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“Changing standing charges for prepayment meters and debt-related costs across  
payment methods” – So Energy Response

Dear Sabreena and Dale,

So Energy is a leading energy supplier providing great value renewable electricity to homes across England, Wales and Scotland. We have consistently been recognised by our customers and the wider industry for our outstanding customer service since we were founded in 2015, including being a Which? Recommended Provider and have topped the Citizens Advice’s Supplier League Table. So Energy is one of the early adopters of the EUK Vulnerability Commitment launched in 2020, helping create a better customer experience for vulnerable customers year on year. In August 2021, So Energy merged with ESB Energy, and our combined business now supplies around 330,000 domestic customers. As one of the last challenger suppliers left in the market and one that is backed by ESB’s resources and expertise, So Energy is able to provide a unique view of the quality of service in today’s energy market.

We understand the context behind this work and the government’s request for Ofgem to consider options for ending the PPM standing charge premium. In our response to the call for evidence we set out in plain terms our deepest concerns regarding the impact levelisation could have on the fixed tariff market, unless steps were taken to provide a forecastable levelisation mechanism.

Having read the statutory consultation, we can only conclude that Ofgem failed to grasp our concerns and as a result has made significant factual errors in its analysis:

1. Ofgem failed to grasp that suppliers selling fixed tariffs would need to apply a significant risk premium to their tariffs in order to price in the variable, largely unforecastable and potentially volatile cost of levelisation over the duration of a contract.
2. Ofgem failed to grasp how this risk premium will cause significant damage to competition, consumer choice and supplier financeability in the retail energy market namely:
  - a. All other things being equal, the cost of providing a fixed DD tariff would rise when compared to price capped tariffs, as the amount to be levelised is derived from price cap allowances.
  - b. That fixed DD tariffs account for 92% of fixed tariffs sold.
  - c. That fixed DD tariffs have historically been the driving force behind competitive pressure in the retail energy market. That there is a strong correlation between the availability of fixed DD tariffs that are cheaper than price-capped tariffs and overall engagement in the market. Switching between suppliers collapsed during the energy crisis, when the price of fixed DD tariffs rose above price capped tariffs.
  - d. That the vast majority of new entrants into the energy market have historically depended on fixed DD tariffs to grow and sustain themselves. As energy supply is a scale business, an inability to grow has consequential impacts on supplier financeability (both in terms of obtaining funding to allow market entry and sustaining new entrants into the

market).

- e. That the energy market landscape in 2023/24 is very different to the pre-energy crisis status quo. Suppliers now struggle to offer fixed DD tariffs that offer even modest savings versus the price cap. In 2023, suppliers only managed to consistently price fixed DD tariffs below price capped tariffs in Q3, and the savings on offer were modest – typically around £25. In short, the market is already on a knife-edge and even a small movement in the cost of providing a fixed DD tariff, when compared to price capped tariffs, would have a substantial damaging impact on consumer choice, consumer engagement in the market and the ability of new entrants to grow and challenge incumbent suppliers.

As a consequence of these factual errors Ofgem has failed to give appropriate weight to promoting effective competition and supplier financeability as part of its decision making. Ofgem has drawn the conclusion that their policy will have no impact on competition but conclusion appears to be based on the following incorrect assumptions:

1. That their proposals will have no worse an impact on a fixed DD tariff than a price capped DD tariff. Ofgem has made no attempt to quantify the added cost of providing fixed DD tariffs when compared to price capped DD tariffs.
2. That the cost of levelisation as a proportion of a fixed DD tariff customer's overall energy bill is the relevant consideration, as evidenced in paragraph 3A.76, rather than the increase in the cost of pricing fixed DD tariffs relevant to price capped tariffs.

Ofgem has also failed to give appropriate weight to the impact on the financeability of new entrants and challenger suppliers, given they more often than not grow to scale through the sale of fixed DD contracts.

As a consequence of the above, Ofgem has failed to properly assess the impact of its proposals on current and future consumers, consumer choice, effective competition and supplier financeability. Ofgem's resulting policy design causes significant damage when assessed against all of these considerations. Ofgem has failed to realise that in attempting to perfectly levelise payment methods now, and for all time, has put the fixed tariff market at risk – if suppliers cannot price below the cap, there is no market. We have seen what such a market would look like during the energy crisis, with consumers lacking tariff options, lacking the opportunity to lock in their energy costs and budgets, with the market suffering from a lack of new entrants and innovation. It does not in any way resemble effective competition. It has also failed to realise that its proposals would have a significant adverse effect on new entrants ability to grow and innovate and, by extension, obtain finance in the first place.

Thankfully, this damage can be avoided with changes that would still achieve the overall policy aim DESNZ asked Ofgem to investigate in the first place. Ofgem should consider the following:

1. Fixing the overall level of money to be collected from DD customers 12 months in advance and using that money to levelise. In essence, Ofgem takes control of the forecasting element, allowing suppliers price certainty.
2. Fixing the amount of money to be collected from fixed DD customers at the point of sale for the duration of their contracts. The amount could change on a monthly basis with notice provided by Ofgem on the rates to be applied – this would allow for relatively stable and well-priced tariff offerings at any given time.
3. Removing fixed tariff customers from the levelisation process entirely.
4. Increasing the level of the price cap itself, such that suppliers can price in the risk premium to fixed DD tariffs and still offer worthwhile savings to price-capped consumers on a consistent basis.

## Fixed Price Forecasting Issues

In this response, we've elected to provide additional context and detail in order to ensure our concerns have been fully understood and that Ofgem is in a position to engage with us regarding our concerns.

In order to help illustrate the difficulty of forecasting the cap we set out below a high level summary of the elements that build a cost stack for a tariff<sup>1</sup>:

1. Wholesale costs, which are hedged to provide certainty. We note that due to a lack of liquidity in the mid-merit and peak electricity markets, the price cap does not adequately account for hedging costs.
2. Regulated pass-through costs, which are provided well in advance in order to provide certainty. These are made up of:
  - a. Network charges (comprising of Distribution, Transmission and Balancing Services costs)
    - i. Indicative Distribution and Transmission costs statements are provided well (up to 15 months) in advance and allow a level of certainty to network costs for a supplier.
    - ii. The Balancing Services costs which are influenced by and can fluctuate with changes in wholesale prices. Suppliers will build additional premium into their fixed offering to account for this volatility, the price cap (through the additional adjustment) along with monthly updates through National Grid offer adequate mitigation to cover within period changes to BSUoS costs.
  - b. Social and Environmental costs
    - i. Costs that fall under the social and environmental category have two further subset, those a supplier can accurately forecast and any additional risk premiums required are small and easily quantifiable - example Renewables Obligation, ECO, GBIS, WHD, Feed in Tariffs etc. Note the cost of providing ECO and GBIS is not adequately accounted for in the price cap as they are based on outdated impact assessments.
    - ii. The second subset are namely Contract for Difference and Capacity Market costs whereby small changes/variance to forecasts can present material risks. A supplier would use the LCCC – Low Carbon Contract Company forecasts which help to reduce some of the forecasting pressure and build in additional premium (for fixed contracts) to accommodate interim volatility which is not adequately accounted for in the price cap and makes it inherently harder to price a competitive fixed contract.
3. Commercial pass-through costs, which suppliers will negotiate with price certainty in mind. These are made up of:
  - a. Metering costs (MOP, DA, DC) which typically index with inflation and are therefore easily forecastable.
4. Operational costs, which are somewhat within a suppliers control and are therefore relatively straightforward to forecast. We note that the price cap operational cost allowance is currently under review and, in our view, does not reflect the true cost to serve.
5. A series of risk premiums to account for uncertainty. These are made up of:

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<sup>1</sup> We have also noted a series of allowances which fail to adequately account for the cost of providing a price-capped tariff and, as a consequence, depress the price cap when compared to fixed DD tariffs. This helps explain why it is so difficult to price a fixed DD tariff below the price cap in the current market environment and, why the additional risk premium associated with levelisation is so consequential.

- a. Unexpected SVT demand and the risk that a customer will exit their fix early during the contract - the price cap forward curve is used to help calculate this, but a significant premium must be added as movements in the cap more than two quarters out are highly uncertain. Note, movements in individual allowances within the cap is typically beyond a sensible level of granularity for the purposes of weighing up this risk as movements in the commodity cost will outweigh movement in the allowances. Exit fees help cover the cost of this risk premium and control for the risk itself.
- b. Early Contract Exit risk – Premium to cover the cost borne by suppliers for selling back volume into the market – covers the risk of within contract losses, exit fees help cover the cost of this risk premium and control for the risk itself.
- c. Commodity risk premiums – Cover the cost of shaping and balancing (e.g. need for suppliers to re-hedge the day ahead (buy more when it's cold, usually when prices are higher)). These premiums vary and can contribute anywhere from 1-5% per fuel on top of the direct commodity cost.
- d. Other premiums accounted for include Collateral costs.

Here is the crux of the problem:

For price-capped DD tariffs, the levy suppliers will pay in order to fund the cost of levelisation<sup>2</sup> will be a regulated pass through cost, like network charges. Because the payment method differential Ofgem is attempting to correct is set out in the cap itself, the size of the levy and the uplift in the DD cap Ofgem will apply in order to pay for the levy should reconcile out<sup>3</sup>.

For fixed DD tariffs, the price is set at the point of sale but the levy to be paid will vary throughout the life of the tariff. Therefore a risk premium must be applied on top of the levy to guard against increases in the levy throughout the life of the contract. The less that's known about potential changes in the magnitude of the levy, the greater the risk premium to be applied at the point of sale. Changes in the amount to levelise are driven by changes in the underlying allowances within the price cap. Based on what we currently know, and don't know, a very large risk premium will need to be applied:

- With regards to levelising the prepay standing charge, much is currently unknown:
  - Over 1/3 of the standing charge differential between DD and prepay, is driven by Additional Support Credit. It is fixed under the 'float' in the float and true up, until September 2024. However, no one knows how it will need to be adjusted after that date. As far as we know, the data that will underpin that analysis have not yet been issued, nevermind calculating what any true up may amount to.
  - It's reasonable to assume that the per-customer fixed costs of providing traditional prepay will rise as the number of customers using the underlying infrastructure will fall, but we don't know when this will happen, the pace at which it will happen, how this will be accounted for in the cap, the amount of notice Ofgem will provide with regards to changes in the cap, when the service will be discontinued and who will make the decision about the wind down and discontinuation of the service.
- On standard credit even less is known:
  - We do not know how levelisation of the unit rate will translate into a levy on fixed tariff customers. The details of the mechanism and how it will be possible to forecast the movement in the levy in the future are unknown. We do not know where to even start with this issue. We note that even though Ofgem has acknowledged that the design and

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<sup>2</sup> We refer to this as 'the levy' throughout our response.

<sup>3</sup> If Ofgem does not believe this to be the case then a risk premium must be added to the DD version of the price cap to account for this.

implementation date of unit rate reconciliation is not known at this time<sup>4</sup>, at the same time it expects suppliers to accurately forecast and price in the cost fixed tariffs from the point the decision has been made, without the addition of any risk premium (as evidenced by the impact assessment provided alongside this consultation).

- At this point in time, no one knows how the operating costs review, which has the debt allowances within its scope, will impact the underlying price cap and no one knows how that will subsequently impact tariff levelisation (except that it will). We do not know when any changes will be implemented – Ofgem cannot be any more specific on the implementation of the operating costs review than 'Winter 2024/25.
- We know that the additional allowance will add £16 to both the DD and SC bill. However, no one knows whether a true up will be applied, and how that true up may impact levelisation. Ofgem has explicitly kept their options open, which means uncertainty for suppliers.
- Once this precedent is set, we do not know how future adjustments to the price cap or new Ofgem policy initiatives that will affect the price cap will impact levelisation the value of the levy on DD fixed tariffs. Will a further float and true up debt allowance be needed in addition to whatever settlement comes out of the operating cost review? How would the removal of standing charges impact levelisation? Having read the statutory consultation, we've concluded that Ofgem did not grasp the point we were trying to make on the risk associated with fixed tariffs. However, if Ofgem were to press ahead following the more detailed response we have submitted here, then we must conclude that Ofgem has shown a casual disregard to the challenge of forecasting and pricing fixed tariffs in general, therefore, a further risk premium must be applied to account for this.

Ofgem may argue that, compared to the overall value of a fixed DD contract, that the value of a risk premium to account for the levy would be relatively small. However, fixed tariffs won't be sold in any volume if they don't provide a saving when compared to the price cap. In the current context, suppliers are already struggling to consistently sell fixed tariffs that are priced below the cap. **Policy changes are not made in a vacuum, it is essential that Ofgem properly assesses the impact of their proposals on the fixed tariff market.** These risk premiums are now very material – they could mean the difference between active growth and a moribund market in a given quarter for a challenger supplier. For a customer it may mean that the only way they can lock in their prices for budgeting purposes would be to pay more than the default tariff cap. This is not what effective competition looks like and the proposals as set put push us further and further away from effective competition.

### The way forward

We have serious reservations about tariff levelisation and reconciliation in general. It is not well targeted enough to address fuel poverty and we worry about the unintended consequences it may bring to what is already an incredibly over-complicated market. We are uncomfortable with the concept of the price cap shaping the market itself, rather than acting strictly as a backstop for consumers who have disengaged.

However, on the matter of resolving the issues we have identified with regards to fixed tariffs, we are keen to engage constructively and work with you on a way forward. We have set out some suggestions above on how this issue may be resolved. There may be others. We urge you to work with us to find the best way forward for current and future consumers.

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<sup>4</sup> See paragraph 1.14 of the statutory consultation.

Below you'll find our responses to each of your consultations. We have also provided commentary on elements the impact assessment published alongside the consultation, and excerpts from Ofgem consultations concerning the uncertainty of price cap allowances.

### Consultation Questions

#### **Q1. Do you have any comments or views on our updated case for the introduction of levelisation of payment methods?**

Consumers as a whole should be charged in the lowest cost and most cost reflective manner possible. Then, issues of fairness and ability to pay should be addressed through a social tariff. This is the proper way to address the issue of fuel poverty.

Ofgem is pursuing tariff levelisation and has launched a call for evidence on the removal of standing charges because it doesn't have the legal powers to create a properly targeted social tariff. Tariff levelisation is a poor and deeply problematic alternative a social tariff because, relies weak proxies for fuel poverty and will result in many wealthy consumers paying less while fuel poor consumers pay more. Payment levelisation uses Direct Debit as a proxy for wealth but Ofgem's own analysis shows that 41% of households on direct debit have an income of less than £30,000.

Our worry is that, should these proposals be enacted, policy makers will consider fuel poverty to have been 'addressed' while millions of the fuel poor will actually end up paying more.

In addition, tariff levelisation introduces another layer of complexity into an already overly complicated market in the form of the reconciliation mechanism. While not the focus of our response, we are worried about the unintended consequences that could arise as a result of the introduction of reconciliation. A social tariff can be easily designed without the need for any reconciliation mechanism.

#### **Q2.Do you agree with our levelisation policy aims?**

*Customers that pay by PPM should not pay a premium & All customers that have the ability to build debt should contribute equally to debt-related costs.*

Ofgem's aim of perfectly levelising the standing charge between prepay and DD and perfectly equalising the contribution to debt costs between SC and necessitates a variable quarterly levy on DD customers. As we have set out above, this limits Ofgem's ability to deliver the overall objective of levelisation while maintaining a functioning fixed tariff market and, consequently, promoting effective competition. We note that the EPG does not perfectly levelise payment methods but instead partially levelises. We urge Ofgem to adjust their aims to align with DESNZ's approach under the EPG as this will open up the opportunity to fix the levy on fixed DD customers for 12 months and resolve the serious issue we have identified with the current approach.

*There should be limited or no gap in support for PPM customers following EPG removal.*

We note that flawed policy design attracts an increased risk of challenge and a suspension of all or part of any decision. We have identified workable solutions to the issues we have raised

as part of this response that still meet the overarching objectives of levelisation. We urge Ofgem to consider these alternative approaches to levelisation.

*Levelisation should be enduring and responsive to policy changes.*

Ofgem state “It should also be able to adapt to any cap changes as a result of interlinked workstreams.” From the point of view of pricing a fixed tariff, this desire for adaptability to price cap changes manifests as uncertainty and will attract a risk premium. We are concerned that, overall, Ofgem is not cognizant of the impacts levelisation will have on the fixed tariff market in the short, medium and long term. The desire for adaptability increases the overall risk of the fixed DD tariff market collapsing semi-regularly or permanently.

We have identified alternative solutions that address our concerns around fixed tariffs but still maintain a level of adaptability.

*The solution should be proportionate*

We strongly agree with the aim that the intervention should be proportionate but the intervention as designed is seriously flawed and will have an unnecessary and disproportionate impact on effective competition.

### **Q3. Do you agree with our proposed approach to levelisation?**

No, we do not agree.

We believe that Ofgem has made a number of fundamental errors in developing its approach and the consequence of these errors will be lasting damage to effective competition, consumer choice and interests of current and future consumers. Our concerns relate to the sustainability of the fixed DD tariff market, were the proposed approach pursued. We have set out our objections and options for Ofgem to address our objections in detail in this response.

Question 3 relates to chapter 3 ‘Levelisation options and proposal’. Below, we highlight what we believe are fundamental errors and issues within the chapter:

*3.13 The other supplier thought that UNC Modification 840 has reduced the PPM premium sufficiently and that we should re-engage with government to understand their appetite for levelisation following this change. Further, they thought that levelisation risks the feasibility of the fixed term contract market by introducing a potentially volatile and unpredictable cost. They proposed that we instead introduce a fixed levelisation value, with 12 months’ notice of any changes to the value, which would reduce the payment method differential.*

*3.14 While we recognise these concerns, multiple other suppliers actively stated that they were not concerned about forecasting levelisation costs. Suppliers face a multitude of variables in their tariff pricing, and we consider that they should be able to forecast levelisation with sufficient accuracy such that the risk to suppliers, and the fixed term contract market, is not prohibitive. The number of customers on each payment method is relatively static over time (especially short periods of time). The expected amount to levelise per customer depends on cap levels, which we expect most suppliers forecast anyway.*

1. The 'variables' in pricing a fixed tariffs attract risk premiums. This does not appear to have been accounted for in any of Ofgem's analysis.
2. The 'variables' with regards to levelisation are particularly difficult to forecast as much of it is driven by Ofgem policy and data from RFIs that have not been issued yet. They will attract particularly large risk premiums to account for this.
3. Ofgem states that in the context of setting the price of a fixed term tariff *'The expected amount to levelise per customer depends on cap levels, which we expect most suppliers forecast anyway.'* There are multiple issues with this statement:
  - a. Movements in the price cap do not directly impact the costs of providing a fixed tariff. To the extent that future movements are relevant, this is only with regards to factoring in the risk of unexpected SVT demand Unexpected SVT demand and the risk that a customer will exit their fix early during the contract - the price cap forward curve is used to help calculate this, but a significant premium must be added as movements in the cap more than two quarters out are highly uncertain. Note, movements in individual allowances within the cap is typically beyond a sensible level of granularity for the purposes of weighing up this risk as movements in the commodity cost will outweigh movement in the allowances. Exit fees help cover the cost of this risk premium and control for the risk itself.
  - b. The amount to levelise depends on the movement of specific allowances within the cap, specifically allowances that drive a higher standing charge for prepay and the debt allowance. This is at a completely different level of granularity compared to forecasting future movements in overall levels of the cap. Furthermore, there's enormous uncertainty underpinning these allowances in the short, medium and long term, rendering them effectively unforecastable in any meaningful sense:
    - i. With regards to prepay, much is currently unknown:
      1. Over 1/3 of the standing charge differential between DD and prepay, is driven by Additional Support Credit. It is fixed under the 'float' in the float and true up, until September 2024. However, no one knows how it will need to be adjusted after that date.
      2. It's reasonable to assume that the per-customer fixed costs of providing traditional prepay will rise as the number of customers using the underlying infrastructure will fall, but we don't know when this will happen, the pace at which it will happen, how this will be accounted for in the cap, the amount of notice Ofgem will provide with regards to changes in the cap, when the service will be discontinued and who will make the decision about the wind down and discontinuation of the service.
    - ii. On standard credit much is currently unknown:
      1. We do not know how levelisation of the unit rate will translate into a levy on fixed tariff customers. The details of the mechanism and how it will be possible to forecast the movement in the levy in the future are unknown. We do not know where to even start with this issue. We note that even though Ofgem has acknowledged that the design (para 1.14) and implementation date of unit rate reconciliation is not known at this time, at the same time it expects suppliers to accurately forecast and price in the cost fixed tariffs from the point the decision has been made, without the addition of any risk premium (as evidenced by the impact assessment provided alongside this consultation).
      2. At this point in time, no one knows how the operating costs review, which has the debt allowances within its scope, will impact the underlying price cap and no one knows how that will subsequently impact tariff levelisation (except that it will). We do not know when any changes will be implemented – Ofgem cannot



be anymore specific on the implementation of the operating costs review than 'Winter 2024/25.

3. We know that the additional allowance will add £16 to both the DD and SC bill. However, no one knows whether a true up will be applied, and how that true up may impact levelisation. Ofgem has explicitly kept their options open, which means uncertainty for suppliers.
- iii. Once this precedent is set, we do not know how future adjustments to the price cap or new Ofgem policy initiatives that will affect the price cap will impact levelisation the value of the levy on DD fixed tariffs. Will a further float and true up debt allowance be needed in addition to whatever settlement comes out of the operating cost review? How would the removal of standing charges impact levelisation? Having read the statutory consultation, we've concluded that Ofgem did not grasp the point we were trying to make on the risk associated with fixed tariffs. However, if Ofgem were to press ahead following the more detailed response we have submitted here, then we must conclude that Ofgem has shown a casual disregard to the challenge of forecasting and pricing fixed tariffs in general, therefore, a further risk premium must be applied to account for this.

**Q4. Do you have any views on the proposed amendments to SLC 28AD and model changes under Annex 9?**

There appears to be enough flexibility within the proposed amendments to address the issues with fixed tariffs we have raised in this response without needing to re-consult. As far as we can tell, there is nothing in the drafting that prevents Ofgem from:

1. Excluding fixed DD tariffs from the levelisation levy.
2. Fixing the levelisation levy for fixed DD tariffs for 12 months.
3. Fixing the levelisation levy for fixed DD tariffs to whatever the levy was calculated as at the point of sale.

**Q5. Do you agree with our proposal to include uncapped contract numbers in the levelisation reconciliation?**

No, we do not agree.

We believe that Ofgem has made a number of fundamental errors in developing it's approach and the consequence of these errors will be lasting damage to effective competition, consumer choice and interests of current and future consumers. Our concerns relate to the sustainability of the fixed DD tariff market, were the proposed approach pursued. We have set out our objections and options for Ofgem to address our objections in detail in this response.

Question 5 relates to chapter 4 'Uncapped tariffs'. Below, we highlight what we believe are fundamental errors and issues within the chapter:

*4.2 In our policy consultation, we stated that our preference is to levelise both capped and uncapped contracts. Uncapped contracts are all domestic contracts not covered by the cap, including fixed term contracts and derogated variable tariffs. This was our preference as it mitigates the risk that capped PPM and SC tariffs become materially cheaper than what suppliers can offer on uncapped contracts (as capped tariffs would be subsidised by DD and uncapped contracts would not).*

Including uncapped contracts, places a levy on fixed DD contracts which accounts for 92% of all fixed contracts. On top of that, because the levy is to vary and is effectively unforecastable, a further large risk premium must be applied to fixed contracts. Therefore, by including uncapped contracts, Ofgem is increasing the risk that capped PPM and SC tariffs, as well as capped DD tariffs, become materially and consistently cheaper than what suppliers can offer on uncapped contracts. This has material impacts on the viability of the fixed DD tariff market and effective competition in energy retail in general.

*4.8 One disagreed, expressing serious concern regarding their ability to forecast levelisation costs and warned that their inclusion would risk the feasibility of the fixed term contract market. They requested that Ofgem introduce a long-term levelisation cost forecasting mechanism, and commit to not changing levelisation charges without long notice periods, without which suppliers would have to remove some offerings and build a levelisation risk premium into others, reducing tariff choice and driving up cost to consumers.*

*4.9 Multiple suppliers commented to the contrary, actively expressing no concern regarding their ability to forecast levelisation costs*

We would note the following:

1. Challenger suppliers sell fixed DD tariffs to grow and disrupt the market. Incumbents to sell fixed DD tariffs to defend their existing market position. If no fixed tariffs are sold, this situation tends to suit incumbents more than challenger suppliers.
2. Anything can be forecasted if a large enough margin of error and, consequently, risk premium is applied. A lack of concern does not necessarily imply that there isn't an issue at play.
3. We would expect Ofgem to engage with regards to the merits of the issues that are raised, rather than relying on the weight of opinion.

**Q6. Do you agree with our proposal not to introduce an SLC requiring suppliers to offer the same standing charge on equivalent DD and PPM tariffs?**

Yes, the rationale Ofgem sets out in paragraph 4.19 of the consultation is sound.

**Q7. Do you have any views on our other considerations related to levelisation, regional levelisation and treatment of smart PPM?**

Consumers as a whole should be charged in the lowest cost and most cost reflective manner possible. Then, issues of fairness and ability to pay should be addressed through a social tariff. This is the proper way to address the issue of fuel poverty.

With regards to smart PPM, we believe that Ofgem has missed an opportunity. A prepay levelisation allowance that diminishes over time would incentivise suppliers to prioritise the replacement of traditional prepay meters with smart prepay. This would gradually reduce the underlying cost to serve and could form part of a wider plan to wind down traditional prepay.

**Q8. What are your views on our updated options including the need for a reconciliation mechanism and phasing of implementation?**

We are, frankly, less close to the reconciliation mechanism as the issue of combining the inclusion of a variable levelisation mechanism with fixed tariffs. However, from what we do understand of it, it generates still further uncertainty and will attract further risk premiums.

With regards to the levelisation of standing charges, our understanding is, that while the amount to be provided through the levelisation allowance will be fixed on a per customer basis each quarter, the amount to be collected on a per DD customer basis through the levy will need to vary each day in order to aid reconciliation. This provides further uncertainty and will attract further risk premiums. We do not know the impact tariff levelisation will have on the balance of customers on various payment methods. For example, no analysis has been carried out by Ofgem on the impact of customers on price-capped SC contracts moving to fixed DD contracts or how the loss of a viable fixed DD contract market may gradually squeeze the pool of DD customers from which the levy is drawn. For a supplier attempting to forecast 12 months ahead for the purposes of pricing a fixed contract, this is especially difficult and relevant. Suppliers will know the general trends of how the payment method mix is changing within its own portfolio but any market-wide view will inevitably lag behind and both views are retrospective, rather than prospective.

With regards to the levelisation of unit rates, the details of the mechanism and how it will be possible to forecast the movement in the levy in the future are unknown. We do not know where to even start with this issue. We note that even though Ofgem has acknowledged that the design and implementation date of unit rate reconciliation is not known at this time<sup>5</sup>, at the same time it expects suppliers to accurately forecast and price in the cost fixed tariffs from the point the decision has been made, without the addition of any risk premium (as evidenced by the impact assessment provided alongside this consultation).

These are fundamental problems and need to be resolved. We advise, that with regards to fixed DD tariff customers, the amount that suppliers need to collect through the levy be fixed so that it may be possible to accurately forecast the cost. Then other elements could be varied, either the amount of discount provided through levelisation or the amount of contribution from price-capped DD customers or both. Alternative routes exist to achieving the high level goal DESNZ asked Ofgem to investigate in the first place.

Finally, we are concerned about the unintended consequences that may derive from this process. For example, at a certain point, it is more cost effective for a supplier to cancel a customer's DD and place them on the SC version of a price-capped tariff as they may derive more revenue through reconciliation than directly from the customer. Given the level of complication, we're reasonably certain that several 'unknown unknowns' will impact the market in ways no one can currently anticipate.

Question 8 relates to chapter 6 'Payment reconciliation mechanism'. Below, we highlight what we believe are fundamental errors and issues within the chapter:

*6.19 The levelised cap and levelisation allowances should be calculated by Ofgem for each fuel, region and payment method and provided to the reconciliation operator and industry on a quarterly basis. We do not think that levelisation allowances can or should be set for a longer period as suppliers should be reasonably able to forecast them and we do not consider that it will have a significant impact on the risk associated with fixed term contracts*

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<sup>5</sup> See paragraph 1.14 of Ofgem's consultation.

Ofgem states that in the context of setting the price of a fixed term tariff '*We do not think that levelisation allowances can or should be set for a longer period as suppliers should be reasonably able to forecast them and we do not consider that it will have a significant impact on the risk associated with fixed term contracts*' There are multiple issues with this statement:

1. Movements in the price cap do not directly impact the costs of providing a fixed tariff. To the extent that future movements are relevant, this is only with regards to factoring in the risk of unexpected SVT demand Unexpected SVT demand and the risk that a customer will exit their fix early during the contract - the price cap forward curve is used to help calculate this, but a significant premium must be added as movements in the cap more than two quarters out are highly uncertain. Note, movements in individual allowances within the cap is typically beyond a sensible level of granularity for the purposes of weighing up this risk as movements in the commodity cost will outweigh movement in the allowances. Exit fees help cover the cost of this risk premium and control for the risk itself.
2. The amount to levelise depends on the movement of specific allowances within the cap, specifically allowances that drive a higher standing charge for prepay and the debt allowance. This is at a completely different level of granularity compared to forecasting future movements in overall levels of the cap. Furthermore, there's enormous uncertainty underpinning these allowances in the short, medium and long term, rendering them effectively unforecastable in any meaningful sense:
  - a. With regards to prepay, much is currently unknown:
    - i. Over 1/3 of the standing charge differential between DD and prepay, is driven by Additional Support Credit. It is fixed under the 'float' in the float and true up, until September 2024. However, no one knows how it will need to be adjusted after that date.
    - ii. It's reasonable to assume that the per-customer fixed costs of providing traditional prepay will rise as the number of customers using the underlying infrastructure will fall, but we don't know when this will happen, the pace at which it will happen, how this will be accounted for in the cap, the amount of notice Ofgem will provide with regards to changes in the cap, when the service will be discontinued and who will make the decision about the wind down and discontinuation of the service.
  - b. On standard credit much is currently unknown:
    - i. We do not know how levelisation of the unit rate will translate into a levy on fixed tariff customers. The details of the mechanism and how it will be possible to forecast the movement in the levy in the future are unknown. We do not know where to even start with this issue. We note that even though Ofgem has acknowledged that the design (para 1.14) and implementation date of unit rate reconciliation is not known at this time, at the same time it expects suppliers to accurately forecast and price in the cost fixed tariffs from the point the decision has been made, without the addition of any risk premium (as evidenced by the impact assessment provided alongside this consultation).
    - ii. At this point in time, no one knows how the operating costs review, which has the debt allowances within its scope, will impact the underlying price cap and no one knows how that will subsequently impact tariff levelisation (except that it will). We do not know when any changes will be implemented – Ofgem cannot be anymore specific on the implementation of the operating costs review than 'Winter 2024/25'.

- iii. We know that the additional allowance will add £16 to both the DD and SC bill. However, no one knows whether a true up will be applied, and how that true up may impact levelisation. Ofgem has explicitly kept their options open, which means uncertainty for suppliers.
  - c. Once this precedent is set, we do not know how future adjustments to the price cap or new Ofgem policy initiatives that will affect the price cap will impact levelisation the value of the levy on DD fixed tariffs. For example, will a further float and true up debt allowance be needed in addition to whatever settlement comes out of the operating cost review? Ofgem have shown a casual disregard to the challenge of forecasting and pricing fixed tariffs in general, this a further risk premium must be applied
- 3. As set out earlier in our answer to this question, the reconciliation mechanism adds further uncertainty and risk premium. Suppliers face a issues forecasting both the allowances and price differentials which and the changes in payment methods, all of which combines to be an extremely challenging situation.

**Q9. Do you agree with our proposal to exclude fixed term contracts agreed prior to our decision date from our levelisation proposal?**

Yes, on the basis that it is better than not excluding these tariffs. However the substantive issue remains with regards to the inclusion of fixed contracts agreed after the decision date within a variable levelisation and reconciliation mechanism. We discuss this these issues at length elsewhere in our response.

**Q10. Do you agree with our proposal for suppliers not to carry out, at their expense, an audit of their systems, processes and data to be used in reconciliation?**

At this point in time we do not think an audit is necessary as it sounds substantially similar to the recent EPG audit.

Feedback on Impact Assessment

Below we set out excerpts from Ofgem's impact assessment along with commentary. The excerpts are in italics. Note, this is not exhaustive feedback as we were constrained by the challenging timeframe for responding to this consultation.

*3A.4 The results of our updated analysis are summarised below:*

*i. Income Weighted Analysis – Using income to assess the effective impact on cost savings/benefits of our policies on consumer finances, specifically those on low income (vulnerability characteristic), relative to disposable income. Both Option 2 & 3 result in a net saving of £103m and £201m respectively.*

We note that throughout the impact assessment no attempt has been made to quantify the impact on the pricing of fixed tariffs, the impact on consumer choice or the impact a lack of fixed tariff has on consumers exposure to volatile wholesale markets.

*ii. Total Debt – We assess that levels of total debt will decrease as a result of both Option 2 and 3 by £12.2m and £33.5m respectively.*

There's no analysis on the impact on fixed customers falling into debt as a result of paying higher energy bills.

There's no analysis on the impact of more customers falling into debt because fewer fixed tariffs are available and they are exposed to the volatile quarterly price cap.

*iii. Bad Debt and Working Capital – We assess that levels of bad debt will decrease as a result of both Option 2 and 3 by £0.3m and £0.7m. We also assess that levels of working capital will decrease as a result of Option 2 and 3 by £1.5m and £4.1m respectively, resulting in lower costs to consumers and improved supplier resiliency and stability which should benefit the market as a whole.*

*iv. Administration Costs – We assess that the costs associated with implementation will be c.£1.5m for Option 2 and c.£4.4m for Option 3.*

To the extent that customers can obtain a fixed contract DD contract, no analysis has been carried out on the impact of the increased cost to serve these customers if they are forced to choose a price capped tariff with quarterly changes instead. It has not factored into Ofgem's analysis or estimate of the costs.

*v. Competition Assessment – As identified in the policy consultation, our analysis continues to indicate that there will be no material impact on competition (positive or negative).*

No assessment has been made of the impact of reduced tariff choice on the market as a result of the increase in the cost of providing fixed DD tariffs, relative to their price capped equivalents. No assessment has been made of the impact on the ability of suppliers to enter, expand and challenge incumbents in the absence of a fixed DD tariff market, nor the impact on the financeability of such suppliers.

*vi. Self-Disconnections – Due to the relatively small savings for PPM consumers and therefore small associated increase in consumption, the reduction in PPM self-disconnections has been determined to be positive but negligible.*

*vii. Health and Wellbeing – The negligible reduction in self-disconnections means improvements to health and wellbeing, as a result of the reduction in self-disconnections, are also positive but negligible.*

No assessment has been made of the mental health and wellbeing of consumers that are exposed to a volatile quarterly cap as a result of the reduction in the availability of fixed tariff options.

To the extent that customers can obtain a fixed contract DD contract, no analysis has been carried out on the impact increased prices will have on these customers health and wellbeing.

#### *Impact on price competition*

*3A.70 It is possible under either Option 2 or 3 that levelisation could have a positive impact on competition insofar as it widens the pool of potential tariff types that a consumer may consider affordable. In particular, a consumer may consider SC (under Option 3) and PPM tariffs (under Options 2 & 3) that they would not otherwise be willing or able to pay for. However, we do not expect this effect to be large. This is because the impact of levelisation on bills is small as a proportion of the total bill paid. For example, the impact for a TDCV PPM consumer is 3% of their annual bill under Options 2 and 3. Given the latest evidence on switching elasticities in*

*the energy sector (which show that switching is relatively inelastic), we consider the bill impact of levelisation is unlikely to drive material volumes of switching between different tariff types.*

It's deeply confusing that Ofgem has cited a pre-energy crisis academic paper and stated that switching is relatively inelastic, when it has direct access to real world data that shows the opposite. The real world data shows a very simple correlation – when the price of fixed DD tariffs is higher than the price cap, switching *collapses*.

The increase in the cost to service fixed tariff DD customers will decrease the availability of acquisition tariffs in the market. As Ofgem points out in para 3A.75 of the statutory consultation, 92% of fixed tariffs use the DD payment method.

Observation of the recent market makes clear – when fixed DD tariffs are priced below the cap, market engagement, switching and competitive pressure improves:

- Switching fell from a high of 369k in March '21 to 39k in November '21 as fixed DD tariffs priced below the cap were withdrawn from the market.
- Switching recovered from 74k in May '23 to 127k in September '23 as fixed DD tariffs offering modest savings (typically £25 off a £2,074 cap) returned to the market.

Number of monthly electricity switches between suppliers March '21 to October '23



Source: Ofgem data portal

The correlation is clear and the underlying rationale is entirely rational and predictable. Market engagement relies on a viable fixed DD tariff market and that market is in jeopardy. Ofgem does not appear to have realised the damage their proposals will do to the fixed tariff markets. It has considered the increased cost of levelisation in terms of the total value of a fixed tariff and has judged the impact to be low. It has failed to identify the additional risk premium that must be placed on fixed tariffs and understand that, in the current context, even small increases in the price of fixed tariffs relative to the cap can have dramatic impacts on tariff availability, competition and consumer choice.

*3A.71 Under Option 2 and 3, levelisation of prices across SC and DD tariffs may lead to a reduction in price-related competition across different payment methods, as tariff differentials are minimised, prices converge and price competition itself is lessened. However, the extent to which levelisation could have a negative impact on price competition, in practice, depends on the extent to which the different payment methods acted to constrain each other in the first place. This, in turn, depends in part on the extent to which consumers view different payment methods as close substitutes.*

All of Ofgem's analysis has been based on the movement in the cost of payment methods across tariffs that are subject to the price cap. No additional price premium to account for uncertainty in pricing fixed DD tariffs has been applied in the analysis. Ofgem omitted the fixed

tariff market, which exists outside the price cap and the role that fixed tariffs play in providing competitive pressure. There is no analysis on the impact of customers switching from a price capped DD tariff to a fixed DD tariff or any price-capped tariff to a fixed DD tariff, which, as Ofgem has identified, makes up 92% of all fixed tariffs sold.

*3A.72 Qualitatively, the different payment methods have different product characteristics with DD being likely viewed as the most convenient payment method. In contrast, PPM and SC methods may provide an easier way for consumers to budget and manage their expenditure. The fact that a price differential of 7% exists and has been maintained between payment methods, may be an indicator of a lack of substitutability between payment methods and suggest consumers do not view the products as close substitutes.*

Again, all of this analysis appears to be predicated around all consumers being subject to the price cap. No consideration has been given to the role of fixed DD tariffs in the market. No consideration has been given to customers switching from a price-capped SC tariff to a DD fixed tariff, the impact this has on the overall mix of payment types in the market and the impact that has on the overall level of debt in the market. In our experience, Direct Debit is far more effective at allowing households to effectively budget, as is evidenced by the bad debt provisioning applied by suppliers to customers on SC when compared to DD under general accounting practise<sup>6</sup>. Customers on SC are clearly at a much greater risk of failing to budget, manage their expenditure and fall into debt. Finally, no consideration has been given to the value of fixed tariffs in enabling customers to budget and manage their expenditure.

#### *Impact on non-price competition*

*3A.73 We do not expect there to be significant impacts on non-price competition under Option 2. To the extent that levelisation does result in a reduction in price-related competition across different payment methods under Option 3, this may lead to an enhanced emphasis on non-price related parameters of competition such as consumer service parameters (eg ease of contact, ease of managing bills and ease of making payments). Suppliers may develop their consumer service offerings in response to try to compete for consumers who prefer a particular payment mechanism and may seek to differentiate their product offering in this way.*

This is entirely speculative. Based on the information we have available on what has driven competitive pressure in the market to date, DD fixed tariffs have been the driving force. When DD fixed tariffs aren't viable, switching collapses customers end up disengaged and on the price cap.

#### *Impact on market entry and exit*

*3A.74 We do not expect there to be significant impacts on market entry and exit under Option 2. Insofar as levelisation under Option 3 makes SC tariffs a more viable option for consumers who would otherwise use DD tariffs, and results in material volumes of switching from DD to SC, it may increase the size of debt-related costs for suppliers with respect to their SC products. To the extent that this ultimately represents an increased costs for suppliers, it could deter entry to (or investment in) the market or precipitate exit from the market for marginal participants.*

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<sup>6</sup> Ofgem will have a market-wide view of how suppliers provision for bad debt across different payment methods through the series of RFIs they have issued to suppliers as part of their bad debt workstream.



Historically, new entrants have relied on fixed DD contracts to enter and grow in the market. In the absence of a viable fixed DD market, it is unclear how any new entrant can grow. If there are limited growth prospects, it is difficult to see how new entrants can attract financing. This does not appear to have been taken into consideration in Ofgem's analysis. We note that the volume of new entrants to the market post-crisis is far lower than the comparable situation pre-crisis. While not the only factor, it is reasonable to conclude that the lack of a consistently viable fixed DD tariff market in 2023 has played a significant role in this.

*3A.75 It is not possible to quantify, ex-ante, the materiality of this possible increase in debt-related costs. However, firstly we note that it would require material volumes of switching, which as explained above, is unlikely to occur as a response to the decrease in price differentials between DD and SC. A further potential impact on market entry and exit under both Options 2 and 3 derives from the fact that the majority of fixed term tariffs are DD tariffs; as of October 2023, 92% of fixed term tariffs were DD compared to 8% SC and 0% PPM.*

*Levelisation therefore closely represents a reduction in SVT prices at the expense of an increase in fixed term tariff prices.*

It appears that Ofgem almost grasped the impact of their proposals on fixed DD tariffs here but, judging by the absence of any other analysis on the impact on the fixed tariff market, or the absence of any impact risks premiums will place on the overall cost of delivering the policy, we can only conclude that Ofgem did not properly understand the impact of their proposals on the fixed tariff market.

*3A.76 This relative price effect could give rise to potential competition effects in the case of new entrants and/or challenger brands that have a larger proportion of fixed term tariff (and therefore DD tariff) consumers and a relatively limited back book of SVT consumers, compared to the more established and incumbent suppliers. As noted in the paragraphs above, however, the asymmetric impact on tariffs for challenger suppliers is not expected to be large due to the relatively small impact of levelisation as a proportion of consumers' annual energy bills as well as the reconciliation mechanism. Ofgem has a duty to facilitate access to the network for new generation capacity, in particular removing barriers that could prevent access for new market entrants and of electricity from renewable energy sources. Our assessment of levelisation on market entry has identified the impact of levelisation on market entry to be immaterial.*

This analysis demonstrates Ofgem's failure to understand the impact of their proposals on the fixed tariff market and new entrants. Instead of focussing on the impact on the differential between fixed DD tariffs and price-capped tariffs, Ofgem has focussed on the cost of the policy as a proportion of the overall energy bill - if suppliers aren't selling any fixed tariffs, the cost as a proportion of a fixed tariff doesn't matter. We expect this is because Ofgem failed to grasp the issue of a risk premium needing to be added to fixed DD tariffs, which, in effect, makes them more expensive when compared to price-capped tariffs, and has therefore used price-capped DD tariffs interchangeably with fixed DD tariffs for the purpose of its analysis of the impacts.

#### *Impact of fixed tariffs*

*3A.77 In October 2023, approximately 10% of total customer tariffs were fixed but we expect this to change as the market stabilises. As competition will likely increase through efforts to capture new customers, our proposal includes a reconciliation mechanism accounting for both*

*fixed and SVT tariffs, which is crucial for levelisation to work. It avoids any perverse incentives for suppliers to offer non-competitive tariffs against suppliers with a large SVT base.*

Ironically, risks associated with an increase in competition are much lower if Ofgem proceeds as planned and creates permanent lasting damage to the fixed DD tariff market.

*3A.78 As the policy supports SC and PPM tariffs, it may indirectly impact competition by increasing supplier debt resilience, especially for those with a significant number of SC and PPM customers (accounting for 75% of debt (£m) in February 2023). Because tariffs have been designed to have a net zero impact and reconciliation would prevent distortions, the competition impact on fixed tariffs should be negligible.*

No consideration has been given to customers switching from a price-capped SC tariff to a DD fixed tariff, the impact this has on the overall mix of payment types in the market and the impact that has on the overall level of debt in the market. In our experience, Direct Debit is far more effective at allowing households to effectively budget, as is evidenced by the bad debt provisioning applied by suppliers to customers on SC when compared to DD under general accounting practise<sup>7</sup>. Customers on SC are clearly at a much greater risk of failing to budget, manager their expenditure and fall into debt.

#### *Impact on innovation*

*3A.79 As described with non-price parameters of competition, to the extent that levelisation does result in a reduction in price-related competition across different payment methods under Option 3, this may lead to an enhanced emphasis on other parameters of competition. This may include innovation in how products are provided, for example with respect to consumer service platforms and consumer contact channels.*

Historically, new entrants have been a key driver of innovation and the market and they have relied on fixed DD contracts to enter and grow in the market. In the absence of a viable fixed DD market, it is unclear how any new entrant can grow, innovate and drive changes to the status quo. This does not appear to have been taken into consideration in Ofgem's analysis.

*3A.80 One supplier was concerned that levelisation could dis-incentivise suppliers from installing smart PPMs by enabling cost recovery of traditional PPMs infrastructure. Following levelisation, suppliers would be no more able to recover these costs, so we do not agree that levelisation results in a perverse incentive away from smart PPMs.*

*3A.81 In fact, levelisation may support innovation through promoting the uptake of smart meters. Although we do not expect these options to drive material volumes of switching between different tariff types, switching to PPM would be the most likely since PPM would be consistently the cheapest payment method available. As well as the capital requirement advantages already discussed, this could support the uptake of smart meters as the majority of new PPM installations are smart.*

Reducing the cost of prepay as the cheapest payment method available through a cross-subsidy is not going to incentivise customers on traditional PPMs to take up a smart meter. It

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<sup>7</sup> Ofgem will have a market-wide view of how suppliers provision for bad debt across different payment methods through the series of RFIs they have issued to suppliers as part of their bad debt workstream.

is removing an existing incentive to choose a smart meter, which can switch between credit and prepay moves.

### Ofgem statements on the uncertainty of price cap allowances

Below we set out in italics text from Ofgem consultations which set out the uncertainty facing the regulator when setting these allowances and how they may change in the future. All this uncertainty will translate into a risk premium on fixed DD tariffs, unless Ofgem makes adjustments to address the issues we have raised.

Temporary Debt Allowance Consultation<sup>8</sup>:

*5.6 If we introduce a temporary allowance, there is still uncertainty around how actual debt-related costs will evolve this winter. One option for addressing this uncertainty could be through a 'float and true-up' approach.*

*5.12 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 (eg 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.*

*5.13 Differences in customer demographics and historic performance may mean it is appropriate for different suppliers to have distinct bad debt provisions. However, these differences can also be due to suppliers' diverse assessments of how economic factors (such as cost of living pressures) will affect ongoing debt collection and write offs.*

*5.14 Given the variability and forward-looking nature of these bad debt provisions, the correct level for any debt-related costs allowance is subject to significant uncertainty, particularly as the underlying cost data (bad debt charges) is open to revision when updated data is available.*

*5.15 This uncertainty about future debt and bad debt levels mean it is difficult to forecast costs, and any attempt would add substantial complexity to our calculation. From our monitoring of the market, we also do not consider that including forecasted future debt-related costs in any April 2024 float is necessary to have regard to supplier financeability*

Additional Support Credit Consultation<sup>9</sup>:

*3.17 We consider providing an initial ex-ante 'float' allowance to be appropriate for several reasons. Primarily, we anticipate an increase in costs of ASC bad debt in 23/24 relative to 22/23, primarily as a result of requirements set out in the Code and associated statutory consultation on Involuntary PPM, and sustained high energy bills. Additionally, this approach enables us to more closely align the cap level in a specific time period to the costs incurred in that period (if a reasonable approximation can be made). We consider this means the*

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<sup>8</sup> <https://www.ofgem.gov.uk/sites/default/files/2023-10/Additional%20debt-related%20costs%20allowance%20policy%20consultation.pdf>

<sup>9</sup> <https://www.ofgem.gov.uk/sites/default/files/2023-06/Price%20cap%20%E2%80%93%20Statutory%20consultation%20on%20introducing%20an%20allowance%20for%20bad%20debt%20associated%20with%20Additional%20Support%20Credit.pdf>

*allowance can support timely issuance of ASC during the forthcoming 23/24 winter period, which we consider to be in consumers' interests given the benefits of ASC.*

*3.18 The provision to adjust at a later stage mitigates the risks associated with an under or over allowance being provided initially. It is likely that any true-up would not commence before spring 2024, and this will be subject to internal workstream prioritisation decisions at the time.*

*4.9 If ASC levels rise due to increased demand from customers, increased issuance from suppliers in line with the action we are taking on Involuntary PPMs and/or suppliers begin to issue a higher ASC payment per application, it is reasonable to also expect the level of ASC bad debt to rise as well.*

*4.10 Based on past survey data (which should not be construed as a prediction of this coming winter), the percentage of people facing financial difficulty, has been increasing. Other factors will affect the level of demand for ASC, for example weather variations, and the level of non-repayable support provided by suppliers and charities.*

*4.11 Furthermore, even if effective bills are at the same or similar levels this coming winter, we expect the continued affordability pressures associated with energy and the wider cost of living, may also increase demand for ASC. We therefore anticipate that the level of ASC will increase this winter relative to winter 2022/23, due to the combination of these factors.*

*4.12 We do not, however, consider that we have clear evidence currently regarding the evolution of the bad debt rate this winter. As the level of effective customer bills is expected to be similar to last winter, it may be that the bad debt rate stays flat or falls closer to market-wide bad debt levels of around 2%.*

*4.13 It is also possible that the rate increases further upon 2022/23 levels, depending on the interaction with continued high energy bills with wider cost of living pressures. However, given this uncertainty on the evolution of the bad debt rate, we consider it reasonable to assume for the purposes of this float allowance that the bad debt rate remains constant in 2023/24.*

## *Conclusion*

*4.21 We propose to use the central scenario to calculate our estimate of bad debt costs associated with ASC this winter. This is because, as set out earlier in this chapter, we consider the amount of ASC is likely to increase this winter given the ongoing cost of living pressures and the additional Code measures relevant to ASC which could both increase the ASC level. However, the evidence we are relying on is necessarily uncertain and we do not consider there is currently sufficiently clear evidence to expect that the proportion of bad debt will increase more than commensurately. As we explained in Chapter 3, this is a float allowance so could be subject to a later true-up adjustment if the allowance materially differs from actual costs.*

*4.22 We recognise our assessment about ASC bad debt levels and ASC bad debt rate is finely balanced and by its nature, relies on forecasts. We welcome specific evidence from stakeholders on our proposed methodological approach and any alternative approaches that we should consider to calculating expected costs from October 2023 onwards. Given the uncertainty presented, we also welcome evidence on the rationale for us to set a float which is different from expected costs that is still in the customers' interest*

Additional Support Credit Decision<sup>10</sup>:

*Review of allowance*

*5.30 As set out in Chapter 3, we consider it appropriate to include an initial ex-ante allowance from October 2023 for anticipated ASC bad costs. In doing so, it is important and appropriate to have the option to review and, if necessary, true-up the allowance if costs significantly differ from the initial allowance. We recognise there is inherent uncertainty around anticipated ASC bad debt costs. The review and any true-up would significantly mitigate the risks associated with an under or over allowance being provided initially.*

*5.31 We recognise that in conducting a review to determine whether a true-up is necessary, there is the potential for suppliers' actual or realised costs to affect allowances, which could reduce efficiency incentives. However, a supplier has no guarantee there would be a true-up adjustment (we would review to determine if one was necessary) and if we did implement one, we would seek to ensure the design and implementation of it mitigated those risks as much as possible.*

Yours Sincerely,

Paul Fuller  
Head of Regulation



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<sup>10</sup> <https://www.ofgem.gov.uk/sites/default/files/2023-08/Allowance%20for%20additional%20support%20credit%20bad%20debt%20costs1692828077507.pdf>