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Energy Price cap: Additional debt costs review consultation

Dear Simon and team

We support Ofgem's proposal to create a modest temporary uplift to the price cap to reflect the increase in debt costs which has been seen across the industry and which is not reflected in the current methodology. The fairest way to collect this is to spread the cost across all credit customers and fuels, and to collect from unit rates.

We urge you to stick to the following elements of your proposals:

- setting this allowance at the lower quartile level. This keeps the impact on customers manageable. It will also provide incentives on suppliers to manage the level of and cost of recovering debt - costs they are capable of influencing, if not controlling fully.
- not introducing a special levy to account for the cost of debt associated with customers where there is a do not install (DNI) prohibition on prepay meter install under warrant.

However, we do not support the proposal that this uplift should be an ex-post adjustment to compensate for shortfalls 2022-2024, with a true up later. We are concerned that these elements of the proposal over-complicate things and will:

- Make ex-post adjustments to the price cap a routine feature of the price cap, contrary to your own decision in 2018 which confirmed that there would not be ex-post adjustments to the price cap allowances[1]. We set out more detail on this in our response to the wholesale cost adjustment consultation;
- Lead to a lengthy and onerous true up process which will never arrive at a fully cost reflective adjustment, and will necessarily raise questions about how additional debt costs in 2024 are to be reflected in the cap.

[1] Default Tariff Cap: Decision Appendix 3 – Updating the cap methodology, 3.24 p17

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Ofgem should instead make a one off interim ex-ante uplift to the cap which falls away once the findings of the opex review have been implemented. This will remove the unnecessary complexity and enable focus on ensuring the cap correctly reflects costs.

We say a little more about each of these points below and would be happy to discuss further at any time.

Sincerely

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The price cap should incentivise suppliers to contain their debt costs

We acknowledge that in 2023 there was a systemic and material divergence from the cap with regards to debt related costs. We agree in principle with Ofgem providing a new, temporary allowance to reflect these additional costs ahead of further review of opex allowances in the cap due to conclude this autumn.

However, we are firmly of the view, and our own performance shows, that the level of debt and the cost and success of recovering this debt are not exogenous. Suppliers can influence all of these metrics, for example by being flexible over the amount and frequency of payments customers can make, being proactive in contacting customers falling into arrears very early on and by designing wrap around support to help those struggling to pay to improve their overall finances (for example by referring them to benefit checks).

To incentivise suppliers to be proactive in controlling their debt related costs, it is important for Ofgem to set allowances at the level of an efficient notional supplier - in this case the lower quartile.

Further, creating a levy that socialises debt related costs of "Do Not Install" customers will have the perverse impact of encouraging suppliers to allow vulnerable customers to get all the way through the debt journey rather than engaging with customers and helping them manage their debt.

Ex-post adjustments run counter to Ofgem's previous decision on operating the price cap

Whilst we recognise the cap no longer reflects the efficient cost of debt we fundamentally disagree with Ofgem introducing an ex post intervention. Not only do ex post adjustments reduce the incentive on suppliers to control their costs

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and lead to frequent lobbying for further cost adjustments, they run counter to Ofgem's 2018 published decision on managing the price cap[2].

In the 2018 document Ofgem made it clear that there will be no mechanism for retrospective corrections in the case of unforeseen circumstances, due to it being "not appropriate or proportionate" and risking distorting competition in the wider market.[3]

For Ofgem to consider ex post adjustments they should first enter in proper consultation as to the costs and benefits of making a change to the 2018 decision document. Until that due process is complete, any intervention in the cap should be made by adjusting ex ante allowances only. The proposal to introduce another ex-post adjustment, without a formal consultation on the rationale for reversing the 2018 decision, is tantamount to changing the agreed nature of the price cap by the back door. Please see our response to the additional wholesale allowance consultation for further details.

A float and true up will be cumbersome and lengthy

Experience has already shown that a float and true up approach is highly burdensome, especially when applied to bad debt costs.

In anticipation of Covid related debt Ofgem introduced a ex ante float to approximate emerging unknown risk, using an ex post true up to ensure it was fair[4]. This true up demonstrated that it is near impossible for Ofgem to make accurate and fair ex post adjustments, especially for bad debt. In the case of Covid bad debt, the true up process was lengthy and required burdensome data collection and analysis. Different supplier provisioning policies for bad debt and the difficulty in establishing a baseline counterfactual for "normal" bad debt

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[2] Default Tariff Cap: Decision Appendix 3 – Updating the cap methodology, 3.24 p17
[3] Default Tariff Cap: Decision Appendix 3 – Updating the cap methodology, section 3, in particular 3.18 p16
[4] Decision on the potential impact of COVID-19 on the default tariff cap

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made the true up a particularly difficult exercise, that can create perverse incentives re real time debt management, and unlikely to reflect the true additional cost of debt incurred.

Ofgem now proposes to apply an ex-post adjustment for additional debt costs incurred in 2022-2024 through a float and true up which will be even more cumbersome. It will inevitably result in calls for further adjustments (e.g. for costs incurred during 2024) and calls for the need for these further adjustments to be trued up, given the time lag required to identify bad debt. It is also likely to spark unnecessary and illogical debate around unique supplier circumstances and how to reconcile costs, further distorting the market.

This is a key risk Ofgem was concerned about when deciding against retrospective adjustments in 2018. We are concerned that Ofgem have effectively left the door open to further debate about special allowances through the true up, suggesting the reason for not considering a levy relates somewhat to resource constraints.

The complexity and distortion associated with the ex-post allowance and true up proposal could be entirely avoided. All Ofgem needs to do is introduce a temporary additional allowance in the price cap from April, which will fall away once the opex review has concluded (due this autumn) and its findings have been reflected in the new price cap allowances. Should the opex review be delayed for any reason Ofgem could, next year, roll over the temporary uplift or reassess the appropriate value based on more recent data.