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Dear Sabreena

**CHANGING STANDING CHARGES FOR PREPAYMENT METERS AND DEBT
RELATED COSTS ACROSS PAYMENT METHODS – STATUTORY CONSULTATION**

We are generally supportive of Ofgem's proposed approach in the statutory consultation, namely levelisation followed by reconciliation. Our answers to the consultation questions are in Annex 1. In summary:

- We support levelisation of standing charges between those who pay by prepayment (PPM) and those paying by Direct Debit (DD) as well as some degree of levelisation between those who pay by Standard Credit (SC) and those who pay by DD.
- We disagree with the extent of levelisation that Ofgem is proposing between DD and SC. Ofgem needs to balance fairness against the need to incentivise efficient customer behaviour. We believe Ofgem's proposed differential of £62 is too low and should be at least £100 to incentivise payment by DD. Ofgem should work with customers, customer groups and suppliers to determine a differential that strikes the right balance between retaining incentives and fairness, and adjust the proportion of bad debt charge that is levelised to achieve this target differential.
- We agree with the proposal to exclude PPM customers from the costs of levelisation, but we disagree with Ofgem's stated rationale, which links the recovery of bad debt costs to the ability to build debt. In attempting to explain this rationale, Ofgem risks misrepresenting the actual situation around debt and bad debt in ways that could create unhelpful precedents. It would be simpler and less contrived for Ofgem to justify its decision on fairness grounds, recognising that PPM customers are more likely to be financially disadvantaged.
- We agree that reconciliation is an essential element of the proposition. Without this, suppliers with a higher proportion of customers paying by Standard Credit (SC) or

PPM would be at a disadvantage to those with a higher proportion of customers paying by DD.

- In relation to reconciliation, we are not convinced that it will be sufficient to base the adjustment on estimated consumption without true up given the potential materiality of errors in estimates. We understand that this matter will be further considered when designing the unit rate reconciliation mechanism prior to its implementation in October 2024.

Once the levelisation / reconciliation mechanism is in place, as part of the Operating cost review, Ofgem should unwind the existing competitive distortions from the smearing of costs between SC and DD in price cap allowances.

Yours sincerely,



Richard Sweet
Director of Regulatory Policy

CHANGING STANDING CHARGES FOR PREPAYMENT METERS AND DEBT RELATED COSTS ACROSS PAYMENT METHODS – SCOTTISHPOWER RESPONSE

1) Do you have any comments or views on our updated case for the introduction of levelisation of payment methods?

We agree with Ofgem's case at a high level, namely that:

- The cost of serving customers varies according to the customer's payment method.
- This must be reflected in what customers pay (ie in the price cap) so that an efficient supplier can recover its costs.
- This leads to accurate price signalling and efficiency incentives, eg to encourage customers to move to cheaper payment methods.
- If cost-reflective charging is shown to be delivering negative outcomes for some consumers, a policy decision could be taken to shield those customers from some or all of this by reducing their tariffs.
- Reducing the tariff for some customers will mean increasing it for others without external subsidy.
- A reconciliation mechanism is therefore essential so that suppliers who still bear the cost-reflective costs are not differentially impacted by the policy, distorting competition and making some customer groups unattractive to supply.

Whilst we do not disagree with Ofgem's proposal to recover SC levelisation costs across all *credit* meter customers rather than across all customers (as proposed in the August policy consultation), we disagree with its stated rationale. We think Ofgem is wrong to justify including credit customers on the basis that they have the ability to build debt, while excluding PPM customers on the basis that they do not normally incur material debt. Rather, we think that Ofgem should acknowledge that customers who are paying their bills, by whatever payment method, are not responsible for bad debt costs caused by those who don't pay.¹ Therefore, as a starting point, Ofgem could consider socialising costs equally across all customers. However, given that PPM customers are disproportionately likely to be struggling with affordability, Ofgem could decide on *fairness* grounds to recover across SC and DD alone. The weakness of Ofgem's rationale can be seen by considering the hypothetical case in which PPM customers were wealthier on average than credit meter customers: it would then be manifestly unfair to exclude them from socialisation of bad debt costs simply on the basis that they do not normally accrue material debt.

Our second disagreement is that Ofgem does not explicitly recognise the need to balance considerations of fairness and efficiency. Even if it appears to be a fairer approach to smear all bad debt costs equally across all credit customers, this is not necessarily the optimal policy response if it weakens incentives for efficient behaviour by customers. As we argue later in this response, we think Ofgem should start by considering what is the minimum differential between DD and SC to encourage efficient choice of payment method and then adjust the proportion of bad debt costs that are smeared across DD to match this differential.

In this context we are unsure what Ofgem is implying when it says "*SC alone is a poor proxy for bad debt as it is also generated by DD customers and there are real advantages to all customers for it to be shared more equally by DD and SC customers.*" If this is simply restating the rationale for recovering costs across all credit customers, our above critique of Ofgem's rationale applies. If Ofgem is commenting on the approach to assessing the costs to

¹ Eg see [Decision on the potential impact of COVID-19 on the default tariff cap \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/consult/condocs/cap/cap19/cap19_122.htm), para 3.111

suppliers of SC customers versus DD customers, for the purpose of the price cap, and suggesting that costs should be allocated more evenly across SC and DD customers in the first place, we fundamentally disagree. Our historical experience to date as a supplier in the retail market, has shown us that customers paying by SC are significantly more likely to get into debt. Customers on DD that move onto SC as a result of lagging behind are much more likely to engage and work out a plan to repay and move back to DD. In our response to Ofgem's Debt related cost RFI in October, we outlined how customers move between payment methods and where debt usually builds up:

- Customers defaulting on DD arrangements will move to SC with a small element of debt building up on DD. However, this is usually lower than the level of debt that is then built up on SC, as the movement to SC will occur after only one missed DD payment, while further non-payment on SC will then build up until the customer engages to agree a suitable repayment plan. Ofgem should also consider that customers defaulting from DD to SC, may have originally moved to DD from SC with a repayment plan to recover debt built up on SC.
- Our data also shows movement from SC to DD with this demonstrating those customers move back to DD where we agree a repayment arrangement on the cheaper DD payment method once the customer engages with us.
- Our data also shows the impact of the PPM moratorium with a significant reduction in movement from SC to PPM during 2023.

In our response to the consultation on the true-up of Covid bad debt on 18 November 2022 (a copy of which we will provide alongside this response), we gave additional data and detail on the debt pathways and the potential for DD/SC allocation of debt.

Finally, whilst we agree with Ofgem's case for its policy proposals in the current regulatory and policy environment, the real issue here is the affordability of energy for lower income households and we still consider there is a need for a social tariff.

2) Do you agree with our levelisation policy aims?

Ofgem has noted two primary aims:

i. Customers that pay by PPM should not pay a premium.

We agree with this aim in principle but consider that it should also apply to unit rates such that if PPM unit rates increase relative to DD unit rates in the future, the levelisation / reconciliation mechanism could kick in.

ii. All customers that have the ability to build debt should contribute equally to debt-related costs.

We do not agree with this aim since (as noted in response to Question 1) we do not agree with Ofgem's rationale in terms of 'ability to build debt', and we consider that fairness needs to be balanced against efficiency. As with the PPM levelisation, we can therefore appreciate the rationale to move some way towards levelling SC and DD tariffs whilst leaving a differential to incentivise customers to choose an efficient payment method. Therefore, we believe the aim should be amended to be the first of the secondary aims **"The SC premium should be reduced but not below the minimum level to incentivise efficient choice of payment methods"**.

We agree that, given the high proportion of PPM customers who are financially vulnerable, there should not be a reallocation of costs to PPM customers.

Ofgem has also highlighted three additional secondary aims, the first of which we consider should be a primary aim, see above. We discuss each of these secondary aims in turn:

- a. **The SC premium should be reduced but maintained to incentivise efficient payment methods.** We agree that SC is a more costly payment method and therefore any policy implemented must retain incentives to move from SC to DD (and not to move from DD to SC). We believe Ofgem's proposed differential of £62 is too low and should be at least £100 to incentivise payment by DD.
- b. **Levelisation should be enduring and responsive to policy changes.** As we noted in our previous response on levelisation, we agree with this sentiment to the extent that it is possible without knowing the future price protection policy or market structure. We consider that it should be made as future proof as possible.
- c. **There should be limited or no gap in support for PPM customers following EPG removal.** We agree with this aim.
- d. **The solution should be proportionate.** Whilst we agree that a solution should be proportionate, Ofgem has only referred to minimising costs in its consideration "*minimising the intervention, risks of unintended consequences, and administration costs*" rather than any consideration of materiality. As such, we disagree with the interpretation of this aim.

3) Do you agree with our proposed approach to levelisation?

Ofgem has proposed three options:

- Option 1: Do nothing (base case) no levelisation
- Option 2: Levelise PPM and DD standing charges
- Option 3: Levelise PPM and DD standing charges (Option 2) and levelisation of DD and SC debt-related costs

Future proofing Option 2

In relation to Option 2, Ofgem has commented that "*this option may be less future proof as it does not necessitate the development of a unit rate reconciliation mechanism which means that the PPM premium could re-emerge should PPM unit rates increase relative to DD*". We see this as an issue for this option that can be easily resolved. Whilst we agree that for practical reasons, it is preferable to start with standing charge implementation to achieve the 1 April 2024 deadline, we consider that the unit rate element of PPM/DD levelisation could be added in due course alongside that of SC/DD levelisation.

Rationale for sharing debt related costs equally in Option 3

In its August policy consultation, Ofgem proposed sharing debt-related costs equally between all customers. The statcon is now proposing to share costs between SC and DD customers, excluding PPM customers, who are more likely to be financially vulnerable. As noted in response to Question 1, we agree with this approach, but we do not agree with Ofgem's stated rationale that only SC and DD customers are able to accrue debt:

“PPM customers, who have the highest proportion of financially vulnerable customers, will not be made to pay for bad debt that their cohort does not typically accrue. DD and SC customers are able to pay for their energy after using it and are therefore able to generate debt. While we recognise that there are exceptions (for example the use of ASC where there is material risk of self-disconnection and customer harm), PPM customers must pay for their energy before using it and therefore do not typically generate debt. The ability to accrue debt is, in effect, a service provided to DD and SC and therefore the costs associated with this service, the debt-related costs, should be levied on only these cohorts, rather than also on PPM customers who do not have access to this service.”²

The above rationale misrepresents the actual position in two key respects:

- *PPM customers not sharing in debt since they do not typically accrue debt*

Many PPM customers will have accrued significant debt on SC and will carry that over with them to PPM. Repayment plan values are currently very low and over lengthy periods of time and it is clear to us that many PPM customers will never repay the debt. In addition, PPM customers are currently accruing debt from Additional Support Credit (ASC) at higher rates than before. This has been recognised by Ofgem in its temporary allowance and this is also obvious from supplier data as well as our own data.

- *Splitting debt related costs equally between DD and SC since both are able to pay for their energy after using it and are therefore able to generate debt.*

Ofgem further argues that the ability to accrue debt is, in effect, a service provided to DD and SC. In our long experience as a supplier, customers paying by SC are significantly more likely to get into debt. Customers on DD that move onto SC as a result of missed payments are more likely to engage and work out a plan to repay and move back to DD. Ofgem’s reference to splitting the costs equally could be read as implying equal ability to accrue debt. In our view, DD and SC customers are not able to accrue debt *equally*. Therefore, we do not agree with Ofgem that Option 3 potentially corrects for inaccuracies in current allocations of debt which we see as mostly being applicable to SC customers.

To be clear, we are not disagreeing with Ofgem’s policy proposal to exclude PPM customers. Our concern is that Ofgem is invoking flawed reasoning to support this position, and this flawed reasoning could then set an unhelpful precedent, for example if it is used to justify other less sensible policy decisions in future. Indeed, we are unsure why Ofgem needs to use this rationale at all. Reducing charges for the more financially vulnerable PPM cohort on *fairness* grounds appears to us to be reason enough.

Unwinding the current bad debt smearing

In line with our views above that bad debt is mostly caused by customers on SC payment type, we believe Ofgem should unwind the current smearing in the price cap and include this in the levelisation / reconciliation mechanism. This would remove and avoid the current competitive distortions in the price cap.

Incentives to move from SC to DD in Option 3

Ofgem’s Option 3 brings up the issue of the SC/DD differential and the financial incentive for customers to move to or remain on more efficient payment methods. There are significant

² Statcon para 3.47

cost implications associated with SC for suppliers, and any approach to levelisation should avoid creating longer-term inefficiencies. For some customers, SC has additional benefits such as helping them feel more in control of their finances and cashflow, but these benefits come at a cost to suppliers. Not retaining an appropriate cost differential may therefore encourage more customers to move from DD to SC which would increase inefficiency.

We propose that Ofgem does not link the levelisation to bad debt allowances but instead to a pre-defined SC/DD differential. This would allow Ofgem to achieve the optimum balance of risks associated with incentives and fairness objectives. Ofgem should do some work with customers, consumer groups and suppliers to consider the level of price difference to maintain the incentives to choose more efficient payment methods.

Administration costs

Ofgem considers the administration costs of its proposals would be cancelled out by savings in relation to bad debt. If this is the case, Ofgem should take these costs and benefits into account in its ongoing review of operating costs in the price cap.

4) Do you have any views on the proposed amendments to SLC 28AD and model changes under Annex 9?

Ofgem has amended SLC 28AD to implement levelisation / reconciliation. It has chosen to include a provision to set the allowance to zero.

Using Electricity SLC 28AD.14B as the reference: *If the Authority has published a statement in writing to terminate or suspend the Levelisation Policy, the value of the Levelisation Allowance is zero.*

Whilst Ofgem expects to only use this in exceptional circumstances and mentions the possibility of “*a brief consultation*”, we do not consider that this is sufficient. The proposal increases regulatory uncertainty and therefore regulatory risk, and we believe it would be good regulatory practice for Ofgem to commit to consulting ahead of any decision.

5) Do you agree with our proposal to include uncapped contract numbers in the levelisation reconciliation?

Yes, we agree that Ofgem should include all domestic customers in the reconciliation mechanism to match the fact that they are included in the levelisation. This is to avoid introducing distortions between FTCs and price cap contracts. In addition, in the future when more customers have moved away from price-capped tariffs, the levelisation amounts would need to fall on a smaller number of price cap customers.

6) Do you agree with our proposal not to introduce an SLC requiring suppliers to offer the same standing charge on equivalent DD and PPM tariffs?

Yes. We agree that the uncapped contract market is generally highly competitive and price-sensitive closely reflecting the cost to serve or lower. As we stated in our response to the August consultation, we see no reason to believe that suppliers' pricing will not be cost-reflective in general (setting aside discounting which suppliers may engage in from time to time for customer acquisition). We also highlighted that one of the risks of non-discrimination conditions is that they may result in higher prices on average for consumers, eg if suppliers respond to the constraint on pricing freedom by levelling up rather than levelling down prices

We therefore confirm our view that the inclusion of uncapped contract customer accounts in the reconciliation mechanism will achieve aims without the need for additional licence condition requirements.

7) Do you have any views on our other considerations related to levelisation, regional levelisation and treatment of smart PPM?

Targeting and regional levelisation

Whilst we agree with the approach not to target levelisation or levelise regional differences from a practical perspective as part of this piece of work, we welcome Ofgem doing more work in this area. On targeting, we consider that Ofgem, Ofwat and other regulators should work together with government to better collect vulnerability data on consumers.

On regional charges, we disagree with Ofgem's view that levelling regional differences would be contrary to the broader direction of reforms looking to increase locational differentiation. Increasing locational price differences should not be an end in itself; rather it should be used to send signals for efficient consumption behaviour. Regional charge differences can reflect the different sunk costs in the different distribution networks and differences in efficiency between DNOs (which are not relevant to efficient consumption behaviour), and we can therefore see some arguments for levelisation in this area. However, any such measures would need to work alongside the locational signalling, and we agree with Ofgem that there would be an additional layer of complexity to this.

Smart PPM

Whilst we consider that smart PPM should be encouraged, we agree that if there is any cost differential relative to traditional PPMs it should most appropriately be considered in the operating cost review.

8) What are your views on our updated options including the need for a reconciliation mechanism and phasing of implementation?

Mechanism requirement

It is essential that any levelisation scheme is accompanied by reconciliation to avoid the risk of distorting competition between suppliers (and potentially other unintended consequences). We support Ofgem's approach to including a reconciliation mechanism. We disagree with the respondent that suggested that reconciliation distorts competition and reduces suppliers' incentives to engage their customers and manage their debt. Different suppliers have different customer bases. Legacy suppliers tend to have a customer base that has higher deprivation and is less engaged in the market. These customers are harder to engage, and many may be less able to pay their bills by DD. There are higher operating costs to serve SC customers, and higher levels of bad debt associated with SC customers since it is easier to not pay and get into debt. Not reconciling for these factors whilst levelling some or all elements of cost reflective tariffs would distort competition between suppliers with different mixes of customers. Levelisation, accompanied by reconciliation, provides an opportunity to mitigate the impact on consumers without distorting competition. As we have noted above, there remains a challenge is to find a proportionate, objective price differential that still incentivises SC customers to move to DD.

An approach to reconciliation could also be used to provide more cost reflective adjustment allowances in other areas and avoid creating winners and losers between suppliers and consequent competitive distortions. For example, the current smearing of bad debt costs in the price cap from SC to DD (via the PAP and PAAC and the additional COVID true-up) is a form of levelisation which distorts competition and risks adverse consequences for consumers. A levelisation scheme accompanied by reconciliation would allow Ofgem to include additional bad debt allowances in the price cap in a way that avoids smearing SC-related costs across DD and hence avoids this sort of distortion of competition between suppliers.

Operator, and type, and invoicing cadence

We support the use of RECCo as operator, reconciliation by difference and monthly invoicing cadence. We do not think having a separate unit rate / standing charge operator would be efficient depending on the ability of RECCo to deliver the requirements.

Approach to reconciliation

For standing charges, we agree with a daily rate adjustment. For unit rates we do not agree with using estimated consumption. We consider that unit rate reconciliation could be done at R1 or R2 settlement runs which would mean a delay in recovery. A decision could be made as to whether any further reconciliation true-up is required beyond R2, balancing administrative costs with accuracy and materiality. We agree with the proposal to develop and consult on this separately.

9) Do you agree with our proposal to exclude fixed term contracts agreed prior to our decision date from our levelisation proposal?

We agree with this proposal.

10) Do agree with our proposal for suppliers not to carry out, at their expense, an audit of their systems, processes and data to be used in reconciliation?

We agree that it is sufficient for data to be verified by a named company director or other authorised person, so that a named individual with sufficient seniority can assure Ofgem and the reconciliation operator that their data is accurate. However, if there is to be no specific requirement for suppliers to commission an audit, we agree it is essential that suppliers are required to keep records of the data to allow Ofgem or other industry bodies to retroactively review data to ensure quality and accuracy. If Ofgem has reason to suspect that there may be issues with a supplier's data, it should then be able to require the supplier to commission an audit.

ScottishPower
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