National Energy Action (NEA) response to the additional debt-related costs allowance policy consultation.

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, safe and healthy home. To achieve this, we aim to improve access to energy and debt advice, provide training, support energy efficiency policies, work on local projects, and coordinate other related services which can help change lives.

Action for Warm Homes

Background to our response

NEA is concerned about the record levels of debt and arrears in the market, recently reaching £2.6bn. This figure demonstrates that an increasing number of households are struggling to afford their ongoing costs of energy and are falling behind. With the majority of the £2.6bn figure coming from arrears, there is a clear need for energy suppliers to ensure that affordable repayment arrangements are being created. The overall figure of debt and arrears does not demonstrate the full extent of the debt risk in the energy sector, as many households are not captured by the definitions of debt which energy suppliers report. We therefore expect that the problem is far greater than it is depicted in this consultation.

Debt can cause physical and mental harm to households, as they resort to extreme forms of self-rationing to maintain some level of control over energy bills. It also puts at risk supplier resilience, which could mean further harm to consumers if this risk is not addressed. Around half (46%) of people in problem debt also have a mental health problem. Almost one in five (18%) people with mental health problems are in problem debt. People experiencing mental health problems are three and a half times more likely to be in problem debt than people without mental health problems (5%).[3] Mental health and debt levels are interlinked. This is an important factor to consider for evaluating the impact of an additional debt-related allowance in the price cap, and what form that allowance takes.

Summary of our response:

The quantum of debt in the energy market has recently reached new highs. Ofgem, in this consultation, is proposing to increase the debt allowance in the price cap to ensure that suppliers can fund their activities, particularly regarding servicing debt. While this action is possibly necessary (due to the duties placed on Ofgem through the Domestic Gas and Electricity [Tariff Cap] Act 2018), it does not serve to solve the problem of mounting debt and will likely increase the level of debt in the market, as it will mean that energy becomes even less affordable for households.

Ofgem has sought a voluntary agreement with energy suppliers at the same time as releasing this consultation. This new agreement, signed by almost all energy suppliers covering 95% of the market, contains only two new provisions to help with debt.[4] While these new provisions are important and welcome, they will not have a material impact on the level of debt in the market. While NEA recognises that it is largely out of Ofgem's remit to introduce policies that can reduce the overall level of debt, it is important to recognise that this consultation cannot provide a solution to the record levels of debt. Ofgem must therefore consider what it is able to do, within its powers as the regulator, to tackle levels of debt in the market on an enduring basis.

With this in mind, our response to the consultation assumes that Ofgem does intend to introduce a new debt-related cost in the price cap and focuses on how to do this in a way that is least bad for fuel poor households. It focuses on three main areas:

- A progressive approach to recovery

- Ensuring that an increased debt allowance has a positive impact for indebted households
- Bringing these proposals together with other important work packages

These are discussed in turn below.

A progressive approach to recovery

If Ofgem is to introduce a new debt-related allowance to the price cap, it is important that it is done in a way that is progressive and fair, not just seeking the most ‘cost-reflective’ route.

Since debt allowances in the price cap scale alongside wholesale costs, the absolute level of debt allowance has come down recently as wholesale prices have fallen. However, the way in which debt-related costs are allocated mean that some consumers, especially standard credit consumers, are paying significantly more than households on direct debit to pay for debt-related costs. Standard credit is the payment method where most of the debt costs faced by suppliers arise from, and the share of bad debt costs paid for by standard credit households is therefore a reflection of their cost to serve on an aggregate basis. However, since it is clear households on standard credit are most likely to be unable to afford their ongoing energy costs, we believe it is counter-intuitive to place the highest proportion of debt-related costs on them.

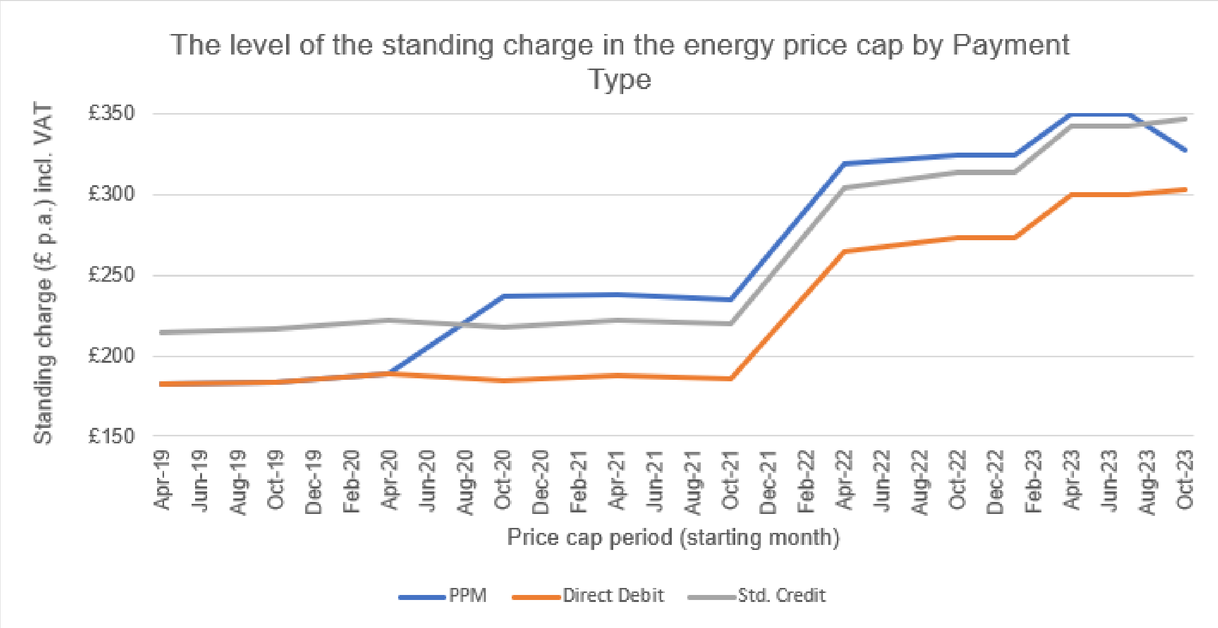
Applying an additional debt-related allowance to the price cap will undoubtedly hurt households. It will push some households into fuel poverty, whilst pushing fuel poor households into deeper poverty. We recognise Ofgem’s view that the price cap must allow cost recovery based on the expected costs of a notionally efficient supplier, otherwise there is an increased risk of market exit(s). However, we feel this must be done in a way to ensure the least-worst outcome for households.

In absolute terms, theredebt-related more households who are fuel poor on direct debit than the other two payment methods combined. However, this does not mean that fuel poor households as a collective would be better off with an allocation of debt-related costs that favours direct debit customers. Households that pay by prepayment are most likely to be fuel poor, with standard credit the second most likely payment method to be fuel poor and direct debit the least likely to be fuel poor. By applying fuel poverty statistics to the estimated cost options for an additional debt-related allowance in this consultation, we have identified an enormous disparity between the impact of some cost allocation approaches compared to others.[5]

Total Cost increase for FP households by payment type	Direct Debit	Standard Credit	Prepayment	Total	Cost per FP household
Option 1	£35,802,000.00	£7,668,000.00	£0.00	£43,470,000.00	£13.35
Option 2	£0.00	£66,518,000.00	£0.00	£66,518,000.00	£20.42
Option 3	£0.00	£83,181,000.00	£12,243,000.00	£95,424,000.00	£29.30
Option 4	£19,572,000.00	£4,452,000.00	£23,001,000.00	£47,025,000.00	£14.44
Option 5	-£10,388,000.00	£100,368,000.00	£18,414,000.00	£108,394,000.00	£33.28

NEA therefore would like to see option 1 of the payment method allocation options be implemented. This option would have the least-worst impact on fuel poor households. While option 4 looks similarly attractive in terms of the cost to fuel poor households, it would result in prepayment households taking a proportion of the costs, which would likely cause an undesirable rise in the frequency and duration of self-disconnections. We therefore would not like to see option 4 implemented. It is imperative that options 2, 3 and 5 are avoided due to the significantly higher costs they would impose for fuel poor households.

Additionally, NEA proposes that the fairest option in terms of cost allocation for an additional debt allowance would be to put charges onto the unit rate. Standing charges have risen considerably over the last few years. Increasing them further would be regressive, as shown in Ofgem's own distributional analysis regarding the issue of standing charges vs unit rate.



<u>Ensuring that an increased debt allowance has a positive impact for indebted households</u>

While we recognise enduring support to tackle levels of debt in the energy market is a matter which requires government intervention, we feel it is important to stress here that such support is desperately needed. Debt levels have risen to a record amount, £2.6bn. This is without factoring in a significant proportion of households who pay by direct debit, but whose direct debit level is lower than the cost of their ongoing energy consumption. These households, in addition to households who pay using credit facilities such as credit cards – in some cases moving energy debt out of the market and becoming credit card debt – are not captured in the £2.6bn figure.

The purpose of a debt-related allowance is to provide suppliers with the ability to recover costs for writing off debt, which is unlikely to be repaid. To add an additional allowance into the price cap should therefore correlate with an increased level of debt write-offs from energy suppliers. There should, therefore, be transparency over the level of these write offs so that stakeholders can see the impact that this significant extra funding for debt-related activity is having.

<u>Bringing these proposals together with other important work packages</u>

In September, we responded to the consultation on levelling the cost of standing charges on prepayment meters. Within our response, we argued for the option to reduce prepayment standing charges to be in line with standing charges paid by direct debit households. Additionally, we argued that Ofgem should go further in reducing the standard credit differential, relative to direct debit, by re-allocating existing debt allowances.

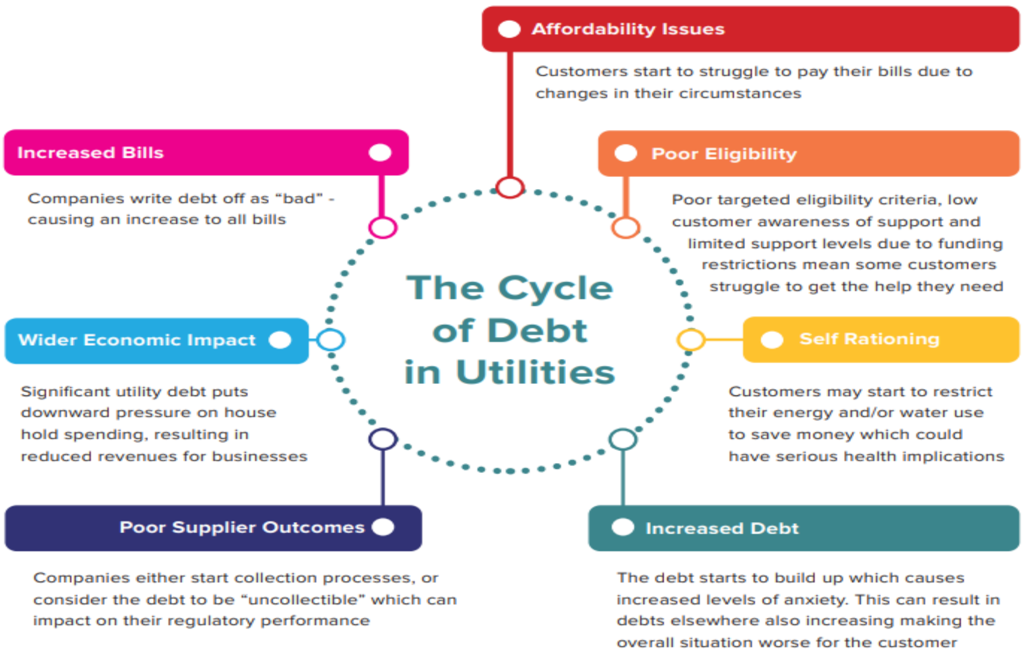
In the context of this consultation, we are mindful that the options for an additional debt allowance could significantly alter the benefits and detriments of measures that could be announced following the levelisation consultation. For example, if the standing charge is increased for direct debit customers in this consultation, this could have implications for the prepayment meter price cap as a result of the levelisation work package. Decisions must be taken in the round to ensure that unintended consequences are avoided.

1. Do you consider that we should make a temporary adjustment to the price cap to account for additional debt-related costs?

No, we don't think a temporary adjustment to the price cap should be made. Households are struggling to meet the costs of their ongoing energy consumption, as the record level of debt in the market shows. Adding further charges to the cap will only serve to produce more debt in the market. But we understand the perception that the cap must allow suppliers to recover costs that would be incurred by a notionally efficient supplier. We recognise that there is a level of concern around suppliers' financial resilience, since market exits could result in a greater cost for consumers than the costs imposed by an additional debt allowance. Our response assumes that an allowance will be added. We are aiming to ensure that the least-worst outcome for households is achieved.

This consultation on the need for an additional allowance demonstrates that debt risk is greater than ever. Ofgem has sought a voluntary agreement with energy suppliers at the same time as releasing this consultation. This new agreement, signed by almost all energy suppliers covering 95% of the market, contains only two new provisions to help with debt.[6] While these new provisions are important and welcome, they will not have a material impact on the level of debt in the market. While NEA recognises that it is largely out of Ofgem's remit to introduce policies that can reduce the overall level of debt, it is important to recognise that this consultation cannot provide a solution to the record levels of debt. Ofgem must therefore consider what it is able to do, within its powers as the regulator, to tackle levels of debt in the market on an enduring basis.

The availability of support with debt is much more advanced in the water sector than the energy sector. In the water sector, 'restart schemes' are common practice. If you take part, you start a regular payment plan and the payments you make are matched by the water company. If you keep up with the payments, the rest of your debt may be written off. To our knowledge there is little evidence of this approach being taken in the energy sector. Ofgem has a role in ensuring that energy companies can learn from other sectors, such as water, in effectively reducing the debt on their books, in addition to ensuring that they remain financeable through the price cap.[7]



2. **<u>Do you think that suppliers cost due to the moratorium on involuntary PPM installation should be included in the adjustment?</u>**

Costs incurred because of the moratorium on involuntary prepayment meter installations should only be recovered where debt from households that would have had a prepayment meter installed has been written off. Since the moratorium was entered into because of potential supplier wrongdoing, an inclusion of these costs must be accompanied by decisive action being taken against suppliers who have performed poorly when involuntarily installing a prepayment meter. Punishment for poor practice is required to deter suppliers from making the same mistakes in the future.

4. **<u>Do you have any views on whether it would be appropriate to explore a specific levy mechanism for DNI (‘do not install’) customers? This would be separate to any adjustment for additional debt-related costs.</u>**

The ‘do not install’ (DNI) category of customer should not face additional costs, in addition to whole market changes, as a result of this work package.

The ‘do not install’ category covers the most vulnerable households for whom a prepayment meter is not appropriate, on account of those households’ reliance on a constant supply of energy. The characteristics of these households do not, in our view, form a basis for an additional debt-related allowance to the one being proposed here. Any competitive distortions that arise from serving a greater proportion of these households should be resolved through other mechanisms, such as policy support for those households to reduce their debt risk.

5. **<u>Do you agree that we should make an initial float adjustment in April 2024, followed by a later true-up? Do you agree it should be included within the cap for a 12 month period? Do you agree that this allowance should be temporary only?</u>**

Yes, suppliers should not be able to over-recover for bad debt. This temporary allowance, which would be additional to the existing debt allowance, must have adequate checks and balances in the form of a true-up to ensure that consumers do not pay any more than they must. An ex-post allowance would likely lead to more concentrated timelines for recovering costs, resulting in shorter-term but more distinctive harm caused to households.

6. **<u>Should the debt-related costs allowance, if introduced for the April 2024 price cap, be subject to a later true-up, and if so, when should this adjustment occur?</u>**

Yes, suppliers should not be able to over-recover for bad debt. This adjustment should be considered along with the temporary allowance added to the price cap for additional support credit costs. The adjustment should occur once suppliers are able to establish with certainty how much bad debt costs they have incurred.

9. **<u>Do you agree with the proposed overarching methodological approach for estimating the existing debt-related costs allowance, and using it to determine whether there has been an over or under-allowance for debt-related costs in 2022/23?</u>**

Over the last year or so, 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 take into account the impact of UK Government schemes to subsidise energy bills.

As debt-related costs scale with the price of energy, and the price cap was calculated independently of the Energy Price Guarantee and Energy Bill Support Scheme, the debt-related costs in the cap are based on a much higher cost of energy that was realised for domestic customers. Based on an assumption that approximately two thirds of energy for a dual fuel customer is used in the winter six months, these debt-related costs are based on the price cap level, which was set at £3,652 in period 9a and £4,414 in period 9b (an approximate actual cost of £2,689 over the six months for a typical dual fuel direct debit customer). In reality, the typical dual fuel direct debit customer faced significantly lower costs during this period. The Energy Price Guarantee reduced the level to £2,500/year, or approximately £1,667 over the period. The Energy Bill Support Scheme reduced this further; to £1,267 during the winter period.

The debt costs allocated in the price cap are therefore based on costs much higher than actually experienced by energy customers. We estimate that based on information in this CfI[8], that energy customers faced an additional £740m in debt costs over the six months of winter. Standard credit customers faced an additional average £127 per customer over the two cap periods.

This over-allocation of costs must be part of the calculation when it comes to adding an additional allowance for debt-related costs in the price cap. Failure to do so will result in an extremely inequitable outcome whereby suppliers have been able to recover significantly more money for debt-related costs than they should have been able to, essentially contributing to an increased profit allowance of 4% for standard credit customers.

13. <u>Do you have any views on which payment method allocation option would be preferable?</u>

Yes, Option 1 is our preference. In absolute terms, there are several more households who are fuel poor on direct debit than the other two payment methods combined.[9] However, this does not mean that fuel poor households as a collective would be better off with an allocation of debt-related costs that favours direct debit customers. Households that pay by prepayment are most likely to be fuel poor, with standard credit the second most likely payment method to be fuel poor and direct debit the least likely to be fuel poor. By applying the latest available fuel poverty statistics from the government to the estimated cost options for an additional debt-related allowance in this consultation, we have identified an enormous disparity between the impact of some cost allocation approaches compared to others.

NEA therefore would like to see option 1 of the payment method allocation options be implemented. This option would have the least-worst impact on fuel poor households. The other option that would result in relatively low costs for fuel poor households would require

Total Cost increase for FP households by payment type	Direct Debit	Standard Credit	Prepayment	Total	Cost per FP household
Option 1	£35,802,000.00	£7,668,000.00	£0.00	£43,470,000.00	£13.35
Option 2	£0.00	£66,518,000.00	£0.00	£66,518,000.00	£20.42
Option 3	£0.00	£83,181,000.00	£12,243,000.00	£95,424,000.00	£29.30
Option 4	£19,572,000.00	£4,452,000.00	£23,001,000.00	£47,025,000.00	£14.44
Option 5	-£10,388,000.00	£100,368,000.00	£18,414,000.00	£108,394,000.00	£33.28

prepayment households to take a proportion of the costs, which would likely cause an undesirable rise in the frequency and duration of self-disconnections. We therefore would not like to see option 4 implemented. All the other options, 2, 3 and 5, would result in fuel poor households paying more than the average cost of bad debt per household. That would create further unnecessary debt risk and inequality in the market, so those options should not be considered further.

While we recognise that the figures provided in the consultation document are estimations, and the figures we have provided will change, it is important to understand the distributional impact of the payment method allocation. A progressive approach would be to apply any debt-related costs to households that are better able to afford the costs of an additional allowance. The result of any of the proposed payment method allocation options will be increased pressure on all households in terms of paying their energy bills.

14. <u>Do you agree with us allocating other debt-related costs (debt-related administrative and working capital costs) uniformly across payment method?</u>

No, as displayed in response to question 10, there is a clear inequity in distributing debt-related costs uniformly. Debt-related costs should be allocated progressively, ensuring that fuel poor households are not unfairly burdened with additional cost.

15. <u>How should we apportion any debt-related costs allowance over the unit rate and standing charge elements of the cap only?</u>

In September, we responded to the consultation on levelling the cost of standing charges on prepayment meters. Within our response, we argued for the option to reduce prepayment standing charges to be in line with standing charges paid by direct debit households. Additionally, we argued that Ofgem should go further in reducing the standard credit differential, relative to direct debit, by reallocating existing debt allowances. In the context of this consultation, we are mindful that the options for an additional debt allowance could significantly alter the benefits and detriments of measures that could be announced following the levelisation consultation. With that in mind, we propose that the fairest option in terms of cost allocation for an additional debt allowance would be to put charges onto the unit rate – Option 1. Applying an additional debt-related allowance to the unit rate would ensure the full benefit of the proposed levelisation of standing charges for prepayment households.

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] Money and Mental Health

[4] Energy UK have confirmed to NEA that the agreement contains only two new firm commitments:
- Suppliers will fully consider information (including budgets, affordable payment offers and prepared Standard Financial Statements) and third-party authority forms from a customer's chosen credible debt or consumer body organisations, including FCA-authorised debt advisors.
- Policies for the use of High Court enforcement and County Court Judgements (CCJs) for debt will be signed off at board level or equivalent.

[5] Calculations were made using the number of households in fuel poverty for electricity by payment method (table 8.2 in the consultation document). Fuel poverty figures for each payment method have been multiplied by the estimated cost of the payment method allocation options to show the amount paid by fuel poor households per payment type.

[6] Energy UK have confirmed to NEA that the agreement contains only two new firm commitments:
- Suppliers will fully consider information (including budgets, affordable payment offers and prepared Standard Financial Statements) and third-party authority forms from a customer's chosen credible debt or consumer body organisations, including FCA-authorised debt advisors.
- Policies for the use of High Court enforcement and County Court Judgements (CCJs) for debt will be signed off at board level or equivalent.

[7] NEA has previously submitted a short paper on accelerating the clearance of utility debt. Further information on the cycle of debt utilities and our suggestions for solutions can be found within it. We would be happy to share our paper again if helpful.

[8] This assumes that there are 4.5 million prepayment customers, 2.5m standard credit customers, and 19m direct debit customers across Great Britain. It also assumes that the proportion of debt-related costs in the price cap for all of these payment types was consistent in cap periods 9a, 9b and 10a.

[9] Government (2023) Fuel Poverty Statistics 2022