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2 November 2023

Dear Dan

ADDITIONAL DEBT-RELATED COSTS ALLOWANCE POLICY CONSULTATION

We welcome the opportunity to respond to your policy consultation on additional debt-related costs in the price cap. This consultation is backwards looking, focusing on temporary additional price cap allowances that are needed as a result of an increase in bad debt in the sector relative to what has been accounted for by the price cap. We would like to highlight the changes Ofgem has recently made to licences in relation to prepayment meters (PPM) that increases the number of customers for whom involuntary PPMs is not suitable. This will increase the level of debt on a forward looking basis. In particular, this will have differential impacts on suppliers with different customer mixes[1] and will particularly affect those with historic legacy customer bases. We therefore welcome Ofgem's consideration of our proposal for a levy mechanism which allows suppliers to recover these costs in a manner that mitigates competitive distortion and strengthens competition for the benefit of all consumers. We urge Ofgem to consult on this as soon as possible.

As we have noted in our previous responses to consultations on additional allowances, the price cap is a one size fits all mechanism and any additional allowances in the price cap are likely to increase competitive distortions between suppliers. Ofgem appears to have ruled out a levy mechanism but with the proposed approach to levelisation, Ofgem could implement something that uses levelisation / reconciliation to avoid competitive distortions and does not create winners and losers.

Notwithstanding our views on this, we have provided answers to the consultation questions in Annex 1. Our main points are as follows:

1. We disagree with the proposal to benchmark debt administration and working capital costs based on the lower quartile supplier for two reasons: (i) variations in costs between suppliers are more likely to be driven by customer mix rather than supplier efficiency, meaning that in general high bad debt costs will be correlated with higher debt and administration costs; and (ii), to the (limited) extent that differences are

[1] Annex 1 explains how Ofwat takes deprivation into account when setting debt allowances

driven by supplier trade-off decisions, low debt administration expenditure is likely to be correlated with higher bad debt and working capital costs (and vice versa). We consider that Ofgem should use a weighted average benchmark for all three cost categories.

2. Rather than benchmarking suppliers' bad debt, administration and working capital costs based on aggregate costs (ie aggregated across all payment methods), Ofgem should instead benchmark separately for each individual payment method. Notwithstanding point 1 above, this is particularly important if Ofgem is intending to use a lower quartile benchmark for administration and working capital costs, since the lower quartile will otherwise be dominated by suppliers with high proportions of Direct Debit (DD) customers for whom debt administration and working capital costs are relatively low.

3. We disagree with Ofgem's proposal to base working capital costs on the 10% cost of capital used in the 2018 price cap calculations. Ofgem's recent review of the EBIT margin set the cost of capital at 12.3%, reflecting an increase to the asset beta in recognition that systematic risks faced by energy suppliers are higher than those estimated in 2018 when the cap was developed. The data underpinning the estimate of 12.3% was taken from time periods which predate or align with the period under consideration for this review. The fact that the EBIT margin was not updated until 1 October 2023 is not a valid reason for assuming that cost of capital jumped from 10% to 12.3% on 1 October 2023. Indeed, the key drivers of increased risk relate to wholesale market volatility which started in late 2021 and the invasion of Ukraine in February 2022.

4. We agree that in the current high interest rate, high inflation environment it is essential to include some uplift for the 'time value of money' to reflect the delay between debt related costs being incurred and recovered via an additional price cap allowance. We believe the appropriate rate for Ofgem to use is the cost of capital faced by suppliers (12.3%) rather than the rate of inflation.

5. We generally agree with Ofgem's proposed float and true-up approach. However, given the significant issues around benchmarking debt administration and working capital costs, we believe Ofgem should allow itself more time to consider its approach, and should therefore exclude any adjustment in respect of these quantities from the initial 'float' amount. Indeed, given the run-rate of bad debt (£14 of the £17 total arising in the final quarter, cap period 10a), the gap between bad debt costs and allowance is set to grow rapidly, meaning that there will be headroom to claw-back any over-recovery in administration and working capital costs, should that be established.

6. We consider the time allowed to respond to this consultation is disproportionately short given the number and complexity of the issues raised. In the time available we have not been able to validate Ofgem's assumptions about the magnitude of existing allowances, and we reserve the right to provide further feedback and arguments on this aspect of the methodology ahead of any interim or final true-up process. Ofgem should not consider these assumptions to be settled (and exempt from further adjustment) in light of the short timescales associated with this consultation.

7. Any additional price cap allowance resulting from this review should be allocated to payment methods based on the raw cost data for each payment method (Ofgem's 'Option 5'), ie without any smearing of Standard Credit (SC) debt onto DD for social policy reasons as was done for the covid bad debt allowance. This is the only way to avoid exacerbating existing competitive distortions between suppliers. (A possible

exception to this is that we could envisage Ofgem reallocating a modest proportion of SC bad debt and working capital costs back to DD, to reflect the payment method on which debt was built up).

8. Depending on the magnitude of the allowances for SC and DD, Ofgem should separately consider whether there is a case for using the 'PPM levelisation' mechanism to implement some cross subsidy between SC and DD in a way that does not distort competition.

9. Ofgem says (paras 4.20-4.21) it is considering whether to fully reflect PPM moratorium costs in any future allowance, given that a supplier who has been in breach of SLCs historically (ie making excessive use of involuntary PPM installation) may see a larger increase in debt-related costs due to the moratorium compared to other suppliers. We do not understand this point. Ofgem's proposed approach is to measure the absolute level of debt costs relative to the allowance. If a supplier has installed more PPMs than it should have done in prior periods, this is likely to reduce the absolute level of debt costs going forward, and result in a lower estimate of PPM moratorium costs. (This might have been a relevant consideration under the old covid bad debt methodology, where the allowance was calculated based on increased bad debt costs relative to prior periods, but we do not believe it is relevant here.)

10. We understand that the initial float allowance will be based on RFI data for the period April 2022 to September 2023. However, given the rate at which bad debt costs are exceeding the allowance (£14 per dual fuel customer in period 10a alone), we are concerned at the lack of clarity as to how and when additional debt-related costs incurred after September 2023 will be recovered. We propose that Ofgem requests an additional RFI to get additional data to cover at least some of the winter period so that the initial float is more realistic where the decision is expected end of February 2024. We request further clarity on these aspects, including Ofgem's considerations around moving to a levy-based process for DNI customers (as proposed by ScottishPower and highlighted in the consultation in paragraphs 4.26 to 4.29).

11. To maintain trust and confidence in the regulatory process, it is essential that Ofgem establishes a confidentiality ring/data room so that its calculations can be exposed to third party scrutiny. We appreciate that Ofgem may not wish to do this at the 'float' stage. However, any decisions on methodology reached prior to testing via a data room should not, as a matter of principle, be considered settled and should be held open for review at the interim or final true-up stage when a data room is established.

Please do not hesitate to contact Richard Sweet or Dena Barasi with any queries on this response.

Yours sincerely,

Richard Sweet
Director of Regulatory Policy

Annex 1

ADDITIONAL DEBT-RELATED COSTS ALLOWANCE POLICY CONSULTATION – SCOTTISHPOWER RESPONSE

This annex provides our answers to the consultation questions. We first provide an overview of ScottishPower's approach to provisions as this provides important context for our response.

ScottishPower's approach to provisions

Bad debt provision rates for domestic debts are assessed annually and are calculated by considering the recoverability of equivalent balances over the previous three years. The data used to assess the rates is at least 12 months old so that debts have completed at least one annual cycle (particularly relevant for the DD payment plan). The percentage of debt which either remains unpaid or has been written off within each age band is deemed to be the rate of provision that should have been applied to the original billed debt.

By considering the core domestic payment plans and ageing brackets separately, this methodology takes account of the risks inherent in each payment type and reflects the increased difficulty in the collection of older debt balances.

Additional provisions are considered when deemed appropriate by management, particularly when assessing forward-looking risk to the existing debt book. This assessment of forward-looking risk includes reviewing macro-economic factors such as GDP forecasts, UK unemployment rates, inflation forecasts and any other relevant factors that management believe would affect a customer's ability to pay. [✂].

Our approach to providing for bad debt costs is fit for purpose. As described above, our bad debt provision rates are reviewed (and if appropriate adjusted) annually to ensure they accurately reflect the risk of non-recovery/write off. The methodology remains broadly consistent with debt age, customer type, live or final status and payment plan/method as key factors. [✂]. In our 1 November response to Ofgem's debt-related costs RFI, we set out under Question 6b our approach to provisioning for a range of scenarios, including our expected outcome, which shows an increase in provision rate for all debt for those customers impacted by the new Involuntary PPM rules who we can no longer move to PPMs. This applies to all customers falling into a DNI category, and a proportion of customers from the FAN category), ranging from between [✂] and [✂] depending on where the customer is in the debt journey. [✂].

Responses to the specific questions in the consultation document

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

As we have noted in our previous responses to consultations on additional allowances, the price cap is a one size fits all mechanism, and any additional allowances in the price cap are likely to create competitive distortions between suppliers. Ofgem appears to have ruled out a levy mechanism but with the proposed approach to levelisation, Ofgem could implement something that uses levelisation / reconciliation to avoid competitive distortions and does not create winners and losers.

Notwithstanding our views above, we consider that if the evidence shows that bad debt costs have materially and systematically diverged from the allowance, then Ofgem should make a

temporary adjustment to the price cap to account for this. Without an allowance, suppliers' financial situations will be weakened by the significant increases in customer bad debt. We would expect that the forward-looking operating cost review would consider more enduring changes to the cap for debt-related costs. This should include correcting for elements such as deprivation (potentially via a levelisation mechanism). Deprivation is recognised as a non-efficiency factor relating to debt by Ofwat, the water regulator.[2]

We note that the run-rate for bad debt costs is much greater than implied by the 15-month total, since £14 out of £17 under-recovery per DF customer relates to P10a and we are approaching the winter period where costs are likely to increase. The size of the allowance depends on how Ofgem seeks to calculate it including on the data used and how it is manipulated and finally how it is applied to customers. In our cover letter and in the rest of this annex, we comment on the following important factors:

- use of lower quartile vs weighted average costs;
- correcting for payment type in calculation of the allowance;
- which costs to account for (PPM moratorium, administration costs, bad debt charge etc) and how to benchmark these;
- the allocation of any additional allowances to payment methods.

We consider it is in customers' interests to ensure there is a provision to enable suppliers to recover efficient debt-related costs of energy supply. In the longer term, we consider the goal should be a social tariff aimed at the more vulnerable in society.

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

The moratorium on involuntary PPM installation is still in force at the time of writing. In February, all suppliers agreed with Ofgem to voluntarily suspend forced installation of PPMs and remote switching of smart meters to prepayment mode. In September 2023, Ofgem published its decision on new rules for suppliers in relation to involuntary PPM which included the introduction of new Supply Licence Conditions. As part of the decision, Ofgem expanded the categories of customers in the "Do Not Install" category who should not have an involuntary PPM.

Ofgem states in the present consultation that the costs of the moratorium have been about £25 million per month since February 2023. We think it is essential that these costs are included in any adjustment. It would be impracticable to exclude them, and as explained below, we do not see that there is any reason to do so.

In its overall approach Ofgem is proposing to look at total bad debt costs relative to the bad debt allowance. This is different from the covid debt cost assessment which considered the increase in bad debt costs relative to previous periods. We therefore do not understand why Ofgem would amend the bad debt charge for a supplier in breach. This could only be even contemplated in the case that Ofgem was comparing bad debt costs from the moratorium with previous period not, as we have highlighted above if total costs are being compared to the allowance.

In any event, we do not see that amending costs for a supplier in breach could be justified in any circumstances. Ofgem suggests that if a supplier has been in breach of the PPM rules historically (ie installing more PPMs than it should), it would see larger increases in debt-related costs as a result of the new rules than if it had been compliant. Our understanding of this view is that if, for a supplier in breach, bad debt provisions were x% prior to the moratorium

[2] For example, see Ofwat - Final Deliverable

and are now y% since the moratorium, then y>x. Bad debt costs for the supplier would be calculated going forward using the y% provision rate. Ofgem is proposing that it may not be appropriate to use the updated y% rate but instead to use the historical x% provision rate for this supplier. We disagree with this since the amended (y%) provision rate is the rate that best reflects the likelihood of the customers of that supplier paying their bills. Furthermore, if we look at the total bad debt that this provision rate has been applied to in the past, this would be lower as a result of their breaches. For example, the following hypothetical scenario:

Supplier A – in breach	
Av debt per consumer	£2,000
No. of PPM installs needed	100
No. installs done	100, (50 in breach)
Bad debt pre moratorium	0
Moratorium cost increase	100*£2,000 = £200,000
Total costs	£200,000

Supplier B – not in breach	
Av debt per consumer	£2,000
No. of PPM installs needed	100
No. installs done	50 (no breach)
Bad debt pre moratorium	50*£2,000 = £100,000
Moratorium cost increase	50*£2,000 = £100,000
Total costs	£200,000

Supplier A is in breach of the rules and has installed 100 PPMs a year instead of 50 PPMs. During the PPM moratorium this supplier A would have seen an increase in debt related costs as a result of customers not having PPM installed. For Supplier A, the *increase* they would have seen in relation to their debt related costs is £200,000 relative to their baseline where they were breach whereas if they had acted responsibly, they would have only seen an increase in debt of £100,000. This breach has reduced supplier A bad debts by 50*£2,000 in bad debt or £100,000. In this example, the bad debt costs for Supplier A would be lower as a result of the breach than they otherwise would have been. Reversing the installs that were in breach would mean higher provisions but bad debt overall would be less than the level that it would have been had the supplier followed the rules more stringently in the first place.

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

As we have stated in the past and above, efficient suppliers with different customer mixes are impacted differently by industry and market trends. A simple adjustment to the price cap to adjust for the impacts of these trends is likely to result in winners and losers, and risks substantially distorting competition. We have proposed a bespoke levy in the past and indeed a specific levy mechanism for DNI customers as discussed in Question 4 below.

However, we recognise that if an adjustment is allowed in the price cap, the issues associated with how the adjustment is applied / allocated relating to the different customer mixes and mix of payment types can also be mitigated using the existing price cap mechanism with a levelisation and reconciliation scheme.

Question 4: Do you have any views on whether it would be appropriate to explore a specific levy mechanism for DNI ('do not install') customers? This would be separate to any adjustment for additional debt-related costs.

We consider it very important that Ofgem further explores a specific mechanism for DNI along the lines referenced in the consultation. The new involuntary PPM licence conditions will create a cohort of customers meeting the Do Not Install (DNI) criteria for whom normal escalated debt recovery pathways will be unavailable and for whom other debt pathways may be distressing. These customers will constitute an exceptionally high bad debt risk, and a supplier with a higher proportion of DNI (often legacy) customers will therefore be disadvantaged. This has been an ongoing issue with the price cap and the latest rules are significantly exacerbating the existing competitive distortions.

The new involuntary PPM rules will also impact the attractiveness of these customers to suppliers, with potential adverse impacts in terms of customer service.

We consider that to justify our proposal for a separate levy mechanism, there is a precedent for compensating companies differently for debt costs reflecting their different customer mixes. Ofwat, as a result of its assessment as to the extent to which debt is within management control or due to external influences, has for many years adjusted water companies' bad debt targets to account for the different deprivation levels of their customer bases[3]. Indeed in this work for Ofwat in 2022, PwC noted that deprivation modelling suggests bad debt levels could rise significantly over the coming 3 to 5 years due to the cost of living crisis.[3] As such, a proposal that recognises the impact that different proportions of DNI customers can have on suppliers in terms of bad debt is justified.

We expect a DNI levy approach such as we have proposed would offer the following consumer benefits:

- suppliers would be incentivised to offer better quality of service to relevant DNI customers (many of whom are vulnerable)
- It would incentivise that non-PPM debt collection methods are more moderate.
- mitigates competitive distortion and strengthens competition for the benefit of all customers.

We understand that the timeframe for this would be separate from the adjustment that is the main focus of this consultation but consider Ofgem should consult on this as soon as practicable, and not later than it consults on the review of operating cost allowances, given the interactions between them.

Question 5: Do you agree that we should make an initial float adjustment in April 2024, followed by a later true-up? Do you agree it should be included within the cap for a 12 month period? Do you agree that this allowance should be temporary only?

Ofgem's lead option is to introduce an initial adjustment allowance using actual data received by that point and follow up with a true-up as it did in relation to covid bad debt.

In the context of this question, we consider that there are a number of factors Ofgem should take into account:

- the very limited time available to respond to this consultation
- the limited availability of data, restricting respondents' ability to critique the analysis;
- the number and complexity of the issues
- the uncertainty of data over the winter period 2023/24 and the expectation that it will show further increases in bad debt
- the potential for customers to move off the cap during the recovery period

The limited time to assess the consultation combined with the complexity of the subject matter and the number of issues raised means that we have not been able to complete our assessment or come to final views on this. We do not see this as an issue if the methodology is not finalised at this stage and there are one or more true-up exercises at which the methodology can be adjusted to deliver a more appropriate adjustment / allocation. One option Ofgem should consider is that the initial float covers bad debt costs only, with further work done on administration and working capital adjustments, as well as updating the bad debt data at an interim true-up or final true-up, to allow time for proper consideration.

[3] For example, see Ofwat - Final Deliverable

Ofgem must also collect actual data after the point of the initial float since as noted above, the run rate of bad debt shows large increases more recently and we expect this to increase further over the winter period. We propose that Ofgem requests an additional RFI to get additional data to cover at least some of the winter period so that the initial float is more realistic where the decision is expected end of February 2024.

We agree that delaying an initial float risks customers moving off the cap. Indeed we consider that Ofgem should take this factor into account in the way the float and true-ups are applied by correcting for customer numbers in each price cap period.

Ofgem's temporary allowances are often applied over a 12 month period and this seems appropriate in this situation. Some consideration must be given to when the true-up is done and when / how costs from winter 2023/24 are recovered. This can be assessed as Ofgem regularly collects more data via the debt-related costs RFI.

Question 6: Should the debt-related costs allowance, if introduced for the April 2024 price cap, be subject to a later true-up, and if so, when should this adjustment occur?

As noted above in response to question 5, we consider at least one true-up is essential given the limited time (as planned) to assess the methodology for the float. A float would allow more time to get the approach right and, as we saw in relation to covid bad debt, the methodology changed over the course of the assessment meaning the true-up stage was essential. In addition, Ofgem has said that the full disclosure process for the model that estimates price cap allowances is proposed to take place during 2024, alongside any true-up[4].

The data that will be used in the initial float will not cover the winter 2023/24 period which is likely to show further increases in bad debt, especially if the weather is cold and prices remain high with no additional support from the Government. There may be a need for an interim and then final true-up depending on the scale of the costs incurred. Ofgem will be able to track this as it collects regular RFIs on bad debt. We would be concerned if at the statutory consultation stage there was a lack of clarity as to how and when additional debt-related costs incurred after September 2023 will be recovered. If this is to be based on the materiality of costs, it would be important to state how this materiality will be assessed.

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

As noted in our response to questions 5 and 6, we do not think Ofgem should limit its approach on true-ups in advance, without knowing the specific situation and whether one or more than one might be suitable. Consideration should be given to this when more data is available. In principle, including the additional support credit in the true-up for bad debt appears to be appropriate.

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

We consider that the best approach would be to uprate for time value of money by using the cost of capital. If Ofgem does not use cost of capital to uprate, inflation could be used, but this would be less reflective of the costs incurred by suppliers than cost of capital. Not uprating would be inappropriate.

[4] Paragraph 6.8

We also believe Ofgem should consider additional adjustments between each cap period to account for changes in customer numbers on the cap. If prices fall and customers move off the price cap tariff to fixed term contracts (FTC) then suppliers would not recover the amount they expected to. This issue should be considered in the true up process as well.

Question 9: Do you agree with the proposed overarching methodological approach for estimating the existing debt-related costs allowance, and using it to determine whether there has been an over or under-allowance for debt-related costs in 2022/23?

We await the full model disclosure process in 2024 promised by Ofgem to respond more effectively to this question and we reserve the right to comment at that stage. To maintain trust and confidence in the regulatory process, it is essential that Ofgem establishes a confidentiality ring/data room so that its calculations can be exposed to third party scrutiny.

Methodological choices

Ofgem has stated that there are three first-order methodological choices to make:

1. Consistency: Ofgem has raised issues relating to the bad debt elements within the operating cost allowance, the EBIT allowance and the fixed element of the PAAC, and proposes to maintain consistency with the 2018 approach in these areas where precise data from 2018 is not available. Without understanding fully and seeing additional detail we are unable to comment on whether consistency is appropriate for these elements or not, but in general we consider that each case should be considered on its own merit. Given that we will not be able to see the detail on this until the disclosure process in 2024, it is vital that Ofgem does not take the view that assumptions regarding allowances made in support of the float process are settled; rather it should remain possible to take a different approach at the true-up stage if evidence and arguments support it.

2. Stringency: As with consistency, Ofgem is proposing to use the same level of stringency as was used in 2018. For example, since lower quartile operating costs were used that should still apply here. We do not think that this rationale can be extended. Each case should be decided on its own merit. As above, we do not have all the detail and we reserve the right to comment in the future.

3. Suppliers: Much has changed since 2018 when the assessment for the price cap was concluded. Using data from benchmark suppliers in the manner proposed may not control for non-efficiency factors such as customer deprivation or payment mix. Using a weighted average does seem appropriate (once factors are controlled for) but limiting the weighted average to the two benchmark suppliers may not be. It is also difficult to assess without understanding the level of variation between the possible methods. As with the areas above, it is difficult to comment without being able to see the detail and we reserve the right to comment in the future.

The allowance for prepayment bad debt costs

Ofgem refers to its recent ASC decision which estimated that in 2022/23, £1.82 of temporary support for ASC bad debt per PPM customer costs would have been "temporarily covered by the large contemporaneous rise in the headroom allowance".[5] As noted in our response to Ofgem's consultation email of 7 August 2023, we do not agree with this assertion and on this point.

[5] Ofgem (2023), Allowance for additional support credit bad debt costs. https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs

1. There is no specific allowance for ASC bad debt

The PAAC price cap element represents the allowance given to suppliers for the additional cost to serve PPM customers compared to DD, which includes any debt-related costs. This was calculated using the CMA's 2016 estimate of the PPM-DD differential[6], when fewer ASCs were given to customers – indeed the licence requirement in relation to ASCs was not introduced until 2020.

When assessing the difference in cost to serve customers paying by DD, Standard Credit or PPM, the CMA's estimate of the PPM-DD differential originally "*had not allowed for the possibility of a PP customer incurring bad debt in its own right".* Some stakeholders, including EON and Economy Energy, responded to the CMA's Provisional Decision on Remedies, (PDR) claiming that PPM customers could build up bad debt, citing cases of change of tenancy where a standing charge had been allowed to build up or when a PPM customer moved supplier with existing debt. EON also requested that bad debt, equal to the level of emergency credits PPM customers could incur, be added to the differential. The CMA noted that *"even when such credit was used, suppliers would generally be able to recoup it when customers topped up their meters."* They did however consider *"that a reasonable allowance for bad debt costs was half the average bad debt cost of DD customers, ie around £2.60 per dual fuel customer".* Therefore they modified the upper bound of their granular assessment to reflect this. This was amended by £1.10/dual fuel customer. We note that the lower estimate was not amended and assumes zero bad debt for PPM customers.

There was no mention of regular credit payments at this time by either suppliers or the CMA. This is not entirely surprising since when a majority of meters were traditional (not smart), a customer would have had to have an engineer sent round to the property to add credit directly to the meter or to travel to a shop to pick up a message. Smart meters can be topped up with credit remotely. A majority of ASCs currently given are to smart meter PPM customers. Currently, ASCs can lead to customers building up material levels of bad debt and this was not envisaged when the cap was developed. As such, we consider that ASCs have not been captured in the current price cap methodology and that currently, ASCs represent a material and systematic efficient cost to suppliers.

2. The existing allowance for PPM debt-related costs has not been amended since 2016

The table below shows our interpretation of what costs were included in the CMA's estimate of the PPM-DD differential, and subsequently the PAAC price cap element.

Cost Element	CMA View
Bad Debt	Concluded that bad debt should be attributed to the payment method under which the debt was first accrued. This resulted in most PPM bad debt being moved onto DD and SC. As described above, the CMA noted the very limited opportunity for PPM customers to accrue bad debt "We recognise that it is possible, for the reasons set out by Economy Energy and EON above for a PP customer to incur bad debt in its own right, albeit it to a (much) more limited extent than would be possible on standard credit or direct debit terms." In response to supplier comments, the CMA added a slight positive revision to the PPM bad debt. This increased the upper estimate of the PPM-DD differential by £1.10/dual fuel customer.[7]
Working Capital	Concluded that working capital costs for bad debt are attributable to the payment method from where the debt originated. Since PPM customers

[6] Appendix 6, Operating Costs, p.10
[7] FR Appendix 9.8: Analysis of indirect costs by payment method (publishing.service.gov.uk), Table 7, p33.

	generally do not accrue bad debt, an adjustment for PPM working capital was not required.
Administrative Costs	CMA did not directly reference debt-related administrative costs.

Given the limitation of the debt-related allowances for PPM, we believe that the CMA did not envisage the growth of supplier-issued ASCs and therefore would not have included the associated bad debt in the price cap. This could indicate that a baseline should be close to zero.

3. The headroom allowance is overused by Ofgem and is unlikely to cover ASC bad debt for PPM customers

Since the introduction of the price cap there has been a lack of clarity as to which of the uncertainty allowances are intended to cover an increasing range of miscellaneous costs and risks. We note that the headroom allowance has been used to cover many varying costs with no specific corresponding allowance, eg RO mutualisation, or uncertainties relating to policy costs. In its August 2022 decision on wholesale adjustments in the price cap, Ofgem stated that in considering the makeup of the headroom allowance, it had "considered each individual item we mentioned when setting headroom in the 2018 decision, and how these might change as a result of increased wholesale prices". Bad debt for PPM customers relating to ASCs was not considered.

Notwithstanding this, in the decision on ASC allowance[8], Ofgem recognised that PPM debt related costs were also considered to have contributed to cover these baseline costs as well as headroom and Ofgem should recognise this.

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

Ofgem is using supplier data to calculate bad debt costs, working capital costs and debt administration costs. In principle, our view is that data must be controlled for non-efficiency factors. In particular, customer mix including debt propensity and mix of payment methods has a significant impact on debt-related costs. Supplier efficiency cannot be judged by plain comparison of data between suppliers, since different customer bases and payment methods have different debt propensity, a factor that is recognised in the make-up of the price cap for these different payment methods and was also recognised by Ofgem in its response on covid bad debt.

On the **bad debt charge**, Ofgem appears to have taken the supplier data as it is, with no control for other factors such as payment mix and customer mix. Indeed, payment mix in particular will have significant impact on bad debt costs. Ofgem should control for payment method mix since this represents the most accurate and robust way of estimating the bad debt costs associated with price cap customers. We support using a weighted average for each payment method but regardless, any weighted average, lower quartile, median calculations should be done separately for each payment method. The wide dispersion that Ofgem found between the different benchmarks could well be explained by not accounting for the payment method mix.

As with bad debt costs, **debt related administrative costs** will vary due to other factors that should be controlled for, such as customer mix and payment type. For example, a supplier with more customers who are vulnerable or low income, and with higher propensity to get into

[8] Allowance for additional support credit bad debt costs (ofgem.gov.uk)

debt, will likely have higher debt administration costs than another supplier with a more affluent customer base that makes more use of DD and has a lower propensity for building up debt. We believe that significant amount of variation is likely due to non-efficiency factors such as payment type and customer mix. In addition, we think that customers on FTCs are less likely to get into debt than those on SVT. Ofgem could check its assumptions that the propensity is the same using the segmented information that some suppliers did provide.

In relation to **working capital costs,** we reiterate the comments above for debt administrative costs, namely these should be assessed by payment type and the differences in FTC and SVT should be objectively considered. In addition, we disagree with Ofgem's proposal to base working capital costs on the 10% cost of capital used in the 2018 price cap calculations. Ofgem's recent review of the EBIT margin set the cost of capital at 12.3%, reflecting an increase to the asset beta in recognition that systematic risks faced by energy suppliers are higher than those estimated in 2018 when the cap was developed. The data underpinning the estimate of 12.3% was taken from time periods which predate or align with the period under consideration for this review. The fact that the EBIT margin was not updated until 1 October 2023 is not a valid reason for assuming that cost of capital jumped from 10% to 12.3% on 1 October. Indeed, the key drivers of the increased risk that led to the eventual increase in cost of capital relate to wholesale market volatility which started in late 2021 and the invasion of Ukraine in February 2022.

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

We consider that it is appropriate to consider each debt related cost in the scope of this review. We are however concerned that there has not been sufficient time available to consider these elements in more detail. More focus has been on bad debt charge which is at a later stage of development. We propose that Ofgem should allow itself more time to consider its approach and should therefore exclude any adjustment for debt related working capital and administration costs from the initial float. Given the high likelihood that debt related costs will increase significantly over the winter period we do not think that this will cause an issue in the final true-up where Ofgem calculations may include adjusting for an over-recovery in administration and working capital costs.

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

Ofgem is considering three options: option 1, a benchmark at the lower quartile combined or separate suppliers, option 2, an average benchmark and option 3, benchmarking each debt related cost separately. Ofgem says it has a preference for option 3. In summary our view is:

a) Within each cost category the different payment methods (DD, SC and PPM) should be benchmarked separately.
b) A weighted average benchmark should be used to benchmark all of these costs.
c) Suppliers' bad debt, administration and working capital costs should be benchmarked together.

Whichever option Ofgem selects, the interaction between different elements must be considered. The remainder of our response to this question explains these views in more detail including the different principles that should be taken into account when benchmarking and the further issues and views raised by Ofgem in the consultation.

<u>Within each cost category the different payment methods (DD, SC and PPM) should be benchmarked separately</u>

Payment method is a non-efficiency factor. This has been recognised in the bad debt allowances in the price cap being the major driver for differences in charges for DD, SC and PPM. Ofgem has the data from the bad debt RFI to benchmark separately for each payment method. Therefore, Ofgem should not benchmark any of the three debt-related costs based on aggregate costs (ie aggregated across all payment methods) but should instead benchmark separately for each individual payment method. We note that there is an interaction between the choice of benchmark and the approach to benchmark. In our view, if Ofgem is intending to use a lower quartile benchmark for administration and working capital costs, it is even more crucial that payment methods are benchmarked separately since, if using all customer data, the suppliers with costs in the lower quartile will likely be those with high proportions of DD customers for whom debt administration and working capital costs are relatively low.

A weighted average benchmark should be used to benchmark all of these costs

We agree with Ofgem's view that a weighted average should be used for bad debt costs. The increase in bad debt is largely linked to the high prices, cost of living crisis and the additional restrictions on installing involuntary prepayment meters.

However, we disagree with the proposal to benchmark debt administration and working capital costs based on the lower quartile supplier. Firstly, we consider that a supplier's costs are impacted significantly by the deprivation levels of their customers, ie the customer mix rather than supplier efficiency. This would mean that a supplier with more customers who are not paying their bills will likely have higher debt working capital and administration costs as well as higher bad debt costs. Efficiency can only be measured relative to suppliers with similar customer mix. Low costs in this area could be linked to an inefficient supplier with fewer customers in debt and in contrast high costs could be an efficient supplier with more customers in debt. This is not unlikely given suppliers whose customer base are more deprived (likely to be incumbent suppliers) may well to need to focus more on the efficiency of their debt collection approaches than those with a wealthier customer base.

In addition, lower administration costs due to reduced warrant activity as part of the PPM moratorium, are reflected in higher bad debt costs due to reduced PPM installation. Using the lower quartile costs for administration and weighted average for bad debt costs does not recognise this interaction. Weighted average should be used for both.

Ofgem has used the argument that a supplier in breach of the PPM rules would have overstated costs as a result of the PPM moratorium and this adds to the justification to remove these costs from the calculation *and* use a lower quartile benchmark. We have explained above in our response to question 2 why we do not consider this is a valid argument. The proposed approach of looking at the absolute level of debt costs relative to the allowance means that if a supplier has installed more PPMs than it should have done in prior periods, this would have the impact to reduce the absolute level of debt costs going forward. From a working capital and debt administration perspective, this would not impact the costs presented by suppliers relative to the allowance either since absolute costs relative to the allowance are considered.

We believe that a weighted average benchmark would still incentivise suppliers to engage in efficient practices with prudent processes in place to manage additional risks since there are still winners and losers relative to the average.

It is also our view that any true-up would correct an overestimate in bad debt charge due to provisions being proved to be incorrect. As we have shown above, it is in a supplier's interests to accurately provision and therefore this would not be intentional.

Suppliers' bad debt, administration and working capital costs should be benchmarked together

As we have explained above, we believe a weighted average benchmark is appropriate for all. To the (limited) extent that differences are driven by supplier trade-off decisions, low debt administration expenditure is likely to correlated with higher bad debt and working capital costs (and vice versa). In addition, we charge some administration costs back to customers which is a data item requested in the bad debt RFI. Much of this is not paid back and would then appear in our bad debt cost number.

Use of separate lower quartile benchmarks would reflect an unachievable level of efficiency, due to trade-offs between costs, ie if a supplier invests less on debt administration, it may need to spend more on bad debt charges. The interactions between benchmarking options must be considered.

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

Ofgem has two main considerations with how to apportion costs. How to apportion costs to PPM customers, and how to apportion costs between credit customers.

We consider that Ofgem should split costs between direct debit and standard credit as they are in the raw data as this is the approach that is closest to reality and minimises competitive distortions. On the assumption that Ofgem will progress with an approach to levelisation, we consider that this should be accompanied by levelisation across the whole market not just PPM / DD to achieve policy objectives and not lead to further competitive distortions in the market.

We are strongly against an even split between SC and DD. Smearing in this way is not cost reflective. Ofgem's approach in the original price cap decision and in its proposed approach to covid-related bad debt creates competitive distortions between suppliers, as a result of smearing SC costs across all credit customers. Suppliers with a lower proportion of SC customers in their SVT base will over-recover costs and suppliers with a higher proportion will under-recover. Ofgem's justification is that "However, we consider that significant amounts of debt are accrued on alternative payment methods before crystallising; for example a customer could begin the debt process on a direct debit payment meter before moving to a standard credit meter (along with their debt)". We strongly dispute this, in particular the "significant amounts of debt" and we would be keen to see evidence to support this. [✂]. In our experience, customers on DD that default onto SC have usually only built up a minimal amount of debt on DD and it is the SC payment method that allows the debt to build up significantly.

We also want to highlight a key trend that contradicts Ofgem's argument. When a customer defaults from DD to SC after accruing a small amount of debt, we contact the customer and if they engage with us we are usually able to agree a repayment plan and will move the customer back to DD on the amended DD amount. This is reflected in our data that shows customers moving from DD to SC but also SC back to DD. Those customers who do not agree a plan and do not engage, will remain on SC, building up more debt on this payment method and will begin the debt journey. Ofgem should also consider that customers defaulting from DD to SC, may have moved to DD from SC with a repayment plan to recover debt built up on SC. It is therefore more cost- reflective to allocate according to raw data and use the levelisation / reconciliation mechanism to achieve policy objectives so as not to distort competition. Further there is a recognition in previous decisions and in the makeup of the payment method differential that bad debt associated with SC is higher than that associated with DD as a result of the nature of the payment method. Splitting equally does not seem to us to be valid.

Ofgem's previous decision on covid bad debt should not be seen as a precedent since it increases competitive distortions between suppliers, as a result of smearing SC costs across all credit customers. Suppliers with a lower proportion of SC customers in their SVT base will over-recover costs and suppliers with a higher proportion will under-recover. As the amount of bad debt involved increases, so does the size of the competitive distortion. Ofgem should consider ways to allow cost recovery to better reflect actual costs incurred.

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

No, we do not agree. For the same reason as we have given for bad debt costs in response to question 13. These costs are correlated with payment method in much the same way as bad debt. We see no reason to treat these differently. Ofgem should make some assumptions for suppliers who cannot provide the data split by payment method.

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

Our view is that any additional allowance for debt-related costs should be allocated across both the standing charge and the unit rate based on the proportional split between the unit rate and standing charge. This reflects how debt is incurred.

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

We consider that there should be the same percentage uplift to gas and electricity, and different meter types.

ScottishPower
November 2023