SCOTTISHPOWER

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CONFIDENTIAL

Dear Andy,

SUPPLIER OBJECTIONS: A CALL FOR EVIDENCE

Thank you for the opportunity to respond to the call for evidence on supplier objections.

In 1995, at the very start of the opening of domestic energy markets to competition, a key risk was identified that switching could make payment for energy effectively optional for customers for whom County Court action was not effective, as payment would no longer be necessary to achieve a continued supply. It was considered that the creation of such a loophole was unacceptable because of the risk that, as word got round, it could be exploited on a large scale. Neither the steps that suppliers might take to try to prevent exploitation of the loophole, nor the costs that would fall on other customers if those steps were thwarted by regulation, were considered to be in the public interest.

Two broad categories of measure were identified to address this – namely compulsory assignment of debt to the gaining supplier, or blocking of the transfer by the losing supplier. The decision in 1995 was that competition was better served by the latter measure because of the risk that assignment would transfer debts to new entrant suppliers that they might have difficulty managing.

The case for allowing suppliers to object to transfers for reason of debt has been assessed on a number of occasions since then and Ofgem has always concluded that the benefits outweigh the costs. The main change has been to introduce limited assignment for PPM customers through the debt assignment protocol, but the principle that switching should not be a means to make genuine charges uncollectable has been maintained. We agree that it is appropriate to revisit this issue in the context of Ofgem's reliable next day switching programme, but we believe the current policy, at least for domestic customers, remains appropriate.

<u>Domestic market</u>

As Ofgem notes in its call for evidence letter, the primary reason for objections in the domestic market is for debt. As discussed above, this right to object for debt was originally designed to protect consumers who do pay their bills from the actions of those who choose not to. In our view removing the right to object for debt, without replacing it with an assignment system, would have three main consequences:

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- *Higher bills, particularly for credit customers*: Suppliers would be exposed to substantially higher bad debt costs as increasing numbers of customers avoid paying their energy bills by switching supplier. These bad debt costs will be recovered through higher prices, particularly for customers on the standard credit payment terms where these costs are likely to be concentrated.

- *Less tolerant approach to customers who get into debt*: Faced with an increased risk that unpaid bills will translate into bad debt write-off, suppliers will seek to intervene earlier to prevent the build-up of debt. This is likely to mean greater use of prepayment meters and disconnections.

- *Greater scrutiny of new customers*: Suppliers will be likely to make more use of credit scoring, security deposits and other techniques to reduce the risk of taking on serial 'bad' switchers. This may make switching harder for some groups of customers – whether or not they intend to exploit the loophole.

We believe the above consequences would not be beneficial for consumers and would outweigh any benefits that might arise in terms of a smoother switching process. While we are open to looking at an assignment based system, we consider that the incoming supplier will need to be able to reject the switch if the assignment sum is over a certain threshold. Such an approach may be more complex to administer than the current system and would involve IT changes.

In the event that new legislation places limits on our retail prices, we would expect to see appropriate arrangements to allow us to pass through costs arising from any changes in our ability to object for debt.

<u>Non-domestic market</u>

We do not believe that any change is required in respect of larger non-domestic customers (except in respect of objecting for debt on deemed contracts), but in the case of microbusiness customers we think there is a strong case to align the objections rules with those that currently apply in the domestic market.

We have provided more detailed comments on the proposals within your document in the attached Annexes, as follows:

- Annex 1 provides comments on domestic objections
- Annex 2 provides our comments on non-domestic objections
- Annex 3 provides views on other markets
- Annex 4 provides an analysis of the average bad debt impact on Standard Credit bills.

Should you wish to discuss any of the points that we have raised, please contact me via the details provided or contact Lorna Mallon (lorna.mallon@scottishpower.com).

Yours sincerely,

Rupert Steele

Rupert Steele
Director of Regulation

Annex 1

SUPPLIER OBJECTIONS - A CALL FOR EVIDENCE: OBJECTIONS IN THE DOMESTIC MARKET

1. Introduction

In our view there are clear benefits to each of the allowed objections and little evidence of detriment. The ability to object for debt avoids the need to put up energy bills to recover bad debt costs; objections to stop incorrect transfers at the customer's request minimise erroneous transfers; and objections where relevant MPANs have not being requested together help avoid billing confusion.

We do not believe that the objections process is a major hurdle in practice for consumers who wish to switch supplier. Fewer than 10% of domestic transfers are objected to and many of these are subsequently resolved; we estimate that between 4 and 5% of transfer attempts are actually stopped.

Nor do we believe that the objections process affects consumer attitudes to switching. Analysis carried out by the UK Regulators Network[1] includes an assessment of barriers to engagement (and therefore switching) in different regulated markets. 'Barriers to and problems with the switching process (contractual, operational and transitional issues)' was a highlighted as key reason for lack of engagement in the retail banking and communications sectors, but there was no evidence that this was the case in energy.

As explained in our covering letter, the right to object for debt was an integral part of the 1995 gas market design, recognising that allowing people to switch to avoid paying their bills could create a loophole which might lead to a runaway growth in bad debt to the detriment of consumers who wished (and indeed put off other expenditure) to pay their bills. It was conceived as the essential corollary of the effective right to be supplied on credit terms.

This problem is also a concern in other jurisdictions. In some, it has been addressed by allowing the losing supplier to assign the debt to the new supplier, though this has the downside that the incoming supplier is left to sort out somebody else's debt problem. In others, there is a more aggressive approach to disconnection and a disconnected customer cannot get a new supplier until the bill is paid. We are open to examination of alternatives, but it is clear that simply making the payment for energy effectively voluntary for those where County Court action is likely to be ineffective would be likely to have widespread consumer detriments.

2. Consequences of removing the right to object for debt

We agree with Ofgem's assessment that the primary reason for objections in the domestic market is for debt.

Levels of consumer debt have been increasing both in the economy as a whole and in energy supply. According to figures published by the Bank of England, unsecured consumer debt reached a 7 year high of £1.25 billion in November 2014[2], a 7% increase over November 2013. According to The Money Charity[3], Citizens Advice deals with 6,407 debt cases every day. Ofgem's Social Obligations Reporting[4] shows an increase in the number of

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[1] Consumer engagement and switching, UK Regulator's Network, 17 December 2014, p13
[2] http://www.bankofengland.co.uk/statistics/Pages/bankstats/default.aspx
[3] www.themoneycharity.org.uk
[4] https://www.ofgem.gov.uk/ofgem-publications/92186/annualreport2013finalforpublication.pdf

gas and electricity accounts in debt at the end of 2013 when compared to 2012 (the latest figures available).

Energy debts are often not a priority for customers, when considered against other bills. Research conducted by RS Consulting in June 2013 on behalf of Consumer Futures[5] found that 71% of consumers surveyed had other debts to consider and that energy debts were low in the list of priority for payment (although not often the lowest priority).

Against this background, it is clear that the issue of energy debt is unlikely to reduce for consumers. We believe there will be three broad impacts on domestic consumers if the right to object for debt is removed:

(a) Higher prices, as suppliers are forced to recover increased bad debt costs;

(b) More aggressive debt follow up, as suppliers attempt to restrict the build-up of further bad debt (in the face of an increasing number of customers taking advantage of the 'payment loophole' created by removing debt objections); and

(c) Suppliers becoming more selective in their offerings for new customers.

We explore each of these in turn below.

(a) Higher prices for existing customers, particularly those paying by credit

Final debts (debts left with a supplier at the end of a contract) are significantly more difficult for suppliers to recover than live debt (debts owed by existing customers). In ScottishPower's experience, we collect around 70% of live Standard Credit debt within 90 days, compared to 40% collection of final debt in the same period, and our debt provision rates for final debt are around 2.4 times greater than for live debt. After 12 months, we assume that 0% of that outstanding final debt will be collected. Final debt that is not collected is eventually written off as bad debt. The costs of bad debt write-off and provisions against bad debt are a significant component of our costs to serve.

If the right to object for debt is removed, suppliers would incur significantly higher bad debt costs as they spend more on debt recovery to recover a smaller proportion of debts. Based on experience in the water sector[6] we would expect the situation to worsen over time, as awareness of the loophole grows and increasing numbers of customers seek to avoid paying their energy bills by switching supplier.

The increased costs of bad debt will lead to higher energy bills, particularly for customers who pay by Standard Credit, given that the increased bad debt risk will be concentrated on this payment method. As a rough estimate, we have calculated a per-service increase of around £10 on a Standard Credit customer bill[7], based on 2014 average customer debt values from our Social Obligations reporting, an assumed annual objection figure and the number of standard credit customer accounts from 2014.

With the increasing trend in consumer debt and drawing on experience in the water industry that indicates increased debt levels as consumers become increasingly aware of the opportunities to avoid paying their debt, it is reasonable to assume that this amount could increase significantly over time, perhaps to £25 per fuel or more. Energy bills are generally

[5] http://www.consumerfutures.org.uk/files/2013/07/Ability-to-Pay-RS-Consulting.pdf
[6] See Annex 3 below
[7] See Annex 4 below

much larger than water bills, so the incentive to utilise any loophole would be correspondingly greater.

Objections for debt therefore act as a necessary backstop tool for recovering debt, so that the supplier has time to install a prepayment meter or pursue other debt follow up arrangements on the basis that dealing with the debt is part of receiving a continued supply. We believe it would be irresponsible to create a loophole that some customers could exploit to avoid paying for their energy, passing on the costs to those who do pay their bills.

(b) More aggressive debt follow up activity

A second consequence of removing the right to object for debt is that suppliers are likely to adopt a less flexible attitude to debt prevention, management and collection in order to avoid the build-up of debt which they now face a greater risk of having to write off. This may lead to greater anxiety for those in financial difficulty or who need additional support, deterring them from engaging with their supplier to seek help when needed.

Currently the debt follow up process takes a minimum of 50 days between the issue of a bill and a warrant visit for non-payment, and in most cases significantly exceeds this. To compensate for the loss of objections, debt management activity would likely be accelerated relative to current timescales, as suppliers seek to avoid the build-up of debt.

Suppliers may also need to place greater reliance on disconnection as an alternative to prepayment meters. Whether the debt moves with the customer or not, disconnection for debt is always considered as a last resort and is only used in cases where there is a complete breakdown in communication with the customer and a refusal to pay. The use of prepayment meters stops open-ended credit commitment from the supplier with little prospect of ever being repaid. It also facilitates the repayment of debts already owed. It is a far better means of credit management than disconnection. However, in the face of an increasing debt risk position (which is likely to be the case in the face of removal of the right to object) suppliers would be forced to strengthen and accelerate their general debt recovery processes, with increased reliance on disconnection.

Finally, if increasing numbers of customers switch without paying their debts, this may lead to greater use of legal enforcement where this is judged to be effective. Legal enforcement is intrusive, with bailiffs and high court enforcement officers possibly seeking to seize goods in order to settle the debt owed. However, there is a significant number of consumers for whom such enforcement is neither practicable nor effective.

These impacts were previously highlighted when Ofgem engaged ILEX Energy consulting to undertake an independent review of the right to object for debt (specifically in the domestic market) in 2006 as part of the Supply Licence Review. In that report, ILEX concluded that debt objections should be phased out over time, on the basis that retaining the right to object as a backstop meant that suppliers were 'too soft' on debt collection. Specifically the report stated:

> *"Based on our review of the arrangements in Great Britain and those of a number of other countries, in our view the most pragmatic way forward for this is to phase out debt-blocking by a stepped series of increases of the threshold of debt which can be objected to.*
>
> *We acknowledge that many of these tools to manage debt may appear to be harder on customers in debt, including credit checks, security deposits, customer black lists, targeted tariffs towards bad payers, accelerated credit control processes, increased use of prepayment meters and ultimately disconnections. This review does not*

> *consider removal of the right to disconnect as a realistic way forward whatever other safety nets were to be put in place.*
>
> *We believe that the companies' current policies of helping customers in genuine difficulties will be continued, but as identified in the independent review by Sohn Associates, "Preventing debt and disconnection – the review", in March 2005, many customers do not see themselves as vulnerable and so some may be caught up in the stronger debt recovery methods. In any event, Ofgem, energywatch, politicians and other agencies will have to be prepared to support companies pursuing debt more vigorously during the inevitable rise in customer complaints."*[8]

In the light of these impacts and other representations from suppliers, Ofgem decided to make no change to the rules on objections in the Supply Licence Review. We consider that this was the right judgment – other options seem to us to have a worse result for consumers than the *status quo*.

While we recognise that smart meters will allow suppliers to engage with customers more quickly if the customer gets into debt, individual customer circumstances would still have to be considered before, for example, using the smart meter to switch to prepayment mode. Therefore, while smart metering may improve suppliers' ability to manage debt earlier in the process, we remain to be convinced that (with the current debt follow up processes) it will remove the need for debt objections. However, we do believe that it could be appropriate to review objections again once smart metering roll out is mature and in light of revised switching processes.

Suppliers becoming more selective in their offerings for new customers

The additional debt risks posed across the industry would drive suppliers to become more cautious about the terms on which consumers are offered a supply. This is likely to include increased use of security deposits, credit checking and the tailoring of supply terms to reflect the increased debt risk of some customers, which might limit the tariff terms available to them.

Most suppliers share information with Credit Reference Agencies (CRAs) on indebted customers, which can have an effect on the customer's overall credit rating. If suppliers face a reduction in their ability to recover debt, it is reasonable to assume that they will increase the use of CRAs, to both flag customers who have an outstanding debt and to gain better information on their customers (new and existing) to aid in managing debt risk. The increased use of CRAs could have a particularly negative effect on consumers who struggle to manage their finances more generally, by reducing their ability to obtain legitimate credit where needed.

ScottishPower does not currently use credit scoring for new domestic customers. However, without the right to object for debt, we believe that suppliers would need to make more use of credit scoring to determine the terms that a customer can be offered, potentially leading to increased use of security deposits for new customers or suppliers seeking to limit the tariffs which customers with a poor credit score can access. For example, suppliers may choose to offer a supply only on Prepayment terms to customers with particularly poor credit scores and who cannot pay a security deposit up front.

Credit scoring and security deposits are a relatively blunt instrument. While they may reduce the ability of dishonest customers to exploit the loophole, they are also likely to impact on

[8] "Domestic Customer Debt Management and the Right to Object – a report to Ofgem", ILEX Energy Consulting, May 2006, page (iv)

honest customers with poor credit ratings, acting as an additional barrier to switching. For example, if a customer has paid a security deposit to their existing supplier and wishes to switch, they may be asked to pay a second security deposit before the first deposit has been refunded (which may not be until their final bill amount is cleared). For many such customers this may not be affordable.

In summary, if objections for debt are removed it may be expected that energy suppliers would credit score any new customer (or at least those seeking credit terms) to assess their overall debt position and ability to pay. Customers whose indebtedness was deemed to be an issue would be subject to additional requirements. This could be through a requirement to pay a security deposit or a requirement to pay by prepayment meter or monthly direct debit (rather than being offered credit terms).

3. Alternatives to the right to object for debt

Ofgem has suggested some alternatives to the right to object to debt within its call for evidence document. Our views on these are set out below.

(a) *Extend the DAP to all domestic customers*

It is not clear whether this alternative is intended to operate with the current threshold of £500 or without limit. If it is intended to apply with a limit of £500, it needs to be clear what the intended process is for customers above that limit. One possibility would be to allow objections for these larger debts; if there was effectively no recourse once the debt reached £500, that would produce undesirable incentives for both the supplier and the customer.

However, the more significant problem is the impact of such a process on the receiving supplier. The benefit of the current DAP process is that the customer changes supplier while using a prepayment meter, which inherently provides the new supplier with a relatively secure means to recover the debt and prevent it from growing. If the process were to be extended to other payment methods (and possibly unlimited amounts) the receiving supplier could be landed with a debt that it could not reasonably expect to collect. Indeed, there is a risk that suppliers could actively encourage indebted customers to switch, in order to monetise the accumulated debt and pass the problem to a competitor.

(b) Adopt arrangements like those in Ireland where suppliers cannot object to a customer leaving but new suppliers can refuse to take on a customer with debt above a certain level (€225 is the threshold in Ireland)

We think that a debt assignment approach where the incoming supplier is able to reject the switch on being informed of the proposed assignment (if it is over a certain threshold value), broadly as used in Ireland, could be workable. However, it appears more complex than the current rules and may end up with a similar result in many cases. We would be happy to work with Ofgem and others to understand better how this might operate.

(c) Introduce new rules for example around security deposits.

We are not clear what Ofgem has in mind for these rules, but we assume the intention is to make it easier for suppliers to obtain security deposits, rather than restricting their use and risking further impacts on those customers who will end up bearing the burden of increased bad debt costs.

As noted above, we can see the potential for increased use of security deposits across the domestic customer base, not just for those with a debt who would actually be blocked from switching under the current rules, but additionally for those with a potential to build up debt in the future. However, as noted above, this would at best be a partial solution to closing the loophole that the lack of an objection or assignment system would present.

4. Objections relating to multiple MPANs (Related Metering Points)

This objection option allows for a smoother customer experience by preventing billing errors and allowing for the better management of complex metering arrangements. This is a process that provides a backstop for the industry and should be continued while there is no other way to ensure that multiple MPANs are linked within the switching process.

There may be opportunities to consider alternative approaches with the move to a centralised switching registration service. Although the need for related MPANs will remain with smart metering, responsibility for making the objection could be passed to MPRS providers or the Central Registration System as the objection decision will be based on data which is held centrally.

5. Objections relating to Erroneous Transfers and Customer Requested Objections

Objections relating to erroneous transfers and customer-requested objections are both key tools for protecting the customer experience. In our view, any intervention that can prevent the need for an erroneous transfer has to be a good thing for consumers and therefore we would be concerned about this impact of removing these grounds for objections without a suitable replacement. However, there may be opportunities to explore the use of the withdrawals process (now that this has been introduced under quicker switching) as an alternative option.

6. Objections relating to indebted customers with Green Deal Plans

As this has been specifically provided for within the Green Deal regulations, and has been designed to protect the finance companies supporting Green Deal arrangements, we would recommend it is not removed. However, we do not currently anticipate that this type of objection is likely to be used in any great volume.

Annex 2

SUPPLIER OBJECTIONS - A CALL FOR EVIDENCE: OBJECTIONS IN THE NON-DOMESTIC MARKET

1. Introduction

ScottishPower has in the past had concerns about the objections practices of some non-domestic suppliers and has raised these concerns to Ofgem as part of previous discussions around the treatment of micro business customers[9]. However, we have recently seen less evidence of these potentially negative practices, possibly as a result of Ofgem's increased scrutiny of this area.

Objections in the non-domestic market are different from those in the domestic market, in that most objections are raised under contract terms agreed with the customer – most commonly where the customer has agreed to a fixed price contract period, for energy purchased at a certain price.

2. Objections for larger non-domestic customers

For larger non-domestic customers (non-domestic customers who do not fall within the definition of a micro business), suppliers' energy purchasing strategies will be based on customers entering into contracts for an agreed period of time, and contract prices will reflect the supplier's reasonable security that the customer will purchase energy at that price for the agreed period of time.

As noted above, suppliers may only object to a switch where such objections are expressly provided for in the contract. Large suppliers will generally be in a position to negotiate the terms of the contract, and if by agreeing to objections they are able to obtain a better price, many will consider this an acceptable trade-off. We do not see any need for Ofgem to intervene to limit the range of contract terms which they can negotiate, particularly if this may result in them paying higher prices.

Under the current rules, suppliers cannot object for debt when the customer is on a deemed contract. We think this is an anomaly and would suggest that this aspect is brought in line with domestic rules.

3. Objections for micro business customers

The concept of a micro business customer was introduced into the supply Licence in 2009. Micro business customers are those who consume smaller volumes of energy and therefore may be more akin to a domestic customer in terms of purchasing behaviour and energy management capabilities. The supply licence provides additional protections for such customers, in recognition of their distinction from larger non-domestic customers.

We see no reason why microbusiness customers should be subject to the same objections rules as large non-domestic customers. Microbusinesses will not typically be in a position to negotiate contract terms and in this respect are similar to domestic customers. Many microbusiness transfers are currently objected to on the grounds that insufficient notice has been given to terminate. This right to object is unnecessary for microbusiness customers,

[9] These practices included objecting to our gain and then using the time to sign the customer onto a cheaper deal, and suppliers trying to bypass the objections process using the change of tenancy flag.

whose consumption is often comparable to large domestic customers, and constitutes a significant impediment to switching and competition. In contrast, debt is a particular concern for microbusiness customers, and objections for debt should be allowed for the same reasons as for domestic customers.

If the ability to object for debt is removed, this will particularly impact on those smaller micro business customers (for example family run businesses or sole traders) who do pay their bills, and who would face increasing energy bills as suppliers are forced to recover the costs of bad debt across their remaining customer base.

The same customers are also more likely to be adversely impacted by the use of additional debt risk mitigation measures that suppliers would have to adopt, such as increased use of credit checking (as some of these smaller businesses, especially new businesses, may not have an established credit record, limiting their access to competitive tariff options) and requests for security deposits.

We suggest that Ofgem considers distinguishing between objections for micro business customers (which should instead mirror the current domestic arrangements) and larger non-domestic customers (which should otherwise see no material change).

We would envision this as a two-stage approach to objections for non-domestic customers, along the following lines:

1. Mirror the domestic objection provisions for micro business customers, allowing objections for debt but removing the right to object for early termination of a contract (which would allow such customers to access other deals in the market but still enable suppliers to protect their wider customer base from the costs of bad debt); and

2. Retain the current objection rules for larger non-domestic customers, which will provide suitable protection against the contractual hedging risks that are more likely to exist with such customers.

4. Microbusiness customers - alternatives to objecting for debt

As in the domestic market, we think a model similar to the arrangements adopted in Ireland is worth exploring further for microbusiness customers, as part of industry-wide discussions.

However, it is worth noting that in the non-domestic environment, suppliers' ability to mitigate bad debt risk through alternative debt follow up tools might be more limited than in the domestic sector. For example, the use of prepayment meters is (for now) currently less common than in the domestic world, due to the complexities of utilising prepayment energy for some business models without impacting those businesses.

Therefore, suppliers who take on a customer with a debt and then struggle to get that customer to repay that debt may have to resort to disconnection more quickly than in the domestic market, where the installation of a prepayment meter is more likely to be an option.

5. Objections relating to erroneous transfers

It is our view that we should retain a mechanism that can aid suppliers in preventing erroneous transfer requests, as we believe this facilitates a better customer experience. However, as with the domestic process, there may be opportunities to explore the use of the withdrawals process (now that this has been introduced under quicker switching) as an alternative option.

6. Objections relating to multiple MPANs (Related Metering Points)

As in the domestic market, this objection option allows for a smoother customer experience by preventing billing errors and allowing for the better management of complex metering arrangements. This is a process that provides a backstop for the industry and should be continued while there is no other way to ensure that multiple MPANs are linked within the switching process. There may be opportunities to consider how this could be done with the move to a centralised switching registration service.

Annex 3

SUPPLIER OBJECTIONS - A CALL FOR EVIDENCE: LESSONS LEARNED FROM OTHER MARKETS

1. Energy markets in other countries

From our understanding, markets in other countries place a different emphasis on the obligation to supply energy to a customer or the processes for managing consumer debt. This reduces the need to object to debt, as the debt is not permitted to build up. For example, in the Spanish market the volume of disconnections is very high compared to the UK, which prevents the build-up of large debts. And once a customer is disconnected, we understand that the debt must be settled before the power is restored, whether or not he or she changes supplier. As a consequence, objection to debt is not a feature currently sought by suppliers, as debt rates are lower. However the Spanish regulator is currently reviewing options to reduce the costs of debt on the overall market.

In the US market, disconnection rates are as high as 8%. Customer charges are split between supply charges (billing and servicing) and transmission and distribution charges. Customers can change their competitive electricity supplier but can still be disconnected for non-payment of the transmission and distribution charges. Some customers have figured out this loophole and will intentionally only pay their transmission and distribution charges to avoid disconnection, therefore leaving behind their supply charges. Suppliers do have the ability to request security deposits when a customer returns to them, making the use of security deposits more prevalent as a means to manage debt risk.

2. Other UK markets

It is common practice in other competitive markets to utilise credit checking and tools such as security deposits or tariffs that reflect a customer's debt risk up front as a way to manage the likely debt risk posed by known bad payers. However these by their nature are more onerous on customers generally, as they are also applied to those who have payment difficulties. We believe that the current UK energy model enables much more tolerance of indebtedness with the knowledge that objection rules apply, and enables long term debt repayment arrangements.

In many UK markets, suppliers simply refuse to provide credit to consumers (for example, supermarkets) or only do so on the basis of (a) a direct debit mandate and (b) a good credit rating. A good example of the latter is mobile telephony, where both of these requirements are common (unless the customer opts for prepayment), and the companies are likely to cut off service more or less instantly if the payment terms are broken.

One anomalous sector in this respect is the water industry, where water companies are particularly limited in their ability to recover debt, with no right to disconnect for debt. This has resulted in increased consumer bills due to bad debt costs. In 2010 an Ofwat report on bad debt stated:

> "*More than five million households currently owe money on their water bills and over the last five years the amount owed has increased by more than 50%. Our latest information shows that the cost of collecting and writing off debts has risen further, adding about £12 to every customer's bill*". [10]

[10] http://www.ofwat.gov.uk/publications/prs_web_1002baddebt.

In January 2012 this amount had risen to £15 per customer[11], suggesting that over the period 2005 to 2012 the amount increased approximately threefold.

The Ofwat report mentioned above also shows an increase in aged debt since 2003/04. It suggests that a key reason for debt building in the water sector is the lack of any real incentive to pay water debts, making it less of a priority than other sectors (eg energy) where there are stronger debt collecting powers (ultimately supported by the right to disconnect, install a PPM or object). It has in essence created a loophole whereby payment for water is voluntary for a customer where County Court action is not possible (for example if the customer does not give his or her name) or effective. As this has become more widely known, more customers have ended up with water debts. Ultimately someone has to pay and in the water market this cost has been passed to the customers who do pay. Water companies have been criticised for the impact that this debt cost has on bills and are being encouraged to take tougher action against debtors to try to prevent this impact from worsening.

The increase in bad debt costs in the water sector in England and Wales following the removal of the right to disconnect, and the associated impact that this has had on consumer bills, highlights the impact of removing a valid protection against bad debt without a suitable, effective alternative option.

[11] Defra consultation 'Tackling Bad Debt in the Water Industry' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/82399/bad-debt-consult-condoc-120123.pdf

<u>Annex 4</u>

IMPACT ON STANDARD CREDIT BILLS OF REMOVING ABILITY TO OBJECT FOR DEBT

The table below provide a high level estimate of the potential increase in domestic Standard Credit bills as a consequence of the loss of the right to object for debt. This analysis takes into account the indebtedness figures for ScottishPower customers from the 2014 Social Obligations Report, an assumption of the number of objections for debt which would be lost in a year if the right to object for debt was removed (on the basis that each objection provides an opportunity for the supplier to recover that debt amount), and the proportion of the resulting 'final debt' (ie debt where the customer has terminated their contract) which would not be collected. This suggests that the additional bill impact for standard credit customers will be around £10 per annum.

However, this does not include the effect of increased numbers of customers switching to avoid paying their bills. Should this loophole become well known and more widely exploited, the impact on bills could be several times this amount. As noted in Annex 3, bad debt costs in the water industry increased threefold between 2005 and 2012 as more customers came to regard payment of water bills as 'optional'. If the same factor applied in energy, the bill impact for credit customers could be around £25 per fuel.

	Gas	**Elec**
Average arrears	£416	£465
Customers in arrears	36,787	53,984
Average debt repayment amount	£496	£311
Customers repaying a debt	57,409	88,178
Weighted average debt value	£465	£370
Annual objections for debt	10,000	21,600
Increased final debt (£m)	4.6	8.0
Proportion of final debt collected	40%	40%
Additional bad debt cost (£m)	2.8	4.8
Standard credit customers	327,261	614,373
Additional annual bill impact	**£9**	**£8**
Increase as loophole is exploited more	x3	x3
Additional annual bill impact (longer term)	**£26**	**£23**

<u>Sources and definitions</u>

Term	**Source**	**Definition**
Average arrears	2014 Ofgem Social Obligations Report	Average billed debt per customer in arrears who is not yet on a debt repayment arrangement
Customers in arrears	2014 Ofgem Social Obligations Report	Number of customers in arrears who are not yet on a debt repayment arrangement at the end of 2014

Term	Source	Definition
Average debt repayment amount	2014 Ofgem Social Obligations Report	Average debt per customer repaying a debt through a debt repayment arrangement using snapshot of debt as at the end of 2014 from Ofgem's Social Obligations Report (i.e. outstanding debt that the customer remains owing on their debt repayment arrangement, excluding debt incurred for subsequent consumption since the start of the payment plan)
Customers repaying a debt	2014 Ofgem Social Obligations Report	Number of customers repaying a debt on a debt repayment arrangement at the end of 2014 from Ofgem Social Obligations Report. (This includes non PPM customers on payment arrangements extending beyond 91 days/13 weeks and all PPM customers with a debt).
Weighted average debt value	Calculated	Weighted average of the average arrears amount and the average repayment debt
Annual objections for debt	Jan 2015 Domestic MMR report	Assumed number of objections based on number of objections for debt from February 2015, extrapolated across 12 months and reduced by 10% as a conservative estimate
Increased final debt	Calculated	Increased final debt resulting from customer switches which would previously have been objected to for reasons of debt (£m) The product of weighted average debt and annual objections for debt.
Proportion of final debt collected	ScottishPower experience	Proportion of final debt collected within 90 days
Additional bad debt costs (£m)	Calculated	Additional costs of bad debt write off resulting from removal of right to object for debt.
Standard Credit customers	2014 Ofgem Social Obligations report	Total number of services across all payment methods other than monthly Direct Debit and Quarterly Credit
Increase as loophole is exploited more	ScottishPower estimate (based on experience in water sector)	Increase in number of people switching to avoid paying bills as the loophole becomes more widely known
Additional bad debt costs (£m) (longer term)	Calculated	

ScottishPower
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