



24 May 2023

By email only

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Dear Sabreena,

Levelisation of payment method cost differentials – Call for Evidence

We support the principle of levelisation to mitigate the customer impact of better reflecting the different efficient costs suppliers incur when supplying different types of customers. It is essential that any levelisation is accompanied by robust reconciliation amongst suppliers to avoid distorting competition.

There are various costs that differ for each type of customer. Payment method is an example of a differentiator, and the only one currently reflected in the price cap methodology, but there are many more. We are concerned that Ofgem's work outlined in this Call for Evidence is based on the outcome (i.e. price level) of the current price cap methodology and an assumption that the cap's payment method differentials are cost reflective. Similarly, we are concerned that Ofgem views cost differentials for anything other than payment method as predominantly due to efficiency factors only. As we illustrate throughout our response, neither of these assumptions is correct and the value of levelisation and reconciliation is undermined by them.

Ofgem has already compromised the cost reflective payment differentials in the cap to limit the impact on customers, effectively introducing implicit levelisation already. To give two examples:

- When originally designing the cap and setting the price cap level for standard credit customers Ofgem said: *"We do not allocate all additional costs to standard credit customers.... there is not a strong case that only standard credit customers should be required to carry all of the additional costs."*¹
- Ofgem's decision on the true-up process for Covid 19 bad debt costs in February 2023 found evidence that costs were *"likely to be significantly greater for standard credit customers"*, but Ofgem ultimately decided to split the price cap allowance across DD and standard credit customers to *"avoid significantly increasing standard credit customers' bills who are more likely to be vulnerable...."*²

Whatever the rationale for these decisions and others like them, they have already created the competitive distortions Ofgem discusses as a potential consequence of its proposals.

¹ <https://www.ofgem.gov.uk/sites/default/files/2023-02/Price%20cap%20-%20Decision%20on%20the%20true-up%20process%20for%20COVID-19%20costs.pdf>

² <https://www.ofgem.gov.uk/sites/default/files/2023-02/Price%20cap%20-%20Decision%20on%20the%20true-up%20process%20for%20COVID-19%20costs.pdf>

The design of the current price cap exacerbates the competitive distortion that levelisation and reconciliation attempts to address. The price cap assumes that, other than differences by payment method (which, as outlined above, are not cost reflective), the cost to supply all customers is the same; it is one-size-fits-all and requires an assumption of efficient costs. There is therefore a more fundamental question to be addressed about the design of the price cap itself and what role it has in the future energy market; answering this could change, reduce or even remove the need for levelisation and reconciliation.

There is a role for levelisation and reconciliation to unpick the competitive distortions that already exist as a result of implicit levelisation in the price cap. Taking this further, we encourage Ofgem to use the principle of levelisation and reconciliation to further explore cost differentials to ensure suppliers are able to recover the efficient costs they incur irrespective of their mix of customers and remove the artificial competitive advantage (or windfall) given to suppliers who have entered the market more recently through their ability to cherry pick specific (lower cost) customer groups. The objective of Ofgem's work in this area should be to build a better understanding of the drivers of suppliers' efficient costs and how these differ between the types of customers they serve, reflect those costs more accurately irrespective of a supplier's mix of customers, but use levelisation and reconciliation to limit the impact on certain customers whose bills would otherwise increase.

It is important that further levelisation does not undermine incentives for customers to minimise costs which, even if levelised, still have a material effect on bills overall. A strong incentive for customers to switch to cheaper payments methods (i.e. direct debit) must be preserved if levelisation by payment method is implemented. Furthermore, there may be a case that perceived barriers to direct debit are now so limited that Ofgem should go even further to encourage customers paying on receipt of bill to move to direct debit. We urge Ofgem to explore what other actions it could take.

We set out our detailed comments on Ofgem's questions below.

Yours sincerely,

Steve Davies

Head of Regulation

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

The objectives of levelisation and reconciliation should be to build a better understanding of the drivers of suppliers' efficient costs and how these differ between the types of customers they serve, reflect those costs more accurately taking account of a supplier's mix of customers, but use levelisation and reconciliation to limit the impact on certain customers.

This better understanding and reflection of costs will reduce existing competitive distortions and ensure suppliers can recover the costs they efficiently incur, avoiding the windfalls the price cap creates for suppliers who have cherry-picked low-cost customers.

As outlined above, the approach Ofgem outlines in the Call for Evidence is based on an already artificial (and suppressed) cost differential between payment methods, with that in mind it is not entirely clear what Ofgem's current objective is.

Question 2: Should we only focus on PPM levelisation or should we also consider SC?

Levelisation and reconciliation should consider any driver of efficient cost differentials, this includes but is not limited to payment methods. Ofgem should use the principle of levelisation and reconciliation to explore more fundamentally and better reflect the material drivers of efficient cost differentials in all parts of the cost stack.

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

It is essential that a strong incentive to switch to DD remains.

It is important to remember that levelisation could reduce the relative price that an individual customer paying by SC pays, but the overall cost to all customers is still higher as a result of a customer paying by SC. There is benefit to all customers in reducing the overall costs of supply, in other words there is benefit to all customers in maximising the number of customers paying by DD.

Taking this further, it is not clear to us what benefit there is to any customer in paying by SC. Despite our best efforts to highlight the benefits and savings customers can make by switching to DD, many continue to pay by SC. There is value in Ofgem exploring what other actions it can take to reduce the number of customers paying by SC irrespective of the outcome of this Call for Evidence.

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?

The approach to levelisation should be driven by the underlying differences in efficient costs to serve different types of customers. Ofgem's approach outlined in this call for evidence is to accept that existing cap levels reflect true, cost-reflective payment differentials when this is clearly not the case (see examples above based on Ofgem's own decisions).

The 5 cases Ofgem analyses in Chapter 3 assume the existing cost allowances in the cap represent the actual cost differentials between payment methods; as described above, this assumption is

clearly not correct. The analysis of the price differentials in the 5 cases and how they affect different customers groups therefore has little relevance to the underlying difference in costs the customer groups drive. The assessment needs to explore the genuine differences in efficient costs of particular customer groups (including stripping out implicit levelisation that already exists within the cap, two examples of which we give above). Only once that input-based assessment of cost differentials is carried out can a decision about how much of the cost differential should be passed through to customers or levelised be made.

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

See our response to Q4 above, a decision on the merits of one levelisation option over another needs to consider the true underlying costs of each particular customer group. The 5 cases Ofgem explores are artificial as the costs to be levelised in those cases bear little resemblance to the actual cost differentials between those customer groups.

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

See our response to Q4 and Q5 above, this assessment can only be made once the true cost differential is understood.

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 outlined above, levelisation and reconciliation should be used as a tool to ensure suppliers can fairly recover the costs they incur for the different types of customers they serve, whilst mitigating the impact on certain customers as a result of the more direct pass-through of higher costs they would otherwise be charged. In effect we do agree with the sentiment behind this question but are concerned that Ofgem is proposing it for the wrong reasons (i.e. without reflecting the true cost differentials) which could lead to unintended consequences.

Ofgem should build on the evidence it already has to better understand the efficient costs of supplying different types of customers (for example via the upcoming work on the operating cost allowance in the price cap). With this information, Ofgem can then make decisions about the appropriateness of levelisation to mitigate the customer impact of more accurate and granular reflection of costs, noting that the price cap would need to align with these categories (but the principle still applies beyond the cap to the extent the cost drivers are not directly cap-related).

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

As described throughout this response, Ofgem's rationale for introducing levelisation is based on sharing an artificial cost differential. Whilst the distributional analysis provides useful insight into the impact of raising and lowering prices for different customer groups, because the cost differential it is based on is artificial, it misses the real value that levelisation and reconciliation can bring.

The purpose of levelisation and reconciliation should be to ensure suppliers recover costs that better reflect the efficient costs they incur, based on the customers they serve. Any distributional analysis needs to be based on the categories of customers who drive the higher costs.

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

We agree that Ofgem's proposals could disincentivise customers to switch to cheaper payment methods. It is therefore crucial that Ofgem preserves a strong incentive for customers to switch to cheaper payment methods, where they have the choice to do so. As outlined above, in our view there are few, if any, reasons why standard credit is better for a customer than direct debit. Many, if not all, of the barriers to or concerns about paying by direct debit have been removed in recent years; there is a strong case for Ofgem to take further action to reduce the numbers of customers paying by direct debit.

Levelisation, coupled with robust reconciliation, which is based on genuinely cost reflective and efficient differentials does not distort competition. However, Ofgem's proposals are not based on cost reflective differentials (see examples above illustrating that current payment method differentials are not cost reflective and comments throughout this response highlighting the need to explore other cost differentials).

In the price cap today, implicit levelisation already exists which already distorts competition. Taking the recent example of the Covid bad debt true-up decision, Ofgem found evidence suggesting the additional bad debt charge for standard credit customers was over £80 per customer and, for direct debit, less than £5 per customer (see table 4.2 of the true-up decision³); yet the final true up cost allowance was split equally between direct debit and standard credit customers. This means that a supplier with a higher-than-average share of direct debit customers could either receive a windfall (by charging customer more than its costs) or an artificial cost advantage by being able to under-cut the level of the cap without incurring any cost.

Levelisation and reconciliation could remove that distortion and prevent further distortion as more granular changes to cost allowances become necessary.

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

Levelisation, coupled with robust reconciliation could and should be used to remove existing competitive distortions resulting from the one-size-fits all price cap and prevent further distortions as more accurate and granular cost allowances are developed.

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

See earlier responses.

³ <https://www.ofgem.gov.uk/sites/default/files/2023-02/Price%20cap%20-%20Decision%20on%20the%20true-up%20process%20for%20COVID-19%20costs.pdf>

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

See earlier responses.

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

Ofgem's own analysis in Chapter 3 demonstrates the impact of levelisation if costs were not reconciled. Suppliers with a higher share of DD customers would receive windfall gains (or an artificial cost advantage), as the allowance for that payment type would include costs relating to the servicing of PPM and SC customers, of which they would not be incurring. Likewise, suppliers with a higher mix of PPM and SC customers would be incurring the costs relating to the servicing of those payment types would be unable to recover those costs in full as they will have been socialised onto DD customers.

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

The costs of levelisation must be reconciled robustly between suppliers to avoid distorting competition by driving windfall gains for some suppliers and under-recovery of cost for others. As highlighted above, this distortion already exists as a result of various cap allowances that do not reflect true underlying costs, either explicitly through decisions Ofgem has made (such as decisions to not reflect the true costs for standard credit customers) or implicitly through the one-size-fits all nature of the price cap, for everything other than a differential by payment method.

Further work is needed to develop a reconciliation mechanism. It must be robust to avoid distorting competition but balance this against simplicity to avoid unnecessary administrative costs.

Subject to the need for further work to develop the options, our initial view is that a mechanism based around a central pot, administered by a third party (such as the feed-in-tariff scheme) is likely to be more suitable than a mechanism like the Market Stabilisation Charge, where suppliers pay each other directly. A central pot is likely to be simpler, with fewer payment flows, and easier to oversee and ensure accuracy and compliance.

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

Further work is needed to develop a reconciliation mechanism. We urge Ofgem to work with suppliers to develop this through workshops.

Question 16: Is there anything else Ofgem should consider with regards to levelising costs across payment methods?

No comment.