

2 January 2024

By email: priceprotectionpolicy@ofgem.gov.uk

Response to Ofgem's statutory consultation on changes to prepayment meter standing charges and other debt costs

Dear Dan and Sabreena

Thank you for your engagement so far in this consultation process. We agree that the price cap uplift is far too high. Prepay and standard credit customers, who are often some of the less well off, are expected to pay too much and certainly more than can be justified on the basis of cost to serve. This is why Octopus prices below the cap for standard credit customers and why we charge our loyal smart prepay customers the same standing charge as direct debit customers¹.

We applaud you working to reduce the prepay and standard credit uplifts in the price cap but we cannot support the current proposals and the design of the supplier reconciliation mechanism in particular. PPM levelisation could be achieved without placing so much additional cost on low income customers. And the standard credit uplift could be reduced without the need for a supplier reconciliation at all.

We urge you not to rush this work through statutory consultation but to take the time to:

- address our 4 concerns below which we have been expressing since these proposals were muted many months ago and which we feel are still not receiving sufficient attention; and
- evaluate our suggested alternative approaches to producing fairer prices for prepay and standard credit customers with less of the downsides.

Our 4 key concerns

1. Many low income consumers will be worse off under these proposals - not just the majority of low income customers who are on DD but those on SC and PPM tariffs with suppliers who have chosen to price below the cap. These suppliers - which include ourselves and British Gas² and account for more than a quarter of the prepay

¹ Currently 45k - practically all - of our smart PPM customers pay the same standing charge as DD customer. This number is expected to increase over time as newly acquired smart PPM customers switch to it.

² British Gas stated publicly that it has already levelised prepayment prices ahead of Government interventions in 2023: 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.

market, and perhaps more³ - will have no choice but to increase their PPM and SC tariffs under these proposals. These proposals to accompany levelisation with a supplier reconciliation process will ask customers to carry a cost that some suppliers have already decided is negligible and can be absorbed.

2. In addition, the reconciliation mechanism as proposed will:
 - a. have a distortive and dulling impact on competition - it places an unavoidable levy on efficient suppliers to cover the inefficiencies and delays in rolling out smart meters of other suppliers. It will create uncertainty and make it difficult to price fixed tariff deals competitively.
 - b. reduce the incentive to replace outmoded traditional PPM meters with smart meters and to encourage customers off standard credit payment arrangements - both of which are needed to reduce costs in the sector and improve customer experience and debt management.
3. We are concerned Ofgem is acting outside its powers - significantly stretching the original intention of the cap which was designed to reflect the efficient cost of a "notional" supplier. Given this, it is very concerning that that Ofgem is relying on price cap licence conditions to introduce levelisation while simultaneously acknowledging that *"levelisation is a much larger intervention [than historic price caps] and the primary aim is to the change the allocation of costs between groups of customers"*⁴.
4. Ofgem's impact assessment is flawed and fails to reflect the factors we have noted in points 1. and 2. above. **In particular, failure to recognise the current below cap pricing behaviour in the IA base case - and the fact that suppliers will have to pass on an unavoidable reconciliation levy - means that Ofgem's Impact Assessment has significantly underestimated the negative impact of these proposals on customers, and particularly those with low incomes.** It is imperative that Ofgem refreshes the IA to account for this before making any decision on the best way forward for customers.

Our suggested alternatives

Ideally, Ofgem would achieve its objectives by first undertaking a thorough opex review and using this to reflect more accurate and lower cost differentials for both standard credit and prepay customers. **It is entirely inappropriate for Ofgem to base the case for, and the level of, a supplier reconciliation mechanism on the assumption that the cost to serve uplift in the current price cap is accurate.** Both these uplifts have become out of date since they were set and particularly since wholesale price inflation has pushed up the price cap and smart meter penetration has increased.

³ We have not done an extensive mystery shop to check if other major suppliers price below the cap for prepay and standard credit customers. Ofgem will need to do its own data collection to obtain definitive data and use this in the IA.

⁴ Ofgem, [Statutory consultation: changing standing charges for prepayment meters and debt-related costs across payment methods](#), November 2023, Draft Impact Assessment, para 3A.53.

In the case of standard credit, we urge you not to rush to a decision on “option 3” debt levelisation proposals, but instead to update the Standard Credit price cap uplift following a thorough opex review. The planned timing of the opex review fits well with the proposal to reduce the standard credit uplift in autumn 2024. With this simplified approach, the price cap for standard credit customers will be lower, more cost reflective and no supplier reconciliation (which is complex to design especially on unit rates and costly to implement) will be required.

The data Ofgem has collected on debt levels per payment method is likely to overstate the payment differentials. A reformed approach to data collection, and setting the uplift on a more accurate and up to date view of actual cost differentials could both reduce the standard credit uplift and eliminate the need for supplier reconciliation altogether. A workshop on this theme could be helpful and we would be happy to assist Ofgem further.

Overall, setting up socialisation of debt costs is a slippery slope. Debt is not an exogenous variable - it's something that suppliers can influence considerably, if not control completely as our own data (which we've shared with Ofgem) has shown.

In the case of prepay we have sympathy with Ofgem's desire to levelise the prepay and direct debit standing charge in April ahead of the conclusion of the opex review. But reconciliation could be done much more cheaply for customers while retaining incentives to roll out smart meters.

Our experience is that those on smart prepay cost very little - if any - more to serve than DD customers. For this reason, the overall cost of levelisation and supplier reconciliation flows should be calculated on the additional cost of serving legacy prepay meters only. As smart PPM accounts for around 56% of all prepay meters (according to EBSS data), this move would cut the cost to consumers by over a half. The supplier reconciliation should also be **subject to a sunset clause, and should taper out to incentivise smart prepay installs.**

Alternatively, Ofgem could consider applying reconciliation only for “edge case companies” like Utilita which has specialised in prepay meter customers and would struggle to survive commercially if the standing charge was suppressed below cost reflective levels.

Other possible adjustments include **a 12 month levy forecast to avoid unintended costs on fixed contracts.** We would like Ofgem to consider setting the levy on a rolling 12 months horizon, with a quarterly update. Without this, it could have unintended consequences for fixed rate tariffs including inflated pricing.

We urge you to take the time to assess these alternative approaches and to update the IA to evaluate them and to account for the deficiencies in the IA noted above. Only when this is



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done will it be possible for Ofgem to assess the best way of protecting customers, and particularly those with lowest incomes.

We will be seeking a meeting with Tim to discuss our concerns, but in the meantime, do reach out to me directly should you wish to discuss any aspect of our response.

Yours sincerely

Alexandra Meagher, Group Head of Regulation, Octopus Energy

Consultation questions

Chapter 2: Case for change and levelisation scope

1. Do you have any comments or views on our updated case for the introduction of levelisation of payment methods?

Ofgem's proposals and case for change have changed very little since the policy consultation and we remain concerned that the proposals:

- increase bills for the majority of fuel poor households, by increasing direct debit bills and increasing prepay for those consumers who are with suppliers that already price below the cap.
- 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

Our concerns with Ofgem's approach translate into flaws in the Impact Assessment (IA), in particular:

- The IA fails to review actual market pricing behaviour. The distributional analysis has failed to take into account the fact that many large suppliers (representing at least a quarter of the legacy prepay market, but perhaps more) have already levelised or gone beyond that to protect their prepay customers.⁵ This means that the actual impact on consumers will be markedly different from Ofgem's assessment - the extra cost to customers is not factored into the IA and is inflating the case for Ofgem's proposals.
- The IA makes no distinction between cost to serve of legacy and smart prepay meters and so overstates the case for a supplier reconciliation mechanism - i.e. the harm to suppliers with a high percentage of customers on prepay meters. Ofgem's - accurate - observation that smart prepay meters have a "*significantly lower cost to serve*" than prepay meters does not feature in its case for change, or the impact assessment.
- Similarly with standard credit, the IA assumes that the current price cap standard credit uplift reflects efficient costs. This is not proven and does not reflect our experience. This assumption is actually unlikely to be upheld with the opex review, and we have concerns in particular with how debt is being allocated across payment

⁵ British Gas stated publicly that it has already levelised prepayment prices ahead of Government interventions in 2023: 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. Other large suppliers may also be pricing below the cap and this requires further investigation.

methods. We have offered Ofgem alternative analysis to support this. Given the uplift is inflated, the IA is inflating the case for a reconciliation and the distortion to competition that will happen if there isn't one.

- The IA does not assess the “moral hazard” risks of the proposed options (which we have repeatedly raised with Ofgem) and which include the reduced incentive to install smart meters (which will impact current and future consumers) and the reduced incentive on suppliers to help customers move from standard credit to other payment methods. This will harm debt repayment, not improve it.

The proposals to accompany levelisation with a supplier reconciliation process will ask customers to carry a cost that suppliers have already decided is negligible and can be absorbed.

Given these concerns, we urge Ofgem not to go ahead until it has looked at the impact of these proposals on the actual cost customers will pay (factoring in the number of prepay and standard credit customers that are already paying below the cap but who will face higher prices once levelisation takes place) and satisfied itself that prepay customers will be better off under these proposals. **If you do go ahead we ask Ofgem to consider adjusting the proposals subject to a sunset clause and more focused on incentivising smart prepay.**

2. Do you agree with our levelisation policy aims?

We agree with the aim of helping to keep bills down for customers with lower incomes and understand the focus upon the level of the uplift in the price cap for standard credit and prepayment methods. These payment methods are disproportionately used by low income customers and are currently too high.

However, in general we consider that Ofgem's levelisation policy aims are too narrow and should be broadened to include:

- ensuring that payment method differentials are accurate and cost-reflective of the technology that best meets customers needs including technology like smart prepay;
- ensuring 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;
- ensuring levelisation does not cut across Ofgem's other price cap workstreams, including the simplification of the price cap; and
- ensuring levelisation and reconciliation does not distort competition and cut across the emergence of genuine supplier model diversity.

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 reconciliation mechanism. This approach is complex and unnecessary. We would like to see Ofgem look at other ways of solving this problem, namely:

- A thorough review of opex costs in the price cap - using updated cost to serve and a more cost reflective approach to allocating debt costs across payment methods will reduce the standard credit uplift against direct debit while avoiding the need for a supplier levelisation.
- Encouraging suppliers to take a common sense approach to this, and avoiding the need for new regulation - large suppliers are already pricing below the cap for their prepay customers.⁶
- Use compliance and monitoring powers to require suppliers to tell Ofgem what they are doing to help customers change payment methods.
- Using its wider powers to control costs, e.g. reviewing the timing of recovery of network costs and other passthrough costs.

In the absence of these approaches, we urge Ofgem to consider:

- **A sunset clause for the proposals** and a move away from enduring proposals.
- **A “smart prepay” alternative to reconciliation** whereby suppliers only get a levelisation uplift in respect of legacy meters. See further on this in response to question 7.

Chapter 3: Levelisation options and proposals

3. Do you agree with our proposed approach to levelisation?

We agree with the aim of making the uplift for PPM and standard credit customers fair and more cost reflective. But we do not agree with the approach Ofgem is taking to assess the cost of this levelisation (particularly the assumption that the current price cap uplift is cost reflective) or the supplier reconciliation arrangements Ofgem proposes. See our cover letter for further details and our answer to question 7 for suggested alternative approaches.

4. Do you have any views on the proposed amendments to SLC 28AD and model changes under Annex 9?

If Ofgem does insist on a reconciliation approach following PPM levelisation we consider the only justifiable solution to be one which does not treat smart and legacy prepay customers as the same, and which recognises - as Ofgem has already acknowledged - that smart

⁶ Octopus's smart prepay tariff is our cheapest standard tariff, set below the direct debit price cap. British Gas stated publicly that it has already levelised prepayment prices ahead of Government interventions in 2023: 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.

prepay has a “*significantly lower cost to serve*”.⁷ See further detail in response to question 7. Adopting this approach may require tweaks to the proposed amendments and model changes.

We note that Ofgem has included very little substantive detail on licence and modelling changes for option 3. We urge Ofgem to take more time and to accelerate the important work in the review of the operating costs allowances and prioritise this over proceeding with option 3. As noted in our cover letter we consider a proper opex review and making the standard credit price cap more cost reflective should succeed in substantially reducing the uplift for standard credit customers without requiring a supplier reconciliation mechanism.

Chapter 4: Uncapped tariffs

5. Do you agree with our proposal to include uncapped contract numbers in the levelisation reconciliation?

We remain concerned about the unintended consequences of applying levelisation to the fixed term contracts market. We are concerned Ofgem is using price cap rules to set a precedent around pricing regulation of non-price cap tariffs. We are not sure this is with Ofgem’s powers.

We are also concerned that this will have (unintended) negative consequences for future consumers on fixed rate tariffs including inflated pricing. This issue could be easily addressed by setting out a 12 month levy forecast to avoid unintended costs on fixed contracts. Unlike many other industry levies including MSC, this one is not easily forecastable. This is particularly the case once levelisation applies to unit rates as is proposed later. We would like Ofgem to consider setting the levy on a rolling 12 months horizon, with a quarterly update.

The risk of inflated prices for fixed price tariffs is yet another reason the supplier reconciliation should not be enduring and should be subject to a sunset clause and a strict review by 2025 to ensure it is operating as intended.

6. Do you agree with our proposal not to introduce an SLC requiring suppliers to offer the same standing charge on equivalent DD and PPM tariffs?

Yes, but we think Ofgem does not go far enough to protect against consumer risks of extending these proposals to fixed term contracts - see our response to question 5.

Chapter 5: other levelisation considerations

⁷ Ofgem, [Statutory consultation: changing standing charges for prepayment meters and debt-related costs across payment methods](#), November 2023, para 5.13.

7. Do you have any views on our other considerations related to levelisation, regional levelisation and treatment of smart PPM?

Smart prepayment

Ofgem should revise the levelisation proposals - in particular the reconciliation mechanisms - so they do not dull existing regulatory requirements and market incentives on suppliers to install smart prepayment meters.

As Ofgem has noted in its evidence to the Select Committee in 2023, smart prepayment meters provide a vastly better and safer experience for customers than legacy prepay.⁸ Further, as Ofgem acknowledges in this statutory consultation, they “*have a significantly lower cost to serve*”⁹ than legacy prepay meters.

Long-term we’re open to Ofgem’s proposals to break out smart prepay as a payment method, but the opex review is not proceeding quickly enough for that to occur by April.

In the meantime, we think Ofgem could just approach reconciliation differently. **We propose that Ofgem could set up a “smart prepay” alternative to reconciliation whereby suppliers only receive a levelisation uplift in respect of legacy meters (which do cost more to serve).** This acknowledges that based on cost to serve, smart prepay customers should not be charged more than direct debit customers. If Ofgem took this cost information into account, it could achieve the same impact for prepay customers but at a lower cost for other customers. We estimate bills would go up for non-prepay customers by £5/year rather than the £11/year proposed by Ofgem. This lower increase is obviously better for those customers, and is also in line with Ofgem’s own research on what customers are willing to bear to protect vulnerable groups.¹⁰

In principle this could look like Ofgem setting an end date for legacy prepay and set up a temporary reconciliation mechanism where, following standing charge levelisation:

(i) suppliers only get compensated for legacy prepay meters (as these have a higher cost to serve);

(ii) the support tapers by a predetermined amount each year, based on Ofgem’s view of the appropriate industry wide rate of replacement of legacy prepay with smart prepay. As suppliers would not be compensated for 100% of their legacy portfolio, they would be encouraged to switch to smart prepay. Further, as it is based on Ofgem’s view of smart ppm roll out, there is no need for additional data collection from suppliers; and

⁸ [House of Commons. Energy Security and Net Zero Committee Oral evidence: Preparing for the winter](#), HC 1720, 13 September 2023, in particular Q179 and Q190.

⁹ Ofgem, [Statutory consultation: changing standing charges for prepayment meters and debt-related costs across payment methods](#), November 2023, para 5.13.

¹⁰ Ofgem, [Consumer attitudes to involuntary prepayment meter installation rule changes](#), April 2023.

(iii) the mechanism has an end date which matches the end date for legacy prepay infrastructure.

We have already provided the Ofgem consultation team with a simple model on how this could work. We would be happy to discuss this option further.

There's a **big opportunity here for Ofgem to show leadership on smart prepay, building on the important steps taken in the prepay code of practice**. The current proposals could undo the progress towards promoting smart prepay in recent months.

Targeted and/or regional levelisation

We support Ofgem's decision not to look further at levelisation targeted on the basis of vulnerability or look at regional levelisation. We caution strongly against Ofgem leaning towards redistribution as the primary trigger for regulatory change. These kinds of approaches would considerably increase the moral hazard of levelising debt as it would bake in the principle that debt is an exogenous variable that is out of a supplier's control and represents a form of competitive distortion. We urge Ofgem to treat these arguments with extreme scepticism. Debt is not an exogenous variable - it's something that suppliers can influence considerably, if not control completely as our own data (which we've shared with Ofgem in our policy consultation response) has shown.

Chapter 6: Payment reconciliation mechanism

8. What are your views on our updated options including the need for a reconciliation mechanism and phasing of implementation?

As set out in our September 2023 response to your policy consultation, we strongly oppose the proposed supplier reconciliation mechanism to deliver levelisation as it:

- damages/dulls incentives on suppliers to encourage their customers off payment methods that have a higher cost to serve, such as standard credit or legacy prepay.
- Distorts competition as some of the largest suppliers have already levelised their smart prepay prices.

As noted in our cover letter, we see no need for a reconciliation mechanism in respect of standard credit customers and urge Ofgem to reduce the standard credit uplift on the back of an opex review to achieve a more cost reflective and fair price cap uplift.

In respect of prepay standing charge levelisation, we are concerned Ofgem appears to have ignored the alternative proposals for a reconciliation proposal we set out in our policy consultation response. We strongly reiterate that if Ofgem insists on a reconciliation approach it should be:

- time limited/subject to a sunset clause - this will ensure that levelisation works well with Ofgem's workstreams on the opex allowances in the cap and does not create undue complexity
- Applied in respect of traditional prepay only, recognising that smart prepay is not more expensive to serve and so as not to dull incentives on suppliers to install smart prepay - as described further in response to question 7.

We also think Ofgem could explore applying a reconciliation only in respect of "edge case" suppliers like Utilita that specialise in prepay.

We would like to see Ofgem resolve issues in its approach to levelisation which will cost customers more than needed, and which dampen the incentive on suppliers to install smart prepay meters. We believe it is important this issue is resolved sensibly and that it should be possible to resolve this in time for levelising the standing charges in April.

Further, we have concerns around how the reconciliation mechanism will work in practice. We have raised these in the RECCO consultation and reiterate them here:

- **Forecasting:** How does this impact general and Fixed Rate Tariff forecasting? We think it's an issue that this levy (unlike many other industry levies including MSC) is not easily forecastable over 12 months. We would like Ofgem and REC to consider setting the levy that DD customers pay towards levelisation on a rolling 12 months horizon, with a quarterly update. Without this, it could have unintended consequences for fixed rate tariffs including additional pricing.
- **MSC Framework Reliability:** Given past inaccuracies with invoicing from MSC, we stress the importance of transparency and clarity with regards to calculations so that we are able to reconcile. A key concern of ours was the need to repeatedly query where inputs were coming from and ask for methodology examples.
- **Dispute Process:** We kindly request SLAs for REC as well as suppliers to avoid prolonged disputes.
- **Payment Exchange:** Clarification needed on practicalities, including whether there is need for separate bank accounts.
- **Data Reporting:** We request an early draft of the RFI for review. We would also like to see this report reflect/split out smart and legacy prepay meters.
- **Data Accuracy:** If you are going to heavily rely on Customer Tariff RFI, it's important to note that it splits out tariffs, not meterpoints— meaning there is less accuracy. We would also like to see this report reflect smart v legacy prepay.

9. Do you agree with our proposal to exclude fixed term contracts agreed prior to our decision date from our levelisation proposal?

Yes, but Ofgem does not go far enough. Excluding prior fixed term contracts is one step towards managing the risk that levelisation creates inflated prices for fixed term contracts. In

order to further reduce this risk, Ofgem should set out a 12 month levy forecast to avoid unintended costs on fixed contracts: unlike many other industry levies including MSC and GGL, this one is not easily forecastable. This is particularly the case when it proceeds to levelisation on unit rates and not just standing charges. Ofgem should consider setting the levy on a rolling 12 month horizon, with a quarterly update. Without this, it could have unintended consequences for fixed rate tariffs including inflated pricing.

10. Do you agree with our proposal for suppliers not to carry out, at their expense, an audit of their systems, processes and data to be used in reconciliation?

No, we consider it imperative to place an audit requirement on suppliers. Given the volume of funds passing through levelisation, and the risks it raises for supplier gaming, it is necessary for Ofgem to introduce an audit as part of this new, untested measure.

As Ofgem points out “*Hundreds of millions of pounds may flow across the [reconciliation] system annually*”.¹¹ These funds are flowing between suppliers who compete and **we are particularly concerned about the gaming risks that levelisation creates**. The reconciliation mechanism favours suppliers with a relatively small direct debit book. It effectively guarantees these suppliers a payment for that subset of their customers. Suppliers can have a significant impact and influence over how many customers they have within the subset which are now being subsidised by their competitors. There is a risk that levelisation encourages suppliers to shape their customer book to both take advantage of the guaranteed revenue, and squeeze competitors who are passing on that revenue via higher prices.

Ofgem has still not reckoned with this considerable gaming risk and impact on competition in its proposals, despite us raising this point at policy consultation. We would expect any Impact Assessment to look into this and are concerned that the current IA does not do so.

¹¹ Ofgem, [Statutory consultation: changing standing charges for prepayment meters and debt-related costs across payment methods](#), November 2023, para 6.28.