Sustainability *first*

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To: retailpolicyinterventions@ofgem.gov.uk

Dear Ofgem

Open letter: Review of how the costs of supplier failure are recovered

Sustainability First is a charity and think-tank with a focus on social and environmental issues in the energy and water sectors. Through our work we have given significant thought to issues of fairness in charging and have contributed to a number of past consultations on this topic. We draw on this thinking to contribute to what we see as an important issue in the context of the current cost of living crisis.

Whilst ostensibly this is a technical regulatory question on how customers should pay for the very substantial cost of supplier failure, there are material 'real-life' additional costs involved for every customer at a time of very tight household budgets. We recognise that this is a difficult question and that any solution will involve some customers who are already in real financial difficulty paying more than they can afford.

In summary, our position is that, while not perfect, a move to a volumetric recovery of SOLR costs on electricity (as is the case now on gas) would, on balance, be more progressive (and as such fairer) than recovery through the standing charge. It would also give consumers greater control over their energy costs, recognising budgeting control is a key factor in affordability and in supporting positive mental health.

However, we recognise that although most low-income households use less energy than average, and hence would pay less under a volumetric approach, there are some exceptions, who will face higher bills as a result. We would like to see further work to understand who these losers would be and any additional mitigating steps Ofgem or government might need to take.

While we welcome Ofgem's commitment to carry out a distributional impact analysis using its standard methodology we previously raised some significant concerns about the details of that methodology (see the Grid Edge Policy report[1] we provided alongside our response[2] to the consultation). We would encourage Ofgem to consider this evidence as a part of this review as it goes to the heart of the questions being debated now. We also advocated a wider discussion with

[1] https://www.sustainabilityfirst.org.uk/publications-consultation-submissions/236-ofgem-s-impact-assessment-guidance-including-distributional-impacts

[2] https://www.sustainabilityfirst.org.uk/images/publications/consultations/sf_ofgem_IA_guidance_final_300920.pdf

consumer groups on the distributional impact methodology to explore the issues we raised and to build confidence in the Ofgem approach. This would now be timely.

Longer-term, with residual costs set to increase further following Ofgem's Access and Charging Review, and in the context of the cost of living crisis, we would encourage Ofgem to take the opportunity to explore this whole area more fully, including looking at more radical solutions to the recovery of fixed costs like this and also looking at what further data sources they might use to better address distributional questions.

Our current work on Sustainability Principles has included looking more broadly at what is meant by "fairness" and highlighted in particular the importance of engaging with consumers on what they see as fair in particular contexts and the regulator being transparent about how it defines fairness.

We have attached our response to the various questions Ofgem raises together with links to our past work in this area. We would be happy to be involved in any further engagement Ofgem wishes to undertake on this topic.

Yours faithfully,

Maxine Frerk

Associate, Sustainability First

Cc Zoe McLeod, Policy Director Sustainability First

Judith Ward, Associate Sustainability First

Ofgem questions

a) Do you agree with the rationale for our review into SoLR cost recovery?

Yes – there was always a question as to why different approaches were taken in gas and electricity. Standing charges have become increasingly material and a growing concern for customers with escalating prices more generally.

b) How do you consider we should manage trade-offs between charging on a fixed charge basis vs. volumetric?

Distributional impacts

Sustainability First has long- taken a considered view that a volumetric charge is less regressive than a fixed charge as set out in the report on the TCR produced by Grid Edge Policy which Sustainability First used as the basis for a consumer group roundtable.

We recognise that there are wide divergences within groups and it is not simply the case that those on lower incomes due to their relative poverty consistently spend less on energy than others - however the Grid Edge research confirmed this is the underlying pattern. And indeed, with the current cost of living crisis following on from the negative financial Covid pandemic impacts, we would expect that budget pressures will have further reinforced that pattern.

Ofgem argues that there is a relatively weak link between consumption and vulnerability and large variations of consumption within vulnerable groups. We recognise these points but maintain – as set out in the Grid Edge Policy report - that the link with low incomes is somewhat stronger than Ofgem's analysis suggests (down, in part at least, to Ofgem's choice of dataset).

On the point about the large variations among low-income households we would note that one particular low-income high-use group is those in electrically heated homes. However, unlike most "policy costs", SOLR charges apply (separately) to gas and electricity customers. Therefore, while these customers will lose out from a move to a volumetric charge on electricity, their total contribution to SOLR costs will not be out of step with those of other low income households (as those in electric heated homes are not paying the gas SOLR charge).

More generally, we do recognise that focusing only on low-income consumers ignores the fact that not all low-income customers are at equal risk – some are more vulnerable to harm from not being able to afford energy e.g. those with young children, with certain long-term health conditions or disabilities who are more highly energy dependent and have higher need. Also, not all low-income customers receive equal social support from the state or from energy companies. To properly assess the impacts on these sub-groups would require Ofgem to have far better data than it does currently but we would encourage Ofgem to consider if there are particular groups of "losers" where additional mitigating action might be needed.

Fairness and control

Public perceptions of fairness are ultimately critical even for an independent regulator –a number of politicians and campaign groups have argued against the standing charge, in part as it is deemed

'unfair' as you don't have a 'choice' in whether you pay it regardless of usage and it takes away 'control' especially important as control is a key factor in affordability and in supporting positive mental health. This sense of injustice is perhaps particularly felt by many prepayment meter customers who may accrue debt/bill costs despite not using any energy or in practice pay more per unit of energy despite lower usage.

Wider economic considerations
While we consider that the impacts on low-income households should be the primary consideration in making this assessment, we are aware that in previous cases (such as TCR) Ofgem has favoured the use of standing charges to minimise distortions to economic price signals. However we would argue that even from an economics perspective there are arguments for the use of volumetric charges.

First, we note the work by David Osmon (Ideal Economics) who has highlighted that lower income households will typically have a higher price elasticity (because of income effects) and hence recovering fixed costs through volumetric charges that impact higher income households more – but who will change their usage less in response - is in line with economic principles.

Second, we would maintain that not all distortions are equally problematic. Encouraging energy efficiency by higher consuming households has benefits from an environmental perspective (that may well not be fully captured by the current charging structure).

c) Should SoLR costs be recovered by fixed charges, unit rate charges (i.e. volumetric), or some other method?

As set out above our preference on balance is for volumetric over fixed charges.

d) Do you consider that vulnerable consumers' interests are best served through the use of fixed charges, unit rate (volumetric) charges, or some other method? Please share evidence where possible.

In discussing charging decisions, the focus should be on those who are financially vulnerable and at risk of the most detriment from not being able to power or heat their homes. Ofgem needs to better understand who those groups are.

As discussed above we see a move to volumetric charges as broadly aligned with the interests of many of those on low income. We understand that NEA also support this position and we would expect them to be basing their view on their direct experience of supporting those in fuel poverty and the most vulnerable of customers.

Moreover, for those who are really struggling with energy our sense is that standing charges are disempowering for customers. For those customers facing really hard choices about where to spend their limited budget there is nothing they can do about standing charges. While there are clearly concerns about customers who cut back on energy usage purely to save money putting their mental and physical health at risk, this does at least give them a way to manage their day-to-day financial pressures.

We are mindful however that there may be some groups, including those with disabilities, who have higher energy needs, who may be disproportionately negatively impacted by this move and may be more likely to suffer detriment. They may also be less likely to benefit from social support delivered by energy companies, government or third parties. This is particularly important as a recent IFS working paper found that half of those in the most materially deprived tenth of the population (1 million) are disabled, but most of that group do not receive disability benefits[3] which are often used as a passport for energy support. In addition, government has rejected calls to extend the £650 one-off cost of living payment to people on disability benefits. In the short-term it seems many disabled people, despite higher living costs will receive less financial support with the cost of living crisis[4].

e) If changes were deemed to be necessary, should that take place: i. On an enduring basis; or ii. On a time-limited basis? iii. And if so, why?

It is not immediately clear why the changes should be on a time limited basis but this will clearly depend on what other changes are happening in the market (eg in terms of energy bill support) and the reasons Ofgem opts for a particular approach.

We would however strongly support a fuller review of the mechanisms for recovery of these and other fixed charges, such as the "residual" element of network costs, which would appear set to increase significantly with reforms such as the socialisation of distribution connection charges. Sustainability First has previously proposed a number of more radical but potentially fairer long-term solutions to residual charge recovery and would argue that the time is right to consider such ideas, alongside current discussions around social tariffs. These include:

- the use of capacity charges (which better reflect the underlying cost structure of the industry going forward and offer a form of rough justice in terms of lower income households typically placing less demands on the system).
- some level of essential usage which would be charged at a lower price or even free to those in financial difficulty (or more radically to all consumers with costs recovered from the state as part of a minimum basic income style approach). The former could be achieved by allocating SOLR costs and residual charges / policy costs on the basis of usage above a defined minimum level as advocated by Dieter Helm in his Cost of Energy review.
- a standing charge for export as a more targeted way of addressing the distortion that drove Ofgem's proposals around TCR (ie that those with their own generation who tend to be better off, have low consumption and hence avoid paying their fair share of the fixed costs of the system if these are recovered through volumetric charges).

While we recognise that such options are more complex to introduce, we do not believe that should be a reason for not considering them as longer term solutions.

In thinking longer term there is also a need to reflect on how residual charges are recovered over the day where they are on a volumetric basis. The changes made in 2016 through DCP228 to recover

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[3] WP202224-Living-standards-of-working-age-disability-benefits-recipients-in-the-UK-2.pdf (ifs.org.uk)

[4] Around six million people who receive disability benefits will get a one-off payment of £150 by the end of September, while those also in receipt of a means-tested benefit will receive the additional £650 payment which will come in two instalments.

distribution residual charges through fixed mark-ups rather than proportionate mark-ups across the red /amber / green time periods for DUOS charges had a significant dampening effect on time of use network price signals (and hence the business case for flexibility providers). As Ofgem indicates in its Net Zero Britain consultation there is an argument for stronger time of use signals on networks to help stimulate flexibility. While the aim clearly is that these should be cost reflective price signals, the question of how the mark-ups are applied for residual charges merits more strategic consideration (alongside the option of small-user capacity charges noted above).

f) If changes were deemed to be necessary, would you rather that they: i. were implemented using standard industry processes, even if this takes longer; or ii. were implemented as soon as possible, even if this meant using nonstandard processes? iii. And if so, why?

We would favour the changes being introduced quickly but recognise the need for industry to have time to implement. That said it remains open to Ofgem to reflect an alternative approach in how it sets the price cap even if the changes have not been worked through in network charges. In the first iteration of the price cap the standing charge was deliberately set at a level below what a cost reflective charge would have suggested because suppliers in the market had done so and Ofgem did not want to increase charges for low-income households. Whether this would be acceptable now to suppliers will depend on whether overall across their portfolio average usage is broadly the same but it is an option that Ofgem might usefully explore.

g) Do you consider there to be any interactions between the method of SoLR cost recovery and the support provided from the recently expanded government Energy Bills Support Scheme?

We are not away of any immediate interaction given that we understand the Energy Bills Support Scheme is being paid to all electricity customers. However, Ofgem may want to also consider the wider social support framework given the link between general poverty and energy bill affordability and who will be the winners and losers of government's overall cost of living package of support. This includes:

- £650 one-off **cost of living paymen**t for those on a range of **means tested benefits** – made in two instalments.

- £300 **Pensioner Cost of Living Payment** to all who receive the Winter Fuel Payment (not means tested) – "pensioners disproportionately impacted by high energy costs, and many low-income pensioners do not claim the means tested benefits to which they are entitled to" – will go to more 8 million UK pensioners.

- £150 **Disability Cost of Living Payment** – to around 6 million people who receive certain disability benefits. Recognises "those with disabilities face a wide range of additional costs such as specialist equipment, food, increased transport costs and these costs are likely to have increased". But significantly lower than the additional costs faced by this group.

- £500m increase in the extension of **Household Support Fund** – **local** support for those who need help with rising cost of food, energy, and water bills. The Government will issue additional guidance to Local Authorities to ensure support is targeted towards those most in need of support, including those eligible for Cost of Living Payments.

h) Do you consider there to be any further impacts that need to be considered, for example on supplier, DNO or IDNO businesses, on the risks held by industry, investors or external parties, or on wider industry arrangements?

No comment

i) Do you consider there are any unintended consequences associated with the potential recovery through fixed or volumetric charges or any alternative method you are proposing?

As set out above we recognise that there is not a perfect relationship between incomes and usage and hence there will be some lower income households with higher usage who will be adversely impacted by such a change. Understanding the characteristics of these low-income high-usage households is complex (as set out in our response on Ofgem's Impact Assessment guidance, referenced above).

One of the problems to date has been a paucity of data linking energy usage and demographics as discussed in our work on access to smart meter data for a public purpose (PIAG). Since our PIAG work – and since Ofgem's IA guidance was produced – the UCL SERL database is now up and running. Alongside the NEED database (which Ofgem does not appear to use for its distributional analysis although it uses it for eg TDCV) the SERL database is worth Ofgem exploring. The recent report from the SERL team shows the kinds of insight into energy consumption by customer segment that can be obtained with better data.

To really understand who are the winners and losers (and hence the potential unintended consequences) of these sorts of reforms requires more sophisticated analysis than carried out previously but that should now be possible as more granular smart-meter energy data-sets become available. In addition, there's a need to build understanding of which groups are most at risk from energy poverty and how much energy is needed in practice for different customer segments in different housing and parts of the country to be healthy and well and participate in modern society.