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17th January 2024

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

Dear Dan,

Re: Energy Price cap: Additional debt costs review consultation – Non-Confidential Version

Thank you for the opportunity to input to your consultation on additional debt related costs.

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

We support an adjustment to the price cap for additional debt-related costs. Customer debt is a growing issue with Ofgem estimating £2.9 billion of arrears across the domestic energy market (by the end of Q3 2023), an increase of £0.3 billion since Q2 2023.[2] ✂ Given that charges to most consumers are currently covered by the DTC, a mechanism to ensure that suppliers can cover the additional bad debt costs that will result is essential.

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

[1] British Gas opens up support fund to help customers this winter | Centrica plc
[2] Energy price cap: additional debt costs review consultation | Ofgem, Executive Summary.
[3] Domestic Gas and Electricity (Tariff Cap) Act 2018 (legislation.gov.uk), 1, 6 (d).

Ofgem propose to set 'relatively stringent initial benchmark approach'

We understand that Ofgem is concerned about the impact of increases in the price cap on customers. However, Ofgem must also consider that the purpose of this additional allowance is to allow suppliers to recover their efficiently incurred debt related costs. It is critical that Ofgem allows suppliers to recover these costs.

In 2018, Ofgem took an aggressive approach to operational cost allowances based on a narrow interpretation of the Tariff Cap Act 2018; Ofgem effectively equated low prices with consumer protection.[4] However, the supplier failures throughout 2021 and 2022 exposed the flaws of focussing unduly on price as the main determinant of competition and consumer interest.

As Oxera correctly noted in its report to GEMA:

> *"It was Ofgem's explicit intent in calibrating the price cap that it should be 'a tough cap that ensures* loyal *consumers pay a fair price that reflects efficient costs.' To the extent that the price cap was calibrated to deliver stretching levels of cost efficiency, it may have left suppliers with insufficient headroom to deal with shocks."*[5]

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

Ofgem recognised the impact of the benchmark level on customer service in the press release setting out these proposals where it said:

> *'it is crucial that suppliers have sufficient funding to ensure they can meet the strict regulations Ofgem has in place around how they treat customers facing payment difficulties'*.[7]

Ofgem also set out the costs that suppliers might incur in helping customers such as 'setting up payment plans; writing off unmanageable debt on a case-by-case basis; and working out affordable repayment holidays.'[8]

Contrary to these points, Ofgem's proposed approach is to set the float at an arbitrarily low level and indicate that further allowance may be provided at the true up stage. This is not consistent with giving suppliers 'sufficient funding' or importantly confidence that such funding will be provided. To remedy this, we urge Ofgem to **adopt a weighted average benchmark.** Notwithstanding this, if Ofgem proceeds with its proposals to adopt a 'tight'

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[4] Ofgem took the same approach to benchmarking the payment method uplift opting for the 2nd supplier in a sample of six to set its benchmark, Appendix 8 - Payment Method Uplift (ofgem.gov.uk), Paragraph, 2.32.
[5] Review of Ofgem's regulation of the energy supply market 3 May 2022
[6] We note that Ofgem has previously applied a weighted average to additional debt related costs in its Price Cap – Decision on the true-up process for COVID-19 costs | Ofgem
[7] Energy regulator sets out proposals to help ensure customers at risk of getting into debt are better supported | Ofgem
[8] Ibid

benchmarking approach for the initial float it should be very clear that this will not pre-judge its final decision on the appropriate benchmark at the true-up stage.

Ofgem is proposing to 'levelise' the allowance between customers

Ofgem is proposing to implement this additional allowance equally between direct debit and standard credit customers. This amounts to a 'levelisation'[9] of these costs. Whilst, Ofgem has now proposed to proceed with levelisation of debt related costs conditional on a supplier reconciliation process, this is expected to be implemented by October 2024 at the earliest.[10] Ofgem therefore proposes to 'levelise' this allowance without an accompanying supplier reconciliation process.

We urge Ofgem to reconsider this. As set out in our response to your consultation on levelisation, levelisation must be conditional on a supplier reconciliation process. As Ofgem set out in relation to levelisation, the supplier reconciliation mechanism 'is required to allow levelisation to function in a competitive market'.[11] Suppliers must be able to recover their efficient costs in order to finance their licensed activities and compete effectively for domestic supply contracts. Without an effective supplier reconciliation mechanism suppliers would be impacted arbitrarily according to their customer base. The supplier reconciliation also benefits consumers by avoiding an unintended impact whereby suppliers 'would have less revenue to attract and serve these consumers'.[12]

Given these factors, the inclusion of an effective supplier reconciliation mechanism is required in order for Ofgem to meet its duties under the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act'). In particular, its duty to have regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.[13] Ofgem has the ability within the constraints of the Act to better allow all suppliers irrespective of their payment type makeup to recover their efficient costs. It should do this.

In the absence of a supplier reconciliation process Ofgem should allocate these costs in a cost reflective manner. Ofgem can then levelise the costs related to this allowance further when it implements levelisation of debt related costs – as early as October 2024.

Should Ofgem proceed with equal allocation among 'credit customers', which amounts to 'levelisation' of these costs, it should undertake to ensure that a supplier reconciliation for debt related costs is implemented at the earliest opportunity i.e. October 2024, and that this reconciliation includes a re-allocation of this allowance and accounts for the levelisation costs accrued during the interim period (i.e. Summer 2024).

Disclosure of models and data

Ofgem has not disclosed the underlying model that it has used to calculate the allowances or out-turn costs on which the proposed allowance relies. It argues that 'Taking into consideration the nature of this review for setting a float, we consider the explanation of our

[9] Levelisation refers to the process of adjusting costs between payment methods to make charges more equal or equitable but less cost-reflective.
[10] [Changes to prepayment meter standing charges and other debt costs | Ofgem]
[11] Ibid, Paragraph 2.67.
[12] Ibid, Paragraph 6.15.
[13] [Domestic Gas and Electricity (Tariff Cap) Act 2018 (legislation.gov.uk)], 1, 6 (d).

methodology provided in this consultation would given sufficient information for meaningful consultation.'[14]

We respectfully disagree with this statement. Disclosure of data and models is required for the following reasons:

- To minimise errors in the interpretation of supplier data by allowing suppliers to see how their information has been processed and used in making Ofgem's decision. This could be remedied by a 'putback' process which Ofgem undertook in its recent wholesale costs review. ✂
- To identify generic errors in the modelling. Whilst error checking can be carried out by Ofgem, Centrica has identified a number of errors during previous disclosure processes ✂.
- To allow suppliers independent economic advisors to review how supplier data has been interpreted industry wide. This is particularly important in allowing stakeholders to comment on issues such as sample selection and issues of data comparability.

On the other had Ofgem do not provide any clear reasons to not disclose models and data save for the 'inherent risks' in sharing confidential information. We do not agree that there are inherent risks in sharing this information. Furthermore, if Ofgem has concerns, as it states, that its data collection process goes beyond the scope of a typical disclosure exercise we would encourage it to design data collections processes in a way that facilitates future disclosure. For example, by using a draft RFI to minimise resubmissions or clarifications.

To remedy this Ofgem should provide sufficient information for suppliers to promptly carry out the putback review and consider any response from suppliers as part of its decision-making process. Ofgem should also commit to a full disclosure process at the true-up stage.

We note that Ofgem has not set out any consultation questions in the consultation document. Instead, Ofgem welcomes views on any of the options and considerations discussed in this consultation, including on the value, methodology and implementation of the proposed allowance for debt-related costs. We will respond to a number of key 'considerations' in turn in the Appendix.

Yours sincerely,

Essie Barnett
Regulatory Manager

[14] Energy price cap: additional debt costs review consultation | Ofgem

Appendix – responses to key 'considerations'

Case for a temporary adjustment for debt-related costs;

Should Ofgem make an adjustment?

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

Customer debt is a growing issue with Ofgem estimating £2.9 billion of arrears across the domestic energy market (by the end of Q3 2023), an increase of £0.3 billion since Q2 2023.[15]

Given that charges to most consumers are currently covered by the DTC, a mechanism is needed to ensure that suppliers can cover the additional bad debt costs that will result. It is essential that efficiently run suppliers can recover their costs and therefore that any material and systematic change in debt-related costs is recoverable. The Domestic Gas and Electricity (Tariff Cap) Act 2018 requires Ofgem to have regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.[16] This reflects the importance of the Default Tariff Cap (DTC) providing appropriate allowances for efficiently incurred costs to the stability of the retail market. Against the backdrop of rapidly escalating debt it is imperative that Ofgem takes the risk to retail market stability seriously.

Alongside changes to the Default Tariff Cap, suppliers are working with Ofgem to ensure consumers struggling with their bills get the support that they need. British Gas has signed up to Energy UK's Winter 2023 Voluntary Debt Commitment.[17] British Gas will also support customers this winter through the British Gas Energy Support Fund. British Gas has committed £100 million since the start of the crisis with the biggest voluntary support package from an energy company. British Gas Energy Support Fund provides grants of up to £1,500 for British Gas and Scottish Gas customers struggling with energy costs. Additionally, the British Gas Energy Trust continues to support all UK energy consumers with grants, advice centres and Post Office Pop Ups.[18]

Ofgem has introduced new requirements to protect certain groups of consumers from on installation of involuntary prepayment meters (PPM)[19] and new and updated consumer standards rules which require energy suppliers to help provide support for domestic customers who are struggling with their energy bills.[20] Ofgem has also provided an additional allowance for Additional Support Credit which suppliers must offer to domestic PPM customers who are in a vulnerable situation. Finally, Ofgem has made proposals to levelise some costs between payment types to make them more equal or equitable.[21]

These measures are both indicative of the debt burden facing the energy industry and an important step towards addressing its impacts. During such a period of change Ofgem is

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15 Energy price cap: additional debt costs review consultation | Ofgem, Executive Summary.
16 Domestic Gas and Electricity (Tariff Cap) Act 2018 (legislation.gov.uk), 1, 6 (d).
17 The Winter 2023 Voluntary Debt Commitment - Energy UK (energy-uk.org.uk)
18 British Gas opens up support fund to help customers this winter | Centrica plc
19 Involuntary prepayment meter decision | Ofgem
20 Consumer standards decision | Ofgem
21 Changes to prepayment meter standing charges and other debt costs | Ofgem

right to increase its monitoring of near-time indicators of debt and to ensure that suppliers can recover their debt related costs through this review. ✂ A well-functioning and investible supply market is crucial to deliver these measures and to support customers who are struggling with their energy bills.

Should Ofgem using a float and true-up approach?

Yes, we agree Ofgem should provide a float and true-up.

Ofgem propose a float in April 2024 and aim to deliver the true-up process by April 2025. Ofgem will consider the following factors on the timing for the true up:

1. 'the interaction with other workstreams (eg the operating cost review and levelisation of payment methods).
2. the time it takes for updates to provisions to stabilise and debt to be written off'.[22]

We agree that these factors are important. By waiting for suppliers to update provisions for bad debt Ofgem can benchmark more effectively because the impact of differential accounting practices, which are a non-efficiency factor, will converge. Ofgem should also consider the need to consider price cap period 12 in the true-up as any revised operating costs allowance is expected to come into force in October 2024.

However, Ofgem should also consider the potential impacts of delaying a true up on customers. As Ofgem is aware any additional allowance will only be paid by customers on default tariffs. This means that the longer a true up is delayed the more likely it is that a different set of customers pay these costs than those that incurred them. In that vein it will be essential that any true up accounts for changes to the number of customers on default tariffs.

Ofgem has included a forecast of costs for Winter 23/24 in the proposed allowance. It argues that this will reduce the size of any true up and prevent bill shock. However, Ofgem's approach to forecasting these costs seems guaranteed to underestimate them. Not least because the trajectory of debt related costs is increasing but also because Ofgem has not accounted for seasonal variation in debt costs, its estimates of which are based on period 10b (July to September 2023).

We therefore ask Ofgem to <u>consider updating this forecast during the allowance period and adding any increment to the cap i.e. in October 2024</u>. An interim true-up would bring recovery of these costs closer to consumption and reduce the impact of a future true up. Finally, Ofgem should ensure that levelisation of debt related costs is in place prior to any wider true up.

Uprating the allowance for inflation or cost of capital

Ofgem should uprate any allowance for inflation.

We agree that 'under-recovery of debt is concentrated in the most recent quarters, reducing the time difference between the costs and allowance' as Ofgem notes. However, adjusting the allowance for inflation would be a relatively simple adjustment so we do not agree that this provides a reason for failing to uprate the allowance. Notwithstanding this any decision

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[22] Energy price cap: additional debt costs review consultation | Ofgem, Paragraph 3.38.

taken for the float should not pre-judge Ofgem's approach to indexing costs of the true-up which should include an uprating mechanism.

In relation to working capital, we do not agree with Ofgem's statement that 'the cap is not intended to align the timing of revenue and costs. Suppliers should have sufficient facilities to manage working capital as part of their normal business.'[23] These costs were by their nature unexpected and could not be expected for form part of supplier's business as usual working capital.

Estimation of the existing allowances

Accuracy of Ofgem's allowance estimates

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

Ofgem state that the data it has used to estimate debt related costs is of 'a sufficient standard to be used for this purpose.' This is contradicted by the following statement which makes plain that there are significant data issues:

> *'The significant data challenges, as set out above, require us to make complex estimations, based in part on judgment and assumptions, across several individual allowances.'*[24]

Despite this admission that the estimated allowances are based on 'judgement and assumptions', Ofgem has not provided any information on these estimates other than its final point estimate. Notwithstanding our preference for Ofgem to share the full model used to estimate these allowances, we would expect at a minimum Ofgem to share any ranges that are relevant to its estimates set out in table 4.2.

This is clearly important in determining the materiality of differences between costs and allowances. Ofgem provides ex-post adjustments to the price cap where costs are judged to differ from allowances materially and systematically. However, any judgement on materiality needs to be made in the context of uncertainty around the allowance estimate. Ofgem has not set any such judgements out if it has made them. This is a material gap in the information shared with stakeholders affecting our ability to respond meaningfully to this consultation.

We urge Ofgem to share the model it has used to estimate allowances with stakeholders. This model is complete and there is no reason to wait for the true-up to do this. Disclosure of this model will also facilitate the operating costs review which will 'consider how an enduring basis how debt-related costs allowance will be included in the cap'.[25] Given this sharing this model as part of the operating costs review would both facilitate stakeholder input on the way in which debt related costs are included in the cap and reduce the complexity of a future true up.

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[23] Energy price cap: additional debt costs review consultation | Ofgem, Paragraph 3.58.
[24] Ibid, Paragraph 4.10.
[25] Energy price cap: additional debt costs review consultation | Ofgem, Paragraph 4.42.

Calculating and benchmarking costs

Has Ofgem disclosed sufficient information to enable meaningful consultation?

No, Ofgem has not disclosed sufficient information to allow suppliers to meaningfully comment on its calculation and benchmarking of costs.

Ofgem has not disclosed the underlying model that it has used to calculate out-turn costs on which the benchmarking of the proposed allowance relies. It has disclosed the steps that it has taken to convert supplier submissions into net debt-related costs prior to benchmarking.

It has now provided further information on the sample of suppliers used to benchmark the proposed allowance.

Ofgem argues that 'Taking into consideration the nature of this review for setting a float, we consider the explanation of our methodology provided in this consultation would given sufficient information for meaningful consultation.'[26]

We respectfully disagree with this statement. Disclosure of data and models is required for the following reasons:

- To minimise errors in the interpretation of supplier data by allowing suppliers to see how their information has been processed and used in making Ofgem's decision. This could be remedied by a 'putback' process which Ofgem undertook in its recent wholesale costs review. ✂
- To identify generic errors in the modelling. Whilst error checking can be carried out by Ofgem, Centrica has identified a number of errors during previous disclosure processes ✂.
- To allow suppliers independent economic advisors to review how supplier data has been interpreted industry wide. This is particularly important in allowing stakeholders to comment on issues such as sample selection and issues of data comparability.

On the other hand Ofgem does not provide any clear reasons to not disclose models and data save for the 'inherent risks' in sharing confidential information. We do not agree that there are inherent risks in sharing this information. Furthermore, if Ofgem has concerns, as it states, that its data collection process goes beyond the scope of a typical disclosure exercise <u>we would encourage it to design data collections processes in a way that facilitates future disclosure</u>. For example, by using a draft RFI to minimise resubmissions or clarifications.

To remedy this Ofgem should provide sufficient information for suppliers to promptly carry out the putback review and consider any response from suppliers as part of its decision-making process. Ofgem should also commit to a full disclosure process at the true-up stage. In addition, and as noted above, Ofgem should share the model estimating debt related costs allowances as part of the operating costs review.

[26] Ibid

Does a lower quartile approach to set the float set the right stringency of benchmark?

No, Ofgem should adopt a weighted average benchmark.

We understand that Ofgem is concerned about the impact of increases in the price cap on customers. However, Ofgem must also consider that the purpose of this additional allowance is to allow suppliers to recover their efficiently incurred debt related costs. It is critical that Ofgem allows suppliers to recover these costs.

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

As Oxera correctly noted in its report to GEMA:

> *"It was Ofgem's explicit intent in calibrating the price cap that it should be 'a tough cap that ensures* loyal *consumers pay a fair price that reflects efficient costs.' To the extent that the price cap was calibrated to deliver stretching levels of cost efficiency, it may have left suppliers with insufficient headroom to deal with shocks."*[28]

This applies equally to this allowance. It is imperative that Ofgem takes a broader view of consumer protection that includes enhanced customer service. **Ofgem should adopt a weighted average benchmark.**[29]

Ofgem recognised the impact of the benchmark on customer service in the press release setting out these proposals where it said:

> *'it is crucial that suppliers have sufficient funding to ensure they can meet the strict regulations Ofgem has in place around how they treat customers facing payment difficulties'*.[30]

Ofgem also recognised the costs that suppliers might incur in helping customers such as 'setting up payment plans; writing off unmanageable debt on a case-by-case basis; and working out affordable repayment holidays.'[31]

Contrary to these points, Ofgem's proposed approach is to set the float at an arbitrarily low level and indicate that further allowance may be provided at the true up stage. This is not consistent with giving suppliers 'sufficient funding' or importantly confidence that such funding will be provided.

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[27] Ofgem took the same approach to benchmarking the payment method uplift opting for the 2nd supplier in a sample of six to set its benchmark, Appendix 8 - Payment Method Uplift (ofgem.gov.uk), Paragraph, 2.32.
[28] Review of Ofgem's regulation of the energy supply market 3 May 2022
[29] We note that Ofgem has previously applied a weighted average to additional debt related costs in its Price Cap – Decision on the true-up process for COVID-19 costs | Ofgem
[30] Energy regulator sets out proposals to help ensure customers at risk of getting into debt are better supported | Ofgem
[31] Ibid

To remedy this, we urge Ofgem to be clear that the cap should reflect efficiently incurred costs, taking into account legitimate differences in costs to serve between suppliers. Any departure from this which is based on uncertainty, including the time it takes for updates to provisions to stabilise and debt to be written off, or affordability concerns should be clearly separate from Ofgem's estimate of the efficient costs of the notional supplier. Furthermore, Ofgem should make clear that any decision on the initial float will not pre-judge their final decision on the appropriate benchmark.

Should benchmarking be set across costs and cap periods?

Ofgem has benchmarked across the three debt related costs allowances over four cap periods (a period of two years). We agree in principle that it is right for Ofgem to benchmark at an aggregated level both in terms of allowances and over time, where the allowances or time periods are inter-related. However, in deciding which costs and cap periods to include Ofgem also needs to consider its test for reviewing price cap allowances which is whether an issue is both material and systematic.

It is not clear from the consultation document whether Ofgem has carried out its 'material and systematic' test at an aggregated level or individually for each cap period and for each allowance. However, we note that, for example, in the initial float decision for Covid -19 debt costs Ofgem did consider whether each allowance showed 'material and systematic' issues and excluded debt related administration costs and working capital costs from the float.[32]

Given this we ask Ofgem to set out in its decision its analysis and conclusions for each allowance. In doing this we note that the box and whisker plots indicate a large range of working capital costs. Our understanding is that the supplier with the lowest working capital costs had an over-allowance of £25 across all four periods. Whereas the supplier with the highest working capital costs had an under-allowance of up to £12.[33]

Ofgem encountered a similar issue in setting looking at working capital costs in the Covid 19 float decision, it noted that:

> *'However, there were some large differences in the submitted data which concerned us. One supplier provided figures that were extremely positive, and another provided figures that were extremely negative. There was also a significant difference in the scale of monthly working capital between suppliers.'*[34]

Given the absence of disclosure of Ofgem's models we are unable to meaningfully comment on any potential data issues in Ofgem's benchmarking process. We ask Ofgem to comment on the extent to which each allowance can be said to materially and systematically different to allowances in its decision.

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[32] In each case Ofgem identified concerns with the quality of data in its decision. *Decision on the potential impact of COVID-19 on the default tariff cap (ofgem.gov.uk), Paragraphs 4.47 and 4.53.
[33] Email from Ofgem on 09/01/24 noted that 'For the working capital example excel deems the minimum point on the restricted sample (approx. –£25) as an outlier on the unrestricted sample so it is not included in the box and whisker plot. Likewise excel deems there to be an outlier point above the box plot for working capital which makes the simple average above the plot for the restricted sample.'
[34] *Decision on the potential impact of COVID-19 on the default tariff cap (ofgem.gov.uk), Paragraph 4.50.

Should Ofgem restrict the sample using a 'more stringent sampling criteria'?

Yes, Ofgem should account for non-efficiency factors in its sampling criteria. This is consistent with Ofgem's aim of estimating the efficient costs of a notional supplier.

Ofgem state that 'if we were to select a lower quartile benchmark, then we will consider the impact of payment type mix on our benchmarking methodology. This will account for some of the variation between suppliers' costs which is driven by factors other than efficiency.'[35]

Ofgem then set out the results of its benchmarking using a 'restricted sample' in which it uses a 'more stringent sampling criteria'. The result is the number of suppliers benchmarked is reduced from 10 to 6.

Ofgem has not shared any analysis used to create its restricted sample. Without this information we cannot meaningfully comment on the appropriateness of Ofgem's sampling criteria. However, we note that Ofgem has stated that the lower quartile supplier, in the restricted sample, is 'reflective of the market and has an average mix of payment method'.[36]

This is not sufficient and <u>Ofgem should ensure that all suppliers in the restricted sample have an average mix of payment methods, particularly the Frontier supplier</u>. The lower quartile supplier is determined relative to all other suppliers in the benchmark; it is not sufficient that only the lower quartile supplier has an average mix of payment methods. For example, all else equal, a supplier with a high proportion of direct debit customers, and therefore lower debt related costs, would set the Frontier for the benchmark. This means that Ofgem's 'lower quartile' would effectively be the Frontier for suppliers with an average mix of payment methods.

This point was made by Ofgem when setting the original price cap payment method uplift:

> *'We do not think it is likely that between the suppliers in our sample that the differences in costs per customer are explained by differences in the customer base.* ***The frontier supplier has a significant proportion of standard credit customers, and a similar proportion to suppliers with substantially higher costs.*** *There is a range of suppliers with very different costs per customer but many of the suppliers have high and similar proportions of default tariff customers paying by standard credit.'* (emphasis added)

We agree with this approach to ensuring sample consistency and urge <u>Ofgem to ensure that all suppliers in the restricted sample have an average mix of payment methods, particularly the Frontier supplier</u>. We also ask Ofgem to set out in its decision whether this is the case. In the absence of disclosure of Ofgem's benchmarking model it is critical that suppliers are able to understand and comment on Ofgem's benchmarking methodology. The current position creates ambiguity as to whether Ofgem intends to properly control for payment type and by implication whether suppliers will be able to recover their efficient cost irrespective of their customer base.

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[35] Energy price cap: additional debt costs review consultation | Ofgem, Paragraph 5.64.
[36] Energy price cap: additional debt costs review consultation | Ofgem

Allocation of the allowance

As Ofgem is aware, the current price cap does not allocate debt related costs in a cost reflective way – payment method uplift is applied 52% to SC customers and the remaining 48% split equally between SC and DD customers. Subsequent to this, the COVID-19 additional debt allowance allocated costs equally between credit customers. Finally, the ASC decision allocated all costs to PPM customers.

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

Allocating costs equally between standard credit and direct debit customers, is likely to exacerbate issues around the cost reflectivity of the DTC and differential impact on suppliers. Whilst this is in line with the COVID-19 decision Ofgem must consider the incremental impact of these decisions on suppliers with a large proportion of standard credit customers.

We also note that in our response to the COVID-19 supplementary consultation we noted that it is vital that Ofgem's approach in respect of COVID-19 bad debt costs does not set a precedent for calculating and recovering bad debt costs under the price cap more generally. This was because Ofgem's approach for calculating and recovering bad debt costs related to COVID-19 was, in our view, likely to be inaccurate because it did not properly account for bad debt costs between payment methods.[37]

As set out in the covering letter, we strongly recommend that this allowance be allocated in a cost reflective manner. Ofgem can then levelise the costs related to this allowance further when it implements levelisation of debt related costs – as early as October 2024. We discuss this in relation to the specific impacts of this allowance below. First we respond to Ofgem's concerns around data limitations.

Are there limitations to the data Ofgem is data on payment type?

Ofgem set out that it has 'identified some limitations in how suppliers were able to allocate costs in their submissions over payment type.' The limitations to which it refers are the allocation of costs to a customers current payment type. Ofgem indicates that it would like to allocate costs to payment type 'at the point of billing', reasoning that this is correct 'because bad debt allowances are built up at the point of consumption against a future risk'.[38]

In discussing 'data limitations' Ofgem assert that the practice of allocating costs to a customer's current payment type 'is likely to over-allocate costs to PPM customers and standard credit customers because customers can move onto these payment methods when they get into payment difficulties.'

We recognise the point that customers may change their payment type. However, we record costs according to a customer's current pay type in the billing system. Ofgem should

[37] Centrica response, Price Cap – Supplementary consultation on the true-up process for COVID-19 costs, 20 October 2022.
[38] [Energy price cap: additional debt costs review consultation | Ofgem](), Paragraph 6.8.

be cautious about how it addresses such a perceived limitation. Ofgem's current view appears to be one-sided focusing on DD customers in payment difficulty who default to SC tariffs. The interaction between payment type and customers in payment difficulties is more complex. For example, customers may also build debt on SC and then move to direct debit following agreement of a payment plan.

It is important that Ofgem recognises these nuances when considering any limitations with data it receives from suppliers. Ofgem should set out precisely how its concerns around data limitations have impacted its proposals on allocation of this allowance. This will allow suppliers to respond meaningfully to these concerns.

How does cost allocation impact customers, debt levels and suppliers?

Customers and debt levels

Allocation of debt related costs between payment types will have distributional impacts on customers. Ofgem sets this out in its impact assessment.[39] Ofgem finds that equal allocation has a marginally lower equity weighted impact than allowance allocation (£27 per dual fuel customer compared to £30) whereas reported cost allocation has a more significantly higher impact. Likewise, Ofgem finds that equal allocation has the lowest weighted average impact on vulnerable customers, though allowance allocation has the lowest maximum impact.[40]

Ofgem also finds that equal allocation will have the smallest incremental impact on customer debt levels on the basis that 'Allocating the majority of debt costs to standard credit customers may worsen the overall debt situation by focusing the increase on the group of customers where non-payment has been most prevalent, increasing the cycle of debt and the impacts on standard credit customers who do pay their debt.'[41]

We agree that this additional allowance may have distributional impacts on different cohorts of customers. However, Ofgem has proposed to address these distributional impacts through its levelisation proposals.[42] which reduce consumer impacting cost-reflectivity. <u>We believe levelisation is the correct mechanism to do this</u>.

How does cost allocation impact suppliers?

Ofgem is proposing to implement this additional allowance equally between direct debit and standard credit customers. This amounts to a 'levelisation'[43] of these costs. Whilst, Ofgem has now proposed to proceed with levelisation of debt related costs conditional on a supplier reconciliation process, this is expected to be implemented by October 2024 at the earliest. Ofgem therefore proposes to 'levelise' this allowance <u>without</u> an accompanying supplier reconciliation process.

As set out in our response to your consultation on levelisation, <u>levelisation must be conditional on a supplier reconciliation process.</u> As Ofgem set out in relation to

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[39] [Energy price cap: additional debt costs review consultation | Ofgem](), Chapter 7.
[40] Ibid, Paragraph 5.62.
[41] Ibid, Paragraph 6.32.
[42] [Changes to prepayment meter standing charges and other debt costs | Ofgem]()
[43] Levelisation refers to the process of adjusting costs between payment methods to make charges more equal or equitable but less cost-reflective.

levelisation[44], the supplier reconciliation mechanism 'is required to allow levelisation to function in a competitive market'.[45] Suppliers must be able to recover their efficient costs in order to finance their licensed activities and compete effectively for domestic supply contracts. Without an effective supplier reconciliation mechanism suppliers would be impacted according to their customer base.

In the absence of a supplier reconciliation process Ofgem should allocate these costs in a cost reflective manner. Ofgem can then levelise the costs related to this allowance further when it implements levelisation of debt related costs – as early as October 2024.

Should Ofgem proceed with equal allocation among 'credit customers', which amounts to 'levelisation' of these costs, it should undertake to ensure that a supplier reconciliation for debt related costs is implemented at the earliest opportunity i.e. October 2024, and that this reconciliation includes a re-allocation of this allowance and accounts for the levelisation costs accrued during the interim period (i.e. Summer 2024).

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[44] Changes to prepayment meter standing charges and other debt costs | Ofgem
[45] Ibid, Paragraph 2.67.