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Sent by email to: priceprotectionpolicy@ofgem.gov.uk

Dear Marcus,

Call for evidence on levelisation of payment method cost differentials

We welcome Ofgem consulting on the levelisation of payment method cost differentials. Retail suppliers have typically looked to maintain a differential between payment methods to reflect the underlying costs to serve. This approach has been taken both when retail prices were deregulated and reflected in the default tariff cap that was implemented from 2019. However, the current default tariff cap methodology does mutualise some of the bad debt costs of standard credit (SC) customers across direct debit (DD) customers.

Any current or further cross-subsidy between payment types under the default tariff cap (DTC) will result in distortive impacts on different suppliers depending on their customer portfolio. Therefore, it is vital that any levelisation between payment methods is accompanied by a cross-supplier reconciliation process to ensure suppliers are not unjustly rewarded or penalised based on their customer portfolio. The need for a reconciliation process is linked to our recent submission on the Ofgem call for evidence on the bad debt allowance under the price cap[1]. To the extent that any costs – including any additional bad debt costs arising from the PPM code of practice – are recovered via payment methods other than where they arise, cross-supplier reconciliation is needed.

We recommend that:

- DD and PPM payment method differentials for standing charge and unit rates in the DTC should be equalised – effective 1 October 2023.
    - Equalising both standing charge and unit rate would mean there is zero differential between the two prompt-payment methods. It also ensures that some of the most vulnerable customers on PPM do not pay more than they

[1] Centrica response submitted on 15 May. Ofgem call for input on the allowance for bad debt related costs: https://www.ofgem.gov.uk/publications/price-cap-call-input-allowance-debt-related-costs

    would if they were on DD, despite the higher cost to serve for PPM customers[2].
  - Our Ofgem approved modification UNC 0840 has brought PPM and DD rates closer together, and we are supportive of full levelisation between these two payment types.
- An appropriate differential between DD and Standard Credit (SC) customers should remain to incentivise SC customers to move to either DD or PPM.
  - SC customers are more likely to accumulate a bad debt cost and it is important that customers are not incentivised to move to or remain on SC when they would otherwise choose a payment method with lower bad debt risk.
- Our support for the equalisation of payment types, as set out above, is predicated on there being a supplier reconciliation mechanism in place that ensures all suppliers are not impacted financially solely because of their customer portfolio.
  - For example, equalising DD and PPM as we have proposed would not be cost-reflective of PPM's higher cost to serve. Therefore, without a reconciliation process in place, an efficient PPM only supplier would be under-compensated under the DTC and an efficient DD only supplier would be over-compensated solely because of their customer portfolio.

Supplier reconciliation would also address the distortive impacts of a cross-subsidy that exists today between DD and SC customers. Bad debt costs are largely restricted to SC customers, yet under the current DTC methodology the bad debt cost that is largely attributed to SC customers is allocated across SC and DD customers in a ratio of 68:32. The result of this cross-subsidy is that any efficient supplier with a larger proportion of SC customer will under-recover through the DTC allowance, and any efficient supplier with largely DD customers will over-recover.

This market distortion exists today and any further move away from cost-reflective allowances under the DTC, i.e., by levelising the differential between payment types, will result in a further distortion that will need to be corrected by a supplier reconciliation mechanism.

The alternative is for Ofgem to allocate bad debt costs in a cost reflective way and place a greater proportion of the bad debt allocation on to SC customers and their tariffs, this increase in costs would lead to an increase on SC tariffs under the price cap.

As set out more fully below, our preferred approach to implementing a reconciliation mechanism is:

- using an existing reconciliation mechanism such as Warm Home Discount or Feed in tariffs (which would enable rapid implementation by October);
- following a principle of reconciliation by difference, as this would represent a more straightforward mechanism to implement over levy and disbursement; and
- reconcile payments monthly, to avoid severe supplier cashflow impacts.

We have also attached a confidential annex that sets out the detailed impacts of the levelisation between different payment types, as well as the impacts of the PPM code of practice. Ofgem should also conduct its own impact assessment that sets out the impacts on

[2] Ofgem recognises – as per the price cap allowances – that PPM costs are higher than standard credit meter costs

different supplier portfolios if there is no supplier reconciliation in place. Having a reconciliation mechanism in place will ensure suppliers are able to finance their activities and Ofgem is discharging its duties in line with Section 1(6)d of the Default Tariff Cap Act[3].

We would value the opportunity to engage with Ofgem bilaterally to discuss both this response and the response we have submitted on the allowance for debt-related costs.

If you have any questions on our response, please do get in touch on
tabish.khan@centrica.com

Yours sincerely,

Tabish Khan

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[3] Default Tariff Cap Act: https://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted

Appendix – responses to consultation questions

This section contains our responses to the specific questions in Ofgem's call for evidence. Where relevant, questions have been grouped together and answered collectively.

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

As set out in our covering letter we consider the objectives of levelisation should be:

- DD and PPM payment method differentials for standing charge and unit rates in the DTC should be equalised – effective 1 October 2023.
- An appropriate differential between DD and Standard Credit (SC) customers should remain to incentivise SC customers to move to either DD or PPM.
- Implementing a supplier reconciliation that ensures all suppliers are not impacted financially solely because of their customer portfolio.

Levelising DD and PPM

Equalising both standing charge and unit rate would mean there is zero differential between the two prompt-payment methods. It also ensures that some of the most vulnerable customers on PPM do not pay more than they would if they were on DD.

While there is a higher cost to serve for PPM customers, as seen in the DTC methodology, we consider it to be appropriate to charge PPM customers the same as DD customers – particularly given the backdrop of the cost-of-living crisis. Customers on PPM may not have chosen their payment type, i.e., they may be on PPM due to their debt profile, and a recent Utilita white paper[4] found that 86% of customers prefer PPM as their payment type. Equalising both the standing charge and unit rate across PPM and DD will ensure both these sets of customers will not be unjustly penalised for their payment type.

British Gas has already taken steps to equalise the rates between DD and PPM and we have introduced new lower prices for prepayment customers from 1 April 2023 to make prepayment the cheapest way to buy energy in the UK[5].

We support levelising DD and PPM, although this is critically dependent on an effective supplier reconciliation process being implemented – see related section below.

Retaining a differential between DD and SC

The current differential between DD and SC under the DTC reflects the higher cost to serve for SC customers to some extent. But the current differential does not fully reflect the bad debt costs attributable to SC customers as these costs are currently split between SC and DD customers in a ratio of 68:32.

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4 Pay As You Go: The solution to helping end self-disconnection – An Industry RED FLAG Report, Utilita, November 2022

5 Press release: https://www.centrica.com/media-centre/news/2023/british-gas-is-first-to-cut-prepayment-prices/

An appropriate differential between DD and Standard Credit (SC) customers should remain to incentivise SC customers to move to either DD or PPM. This differential is needed as SC customers are more likely to accumulate a bad debt cost and it is important that customers are not incentivised to move to or remain on SC when they would otherwise choose a payment method with lower bad debt risk. If more customers remained on SC this would make it harder for suppliers to recover debt costs, who would then need to recover these costs through an uplift to the DTC bad debt allocation – ultimately leading to higher costs for customers across all payment types.

We do not have a strong view on the exact differential that should remain between DD and SC but consider a differential of at least £100 per annum is required to incentivise customers to move away from SC.

Supplier reconciliation

As set out above there is a current cross-subsidy that exists between DD and SC customers. Any further equalisation of payment types will drive a further move away from cost-reflective charging and therefore will lead to greater cross-subsidies.

These cross-subsidies between payment types will result in efficient suppliers losing out solely due to the composition of their customer portfolio. For example, equalising DD and PPM as we have proposed would not be cost-reflective of PPM's higher cost to serve. Therefore, without a reconciliation process in place, an efficient PPM-only supplier would be under-compensated under the DTC and an efficient DD-only supplier would be over-compensated solely because of the nature of their customer portfolio.

These market distortions are why our support for the equalisation of payment types, as set out above, is predicated on there being a supplier reconciliation in place that ensures all suppliers are not impacted financially solely because of their customer portfolio.

Further evidence on the need for supplier reconciliation is provided in the confidential annex we have attached to our response.

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

Ofgem should prioritise the levelisation of PPM with DD for it to be implemented by 1 October 2023 with a supplier reconciliation mechanism in place to ensure no efficient suppliers is negatively impacted financially.

A partial levelisation or adjustment to SC may proceed alongside PPM levelisation if it isn't at the expense of implementing PPM levelisation by 1 October 2023. As noted above we also consider it important that an appropriate differential is maintained between DD and SC to ensure customers retain an incentive to move to DD. The current cross-subsidy between DDC and SC, as set out in our covering letter, should also be addressed as part of implementing a supplier reconciliation mechanism.

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?

The current differential between DD and SC under the DTC reflects the higher cost to serve for SC customers to some extent. But the current differential does not fully reflect the bad debt costs attributable to SC customers as these costs are currently split between SC and DD customers in a ratio of 68:32.

An appropriate differential between DD and Standard Credit (SC) customers should remain to incentivise SC customers to move to either DD or PPM. This differential is needed as SC customers are more likely to accumulate a bad debt cost and it is important that customers are not incentivised to move to or remain on SC when they would otherwise choose a payment method with lower bad debt risk. If more customers remained on SC this would make it harder for suppliers to recover debt costs, who would then need to recover these costs through an uplift to the DTC bad debt allocation – ultimately leading to higher costs for customers across all payment types.

We do not have a strong view on the exact differential that should remain between DD and SC but consider a differential of at least £100 per annum is required to incentivise customers to move away from SC.

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?

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

While there are benefits to each of the five cases Ofgem has put forward, we propose a sixth alternative that, in line with our covering letter:

- Levelises PPM and DD unit rates and standing charge.
- Retains a differential between SC and DD to incentivise customers to move to DD or PPM.

The full rationale for our proposal may be found in our answer to question 1.

Both elements of our proposal above may be found individually within Ofgem's cases – i.e., Ofgem's case 3 levelises the PPM/DD differential and Ofgem's cases 1 and 5 retain a significant differential between SC and DD. However, there is no one Ofgem case that matches both elements our proposal.

Hence, we are proposing an alternative case that we consider delivers the right outcomes for customers and suppliers, while also remaining within the scope of Ofgem's call for evidence. We also consider it to have the added benefit of being simplest for customers to understand – i.e., if a customer is on one of the prompt payment types of PPM or DD, their tariff will be the same.

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

As set out in our answer to question 1, there is a current cross-subsidy that exists between DD and SC customers. Any further equalisation of payment types will drive a further move away from cost-reflective charging and therefore will lead to greater cross-subsidies.

These cross-subsidies between payment types will result in efficient suppliers losing out solely due to the composition of their customer portfolio.

These market distortions are why our support for the equalisation of payment types, as set out above, is predicated on there being a supplier reconciliation in place that ensures all suppliers are not impacted financially solely because of their customer portfolio.

This existing cross-subsidy is not referenced within Ofgem's call for evidence and should be addressed through a supplier reconciliation mechanism, as part of all other equalisations of payment type differentials that take place as part of Ofgem's wider levelisation consultation.

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?

While there may be merit in targeting levelisation to groups within payment methods, this is likely to be a highly complex exercise to ensure all distributional impacts are captured in a thorough cost-benefit analysis, and complex and costly for suppliers to implement.

Therefore, we propose that Ofgem implements levelisation and supplier reconciliation first. Once implementation of supplier reconciliation is complete, Ofgem should then consider conducting a full cost benefit analysis on whether levelisation should be targeted at certain groups.

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

Ofgem's analysis finds that: "If SC unit rates are levelised … then this has a large impact on overall costs. The impacts on lower income archetypes are greater." This supports our case that any levelisation of SC should be only partial otherwise the distributional impacts may outweigh any benefits for SC customers.

Furthermore, Ofgem's analysis finds that "Equalising standing charges has little variation in impact across the distribution of customers", suggesting that changing the standing charge of PPM to match DD would not have any adverse impacts on customers. However, it would make PPM cheaper than DD and that is why we are proposing equalising unit rates between DD and PPM – as well as standing charge. Our proposal would also reduce the levels of supplier reconciliation required between suppliers, when benchmarked against Ofgem's case 5

Both DD and PPM carry very little debt cost and are prompt payment types, therefore customers should not be faced with different costs whether they are on DD or PPM. It is why we are proposing to equalise unit rates and standing charges across both payment types, and it will be simpler for customers to understand if the rates are the same across both DD and PPM.

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?

Ofgem's table 14 and accompanying modelling concludes that it "could pose a significant risk to SC and PPM supplier stability if implemented without a reconciliation mechanism." We agree with this analysis, and it is why a reconciliation mechanism is vital if there are further moves away from cost-reflective differentials between payment types.

Ofgem has found that "On an absolute basis, a greater number of vulnerable customers exist on DD than PPM". It is why we propose levelising PPM with DD across both unit rate and standing charge to ensure vulnerable customers across both payment types pay the same. Some of Ofgem's cases, such as case 5, result in cheaper tariffs for PPM over DD and we would consider this to be unfair on the vulnerable customers on DD.

We fully support Ofgem's wider market impact that "Levelising SC costs will remove some of the incentive for customers to switch to DD or remain on SC. The potentially larger number of customers on SC tariffs than what would occur in the absence of levelisation could increase the likelihood of debt related costs, leading to more customers building up problematic levels of debt and could have an impact on supplier financeability… These higher costs could lead to higher bills and could make it more difficult for suppliers to enter or remain in the market."

It is for these reasons, that Ofgem has identified, that any levelisation of SC customers must only be partial and a financial incentive for customers to switch away from SC must remain in place.

Furthermore, we agree with Ofgem's finding that "The ability for customers to switch between levelised and non-levelised tariffs would have implications for the movement of customers and the impact on market competition." It is why we support a supplier reconciliation mechanism that is effective across all tariffs – not just those under the DTC.

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

We have no impacts to highlight beyond the current cross-subsidy between DD and SC customers that we have highlighted in our covering letter and our answers to questions 1 and 3.

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

We strongly oppose any levelisation without a reconciliation mechanism in place. Levelisation without reconciliation would result in significant market distortions as set out in our covering letter, question 1 and the confidential annex appended to this response.

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

An implemented supplier reconciliation mechanism must be fair, transparent and implemented quickly– i.e., any mechanism that requires changes to legislation is likely to be slow to implement and therefore should be avoided.

Our preferred qualities for a reconciliation mechanism are:

- Co-opting an existing reconciliation mechanism such as Warm Home Discount or Feed in tariffs may help ensure a reconciliation mechanism is implemented by October.
- Reconciliation by difference would be a more straightforward mechanism to implement over levy and disbursement.
- Monthly payments are preferable from a supplier cashflow perspective.

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

We are unaware of any other reconciliation mechanisms worth considering.