By email to RetailPriceRegulation@ofgem.gov.uk

Friday 9 October 2020

Dear Anna

Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation

Shell Energy Retail Limited ("SERL") welcomes the opportunity to respond to this consultation, and Ofgem's recognition that COVID-19 will likely put pressure on the Default Tariff Cap's methodology.

For the sake of simplicity, we agree with Ofgem that any COVID adjustment should be made using the "Adjustment Allowance" mechanism "on top" of the Cap, rather than amending individual cap allowance methodologies. However, as stated in Section 3 below, we believe a Covid Network Levy would be a fairer and more efficient means of recovering bad debt than via a Default Tariff Cap ("Price Cap") adjustment.

At this point, we agree a COVID-adjustment will be unnecessary for PPM customers, given the negligible bad debt risk, but we ask that Ofgem keeps this under review, particularly as new requirements to protect against self-disconnection are introduced.

1. COVID-related cost pressures for SVT customers

We support Ofgem's conclusion that key areas of cost pressure are likely to include:

- **Operating costs:** In our view, suppliers could face inefficient COVID-related costs, due to staff on leave as they self-isolate, greater customer contact volumes, with more customer service agents operating in virtual teams from home; and an inability to physically read meters.

- **Network charges and policy costs are already higher than forecast because these are fixed costs, smeared across all energy customers based on demand.**
    - We note that Ofgem approved two modifications to cap the half-hourly cost at £15/MWh from 25 June to 13 August and £10/MWh from 14 August to 25 October. We expect to be able to recover these costs through the Cap's existing methodology.

    - Contract for Difference (CfD) costs are set a quarter in advance and have been partially offset in the short term by a loan from BEIS, although this will be recovered in the first quarter of next year. We expect the Cap's existing methodology will enable us to recover these costs.

    - Low demand, combined with high solar load factors have driven Feed in Tariff (FiT) costs up to an all-time high for Q220 (April – June), reaching close to £10/MWh and on this basis, We welcome Ofgem's decisions to review the Cap's methodology to ensure realised FiT costs can be recovered.

    - The impacts of recovering fixed network charges over a smaller demand base will crystallize from 2022, when any network under-recovery will be recovered through increases to allowed revenues. Again, we expect the Cap's existing methodology will enable us to recover these costs.

- **Additionally, if a supplier goes insolvent without paying its debts, other customers must make up the difference through "mutualisation".** Costs that can be mutualised include network costs; the cost of low carbon levies such as the Renewables Obligation, Contracts for Difference, the Capacity Market and small scale Feed in Tariffs; and, in the domestic market, credit balances held and then lost by an insolvent supplier where the Levy is called upon. Altogether costs with the potential for mutualisation total c.£25 billion a year across domestic and nondomestic sectors (although over different timescales; balancing costs are calculated daily, but some network costs will take 2 years to feed through). Cornwall Insight estimates that every £60mn mutualisation costs customers an extra ~70p on a household bill[1].

  There is a risk that we could see a wave of SoLRs and mutualisations in 2021, as deferred charges become due, and as the economic impact of COVID-19 becomes clearer on customers ability to pay. Given the financial data per supplier now available to Ofgem, we note Ofgem's increased ability to keep the impact of this on the Cap under review.

- **"Bad Debt":** Supplier licence conditions rightly contain a legal commitment to consider "ability to pay" when setting payment schedules. In recognition that some customers will be unable to meet repayment plans, the Price Cap's operating cost allowance, payment method uplifts and uncertainty mechanisms enable the socialisation of some aspects of unrecoverable debt across the entire customer base. However, if significantly more customers than normal default on bills by dent of vulnerability - Ernst and Young for Energy UK modelled a range of 3 - 9% - the Price Cap's current methodology makes it impossible for suppliers to socialise that cost.

Given action to defer balancing and LCCC costs to 2021, we agree with Ofgem that, at this time, supplier provision for bad debt is likely to be the most material cost. We therefore likewise agree bad debt should be the focus of initial work. However, we ask that Ofgem continues to keep other costs under review as the COVID-19 situation continues, especially tied to mutualisation.

2. Consideration of bad debt

SERL realises these are extremely challenging times and standds ready to support all our COVID affected customers by offering energy bill pauses and repayment plans. We note all domestic energy suppliers have committed to ensure that *"any energy customer in financial distress will be supported by their supplier, which could include debt repayments and bill payments being reassessed, reduced or paused where necessary, while disconnection of credit meters will be completely suspended."*[2]

The above commitment by suppliers has both an immediate and a longer term implication. First, suppliers funding repayment plans will have substantially less cash than usual (noting suppliers are required to fund all their customer's debts to the rest of the energy supply chain, i.e. network charges, policy costs etc). Second, depending on the depth of long-term COVID-related vulnerability, it may not be possible for all customers to meet their agreed repayment plans without unacceptable financial stress to them. This would lead to unrecoverable or "bad" debt over a two year period.

The immediate impact on cash flow is why we support the proposed "float and true up" approach: an "ex post" approach would require suppliers to hold significant balance sheets.

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1 Cornwall Insight, November 2019, Link

2 *Government agrees measures with energy industry to support vulnerable people through COVID-19*, BEIS Press Release, 19 March 2020, Link

However, we do not support Ofgem setting the float *"lower than we estimate it is likely to be"* in order to consider the "*impact*" on customers: an overly cautious approach would mean that suppliers would either (1) fail to adequately fund repayment plans, leading to customer detriment or (2) fund plans they do not have the balance sheet to carry, leading to their collapse and the subsequent mutualisation of their debts, including customer repayment plans. The latter would be an unexpected cost which could itself send more suppliers into a Supplier of Last Resort (SoLR) situation.

In terms of setting the initial float: suppliers use roll rates — overdue balances that go from one 30-day cycle to the next without repayment — to determine the % likelihood of an outstanding balance being repaid, with this decreasing until the debt is written off, usually after two years. Ofgem could potentially use an average of such roll-rates to determine an initial "float", which would be trued up as debt crystallized.

We support Ofgem's proposal to benchmark the net change in bad debt between 2019 and 2020 as a proxy for the impact of COVID. However, we are concerned about Ofgem's proposal to benchmark costs based on a lower quartile supplier's change in costs because Ofgem holds the *"the bulk of the debt-related costs are related to recovering bad debt during a recession. Suppliers should have been aware of this as a potential scenario, and should have developed processes accordingly."*

In our view, bad debt is a function of three separate issues, which will all be affected to a greater or lesser extent by COVID-19:

1. **Supplier processes**, such as ensuring regular meter readings are carried out, customer direct debits are set at the right level, early warning signs of payment difficulty are identified, customer support and repayment plans are put in place when required, and appropriate debt collection activities are facilitated for those who "won't" rather than "can't" pay.

   In our view, such processes will likely be less efficient during COVID-19 due to areas outside of suppliers control, e.g. an inability to access meter reads; pause in debt collection for those who "won't" pay. Fitting prepayment meters as a customer option to repay debt will also be impacted.

   We also note suppliers are experiencing COVID differently, including whether these were able to obtain Govt funding/loans, and if they accessed network charge deferrals. This could skew using a subset of suppliers to determine efficient costs.

2. **Customer base:** The economic impact of COVID is as yet unclear, but it is a fair assumption that the impacts will be greater for customers who cannot easily work from home and for those in transient, low-paid work, above all in hospitality. In our view, newer suppliers with a more active base will be less likely to hold these customers, given Ofgem's own analysis (Ipsos Mori, 2019) th*at "Engaged consumers remain skewed towards mid-aged consumers, ABC1s and owner occupiers"*. Both the profile of customers (furlough/UC/self-employed/age groups and areas) and spread of customers (local lockdowns) could have significant impacts on levels of bad debt, again for reasons not related to operational efficiency.

3. **The bulk of additional costs will be related not to inefficient administration but to customer need, i.e. the cost of funding repayment plans as per the March 2020 agreement with government**. It is this last issue - customer need - we find especially problematic: an inappropriately low bad debt allowance will mean suppliers cannot support impacted customers without risking insolvency, given writing off one energy bill (£1050) requires the profit margin of more than 50 customers (£20 allowed under the Cap).

   A further concern is that suppliers are unable to increase non SVT tariffs quickly to reflect these higher costs, given the majority of tariffs are Fixed (either actively chosen 1, 2 or 3 year fixes). Indeed, we believe the current structure of the market makes it difficult to increase Fixed tariff levels at any point, which we detail further in Section 3 below. As such, Ofgem's current proposal is that suppliers will be under-recovering costs under the Cap, and potentially failing to recover them at all from active customers.

We recognise that a central challenge for Ofgem is the requirement to set a uniform allowance for all suppliers under the Cap. We therefore recognise that any approach which allows suppliers with a significant proportion of vulnerable customers to fully socialise the cost of repayment plans would result in SVT customers as a whole paying more. However, in our view taking the opposite approach risks even more significant customer detriment. If Ofgem sets allowances too low, then suppliers with vulnerable customers will either stop providing plans to customers in need, or else face bankruptcy and SoLR, in which case repayment plans will be socialised in any case via the SoLR Levy.

Perhaps an alternative approach could be a form of reconciliation, where a standard amount is raised from each customer and suppliers pay into a fund / receive monies from a fund dependent on the proportion of customers on repayment plans, as already exists for e.g. the Warm Home Discount scheme. This could potentially be conducted within the confines of the Price Cap, although in this case Ofgem must allow suppliers to collect a per £ per customer cost from Fixed as well as SVT customers by a new line item and contract variation in existing Fixed contracts. We appreciate this latter approach would be highly novel, but the scale of the COVID challenge requires an honest discussion about the type of mechanisms required to protect customers and safeguard the solvency of responsible suppliers.

Our strong preference is, however, for the fairer and more transparent approach of a COVID Crisis Levy on network charges. We set this out below.

3. An alternative proposition: COVID-Related Crisis Levy

The consultation proposes Ofgem will set a £ / per customer allowance for costs under the Cap.

The expectation is that customers on active tariffs (who aren't price regulated) will be charged a similar amount to those under the Default Tariff Cap.

However, in practice the ability to pass-through costs in the active market without losing significant market share is severely constrained because:

- **Larger suppliers face £50+ per customer of additional costs** because smaller suppliers are exempt from paying to help the vulnerable (via the Energy Company Obligation and Warm Home Discount) and from delivering binding smart meter rollout targets

- **Pricing in the active market has historically been driven below cost by poorly financed and managed suppliers who fund their operations not through equity or bank financing, nor through having in place appropriate risk management, but rather through customer credit balances or by avoiding meeting their legal cost obligations** towards Government schemes (which are then mutualised should they fail). According to Cornwall Insight, one fifth of suppliers offering the market cheapest tariffs have eventually exited. We welcome Ofgem's commitment to improving the behaviour of irresponsible suppliers but this work has been understandably paused due to COVID.

In our view, without policy change - i.e. removing the small supplier threshold and bringing forward Ofgem's proposed package of greater financial scrutiny for suppliers - it will be impossible for responsible larger suppliers to fully pass through the cost of bad debt to active customers. This would be deeply unfair on customers, because those on default tariffs would bear the cost of bad debt, but active customers - who are typically wealthier and less vulnerable - would not. It would also impact supplier solvency as full cost recovery would be constrained.

In our view, a fairer mechanism would be for Ofgem to cap bad debt at a certain % of revenue, with any debt above this amount recovered through network charges, paid back over a number of years by all customers. One option here could be for an COVID Crisis Levy on all future network charges, returned to suppliers in the proportion of payment plans paid out. This would be fairest to those customers with the largest number of COVID-affected customers, but would take several years to wash through, creating liquidity concerns for some suppliers. If this approach was pursued, we would therefore still propose a version of the "float and true up" approach suggested above, facilitated by an interest free government loan to provide the initial float, of the kind used to support the LCCC.

The advantage of this proposed approach is that money would flow directly to repayment plans, i.e. affected customers; and would be funded by ALL customers, Fixed as well as SVT.

Alternatively, Ofgem could determine the market average increase in bad debt as a % of turnover, and return that to all suppliers on a per customer basis through a reduction in network charges later this year, recouped via a future network charge levy. This would be easier and quicker to implement, and fairer than using the Price Cap as all customers, including Fixed, would contribute. However, a core concern would be that customers with a large % of repayment plans could potentially fail to recover full costs.

In either case, in order to prevent gaming, Ofgem could require suppliers to demonstrate they have efficient debt management processes in place before accessing the Fund, with perhaps a centralised definition of levels of effort expected to recover debt (and communications support for this) and write-off approaches. Ofgem could prohibit, or heavily discount, access to the Fund for suppliers who do not have appropriate debt management procedures in place.

Conclusion

The Price Cap's methodology is set for "normal" times. With potentially 1 in 7 workers facing unemployment, according to the OECD, suppliers will be unable to offer plans to all in need without either (1) direct taxpayer funding, such as a rebate from government to COVID-affected households to manage energy bills or (2) the ability to socialise doubtful and bad debt across those customers still able to pay - including Fixed as well as SVT customers.

As such, we ask that Ofgem:

- **Appropriately account for the likely impact of bad debt:** seeking to minimise recovery now, either by setting the float too low or by by benchmarking against lower quartile costs, will simply lead to suppliers unable to fulfil their legal obligations to customers without the risk of bankruptcy

- **Consider an alternative approach, whereby some costs are reconciled** to ensure suppliers who over-index on affected customers are able to continue offering repayment plans

- **Ensure the cost of any COVID-related "unrecoverable debt" is bourne fairly by society by ensuring Fixed as well as SVT customers bear the cost**: The simplest mechanism for this would be a Levy on network charges, with an initial "float" to fund repayment plans via an interest free government loan. Alternatively, Ofgem could use the SVT Price Cap mechanism but additionally require suppliers to collect a per £ per customer cost from Fixed as well as SVT customers by a new line item and contract variation in existing Fixed contracts.

We appreciate many of the proposals we discuss above are novel. However, in our view the scale of the COVID challenge requires an honest discussion about the type of mechanisms required to protect customers and safeguard the solvency of responsible, viable suppliers.

In this respect, we especially ask that Ofgem's next policy consultation contains a detailed impact assessment of proposals on suppliers of different sizes, locations and customer bases to help make clear the risks facing industry.