Utility Warehouse

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Additional debt-related costs allowance - UW response

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Utility Warehouse was one of the first 'challenger' brands when it entered the retail energy market over 20 years ago, and we have a unique perspective in that we operate across numerous regulated markets: energy, telecoms and insurance. Today we serve over 900,000 households.

UW overarching view

Addressing debt-related costs in the industry is both an urgent and high impact issue that requires Ofgem's immediate attention. We therefore welcome Ofgem's consultation on this issue. However, we note that it is not logical or plausible that the net impact of all the debt related costs might lead to a lower overall allowance (ie a negative adjustment) - this consultation has been triggered by a recognition that suppliers are being placed under tremendous pressure as a result of the deteriorating patterns of customer payments; so to reach any other conclusion than to provide a higher overall allowance for debt related costs would be an aberration.

We have responded to Ofgem's consultation questions, and below we set out our positions on what we consider to be the two most important considerations in the consultation.

1) **Allocation of the allowance - option 1**

Option 1 is the only option that avoids a socially divisive outcome whereby Standard Credit (SC) and Prepayment (PPM) customers are unfairly loaded with debt costs from other customers at a time of high energy costs and a cost of living crisis. This would be highly inequitable and practically counterproductive. We have expanded below:

- Ofgem should not adopt any option that would unfairly inflate the costs for SC customers who have some of the highest levels of debt in the industry. This would be unethical and socially divisive, particularly given we are in the midst of a cost of living crisis, compounded by a prolonged period of high energy prices.

- A significant number of SC and PPM customers who currently have outstanding debt will have been initially set up as DD customers. Their transition out of DD process is precisely as a result of them falling into a debt position, a point that Ofgem itself has recognised in paragraph 8.9 in the consultation. Therefore it would be inappropriate to use the end-point payment mechanism (SC) to burden these costs specifically onto those customers who have now fallen into debt, especially considering that many of them were originally DD customers.

- Ofgem should recognise the real risk of unintended consequences of loading debt-costs onto SC. For example, there is a separate segment of SC customers who are loyal, good payers and so Ofgem would create market distortions by loading debt onto this group. Further, by attempting to recover the majority of debt costs from SC, Ofgem would likely push these customers onto PPM or DD, skewing the outcome of the intended methodology, creating a counterproductive result.

- Ofgem should avoid any allocation approach that penalises PPM customers. PPM customers are already repaying their debt via their meter and it would be entirely inappropriate for them to be incurring the debt-related costs of other customers. Additionally, via the ACS and PPM standing charge levelisation policies in development/in operation, any approach Ofgem takes to load costs back on to PPM would be counterproductive to Government and Ofgem wider policy objectives.

2) Approach to benchmarking costs - option 2

We strongly support option 2; a weighted average approach is the only way to deal with the interplay between the cost components and to avoid distortion in the market. In summary:

- Debt costs are so inherently interlinked that the only way to avoid creating an impossible and unachievable benchmark for suppliers to target is by applying a consistent application of the weighted average across the cost components. The allowance must be realistic and as reflective as possible of a notionally efficient supplier in order to comply with the objectives of the Cap.

- Adopting a lower quartile approach in any of the benchmarks carries risk of misrepresenting costs and risks under-investment in the debt management process, which could lead to unintended consequences. At a time when investment in debt administration is so vital, Ofgem should avoid building in risk of an unreflective cap that could drive underinvestment or irresponsible behaviour.

- A weighted average benchmark allowance will allow suppliers to adapt to shocks or changes in the regulatory environment, ultimately supporting higher service standards in relation to debt-management. We also believe it is important for Ofgem to maintain consistency with the benchmarking approach used in the COVID-19 true-up.

- Lastly, the benchmark should reflect the market conditions we face today, ensuring that suppliers can efficiently recover the costs they incur.

Consultation questions

Q1	**Do you consider that we should make a temporary adjustment to the price cap to account for additional debt-related costs?**
	An adjustment to the price cap is absolutely required to account for additional debt-related costs. As we know from Citizens Advice and supplier data, debt instances are not only increasing, but the value of debt energy consumers owe is also increasing. Government support has come to an end while the era of high energy prices continues to grow; debt costs are going to continue to increase and it is therefore right for Ofgem to address this in the price cap now, to get ahead of this issue as much as possible. While we fully appreciate the temporary nature of the adjustment, it is important to consider that this will be needed for some time given that we are in what is expected to be a prolonged period of high energy prices and an ongoing cost of living crisis, both contributing to high instances of bad debt.
Q2	**Do you think that suppliers' costs due to the moratorium on involuntary PPM installation should be included in the adjustment?**
	Yes. The moratorium on PPM has meant that customers have been able to build up an increased debt level on SC and DD tariffs that would not have been possible on PPM, as per Ofgem's ASC consultation. This moratorium has therefore led to increased debt levels and costs to service that debt, so it is right that Ofgem’s adjusted allowance accounts for this new cost. In respect of Ofgem's consideration in paragraph 4.21 around whether to account for the full cost of the moratorium in the adjustment, we would argue strongly that it should be. The moratorium has affected those suppliers who were compliant, as well as those who are non-compliant. Costs incurred by compliant suppliers due to the moratorium must be covered. Even though ‘on-hold’ compliant installations will still be progressed under the new rules, there is a cost to the delay that needs to be covered. Further, the new code of practice precludes the installation of PPM customers for a broader set of the population than previously and so this will increase these costs - both in terms of increased value of debt and ageing of debt.
Q3	**Do you agree that any adjustment should be made using the existing price cap mechanism, rather than a bespoke levy or other new mechanism?**
	We agree with Ofgem that a cap adjustment mechanism (e.g. using the Adjustment Allowance as per the Covid-19 true-up) is the most appropriate option, and that it is for suppliers to manage their own policies to recover debt costs on non-cap tariffs. We also agree that a levy risks discouraging efficiency and that it is practically challenging and resource-intensive to implement. This is a particularly important consideration given the need to implement this allowance quickly. Finally, given the temporary nature of the allowance, the price cap mechanism - as opposed to a bespoke levy - would be the most practicable solution.
Q4	**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 believe this cost should be considered in the scope of any treasury-funded future social tariff, which UW believes must sit alongside a continuing universal SVT price cap. Adding a levy to recover the costs of DNI customers without the support of a

	Treasury-funded social tariff would merely load more debt onto the wider customer base at a time of increased energy costs, a cost of living crisis and high instances of debt; and would be unlikely to allow suppliers to recover the debt. We believe this is part of a wider and separate debate (treasury-funded social tariffs) and we do not believe it should be considered in isolation or via a dedicated levy.
Q5	**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 with the proposal for a float and true-up approach and that the adjustment allowance should initially be introduced for 12 months; as per our response to Q1 we note that Ofgem should be ready to extend the timeframe should circumstances require.
Q6	**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?**
	The allowance is urgently required, and so delays beyond Apr-24 should be avoided. We agree that any true-up should be applied 12-months later.
Q7	**Do you agree that we should carry out only one wider debt-related costs true-up?**
	It is our view that PPM customers should be entirely excluded from the allocation of the updated debt-related cost allowance for the reasons set out in our response to Q12. As such, we consider that the dynamics of this true-up will be very different from that of the ASC workstream and thus should be considered by Ofgem separately. We therefore support separate true-up exercises.
Q8	**Should the float allowance be uprated to account for inflation, or should we make no additional adjustments?**
	Yes. Inflation is a cost that the business incurs so the allowance should be uprated to account for this.
Q9	**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?**
	A broader discussion is needed regarding the data and methodology used in calculating these allowances, as well as an accurate assessment of the actual costs incurred. Currently, there appears to be a significant risk of under-recovery across the industry. This consultation was initiated in response to the recognition that suppliers are facing challenges due to deteriorating patterns of customer payment. Therefore, the ultimate conclusion should acknowledge this and result in a higher overall allowance for debt-related costs.
Q10	**Do you have any other suggestions of alternative methodologies or other factors we should consider for how to calculate the debt-related costs over or under-allowance in 2022/23?**
	We strongly favour Ofgem's proposed option 2 for the reasons set out in Q12 - please refer to that answer here. A weighted average approach is the only way to deal with the interplay between the cost components.

Q11	**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, they should all be considered in scope for this review; however, Ofgem's approach must recognise that the three cost items that make up debt-related costs (bad debt, debt administration, and working capital) are inherently intertwined and utilising a weighted average across all three items is the most effective means to address the interplay between the cost components. Please also refer to our response to Q12. If Ofgem requires additional time to assess the debt administration and working capital allowances, we propose that Ofgem provides a bad debt allowance on a weighted average basis by April 2024. Subsequently, the debt administration and working capital costs should be part of the later and more comprehensive operating cost review. This broader review should also follow the weighted average approach to ensure it supports sustainable competition.
Q12	**Which, if any, of the benchmarking options do you favour?**
	We disagree with Ofgem's favoured option (option 3) of a blended benchmarking approach. We strongly support option 2. A weighted average approach is the only way to deal with the interplay between the cost components and to avoid creating an impossible benchmark. Additionally, option 2 gives suppliers slightly more flexibility to manage their debt-related process in a way that can better account for factors that are outside of a notionally efficient supplier's control, such as the ongoing gas price crisis and wider cost of living crisis. By doing so, this option also helps promote innovation, sustainable competition and higher service standards in relation to debt-management. <u>A weighted average approach is the only way to deal with the interplay between the cost components</u> We have set our our justification for this position below: • Ofgem's approach must recognise that the three cost items that make up debt-related costs (bad debt, debt administration, and working capital) are inherently intertwined and that a weighted average is the only way to deal with the interplay between the cost components and to avoid distortions in the market. • Adopting a lower quartile approach in any of the benchmarks carries risk of misrepresenting costs. A supplier may only be achieving lower quartile in one component because it is achieving a higher quartile in another. It could also be the case that a supplier appears to be in the lower quartile in debt-administration because it is cutting corners. At a time when investment in debt administration is so vital, Ofgem should avoid building in risk of an unreflective cap that could drive underinvestment or irresponsible behaviour, and set a dangerous precedent. • Debt costs are so inherently interlinked that the only way to avoid creating an impossible and unachievable benchmark for suppliers to target is by applying a consistent application of the weighted average across the cost components. The

	allowance must be realistic and as reflective as possible of a notionally efficient supplier in order to comply with the objectives of the Cap[1] ● Investing more in debt administration processes, such as promptly reaching out to customers after missed payments in accordance with the new Consumer Standards Framework, may hold the key to reducing debt. So if a lower quartile approach is adopted it could result in under-investment and lead to poorer customer service. At a time when we are trying to improve customer service, which is only achieved via more investment and strengthening processes, Ofgem must avoid introducing risks of underinvestment. ● We strongly support a weighted average benchmarking approach that encourages sustainable competition. This is an important point, which Ofgem itself discusses in its Operating Cost review working paper[2] (Table 3), where it scores a cap that promotes sustainable competition highly because it is most effective in incentivising efficiency, enabling competition and incentivising switching. ● Given the above, and that Ofgem makes reference to the intertwined nature of debt-related costs in its Operating Cost Review Working Paper (and thus points to it as an example of where costs are intertwined and thus it is more appropriate to consider them at a total cost level[3]). <u>Maintain consistency with the benchmarking approach for the Covid- true up</u> ● Ofgem's decision during the COVID-19 true-up, which adopted a weighted average benchmark, was a response to the unique and exceptional challenges presented by the pandemic. It remains relevant today, especially given the current cost of living crisis. While suppliers may have optimised their processes for normal conditions, these processes may not perform as effectively in the face of unexpected disruptions caused by the ongoing circumstances. By allowing a weighted average benchmark allowance, it will enhance suppliers' ability to adapt to shocks or changes in the regulatory environment, ultimately supporting higher customer service standards. <u>The benchmark should reflect the market conditions we face today</u> ● The decision to use the lower quartile for debt administration costs and working capital was initially based on a precedent from 2018, although we now recognise that the cap implemented during that period didn't adequately cover supplier costs. It's essential to acknowledge that the landscape of bad debt and related processes has significantly changed since 2018. In the original cap setting, the lower quartile benchmark was used as an incentive to encourage suppliers to aim for greater efficiency. However, this consultation deals with costs that have already been incurred or are currently being incurred, leaving suppliers with no chance to develop plans to achieve the lower quartile of the efficiency frontier.

[1] https://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted; Section 1, para 6 (a)-(d)

[2] https://www.ofgem.gov.uk/sites/default/files/2023-10/Energy%20price%20cap%20operating%20cost%20review%20benchmarking%20working%20paper1696956062375.pd; Section 3, table 3

[3] https://www.ofgem.gov.uk/sites/default/files/2023-10/Energy%20price%20cap%20operating%20cost%20review%20benchmarking%20working%20paper1696956062375.pdf para 4.4-4.6

Q13	**Do you have any views on which payment method allocation option would be preferable?**
	Allocation of the allowance - Option 1 is the most suitable approach Option 1 is the only option that avoids a socially divisive outcome whereby SC and PPM customers are loaded with debt costs from other customers at a time of high energy costs and a cost of living crisis. Our view is that this approach would be highly inequitable and practically counterproductive. Option 1 best reflects - as much as is possible - the limited data and knowledge available around debt accrual, and it is consistent with wider related policies from Ofgem and Government. From a social perspective, it is the most customer-centric solution, particularly in the current climate of a cost-of-living crisis. Ofgem should not unfairly inflate the costs for Standard Credit customers We do not believe Ofgem should adopt any option that would unfairly inflate the costs for SC customers. This would be unethical and socially divisive; we have set out our reasoning below: ● We are in the midst of a cost of living crisis, compounded by a prolonged period of high energy prices. The SC customer base is made up of customers who have some of the highest levels of debt in the industry and would suffer disproportionately from any interventions from Ofgem that loaded more costs onto their bill. It is our view that the proportion of fuel-poor customers on SC is greater than DD, which is likely to be because these customers are more vulnerable (could be elderly, or unable to access a bank account, already been removed from a DD tariff for debt etc). These customers would suffer disproportionately from any option that pushed debt costs onto their bills. The impact of current high energy bills would be exacerbated during a cost-of-living crisis, and likely push them further into debt. ● A significant number of SC and PPM customers who currently have outstanding debt will have been initially set up as DD customers. Their transition out of DD process is precisely as a result of them falling into a debt position, a point that Ofgem itself has recognised in paragraph 8.9 in the consultation. Therefore it would be inappropriate to use the end-point payment mechanism (SC) to burden these costs specifically onto those customers who have now fallen into debt, especially considering that many of them were originally DD customers. Further, in the case of UW, due to the smaller number of SC customers, a much higher debt allowance will have to be paid by them. For example, option 5 would add an additional allowance of £144 to their bills. ● Ofgem should recognise the real risk of unintended consequences of loading debt-costs onto SC: ○ Firstly, there is a separate segment of customers who are long-standing SC customers, usually loyal to their supplier and are good payers. By allocating all credit costs onto SC customers, Ofgem would be creating distortion by a) legacy suppliers with long-standing SC customers would receive a windfall relative to other suppliers, who would be bearing unrecoverable debt costs and associated funding costs, and b) loading debt allowances on to customers who are historically good payers.

- Secondly, aside from the social impact, loading all debt costs onto SC would further increase debt-related costs in the industry, and likely push these customers onto PPM or DD, skewing the outcome of the intended methodology meaning the industry under-recovers. Such an approach would be both socially unacceptable and practically counterproductive.

Ofgem should avoid any allocation approach that penalises PPM customers

We strongly believe that PPM customers should not incur debt charges via this revised allowance and we have set out our reasoning below:

- PPM customers are already repaying their debt via their meter and it would be entirely inappropriate for them to be incurring the debt-related costs of other customers. As Ofgem points out, debt-related costs recorded on PPM tariffs largely relate to consumption while on previous payment methods. Customers on PPM are often already vulnerable and make up the majority of fuel poor customers, and as such should not be charged for debt built up on other payment methods. This supports the case for allocating debt-related costs to those payment methods rather than PPM.

- As Ofgem notes, the main source of bad-debt originating from PPM is ACS. Ofgem is already consulting on levelising this cost. As such, a) this cost is already accounted for in policy development, and b) a policy precedent is being set with regard to PPM debt-related costs. Our view is that Ofgem should remain consistent with that workstream and lean towards an allocation approach for debt-related costs that apportioned zero costs to PPM.

- There is a clear policy ambition both at the government and regulator level to remove the 'PPM penalty'. Work has begun on this, with a temporary adjustment already in place. It would seem counterproductive to remove charges from PPM under one workstream to deliver on this policy, then add to them via another workstream. Publicly, this would be unpalatable.

Ofgem should draw on the available data and limit assumptions that disproportionately affect SC customers

- Payment method is a transient status; customers move regularly between methods to accommodate their circumstances and therefore the distinction between the two payment methods is in some way artificial, supporting the logic that debt costs should be split equally between them. [redacted]

	• As Ofgem points out, the data available is insufficient to be able to accurately determine on which payment methods customers have built up debt; the data available does not provide a picture of where a customer's debt was first accrued - it only provides information on a customer’s current payment method. It is therefore not possible to determine an accurate picture of debt accrual across the sector and to then apportion debt costs to the relevant payment method segment. Any approach adopted by Ofgem should therefore ensure that its impact on consumers is as balanced and proportionate as possible. <u>The evidence informing the Covid-true up decision remains true today</u> • The decision made by Ofgem for the Covid-19 true-up to a) allocate costs equally across credit customers, and b) allocate PPM debt-related costs to credit customers, was based on logic and evidence that remains true today. PPM meters do not carry debt except the debt that is being repaid, so it is only right that they do not contribute to bad debt costs; secondly, the split between credit customers across DD and SC is to some extent artificial because customers move between these payments methods when it comes to defaulting on bills and replaying debt. In the interests of consistency and to avoid over-engineering the solution for an inherently complicated problem, we would encourage Ofgem to adopt the same approach to cost allocation across payment methods.
Q14	**Do you agree with us allocating other debt-related costs (debt-related administrative and working capital costs) uniformly across payment method?**
	Credit customers routinely move between payment methods, especially if they begin to struggle with their bills, therefore it is only fair that the allowance should apply uniformly across credit payment methods (DD/SC). It is also worth noting that PPM meters do not accumulate debt beyond the debt amount that is being repaid. Therefore it is logical that they do not contribute to bad debt costs. In the interest of consistency and to avoid making the solution overly complex, we would encourage Ofgem to adopt the same approach they have used in the past (i.e for Covid-19 true up) to allocate costs equally across credit payment methods only.
Q15	**How should we apportion any debt-related costs allowance over the unit rate and standing charge elements of the cap only?**
	Debt-related costs should be allocated exclusively to the unit rate element of the cap. This approach aligns with the fact that debt tends to scale with consumption, making it a fair and practical allocation.
Q16	**How should we apportion any debt-related costs allowance between fuel and meter types?**
	The debt-related costs allowance should be apportioned uniformly across the fuel and meter types, this approach ensures simplicity, fairness and avoids the imposition of undue burdens on any particular group. This also aligns with our fundamental request to uniformly distribute the additional bad debt adjustment across credit payment methods (Refer to Q14).