Energy UK

The voice of the energy industry

Ofgem
10 South Colonnade
London
E14 4PU

18th May 2023

Dear Price Protection Team,

We are writing to you in response to Ofgem's Call for Evidence on the levelisation of payment method cost differentials.

Whilst there is a degree of judgement behind any decision to levelise tariffs across different payment methods, it is important to establish principles for those decisions. We believe there are three important principles that could be applied.

- Levelising the tariffs should align with broader social/regulatory objectives. This is clearest with smart prepay and direct debit levelisation.
- It should only be done if it results in incentives that will be net positive or net neutral from a system perspective. This is important for an intentional approach to cross-subsidisation as well as to address any unintentional poor cost reflectivity that could create supplier incentives contrary to consumer interests via the planned Opex Review. This is to ensure that suppliers are incentivised to compete for and serve all customers in the way that provides positive outcomes for all customers[1].
- The costs should be recovered fairly in a way that doesn't result in market distortions that adversely impact competition.

Supporting the case prepayment levelisation

Overall, against these principles, we think that there is a strong case for levelising prepayment and direct debits tariff caps because it would be a broad socialisation of costs associated with a desired market outcome that enables all customers to have access to tariffs that supports customers in their close control, monitoring and budgeting of costs without a cost premium. However, further uncertainty around cost recovery risks delaying suppliers' ability to offer fixed term offers and boost competition in the market.

Customers that want prepayment because it supports their preferred accessibility and engagement needs shouldn't have to pay a premium for such a reasonable accommodation. There are few risks to this approach because the costs of a customer paying for their energy through smart prepayment are similar to that of direct debit.

Levelisation would also align to desired market outcomes by encouraging access to better supplier support for customers which can be achieved through smart prepayment. Smart prepayment offers the unique capabilities of monitoring top-ups and a route to promptly provide discretionary credit or do-not-disconnect options. This will improve customer service outcomes in the energy market relative to customers remaining on other payment types.

[1] There is some concern from members that the standard credit uplift has deviated from a cost reflective estimate of the additional cost to serve.

Cumulatively, the incentive effect of levelising PPM and DD tariffs will not result in significant direct system cost increases. Over time, it will support better customer engagement which may reduce suppliers' overall costs to serve customers in financial difficulty that were previously on other payment types. However, given the levelized tariffs will not reflect the supplier's cost to serve per PPM customer, most, but not all suppliers agree that a reconciliation process is needed.

Rejecting the case for standard credit levelisation

Far from being applied to Standard Credit (SC), the levelisation of PPM and direct debit tariffs should prompt wider reflection on the role of standard credit as a payment method in the market. Unlike PPM, the ability of the SC payment method to provide additional functionality or customer control is negligible and there may be more effective ways to achieve similar system outcomes for these customers. As a result, the value of requiring suppliers to maintain SC appears likely to be increasingly limited.

There are significantly higher costs to serve standard credit customers relative to prepayment, and this differential should be accurately reflected in tariffs. A significant part of this is debt accrual which is a major industry issue. To further incentivize standard credit beyond the current cross-subsidy of debt between standard credit and direct debit by offering below-cost reflectivity risks higher system costs for all customers through higher bad debt.

There does not seem to be a clear service benefit for encouraging further use of standard credit as a payment method. Although some customers may like it, the actual service value it provides is low and the cost to provide it is high. We would expect to see consideration of standard credit levelisation based on a view of the energy system cost and customer benefit or loss that could be achieved over time. Unlike with PPM levelisation, this is not clearly a positive overall system value or aligned to desired market outcomes.

Costs

Most, but not all, of our members think that the levelisation of tariffs will require some degree of cross-subsidy between payment types which will affect different consumers and suppliers differently. This outcome could be avoided through taxpayer funding. Whatever approach is taken, it must be based on an accurate reflection of costs to serve customers and Ofgem's Opex Review is an opportunity to ensure that suppliers are incentivised to gain and operate all customers in the way that provides them with the best service.

If any cross-subsidy is required, then all customers, and therefore all tariffs types should contribute to the cost of levelisation, this will need to be done in a way that seeks to minimise market distortions. As a change which is designed to deliver an overarching desired market outcome, there is no rationale for a subsection of the market to bear the cost. This is important as more customers move onto fixed tariffs, which should be the sign of a competitive market offering value to consumers. It would unfairly narrow the pool of cost recovery if that recovery were limited to the default tariff cap. Please see our response to debt recovery consultation on how a mechanism for cost recovery should attempt to limit market distortion.

Please do get in touch if you would like to discuss this response in further detail.

Kind regards

Ed
Senior Policy Manager, Energy UK