Octopus Energy
UK House,
164-182 Oxford Street,
London W1D 1NN
w: octopus.energy
e: hello@octopus.energy
p: 0808 164 1088

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By email: priceprotectionpolicy@ofgem.gov.uk

Response to Ofgem's call for evidence on levelisation of payment method cost differentials

Dear Sabreena

We **strongly welcome Ofgem taking steps to review the significant and growing price cap uplift for standard credit customers,** as we have been requesting. The standard credit uplift is well in excess of the cost to serve differential and is causing harm to some of the most vulnerable customers in society, with 28% of those paying in this way being over the age of 65. The current situation also - intentionally or not - favours suppliers with a relatively large proportion of standard credit customers, which are likely to be legacy suppliers. Reviewing this is an important way that Ofgem can support customers through the affordability crisis.

We also welcome the changes UNC modification 0840 will make to prepay pricing but we think that **any assessment of prepay price differentials should be firmly anchored on the cost of smart prepay.** Smart prepay is a better customer experience and does not have the same cost to serve issues as legacy prepay which are driven by legacy infrastructure. We urge Ofgem to set a clear end date for winding down of legacy prepay infrastructure.

In implementing any levelisation, however, we **strongly oppose any supplier levy or reconciliation mechanism to deliver this. Any such reconciliation is fraught with moral hazard.** Such a mechanism should also be avoided to "compensate" individual suppliers that have higher than average levels of per customer bad debt. It will severely damage the incentive on suppliers to encourage their customers off standard credit, to contain any additional costs associated with serving standard credit or prepay customers and/or to replace legacy prepay with smart prepay. It ignores steps that are in suppliers' control to address payment methods used by customers - and any additional costs associated with those payment methods. It ignores the errors in the current price cap differentials and the opportunity this exercise provides to improve the cost reflectivity of the price cap for different payment types. Further detail on the issues with reconciliation is set out in our response to the recent *Call for Input on the price cap allowance for debt-related costs*.

This paper sets out our initial reactions. We note, however, that we have had limited time to formulate our views in detail given the short number of working days allowed and overlap with numerous other Ofgem consultations. We would appreciate the chance for further engagement.

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It is crucial that this exercise is not seen in terms of a “social” obligation that disrupts a “perfect” set of relative price caps to solve an apparent unfairness to consumers. In response to this Call for Input, Ofgem will likely hear that the current approach to payment method levelisation is accurate, but that the payment differential is perceived as being unfair and that “perceived unfairness” is the problem. We disagree with this framing of the problem. **Fixing payment differentials is not only a matter of unfairness to consumers. It is a problem of the current approach being inaccurate / not cost-reflective and therefore misaligning incentives between suppliers and customers.**

With this in mind, we think Ofgem should take the following steps:

1. **The payment differential between standard credit and direct debit should be narrowed very substantially**. The uplift for standard credit customers has crept up in the price cap and is no longer cost-reflective. Under the cap, these customers can be charged ~£200 more than direct debit customers, whilst we consider a more cost-reflective figure may look more like ~£80 (which is how we have priced our tariff). The uplift is now effectively a profitable premium for suppliers who price in line with cap. Our research has shown that 75% of customers who pay in this way do not realise they are being charged much more than direct debit customers (see **Annex I**). The inflated standard credit price cap actually provides a perverse incentive on suppliers to keep customers on a less efficient and customer-friendly payment method. This issue - effectively a hidden “loyalty penalty” as SC customers are often those who have never switched supplier - must be addressed. This behaviour is particularly egregious in a cost of living crisis which has seen more customers switch to standard credit to have “control” over their payments, only to be put on higher rates by suppliers who then benefit from those higher rates.

   When setting this differential, we urge Ofgem to remember that the current price cap payment uplifts are not precise, “gold standard” benchmarks. Allocating costs to different payment types is an art not a science. This is especially the case for bad debt, which is a very difficult to calculate cost category spread across the price cap.

2. **The payment differential between standard credit and direct debit should <u>not</u> be removed altogether.** There is a higher cost to serve for standard credit customers compared to direct debit customers. Retaining a differential is accurate and provides suppliers with a clear incentive to encourage their customers off standard credit and onto direct debit or smart prepay. Both these payment arrangements are better for customers because they help customers avoid falling into debt - customers who miss one payment are then more likely to miss another payment as they fall behind and can't afford to recover. In addition, these methods help lower and contain overall systems costs. Our own experience is that highlighting the higher cost to consumers does prompt a change in behaviour. For example, in September last year we reviewed our prices and made direct debit SVT cheaper than

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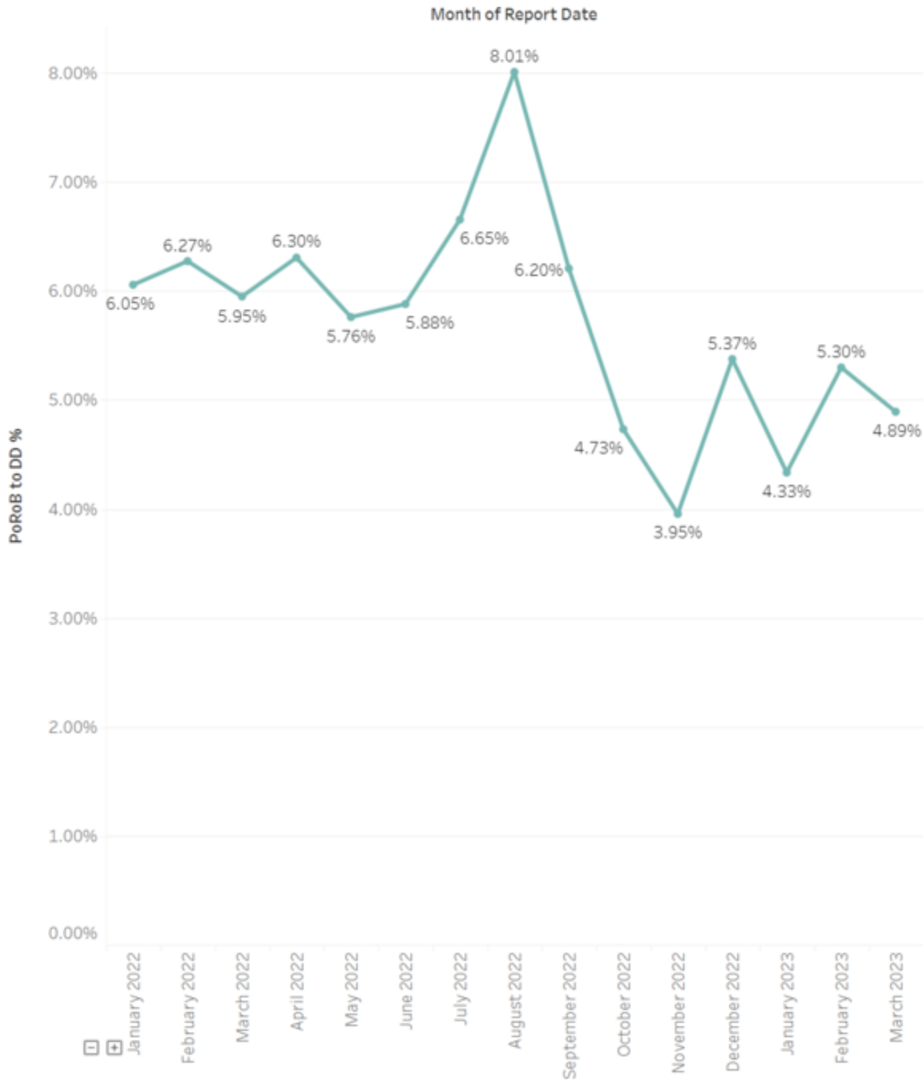
other payment methods (a change we had previously held off). At the point we informed customers that non-direct debit prices would be £80 higher we saw a surge in customers setting up a direct debit. See **Chart 1** below.

Chart 1: % of Standard Credit Customers setting up Direct Debit



Source: Octopus Internal Data

3. **The differential for prepay should be set on the basis of smart prepay cost to serve, rather than legacy prepay costs to serve.** This mechanism will again encourage suppliers to replace legacy prepay meters with smart prepay. Legacy prepay meters offer a poor customer experience, are more costly to run and do not allow us to monitor self disconnections and help customers struggling to afford the

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energy they need. We are removing approximately 600 legacy prepay meters a month in favour of smart meters. We applaud the commitment to "smart by default" in the new Code of Practice on involuntary prepay and urge Ofgem to take this further by doing all you can to enforce the "new and replace" licence obligation and setting a clear end date for winding down legacy prepay infrastructure.

4. **No supplier levy or reconciliation process is necessary to facilitate this correcting of the payment method cost differentials.** Any reconciliation mechanism is fraught with moral hazard. It assumes that the customer payment portfolio of suppliers is an exogenous variable which suppliers have no control or influence over. It is not. As our own data shows (Chart 1 above), suppliers have the ability to influence the payment methods that their customers choose. Ofgem should be aiming to incentivise suppliers to communicate with - and take other measures - to encourage their customers onto payment types which are cheaper and better for the customer and for the system as a whole. **Ofgem should also consider investigating what suppliers with a large % of standard credit customers are doing to offer those customers an alternative, cheaper way of paying, such as direct debit, and thereby reduce their potential standard credit costs to serve.**

   Ofgem assumes that levelisation will make the allocation of costs across payment methods less accurate, and that there will be winners and losers across suppliers. Our view is that the current price caps no longer reflect a defensible view of differences in cost to serve and correcting these errors is vital - but does not warrant a supplier reconciliation process. Reconciliation/levy type processes are appropriate where the problem being solved is an exogenous cost (such as is the case with the Green Gas Levy or the Feed-in Tariff), or is making tariffs less cost reflective. This is not the case with payment method cost differentials. Ofgem should be very careful to avoid this category error.

Yours sincerely

Alexandra Meagher
Group Head of Regulation

Responses to questions in the Call for Evidence

Question 1: What do you think the objectives of levelisation should be (e.g, full levelisation across payment methods, partial levelisation, anything else)?

The objectives of levelisation should be to ensure that: (i) payment method differentials are accurate and cost-reflective of the technology that best meets customers needs; and (ii) suppliers incentives align with customer and system needs. In particular, suppliers have a

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clear incentive to encourage their customers off payment methods like standard credit and onto better and more efficient payment methods like direct debit or smart prepay.

In practical terms, we think this means lowering the payment differential between standard credit and direct debit, and ensuring that any payment differential for prepay is based on smart prepay cost to serve. Further details are set out in the cover letter.

Question 2: Should we only focus on prepay levelisation or should we also consider standard credit?

We strongly welcome Ofgem taking steps to review the significant and growing price cap uplift for standard credit customers, as we have been requesting. The current standard credit uplift is well in excess of the cost to serve differential. A large part of the cost differential is associated with the bad debt costs that come with standard credit customers which apply at a portfolio level, but not always at an individual customer level. Not all customers that pay by standard credit are 'bad payers' and may be amenable to paying in an alternative way - it is within the control of suppliers to explore this as a way of reducing the cost.

The inflated standard credit price cap actually provides a perverse incentive on suppliers to keep customers on a less efficient and customer-friendly payment method. This issue - effectively a hidden "loyalty penalty" as SC customers are often those who have never switched supplier - must be addressed. Our research has shown that 75% of customers who pay in this way do not realise they are being charged much more than direct debit customers (see **Annex I**). This behaviour is particularly egregious in a cost of living crisis which has seen more customers switch to standard credit to have "control" over their payments, only to be put on higher rates by suppliers who then benefit from those higher rates - and decline to tell their customers.

When setting this differential, we urge Ofgem to remember that the current price cap payment uplifts are not precise, "gold standard" benchmarks. Allocating costs to different payment types is an art not a science. This is especially the case for bad debt, which is a very difficult to calculate cost category spread across the price cap.

Question 3: If standard credit is included in levelisation, should some degree of price difference remain, whereby standard credit is higher than direct debit to maintain an incentive for customers to go on direct debit?

Yes. A price differential is a valuable incentive to encourage customers onto direct debit which is generally better for customers and has lower system costs overall. Our own data (see Chart 1 above) shows that when an accurate price difference between payment differentials is communicated clearly to customers, customers will respond by moving to direct debit.

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However, this price difference should be considerably lower than it is at the moment. In our own pricing, we have considered it fair to keep the standard credit difference at £80 - in line with the original uplift. Ofgem should be sceptical of inflated claims about the cost of serving standard credit customers.

Question 4: After considering the different levelisation options presented (charge type, individual elements of the price cap, extent to which levelisation should occur), are there any further levelisation options that you think should be considered?

No. However, we would like Ofgem to look again at the cost to serve of smart prepay customers and consider the overall reduction in system costs that should be achieved through the industry-wide move to smart prepay. This is distinct from levelisation - i.e where a fixed amount of costs are being recovered from DD customers rather than from prepay customers. This could be addressed through Ofgem's planned call for input on operating costs allowance in the price cap.

Question 5: Can you provide any evidence on why one levelisation option should be preferred over another?

Options which reduce the unit rates for standard credit and which levelise the standing charges of prepay and direct debit seem to have merit and be worth further consideration. As Ofgem takes these options further, we ask that a pragmatic and common sense approach is taken, recognising that the current cost estimates and allocation methods between payment methods are themselves approximations.

We think option C1, C3 and C5 should be ruled out. Options C1 and C5 make so little difference it does not seem worth changing the price cap methodology. C3 harms prepay customers and is not justified given the lower cost to serve for smart prepay customers. C2 and C4 appear to be options worth further consideration.

Question 6: Can you provide any evidence of levelisation effects that should be avoided that have not been shown within our analysis?

No.

Question 7: What are your views on targeting levelisation to particular groups of customers within payment methods (eg customers under the price cap or in vulnerable situations)? Do you have evidence to support your views?

As above, we don't see this as a social obligation exercise, but one of getting more cost reflective and incentive - positive price cap in place. So the levelisation shouldn't be targeted to specific customer groups. Bill support (a social intervention ideally tax-payer funded) should be targeted to be efficient but this is a different issue altogether.

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Question 8: Given the distributional impacts analysis provided above, what is your view on the benefits to consumers on the levelisation of payment methods?

The impact analysis shows that option C3 is not a credible approach, given the relatively significant detriment to prepay customers and particularly those in lower income brackets. We note that all options do have a disproportionately disadvantageous impact on lower income DD customers, given the ratio of energy costs to income. If this levelisation goes ahead there is further argument for targeted bill support for the poorer households.

Market competition and incentives

Question 9: Do you agree with our characterisation of the effects on competition? Can you explain why or why not?

Question 10: Are there any additional impacts on competition or other areas that we should consider? Can you provide evidence of these?

Question 11: Do you agree with our assessment on market competition and incentives? Can you explain why or why not?

Question 12: Are there any other impacts on your organisation or the market that we have not considered?

Overall, Ofgem's analysis of the effect of levelisation on competition tends to overstate the cost reflectivity and accuracy of the current price cap levels for different payment types. As noted above, we consider that the current standard credit uplift in particular has increased far beyond the point of being credible. And in the case of prepay, the cost differentials have been anchored on legacy prepay where now smart prepay should be the norm. These inaccuracies are already distorting competition and creating winners and losers. For these reasons, we would see the levelisation exercise as being a correction to an methodology that has become divorced from actual cost differentials. If this is the case, levelisation would be good for competition - making sure that suppliers do not benefit simply by virtue of being able to charge excessive prices to their standard credit or prepay customers.

We further note that any supplier wanting to enter the market to specialise in prepay will do so on the back of smart prepay technology (not legacy) and so the proposal to anchor the prepay price cap on smart costs should not disrupt the incentive to enter this part of the market. We think there should continue to be an uplift charged to standard credit customers - just one that is much lower than the current £200 uplift - and this will provide space for

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companies to provide below price cap standard credit tariffs, if they wish, when the market for acquisition tariffs starts again.

Ofgem's analysis is static and has not considered how suppliers might encourage their customers to switch away from standard credit onto direct debit or prepay in the event that the price cap made it harder to recover the cost of serving these customers.

Finally, we would like to see Ofgem's analysis evolve to reflect more realistic characterisations of the various customer portfolios across the large players in the market. We note that Octopus Energy (now with Bulb customers in the portfolio) has [redacted] of its customers on standard credit. We are not aware of any large supplier that has 90% of its customer base on standard credit (as Ofgem has assumed in its supplier typology),with perhaps the norm amongst legacy suppliers being more like 30%[1]. In reality, with lower portfolio differences across suppliers than Ofgem has assumed, the scale of "winners and losers" will be reduced - noting that in any case the current situation is already favouring suppliers with a relatively large proportion of standard credit customers.

Question 13: If costs are not reconciled, what would the impact of payment method levelisation be on your organisation, where relevant?

As set out in response to question 14, we strongly oppose the setting up of any supplier levy or reconciliation mechanism to deliver levelisation of payment method cost differentials. Any such reconciliation is fraught with moral hazard.

If there is market-wide levelisation, we do not see a specific impact on our customers as we have tried to price fairly rather than being driven by Ofgem's price cap. For our standard credit and smart prepay tariffs, we already price below the price cap. We charge only a small uplift (~£80, below the price cap level of ~£200) for standard credit customers already as we do not think the current uplift is justified. Even before UNC Modification 0840, our prepay tariffs were the lowest available to existing customers.

Rather, we think there will be benefits for the customers of other suppliers who will finally be offered lower, more cost-reflective pricing and have suppliers who are incentivised to engage with them.

Question 14: Do you consider that the costs of levelisation should be reconciled between suppliers? What are your views on the reconciliation mechanisms presented?

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[1] According to BEIS data, as of December 2022 17% of electricity and gas customers across GB were on standard credit, with the highest proportion found in London where 25% are on SC. We would be surprised if any supplier had significantly more than 30% of their customers on SC. [Percentage of domestic gas customers by region by supplier type (QEP 2.5.1)]

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No, we strongly oppose the setting up of any supplier levy or reconciliation mechanism to deliver levelisation of payment method cost differentials. Any such reconciliation is fraught with moral hazard. Such a mechanism should also be avoided to “compensate” individual suppliers that have higher than average levels of per customer bad debt.

First, a reconciliation mechanism will severely damage (and possibly eliminate) the incentive on suppliers to encourage their customers off payment methods that have a higher cost to serve, such as standard credit. Suppliers have the ability to influence the payment methods their customers choose - our own data in Chart 1 is an example of that. Ofgem should be aiming to incentivise suppliers to encourage their customers onto payment types which are cheaper and better for the customer and for the system as a whole. A reconciliation mechanism undermines this.

Secondly, a reconciliation mechanism also undermines the incentive on suppliers to contain any additional costs associated with serving standard credit or prepay customers and/or to replace legacy prepay with smart prepay. Once again, this assumes that these costs are out of the control of suppliers when this demonstrably is not the case.

Further detail on the issues with reconciliation and the ways suppliers can control their debt costs is set out in our response to the recent *Call for Input on the price cap allowance for debt-related costs*.

Question 15: Are there any other reconciliation mechanisms that you think we should consider that we have not discussed?

Reconciliation is a very bad idea for the reasons set out in response to question 14.

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Annex 1: Octopus research into customer awareness of SVT standard credit charges

See further in this Octopus Energy press release, 30 January 2023.

The extra charges for paying by cheque, cash or card:

	Premium for non-direct debit	Excess charge compared to original Ofgem calculations from 2019
Octopus	£80	-£1
Typical energy supplier	£254	£173
Ofgem price cap allows 2019	£81	£0
Ofgem price cap allows 2023	£254	£173

Octopus Survey Results:

*75% of customers think that paying by cash, cheque or credit saves money or is the same as paying by direct debit – but in reality it's £254 more expensive for the average typical household on the new cap.

Older people are particularly affected, with 28% of people who pay on receipt of bill being aged 65 and over:

Age group	% of customers who pay on receipt of bill
25-34	19%
35-44	19%
45-54	16%
55-64	19%
65+	28%

Research carried out by Google commissioned by Octopus Energy on 7th April 2022 based on a sample size of 19,909 UK adults. Total number of 'Pay on Receipt of Bill' customers taking part in the survey: 1,537.