Action for Warm Homes

CONSULTATION RESPONSE

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National Energy Action (NEA) response to Ofgem's call for input on the allowance for debt-related costs (price cap)

About National Energy Action (NEA)

NEA[1] works across England, Wales, and Northern Ireland to ensure that everyone in the UK[2] can afford to live in a warm, dry home. To achieve this, we aim to improve access to energy and debt advice, provide training, support energy efficiency policies, local projects and co-ordinate other related services which can help change lives.

Background to this response

Since the creation of the price cap, and the integration of the safeguard tariff into the default tariff price cap, NEA has consistently advocated for fair allocation of costs within the price cap itself, and for Ofgem to ensure that consumers are not overpaying for their energy.

NEA understands the duty placed on Ofgem to have regard to "the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence", when setting the level of the price cap. As the Call for Input details, the situation regarding debt in the energy market has changed significantly over the last year, and NEA is therefore pleased that Ofgem has asked for input before it makes any substantive changes to the price cap in this respect. We believe that it is important that Ofgem's response to the changes in debt level must take into account the net position regarding over- and under-allocation of the debt allowance in previous price cap periods, be fair in its allocation of costs to different groups and facilitate good outcomes for customers.

Our response below details our thoughts on these aspects.

Summary of our response

NEA is pleased that Ofgem is asking for views on how to respond to the changes in debt costs in the energy market. Our response is based around three main themes:

- Taking into account over-allocation of debt costs over winter 2022/23, as well as any under-allocation that has occurred due to new rules regarding the forced installation of prepayment customers.
- Who pays the costs is important (as per levelisation CFI).
- The outcome for consumers beyond price is crucial.

Each of these issues is addressed in turn below.

<u>Taking over-allocation of costs into account, as well as under-allocation</u>

Over the last year, several factors have had an impact on the quantum of debt related costs in the price cap. The pause on forced installation of prepayment meters is likely a factor in this, leading to an under allocation of costs. However, other factors must also be considered.

NEA is particularly concerned about an over allocation of debt related costs in carp period 9a and 9b (the period covering October 2022 to the end of March 2023). We believe that there has been a significant over allocation of costs during this period. This, we believe, has arisen because the calculation of debt related costs within the price cap during this period did not consider the impact of UK Government schemes to subsidise energy bills.

This over-allocation of costs must be part of the calculation when it comes to recalculating the level of debt related costs in the price cap.

<u>Where debt costs are allocated in the price cap remains important</u>

In the current price cap period (April – July 2023), there are significant price differentials between payment types in the energy market. Households paying by standard credit pay on average ~£200 more than direct debit customers on an annual basis for their energy. This is, to a large extent, due to the way that debt related costs are allocated between customers.

Standard credit are more likely to be vulnerable across a number of metrics[3], including:

- Having a lower income
- Being more likely to be fuel poor
- Being more likely to be a single parent.

The reason for this is because, for the most part, households often use standard credit because they have some level of financial vulnerability. For example, a household may have moved onto standard credit, because their monthly direct debit is simply unachievable. A household may also be using standard credit because they do not feel comfortable giving control of their bank account to a third party through the direct debit system. Penalising these households, which are financially vulnerable, through price differentials, essentially amounts to adding to their costs as a direct result of their vulnerability. This is unfair. Ofgem has a statutory duty to consider the needs of vulnerable households. It is imperative that it uses its power to protect these households from unfairness in the market, not to extend unfair outcomes towards them.

Additional to this overall unfairness, there is a specific level of unfairness that comes from the allocation of debt related costs in the price cap. Currently, these costs are allocated based on which payment types are most likely to incur them. This is counter-productive – putting more costs on those households that are least able to afford their energy in the first place. Placing an additional burden on the most financially vulnerable households leads to increasing their financial vulnerability and increasing their debt risk.

Using this technique is also particularly unfair for those households that use standard credit, but do not cause a debt related cost for suppliers. Many standard credit customers use this payment method out because of a lack of confidence with online banking and direct debt, not because they have payment difficulties. The current system penalises them for little reason.

In order to address these issues, the Ofgem should stop allocating debt related costs disproportionately towards standard credit customers, thereby reducing their payment differential.

<u>Beyond the allocation of costs in the debt cap, how this income is used by suppliers is crucial</u>

It is not just the quantum of costs, and where those costs fall that is important when considering debt costs in the cap. It is equally important to ensure that energy suppliers are using this funding in a transparent way, and in a way that is helpful for their customers, driving better outcomes.

Currently, there is little to no oversight of how the debt allocation is spent by suppliers, nor rules on how this can be spent. With the current pause on the forced installation of prepayment meters and the implementation of new rules on this topic, there will be a financial incentive for suppliers to find other solutions to deal with debt. One particularly adverse outcome of this could be that suppliers increasingly look to sell on debt to third parties. We understand that this is a particularly cheap way for suppliers to deal with debt. While this has some advantages for customers (the debt would no longer be priority, and there would be no threat of disconnection/self-disconnection), protections offered by the standard licence conditions would no longer be available.

An increase in this activity must be avoided, if possible, especially if debt related costs increase in the cap. Instead of this, Ofgem should ensure that the use of funding from the debt allocation is much more transparent. Additionally, Ofgem should work with energy suppliers to use the allowance to help those households who are in debt to clear it, thereby reducing their overall exposure to bad debt. This could be achieved by a debt repayment matching scheme, something that is seen as best practice in the Water sector. **Ofgem should work actively with suppliers to improve transparency and effectiveness of debt collection operations, through the lens of ensuring better outcomes for customers.**

Answers to the Call for Input

Question 1: Do you agree with the proposed overarching methodological approach, set out in paragraphs 4.2 – 4.6, for calculating whether there has been an over or under-allowance for debt-related costs in 2022/23?

Partly. While it is important for Ofgem to fully understand the debt related costs that suppliers have faced during the last year, the approach that is set out could incentivise gaming the system, because of a significant asymmetry of information on debt costs between Ofgem and the energy suppliers.

NEA is particularly concerned about an over allocation of debt related costs in carp period 9a and 9b (the period covering October 2022 to the end of March 2023). We believe that there has been a significant over allocation of costs during this period. This, we believe, has arisen because the calculation of debt related costs within the price cap during this period did not consider the impact of UK Government schemes to subsidise energy bills.

Question 2: Are there alternative methodologies or other factors we should consider when calculating if there has been an over or under-allowance for debt-related costs in 2022/23?

As above, the methodology must take into account that the gross impact of the EPG and EBBS was an over-allocation of debt related costs in the price cap periods 9a and 9b.

Question 3: Do you have any other suggestions about how the calculation on 2022/23 debt related costs and/or allowances should be carried out?

No.

Question 4: What are the merits and/or demerits of the potential methodological approaches in paragraph 4.9 for calculating the effect of the PPM moratorium on debt-related costs, and are there other methodological approaches we should consider?

As stated above, one significant downside arises from the asymmetry of information between Ofgem and energy suppliers. This leads to a significant opportunity to game the system.

This could be at least partially mitigated through placing more rigorous controls on how suppliers can use the allowance, including a greater level of transparency on how they use the funding to clear bad debts, and address indebted customers.

Currently, there is little to no oversight of how the debt allocation is spent by suppliers, nor rules on how this can be spent. With the current pause on the forced installation of prepayment meters and the implementation of new rules on this topic, there will be a financial incentive for suppliers to find other solutions to deal with debt. One particularly adverse outcome of this could be that suppliers increasingly look to sell on debt to third parties. We understand that this is a particularly cheap way for suppliers to deal with debt. While this has some advantages for customers (the debt would no longer be priority, and there would be no threat of disconnection/self-disconnection), protections offered by the standard licence conditions would no longer be available.

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Question 5: What impact, if any, do you expect the newly published Code of Practice on Involuntary PPM to have on debt-related costs? If you foresee an increase or decrease in costs, please provided associated analysis, and explain why and whether you consider this would be a temporary or sustained change

NEA suspects that these changes to the prepayment market would, in isolation, lead to an increase in debt related costs. We are not sure of the gross impact however, and therefore are unsure of the net impact when combined with the gross impact of an over allocation in price cap periods 9a and 9b.

We would not expect the impact to be sustained. The new rules are, for the most part, a clarification of previously existing rules. Those suppliers who followed the rules should not see a significant increase in debt related costs.

Question 6: What reasonable mitigations should be taken by efficient suppliers to reduce the likelihood of bad debt in light of the PPM Code of Practice and PPM moratorium, and how should we account for this in our calculation of anticipated debt-related costs in 2023/24?

As stated above, this could be achieved through more transparency on how the debt allowance is used, and more schemes to use the allowance to actively help customers to reduce their debt, therefore reducing debt related costs.

Question 7: If there are examples of previous poor practice on PPM which have supressed debt-related cost levels, how should this be accounted for in our debt-related costs calculations?

Where there has been poor practice, these costs should not be factored into the price cap calculations. Suppliers should not gain a price advantage in the price cap due to the poor treatment of customers. Doing so would potentially incentivise to significant price manipulation by reducing service standards in future periods.

Question 8: What factors should we take account of when calculating the effect of other changes to PPM practice, such as the issuing of additional support on credit meters in recent months?

NA

Question 9: What has been the role of non-repayable discretionary credit or support from third parties (eg. charities) in helping consumers avoid debt, and how does this impact debt-related costs on a net basis?

NEA distributed ~ £500,000 in vouchers to ~4000 clients during the 2022/23 financial year.

Question 10: Are there any other material and systematic factors you consider could impact on debt-related cost levels in 2023/24?

As per our answer to question 1, the over-allocation of debt related costs in price cap periods 9a and 9b are material and require consideration.

Question 11: Do you agree with the proposed approach to combine our estimate of the costs for cap periods eight – nine (April 2022 – March 2023), and the anticipated costs for cap periods 10a - 11b (April 2023 – March 2024), to determine whether an adjustment to the cap for debt-related costs is necessary?

Yes, we agree with this approach.

Question 12: Are there any additional considerations to those identified in paragraphs 4.16 - 4.21 that we should take account of when considering any adjustment?

No

Question 13: If an adjustment allowance in the cap for debt-related costs is deemed necessary, do you agree with our intention to work towards an October 2023 cap adjustment?

Yes, we agree with this intention.

Question 14: Do you have other comments at this stage about the potential for an adjustment to the price cap for debt-related costs?

No

Question 15: Are there any non-price cap mechanisms you think should be considered as an alternative or addition to an adjustment in the price cap for debt-related costs? Please set these out, including why they may be needed and how they could work.

As stated above, we would like to see more transparency on how the debt allowance is used, and more schemes to use the allowance to actively help customers to reduce their debt, therefore reducing debt related costs.

Additionally, we believe there should be stronger rules governing the use of debt related costs to 'sell' debt onto third parties. While this may be an economically sound decision for a supplier to take, it is not in the best interests of consumers. One particularly adverse outcome of this could be that suppliers increasingly look to sell on debt to third parties. We understand that this is a particularly cheap way for suppliers to deal with debt. While this has some advantages for customers (the debt would no longer be priority, and there would be no threat of disconnection/self-disconnection), protections offered by the standard licence conditions would no longer be available.

References and Notes

[1] For more information visit: www.nea.org.uk.

[2] NEA also work alongside our sister charity Energy Action Scotland (EAS) to ensure we collectively have a UK wider reach.

[3] CMA Energy Market Investigation Appendix 9.9 – Prepayment, CMA, 2016