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By email: priceprotectionpolicy@ofgem.gov.uk

Response to Ofgem's policy consultation on levelling the cost of standing charges on prepayment meters

Dear Dan and Sabreena

We support Ofgem looking at the payment method differentials. It is crucial we do all we can to help those struggling to pay - and prepay and standard credit customers, who are often some of the less well off, are paying too much. But overall this should be about checking payment method differentials are cost reflective, and specifically ensuring prepay customers are not paying too much in what should be a smart world. We are concerned the proposals:

- **increase bills for the majority of fuel poor households,** by increasing direct debit bills. A significant number of prepay customers will also pay more because companies like us[1], British Gas[2] and Utilita already set standing charges for smart prepay at equal to or below direct debit standing charges.

- **dilute the incentive on suppliers to install cheaper smart meters for prepay customers**, depriving them of a cheaper, more customer friendly technology which allows us to help them out when they're in trouble.

- **impose a reconciliation mechanism which carries significant moral hazard and distorts competition.** Even if the levelisation proposal stands, Ofgem must take a closer look at the reconciliation mechanism to remove these risks.

Ofgem does not need to introduce this complex approach. It can use tools it already has. We offer the following suggestions, which can be done now:

1. **Bring forward the review of opex costs in price cap and use it to drive down payment method differentials to a more accurate, cost-reflective level.** The opex review is the simplest way to improve cost reflectivity in the price cap. A prepay price cap based wholly on smart prepay costs would reveal little if any cost uplift for prepay over direct debit. We see no reason why it cannot be done this winter.

[1] Octopus's smart prepay tariff is our cheapest standard tariff, set below the direct debit price cap.
[2] British Gas, British Gas is first to cut prepayment prices, 29 March 2023. British Gas represents ~25% of the legacy prepay market according to public analysis by Utilita Energy, June 2023.

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2. **Encourage suppliers to take a common sense approach to ending the prepay premium.** British Gas, Utilita and ourselves have done this. Where the market is already responding and showing it can bear the cost, Ofgem must consider if regulatory change is appropriate where sensible conversations might suffice.

3. **Require suppliers to set out what they are doing to enable their customers to choose cheaper payment methods.** Ofgem's evidence shows most prepay and standard credit customers want to switch to paying by direct debit.[3] Our own data (see question 10) shows that customers respond to this price signal. Ofgem could test suppliers on what they are doing to help customers understand their payment method. If suppliers are not doing so - you should take targeted compliance action.

4. **End legacy prepay by 2025, make smart prepay the default, setting an annual target for suppliers to replace legacy meters.** Ofgem said at the Select Committee that the benefits of smart prepay far outweigh legacy meters. Only Ofgem can take the step to end this infrastructure for the industry. Now is the time to do so.

5. **If Ofgem insists on a levelisation and redistribution approach it should be time limited and incentivise smart prepay.** Ofgem could radically redesign the redistribution mechanism so it is an "off ramp" for ending legacy prepay. This might look like an end date for legacy prepay and a mechanism where (i) suppliers only get compensated for legacy prepay meters (as these have a higher cost to serve); (ii) the support tapers - suppliers cannot get compensated for 100% of their legacy portfolio, in order to encourage them to switch to smart prepay; and (iii) the mechanism has an end date which matches the end date for legacy infrastructure. We would be happy to discuss this option further with Ofgem

Stepping back, we are concerned that Ofgem has designed a complex and narrow solution to a broad problem, being how do we help lower income people afford energy. The target alternatives above will help with this. Looking more closely at standing charges and unit rates - and seeing if there are more progressive ways of recovering costs - would also be useful. Overall, we urge you not to rush proposals when many more customer and competition friendly options are available.

We set out below our overarching concerns and response to your questions.

Yours sincerely

Alexandra Meagher, Group Head of Regulation, Octopus Energy

[3] Ofgem, Consumer Impacts of Market Conditions survey - Wave 3, December 2022, page 25.

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A. Overarching concerns with the levelisation proposal

We are concerned the proposed approach to levelisation is not in the interests of the majority of fuel poor customers. On the surface it looks like it will help prepay customers but it is bad for most vulnerable customers in the short term and bakes long-term costs into the system for lower income customers. The proposal:

a. **Increases standing charges for the majority of customers at a time of very high bills.** As set out in the draft Impact Assessment, of households in fuel poverty, a much higher proportion pay by direct debit than other methods.[4] Ofgem's option 2 would increase bills for the average direct debit customers by £11/year. Ofgem claims this is "a small impact of annual bills"- but this is more than double the £5/year that Ofgem's own research suggests consumers are willing to bear to protect vulnerable groups.[5]

b. **Bakes expensive legacy prepayment costs into the market for the long-term by reducing the incentive to bring in smart prepay.** Smart prepay is a far superior product for consumers and does not carry the increased operating costs that come with legacy prepayment meters. Suppliers and consumer groups agree that legacy prepayment meters must end. However, the proposal means more customers will be saddled with the poor experience of legacy meters - and the higher costs. This appears to undermine Ofgem's objective to protect future consumers, as well as current consumers. The price cap differential for prepay over direct debit 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.

c. **Sets a precedent around pricing regulation of non-price cap tariffs**, which seems unnecessary (especially given the fact that this kind of pricing already happens in the market) and is likely to have unintended consequences.

B. Overarching concerns with the reconciliation model

We urge you to rule out any redistribution/reconciliation model. This approach distorts competition by advantaging legacy suppliers over challengers, and carries significant moral hazard. The redistribution mechanism:

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[4] Ofgem, Levelling the cost of standing charges on prepayment meters - policy consultation, August 2023, para 2A.42
[5] Ofgem, Consumer attitudes to involuntary prepayment meter installation rule changes, April 2023.

a. **Carries significant moral hazard as it accepts the view that redistribution is necessary because the suppliers' customer portfolio - and the cost of serving PPM customers - is apparently outside their control.** This seems like a slippery slope. Firstly, the cost of serving prepay customers is very significantly within the control of suppliers - with very significant cost savings from installing a smart meter, amongst other measures. Further, the price cap does not make special allowances for companies with higher weighted average cost of capital or higher roll to SVT (exogenous, uncontrollable costs which are typically higher for challenger businesses), so it's unclear why the approach to the cost of serving prepay customers should be different. Ofgem refers to the "significant supplier revenue impacts" of levelising the standing charge for PPM customers, but it's not clear how they would compare to the significant supplier cost impacts of setting the cost of capital in the price cap far below the actual cost of capital experienced by challengers.

b. **Erodes incentives on suppliers to do their best to engage with their customers and reduce and avoid debt.** Ofgem's data found that standard credit and prepay customers would prefer a different payment method.[6] Octopus's data shows that contacting customers about the availability of different payment methods and the different price does incentivise customers to change (see our response to question 8 below). This is better for consumers and better for system costs. Levelising payment methods - especially with a redistribution fund - removes these incentives on suppliers to engage with their customers and offer them a lower cost payment method. In this scenario, suppliers face weaker incentives to control the higher cost to serve of prepay customers as this cost is socialised. This will have perverse impacts: it's cheaper for one supplier to lobby Ofgem to change the levelisation fund than it is to engage with customers, install smart meters or improve operational efficiencies and offer lower prices. Ofgem has not reckoned with this challenge sufficiently in its consultation.

c. **As large prepay suppliers have demonstrated they can bear the cost of levelising standing charges, the proposed reconciliation process is likely to be distortive not corrective.** This fact that suppliers are already making a decision to levelise undermines Ofgem's view that a redistribution mechanism is necessary and without it, levelisation would pose a "significant risk" to supplier stability. Ofgem's proposals would require suppliers like Octopus (who have a majority of direct debit customers) to put up prices for our customers, and pass through that revenue to other suppliers who have already made pricing decisions that assume they will not receive that revenue. It therefore just helps those legacy suppliers pay off historic

[6] Ofgem, Consumer Impacts of Market Conditions survey - Wave 3, December 2022, page 25.

bad debt, or increase their profits. Ofgem has not reckoned with this challenge sufficiently in its consultation.

d. **The redistribution mechanism favours suppliers with a relatively small direct debit book - generally legacy suppliers - compounding the impact of other decisions which favour non-majority direct debit suppliers.** Under Ofgem's analysis, majority direct debit suppliers (which are often challenger businesses) are classed as the policy 'winners'. However in reality these suppliers are likely to be the policy 'losers'. Direct debit suppliers would be mandated to put up prices to meet a regulatory obligation, and to hand over customer money to competitors who can pocket the proceeds, even though they do not need it as their pricing shows they can bare the cost. Further, these competitors - who do have influence over the payment methods of their customers - could shape that customer book, putting more customers onto prepay arrangements, which is now effectively a tool to squeeze their challenger competitors.

C. Responses to Consultation questions

1. **Do you have any views on our proposed case for the introduction of levelisation of payment methods?**

We support Ofgem looking at the payment method differentials but this should be about checking they are properly cost reflective and specifically ensuring prepay customers are not paying too much in what should be a smart world.

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

We further think Ofgem could consider the balance of cost recovery between standing charges and unit rates - as there is a degree of arbitrariness here and scope to set the price cap in a way that helps with fairness and affordability.

Our overall concerns about the proposals are set out in Sections A and B above.

2. **Do you have any views on our proposed policy considerations for levelisation? Are there any additional ones we should consider**

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Our overall concerns about the proposals are set out in Sections A and B above.

As set out further in our cover letter, we would like to see Ofgem look at other ways of solving this problem, namely:

- Accelerating review of opex costs in the price cap - using smart prepay costs as the benchmark will drive down the cost uplift against direct debit.
- Encouraging suppliers to take a common sense approach to this, and avoiding the need for new regulation - large suppliers have already doing this.
- Use compliance and monitoring powers to require suppliers to tell Ofgem what they are doing to help customers change payment methods.
- End legacy prepay and make smart prepay the default, to drive down costs over the long term, and improve customer outcomes.

3. **Do you agree with our initial preference to levelise PPM and DD Standing Charges?**

We support Ofgem looking at the payment method differentials but this should be about checking they are properly cost reflective and specifically ensuring prepay customers are not paying too much in what should be a smart world. The review of operating costs allowance in the price cap is the neatest and quickest way to improve cost reflectivity in the price cap for different payment methods. A prepay price cap based wholly on smart prepay costs would reveal little if any cost uplift for prepay over direct debit.

4. **Do you think we should also levelise the bad debt charges across PPM, DD and SC, which would reduce the differential between SC and DD? Please provide any evidence /data that may benefit consumers as a whole.**

No. Our preferred approach would be for Ofgem to look at narrowing the payment differential between standard credit and direct debit by looking at the opex allowance in the price cap, and the mechanism for the payment method uplift in the cap.

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 <u>correction</u> 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.

In any case, we do not think the payment differential between standard credit and direct debit should be removed altogether. There is a higher cost to serve for standard credit

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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.

Ofgem's proposed levelisation mechanism (option 3) carries many of the same issues as with option 2 that we describe in the cover letter and should not be pursued.

5. **How should we ensure that levelisation transfers are correctly applied to customers on tariffs not covered by the cap (ie uncapped)?**

We do not consider that Ofgem should be looking at regulating non-price cap tariffs. This seems unnecessary interference in the market, especially given the fact that there are already lower priced prepay tariffs in the market. It adds a high degree of additional reporting and compliance into Ofgem. Straying into regulation of non-price cap tariffs is a significant step and Ofgem should be cautious of unintended consequences.

6. **Do you agree with our proposal not to levelise across regions?**

Yes. We think this would add considerable complexity and caution against Ofgem leaning towards redistribution as the primary trigger for regulatory change.

7. **Do you agree with our proposal not to target levelisation?**

Yes, we agree that levelisation should not be targeted based on vulnerability characteristics, We don't consider that levelisation is a social obligation exercise and is rather one of getting more cost reflective and incentive - positive price cap in place. So the levelisation should not 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.

However, Ofgem could explore refining the reconciliation mechanism to make it more targeted - for example it could be limited to recovery on smart prepay meters so that it does not dull the incentive to end these meters.

8. **Should we set new licence conditions to ensure suppliers pass the costs/benefits through to all customers?**

We do not quite follow Ofgem's question here, but we note that the question suggests a concern that Ofgem's proposals are open to gaming. The complexity of the proposals and the risks inherent in the reconciliation model (as set out in our cover letter and response to

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question 10) mean it is open to gaming. We urge Ofgem to approach levelisation in a different way - some further suggestions are in our cover letter and our response question 9.

9. Do you have any views on our other considerations?

Overall Ofgem has taken a very narrow approach to trying to solve the levelisation issue, i.e. it has only looked at imposing a levelisation requirement on suppliers and supporting that through a redistribution mechanism. This approach is complex and unnecessary. As set out further in sections A and B above, we would like to see Ofgem look at other ways of solving this problem, namely:

- Accelerating review of opex costs in the price cap - using smart prepay costs as the benchmark will drive down the cost uplift against direct debit.
- Encouraging suppliers to take a common sense approach to this, and avoiding the need for new regulation - large suppliers have already doing this.
- Use compliance and monitoring powers to require suppliers to tell Ofgem what they are doing to help customers change payment methods.
- End legacy prepay and make smart prepay the default, to drive down costs over the long term, and improve customer outcomes.

10. What are your views on the reconciliation mechanism, the type of mechanism, invoicing cadence, and mechanism operator?

We strongly oppose the setting up of any supplier levy or reconciliation mechanism to deliver levelisation of payment method cost differentials.

First, a reconciliation mechanism will severely damage the incentive on suppliers to encourage their customers off payment methods that have a higher cost to serve, such as standard credit or legacy prepay. [REDACTED] 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.

Finally, we have concerns that a reconciliation approach distorts competition - as set out in the cover letter.

If Ofgem insists on a reconciliation approach it should be time limited and incentivise smart prepay. Ofgem could radically redesign the redistribution mechanism so that it is an “off ramp” for ending legacy prepay. Ofgem could set an end date for legacy prepay and set up a temporary reconciliation mechanism where (i) suppliers only get compensated for legacy prepay meters (as these have a higher cost to serve); (ii) the support tapers - suppliers cannot get compensated for 100% of their legacy portfolio, in order to encourage them to switch to smart prepay; and (iii) the mechanism has an end date which matches the end date for legacy infrastructure. We would be happy to discuss this option further with Ofgem.

11. **Do you have any views on our preferred approach of a fixed reconciliation amount to reconcile standing charges levelisation and a volumetric reconciliation amount based on estimated consumption to reconcile unit rate levelisation?**

12. **Do you agree that all domestic customers should be included within the reconciliation mechanism?**

13. **Can you provide an estimate of implementation and ongoing costs on your organisation of the different levelisation options and approaches?**

14. **Do you have any comments on potentially phasing the implementation of the reconciliation mechanism?**

15. **What considerations should we take to tariffs that exist prior to the implementation of levelisation?**

16. **Are there any other financing impacts on your organisation that we have not considered as part of Chapter 4 or the IA?**

Yes. The IA has not considered actual prepay pricing practice in the market when examining the impact on suppliers. As large prepay suppliers have demonstrated they can bear the cost of levelising standing charges (as referenced elsewhere in this response) the proposed reconciliation process is likely to be distortive not corrective. Ofgem's proposals would require suppliers with a majority of direct debit customers to put up prices for customers, and pass through that revenue to other suppliers who have already made pricing decisions that assume they will not receive that revenue. It therefore just helps those suppliers pay off historic bad debt, or increase their profits. Further, these competitors - who do have influence over the payment methods of their customers - could shape that customer book, putting more customers onto prepay arrangements, which is now effectively a tool to squeeze their challenger competitors. Ofgem has not reckoned with these competition challenges sufficiently in its consultation or its IA.

17. **Are there any other considerations for the reconciliation mechanism we have not explored?**

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As set out in detail in our cover letter, we are very concerned about the reconciliation model in general and urge you to rule it out. This approach distorts competition by advantaging legacy suppliers over challengers, and carries significant moral hazard by reducing suppliers to engage their customers and manage their debt. It also causes practical difficulties if extended to non-price cap tariffs, as it will be difficult to anticipate what the levelisation “tax” due each year is. We would be happy to discuss this further.