The voice of the energy industry

Ofgem
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17/1/24

Dear Dan and Team,

We are writing in response to Ofgem's Additional debt costs review consultation.

As a result of high wholesale prices, energy bills remain unaffordable for millions of households. For many customers this means they are falling into increasing arrears. This has damaging consequences for households and for the resilience and investability of the sector, which is supplying an essential service. While we continue to urge Government to take action to support vulnerable households who cannot afford their bills, it is essential that Ofgem is taking steps to ensure that suppliers are confidently and promptly able to recover the efficient costs incurred in supplying their customers. This is vital for the future of the retail market; temporal fairness of consumer cost recovery through bills and for the diversity of the market and the inclusivity of customers with affordability issues.

The consultation evidence is clear that not only is debt rising, but that more of that debt is unlikely to be recovered. This is demonstrated in part by the fact that over one million accounts are now in arrears of over £2,200 and without any repayment plan in place. It is also exacerbated by new market rules and guidance, which are intended to prioritise customers staying on supply over minimising the accrual of problem debt.

Towards a reasonable estimate

By not provisioning in the float for an average benchmarking approach and plausible trajectory for bad debt over the winter, Ofgem is betting against the expertise and evidence from the sector about the level of bad debt provisioning required. This position is seemingly at odds with Ofgem's own rules regarding suppliers' requirements for responsible capital provisioning which means suppliers need to be responsive to the indicators about the likely direction of bad debt.

We fully understand the importance of ensuring any adjustment for increased debt costs is not set too high. Customers are already facing acute challenges with affordability[1], and we have consistently called for action to support those customers which is taxpayer funded. However, on the balance of evidence, we believe Ofgem are underestimating the trajectory of bad debt in the sector, over-estimating the ability of suppliers to control it, while positing an unrealistic scenario of over-allowance which assumes a rapid and unexplained resolution of bad debt accrual by April 2024. As such we think the proposed float is too 'stringent' which will result in problems for Ofgem, industry and customers.

We believe that too many stringencies have combined to make the proposed float insufficient. While some stringency is appropriate to ensure the float is not set too high, we are concerned that the size of delta between the median and lower quartile, combined with

[1] Citizens Advice (2023) The rising tide of energy debt

the limited control supplier have over debt accrued by vulnerable customers make the lower quartile approach to benchmarking the wrong one in this case. Most of our members agree that the lower quartile approach to benchmarking for the float is a concerning signal to energy suppliers about cost recovery for high debt customers. While we think it is essential that suppliers retain an incentive to manage debt efficiently and try to minimise bad debt accrual, significantly undercompensating the market for bad debt is a clear signal to suppliers to be more risk adverse in their tariff offerings and robust in their management of debt than existing provisioning rates would imply. This latter point is a contrary signal to that which Ofgem have explicitly made in guidance to suppliers on Additional Support Credit, in which Ofgem is clear that keeping vulnerable customers on supply should be prioritised over limiting their accrual of debt.

Ofgem's evidence of suppliers highly differentiated bad debt provisioning is likely to be to some extent based on different suppliers' methods of accounting. Nevertheless, the diversity suggests the potential for significant divergence of suppliers' bad debt positions potentially linked to non-efficiency factors. As set out in our previous response[2], we expect, based on the current proposal, a large, complex, contested, and therefore, likely delayed true up. This risks a significant impact on suppliers, particularly those with a high proportion of customers that are not paying their bills. Both financially and for the competitive incentive of the market on suppliers to acquire customers with propensity to accrue bad debt.

The float allowance, as set out, risks damaging the incentive for suppliers to offer tariffs to those with affordability challenges. At the same time Ofgem appears to be developing options on what they can do to encourage low standing charge tariffs for low usage customers. This is a very mixed signals as to what Ofgem want to see in the market.

More broadly, we think the proposed under recovery of debt costs continues a trend of overly optimistic price cap assumptions about necessary allowances followed by ex post corrections to the cap allowance. Most of our members see no other option in the short term than utilising a float and true-up, given the urgency of the issue. But all agree, that this position represents a clear shortcoming of the price cap. The issues with float and true ups are the complexity, resource intensity, uncertainty for supplier finances, risk of delay, backloading costs on future consumers and distraction from the underlining issues with the cap. As Ofgem has publicly accepted the way the current form of cap is operating is problematic with ongoing volatility[3] and we hope that the Opex review could represent scope for reform. In particular, the ex ante planned scalability of the cap allowances to reflect external market factors needs to be significantly improved to better reflect a more volatile market than previously assumed by the price cap.

In the absence of a higher initial float Ofgem should make clear that any decision it makes on benchmarking will not prejudge the decision at true up stage. Whilst we do not agree that Ofgem should defer cost recovery unreasonably we are also concerned that Ofgem provides certainty to suppliers on long-term recovery.

Float

[2] Energy UK (2023) Energy UK response to debt recovery consultation (May)
[3] Jonathan Brearley's speech at Energy UK Annual Conference 2023

A debt allowance float that leads to an over-recovery would be unhelpful for numerous reasons as set out in the consultation and it is an important outcome that Ofgem is right to avoid. Yet, it is also important to avoid a period of protracted under recovery for suppliers and to consider the impact on competition and diversity in the market. We think that Ofgem needs to provide a higher initial float which we think will reflect a very low risk that it will negate the need for a significant true up while helping ensure debt recovery adequacy and a clearer encouragement for a broader array of competitive products.

The combination of assumptions about a flat projection of bad debt in Q4 2023 and Q1 2024 combined with a lower quartile benchmark means that Ofgem is aiming low in the bottom half of a possible range. These choices appear to ignore the wider context to the consultation: the growing level of bad debt accrued; the limits placed on supplier ability to manage debt; and the ever-present worse case scenarios including cost of living pressures. This seems at odds with the context of high bills over winter and evidence of consumers' ability to cope with cost of living crisis.

While we recognise that choice of a lower quartile approach reflects a caution about keeping consumers bills low in the short term and avoids over recovery risks, the scale to which it deviates from weighted averages – by an estimate of hundreds of millions, by itself a bold decision. This position does not reflect the risks of over-stringency of the extended period – now including Period 11 costs – that the float is intended to cover and the possibility of a spiraling debt position beyond suppliers' scope to manage. We think this needs to be rectified before Ofgem comes to a decision.

Transparency

Energy suppliers do not feel confident they are clear how their data has been used to come to the data provided in the consultation. We think that a putback process like that used on wholesale costs is necessary and should be used if time allows.

As stated, we anticipate the true up process to be complex and contested and to mitigate this we encourage Ofgem to be transparent with their proposed methodology to avoid delay. Specifically, Ofgem should share the model used to calculate the allowances early as part of the operating costs review. This will facilitate a wider discussion on how debt related costs are embedded in the operating costs allowances as well as allowing suppliers to comment on the methodology for calculating these allowances ahead of the true up.

True up

As referred to in this response the true up is likely to be very difficult for Ofgem given there needs to be a decision about the mechanism under which it will be provided and the potential scale. The benchmarking decision will however have the benefit of being informed by outturn evidence.

The following factors will increase the scale of the necessary true up:

- **Forthcoming bad debt costs.** Ofgem has not yet set out how it would deal with bad debt costs from April 2024 onwards through to the likely date of a true up in 2025. It does not seem credible given the growth of bad debt that the problem will be solved by April 2024.

- **PPM restart.** The restart of involuntary PPM installations will lead to increases in debt administration costs when PPM warrant installation resumes in Q1 2024. This point was made consistently during the development of the code of practise. The knock on consequences of the moratorium alongside the increased administration requirements of the code, will likely increase administrative costs.

- **Ofgem have not distinguished between Standard variable tariffs (SV) and fixed term contracts (FTC) in their calculations**. In taking an average, Ofgem's float fails to take account of significant differences between customers. For example, debt administration costs are predominantly incurred by customers paying by standard credit (SC) and the proportion of customers paying by SC is typically higher for SVT than for non-SVT.

- **Treatment of inflation and cost of capital**. Ofgem's float methodology does not include an inflation allowance. As Ofgem suggest, it is necessary to reflect the 'time value of money' to reflect the delay between debt related costs being incurred and recovered via an additional price cap allowance. Given the high levels of inflation a debt in March 2023 of £10 was already worth £10.22 in November 2023[4]. Inflation levels are not expected to return to stable levels much before the end of 2025[5]. Further, the updated cost of capital rate of (12.3%), should be used for the periods that Ofgem deemed it the adequate level in its EBIT review.

Reducing the size of the true up through increasing the float helps mitigate some of the commercial pressure on suppliers in the interim and on the timing of the true up and it would better signal Ofgem's focus on protecting suppliers' scope for cost recovery from customers whose bad debt makes them expensive to serve.

Reconciliation

Our members have different views on the appropriateness of a reconciliation mechanism to reflect bad debt propensity of different customer types. Energy UK believes that Ofgem should be evidence-led in a decision on the appropriateness of a mechanism and that a price cap allowance is the right first step in the absence of robust outturn data. However, we are concerned about the impact of debt both across the market and areas of concentrated impact.

The cost of bad debt varies across payment methods and recent market developments may result in certain customers being more likely to accrue bad debt. Suppliers have varying quantities of customers on the different payment types. It is important for Ofgem to consider the evidence as it emerges on this situation. It is also important for any future decision to reflect, proportionately, the degree of control suppliers can have over debt by adapting to the needs of their customers through communication strategies, feedback tools and signposting, for example being more sensitive and agile to repayment plans where a customer cannot afford their bills. This is important to ensure incentives are maintained for the efficient management of customer debt while protecting vulnerable customers. As a result, any levy option under consideration should not be based on individual suppliers' actual debt positions

[4] Bank of England Inflation Tracker (2024)
[5] Bank of England (2024) When will we get back to low inflation?

but instead remain a notional level that reflects potential supplier divergence of customer types.

The ability for efficient suppliers to recover costs for all customers should ideally be assured achieved through Government intervention, funding progressive financial support to vulnerable households who need protection. Ofgem should be clear with Government that such an intervention is needed and that it does not have the necessary tools to achieve it without direct Government intervention.

To come to an evidence-based decision on whether the price cap or a levy are the most equitable reimbursement of efficient supplier costs will be challenging. We think it is important that their remains an incentive on suppliers' ability to reduce individual customers debt and manage debt efficiently. We welcome Ofgem's ongoing engagement with Energy UK and will seek to support Ofgem in collaboration with our members on how Ofgem can ensure adequate incentives to acquire and retain all customer types.

Please do get in contact if you have any questions.

Kind regards,

Ed Rees

Senior Policy Manager

Energy UK