SO ENERGY

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"Additional debt-related costs allowance policy consultation" – So Energy Response

Dear Dan,

So Energy is a leading energy supplier providing great value renewable electricity to homes across England, Wales and Scotland. We have consistently been recognised by our customers and the wider industry for our outstanding customer service since we were founded in 2015, including being a Which? Recommended Provider and have topped the Citizens Advice's Supplier League Table. So Energy is one of the early adopters of the EUK Vulnerability Commitment launched in 2020, helping create a better customer experience for vulnerable customers year on year. In August 2021, So Energy merged with ESB Energy, and our combined business now supplies around 330,000 domestic customers. As one of the last challenger suppliers left in the market and one that is backed by ESB's resources and expertise, So Energy is able to provide a unique view of the quality of service in today's energy market.

We would like to make the following key points:

1. As debt costs and the debt allowances are both moving considerably, the true up will need to account for significant volatility. So some sort of interim adjustment of the float should be considered if Ofgem's ongoing debt RFI data indicates that the float is clearly moving out of alignment with real debt-related costs and inevitably increasing the size of the true up.

2. We have serious questions about how the discreet debt allowances are being calculated and this has very significant implications given Ofgem's preference for lower quartile on two of the allowances. For example, suppliers are underspending versus the calculated debt administration allowance (which adjusts by CPIH) despite the number of customers in arrears with no payment plan having increased 61% since the original benchmark was established. This doesn't seem plausible.

3. The allowances should be benchmarked on a weighted average basis. We set out 5 reasons why in our response to question 12.

4. We agree that charge should be split evenly between Direct Debit and Standard Credit. Ofgem's approach to collecting debt data using standard accounting methodology means that the value of debt built up by customers on Direct Debit is systematically underestimated.

5. We note some confusion over where any enduring review of debt now sits. Page 16 of the concurrent operating cost review working paper[1] talks of separating out debt costs from the operating cost review but this paper is still benchmarking off of an old 2018 operating cost benchmark. It would be good if Ofgem could set out a roadmap for how they will account for debt in the price cap in both the short and longer term.

[1] https://www.ofgem.gov.uk/sites/default/files/2023-10/Energy%20price%20cap%20operating%20cost%20review%20benchmarking%20working%20paper1696956062375.pdf

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

Yes, an adjustment should be made. We note that while the allowance has been characterised as temporary, further temporary allowances may be needed between now and the full implementation of any enduring changes to the debt allowances under the forward-looking operating costs review. The increasing maturity of debt, loss of government support and sustained high energy prices all point toward further upwards pressure on bad debt.

2 Do you think that suppliers cost due to the moratorium on involuntary PPM installation should be included in the adjustment?

Yes, an allowance should be provided due to the moratorium on involuntary PPM installation. With regards to suppliers that may have overstated their moratorium costs due to previously being in breach of their licence conditions, we note that only a single allowance can be provided in the price cap. To exclude certain costs impacts compliant suppliers ability to recover their costs. Ofgem can instead ensure that non-compliant suppliers are not rewarded for previous non-compliance by using their enforcement powers to levy penalties on offending suppliers. This is the typical manner by which Ofgem ensures that suppliers do not save money by not complying with the licence. We see no reason why the cost of non-compliance should instead be socialised by adjusting the price cap allowance.

3 Do you agree that any adjustment should be made using the existing price cap mechanism, rather than a bespoke levy or other new mechanism?

When Ofgem wants to place unforecastable additional cost onto fixed-term contracts, as with levelisation, it suggests that this is entirely possible. However, when it comes to recovering costs already incurred Ofgem, suggests that the practical challenges associated with doing this make this impractical. Ofgem needs to adopt a consistent approach. If Ofgem are to proceed with their suggested approach to recovering debt, then fixed tariffs should be excluded from payment method levelisation.

4 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.

Every supplier is different and yet there is a single price cap. Suppliers have different exposures for different elements of the price cap, which distorts competition in all sorts of ways. For example, a supplier entering into the crisis with a larger than average proportion of fixed tariff customers faced a greater exposure to unexpected SVT demand when energy prices shot up as a result of global post-covid supply constraints and, subsequently, Russia’s invasion of Ukraine. The single price cap allowance for unexpected SVT demand would not have covered their reasonably efficient costs.

If one were to pursue one levy, there is a legitimate question as to why it is acceptable to stop there. Should not every variable be subject to a levy mechanism in order to create a ‘level playing field’? Inconsistent applications of levelisation and reconciliation bears the risk of creating the greatest market distortions as suppliers could steal a competitive advantage by ‘shouting loudest’ at the regulator.

Secondly, with regards to the DNI levy itself, how would DNI customers be identified? Would it be self-identification through the PSR register? This would encourage gaming of the PSR in order to maximise the levy. Would it be limited to customers where the supplier has attempted to force-fit a prepay meter? That would encourage suppliers to pursue the force fit of prepay meters in order to maximise the levy.

Each individual levy itself creates further complexity in the market and is as likely to distort the market as create a ‘level playing field’. Furthermore, once a DNI levy is agreed, there will be calls for further levies as every supplier can likely point at an area where they are unfairly disadvantaged. Levy stacked on top of levy means complexity stacked on top of complexity and distortion on top of distortion. It is difficult to project what, if any, sort of a retail market would remain in that circumstance.

In line with precedent, a single adjustment should be provided for in the price cap to account for the additional cost of serving DNI customers.

5 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?

We agree that a float and true up approach should be taken. However, steps should be taken to ensure consumers aren't exposed to price shocks when the true-up is applied.

The situation around debt is very volatile – the volume of debt is rising at the same time as the allowance is falling. Data from the first two RFIs showed no material deviation from the allowance but data from the most recent RFI did. Data captured from the July '23 to September '23 is likely to show a still greater deviation as growing and aging debt combines with a 40% fall in the cap (and therefore the allowance). This deviation is likely to grow as the cap fell in Q3 and commentary from Ofgem is forecasting further issues with customer debt in the future.

There is a substantial risk that if the float is left unadjusted over its lifetime the subsequent true-up will constitute a dramatic adjustment in the cap. If the true up were unfortunately timed, converging with a rise in the wholesale price, consumers would face a substantial price shock. It would be prudent for Ofgem to adjust the float as it receives more up to date bad debt data from suppliers in order to manage the size of any subsequent true-up. This doesn't necessarily mean re-running the float exercise or an interim true-up. What we are suggesting is the float be adjusted if it's plainly obvious that, were it not adjusted, the size of the eventual true-up would inevitably increase.

6 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?

Ofgem states that it will not have actual data on under or over allowance until at least October 2024. However, it will have strong indicative data through it's ongoing bad debt RFIs. Ofgem should use this data to adjust the float in order to ensure any subsequent true up is not too large. So long as this is done, then a later true-up adjustment can be tolerated, even in the context of high levels of volatility. See our response to question 5 for further information.

7 Do you agree that we should carry out only one wider debt-related costs true-up?

So long as the true up is adjusted to reflect Ofgem's latest view of bad debt, as suggested in our responses to questions 5 and 6, then a single true up should not expose consumers to a price shock.

8 Should the float allowance be uprated to account for inflation, or should we make no additional adjustments?

Inflation has risen 9 fold compared to the when Covid-19 true up was agreed[2], and this necessitates a different approach. If Ofgem does not adjust for inflation and bad debt volatility, consumers risk being exposed to a substantial price shock in the true-up.

Therefore, the float should be periodically adjusted to account for inflation as well as Ofgem's latest view of bad debt, based on RFI data.

9 Do you agree with the proposed overarching methodological approach for estimating

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2 https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/february2021
https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/september2023

<u>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>

Our understanding is that Ofgem has attempted to recut the data that underpinned the original price cap assessment in order to carve out a debt allowance. However, Ofgem faced a number of limitations in terms of the data they have available to them as the original dataset was used for a top-down assessment. Instead Ofgem has drawn from other RFI information obtained from the same period in an attempt to carve out three distinct debt allowances from three broader price cap allowances. Those allowances were set on the basis of data from benchmark suppliers, chosen at the formation of the price cap for reasons other than calculating bad debt, debt recovery costs and debt cost of capital.

This presents a number of issues.

Firstly, while the benchmark suppliers may have been appropriate for the operating costs allowance, for example, that doesn't necessarily mean that they represent an appropriate benchmark for a bad debt charge or bad debt admin allowance. We have no way of telling how representative these suppliers were in the context of the broader 2018 market.

Secondly, Ofgem is relying on 2018 data that wasn't collected for the purpose it's currently using it for. We don't know if the suppliers in question natively held debt data at that level of granularity or if they were obliged to make assumptions in order to complete Ofgem's RFI. It may be that assumptions were fine for the purpose of what the data was originally collected for but that may no longer be the case. Where assumptions have been made, we do not know how accurate these assumptions are. Even if 'real world' data was used, we do not know whether differing accounting practises and internal treatment of debt have had an impact on the data presented the RFI.

We understand that some sort of allowance must be created so that supplier performance can be benchmarked. However, what's concerning is that in later parts of the consultation an assumption is taken that these distinct benchmarks are accurate and therefore that one can accurately use a lower quartile approach in some respects and a weighted average in others because unquantified efficiency and non-efficiency factors may or may not apply. There's a substantial risk that Ofgem will be benchmarking against unrepresentative numbers. A weighted average approach to benchmarking should be adopted across the board in order to account for potential inaccuracies in the allowance.

Finally, we note that Ofgem has raised issues of these nature in its concurrent operating costs working paper:

> *We consider that the approach of benchmarking at the total operating costs level is still proportionate from a time and data perspective, and is less technically complex. For example, it reduces some of the challenges associated with ensuring that operating costs are allocated to individual categories on a consistent basis across suppliers, providing more confidence that the data for each supplier is comparable. The difficulty of ensuring consistent allocation of costs between expenditure categories was a concern raised by a number of stakeholders.*
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> *It also takes into account the fact that costs incurred in some categories of the operating costs may be correlated with other cost categories. For example, suppliers who incur more debt-related administration costs to manage debt collection, may have lower level of bad debt costs in their accounts. This could mean that the sum of individually benchmarked cost lines might not be achievable by a notionally efficient supplier, particularly when using a more stringent benchmark approach.*
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> *We consider that some cost components (cost lines) can be grouped into broad cost categories, such as debt and debt-related costs and metering costs. Where we have confidence that such groups are identifiable in isolation and do not correlate with other cost components (for example, bad debt and debt-related costs do not correlate with*

metering costs), we may consider benchmarking these costs at a broadly defined cost level. Additionally, this does not preclude us from considering different benchmarks over different parameters (eg different benchmarks for different payment methods).

10 Do you have any other suggestions of alterative methodologies or other factors we should consider for how to calculate the debt-related costs over or under-allowance in 2022/23?

We note that the tables presented on Chapter 7 are based on incomplete data as further RFI data is to be collected. However, we also understand that the indicative figures presented are based on RFI data received to date and is therefore not purely illustrative.

As set out in our response to the previous question, we have questions about whether the allowance as has been calculated by Ofgem is truly accurate at the level of granularity shown in Chapter 7. For example, Table 7.2 shows that suppliers are underspending versus the calculated debt administration allowance (which adjusts by CPIH) despite the number of customers in arrears with no payment plan having increased 61% since the original benchmark was established[3]. Table 7.2 indicates that suppliers on a weighted average basis, are beating the ‘benchmark’ suppliers used to calculate the original price cap.

This raises questions about the accuracy of debt allowance calculations when presented at this granularity. It would lead us to believe that the debt admin allowance has been calculated incorrectly as it does not appear to align with broader debt trends. Applying a lower quartile allowance in this context would compound this issue.

11 Do you agree that we should consider each debt-related cost (bad debt, debt-administrative costs, and working capital costs) in scope of this review?

We believe that the calculation of the bad debt admin cost does not align with broader debt trends and therefore may need reassessment. However, that does not necessarily mean it should be excluded from any float while those issues are investigated. Subject to further QA of the debt admin allowance should be undertaken.

12 Which, if any, of the benchmarking options do you favour?

We recommend that Option 2, a weighted average benchmark, should be chosen. Our reasons are as follows:

1. As set out in our response to Questions 9-11 we have serious doubts about the accuracy of each individual debt allowance given the age and nature of the RFI data being used to calculate the allowances. Certainly we have questions about the debt admin allowance given suppliers apparent performance against that allowance in the context of massive increases in debt.
2. Using a weighted average allowance across the piece helps address these issues:
    a. Of one allowance is too stringent while another is too generous, then using a consistent benchmarking approach helps cancel these inaccuracies out.
    b. It also helps with any timing issues between debt admin costs, bad debt and cost of capital as customers go through the debt journey at the time the float is set.
3. We do not think it is advisable for Ofgem to prioritise ‘efficiency of debt administration’ in the current context. Ofgem’s recent Consumer Standards decision placed a number of additional requirements on suppliers around proactive engagement of customers who may be getting into payment difficulty. It is contradictory for Ofgem to place obligations on suppliers to do more and more while at the same time advocating a cost cutting approach to helping customers with their debt issues. Ofgem need to resolve

[3] Between Q2 2017 and Q2 2023, the number of electricity customers in arrears with no payment plan increased from 515,910 to 830,330. Source: Ofgem Data Portal. According to Appendix 1, Ofgem has relied on 2017 data to calculate the debt allowances.

this contradiction.

4. While we understand that the cost of capital was set at 10% under the price cap, Ofgem has used historical data from the same time period as the bad debt RFIs to determine in its recent EBIT decision that the cost of capital should have been 12.3%. To compound this inaccuracy by applying a lower quartile benchmark against a 10% allowance represents a substantial deviation from the real world capital costs faced by suppliers in the relevant period.
5. No explanation has been given of how ‘commercial decisions and underlying efficiency in debt practices’ would directly and materially the Asset Beta of a company and therefore the cost of capital under the CAPM methodology used in the price cap.

13 Do you have any views on which payment method allocation option would be preferable?

We recommend Option 1, allocating evenly between Standard Credit and Direct Debit should be chosen. Our reasons are as follows:

1. This approach follows the approach taken in the Covid-19 true-up decision. We are unaware of any compelling new information that would suggest that a different approach is advisable here.
2. As set out by Ofgem, the Additional Support Credit allowance already exists for Prepayment customers and the vast majority of Prepayment debt was accrued on other payment types.
3. Just as Prepayment debt accrued on other payment types a large proportion of the debt that would be allocated to Standard Credit customers under standard accounting practice is actually accrued while customers are on Direct Debit. Many customers who have an active Direct Debit may have been accruing a debit balance because of historic underpayment. However, when suppliers provision for debt they treat Direct Debit customers and Standard Credit customer differently. Therefore, when a Direct Debit customer who has accrued a large debit balance cancels their Direct Debit, the historic debit balance will be ascribed a much higher provisioning figure. Because Ofgem’s RFIs follow this standard accounting practise, it means that debt accrued by Direct Debit customers is systematically under-represented. In addition to this, customers on Direct Debit and on a debt repayment plan and customers having their Direct Debit reduced below their ongoing energy costs due to affordability issues are increasingly common. Option 5, which allocates costs in a manner consistent with Ofgem’s RFI, suggests for Direct Debit customers, suppliers have outperformed a £174.78[4] allowance by £28 in the context of record rises in energy costs, the volume of customers encountering debt issues and overall indebtedness – this simply isn’t plausible.
4. Increasing the price cap for Standard Credit customers by £144 is likely to exacerbate indebtedness issues in the industry. Debt accrued on this payment method is most likely to become bad debt.

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

The consultation implies that these costs will be allocated across all payment methods equally, Direct Debit, Standard Credit and Prepay, and it states that this is consistent with the Covid-19 decision. However, reviewing that decision[5] it would appear that no cost was allocated Prepay:

[4] Calculated by adding all the Direct Debit allowances in Table 6.2 of the consultation.
[5] https://www.ofgem.gov.uk/sites/default/files/2023-02/Price%20cap%20-%20Decision%20on%20the%20true-up%20process%20for%20COVID-19%20costs.pdf

Table 6.1: COVID-19 true-up allowance allocation by payment method

	COVID-19 true-up allowance
Standard credit	£12.02
Direct debit	£12.02
Prepayment meter	£0.00

Note: all numbers are £ per typical dual fuel customer

We believe that the approach of dividing equally between Standard Credit and Direct Debit is the correct one and appears to be consistent with the Covid-19 decision and Ofgem's rationale provided within that decision. We would like Ofgem to provide clarity on this matter.

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

It is difficult to comment on this given the interactions between this proposal and tariff levelisation. Choices made by Ofgem there will influence the risk profile of the options presented here, and vice versa. Therefore, our preference is dependent on what happens with tariff levelisation.

The case for applying to the standing charge

We have significant concerns about the detrimental effect tariff levelisation may have on competition in the market.

If prepay would be excluded from this debt allowance as suggested in our response to question 14, the charge would be applied to standing charge only and prepay tariff levelisation could be abandoned entirely as the standing charge differential would be eliminated. This approach would have substantial benefits in terms of preventing cross-subsidy related distortions in the market and providing price certainty and lower risk premiums for fixed tariff offerings.

The case for applying to the unit rate

It is reasonable to say that the level of debt incurred by customers will be correlated with their consumption. Therefore, tying the charge to the unit rate is more reflective of the source of bad debt and also incentivises consumers to reduce their exposure to bad debt by reducing consumption.

Furthermore, standing charges in general have increased considerably in recent years and the general perception that bills are rising and there is no action a consumer can take to avoid that fate has had a detrimental impact on consumers' perception of industry and the regulator. Compounding that issue by increasing the standing charge further still, will not help overall levels of trust in the market.

In conclusion, we believe there is only a case for applying the costs to the standing charge as a means of avoiding the introduction of tariff levelisation and the problems it brings. Otherwise, it should be applied to the unit rate.

16 How should we apportion any debt-related costs allowance between fuel and meter types?

This will depend on the quality of the debt data obtained by Ofgem and the strength of any deviation between types. Ultimately all approaches will create winners and losers. There is no clean line of proxy for bad debt when it comes to fuel and meter type. Therefore, the priority should be on ensuring that no one category of customer is unduly impacted by the cost increase should be a strong consideration and that would point towards an equal allocation of costs between meter and fuel. Dual fuel customers would pay the most overall but we note that off gas customers tend to occupy lower income bands[6].

Yours Sincerely,

Paul Fuller
Head of Regulation
SO ENERGY

[6] See 'Distributional Impacts' https://www.ofgem.gov.uk/sites/default/files/2023-04/Levelisation%20of%20payment%20method%20cost%20differentials_Call%20for%20evidence_2604231682350750835.pdf