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Dear Sabreena,

Levelisation of payment method cost differentials: a call for evidence

We welcome this call for evidence and believe Ofgem is right to consider levelising costs across different payment types. Customers in vulnerable circumstances account for a higher proportion of consumers on prepayment (PPM) and Standard Credit (SC) terms compared to Direct Debit (DD). As payment method cost differentials under the retail price cap have broadly increased in line with the level of cap this means customers in vulnerable circumstances have been disproportionately impacted overall by these increases.

So, we support some levelisation of payment method cost differentials. We believe that the levelisation should:

- Apply to SC as well as PPM. The payment method cost differential between SC and DD has increased markedly - from £84 in April 2021 to £203 in April 2023.
- Maintain some degree of cost-reflectivity to ensure consumers still have an effective incentive to choose more efficient payment methods. Without this, overall industry costs will rise, increasing bills for all consumers.
- Avoid distorting competition, particularly with regards to the ability of suppliers to offer competitive prices outside of the retail price cap.

We assess that this means the following for how levelisation should be applied:

- Standing charges should be levelised, where PPM or SC standing charges are higher than SC. Standing charges do not provide any signal for energy usage and so become, in effect, a penalty related to payment type.
- Unit rates should be partially levelised. Levelising the bad debt element of unit rates for SC would be a sensible way to do this. The separate review of debt allowances within

the retail price cap has the potential to increase payment type cost differentials. Bad debt levelisation would mitigate against this.

- Levelisation should ideally apply to all tariffs, including fixed-price contracts outside of the price cap. Otherwise, suppliers are unlikely to be able to offer fixed-price contracts for PPM and SC customers that are competitive against the levelised retail price cap.

We also support the review into Operating Cost allowances within the retail price cap. Uplifts for payment methods are linked to either the overall level of the cap or inflation and it is unclear how cost-reflective this is. The review should also include the allocation of costs between standing charges and unit rates.

Answers to selected consultation questions are provided below.

Yours sincerely,

Andy Manning

Principal Economic Regulation Specialist

Responses to selected questions

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

Levelisation should apply to SC as well as PPM. The payment method cost differential between SC and DD has increased markedly - from £84 in April 2021 to £203 in April 2023.

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?

Some degree of cost-reflectivity should be maintained to ensure consumers still have an effective incentive to choose more efficient payment methods. Without this, overall industry costs will rise, increasing bills for all consumers.

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?

Levelisation should ideally apply to all tariffs, including fixed-price contracts outside of the price cap. Otherwise, suppliers are unlikely to be able to offer fixed-price contracts for PPM and SC customers that are competitive against the levelised retail price cap.

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

It is difficult to see how avoiding distorting competition can be achieved without a reconciliation mechanism. To avoid distortions, a reconciliation mechanism is required that adjusts the costs effectively experienced by suppliers to be consistent with the retail price cap (post-levelisation). This would also enable levelisation to be applied to fixed-price contracts as these should reflect the effective costs, after taking account of reconciliation, experienced by suppliers.

We recognise there are general feasibility issues with the reconciliation mechanisms. Maintaining a transparent process, with aggregated reconciliation values published as a minimum, will be important as any process is likely to rely on data items not typically used in energy settlements (e.g. the number of customers on SC).