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Response to Ofgems Additional debt-related costs allowance policy consultation

Dear Dan and team

Ofgem has taken the responsible but difficult decision to review the debt allowances in the cap, given extraordinary and volatile market conditions. The breadth and depth of customer indebtedness has fundamentally escalated in recent months.

We recognise that the questions Ofgem are tackling, put at its simplest, are:

1. Over this extraordinary period, has there been a significant divergence between the "efficient" debt costs suppliers have incurred and allowances in the price cap? And if so
2. What is the fairest way to intervene, to ensure suppliers are able to recover their efficient costs and that customers are treated fairly in the process?

Our answers to this are:

1. **Regrettably, Ofgem needs to make a temporary upward ex-ante adjustment to the price cap to cover additional debt related costs.** It is clear to us that by looking at cap periods where the picture is not complicated by the provision of vital Government bill support, there is an indisputable and material uptick in customer debt and related costs. This is already resulting in a change to bad debt, as Ofgem will see through the next round of data submissions, with debt and related costs likely to increase as this winter progresses.

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2. **Ofgem should therefore make a temporary upward adjustment no later than April 2024, with a review to consider its extension after a year. But we do not support a "float and true up" approach.** An adjustment in April 2024 is the fairest for suppliers, ensuring that allowable charges reflect these higher costs as soon as possible, and also for customers - who will experience a higher price but start on summer usage. The alternative, which is to make an ex post adjustment in October 2024, could strain the financial resilience of some suppliers and cause a bill shock to consumers going into winter.

   We do not support a float and true up approach. With a temporary adjustment in place from April 2024, a full and thorough Opex review in 2024 and potential market changes as competition adjusts to the removal of MSC, Ofgem will be in a good place to complete a review of the situation in spring 2025. This should focus on determining if the temporary adjustment has served its purpose, has been set at an accurate level and if it needs to be removed or extended for a further period of time.

3. **Ofgem should not be tempted to overly complicate the calculation of this temporary adjustment**. The analysis Ofgem has carried out is spuriously accurate and detailed, inferring 3 different types of debt related cost allowances embedded within 4 different elements of the price cap, spanning the cap for 3 different payment methods. Fundamentally the analysis will never provide a highly accurate picture for how debt related costs have deviated from the price cap allowances, given that Ofgem has to impute the price cap allowance baseline in the first place. Also this is a backward looking analysis based on at most two "representative" periods in order to set a temporary ex-ante allowance in 5 months time. This suggests a simpler approach recognising the limitations of the data Ofgem has at its disposal.

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4. **The adjustment should focus on bad debt charges only - they account for the lions' share of debt related costs.** Ofgem's analysis of deviations of actual costs from price cap allowances for debt admin and working capital costs is not sufficiently robust to be used in setting the value of the temporary adjustment. And it certainly should not be used to depress the value of the uplift required to reflect movements in bad debt charge costs. We respect that Ofgem has a responsibility to ensure that default prices are fair by considering efficiency, for example, however, we suggest that any adjustment set on the basis of a backward look of the deviation between actual debt costs and price cap allowances (particularly one looking at a period of significant government price support) errs in favour of customers, given debt and associated costs are likely to rise significantly over the winter. Further conservatism would be built in if, as we propose, there is no "true up" process in place, but simply a review to decide if the uplift needs to continue.

   Debt administration cost movements should be wound into the wider Opex review, rather than trying to pinpoint what has happened - and predict what will happen - to this relatively minor element of debt costs.

5. **If Ofgem is to include working capital in its assessment (which we think is not necessary or appropriate), adjustments based on median or lower quartile suppliers should not be made given the wide variations in cost of capital across the sector.** We are struggling to see why an increase in customer debt would result in some companies outperforming against Ofgem's imputed debt related working capital costs (which is what Ofgem's analysis shows has happened for median and lower quartile suppliers). We can only presume Ofgem's results are picking up the impact of some companies having a cost of capital below the one Ofgem uses in the price cap, rather than anything to do with changes in customer levels of debt. It does not appear safe to assume that the movements Ofgem has observed in working capital costs relative to the imputed cost allowance baseline are a good indicator of what is likely to happen over the next 12 months.

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6. **Debt related costs should be recovered through the price cap, not through a levy, especially in the case of debt associated with customers who should not be force fitted with a prepayment meter.** There must be a very high bar to the creation of levies, as socialisation mechanisms significantly reduce the incentive on suppliers to take the initiative to control their own costs. In the case of debt related costs, whilst the cost of living crisis is outside of suppliers' control, the way suppliers support and assist customers through this crisis - preventing indebtedness and reducing the scale of it - is very much within their control. Creating a levy that socialises debt related costs of "Do Not Install" customers will have the perverse impact of encouraging suppliers to allow vulnerable customers to get all the way through the debt journey rather than helping the customer manage their debt.

7. **To be fair to customers, the uplift should be on both Direct Debit and the Standard Credit price cap and on unit rates only.** It is clear that debt growth exists on all payment types, affordability is not a symptom of one payment mechanism. However it can be the case that customers fall into debt they stray from previous payment routines and end up with a standard credit solution (as such analytically it can look like standard credit is the biggest driver of debt). The fairest way to reduce cost to any one household is to spread the costs across both payment methods and to apply them to unit rates. Unlike unit costs, customers cannot avoid or reduce their standing charges. They can be barriers to accessing energy and need to remain low.

Sincerely

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

Yes. This is needed because there has been a fundamental and - we suspect growing - deviation of actual debt related costs from the price cap allowances, with the price cap methodology breaking down in the context of unprecedented levels of consumer indebtedness. This upward trajectory is sharp and shows no sign of slowing in spite of energy prices starting to drop this summer, a reflection of the impact of the wider cost of living crisis on customers' ability to pay.

The picture Ofgem presents in its figure 4.1 is somewhat confused by very high Government bill support in periods 9a and 9b which had the effect of suppressing customer debt and associated costs. However, Ofgem's own analysis shows that both prior to this support being introduced (period 8) and once this support starts to taper off with the removal of EBSS (from period 10a), the disconnect between costs and price cap allowances is very pronounced. We suspect that the emerging picture will get worse as the winter progresses and we welcome Ofgem taking 10b data into account.

Ofgem's analysis of debt related costs in figure 4.1 aligns with the picture we see on customer indebtedness. The confidential chart below shows that customer indebtedness has been on an upward trajectory throughout this crisis (from cap period 8 onwards) but it becomes pronounced in summer 2023 (a time where you would normally expect debt growth to flatten), with the removal of EBSS. We therefore expect that Ofgem will see this disconnect between the price cap allowance and the bad debt charge continue or even widen when it looks at 10b data.

The following graph, **shared in confidence**, demonstrates the impact of government support of debt growth. Here we have considered the price cap inclusive of EBSS (at an annualised value).

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[redacted]

The above analysis calls into question the validity of Ofgem using debt related cost data from periods 9a and 9b in setting an ex-ante temporary uplift. If these periods are taking into account, it will mean that any uplift is likely to underrepresent the additional debt costs suppliers are likely to be facing. That may have a bearing on Ofgem's choice of benchmarks (median, weighted average, lower quartile) and other decisions such as on inflation uplifts.

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

It would be very easy to over complicate this allowance review by examining each possible driver of increased customer debt. The reality is that the headline figures already include the impact of the moratorium - without the use of a smart prepay budgeting tool for those who "won't pay" it is inevitable that bad debt has worsened and has already been factored into the charges and provisioning that Ofgem are referencing. There is no need to separately consider this. As explained in answer to Q4 we do not support any separate adjustment or levy for these debt costs.

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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. There should be a high bar to creating bespoke levies and industry should always seek to use and improve existing mechanisms where possible. A majority of customers are currently, and are likely to remain, on price capped products for some time and as such using the cap to spread the cost fairly is perfectly possible. Furthermore, to the extent that customers move onto acquisition tariffs, the level of these tariffs will to some extent reflect additional debt costs too, meaning that all customers carry some of this burden, not just those on SVT.

We are also concerned that a levy which “socialises" these additional costs may lessen the incentive on suppliers to take action to manage debt and their debt related costs. A levy would be complex and burdensome to administer - especially given that market shares are likely to move post MSC ending and bad debt provisioning policies vary significantly across suppliers and could be gamed to take advantage of the levy arrangements. Although we have concerns about the limitations of the analysis which Ofgem has carried out for this review, we consider a temporary uplift on an imputed ex ante price cap allowance to be better than a mechanism which centralises debt costs and recovers them through a levy.

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 don't not agree with creating specific levy mechanisms generally and especially where costs are within the supplier's influence.

It is clear that in any crisis retailers must adapt and consider the changing needs of their customers. The energy crisis is no different. Up to 12m households are

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spending over 10% of their disposable income on energy[1] and it is incumbent on suppliers to work with those customers to design affordable and accessible repayment plans. A portion of these customers will be vulnerable and suppliers have a duty to support - which may well include bespoke payment plans and provision of targeted debt assistance schemes. Suppliers have a degree of influence on outcomes here.

If Ofgem were to create a levy (especially for PSR/DNI customers) then it creates the perverse incentive to not help these customers - the easier route becomes socialising the problem rather than targeting meaningful support.

More generally, suppliers do have some influence over how much debt their customer base accumulates and how much of that turns into bad debt. We do not consider that the introduction of new DNI regulations should have a material impact on suppliers' ability to take measures to control debt related costs.

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 to an uplift in April 2024 but we do not agree with using the "float and true up" approach. An ex-ante adjustment in April is significantly preferable to an ex-post adjustment in October. We recognise that Ofgem only has two price control periods (10a and 10b) of representative data to look at to assess how debt related costs are moving but see there is scope to refer to period 8 in order to understand the direction of travel.

[1] *DESNZ projection of number of households spending over 10% of income on energy 2023 (after housing costs), inclusive of government support packages (Annual Fuel Poverty Statistics LILEE Report 2023, p 79)*

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An adjustment in April 2024 is the fairest for suppliers who should be allowed to charge prices that reflect these higher costs as soon as possible and also for customers who will experience the higher price on summer usage. An ex post adjustment in October 2024 could strain the financial resilience of some suppliers and cause a bill shock to consumers going into winter.

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?**

Ofgem should work to implement a temporary adjustment for 12 months commencing in April 2024 with the default that it expires at the end of that period. Before then, Ofgem should complete a review of this adjustment.

We would not see this as a "true up" exercise. Ofgem would not be attempting to calculate what the temporary allowance should have been over the 12 months from April 2024 with a view to adding or subtracting this from allowances in the period from April 2025 onwards. Rather, Ofgem would look at the wider changes in the market and in the price cap (which we hope will include the conclusion of the Opex review) and consider a) is there a case for continuing with a temporary uplift for debt related costs - i.e the cap is not sufficiently accounting for these costs and if so b) what is the correct level for this uplift for the year ahead.

We consider this is a simple and easy to manage approach, recognising the difficulty of assessing bad debt and building on the lessons of the Covid bad debt float and true up. By taking this approach rather than a "true up" Ofgem will help to ensure that there is no creation of perverse incentives (such as gaming write offs or minimising customer support packages).

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

We recommend that the temporary ex-ante adjustment seeks to capture only an estimated additional bad debt charges, and that Ofgem should not over-complicate matters by trying to factor in movements in debt related administration and working capital costs. These last two categories account for the minority of debt costs and estimating or predicting the scale of movements against an imputed benchmark with any degree of accuracy is highly problematic and adds a spurious degree of accuracy to the exercise. This is particularly the case because Ofgem has limited observation periods where the debt related costs and their relationship to the price cap allowances have not been significantly skewed by Government bill support.

If Ofgem follows this approach then in 2025 Ofgem will only need to conduct one review, focused only on whether a continued uplift is required to reflect bad debt charges.

As per our answer to Question 6 above, we do not support a “true up” but rather a review towards the end of the 12 month period of whether a continued temporary adjustment is warranted, and if so, at what level. If Ofgem takes this approach it would make sense to look at all debt related costs together, not to separate out its assessment per cost category.

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

We currently see no reason why the mismatch between allowances and observed costs (which is what the allowance is trying to mirror) should scale with inflation and would like to understand Ofgem’s thinking more. This would suggest no adjustment for inflation in the temporary allowance for April 2024 but, should

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Ofgem see a particular and material risk has emerged through the spring 2025 assessment this can be discussed then.

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 think the methodology for imputing price cap debt related costs is overly detailed and does not take sufficient account of the data limitations. We are sure that Ofgem is using best endeavours to arrive at the estimated price cap allowances but they can, by definition, only be ballpark. We are worried that the limitations of these estimates are not being properly taken into account in Ofgem's overall approach to setting the temporary allowance. In particular, we think that imputing separate price cap allowances for three different types of debt costs is creating a level of complexity that is not matched by the accuracy of the data.

Instead, we would like to see Ofgem take a more broad brush approach, commensurate with the accuracy of the data it has at its disposal. This would involve Ofgem:

a) making its assessment on the scale of the temporary uplift on the basis of bad debt charges only, which account for the lions' share of bad debt costs in any case
b) ignoring admin costs as they are relatively low (by Ofgem's estimation) and should be wound into the wider Opex review. The only sensible assessment of Opex costs is a holistic one, where all the different cost drivers are looked at together. It makes no sense to look at an imputed debt related Opex allowance in isolation of other elements
c) either ignoring working capita deviations or adjusting up the temporary allowance in anticipation of the working capital cost associated with increased debt.

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In more detail, and focusing on the entire methodology, not just the estimation of the price cap allowances:

Bad Debt

As discussed in question 1 we do not feel the bad debt charge has been fully understood by Ofgem. We recognise that Government support makes analysis difficult and suggest that using the average of 10a and 10b as opposed to the weighted average of multiple periods will eradicate that complexity.

Debt-related administrative costs

Ofgem are forced to backward engineer an answer to debt related administration costs, the baseline has to be imputed and the result is a spurious assumption of costs. Customers deserve a clear and transparent understanding of why costs are increasing and this level of complexity does not deliver that.

Our preference would be to remove this element from the debt allowance consultation altogether and work with suppliers over 2024 to ensure that a full Opex review is carried out.

Working capital costs

Ofgem's analysis suggests that an increase in customer bad debt has resulted in some companies outperforming against Ofgem's imputed debt related working capital costs, leading to a median outperformance position. This is counter-intuitive and calls the validity of Ofgem's analysis into question. We can only presume Ofgem's results are picking up the impact of some companies (in particular the larger legacy suppliers) having a cost of capital below the one Ofgem uses in the price cap, rather than anything to do with changes in customer levels of debt. It does not appear safe to assume that the movements Ofgem has observed in working capital costs relative to the imputed cost allowance baseline

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are a good indicator of what is likely to happen over the next 12 months. For this reason, if Ofgem is to use working capital in its assessment, we urge Ofgem to dismiss the option of using the median or lower quartile deviations in its analysis.

10. 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?

Yes. See answer to Question 9 above.

We agree that there has been a divergence between costs and cap allowances and as such a temporary upward adjustment needs to be made from April 2024. But we are concerned that Ofgem has made the approach to estimating the adjustment required overly complex and that it risks delivering confusing and opaque decisions. We also learnt from the Covid-19 adjustments that a "float and true up" can become intensely complex and we are still not convinced they resulted in fair outcomes for consumers.

A more simple and transparent solution is to implement a one year upward adjustment based on the observed additional bad debt charges from period 10a and 10b and then to hold an assessment of the continued need for and scale of the uplift ahead of Spring 2025.

In the meantime Ofgem can focus on an Opex review that will tackle the debt administration cost concerns for sure and could also encompass working capital assumption reviews.

By 2025 Ofgem should have a good view of whether there remains a clear divergence in allowances versus costs and if the value of the adjustment remains suitable/necessary given the completion of Opex review and any changing market conditions.

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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?

No, we believe the focus of this consultation should be on the bad debt charges only.

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

As noted above, the appropriate benchmarking option may vary depending upon which reference periods Ofgem is looking at. The combination of using data from periods 9a and 9b where debt and debt costs are suppressed, and using lower quartile benchmarks is likely to result in an allowance that significantly under accounts for the additional costs suppliers are facing. Equally, Ofgem will need to consider, if it only uses data from periods 10a and 10b, whether it would be fairer to customers (and drive efficiency in suppliers) to use benchmarks at closer to the median, rather than the weighted average benchmark.

If (notwithstanding the very significant concerns we have about this analysis) Ofgem does want to make an adjustment to reflect its view of actual versus estimated allowed working capital costs it must only do this with regard to the weighted average position in the industry, given the divergence of cost of capital across the sector. Using a lower quartile or median benchmark is not warranted.

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

It is key that Ofgem looks to deliver the fairest solution and does not try to overcomplicate. This means that the Ofgem should apply a flat increase across DD and standard credit payment types - option 1 within the consultation.

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

We do not see the need to add this complexity into the adjustment even if Ofgem does include other debt related costs in its assessment of the temporary uplift (which we do not think it should do). These costs should be allocated in the same way as bad debt charges.

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

We recognise this will be a difficult decision for Ofgem to make. We think the most fair solution would be to add the allowance into unit rates. Standing charges are unavoidable costs for customers and there is, in any case, pressure on Ofgem to reduce them.

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

As per Q15 we think Ofgem should strive to deliver what is fairest for households and we expect that is likely to be all fuel credit meter customers. There may be an argument for favouring the allowance on the gas price cap given that all environmental levies are already placed on electricity. However, we appreciate Ofgem may need to consider whether it has the vires to do this.