the adjustment to remove PPM costs from the total operating costs, we would have removed an additional £4.16. This is sufficient to cover the maximum potential shortfall in the PPM uplift, for suppliers with market average proportions on PPM customers and customers with other payment methods.

Suppliers' ability to recover their efficient costs

4.40. Regarding suppliers' ability to recover their efficient costs, the tariff differential approach means that suppliers will partially under-recover the efficient cost of each PPM customer with a traditional meter and over-recover for each direct debit customer. Suppliers with fewer PPM customers than average will be able to over-recover their costs. In practice, most non-specialist suppliers have a mixed customer base that allows them to recover their efficient PPM costs, or a substantial proportion of them. The majority of PPM customers (80%) are served by non-specialist suppliers.

4.41. We recognise that PPM specialists are at a disadvantage. They do not have a sufficient proportion of customers with other payment methods to recover their PPM costs in full across default tariff customers. For that reason, we seek to take steps to mitigate the effect, which we discuss below.

Our consideration of stakeholder views

4.42. We received several responses to our May 2020 consultation from suppliers and consumer groups. We consider the responses below.[41]

Considering efficient suppliers' finances

4.43. In response to our May 2020 consultation, several stakeholders disagreed with our approach to accounting for PPM costs and argued that we should make the PPM uplift cost reflective. Two suppliers argued that PPM specialist suppliers would not be able to recover the excess PPM costs already in the operating cost allowance from their customer base. One supplier considered our approach reasonable.

4.44. Under our tariff differential approach a supplier's ability to recover, or over-recover, its costs depends on the mix of customers in its portfolio. Suppliers with an average proportion of PPM customers would recover their efficient costs.

[41] For additional stakeholder views raised in response to our March 2020 consultation and our considerations, please refer to the May 2020 consultation.

4.45. Suppliers with more PPM customers than average would under-recover efficient costs to an extent (as they lack enough non-PPM customers to recover the efficient PPM costs over). The inverse is true of suppliers with more direct debit customers than average – they could over-recover from direct debit customers. This is a matter of degree: the more a supplier differs from market average proportions, the greater the impact.

4.46. We adopt a tariff differential approach because we consider that the present situation whereby a portion of PPM costs is covered by the credit default tariff cap is acceptable in the circumstances. We consider the impact for customers and suppliers to be consistent with section 1 of the Act, of which the primary objective is to protect customers. 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. We considered that this approach protected customers, and in doing so, we had regard to suppliers' finances, notwithstanding the potentially distorting impact the approach has on cost-recovery. In making our decision, we have taken account of the various matters set out in section 1(6) of the Act, while giving particular weight to the overriding requirement of customer protection and applying that requirement to the context.

4.47. In practice, 80% of customers are served by non-specialist suppliers. These suppliers have sufficient customers of each payment type to recover efficient PPM costs.

Considering the impact on specialist suppliers

4.48. Our tariff differential approach has a negative impact on suppliers with business models that specialise in serving customers with high cost traditional PPMs. These suppliers serve 20% of the PPM market. We do not consider it protects PPM customers to increase tariffs and reduce protection for 4 million PPM customers, most of whom are not served by specialist suppliers.[42]

4.49. In addition, even if the PPM uplift understates the costs of PPM customers *with traditional meters.* Suppliers are replacing traditional meters with cheaper smart meters. The rollout of smart meters should erode the high costs differential of serving

[42] PPM specialists cover approximately 20% of the PPM market based on 2019 customer accounts.

traditional PPM customers. We would not seek to continue recovering all the additional PPM costs over all payment methods as the costs to serve PPM decreases from the rollout. On that basis, the disadvantage from serving customers with expensive traditional meters should be temporary.

Considering protecting consumers

4.50. To the extent that true efficient incremental PPM costs exceed the PPM uplift, the tariff reference approach affords greater protection to PPM customers.

4.51. We consider this appropriate because a cost reflective approach would increase prices for PPM customers (before considering the impact of the smart meter rollout). We do not consider it desirable to increase the tariffs for PPM customers, compared to the current tariff differential they already pay. In line with consumer groups' views, 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, are less able or likely to switch to cheaper tariffs independently.

4.52. Given that there are fewer PPM customers than direct debit customers, the impact of recovering PPM costs across all payment methods decreases bills for PPM customers to a greater extent than it increases bills for direct debit customers. A £4 reduction in PPM tariffs increases charges for all default tariff customers by about £1. (As we do not propose to reduce the cap for credit customers, in any event, these customers will not pay more).

4.53. We consider that high-cost traditional PPMs increase costs for customers who are more likely to be vulnerable or in financial difficulty. This is a legacy problem that should reduce as smart meters replace traditional meters. Smart meters do not cost significantly more in prepayment mode than they do in credit mode. We consider that is appropriate to provide additional protection to PPM customers (potentially setting the PPM uplift below efficient costs for some suppliers) during that transition.

4.54. However, in principle, we seek to (a) not increase operating cost charges for PPM customers above their current levels and (b) not recover PPM costs across all default tariff customers once smart meters have eroded the majority of high traditional PPM costs. Later in this chapter, we discuss how we will offset the tariff differential approach as the smart meter rollout reduces the costs to serve PPM customers.

Considering the level of PPM costs in the credit default tariff cap

4.55. Two consumer groups said we should cover more of the PPM costs than we proposed in our May 2020 consultation, implying we should remove the differential so that direct debit and PPM customers pay the same price.

4.56. One supplier questioned why we set the PPM uplift to the current PPM cap level and proposed to cover any costs above that in the credit level of the default tariff cap.

4.57. We have decided to set the level at the current PPM uplift to avoid a price increase for PPM customers, who are disproportionately likely to be vulnerable. Furthermore, the amount of PPM cost in the operating cost allowance offsets the differential both across the board and for the majority of suppliers.

4.58. We do not include in the credit default tariff cap a greater amount of the PPM costs as this exacerbates the under-recovery of suppliers with a higher than average proportion of default PPM customers. If we included a higher proportion of PPM costs in the credit default tariff cap, such suppliers would find it increasingly difficult to cover their costs. We deem the current tariff differential a good and temporary balance between protecting customers many of whom are vulnerable (they do not see a sudden and significant increase in their prices, relative to customers on other payment methods, driven by additional PPM costs) and financing suppliers.

Considering our policy intention

4.59. One supplier stated that our proposal to adopt a tariff differential approach to protect vulnerable PPM customers contradicts our 2018 default tariff cap decision where we said that we were not recovering standard credit costs from all default credit customers on a vulnerability basis. They repeated our rationale that while standard credit customers were more likely to be fuel poor, the absolute number of fuel poor direct debit customers is higher.

4.60. In our 2018 decision, with respect to recovering standard credit costs, we said that we did not consider it a strong argument to reduce the payment method differential in

order to protect vulnerable consumers. While standard credit customers are twice as likely to be fuel poor, twice as many fuel poor customers pay by direct debit.[43]

4.61. First, in the context of standard credit customers, we noted that recovering costs over different payment methods on the grounds of vulnerability is complicated, as both direct debit customers and standard credit customers can be fuel poor. However, it was not an absolute constraint. In our 2018 decision, we included a proportion of standard credit costs in the direct debit cap level.

4.62. Secondly, the context for PPM customers is different. With respect to their energy usage, a PPM customer's situation is different to that of a standard credit customer. PPM customers are subject to disconnection if they do not top up their meters. The impact of bill increases for PPM customers is therefore different.

4.63. Additionally, the impact of some PPM costs being recovered over all default tariff customers has a lower impact on direct debit customers than the impact of recovering standard credit costs over all non-prepayment default tariff customers (as we did in the 2018 decision). There are roughly four default tariff non-PPM customers for every default tariff PPM customer, so the impact on fuel poor direct debit customers of a portion of PPM costs being covered by the credit cap is relatively small.

4.64. Thirdly, the high costs of serving PPM customers should be a temporary and technological issue that will pass as smart meters erode the costs of traditional meters. That allows us to reverse the effect of the tariff differential approach for PPM customers in the medium term.

Considering the impact on competition

4.65. One supplier stated that the tariff differential approach could reduce the level of competition in the market. This was on the basis that if suppliers cannot recover their efficient costs then they will be forced to price at the cap rather than actively trying to acquire customers. They believed that reducing competition would fail to protect future

[43] Ofgem (2018) – Appendix 8 – Payment method uplift, paragraph 3.54 (https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf)

consumers, and state that a price cap set below cost deters innovation and investment.

4.66. In response to our March 2020 consultation, one supplier argued that a tariff differential approach would have the effect of creating distortions to a competitive market.

4.67. As mentioned in Chapter 2, we do not consider competition is working for PPM customers and have therefore decided to extend price protection for them.

4.68. We do not consider the tariff differential approach will reduce competition in either the direct debit or PPM market. The situation whereby the PPM cap may not fully cover incremental PPM costs already exists in the PPM market under the existing cap, so maintaining this state of affairs in the short term is unlikely to reduce the current level of competition. Furthermore, we have decided to offset the effect of the tariff differential approach in the medium term, through the PPM SMNCC.

4.69. We believe the tariff differential approach protects current and future customers during the transition to competition facilitated by technology changes (e.g. smart meters).

4.70. With regards to competition in the direct debit market, we do not consider the cost allocation to make a difference. There is an average difference of around £200-£300 between the default tariff cap and the basket of competitive tariffs. An increment of £4 is unlikely to make a significant difference to the ability of suppliers to compete.

Setting the PPM uplift at nil consumption

Our decision

4.71. We have decided to apply the PPM uplift equally at benchmark and nil levels of consumption as is done in the current PPM cap. This is the same as our proposal in May.

Our consideration of stakeholder views

4.72. Two consumer groups and the Welsh Government raised concerns about how standing charges work for PPM customers. One consumer group argued that our reluctance to stray away from cost reflectivity in terms of the PPM uplift at nil consumption has

negative consequences for PPM customers. When a PPM customer self-disconnects, they still incur the standing charge and build up debt. The debt they build up (which is in proportion to the standing charge) may make it harder for some customers to get back on supply as they need to repay accumulated standing charges when they next top-up, meaning these customers could go without electricity and heating for more prolonged periods of time.

4.73. There is not a cost-based reason to set a lower standing charge for PPM customers. The majority of the costs of serving PPM customers do not vary with consumption.

4.74. We appreciate that standing charges can have a negative impact on customers that have low incomes and those that are at risk of self-disconnection. However, we believe the default tariff cap is a blunt tool for addressing this issue.

4.75. As we noted in our May 2020 consultation, our review into self-disconnection and self-rationing identified that the impact of standing charges on vulnerable PPM customers is mainly a seasonal issue, where customers do not top up their gas PPM meters during summer and they accrue standing charges, which can lead to self-disconnection when they next top-up in the winter.[44] Existing obligations require suppliers to treat customers fairly and identify those who are in vulnerable circumstances. Suppliers are also required to provide information so that each consumer can understand the key features of their tariff and make informed choices on when and how much energy they consume. We expect this to include customers having the necessary information about standing charges and the potential build-up of these charges during periods of no consumption. We have also highlighted good practice by suppliers who run summer information campaigns to remind customers to keep their PPM meters topped-up to a minimum where possible.

4.76. In June 2020 we published a statutory consultation on our proposals to require suppliers to identify PPM customers who are self-disconnecting and provide appropriate support as needed, including by taking into account customers' ability to pay when

[44] https://www.ofgem.gov.uk/system/files/docs/2019/08/proposals_to_improve_consumer_outcomes_self-disconnection_and_self-rationing_1.pdf

repaying debt.[45] We expect the new proposed obligations to provide the necessary consumer protection to those negatively impacted by self-disconnection.

Using the SMNCC to offset the effects of the tariff differential approach

Our decision

4.77. We have decided to use the SMNCC to gradually mitigate the effect of the PPM uplift not covering all incremental PPM costs to serve. We will offset the tariff differential approach to the extent that the additional PPM costs are offset by the benefit of replacing traditional meters with smart meters. We will use the SMNCC to mitigate the effects of the tariff differential approach by not reducing that allowance in line with the net benefits of installing smart meters until the effect of the tariff differential approach is offset. The operating cost allowance will remain unchanged; in effect increasing headroom across all payment methods by £4 (as the £4.16 is no longer required to recover the additional PPM costs).

4.78. For the next two cap periods, we have decided to implement our contingency option of £0 for the non-pass-through PPM SMNCC. In Chapter 5 we conclude that smart meters *have* reduced suppliers' efficient operating costs, but our methodology does not calculate the average benefit accurately. On that basis, by setting the non-pass-through PPM SMNCC at £0 the effect of the tariff differential approach is already unwound in part or in full.

Rationale

4.79. As stated in our May 2020 consultation, replacing expensive traditional prepayment meters with cheaper smart meters will reduce suppliers' operating costs, eroding the additional cost of serving prepayment customers. Rather than reducing the PPM uplift, we recognise the benefit of the rollout in the PPM SMNCC, offsetting costs recognised in the operating cost allowance and PPM uplift.

[45] https://www.ofgem.gov.uk/publications-and-updates/self-disconnection-and-self-rationing-final-proposals-statutory-consultation

4.80. We seek to achieve two outcomes:

- that, once the high costs of traditional PPMs are removed and the costs of serving PPM customers are comparable to those for other customers, those other customers no longer in effect pay a proportion of additional costs of serving PPM customers; and

- that we do not increase tariffs for PPM customers with traditional PPMs, who are more likely to be vulnerable than other customers.

4.81. To achieve both outcomes, we proposed in our May 2020 consultation to offset the tariff differential approach as the smart meter rollout continues and erodes suppliers' additional operating costs. In practice that means we would not reduce the PPM SMNCC until the net benefits of installing smart meters exceed the excess PPM costs (of up to £7.95 electricity and up to £8.97 gas).

Stakeholder responses

4.82. Several stakeholders questioned how we planned to achieve this effect using the SMNCC. One stakeholder considered the offset to be measured at a dual fuel level and suggested we should entirely reverse the effect of the tariff differential approach in cap period five based on our consultation figures.

4.83. One supplier stated that we should reverse the effects at both nil consumption and benchmark consumption.

Our considerations

Using the SMNCC to off-set the effects of the tariff differential approach

4.84. We will use the SMNCC to off-set the effect of the tariff differential approach up to the point the PPM SMNCC offsets the increase in cost. By doing this, we will simultaneously ensure that prices do not increase for PPM customers (absent the effects of other

considerations)[46] and that we do not continue to cover a portion of PPM costs through the credit cap when the additional PPM costs are eroded by the smart meter rollout.

4.85. In practise, this means off-setting the excess PPM cost of up to £17 (£7.95 electricity and £8.87 gas) against the level of the PPM SMNCC each cap period. We show an illustrative worked example in Table 4.1 using the consultation values of the PPM SMNCC.

4.86. We offset the tariff differential approach through the PPM SMNCC because the payment method uplift is fixed. That makes it difficult to update each cap period. In practice, the impact on customers and suppliers is the same, whether we increase the PPM uplift to the extent that the SMNCC offsets that increase, or do not reduce the SMNCC to the extent that the excess costs would offset those benefits.

Table 4.1: Example non-pass-through (NPT) PPM SMNCC and offsetting excess costs

	Cap period x	Cap period y
NPT SMNCC - Electricity	-2.34	-6.47
NPT SMNCC - Gas	-17.29	-21.47
excess costs to offset - Electricity	7.95	7.95
Excess costs to offset- Gas	8.97	8.97
Max cost offset in period - Elec	2.34	6.47
Max cost offset in period - Gas	8.97	8.97
Net NPT SMNCC - Electricity	0	0
Net NPT SMNCC - Gas	-8.32	-12.50
Remaining costs - Electricity	5.61	1.48
Remaining costs - Gas	0	0

4.87. We will offset the tariff differential approach in Annex 5 – smart metering costs. We plan to edit the Annex 5 model by adding an additional calculation step that nets off the additional PPM costs with the SMNCC. We will implement this change when we consult on setting the PPM SMNCC for cap period 7.

[46] Other cost components in the default tariff cap could affect the prices (e.g. wholesale costs). Here we are referring to the impact of changes in operating costs.

4.88. We have decided to use our contingency option, and set the PPM non-pass-through SMNCC to £0 for cap periods five and six. However, despite setting the SMNCC at £0, smart meters have reduced efficient costs (on average), and the effect of the tariff differential approach is in part or fully offset (see Chapter 5 for details on the reasons for contingency level of the SMNCC).

Off-set the effects of the tariff differential approach at nil consumption

4.89. We would unwind the offset of the effect of the tariff differential approach at both nil consumption and benchmark consumption, as one supplier suggests.

4.90. In our 2018 decision, we decided to protect low consumption customers with credit meters from increases in standing charges. We did this by setting the default tariff cap level at nil consumption in line with the average standing charge in the market and not at a cost reflective level, which was higher. The effect was that the SMNCC in the default tariff cap at nil consumption is 69% of the level at benchmark consumption.

4.91. In principle, the SMNCC should not differ by consumption level. For credit, where the SMNCC is a net cost, recognising 69% of those costs reduces the SMNCC and protects customers with low consumption. However, for PPM, where the SMNCC is a net benefit (negative), applying the 69% scaling factor would reduce the benefit for low consumption users, undermining protection for these customers. That is the opposite effect of what we intended in our 2018 decision.

4.92. We do not think that applying the scaling factor to the NPT SMNCC for PPM customers is in line with our original policy intent to protect consumers. Therefore we would not adjust the SMNCC at nil consumption. Removing the scaling factor means we would perform the same off-setting exercise at nil and benchmark consumption. We will implement this change when consulting on setting the PPM SMNCC for cap period 7.

5. Allowing for the costs of the smart meter rollout to prepayment customers

Section summary

In this chapter, we describe our decisions to maintain the pass-through SMNCC allowance for PPM customers, and to set the PPM non-pass-through SMNCC to £0 for cap periods five and six.

Summary

5.1. We have decided to set a PPM-specific non-pass through SMNCC allowance for the PPM default tariff cap.

5.2. We consider that our proposal to use a weighted average profile would set the SMNCC below average costs, which was not our intention. However, to adjust this we would need to make methodological changes which would require further consultation. We have therefore decided to set the PPM-specific non-pass-through SMNCC allowance to £0 for cap period five and six (1 October 2020 to 31 March 2021 and 1 April 2021 to 30 September 2021). This in effect maintains the cap level that would be set using the current PPM cap methodology and reflects the contingency position we presented in our May 2020 consultation.

5.3. We will introduce an SMNCC that recognises the benefit of installing smart meters from 1 October 2021. This provides time for government to conclude its autumn 2020 consultation on the tolerance levels for its new rollout Framework, so that we can understand the implications of tolerance levels for the enforcement regime on suppliers. If suppliers do not keep pace with the targets, for PPM, the SMNCC will reduce *faster* than their costs.[47]

[47] Note that this is the opposite effect to the one we discuss when considering the SMNCC for credit customers. That is because replacing traditional credit meters with smart meters increases suppliers' costs.

5.4. We have decided to set the pass-through SMNCC using the same methodology we use to set the default tariff cap for other payment methods. The existing PPM cap already includes this allowance, so there would be no change in terms of the impact on customers and suppliers. This is unchanged since our May 2020 proposal.

5.5. We will apply our proposed approach to carry forward from 1 January 2021, the date at which the CMA PPM cap expires and PPM customers are protected by the default tariff cap.

Table 5.1: Current PPM cap and default tariff cap for PPM customers non-pass-through smart metering net cost change allowance, cap periods 5 and 6 (£)

	Current allowance for PPM customers	Allowance, Cap 5	Allowance, Cap 6
		Oct 20 - March 21	April 21 - Sept 21
Elec	0	0	0
Gas	0	0	0
Implied dual fuel	0.00	0.00	0.00

Notes:

(1) All figures are shown in nominal terms.

(2) The current PPM cap set by the Competition and Markets Authority does not include an allowance for non-pass through smart metering costs, and so this is set to zero.

Accounting for the smart meter programme

Allowances for smart metering costs

5.6. The default tariff cap allows for the costs and benefits of the smart metering rollout (compared to the continued use of traditional meters) through:

- The operating cost allowance, which rises with inflation each period. This includes the costs of the smart meter programme in 2017.

- The SMNCC allowance. This accounts for the net impact on the costs in our operating cost allowance baseline of replacing traditional prepayment meters with smart meters. This net impact can be positive or negative. The SMNCC is **not** an allowance for the gross costs of the smart meter rollout, it allows for changes in operating costs due to smart meters compared to the 2017 baseline. It has two components:

- the pass-through SMNCC, accounting for the costs to suppliers of industry charges relating to the smart meter programme; and

- the non-pass through SMNCC, accounting for all other efficient changes to costs and benefits of the smart meter rollout to suppliers since 2017.

Decision regarding the pass-through SMNCC

5.7. As the smart meter rollout progresses, suppliers pay industry body charges. These cover the costs incurred by the Smart Data and Communications Company (DCC), Smart Energy Great Britain (SEGB), Alt Han Co, and SMICoP.[48]

May 2020 proposal

5.8. In our May 2020 consultation, we proposed to maintain the pass-through SMNCC allowance for PPM customers, using the same methodology we use for credit customers. We calculate the change using industry charging statements.

5.9. Our rationale for this proposal was that:

- We do not consider that the costs covered in the pass-through SMNCC would vary by payment method. The pass-through SMNCC methodology is set out in our 2018 decision and was adopted by the CMA in their 2019 review of the PPM cap.[49]

- We do not consider it appropriate for only customers with smart meters to pay the pass-through SMNCC allowance. In due course, all customers will have smart meters, so all customers should contribute to the costs, rather than placing additional burden on those who have installed a smart meter relatively early in the rollout.

[48] Smart Meter Implementation Code of Practice
[49] 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

Our decision

5.10. We have decided to maintain the pass-through SMNCC allowance for PPM customers, using the same methodology we use for credit customers. We calculate the change using industry charging statements. This is unchanged from our May 2020 proposal.

Stakeholders' views

5.11. Four stakeholders supported our proposal; one suggested that the pass-through smart metering costs should be excluded from the default tariff cap level for PPM customers entirely.

Considerations

Excluding pass-through smart metering costs

5.12. The pass-through smart metering costs represent costs incurred by suppliers to complete the rollout. If we excluded these costs from the default tariff cap, suppliers would not be able to recover those costs. We do not consider this to be in the long-term interests of either consumers or suppliers.

Decision regarding the principles of the non-pass-through SMNCC

May 2020 proposal

5.13. In our May 2020 consultation, we proposed that the PPM default tariff cap should include a PPM-specific SMNCC which applies to all PPM customers within the scope of the cap.

Including a PPM SMNCC

5.14. We considered that including a PPM SMNCC is necessary. The smart meter rollout affects suppliers' net operating costs. Excluding this cost category would assume that installing smart meters has no impact on suppliers' net costs. The operating cost allowance would remain constant in real terms, diverging from suppliers' underlying efficient operating costs of supplying PPM customers over time as suppliers replaced expensive traditional PPMs with cheaper smart meters. Suppliers would consistently over-recover their efficient costs.

A specific allowance for PPM customers

5.15. We considered that rolling out smart meters to PPM customers reduces suppliers' operating costs, whereas rolling out smart meters to credit meter customers increases suppliers' operating costs (in the short term, and on average, in both cases). As the non-pass-through SMNCC tracks the change in suppliers' efficient costs, we cannot use the same allowance for PPM as we do for credit meters.

A single allowance for all PPM customers

5.16. We consider the PPM SMNCC should apply to all customers in scope of the PPM cap level, not just those with a smart meter for the reasons set out in Chapter 3 (3.4 to 3.10). We consider the costs and benefits of the rollout should be shared across all PPM customers, otherwise those who are least engaged, or able to engage, would be left behind.

Decision

5.17. We have decided that the PPM default tariff cap should include a PPM-specific SMNCC which applies to all PPM customers within the scope of the cap. This is unchanged from our May 2020 proposal.

Stakeholders' views

5.18. Three stakeholders supported, in general, the adoption of a non-pass-through SMNCC for PPM customers.

5.19. One stakeholder said that we should transfer the cost of the smart meter rollout to those customers who have a smart meter, implying that the SMNCC should only apply to smart PPM customers rather than all PPM customers within the scope of the cap.

Decision regarding the value of the non-pass-through SMNCC

May 2020 proposal

5.20. In our May 2020 consultation, regarding how we proposed to calculate the PPM SMNCC, we proposed to take as our starting point the credit meter non-pass-through

SMNCC, and make changes to reflect the specific costs and benefits incurred through the smart meter rollout to PPM customers.

5.21. We also proposed to base the PPM non-pass-through SMNCC on the efficient operating costs of a supplier with a weighted average rollout profile (in effect, the aggregate progress of all suppliers). We proposed to set a single rollout profile, using the same proportion of rollout for PPM and credit meters, representing average progress, so that:

- for years up to and including 2019: the rollout profile for each type of meter reflects suppliers' weighted average cumulative progress as a proportion of mandated meters for each fuel type, as shown by data published by BEIS;
- for subsequent years: we set the rollout profile for each type of meter in 2020 at 30% of the average annual installations between 2017 and 2019 (to approximate the impact of COVID-19), and at 100% of that level in 2021 and subsequent years.

5.22. Our proposals resulted in a PPM SMNCC allowance that is lower than the SMNCC for credit meters, primarily due to differences in asset cost, asset lifetime, and the operational benefits of reduced costs to serve between credit and PPM.

5.23. We also proposed a contingency option, if we were unable to develop a sufficiently robust and scrutinised set of values for the non-pass-through SMNCC in time for cap period five. In this case, we would set the SMNCC to £0 for cap period five.

Our decision

5.24. We have decided to implement the contingency position from our May 2020 consultation, and set the PPM-specific non-pass-through SMNCC allowance to £0 for cap periods five and six.

Rationale

5.25. Our proposal to use a weighted average profile would set a PPM non-pass-through SMNCC below average costs, which is not our intention. This is because the effect of one supplier's rollout on the average rollout distorts the average costs, such that the cost of the average profile is lower than the average cost of *each* profile taken

separately. In order to address this, we would need to make methodological changes which would require further consultation.

5.26. We have decided to set the contingency allowance at £0 for two cap periods, and will introduce a PPM non-pass-through SMNCC that recognises the benefit of installing smart meters from 1 October 2021. The contingency allowance does not mean that smart meters have not reduced suppliers' efficient costs. They have. It means that our proposed methodology needs adjusting to reflect that reduction more accurately.

5.27. Setting the contingency allowance for two periods provides time for government to conclude its autumn 2020 consultation on the tolerance levels for its new rollout Framework, and so that we can understand the implications of tolerance levels on the enforcement regime.

5.28. We note that once we have set the PPM non-pass-through SMNCC, taking targets and the enforcement regime into account, for suppliers that do not achieve those targets, their SMNCC allowance will reduce *faster* than their actual costs.[50]

Considering contingency

Application of contingency

5.29. Several suppliers supported our contingency approach, to allow more time to refine and scrutinise proposals, and to observe the effects of COVID-19. Some suppliers argued we should gather more data. One consumer body supported implementing the new PPM non-pass-through SMNCC from 1st October 2020 in order to lower prices for this winter.

5.30. We have applied the contingency because our proposal, using the average rollout profile, does not reflect the average (and therefore aggregate) costs of the rollout.

[50] Note that this is the opposite effect the one we discuss when considering the SMNCC for credit customers. That is because replacing traditional credit meters with smart meters increases suppliers' costs.

Value of contingency

5.31. In our May 2020 consultation, we proposed a contingency non-pass through SMNCC value of zero. This has an equivalent effect on prices to the existing PPM cap methodology, which does not include a non-pass through SMNCC cost allowance.

5.32. All stakeholders who commented were supportive of using a zero value for the non-pass through SMNCC in the event contingency was needed. No alternatives were proposed, and we have not identified any other reason to change our proposal.

5.33. We have set the contingency value at £0, in line with our proposal. It provides continuity with the current PPM cap, which includes no SMNCC. It also unwinds, in part or in full, the effect of setting the PPM uplift using tariff-differential approach. Smart meters have reduced suppliers' costs. An updated methodology for the SMNCC would reduce the cap. As we have decided to use the SMNCC to unwind the effect the tariff-differential on the PPM uplift *before reducing the cap level,* the impact of our contingency on customers and suppliers is minimal (as the understatement of the PPM uplift and SMNCC would have largely offset each other in any event).

Considering a single weighted average rollout profile for all suppliers

Stakeholders' views

5.34. Two stakeholders said that the use of a weighted average rollout profile for PPM was inappropriate because of the impact that specialist PPM-only suppliers would have on the average PPM rollout profile would not be representative of non-specialist suppliers. Stakeholders suggested that we use another mechanism for calculating the rollout profile for use in the SMNCC model, such as a median, or a weighted average excluding PPM specialists.

Our consideration

5.35. The SMNCC model takes as a key input the weighted average industry rollout profile. For credit meters, there is a linear relationship between rollout and net cost: installing more meters results in a higher net cost, and the net cost of the average rollout profile is equivalent to the average of net efficient costs for different rollout profiles. Our intention is that the cost of the average profile is equivalent to the average efficient

cost to customers of suppliers' different profiles (or in other words, equivalent to the aggregate costs for customers collectively).

5.36. This is not the case for PPM. As we noted in our May 2020 consultation:

- *Suppliers whose smart PPM installations are above the average number of installations we include in the SMNCC model will have higher-than average costs (and they will under-recover).*

- *Suppliers whose smart PPM installations are less that average, but enough to replace expired traditional meters will have lower-than-average costs (and will be able to over-recover).*

- *Suppliers whose smart PPM installations are less that average and continue to replace (a significant proportion of) expired traditional PPMs with new expensive traditional PPMs – because their smart PPM rollout does not yet cover all traditional PPM end-of-life replacements – will have higher-than-average efficient costs (and they will under-recover).*[51]

5.37. The relationship between rollout and cost for PPM is not linear: suppliers whose rollout progress is at (or near) the weighted average rollout profile will have lower costs than suppliers whose rollout profile is significantly above or below average.

5.38. Further, our analysis shows that the effect of one supplier's rollout on the average distorts the average costs, such that the cost of the average profile is lower than the average cost of each profile. The per-meter efficient smart PPM rollout net cost is greater when calculating costs using each profile in turn than the per-meter net cost resulting from the weighted average rollout profile. For PPM, the net cost of the average rollout profile is not equivalent to the average of net efficient costs for each supplier. It is lower.

[51] Ofgem (2020), Protecting energy consumers with prepayment meters: May 2020 Consultation, paragraph 6.23
https://www.ofgem.gov.uk/system/files/docs/2020/05/protecting_energy_consumers_with_prepayment_meters_may_2020_consultation.pdf

5.39. If we were to use a single weighted average rollout profile to calculate the SMNCC, the allowance would be too low: it would not capture the aggregate net costs of the PPM rollout. Consumers would be paying for less than the total cost of the smart rollout. We do not consider this to be in the interests of either consumers or suppliers.

5.40. There are a number of options for addressing this consideration. However, we consider any of them would require substantial methodological changes and so need further consultation.

Considering the period of contingency

Stakeholders' views

5.41. In its June 2020 response, government announced its decision to set a new four-year Framework from 1 July 2021, which will set targets for each supplier to complete the rollout subject to tolerance levels it will consult on in autumn 2020.

5.42. In their responses to our May 2020 consultation on the SMNCC *for credit meters*, suppliers considered that we should reflect government's target in the rollout profile we use to set the SMNCC in future years. That would ensure that suppliers have the efficient resources to achieve government's aim. We have included government's target in our decision on the SMNCC for credit meters.

5.43. Suppliers also consider that setting the rollout profile at the average level would not provide sufficient funding for suppliers that have made greater progress. Those suppliers may have to slow down, in order to align their costs with the allowance.

Our considerations

5.44. Although these issues were raised with regard for the SMNCC for credit customers, we have considered the implications for PPM customers.

5.45. The circumstances for PPM customers differ. Replacing traditional prepayment meters should reduce suppliers' operating costs when serving PPM customers, not increase them. On that basis, a profile that reflects targets could set an allowance below suppliers' efficient costs, if suppliers did not achieve those targets.

5.46. Similarly, the supplier with the most progress may have the lowest costs, but not necessarily. As we state above, the relationship between rollout and costs is not linear for PPM, so the impact on suppliers of the rollout profile used to set the SMNCC will differ from credit.

5.47. On that basis, we have decided to set the contingency allowance for two cap periods. This also allows time for us to understand the new Framework in full (after the autumn 2020 consultation on tolerance levels) and understand its implication for how the enforcement regime will work in practice.

Considering other issues

5.48. Suppliers considered our proposals and scrutinised the SMNCC model that underpinned our proposals. Many of the comments on the model and proposals are superseded by our contingency decision. However, we comment on key themes below.

Smart PPM costs and benefits

5.49. Six stakeholders disagreed with our analysis of individual cost and benefit components. These stakeholders stated that we have:

- over-estimated the cost-to-serve reduction for smart PPM;
- under-estimated the costs of remote mode changes, tariff changes, and top-ups (including payments infrastructure) for smart PPM;
- under-estimated the cost of SMETS1 enrolment and adoption for PPM; and
- underestimated the number of on-going traditional PPM installations.

5.50. These stakeholders said that, in aggregate, we have understated the net cost of smart PPM. Stakeholders also said that we should gather more data on the costs and benefits of smart meters in prepayment mode to inform our analysis.

5.51. We will consider changes to our assessment of costs and benefits in our updated proposals and reflect these in updated proposals where necessary. Generally speaking, we consider the Annual Supplier Returns to capture the major costs and benefits

sufficiently, but will discuss with BEIS if refinements or supplementary information is required.

Historic PPM rollout progress

5.52. Four stakeholders said we should not assume that PPM and credit installations occurred at the same rate historically, and that we should use the Annual Supplier Returns (ASR) data to calculate the specific values for PPM. Stakeholders also said that, if we were to do this, we would see that the rollout of smart meters in prepayment mode is significantly behind that of credit (proportionally).

5.53. To determine if historical PPM rollout is proportionally equivalent to historical credit rollout, we have analysed Annual Supplier Returns (ASR) data from BEIS that show installations by payment type.

5.54. This data is not directly comparable to the profile on market wide progress, because it:

- does not go back beyond January 2016;
- is for large suppliers only;
- is not split by fuel type.

5.55. Nonetheless, taking these limitations into account analysis of this data suggests that the PPM smart rollout is not significantly behind credit, and has been ahead in some years (see Table 5.2).

Table 5.2: Proportion of mandated rollout complete

	2017	2018	2019
Single average rollout profile (from BEIS smart meter statistics)	19.0%	28.4%	37.3%
PPM weighted average (ASR sample) profile	24.3%	34.0%	38.6%

5.56. A decision on whether to use a PPM specific profile is superseded by our contingency decision. Nonetheless, we will consider whether to use a specific PPM rollout profile in

our updated proposals. We suspect the issue is not that the progress of the PPM rollout is significantly different to the credit rollout *in general.* It is not.

5.57. The real issue appears to be that, as we said in our May 2020 consultation, that the *variation* in suppliers' progress installing smart meters in the homes of their PPM customers varies around the average progress substantially, and to a greater extent it does for credit customers. Individual suppliers have made less progress with their PPM rollout, rather than the market as a whole. Understandably, suppliers know their own situation, but that does not mean that their own situation, even if they are a very large supplier, is representative of others' position, individually or in aggregate.

5.58. That variation creates difficulties. We must set a single allowance for all suppliers. And we must consider the impact of our proposals on all suppliers and customers. In that circumstance, we cannot set an allowance that provides the optimum circumstances for each stakeholder considered in isolation.

Forecasting future performance and targets

5.59. Four stakeholders noted that the new rollout Framework, published in June 2020, would have an effect on the forecast component of the rollout profile in the SMNCC (this applies to both PPM and credit models).

5.60. The SMNCC model requires a forecast of installations for future years.

5.61. In prior versions of the SMNCC, this forecast was taken from the BEIS 2019 CBA. Historical supplier rollout performance is now incompatible with the forecast rollout profile in the 2019 CBA, so a different forecast profile is required.

5.62. In our May 2020 consultation, we proposed to set the rollout profile for each type of meter in 2020 at 30% of the average annual installations between 2017 and 2019 (to approximate the impact of COVID-19), and at 100% of that level in 2021 and subsequent years.

5.63. Since the publication of our May 2020 consultation, BEIS published the new Framework, which comes into force on 1 July 2021 and targets market-wide rollout by mid-2025.

5.64. We have therefore included this in our decision on the level of the default tariff cap for credit customers.

5.65. However, for PPM this issue is superseded by our contingency decision. We would expect to take the same approach for the PPM non-pass-through SMNCC from 1 October 2021. As discussed above, suppliers should note that the risk of underperformance against the rollout profile target differs from credit. For most suppliers, efficiently installing a smart PPM is a net benefit, and therefore if a supplier installs fewer PPMs than the rollout profile implies, their efficient costs (all other things being equal) will be higher.

6. Next steps and reviews

Transition from the PPM cap

Issue

6.1. The CMA's PPM cap will expire on 31 December 2020. In response to our March 2020 and May 2020 consultations, suppliers and consumer groups sought to avoid a mid-cap period price update, as price changes on the 1 January 2021 would cause disruption for suppliers and customers.

6.2. In our May 2020 consultation we proposed introducing changes to the default tariff cap with effect from 1 October 2020, which required a CMA direction for us to end the existing prepayment cap early. We discussed, and proposed rejecting, an alternative option to introduce the changes with effect from 1 January 2021, due to the disruption a mid-period price change would entail (if we set the cap level using a methodology that differed from the current PPM cap).

Our decision

6.3. We have decided to modify the licence conditions to introduce a PPM level to the default tariff cap in time for cap period five (1 October 2020). As the PPM cap level and the default tariff cap level for PPM customers will be the same, the CMA will not issue a direction.

6.4. As set out in Section 3 of the Act, PPM customers on default tariffs will still be exempt from the default tariff cap until the existing CMA prepayment cap expires.

6.5. On 1 January 2021, PPM customers on default tariffs will be protected by the default tariff cap, paying prices at the same level they did in the previous three months.

Rationale

6.6. We want seamless coverage from the CMA prepayment cap to the default tariff cap on 31 December 2020. We do not think that the mid cap period expiry will cause any disruption or administrative burden for customers as the cap levels are identical for the

October 2020 cap period. For this reason, the CMA is not issuing a direction to end the current prepayment cap early.

Considering stakeholders' views

Initiation of contingency

6.7. Five suppliers supported a single price for the cap five period, with no mid-period price change, due to the administrative costs and risk of confusing customers with multiple price changes. Some of these suppliers supported the methodology changing to the default tariff cap in October 2020 to support this outcome.

6.8. As we are applying a contingency position of setting the non-pass through SMNCC to zero, there is no mid-period price change. As such the expiry of the existing PPM cap mid cap period will not cause any disruption or administrative burden for customers or suppliers. Consequently, the CMA is not issuing a direction to end the current prepayment cap early and so this will remain in force until 31 December 2020. The default tariff cap will apply to PPM customers from 1 January 2021.

Changes to our draft licence modifications

6.9. In our May 2020 consultation, we published a draft notice of proposed modifications to SLC 28AD of the electricity and gas licence conditions. The purpose of the modifications is to introduce a PPM payment method to the default tariff cap.

6.10. One supplier commented on our proposed modifications. They stated that where we had defined "Prepayment" as "a Payment Method whereby a Domestic Customer pays the licensee for Charges for Supply Activities through a Prepayment Meter or a Smart Meter running in Prepayment Mode", we had referred to Smart Meter as a defined term but not expressed the definition in the draft licence conditions.

6.11. We have now amended the definition of "Prepayment" to "a Payment Method whereby a Domestic Customer pays the licensee for Charges for Supply Activities through a Prepayment Meter or a Smart Metering System running in Prepayment Mode". Smart Metering System is a term that we have already defined and used in the supply licence conditions. We believe that using a defined term provides additional clarity to the modified license condition.

Reviewing the PPM cap

Our decision

6.12. We will update the PPM cap, in line with the methodology set out in the licence every six months. The schedule will be the same as the existing schedule for the default tariff cap and the PPM cap. We will announce a winter cap period on the fifth working day of August, effective from 1 October. We will announce a summer cap period on the fifth working day of February, effective from 1 April.

6.13. We will introduce a new PPM-specific non-pass-through SMNCC methodology, following consultation, in order to set the seventh cap period, starting on 1 October 2021. That consultation will consider:

- BEIS' decision on the autumn 2020 consultation on its new Framework;
- latest data on costs, benefits, and suppliers' progress as set out in the Annual Supplier Reports (ASRs), including the impact of COVID-19 on smart meter rollout;
- the effects on rollout performance of basing the SMNCC on an average rollout profile, and the impact on consumers if some suppliers reduced their rollout as a result of the SMNCC level.

6.14. We will review the PPM non-pass-through SMNCC every 12 months, using the latest ASRs, adjusting the SMNCC to deduct any advanced payments between 1 January 2021 and the cap update in question (from 1 October 2021).

Considering stakeholders' views

Frequency of reviewing the PPM non-pass through SMNCC

6.15. Our May 2020 consultation proposed annual reviews of the SMNCC, one in 2021 and another in 2022 as our preferred option. An alternative was a one-off review in 2020.

6.16. All stakeholders who commented on our May 2020 consultation supported reviewing the SMNCC at least once. Three stakeholders want a one-off review. They argued that further reviews increased budget uncertainty for operational planning, and increased

financial risk on already incurred expenditure due to the interaction with carry forward. Five other stakeholders supported our consultation proposal of reviewing every 12 months, to be more accurate.

6.17. We consider that, as we are applying contingency until October 2021, we should align the next review to this timetable, i.e. for the results to be implemented for cap period seven. This also aligns to reviewing the credit SMNCC.

6.18. We consider that there are clear benefits for a further review in time for October 2022, i.e. for the results to be implemented for cap period nine. In particular, it allows for an additional year of data to be used in setting the allowance, improving accuracy, for example if rollout diverges from expectations or efficient costs change materially over time.

6.19. Some suppliers would prefer us not to review the SMNCC more than once, as certainty about future SMNCC levels provides greater stability for their business planning. We consider that benefit is not an overriding one. First, we consider it important that we can review and update the SMNCC having regard to whether efficient aggregate costs and the allowance (i.e. the amount that suppliers as a whole can charge to recover those costs) remain broadly consistent with each other. If suppliers substantially under-recovered their efficient costs (as a group), or customers paid substantially more than the efficient costs of the rollout, then we would likely decide to adjust the allowance.

6.20. Secondly, in setting the SMNCC we seek to cover efficient costs over the lifetime of the cap. Deviations between the allowance and costs in a specific cap period may be entirely acceptable in that context. Overall, we do not at present consider that considerations of the effect on short-term or medium-term operational or financial planning should prevent us setting the SMNCC at a level which properly reflects the costs of the rollout.

The scope of reviewing the PPM non-pass through SMNCC

6.21. In May 2020 we proposed limiting the scope to updating the smart meter rollout profile and updating data from the latest ASRs. We listed specific items we expected to update. Several stakeholders wanted a wider scope than we proposed. Some advocated consulting on the scope.

6.22. We consider that it would be disproportionate and unnecessary to re-open the entire SMNCC every time we conduct a review. In normal reviews, we intend to update the inputs to the SMNCC model that have a large impact and are sensitive to changes. Of course, if circumstances occur that mean other inputs, costs, or benefits have become material or sensitive unexpectedly then we will consider those at that time. For illustration, the impact of COVID-19 on costs and benefits would have been unforeseen in advance. We cannot, and do not, rule out adjusting the scope if changed circumstances require it.

6.23. Our next review will have a wider scope. We intend to:

- consider latest data, from the ASRs including the impact of COVID-19;
- consider latest policy announcements, including government's decision on its autumn 2020 consultation on its new Framework;
- consider an alternative methodology in order to reflect the aggregate costs of the rollout; and
- consider the impact on customers of setting the SMNCC in lines with the average (and therefore aggregate) costs of the rollout.

Other reviews

Our decision

6.24. Our May 2020 consultations stated that clear, material, unforeseen errors that necessitate changes to protect customers should be corrected, including retrospective corrections. In addition to COVID-19 (discussed above), we also stated we may review the ECO allowance.

6.25. Several suppliers considered that we should review the cap level as a whole, citing that many suppliers had published financial statement showing losses across their business. One supplier stated that any review of ECO should include a reassessment of costs, which it states have increased.

Considering reviews in principle

Clear systematic material errors

6.26. We maintain the principles that we set out in our November 2018 decision in relation to whether reviews are needed, as explained and elaborated in this chapter.

6.27. We do not consider it is in customers' or suppliers' interests to rule out reviews. In the case that clear systematic material errors occur, these would disadvantage either suppliers or customers (depending on the direction of the error).

6.28. In our November 2018 decision, we did not rule out the possibility of carrying out reviews or making corrective adjustments. We indicated that we would not usually make corrective adjustments for ordinary forecast error. This did not preclude us from making adjustments for serious and systematic errors, as we made clear. Furthermore, we did not exclude the option to identify specific types of errors in future and give notice that they might be subject to review.

6.29. We stated in our November 2018 decision that we did not intend to review the cap, but would do so if there were specific systematic errors that were unforeseen, clear, material, and necessitated changes.[52]

6.30. In our November 2018 decision we considered that scheduled reviews could undermine suppliers' incentives to improve their efficiency. We still consider this to be the case. The net impact of changes to minor cost categories (such as changes to individual line items within suppliers' operating costs) and the long-run impact of non-systematic volatility (such as wholesale demand forecasting) are judgemental and uncertain. Detailed and frequent adjustments could undermine incentives to improve efficiency and fail to protect consumers.

6.31. In our November 2018 decision we considered that we would not review or correct forecast errors. We considered these were uncertain, judgemental, and would net out in the long-run where error was non-systematic. We still consider this to be the case,

[52] Ofgem (2018), Decision – Default tariff cap – Overview document, paragraph 3.16. https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document_0.pdf

but recognise that not all forecast errors have impact of that kind. We still consider that clear, material, unforeseen errors that necessitate changes to protect customers should be corrected, including retrospective corrections.

Considering issues in the cap that we should review

6.32. The future pace and cost of the smart meter rollout is highly uncertain. This increases the chances that the SMNCC is clearly, materially, and systematically misstated. In response to our consultations on the credit SMNCC, most suppliers have suggested that reviews will be inevitable. We consider that frequent reviews of net smart metering costs are necessary to protect customers and have regard to suppliers' efficient costs.

6.33. We consider that other aspects of the cap may need to be reviewed, not just the SMNCC. We highlight areas where we are considering, or have committed to, further reviews below.

6.34. It is not always clear cut if and where a review is necessary. However we seek to consider the issues and reasons for reviews in fair and unbiased ways. Reviews are subject to consultation, giving stakeholders an opportunity to consider and scrutinise our proposals.

Impact of COVID-19 on suppliers' other costs

6.35. Suppliers have likely incurred additional costs due to COVID-19. This is an unforeseen event that may have clear material net costs.

6.36. We have previously committed to reviewing the impact of COVID-19 on suppliers' bad debt costs, and include a retrospective adjustment in the cap from 1 April 2021, if suppliers' efficient bad debt costs have materially increased.

6.37. In our May 2020 consultation we noted that disruption to ECO (a programme requiring suppliers to install insulation in certain customers' homes) would likely mean that the allowance suppliers receive to install insulation in a certain number of properties would exceed actual costs. We were we to review the allowance we would consider what information we needed in order to make the assessment of costs suppliers have actually incurred, compared to the allowance for ECO.

6.38. Suppliers have raised other areas of the costs affected by COVID-19, including policy costs such as feed-in-tariffs. The fall in non-domestic energy demand has meant that the charges we include in the cap have not matched the costs to suppliers. When non-domestic energy demand returns there should be the same effect in reverse. We may need to review the net impact of this misalignment between the allowance and costs.

Market conditions

6.39. Several stakeholders have suggested that we review headroom and the financeability of the suppliers, since the cap was introduced. For instance they indicate that most of the large suppliers affected by the cap have reported losses in their Consolidated Segmental Statements.

6.40. The combined pressure of price protection for default tariff customers and suppliers offering less profitable competitive tariffs, set below the level of the cap, is proving a significant challenge. This issue is broader than the price cap alone, and we continue to monitor it closely.

6.41. Some suppliers have also raised concerns that the mutualised costs of supplier failures may increase this winter, and require additional allowance in the cap. The extent and cost of supplier exits is difficult to establish in advance. We will assess the impact of mutualised costs that occur, and will consider what action is appropriate if it rises above the level experienced in previous years.