

Sabreena Juneja
Retail Price Protection
Ofgem
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22 September 2023

Dear Sabreena,

Levelling the cost of standing charges on prepayment meters

At a high level, we support Ofgem's approach to levelising Prepayment Meter (PPM) and Direct Debit (DD) standing charges and including Additional Support Credit (ASC) credits in the levelisation. We are strongly in favour of including a reconciliation mechanism, it is essential that any levelisation scheme is accompanied by a reconciliation scheme to maintain a level playing field between suppliers. We do not have concerns relating to the implementation or the complexity of the scheme and consider that the necessary increase in complexity is balanced by the significant negative impacts of not including a reconciliation mechanism. However, we have some concerns with the implementation approach in the following areas.

Standing charges vs unit rates

We strongly support what we see as Ofgem future-proofing the levelisation/reconciliation method by including both a fixed element (standing charges) and a volumetric element in the reconciliation mechanism¹. However, we are concerned that throughout the document Ofgem has referred to its intention not to levelise/reconcile for unit rates. The PPM unit rate is currently lower than that for DD so there is no need for this to be in place by April 2024 but this could change in the future as it did with the more cost reflective allocation of Unidentified Gas (UIG)². Therefore, we consider that Ofgem's decision should make it clear that the levelisation/reconciliation architecture should include standing charges (fixed) and unit rate (volumetric) to make it future proof. Implementation of the unit rate/volumetric element could extend beyond April 2024 since it will not be needed at this stage. On that basis we believe Ofgem should initially adopt a variant of option 2, '**Option 2A**', which is future-proofed to ensure PPM tariffs can be levelised with DD by including both standing charge and unit rates in the levelisation and reconciliation mechanisms, even though unit rate levelisation is not applicable at present.

¹ Paragraph 4.12, 4.13 and Table 11 imply that the reconciliation mechanism to include unit rates fits in Option 2

² This was corrected by UNC840 which removed the additional cost reflectivity of UIG allocation

Cap vs uncapped tariffs - extending regulation into the competitive market

We agree that the policy should cover both price cap tariffs and Fixed Term Contracts (FTCs) however we strongly disagree with Ofgem's proposal to introduce licence conditions (and associated compliance processes) to require equal standing charges for DD and PPM in the FTC market. The FTC market is a highly competitive market where the existence of the reconciliation mechanism would ensure that suppliers are incentivised to offer tariffs that align with the cheapest possible rate. The proposed licence condition is a form of non-discrimination condition, and Ofgem should be mindful of the lessons of previous such interventions, notably SLC25A which was introduced in face of opposition from Ofgem economists and was found by the CMA to have weakened competition. In addition to the risks to competition, Ofgem's proposed licence conditions will impose an unnecessary compliance burden on suppliers and possibly disincentivise suppliers from offering certain tariffs.

Impact of levelisation on FTC pricing

We do not see any particular issues with including the expected levelisation amount in our FTCs; there have historically been uncertainties with many tariff elements such as BSUoS and this is no different.

Current smearing within the price cap

Once Ofgem has introduced a levelisation/reconciliation mechanism it should give serious consideration to whether it can use the mechanism to remove some of the cross-subsidies in the price cap which result in distortions of competition. Rather than cross-subsidising within the price cap, price cap allowances could be made fully cost-reflective and the levelisation/reconciliation mechanism used to return the overall price cap levels to their original cross-subsidised levels in a way that avoids competitive distortion. Consumers would still face the same SVT prices, but they would benefit from a more competitive market where suppliers with different customer mixes are able to compete on more equal terms. In other words, rather than Option 3, in which SC and DD prices are levelised (or the differential reduced), we believe Ofgem should give serious consideration to **Option 3A** in which the current differential between SC and DD tariffs is maintained, but the 'smearing' of bad debt costs within the price cap is unwound and the levelisation/reconciliation mechanism is used to achieve the same outcome (but in a way that avoids competitive distortions).

Please do not hesitate to contact Richard Sweet or Dena Barasi with any queries on this response.

Yours sincerely,



Richard Sweet
Director of Regulatory Policy

**LEVELLING THE COST OF STANDING CHARGES ON PREPAYMENT METERS –
SCOTTISHPOWER RESPONSE**

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

We agree with Ofgem's case that some levelisation of payment methods should be introduced since we believe that the benefits to consumers of a PPM vs DD levelisation/reconciliation scheme are likely to outweigh any negative impact from the distributional effects. Although DD customers will see higher bills and as Ofgem notes, greater numbers of vulnerable customers pay by DD than other payment methods, the bill increase for DD will be less than the reduction for PPM. As Ofgem also notes, PPM are more likely to be households with lower income and therefore vulnerable customers in aggregate will still benefit.

We welcome Ofgem's proposed position to include a reconciliation mechanism and reiterate our view that it is **essential** that any levelisation scheme is accompanied by a reconciliation scheme to maintain a level playing field between suppliers.

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

Ofgem has noted five policy considerations which we discuss below.

1. ***This policy should be designed to endure with the price cap or any future alternative.*** We agree with this sentiment to the extent that it is possible without knowing the future price protection policy or market structure. We would certainly expect this policy to be consulted on alongside any large structural or other significant changes to the retail market. As part of this principle, we consider that it should be made as future proof as possible and that Ofgem should include in its decision a commitment that it will levelise unit rates for PPM should these diverge from DD significantly. This would further future proof Ofgem's proposed solution and restrict the need for any delays in implementation due to additional consultation.
2. ***PPM standing charges should be equal to or less than DD.*** We agree with this policy consideration but consider that it should also apply to unit rates such that if PPM unit rates increase relative to DD unit rates in the future the levelisation/reconciliation mechanism could kick in. Our views are detailed further in our response to Question 3.
3. ***Ofgem should consider whether to allocate debt costs more broadly within payment methods.*** We believe that Ofgem is correct to be considering how to allocate debt costs more broadly. We are expecting the already increasing debt costs to continue to increase and that these are likely to be focused on Standard Credit (SC) customers who can no longer be moved to PPM as a result of the new Code of Practice and subsequent licence condition restrictions. Ofgem will need to keep this area under consideration as a result of the likely need to increase the bad debt allowance in the price cap and the increasing divergence between PPM and DD vs SC. Given the likely increase in bad debt relating to customers affected by the new requirements for Involuntary PPM, we believe that an increase in the price cap allowance is not appropriate and a separate mechanism for bad debt recovery should be used that

could make the most of the levelisation/reconciliation mechanism to avoid creating competitive distortions.

4. ***To ensure that suppliers are incentivised to offer services to customers on all payment methods, they should expect to be able to recover notionally efficient costs irrespective of the proportion of customers they have on each payment method.*** We are strongly in agreement with this. Ofgem's analysis showed significant impacts on suppliers without a reconciliation mechanism in place. Without an effective reconciliation mechanism, suppliers would be incentivised not to offer PPM tariffs.
5. ***The process will need to be designed to be agile to allow for adjustments as a result of the outputs from other interlinked workstreams.*** There are several interlinked workstreams and a high likelihood of the need in future for a reconciliation mechanism to help Ofgem avoid the competitive distortions that are characteristic of a one size fits all cap. In fact, we believe that this mechanism should be used to avoid competitive distortions likely to result from Involuntary PPM policies as a result of different suppliers having different proportions of affected customers.

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

We agree with the proposal to levelise the PPM and DD standing charges. An allowance for bad debt associated with ASCs is included in the price cap, and therefore we agree that this should therefore be included in the levelisation. However, we question the inclusion of this allowance for ASCs in the standing charge, given that debt is generally related to additional consumption with the unit rate therefore being more appropriate. If the allowance for ASC continues beyond the initial expected year, we would expect Ofgem to re-assess how it is recovered and the appropriateness of including it in the standing charge relative to the unit rate.

We agree that levelisation should be used to bring PPM price cap levels down to the level of DD but should not be used to increase PPM price cap levels if they are already lower than DD. We can see why Ofgem would in particular target standing charges for levelisation due to the fact that a high proportion of PPM customers are vulnerable and PPM customers find standing charges particularly problematic due to seasonal usage patterns. If gas heating is not used over the summer there is a large standing charge build up to pay off before any heating in the winter. However, we note that:

- The reconciliation mechanism should be designed such that it could apply to unit rates. Ofgem should make clear that the policy intent also applies to DD vs PPM unit rates. Even though PPM rates are currently lower and the unit rate levelisation would not be expected to operate in April 2024, if the unit rate did increase above that of DD rates, it would be optimal for the policy to kick in rather than be delayed as a result of additional consultations and decisions.
- Some consideration should be given to incentives for PPM customers to move to smart meters with the advantages this has to customers and suppliers, removing the high costs associated with legacy metering and allowing the supplier to monitor the customer more closely, for example for potential self-disconnections.

We note that a proposal to remove the additional cost reflectivity in relation to UIG was removed by UNC modification 0840. Allocation of UIG was made more cost reflective but exacerbated the PPM/DD differential in the unit rate. In addition, when the price cap was established, some bad debt costs were smeared onto Direct Debit customers. Once a

reconciliation mechanism is established, Ofgem should consider increasing the cost reflectivity (by undoing the smearing) and using the reconciliation mechanism to effect levelisation. Using this mechanism would remove and avoid the current competition distortions in the price cap.

Our view, therefore, is for a variant of Option 2 to be implemented, Option 2A which would ensure PPM tariffs are levelised with DD if they were higher in either or both the standing charge and the unit rate. We believe this best reflects Ofgem and Government's policy intent. In addition, by including both standing charge and unit rates in the levelisation and reconciliation mechanisms, the policy is future proof even though unit rate levelisation is not required currently.

Question 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.

There are significant cost implications associated with SC for suppliers and any approach to levelisation could therefore create longer-term inefficiencies as suppliers are not incentivised to encourage consumers onto more cost-efficient payment methods. For some customers, SC has additional benefits such as helping them feel more in control of their finances and cashflow. Not retaining an appropriate cost differential may therefore encourage more customers to move to SC which would increase inefficiency.

If Ofgem progresses with levelisation of some sort across SC and other payment methods, consideration should be given to the level of price difference to maintain the incentives to switch payment methods.

However, we would support a variant of Option 3, **Option 3A** which would retain a differential between SC and DD tariffs but unwind the current cross-subsidy in the cap whereby SC costs are 'smeared' over DD, resulting in competitive distortions. The levelisation/reconciliation scheme would then be able to bring the differential back to an appropriate level in a way that does not distort competition.

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

We agree that uncapped tariffs should be within scope to mitigate the risk that capped PPM (and SC) tariffs become materially cheaper than suppliers are able to offer on uncapped contracts. We do not see any particular issues with including the expected levelisation amount in our FTCs.

We consider that competition in the FTC market would lead to the reduced standing charges being applied to customers on uncapped tariffs and therefore we consider that customers seeking FTCs and switching from the price cap would also receive the benefit of the levelisation/reconciliation mechanism. Suppliers would be expected to compete for customers to the full extent and we can see no reason why they would not. (See response to Question 8.)

Question 6: Do you agree with our proposal not to levelise across regions?

Ofgem has stated time and complexity as a reason not to levelise across regions. We note that the impact of levelising across regions has not been assessed fully. We do not believe that it would be appropriate to progress with this proposal without further assessment.

The price cap is largely based on cost reflectivity, with differences in costs between customers, reflected in tariffs, for example network charges and losses. However, there are certain elements where smearing is acknowledged and has been used to moderate the differences between customers. The issue with going away from full cost reflectivity is highlighted by Ofgem's analysis in Annex 2, Impact Assessment which shows that without a reconciliation mechanism, levelisation introduces competitive distortions between suppliers.

The levelisation/reconciliation mechanism will provide both an opportunity for additional smearing of undesirable cost differences between customers without introducing distortions and also opportunity to unwind any current cost smearing and remove existing competitive distortion.

Table 1: Potential options for Ofgem to assess the benefits of levelisation/reconciliation

	Elements of the price cap that could be considered
Cost reflective elements of tariffs with potential to be levelised/reconciled	<ul style="list-style-type: none">• Network charges• Losses
Current elements smeared in a non-cost reflective way with potential to be unwound and levelised/reconciled	<ul style="list-style-type: none">• Bad debt allowance in the price cap smears bad debt between suppliers creating competitive distortions for those with higher proportions of vulnerable customers with affordability issues• SC/DD smearing of bad debt that exists from the development of the price cap• The smearing of costs between smart and traditional PPM• UIG allocation between PPM and credit meters.

Question 7: Do you agree with our proposal not to target levelisation?

Whilst we agree with Ofgem's decision not to target the levelisation to a subset of customers, such as those in receipt of the Warm Home Discount (WHD), we remain of the view that the most appropriate approach to addressing affordability of energy bills is via an appropriately targeted social tariff.

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

Option 2 as described by Ofgem in paragraph 3.45, has two elements to it:

1. Levelise all capped customer standing charges through adjusting the cap level
2. Levelise uncapped contracts through introduction of a licence condition requiring suppliers to offer the same standing charge on equivalent DD and PPM tariffs.

We disagree with Ofgem's proposal to introduce new licence conditions to require suppliers to offer the same standing charge on equivalent DD and PPM tariffs on two grounds:

- It represents an unnecessary constraint on suppliers' pricing freedom in a competitive market which may harm consumer interests in the same way as a non-discrimination condition
- It creates an additional unnecessary compliance burden for suppliers (and for Ofgem in policing it).

Impact of non-discrimination condition on competition

The proposed requirement to offer the same standing charge on equivalent DD and PPM tariffs is akin to a non-discrimination condition, and Ofgem should be mindful of the lessons from previous such interventions, notably the SLC25A non-discrimination condition which was introduced in 2008 in face of strong opposition from its own economists, and found by the CMA to have weakened competition:

“ ... we have reviewed the effectiveness of previous non-discrimination remedies applied in the retail energy markets, and we consider that there have been difficulties in effective implementation and in some cases unintended consequences. In particular, when Ofgem prohibited suppliers from offering out-of-area discounts for new customers, the effect was to increase prices for out-of-area customers and reduce the strength of competition”³

“The decision to introduce SLC 25A prohibiting regional price discrimination, which has been criticised by previous regulators, one of whom resigned from Ofgem's board as a result, and which we have found has likely had the effect of softening competition on the SVT.”⁴

The FTC market is generally highly competitive and price-sensitive, and in the absence of regulatory constraints there is no reason to believe that suppliers' pricing will not be cost-reflective in general (setting aside discounting which suppliers may engage in from time to time for customer acquisition). However, one of the risks of non-discrimination conditions is that they may result in higher prices on average for consumers, eg if suppliers respond to the constraint on pricing freedom by levelling up rather than levelling down prices.

As we understand Ofgem's proposals for levelisation, suppliers will be subject to a fixed levy of £11 per DD customer and receive a subsidy of £54 per PPM customer (condoc Table 4). We see no reason in a competitive market why these costs/subsidies should not flow through directly to retail pricing. However, this does not mean that individual suppliers' cost-reflective prices would be levelised. The price cap is only an average, and if individual suppliers' costs are higher or lower than allowed for in the price cap, their DD-PPM cost differential may also be higher or lower. If Ofgem's proposed licence condition were to result in levelling up of prices, it is likely that this would be to the detriment of consumers.

Ofgem's justification for the non-discrimination condition

Ofgem offers no justification for the non-discrimination condition other than a passing comment in the impact assessment (paragraph 2A.77) where it speculates that:

“For these [FTC] tariffs, suppliers may increase prices to cover any unrecoverable costs of supplying other consumers and/or to earn additional margin. For Option 2 this risk could be mitigated by introducing an SLC requiring suppliers to offer the same or lower standing charges for PPM customers compared to DD customers on equivalent tariffs.”

³ CMA Energy Market Investigation Final Report, 24 June 2016, paragraph 14.44

⁴ Ibid paragraph 18.9(b)

The concern that suppliers may increase prices to cover any unrecoverable costs of supplying other consumers and/or to earn additional margin is only valid in a market where there is weak competition and suppliers can price independently of the market. The FTC market has generally been characterised by strong competition and we are aware of no suggestion in the CMA EMI report or elsewhere that this is not the case.

We understand from subsequent discussions with Ofgem that their proposal is also motivated by concerns that some suppliers might be able to 'game' the levelisation/reconciliation mechanism, and the condition would prevent such gaming. We cannot at the moment see how such gaming could work in practice. If Ofgem's main reason for introducing the licence condition relates to gaming, it should explain its rationale in sufficient detail for stakeholders to understand or challenge it as appropriate.

Compliance burden

The existing reporting and compliance process for price capped tariffs has proved a significant burden for suppliers (and we suspect Ofgem) and Ofgem should be particularly cautious about increasing the scope of compliance activities unnecessarily.

Furthermore, Ofgem should be alive to the risk of unintended consequences from such an approach. For example, it is not inconceivable that suppliers may be discouraged from offering FTC PPM tariffs to remove themselves from both the risks associated with any compliance requirements as well as from the administration of the compliance requirements.

Question 9: Do you have any views on our other considerations?

Smart vs traditional PPMs

Ofgem notes that it does not currently identify smart PPMs as an independent payment method in the price cap methodology or calculate a separate cap level. However, were it to introduce smart PPM as a separate payment method with its own cap level, in light of its opex review, it would need to consider how this could/should be levelised. We agree that this needs to be considered in the context of the wider opex review, but our initial view is that it would be mistaken to use smart prepayment meter costs as the benchmark for the efficient cost to serve all PPM customers, since this could lead to non-recovery of unavoidably incurred traditional meter costs.

Social tariff

As noted above, we support development of a social tariff to help customers who have affordability issues.

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

We agree with the need for a reconciliation mechanism and the risk to some suppliers of not having a mechanism is described by Ofgem in Chapter 4 of the consultation. We also agree with many of the elements of the high level approach proposed by Ofgem:

- A new mechanism seems appropriate for this reconciliation since it would be bespoke and designed to fulfil the requirements more effectively.

- The new mechanism should be run by an existing industry body that can use its existing experience of similar data, billing and credit expertise.
- Reconciliation by difference seems appropriate.
- Monthly reconciliation is a reasonable cadence to provide the right balance between administration costs and cost exposure from lack of reconciliation.

As noted above, we disagree with additional compliance requirements on the competitive part of the market, however we could see some benefit in proportionate audit to validate the payment method reporting.

We are keen to continue to engage with Ofgem on the detail of how the mechanism could work.

Question 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?

We consider that this is an appropriate approach. We do not believe it is worth developing a new levelisation/reconciliation mechanism that could only be used to reconcile fixed cost elements. If this mechanism had been in place when UIG was being more cost reflectively allocated, the mechanism could have been used rather than invoking emergency modifications with the associated risks and the impact on cost reflectivity. Building in the capability for unit rate levelisation not only future proofs this policy but also enables this mechanism to be used to reduce competitive distortions in relation to how other costs are allocated as a result of the fact that the cap is one-size fits all.

However, we strongly disagree with the proposed approach of using estimated consumption favoured by Ofgem on the grounds that it is simpler. As we saw in Winter 2022/23, consumption can vary significantly from forecasts and unless the amounts being reconciled are very small, this could expose suppliers to unacceptable risks. We would support a phased implementation, with the fixed (standing charge) element of the solution being implemented in advance of any volumetric solution to help ease delivery risks by April 2024 and to ensure we can include at least one further reconciliation of consumption in the mechanism.

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

Yes, we agree that Ofgem should include all domestic customers in the reconciliation mechanism to match the fact that they are included in the levelisation. This is to avoid introducing distortions between FTCs and price cap contracts. In addition, in the future when more customers have moved away from price cap tariffs, the levelisation amounts would need to fall on a smaller number of price cap customers.

Unless the market opens up significantly we do not expect this to be a major issue and consider that Ofgem should not aim to regulate in the competitive arena.

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

We cannot provide an exact estimate of the costs before the reconciliation approach is finalised. However, we expect the costs to be similar to those that we have incurred for the EPG. These should be considered in Ofgem's operating cost workstream.

Question 14: Do you have any comments on potentially phasing the implementation of the reconciliation mechanism?

As noted above, we do not agree with using estimated consumption for unit rate reconciliation. Since the volumetric element of the reconciliation approach does not need to be finalised for April 2024, we consider that a phased implementation would allow time to design the most appropriate mechanism.

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

As we noted above, unless the market opens up significantly we do not expect this to be a major issue and consider that Ofgem should not aim to regulate in the competitive arena.

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

No, Ofgem has raised the issue of VAT which we agree should be considered.

Question 17: Are there any other considerations for the reconciliation mechanism we have not explored?

We expect that when getting into the detail of the mechanism and how it would operate, additional considerations would arise and issues may need to be resolved. Therefore, we would request ongoing communication between Ofgem, the reconciliation mechanism operator and suppliers to address any issues in the most appropriate way.

ScottishPower
September 2023