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Sent by email to: priceprotectionpolicy@ofgem.gov.uk

Dear Dan

Re: Additional debt-related costs allowance policy consultation – non-confidential

Thank you for the opportunity to input to your policy consultation on additional debt related costs. The cost-of-living crisis is still putting pressure on consumer finances, and we know that many of our customers will still struggle with their household bills this winter. British Gas has committed £100 million since the start of the crisis with the biggest voluntary support package from an energy company. British Gas Energy Support Fund provides grants of up to £1,500 for British Gas and Scottish Gas customers struggling with energy costs. Additionally, the British Gas Energy Trust continues to support all UK energy consumers with grants, advice centres and Post Office Pop Ups.[1] British Gas also provides further direct support itself.

We support an adjustment to the price cap for additional debt-related costs. As Ofgem points out in this consultation, customer debt is a growing issue with current energy debt and arrears over £2.6bn.[2] ✄ Given that charges to most consumers are currently covered by the DTC, a mechanism to ensure that suppliers can cover the additional bad debt costs that will result is essential. We believe there is generally no expectation in today's climate that bills will return to pre-cost-of-living-crisis levels until at least 2025. In this scenario debt and arrears will continue to grow. ✄

The Domestic Gas and Electricity (Tariff Cap) Act 2018 requires Ofgem to have regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.[3] This reflects the importance of the Default Tariff Cap (DTC) providing appropriate allowances for efficiently incurred costs to the stability of the retail market. Against the backdrop of rapidly escalating debt it is imperative that Ofgem takes the risk to retail market stability seriously.

[1] British Gas opens up support fund to help customers this winter | Centrica plc
[2] Additional debt-related costs allowance policy consultation | Ofgem, Executive Summary.
[3] Domestic Gas and Electricity (Tariff Cap) Act 2018 (legislation.gov.uk), 1, 6 (d).

Allocation of the allowance between customers

We continue to support this allowance being in place for April 2024. However, we note that this timing means that Ofgem is consulting on these proposals before making a decision on the levelisation of the cost of standing charges on prepayment meters.[4] There are important interactions between these two consultations. The impact of an increase in debt related costs on customers will depend on how costs are allocated between them; Ofgem has produced a very broad range of proposals in this area.

Given this, suppliers will rightly struggle to respond to Ofgem's proposals. Levelisation could mitigate the impact of some options on customers; however, it is not clear whether it will. It is also not clear whether the differential impact of some options (which are not cost reflective) on suppliers could be mitigated through the supplier reconciliation associated with the levelisation proposal. Therefore, we reserve the right to comment further on these proposals. For the avoidance of doubt, if Ofgem does not proceed with Option 3 under levelisation, at least Options 1 and 4 in this consultation would increase the level of cross subsidy within the price cap and widen the differential outcome between companies. The cumulative impact of this on suppliers with large standard credit customer bases should be a priority for Ofgem to consider in its forthcoming statutory consultation. In doing so, Ofgem should carefully consider the interaction between benchmarking, recovery and levelisation; use of a benchmark with disproportionately more Direct Debit customers and recovery disproportionately from Direct Debit customers risks suppliers with a greater proportion of Standard Credit customers not recovering their efficient costs, an effect that will be exacerbated if there is no cross-supplier reconciliation.

Benchmarking of the allowance

We strongly oppose Ofgem's initial view to benchmark these allowances using Option 3 which selects different benchmarks for each debt-related cost.

Selectively benchmarking individual costs lines creates benchmarked costs that could not be achieved by any supplier. This approach has been previously discredited and was abandoned when Ofgem set the price cap in 2018.

In 2018, Ofgem took an aggressive approach to operational cost allowances based on a narrow interpretation of the Tariff Cap Act 2018; Ofgem effectively equated low prices with consumer protection.[5] However, the supplier failures throughout 2021 and 2022 exposed the flaws of focussing unduly on price as the main determinant of competition and consumer interest.

As Oxera correctly noted in its report to GEMA:

> *"It was Ofgem's explicit intent in calibrating the price cap that it should be 'a tough cap that ensures* loyal *consumers pay a fair price that reflects efficient costs.' To the extent that the price cap was calibrated to deliver stretching levels of cost efficiency, it may have left suppliers with insufficient headroom to deal with shocks."*[2]

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[4] Levelising the cost of standing charges on prepayment meters (ofgem.gov.uk)

[5] Ofgem took the same approach to benchmarking the payment method uplift opting for the 2nd supplier in a sample of six to set its benchmark, Appendix 8 - Payment Method Uplift (ofgem.gov.uk), Paragraph, 2.32.

It is, therefore, imperative that Ofgem takes a broader view of consumer protection that includes sustainable competition, financial resilience, and incentives to invest in differentiated and enhanced customer service. **Ofgem should adopt a weighted average benchmark unadjusted.**[6]

Finally, given Ofgem's indication that it will rely on selective data from individual suppliers to set this allowance it will be crucial that Ofgem shares its benchmarking model with suppliers including either anonymised data or using a confidentiality ring and disclosure room.

We respond to each of the consultation questions in the Annex to this response.

Yours sincerely,

Essie Barnett
Regulatory Manager

[6] We note that Ofgem has previously applied a weighted average to additional debt related costs in its [Price Cap – Decision on the true-up process for COVID-19 costs | Ofgem]

Appendix – responses to consultation questions

Case for a temporary adjustment for debt-related costs

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

Yes, we strongly support an adjustment to the price cap for additional debt-related costs.

As Ofgem points out in this consultation customer debt is a growing issue with current energy debt and arrears over £2.6bn.[7]

Given that charges to most consumers are currently covered by the DTC, a mechanism is needed to ensure that suppliers can cover the additional bad debt costs that will result. We believe there is generally no expectation in today's climate, that bills will return to pre-cost-of-living-crisis levels until at least 2025. In this scenario debt and arrears will continue to grow and the time period associated with the adjustment must reflect this reality, especially as suppliers' options to manage debt are more restricted under the new PPM licence requirements.

It is essential that efficiently run suppliers can recover their costs and therefore that any material and systematic change in debt-related costs is recoverable. The Domestic Gas and Electricity (Tariff Cap) Act 2018 requires Ofgem to have regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.[8] This reflects the importance of the Default Tariff Cap (DTC) providing appropriate allowances for efficiently incurred costs to the stability of the retail market. Against the backdrop of rapidly escalating debt it is imperative that Ofgem takes the risk to retail market stability seriously.

Ofgem is also right to consider the impact of debt on debt-administration costs and suppliers working capital costs; higher levels of debt impact on all of these areas.

Alongside changes to the Default Tariff Cap, suppliers are working with Ofgem to ensure consumers struggling with their bills get the support that they need. British Gas has signed up to Energy UK's Winter 2023 Voluntary Debt Commitment.[9] British Gas will also support customers this winter through the British Gas Energy Support Fund. British Gas has committed £100 million since the start of the crisis with the biggest voluntary support package from an energy company. British Gas Energy Support Fund provides grants of up to £1,500 for British Gas and Scottish Gas customers struggling with energy costs. Additionally, the British Gas Energy Trust continues to support all UK energy consumers with grants, advice centres and Post Office Pop Ups.[10]

Ofgem has introduced new requirements to protect certain groups of consumers from on installation of involuntary prepayment meters (PPM)[11] and new and updated consumer standards rules which require energy suppliers to help provide support for domestic

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[7] Additional debt-related costs allowance policy consultation | Ofgem, Executive Summary.
[8] Domestic Gas and Electricity (Tariff Cap) Act 2018 (legislation.gov.uk), 1, 6 (d).
[9] The Winter 2023 Voluntary Debt Commitment - Energy UK (energy-uk.org.uk)
[10] British Gas opens up support fund to help customers this winter | Centrica plc
[11] Involuntary prepayment meter decision | Ofgem

customers who are struggling with their energy bills.[12] Ofgem has also provided an additional allowance for Additional Support Credit which suppliers must offer to domestic PPM customers who are in a vulnerable situation. Finally, Ofgem has made proposals to levelise some costs between payment types to make them more equal or equitable.[13]

These measures are both indicative of the debt burden facing the energy industry and an important step towards addressing its impacts. During such a period of change Ofgem is right to increase its monitoring of near-time indicators of debt and to ensure that suppliers can recover their debt related costs through this review. ✂ A well-functioning and investible supply market is crucial to deliver these measures and to support customers who are struggling with their energy bills.

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

Yes, it is important that efficiently run suppliers can recover their costs and therefore it is important that any material and systematic change in debt-related costs is recoverable. The Domestic Gas and Electricity (Tariff Cap) Act 2018 requires Ofgem to have regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.[14]

In February 2023 Ofgem agreed a moratorium on Involuntary PPM installations and an Involuntary PPM Code of Practice (Code). Ofgem set strict conditions that suppliers must meet before re-starting involuntary PPM installations. Alongside this, the courts in England and Wales stopped accepting warrant application listings.

Ofgem recognised that that the moratorium combined with rules in the Code of Practice could result in fewer PPM installations on a permanent basis and thus contribute to higher levels of bad debt. Given this, Ofgem 'committed to further assess the bad debt levels and costs to serve, and adjusting that allowance if we thought necessary in light of the evidence.'[15]

Ofgem began this assessment with a Call for Input in April 2023. Alongside this Call for Input Ofgem issued an RFI which asked suppliers for information on the effect of the moratorium on involuntary PPM installations. In doing so Ofgem recognised that 'changes to PPM practice and policy could impact the level of consumer debt and suppliers' ability to collect those debts.'[16] It went on to set these impacts out saying that 'as more customers may remain on other payments methods, such as standard credit, which are associated with higher levels of bad debt than PPM. It may also reduce the effectiveness of suppliers' activities to collect debts owed to them.'[17] ✂

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[12] Consumer standards decision | Ofgem
[13] Levelising the cost of standing charges on prepayment meters (ofgem.gov.uk)
[14] Domestic Gas and Electricity (Tariff Cap) Act 2018 (legislation.gov.uk), 1, 6 (d).
[15] Involuntary PPM (ofgem.gov.uk), Paragraph 7.2.
[16] Call for Input (ofgem.gov.uk), Paragraph 1.4.
[17] Ibid, Paragraph 3.3.

Ofgem has not set out any reasoning for which an efficient notional supplier would not incur costs because of the PPM moratorium.[18] In fact, Ofgem has clearly set out the reasons why it would. We strongly disagree with Ofgem's proposal to exclude industry wide costs resulting from the PPM moratorium from any debt related costs adjustment.

Ofgem asserts that 'A supplier who has been in breach of standard licence conditions historically may see a larger increase in debt-related costs due to the moratorium, compared to other suppliers.'[19] Ofgem has no basis to infer that this is the case. Firstly, as far as we are aware, Ofgem has not identified any suppliers who have been in breach of standard licence conditions historically. Secondly, Ofgem offers no evidence to support its assertion which, in any event, could not justify excluding additional costs compliant suppliers have incurred due to the moratorium.

We are concerned that Ofgem proposes to incorporate compliance assessments into the price cap calculation. Ofgem should not confuse the need for a rigorous investigation and appropriate enforcement action with the recovery of efficient costs.[20]

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?

Yes, we agree that a bespoke levy would face practical challenges in this case. However, if Ofgem does implement an adjustment through the Default Tariff Cap it must consider the fact that the DTC itself does not recover debt in a cost reflective manner.

Ofgem has not set out, in this consultation, any proposals for a 'bespoke levy of other new mechanism.' However, we infer that Ofgem is considering a market wide mechanism in place of the DTC, which only covers tariffs for SVT customers.

We agree with Ofgem that there are 'practical challenges associated with creating a bespoke levy.' We also note that this is a temporary adjustment, and the vast majority of customers are currently on SVT tariffs.[21]

The original approach to the bad debt methodology set in November 2018 requires bad debt costs to be collected from a combination of SC customers and DD customers which 52% allowed to SC customers and the remaining 48% split equally between SC and DD customers. This provision was introduced to avoid too wide a gap between tariffs for different payment types. However, it does mean that those suppliers with proportionately more SC customers are likely to under-recover bad debt costs and those with a lower

[18] Though it has set out that it would expect 'an efficient supplier would use other mitigations in line with debt management best practice to try to reduce the likelihood of bad debt for customers who would otherwise have a PPM installed, rather than there being a presumption that all of the debt would automatically become unrecoverable.' Call for Input (ofgem.gov.uk), Paragraph 4.10.
[19] Additional debt-related costs allowance policy consultation | Ofgem, Paragraph 4.20.
[20] We note that Ofgem excluded any fines for non-compliance from costs assessed for the purposes of the price cap and that this was set out in relation to the operating costs allowance in 2018. Appendix 6 - Operating costs (ofgem.gov.uk), Table A6.3.
[21] For example, according to Retail market indicators | Ofgem 'when considering electricity customer accounts on all payment methods, the proportion on default tariffs in April 2023, based on the data for the suppliers shown in the chart excluding Bulb, was 86%.'

proportion of SC customers would over-recover. A hypothetical company with only DD customers is able to collect £20[22] per customer to cover bad debt costs.

Since 2017 there have been two further developments. Firstly, since the energy crisis, nearly all consumers are now on the default tariff including a much higher proportion of DD consumers. Secondly there has been a continuation of the progressive switch away from SC contracts to DD. Both these have served to increase the actual level of percentage uplift which suppliers, on average, can realise particularly those with a high share of DD customers. Meanwhile, the propensity of SC consumers to default has probably also increased due to the higher cost of energy. Ofgem has recognised this issue in setting out five options through which any additional allowance could be allocated among payment types. Whilst Ofgem has rightly set out the impact on customers of these different options, they have not set out the impact on suppliers. For example, in Ofgem's illustrative example of its proposed Option 1, suppliers could recover an additional £18 per direct debit customer.

To address this, Ofgem should set out the supplier impact of its proposals in the next stage of the consultation process. In doing this Ofgem should include the impact of its levelisation decision and associated supplier reconciliation process.

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.

Ofgem has set out a proposal to explore a specific levy mechanism for ('do not install') customers. Ofgem proposes to consider this on a later timeframe than the current proposed adjustment.

We agree that Ofgem should continue to explore this proposal and consider, more broadly, how the costs of debt should be recovered from different customer groups.

The current picture is complex. Since it was introduced in 2018 the DTC has spread some debt related costs among credit customers (direct debit and standard credit). The Additional Support Credit Allowance spreads costs incurred by PPM customers across all payment types. Levelisation may further spread costs among payment types, whilst reconciling the costs that suppliers bear because of this. This proposal for a temporary adjustment to debt related costs, may introduce a temporary allowance which either further spreads costs or tries to apportion them in a more cost reflective way.

Ofgem should ensure that in the short term any additional debt related costs allowance is implemented in a way that protects customers and allows suppliers to recover their efficiently incurred costs. The primary vehicle for doing this should be the DTC combined with levelisation and the upcoming operating costs review. Longer term, Ofgem may want to look at this proposal to support do not install customers.

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[22] Additional debt-related costs allowance policy consultation (ofgem.gov.uk), Cap period 11a, Table 6.2.

Float and true-up approach

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?

We agree that Ofgem should provide an initial float in April 2024.

However, whilst Ofgem has given an 'initial view' on its benchmarking approach we consider that there is significant uncertainty over the level of any float allowance that will be provided. Any initial float would be subject to Ofgem consulting on its proposed allowance and how that will be recovered from customers. In doing this Ofgem should share its benchmarking model with suppliers including either anonymised data or using a confidentiality ring and disclosure room. This disclosure process is important to ensure that the initial float is set an appropriate level and should begin as soon as possible to enable suppliers to properly engage.

We agree that a 12-month recovery period would be appropriate subject to Ofgem's final proposals on the level of any allowance.

Ofgem has proposed that this allowance should be temporary in nature because the operating costs review will review these costs as part of its scope. However, we note that this review will not cover price cap period 12 as any revised operating costs allowance is expected to come into force in October 2024. Ofgem is increasing its monitoring of near-time indicators of debt. This is an important step and Ofgem should continue to keep debt related allowances in the DTC under review including during period 12.

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?

Yes, the allowance should be subject to a later true-up. This will be necessary to include costs relating to cap period 11.

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

The true up for Additional Support Credit allowance is expected to take place during 2024. In general, Ofgem should look to true up costs relating to adjustments as early as practicable. However, a delay in order to carry out only one wider debt related costs true up may be proportionate if the ASC true up is small in value. Ofgem should continue to keep debt related allowances in the DTC under review.

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

Yes, the float allowance should be uprated to account for inflation.

We note that the COVID-19 float allowance was not adjusted for inflation. The COVID-19 float allowance allowed for the recovery of the costs of cap periods four and five over cap periods six and seven, and the costs of cap period six over cap period six. Therefore, there was a 12-month lag in recovery of the costs of cap periods four and five. The costs of cap period six were recovered contemporaneously with costs.[23]

In the case of the proposed adjustment the float is proposed to include costs over periods 8, 9 and 10 (from April 2022 to October 2023). These costs will be recovered in periods 11 and 12 (from April 2024 to March 2025). These means that all costs will be recovered with a lag. Ofgem has not set out how costs will be recovered over the 12-month period, but we expect costs from periods 8 and 9 will be recovered with a 24-month lag and costs from period 10 with a 12-month lag.

Given the longer lag relative to the COVID-19 float allowance, and higher inflation rates over the period, we think Ofgem should include consider applying inflation to the float adjustment.

Calculation of the existing allowance

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 would need access to Ofgem's allocation model to respond to this question. We set out some initial thoughts below but reserve the right to comment further when Ofgem releases its model; which should be alongside the statutory consultation or before.

Ofgem refers to this consultation as a review of additional debt-related costs allowances in the default tariff cap. However, as Ofgem is aware there are no explicit and dedicated debt-related costs allowances in the default tariff cap. In estimating implicit debt-related costs allowances Ofgem has included elements of the following DTC allowances:

- Core operating costs
- Payment Method Uplift (PAAC)
- Payment Method Uplift (PAP)
- EBIT
- The ASC additional allowance; and
- Headroom.[24]

In addition to these Ofgem has recovered debt related costs through the COVID-19 float and true up.

Because of this, Ofgem cannot directly observe debt-related costs allowances and it must estimate them if it is to carry out this review. We will not be able to carry out a full review of Ofgem's approach until it shares with us the model that estimates these allowances. Ofgem has said that the full disclosure process for this model is proposed to take place during 2024, alongside any true-up.

However, based on Appendix 1, which sets out the estimation steps for Debt-related costs allowances, we would like to consider further Ofgem's calculation of bad debt costs and debt

[23] Decision on the potential impact of COVID-19 on the default tariff cap (ofgem.gov.uk), Paragraph 3.2.
[24] Additional debt-related costs allowance policy consultation | Ofgem, Table 6.2

administration costs for direct debit customers. These appear to be based on the benchmark supplier for operating costs, which was set when the price control was baselined in 2018 (using 2017 data). We are not aware of whether Ofgem considered individual cost lines when carrying out this benchmarking, but it is possible that the benchmark suppliers[25] had an atypical level of bad debt and debt administration costs and it is also true that there was a wide variation between different suppliers in the 2018 assessment. Ofgem recognises this point itself noting:

> 'However, with top-down benchmarking, the benchmark suppliers are chosen based on their overall efficiency level. This does not mean that the supplier was equally efficient for all sub-components.'[26]

The simplest way for Ofgem to consult on this issue, and any other arising from the estimation of the 'allowances' would be to share the model it has used. We see no reason for Ofgem to delay this process until the true up stage and our view is that they should share it alongside the statutory consultation.

Calculating and benchmarking costs

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?

We do not have any alternative suggestions; however we note that in order to properly understand Ofgem's approach we would need to see the model used to estimate these allowances. As noted above, Ofgem should share this as early as possible and at least alongside the statutory consultation.

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?

Yes, we agree.

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

Ofgem should adopt a weighted average benchmark unadjusted.

In 2018, Ofgem took an aggressive approach to operational cost allowances based on a narrow interpretation of the Tariff Cap Act 2018; Ofgem effectively equated low prices with consumer protection.[27] However, the supplier failures throughout 2021 and 2022 exposed the flaws of focussing unduly on price as the main determinant of competition and consumer interest.

As Oxera correctly noted in its report to GEMA:

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[25] Ofgem set out that they used the weighted average over the two suppliers nearest the benchmark, Additional debt-related costs allowance policy consultation | Ofgem, Paragraph 6.19.
[26] Ibid, Paragraph 6.16.
[27] Ofgem took the same approach to benchmarking the payment method uplift opting for the 2nd supplier in a sample of six to set its benchmark, Appendix 8 - Payment Method Uplift (ofgem.gov.uk), Paragraph, 2.32.

> *"It was Ofgem's explicit intent in calibrating the price cap that it should be 'a tough cap that ensures* loyal *consumers pay a fair price that reflects efficient costs.' To the extent that the price cap was calibrated to deliver stretching levels of cost efficiency, it may have left suppliers with insufficient headroom to deal with shocks."*[2]

It is, therefore, imperative that Ofgem takes a broader view of consumer protection that includes sustainable competition, financial resilience, and incentives to invest in differentiated and enhanced customer service.

We note from Ofgem's own analysis outlined in Table 2 of the recently published working paper on operational cost benchmarking[28], that achieving any one of these wider objectives, let alone all three, requires a looser (weighted average) approach to benchmarking. To put it another way, maintaining Ofgem's proposed approach to benchmarking (which indicates lower debt related costs than the lower quartile[29]) is *prima facie* incompatible with sustainable competition, higher customer service standards or increased financial resilience, underlining the clear need for a substantial change in approach.

In addition to this general point, we are concerned that there has not yet been sufficient disclosure for us to comment meaningfully on Ofgem's proposed benchmarking approach. In particular, Ofgem has not set out the sample of suppliers on which its benchmarking analysis so far has relied. This lack of consideration of the sample is important as we explain below. It also related to structural concern with Ofgem's 'initial view' that Option 3 is an appropriate benchmark. We discuss these points below followed by a more detailed discussion of the disclosure process.

Ofgem should set out the sample for its benchmarking analysis

Ofgem has set out that its benchmarking analysis is based on a series of Requests for Information. ✂[30]

Ofgem notes in the Consultation that:

> *'The data that has been gathered from our debt-related costs RFIs has already been subject to some revision by suppliers,* ***and there is wide variation in the costs incurred between different suppliers. This variation is partly caused by differences in payment methods (e.g. the proportion of customers that pay by standard credit)****. It is also significantly driven by the different assumptions suppliers make around the levels of non-payment, as seen through differing provisioning rates for debt of a particular age and payment type.' (Bold added)*

This is an important point but does not appear to have been applied to Ofgem's benchmarking analysis. It is noteworthy that when operating costs were benchmarked in 2018 Ofgem made two adjustments to the sample:

- It limited analysis to suppliers operating at scale i.e. with more than 250,000 customers as of April 2017; and

[28] [Energy price cap operating cost review benchmarking working paper | Ofgem]
[29] [Additional debt-related costs allowance policy consultation (ofgem.gov.uk)], Table 7.6.
[30] ✂

- excluded four suppliers because they had atypical customer bases (due to their business strategy).[31]

Likewise, when benchmarking the payment method uplift in 2018, though Ofgem had a limited benchmarking sample for data reasons it did consider whether the sample was likely to be representative:

> *'We consider this mix of suppliers to be representative of the market as they supply over three quarters of standard credit default customers.'*[32]

Given this precedent Ofgem's omission of a discussion on the sample is surprising. This is particularly salient because Ofgem's 'initial view' is to proceed with Option 3 which benchmarks debt-related administrative and working capital costs at a lower quartile. Benchmarking at the lower quartile increases the importance of the sample because, without considering representativeness of the sample, an atypical supplier could set the benchmark.[33]

Option 3 is not a fair benchmark

Ofgem has set out that its 'initial view' is to proceed with Option 3 which uses the lower quartile benchmark for debt administration and working capital costs and the weighted average for bad debt.

We have two significant concerns with Ofgem's option 3. First it is not internally consistent and second Ofgem's reasoning that debt administration and working capital costs are within a suppliers' control is completely unjustified.

Option 3 is not internally consistent

As a general principle, there will be elements of operating costs that are cross correlated. This is why Ofgem cannot responsibly benchmark across suppliers at a highly granular level; cherry picking "efficient" benchmarks narrowly and summing them disregards the link between lower costs in some areas and correspondingly higher costs in others, thereby producing an unrepresentative overall benchmark that is unattainable by any efficient supplier in practice.

Even Ofgem recognises in the same consultation document, that a 'separate' benchmark (one that combines different suppliers across the three cost areas) can lead to an unachievable level of efficiency, *'due to trade-offs between costs i.e., if a supplier invests less on debt administration, it may need to spend more on bad debt charges.'*[34]

The general principle, which Ofgem appears to support, is inconsistent with Ofgem's 'initial view' to proceed with Option 3. In the example that Ofgem sets out option 3 implies lower debt related costs than the lower quartile supplier (Option 2).[35] This implies a frontier like

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[31] Appendix 6 - Operating costs (ofgem.gov.uk), Paragraph 2.12.
[32] Ibid.
[33] In a weighted average approach atypical suppliers will still affect the benchmark, but the impact will be weighted by customer volumes.
[34] Additional debt-related costs allowance policy consultation (ofgem.gov.uk), Paragraph 7.32.
[35] Although in theory Option 3 uses a looser benchmark for bad debt, because the three allowances move in different directions, this actually leads to a larger over-recovery than Option 2 (the lower quartile supplier).

benchmark which is inconsistent with Ofgem's aims in setting this allowance which are well articulated here:

> *'We consider that it is in the interest of customers **to allow suppliers as a whole** to recover efficiently incurred costs, as it ensures that that they are adequately funded for the services they provide.'*[36] (bold added)

It is plain that using a benchmark which is tougher than the lower quartile will not 'allow suppliers as a whole' to recover efficiently incurred costs.

Working capital and debt related costs are not within a supplier's control

Ofgem sets out that:

> 'we consider that suppliers continue to have greater control over debt-related administrative and working capital costs, with variations between suppliers on these cost components therefore driven more by suppliers' commercial decisions and underlying efficiency in debt practices.'[37]

That suppliers may have 'greater' control over these elements (than they do over bad debt) is irrelevant. What matters is whether suppliers' costs are driven by efficiency factors or non-efficiency factors. ✄

Given the clear and significant non-efficiency factors driving these costs we do not agree that a lower quartile benchmark is appropriate. Furthermore, Ofgem has not set out any countervailing evidence for its assertion that these costs are driven by supplier efficiency.

Disclosure process

Ofgem has referred to a number of data issues in the Consultation. These include:

- **Data consistency:** In relation to the June update letter, Ofgem noted that there was 'insufficient data and inconsistent supplier treatment of government support packages' in RFI data.[38] Which meant that Ofgem was 'unable to consistently review working capital costs at that stage due to insufficient data and supplier assumptions on government support packages.'[39]

- **Revisions to bad debt data:** In the Consultation, Ofgem notes that 'the data that has been gathered from our debt-related costs RFIs has already been subject to some revision by suppliers, and there is wide variation in the costs incurred between different suppliers'.[40] Which is 'driven by the different assumptions suppliers make around the levels of non-payment, as seen through differing provisioning rates for debt of a particular age and payment type.'[41]

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[36] Additional debt-related costs allowance policy consultation (ofgem.gov.uk), Executive Summary.
[37] Additional debt-related costs allowance policy consultation (ofgem.gov.uk), Paragraph 7.47.
[38] Additional debt-related costs allowance policy consultation (ofgem.gov.uk) , Paragraph 7.3.
[39] Ibid
[40] Additional debt-related costs allowance policy consultation (ofgem.gov.uk), Paragraph 5.12.
[41] Additional debt-related costs allowance policy consultation (ofgem.gov.uk), Paragraph 5.12.

- **Estimating the allowances themselves**: In the Consultation, Ofgem notes that 'the top-down nature of the benchmarking from the price cap's development in 2018 means we are not able to directly identify an apportionment between debt related costs and non-debt-related costs in some specific allowances (such as operating costs). We therefore must estimate it.' [42]

- **Consistency across 'allowances'**: Ofgem needs accurate data across all three 'allowances' for benchmarking options 1 and 2. However, they note that 'As one supplier has not yet submitted consistent working capital data, we have not included them in our calculation of any benchmarks presented in this chapter, to aid comparability across benchmark options.'[43]

Whilst Ofgem may be able to resolve, or may have already resolved, some of these data issues they illustrate the complexity of benchmarking these costs against their estimated allowances. We set out in our response to Ofgem's policy consultation on the original price cap our concerns about Ofgem's process where there are data uncertainties:

> "…the robustness of the analysis will ultimately depend on the data provided by suppliers, which we have not been able to see … This is a procedural error and it has substantive consequences: it means that Ofgem will not benefit from proper, informed responses and its decision making will, accordingly, be compromised."[44]

Ofgem should ensure it does not repeat this procedural error and shares sufficient information for suppliers to provide proper, informed responses. We are concerned that Ofgem has already noted that it will not share the model it uses to calculate the allowances until sometime during 2024. There appears to be no reason for this and any errors in the calculation of allowances could have a material impact on Ofgem's estimates of under or over recovery.

In addition to this our view is that Ofgem should fully disclose its benchmarking model through a confidentiality ring. This will be especially important if Ofgem proceeds with Option 3 which may use an individual supplier to set two of the three benchmarks.

As Ofgem is aware any benchmarking analysis is reliant on the data that is available. Ofgem needs to be clear about any data limitations that affect its estimates and allowing suppliers full disclosure is the best way to do this. Where there are limitations it is important that this is well understood because it should form part of decision-making process informing the appropriate stringency of any benchmark.

Allocation of the allowance

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

Ofgem has set out five options for payment method allocation. All options will impact SVT consumers who ultimately bear costs allocated through the Default Tariff Cap. However, there are also significant distributional impacts between both customers and suppliers of some options. We consider these impacts first.

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[42] Ibid, Paragraph 7.2.
[43] Ibid
[44] Centrica response to Policy Consultation (June 2018) para 186, p.44.

Distributional effects

Ofgem does not set out the distributional impact of options 3 - 5 on PPM customers though we know from the recent levelisation consultation that Ofgem is concerned about the impact of standing charges on PPM customers. We are also aware from the Government's spring budget that it has committed to ending the PPM premium.[45]

Ofgem does set out the distributional impacts of allocating costs between credit customers. They find that:

> *'the percentage of households that are classed as fuel poor is proportionally higher for PPM and standard credit, than for direct debit. However, of all households in fuel poverty, the majority pay by direct debit.* ***This means that an option which adds costs to direct debit would likely increase costs for the largest number of fuel poor customers, who we must give particular regard to these customers****.'*[46] *(bold added)*

This is an important point, and we note that options 1 and 4 would increase costs for direct debit customers. However, these options also increase costs for standard credit customers by the same amount.

Ofgem's silence on the distributional effects on PPM and SC customers is surprising. We assume that this is because the ultimate distributional effects will be driven not just by how Ofgem decides to allocate costs within the price cap (Options 1 – 5) but also by Ofgem's forthcoming decision on levelisation. In the context of that decision, Ofgem has asked stakeholders to:

> 'when considering which of these payment method allocation options is preferable, stakeholders should therefore consider those interactions in the round.'[47]

Asking stakeholders to consider these complex issues 'in the round' is not reasonable. Ofgem needs to set out these interactions in full in future consultation.

In addition to distributional effects, Ofgem must consider cost reflectivity and with it the impact of payment method allocation on suppliers.

Cost reflectivity

The current price cap does not allocate debt related costs in a cost reflective way – payment method uplift is applied 52% to SC customers and the remaining 48% split equally between SC and DD customers.

We have set out this point above in response to question 3. The COVID-19 additional debt allowance allocated costs equally between credit customers. Finally, the ASC decision allocated all costs to PPM customers.

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[45] Spring Budget 2023 (HTML) - GOV.UK (www.gov.uk)
[46] Additional debt-related costs allowance policy consultation (ofgem.gov.uk), Paragraph 8.24.
[47] Ibid, paragraph 8.15.

The ASC decision is therefore the only time that Ofgem has allocated debt costs in a cost reflective way. This in part reflects Ofgem's view that current payment method can be a poor proxy for the payment method on which debt was incurred. (The exception to this is ASC costs which can only be incurred by PPM customers).

Even if payment method is an imperfect proxy for the incidence of debt related costs, Options 1 and 4, which allocate costs equally between standard credit and direct debit customers, are likely to exacerbate issues around the cost reflectivity of the DTC and differential impact on suppliers. Whilst this is in line with the COVID-19 decision Ofgem must consider the incremental impact of these decisions on suppliers with a large proportion of standard credit customers.

We also note that in our response to the COVID-19 supplementary consultation we noted that it is vital that Ofgem's approach in respect of COVID-19 bad debt costs does not set a precedent for calculating and recovering bad debt costs under the price cap more generally. This was because Ofgem's approach for calculating and recovering bad debt costs related to COVID-19 was, in our view, likely to be inaccurate because it did not properly account for bad debt costs between payment methods.[48]

An obvious way to remedy this would be to implement Option 3 of Ofgem's levelisation proposals which would enable suppliers to recover the costs according to their customer base whilst increases in debt costs can be shared in a way that prioritises the needs of vulnerable customers.

Recognising the link with levelisation, Ofgem has asked stakeholders to

> 'when considering which of these payment method allocation options is preferable, stakeholders should therefore consider those interactions in the round.'[49]

We are simply unable to do this because Ofgem has not yet published a decision on levelisation. Therefore, we reserve the right to comment further when such a decision is published. For avoidance of doubt, if Ofgem does not proceed with Option 3 under levelisation, at least Options 1 and 4 in this consultation would increase the level of cross subsidy within the price cap. The cumulative impact of this on suppliers with large standard credit customer bases should be a priority for Ofgem to consider in its forthcoming statutory consultation.

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 that debt administration and working capital costs should be allocated uniformly across payment types.

Ofgem argues that because suppliers were not able to allocate debt-related administrative costs and non-customer working capital across payment types these costs should be allocated uniformly. Ofgem should not confuse data availability with an absence of cost drivers.

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[48] Centrica response, Price Cap – Supplementary consultation on the true-up process for COVID-19 costs, 20 October 2022.
[49] Additional debt-related costs allowance policy consultation (ofgem.gov.uk), paragraph 8.15.

Furthermore, the current price cap does not allocate these costs uniformly, despite similar data constraints being noted when the cap was set in 2018.[50] When setting the cap Ofgem allocated 52% of debt administration costs to standard credit noting that

> 'suppliers incur higher administrative costs (excluding working capital and bad debt) when serving standard credit customers.[51]

Working capital costs were allocated to standard credit customers and Ofgem noted that:

> 'Working capital is a feature and cost of standard credit…'.[52]

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

In general, we share Ofgem's concerns on the impact of standing charges on customers and support its recent commitment to consult on this.[53] However, in the case of this proposed adjustment Ofgem will need to consider whether allocating debt-related costs to the standing charge would facilitate levelisation across payment types; supported by a supplier reconciliation.

Ofgem's preferred option for levelisation is to levelise the new Additional Support Credit bad debt allowance (on the PPM standing charge) across all payment methods and levelise PPM and DD standing charges.[54] Ofgem is considering a further option to also levelise the bad debt allowance in the payment method uplifts, across all consumers proportionately.

This allowance will exacerbate the issues that led to Ofgem's levelisation proposals, especially under option 5 which would have a significant impact on standard credit customers.[55] Given this Ofgem will need to consider whether levelisation can be used to mitigate the impacts on customers. Based on current proposals this appears most likely if debt-related costs are apportioned to the standing charge.

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50 Appendix 8 - Payment Method Uplift (ofgem.gov.uk), Table A8.3: Breakdown of uplift figures for a dual fuel customer.
51 Appendix 8 - Payment Method Uplift (ofgem.gov.uk), Paragraph 2.24.
52 Ibid, Paragraph 3.46.
53 Jonathan Brearley's speech at Energy UK Annual Conference 2023 | Ofgem
54 Levelising the cost of standing charges on prepayment meters (ofgem.gov.uk)
55 Option 5 allocates the additional debt related costs to the payment method which suppliers reported those costs on.