ofgem
Making a positive difference
for energy consumers

Authority decision on REC modification proposal R0147 - Prepayment Levelisation	
Decision:	The Authority[1] has decided to approve[2] this modification[3]
Target audience:	REC Panel, Parties to the REC, Energy Suppliers and other interested parties
Date of publication:	23 February 2024
Implementation date:	28 March 2024

Background

The Domestic Gas and Electricity (Tariff Cap) Act 2018 ("Default Tariff Cap Act") places a legislative requirement that energy suppliers must charge standard variable tariff consumers and default tariff consumers at or below a level determined by Ofgem in accordance with the Default Tariff Cap.[4]

The Default Tariff Cap methodology historically has been largely cost-reflective and allows energy suppliers to charge in a way which reflects a number of variables that could affect the cost to serve consumers, including regional variations, tariff type and payment method. This currently means that consumers on prepayment meter (PPM) and standard credit (SC) payment methods, who are more likely to have a heightened vulnerability, usually pay more than the equivalent consumers on direct debit (DD). Traditional prepayment meters have higher operational costs, driving the higher standing charges paid by PPM consumers which are the main cause of the differential between DD and PPM. For SC consumers, the differential is driven by both fixed operational costs and debt related costs on standing charge and unit rate.

[1] References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day-to-day work. This decision is made on behalf of GEMA.
[2] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989 and section 38A of the Gas Act 1986.
[3] 'Change', 'Change Proposal' and 'modification' are used interchangeably in this document.
[4] Set out in the Domestic Gas and Electricity (Tariff Cap) Act 2018.

In March 2023, the Chancellor announced that the government would align the tariffs of PPM and DD consumers, by making an additional allowance within the Energy Price Guarantee (EPG), effectively providing an additional subsidy to energy suppliers in order that the additional costs of providing PPMs and associated services are not passed onto those consumers. The EPG will remain in effect until the 31 March 2024. The government asked Ofgem to assess options to develop an enduring policy to remove the 'PPM premium' completely.

In April 2023, Ofgem issued a 'Call for Evidence' on the process of adjustment of payment charges between payment methods by consumers, referred to as 'Levelisation'.[5] This was followed up on 25 August 2023 by an Ofgem Policy consultation: Levelling the cost of standing charges on prepayment meters.[6] This consultation set out options for adjusting standing charges for consumers on PPM, so that they are level with other payment methods.[7] The consultation also set out several options for delivering the scheme which will reconcile the costs of Levelisation between domestic suppliers ("Reconciliation"), mitigating any adverse impacts upon competition between them.

In September 2023, Ofgem selected the Retail Energy Code Company (RECCo) as their external delivery partner for non-volumetric payment method levelisation.[8] As the delivery partner, RECCo were responsible for designing the industry processes that would enable the facilitation of payments between suppliers to allow Reconciliation to take place. The decision to select a delivery partner was taken in September in the interest of time, as it was imperative to commence the design and development of industry processes as early as possible, to have Reconciliation ready for delivery by 31 March 2024 otherwise PPM consumers may have suffered an increase in their charges as the HMG support scheme was removed.

In October 2023 Ofgem selected RECCo as the external operator for non-volumetric payment type levelisation.[9] This work was to further develop industry processes, as well as design, build, test and deliver a functional system that enabled the facilitation of Reconciliation

[5] The 'Call for Evidence' appears on the Ofgem website.
[6] The August 2023 consultation appears on the Ofgem website.
[7] The 'standing charge' is the maximum charge to consumers for nil consumption
[8] The Retail Energy Code (REC) sets out the powers, functions and constitution of the Retail Energy Code Company (RECCo). RECCo is a non-profitmaking limited liability company established to facilitate the effective delivery, implementation and operation of the REC.
[9] The October 2023 selection letter appears on the Ofgem website.

between energy suppliers, for standing charge Levelisation. RECCo were selected as the delivery partner and the reconciliation operator as they already operated on a dual fuel basis and were able to work 'at risk' with the industry to carry out the required changes. As we were developing levelisation and reconciliation processes in tandem and at pace, RECCo was well placed to deliver the necessary code changes efficiently and with low potential costs in the possible event that Levelisation did not proceed. Since Reconciliation would require a code amendment and given that the REC covers both gas and electricity, it was deemed both an effective and efficient selection decision. Furthermore, the initial cost estimations suggested that RECCo could carry out both roles in the most cost-effective manner. Lastly, RECCo already has a means of recouping the costs of Levelisation, whereas other considered parties do not.

The options for the design of Levelisation were presented in a statutory consultation, which proposed modifications to the Gas and Electricity Supply Licences.[10] The licence modifications will come into effect on 1 April 2024 to coincide with the end of the EPG.

As published in the Decision on adjusting standing charges for Prepayment Customers (Levelisation Decision) today, from 1 April 2024 onwards, energy suppliers will be required under the price cap to set standing charges for default tariff customers in a way that means that PPM charges are not higher than DD, within any one region.[11] Reconciling between suppliers is not entirely novel, but does require a careful assessment of whether intervening in this way, and carrying the risks and benefits into the market is overall appropriate. We note that, in the absence of Reconciliation, energy suppliers may recover materially more or less than the notionally efficient cost to supply their customer base. As each energy supplier has a different ratio of PPM and DD customers within their portfolio, it could have an adverse effect on competition, meaning that energy suppliers with a high proportion of PPM consumers may be unable to fully recover their notionally efficient operating costs.[12] Reconciliation establishes a mechanism for a timely and accurate reconciliation of the cost of the Levelisation. This will support maintaining cash flows as they would have been without Levelisation, which we are satisfied supports consumer interests at least in the short term whilst further work to develop and assess volumetric or longer-term reconciliation is done.

---

[10] The November 2023 statutory consultation appears on the Ofgem website.
[11] See Levelisation Decision for statutory basis on Levelisation. Amongst others, see paragraphs 2.1-2.3.
[12] Although reconciling between suppliers also potentially affects competition.

The Authority recognises the importance of ensuring compliance and enforcement of R0147 and the details of such compliance and enforcement are provided in the Levelisation Decision.[13]

The change proposal

R0147 was raised by RECCo on 22 September 2023 to implement Reconciliation in the REC. The Change Proposal seeks to introduce the necessary governance and charging arrangements into the REC to facilitate Reconciliation between suppliers. This will reconcile the impact of price differentials on domestic energy suppliers by levelling the cost of standing charges paid by PPM consumers, compared with those paid by DD consumers.

REC Change Panel[14] recommendation

At the REC Change Panel meeting on 16 January 2024, the Change Panel unanimously considered that R0147 would better facilitate the REC Objectives under standard supply license condition ("SLC") 11B for electricity and SLC11 for gas ("REC Objectives"), and the Change Panel therefore recommended approval.

Our decision

We have considered the issues raised by the Change Proposal and the Final Change Report ("FCR") dated 16 January 2024.[15] We have also considered the responses to the industry consultation, which are attached to the FCR. We have concluded that:

- implementation of R0147 will better facilitate the achievement of the applicable REC Objectives; and
- approving R0147 is consistent with our principal objective and statutory duties.[16]

---

[13] See Levelisation Decision, in particular paragraphs 6.51-6.53
[14] The REC Change Panel is established and constituted pursuant to and in accordance with Standard Condition 11B.8(a) of the Electricity Supply Licence and Standard Condition 11.8(a) of the Gas Supply Licence.
[15] The final change report can be found on the REC Portal.
[16] The Authority's statutory duties are wider than matters the Change Panel must take into consideration and are detailed mainly in the Electricity Act 1989 and the Gas Act 1986.

Reasons for our decision

As explained below, we consider that R0147 will better facilitate the REC Objectives (a), (b) and (c).

(a) to ensure the REC operates and evolves in a manner that facilitates the achievement of its mission statement

The REC mission statement states that *"The REC will facilitate the efficient and effective running of the retail energy market, including its systems and processes. It will promote innovation, competition, and positive customer outcomes"*. R0147 will facilitate this objective by enabling Levelisation to work effectively, on balance helping to minimise any detriment to current and future supplier stability, market diversity and competition, in particular by providing greater certainty that specialist suppliers can recover efficient costs. This proposal will facilitate the effective running of the retail energy market, with a focus on minimising supplier impact and facilitating positive customer outcomes, particularly in relation to PPM customers.

The Levelisation Decision assesses the need for a reconciliation mechanism.[17] The most relevant analysis from the Impact Assessment is summarised below. Within the model, four theoretical suppliers were used to illustrate the impact, shown below:

Table 1: Proportion of consumers by payment methods for hypothetical suppliers

Supplier	DD	PPM	SC
1	33%	33%	33%
2	90%	5%	5%
3	5%	90%	5%
4	5%	5%	90%

The percentage impact on revenue is provided within Table 2. The supplier with a majority of DD consumers experiences an increase in revenue whereas the supplier with a majority of PPM and SC consumers experiences a decrease in revenue. This continues to show that the impact on revenue, and by association profit and loss, is significant and therefore to ensure the

[17] See Levelisation Decision, in particular Chapter 6.

potential for specialist suppliers a reconciliation mechanism is required to support Levelisation. These suppliers would incur revenue impacts without Reconciliation that could impact their ability to serve PPM customers and cause PPM market distortions.

Table 2: Non-volumetric Levelisation impacts on supplier revenues

Supplier	Non-volumetric Levelisation – Revenue Impact (£ change)	Non-volumetric Levelisation – Revenue Impact (% change)
1	-£13.9m	-0.8%
2	£6.7m	0.4%
3	-£46.2m	-2.7%
4	-£2.1m	-0.1%

As demonstrated above, implementing Reconciliation means that Levelisation can proceed in a way that does not unduly distort current market competition, and helps preserve specialism for prepayment suppliers. We have considered that reconciliation mechanisms have downsides and may not be appropriate in all circumstances. There is a cost and complexity associated with the mechanism; reconciliation mechanisms have collateral risks if a supplier cannot pay into the mechanism and can distort competition. However, in this specific case, on balance, we consider it to be appropriate to implement, particularly due to the impact on notional payment method specialist suppliers who, without this mechanism even if they were efficient, may no longer be viable.[18]

The updated impact assessment delivered in the Levelisation Decision further demonstrates in detail how non-volumetric Levelisation generates positive consumer outputs.[19] We have decided to use Reconciliation to support those Levelisation outcomes and so are approving R0147.

[18] See Levelisation Decision, in particular paragraph 6.30
[19] See Levelisation Decision, in particular Appendix 2

Table 3: Analysis of non-volumetric Levelisation

Income Weighted Analysis[20]	Admin costs[21]	Bad Debt[22]	Working Capital Reduction[23]
£112m net saving	c.£1.5m	£0.4m net saving	£1.5m net saving

Since Levelisation results in transfers between consumers, we found relatively small individual net benefits related to changes in consumer debt, bad debt, working capital and self-disconnections, however, collectively these elements sum up to a meaningful impact. Suppliers' impacts would be passed through to consumers by offsetting the administration costs. In addition to the direct costs and benefits there is a greater significant positive distributional impact from Levelisation.[24]

As explained above, R0147 helps the REC to achieve its mission statement of facilitating the efficient and effective running of the energy market in promoting innovation, competition, and positive consumer outcomes.

We therefore consider that R0147 better facilitates REC Objective (a).

(b) to ensure customers interests and data is protected in the operation of the REC

RECCo is responsible for developing and implementing a reconciliation function, with the necessary governance and charging arrangements and a suitable invoicing and billing mechanism. This function should deliver a solution for energy suppliers (and ultimately customers) and R0147 (including its legal text) gives confidence that appropriate funds will be transferred from and to energy suppliers in a reasonable timeframe.[25] Therefore, the Change Proposal establishes the framework for RECCo to develop such an aforesaid mechanism.

Furthermore, the R0147 allows the industry to have an operational mechanism to comply with Levelisation, thus ensuring that customers interests are protected in operation of the REC.

[20] Uses income to assess the effective impact on cost savings/benefits of our policies on consumer finances.
[21] Calculates the costs associated with administering the policies.
[22] Calculated the amount that we expect bad debt to decrease by.
[23] Linked to the reduction in bad debt, we assess the reduction in suppliers working capital.
[24] See Levelisation Decision, in particular paragraph A2.6
[25] This can be found on the REC Portal

The solution requires information to be provided by energy suppliers, in order for RECCo to calculate invoices and credits. This information is related to suppliers' customer portfolio data, which is similar to what suppliers already submit to Ofgem on a quarterly basis (Tariff RFI data), using secure data transfer methods. Levelisation would require customer portfolio data to be submitted monthly and in a simpler format. Data will be uploaded onto a secure delivery site that only RECCo and Ofgem will have access to. These measures will ensure that customer data is protected.

We therefore consider that R0147 better facilitates REC Objective (b).

(c) to drive continuous improvements and efficiencies in the operation of the REC and the central systems and communication infrastructure it governs

The Final Change Report notes that the solution development and IT procurement approach have enabled efficiencies in the operation for the new governance and charging arrangements by:

i. Developing the solution based on a set of principles which align with those previously developed and still in use for the Market Stabilisation Charge; and
ii. Optimising the existing technical and performance assurance service arrangements provided by the RECCo

On the aforementioned basis, the Final Change Report concluded that R0147 has a positive impact on REC Objective (c). We conclude that, on the aforementioned reasoning, R0147 better facilitates REC Objective (c).

Assessment against the Authority's Principal Objectives and Statutory Duties

Ofgem's principal objective in carrying out its regulatory functions (including use of its licensing and code modification powers) is to protect the interest of existing and future energy consumers as a whole. While discharging our functions, we must have regard to the interests of particular groups of consumers, including low income, pensionable age, disabled/sick and rural area-based consumers. Under our statutory framework we are required to carry out functions in the manner best calculated to further our principal objective wherever appropriate by the promotion of effective competition between suppliers.

As provided and explained in the Levelisation Decision, the reduction in the PPM Standing Charge is an overall net benefit to existing and future consumers, as a whole.[26] Even though Levelisation creates benefits, without Reconciliation there may be competition distortions in the PPM supplier market. Without Reconciliation, the benefits of Levelisation are dampened due to the potential negative impact on competition described above. Reconciliation will help to further facilitate the consumer benefit achieved by Levelisation by mitigating these competition impacts on the PPM supplier market. This will help to support financeability of specialist suppliers.[27] The reconciliation mechanism should be neutral on the ability for a notional supplier to get investment for business as the position following Reconciliation should be the same as now.

As explained in relation to the REC Objectives above, Levelisation with Reconciliation reduces total debt, bad debt and supplier working capital which results in improved supplier resiliency.[28] Greater supplier resilience promotes competition in the market, thus providing consumers with a wider choice of supplier offering. This ultimately results in better outcomes for consumers and achieves the Authority's principal objective of protecting consumer interests, particularly in relation to supplier resilience and differentiation in the market.

As aforementioned and as assessed in more detail in the Levelisation Decision, on balance we are satisfied that the introduction of Reconciliation neutralises the impacts of Levelisation on all capped suppliers protecting competition, collectively stimulates positive consumer outputs and, therefore, protects the interest of existing and future energy consumers as a whole. [29] These benefits are in line with the Authority's principal objectives and statutory duties.

Therefore, we consider that approval of the Change Proposal is consistent with our principal objectives and statutory duties.

[26] See Levelisation Decision
[27] See section 3A(2)(b) of Electricity Act 1989 and 4AA(2)(b) of the Gas Act 1986.
[28] See Table 3.
[29] See Levelisation Decision, in particular paragraphs 4.16 – 4.24

Decision notice

In accordance with Standard Condition 11B of the Electricity Supply Licence and Standard Condition 11 of the Gas Supply Licence, the Authority hereby approves REC Change Proposal R0147: Prepayment Levelisation.

Melissa Giordano

Deputy Director, Retail Systems and Processes

Signed on behalf of the Authority and authorised for that purpose