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# Review of domestic debt objections

## Impact Assessment

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**Overview:**

This document assesses the impact that the existing debt objections rules have had on domestic consumers and competition in comparison to a counterfactual where debt objections are not allowed. Our analysis suggests that the current regime delivers net benefits to domestic consumers but that some aspects of the arrangements could be improved. We address these in our decision letter.

As part of the Switching Programme Ofgem is discussing with suppliers how the detailed industry processes that support the objections regime might be adapted to facilitate next day switching. Those developments are not within the scope of this document but are likely to be the subject of a separate impact assessment.

# Context

Standard condition 14 of the gas and electricity supply licences set out the circumstances in which a supplier may raise an objection to a customer transfer. The vast majority of objections (well over 90%) in the domestic market occur because a customer is in debt. Erroneous transfers make up most of the rest.

Before objecting on grounds of debt, the supplier must have written to the domestic customer to request payment of the debt and the debt must have remained outstanding for more than 28 days. A supplier cannot object for an outstanding amount 'on their system' (whatever the amount) if they have not previously informed the customer about it and the debt has not been outstanding for 28 days. Prepayment meter customers with a debt of less than £500 may, if the new supplier agrees, switch using arrangements known as the Debt Assignment Protocol (DAP). Customers switching via the DAP must pay the debt to the new supplier.

Where a domestic supplier raises an objection, it must inform the customer as soon as reasonably practicable. This notice to the customer must state the reason for the objection and say how the customer can resolve or dispute it. The notice must also contain advice (or information about how and where consumers can get advice) on energy efficiency, debt management and alternative, available contracts offered by the supplier that may be preferable to the existing contract.

This document presents our assessment of the impact of abolishing domestic debt objections. It should be read in conjunction with our decision letter, which outlines how suppliers should improve their communications with debt blocked customers. The letter also notes our intention to keep a close watch of suppliers' debt blocking activities and internal switching rates.

# Associated documents

Call for evidence, February 2015
https://www.ofgem.gov.uk/sites/default/files/docs/2015/02/call_for_evidence_27_february_2015_re-uploaded_0.pdf

Update and responses to call for evidence, November 2015
https://www.ofgem.gov.uk/publications-and-updates/supplier-objections

'Switching Suppliers for Domestic Consumers with Debt', Ofgem Consumer First Panel report, November 2015
https://www.ofgem.gov.uk/sites/default/files/docs/ofgem_consumer_first_panel_year_6_wave_4_report.pdf.

# Executive Summary

This document evaluates the current domestic debt objections regime against a counterfactual where debt objections are not allowed.  In particular, we have assessed the likelihood of whether there would be a net benefit or cost to domestic customers if debt objections were abolished. While it is not quantifiable, the level of engagement in the market from customers is a consideration (this may be inferred by the level of switching requests). Where objections reduce switching, this will reduce the number of potential switching requests. To the extent that customers would otherwise switch to better tariffs, debt blocking leads to customer detriment.

As of March 2016, the annual objection rate was 6% for electricity transfers and 5% for gas transfers (in each case 1% down on March 2015).  Debt objections account for over 90% of these objections.  The average debt of debt blocked customers rose from £268 in 2013 to £418 in 2015.  Many suppliers operate an informal threshold below which they allow an indebted transfer to proceed.  Indeed, around 70% of transfers by indebted domestic customers take place without objection.  This proportion is even higher at low levels of debt.

**Impacts of removing domestic debt objections**

Based on the data available to us, we have concluded that removing debt objections would be likely to increase debt across suppliers' customer bases as customers switch away, leaving a debt which is harder for suppliers to recover.  This would be likely to produce an increase in debt across suppliers' customer bases, leading to increased debt management costs and increased risks of customer bad debt.  These effects are likely to be passed on through higher bills to domestic consumers.

*Quantitative impacts*

If debt objections are not allowed, suppliers expect to have to make a larger provision for unpaid bills and have said they would include a tariff premium to offset this.  Almost all suppliers responding to the RFI indicated that they would recover these additional costs from across their domestic customer base.  Estimates of the bill increases vary widely but range from £0.38p to £10 per customer after 1 year and from £1.80 to £52 per customer cumulatively over 5 years (and up to £72 cumulatively over five years for economy7 customers).

Most of the estimates are in excess of any benefit potentially accruing to the indebted customers who would no longer be debt blocked (even on the most generous assumption that might be made about the ability of those customers to maximise their savings).  We used two figures to estimate the potential bill savings. The lower figure of £200 is from DECC research in October 2015.  The second is from DECC's March 2015 'Power to Switch' campaign, for which the average annual saving for dual fuel switches was £312.  (In June 2016 the differential was around £300.)  The maximum annual benefit to formerly debt blocked domestic customers is £37m on the October 2015 figures and £59m on the March 2015 figures.

Using the higher estimate of savings to indebted customers, removing debt objections would produce a net cost to domestic consumers if their bills increased by more than £2.19. On the lower estimate a bill increase of just £1.05 would lead to net costs for domestic consumers. Only two suppliers' estimates were lower than this figure.

Removing debt objections would encourage switching activity amongst indebted domestic customers who had not previously tried to switch supplier. This would clearly increase the potential benefits of removing debt objections. It is difficult to estimate the proportion of indebted customers that would switch supplier if debt objections were to be removed. If, for example, these customers were to switch at a similar rate to the general population, it is likely there would still be a net cost to domestic consumers as a whole. Some suppliers' estimates were well in excess of the benefits that could be achieved.

It is not clear that removing debt objections would benefit domestic customers as a whole. Indeed, it appears likely that removing debt objections would produce a net cost for most domestic customers in most circumstances. There could also be a significant distributional impact. Moreover, the evidence suggests a high proportion (around half) of the financial benefits of switching could be achieved by switching to the existing supplier's cheapest tariff. This is not happening much currently.

There is, therefore, evidence that for the quantified benefits and costs, the benefits of the current objections regime exceed the costs. This is mainly due to the reduced risk premiums on domestic tariffs. However, our results are sensitive to changes in assumptions and it is not straightforward to infer how any decision to abolish debt objections would ultimately impact on bills and the level of competition.

*Qualitative impacts*

Removing debt objections would be likely to lead to greater use of other credit management tools in the customer acquisition process to protect a supplier's credit rating from the increased risks of bad debt. Customers may be more likely to be offered only PPM terms and, to a lesser extent, be required to pay security deposits. There would be a risk that suppliers took a more aggressive approach to recovering debts from indebted ex-customers, who would typically no longer be offered the help available for existing customers (such as affordable repayment plans).

The IA suggests there are material net benefits from retaining debt objections. We therefore conclude that it is unlikely to be in the interests of domestic consumers to remove the transfer blocking conditions set out in standard condition 14 of the gas and electricity supply licences.

This document also considers, but rejects, two alternatives to debt objections: extending the Debt Assignment Protocol to include credit as well as PPM customers, and introducing a system of debt flagging.

# 1. Introduction

## Background to debt objections in the domestic market

1.1. Customers who search for the best deal and then switch supplier are an important driver of competition between energy suppliers. However, the right of domestic gas and electricity customers to choose their supplier is not absolute. Where a customer intends to switch supplier, the existing supplier has a period of time (the 'objection window')[1] in which they can object to the transfer. If they do object, this is known as a 'debt objection' or 'debt blocking'. The supplier may withdraw its objection within a set timeframe.

1.2. Domestic debt objections are an established feature of the gas and electricity supply markets in Britain. Debt objections were originally introduced because of the risk that some customers might switch supplier regularly in an attempt to avoid paying outstanding bills and because suppliers could only disconnect customers' premises - the most severe sanction for non-payment - if they were still the registered supplier.

1.3 In that context, if customers with debts switched supplier, the costs to suppliers of collecting these debts was judged likely to increase significantly. It was believed that the costs of unrecovered debts and increased debt recovery activity from suppliers would ultimately be borne by the rest of the suppliers' customers.

1.4 The solution adopted then was to give suppliers the right to object to transfers if the customer was in debt. This enables suppliers to manage the risk caused by the fact that many domestic customers, on credit terms, build up debt which they repay on a quarterly or monthly basis. Suppliers have consistently said that it also allows them to offer better prices. The ability to prevent a customer switching supplier because of debt is not a common characteristic of competitive markets. However, it reflects the status of gas and electricity as an essential service that suppliers must provide regardless of the financial position of the domestic customer.

1.5 Ofgem examined the case for removing domestic debt objections as part of the 2006/7 Supply Licence Review. In December 2006, we set out our intention to retain the objections arrangements but to keep them under review to ensure that they operate in the best interests of customers.[2] Since then we have monitored the overall level of domestic objections, which have typically represented 6-7% of domestic customer transfers.

1.6 We re-examined debt objections during our retail market probe in 2008. We considered whether to remove debt objections for all consumers, for specified consumer groups or for consumers with debts below a fixed level. We also

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[1] In electricity, under the Master Registration Agreement, this period is "five working days". For gas, under the Uniform Network Code, the window varies to enable a three-week switch to be achieved and could be "as low as two working days depending on the number of public holidays and other non-business days".
[2] Supply licence review further proposals. See Appendix 7, page 94.

considered extending the DAP to all consumers. Suppliers and consumer groups were largely polarised in their views.

1.7 Many suppliers, including all the six largest, said that removing debt blocking might lead them to pursue other debt mitigation strategies that could be more detrimental to customers' interests such as a more robust approach to debt recovery, higher disconnection and litigation rates, more PPMs and greater use of credit vetting and security deposits.

1.8 On the other hand, some suppliers accepted that they could provide a more supportive approach to debt prevention and management through trust funds, social tariffs, education and advice. Consumer groups said that objections were a barrier to competition that could exacerbate fuel poverty and delay debt repayment.

1.9 On balance, we concluded that "major reform [was] not appropriate" because of the risks of more aggressive actions by suppliers to protect their revenues. Instead, we introduced changes such as requiring suppliers to provide debt and energy efficiency advice to customers whose transfer is being blocked and to offer them an alternative contract if it is preferable to the existing one. We also doubled the DAP threshold for PPM customers to £200 (this has since been raised to £500.)

1.10 Ofgem has long been concerned that the objections process could act as a barrier to domestic customers (including vulnerable customers) engaging effectively with the market. Vulnerable, low income customers are likely to be disproportionately affected by the objections arrangements, with the result that the consumers who are struggling most to pay their bills are trapped on relatively expensive deals.

1.11 This concern is particularly acute when there is a substantial differential between suppliers' standard tariffs and their most competitive fixed price offers. The differential in early 2015 was around £250 and it was this particular concern that prompted the current review.

## The current review of objections

1.12 In our Forward Work Programme[3] for 2015-16 we committed to a review of domestic and non-domestic objections. We noted that a key consideration would be whether the current arrangements could be improved so that domestic customers in debt are more easily able to get the best deal, while ensuring that suppliers can take appropriate steps to have debt repaid.

[3] Ofgem's Forward Work Programme 2015-16.

### Call for evidence

1.13 We launched the review with a call for evidence[4] from all interested parties on the potential benefits, costs and risks of reforming, or removing, the right of suppliers to object. We noted that the conclusions of the review would inform our wider work to create a faster and more reliable switching process.

1.14 In their responses, all the domestic suppliers except one supported retaining debt objections. They argued that domestic debt objections

- maximise the incentive on consumers to manage and pay debt
- minimise and target debt costs on those who cause them rather than on those who are merely a credit risk (or even more widely)
- avoid the need for more expensive debt recovery practices(debt recovery agencies or the courts) and
- prevent 'supplier hopping' to avoid payment of bills.

1.15 Many domestic suppliers said that debt objections do not stifle competition but actually allow suppliers to manage wholesale market risk cost-effectively. This in turn enables them to offer more competitive fixed-price deals. Without debt objections, they would be less likely to offer terms to customers that they see as a credit risk and less likely to offer long-term fixed-price deals. Some domestic suppliers said the ability to 'debt block' was the natural corollary of credit meters and the customer's ability to pay in arears. They said that they would increase their use of credit vetting, security deposits, prepayment meters and disconnections if debt objections were abolished.

1.16 Citizens Advice noted that abolishing domestic debt objections could help improve access to the energy market for low income disengaged customers. However, Citizens Advice considered that any such reform should be part of a package that includes requiring suppliers to focus credit vetting solely on energy payment records, strengthening the rules on eligibility for prepayment meters and the debt repayment period and best practice guidance on how suppliers should manage at-risk consumers.

1.17 The report of the Consumer First Panel indicated that most panellists in their discussions opposed any action that would increase the likelihood of bill payers subsidising non-payers. Rather, customers and suppliers should do all they can to avoid debts building up and customers should be directed towards their suppliers' cheapest relevant tariff to enable faster repayment.

1.18 We published the Consumer First Panel report and the non-confidential responses to the call for evidence in November 2015.

### Formal requests for information

1.19 We considered the responses carefully and identified areas where further data was necessary to inform our policy conclusions. In September 2015 we therefore issued a formal request for information from a range of domestic suppliers (including the six largest and a representative cross-section of

[4] https://www.ofgem.gov.uk/publications-and-updates/supplier-objections

smaller suppliers). The information requested was intended to help us understand the development over time[5] of suppliers' policies and practices in relation to blocking transfers in accordance with standard condition 14.

1.20 Amongst other things, we requested information (broken down by fuel type and payment method) on the number of debt objections raised, the number of customers in debt who were allowed to switch supplier, the number of debt blocked customers who switched to an alternative, preferable contract, and the average debt and the distribution of debts of both the customers who were debt blocked and of those who were allowed to switch supplier. We also requested examples of the letters that suppliers had sent to customers whose transfers were being blocked on grounds of outstanding debt.

1.21 In the earlier call for evidence, many suppliers stated that removing debt objections would significantly affect the way in which they sought to recover debt and potentially reduce their ability to recover debt. Those suppliers said this would have negative impacts for customers more widely because they would be likely to spread these extra costs across their customer base. However, few of those suppliers quantified these impacts.

1.22 The information request was therefore also intended to enable suppliers to quantify these impacts as far as possible. We requested data on suppliers' existing uncollected debt levels and how these could be affected by the removal of debt objections. We also requested that suppliers provide estimates of how bills would alter for each payment type both initially and over time if debt objections were to be abolished. We received responses from suppliers in September and October 2015 and supplemented them via bilateral meetings with some suppliers and with consumer groups.

1.23 We also engaged the Centre for Sustainable Energy (CSE) to assess suppliers' responses to the information requests and to produce a report for us on the costs and benefits of removing debt objections. The CSE submitted its report to Ofgem at the end of January 2016. This confidential report contains conclusions and recommendations that Ofgem has considered carefully and which have helped inform our decision. The analysis has enabled us to identify trends in objected transfer requests, to reach a conclusion on whether debt objections represent the best tool through which domestic suppliers can manage credit risks (and hence whether they best deliver consumer benefits), and to form views on the quality of suppliers' communications with their debt blocked customers.

[5] The data typically covers the period January 2013 to September 2015.

### Key findings from the current objections review

*Number of debt objections and number of customers debt blocked*

1.24 The findings in this section are drawn from an analysis of suppliers' responses to the request for information issued in September 2015. Data was requested for the years 2013 and 2014 and the period January to September 2015.

1.25 The total number of objections for debt[6] was 374,463 in 2013 and 285,697 in 2014 (a reduction of 24%). The figure for the first 9 months of 2015 was 284,323. After taking account of multiple objections (many of which were caused by customers attempting to switch gas and electricity accounts at the same time rather than making multiple switching attempts over time), the number of domestic customers experiencing an objection was estimated to be approximately 187,232 in 2013, falling to 142,848 in 2014 and 142,162 from January to September 2015.

1.26 The figures from the RFI suggest a broadly stable debt objections rate of about 6% of all attempted domestic customer transfers. This is consistent with the objections rates for all types of objection that we publish annually in our retail market indicators. (The latest figures, for March 2016, show an objection rate of 6% in electricity and 5% in gas, which is down by 1% in both markets from March 2015.) Across the time period the number of debt objections split approximately equally between gas and electricity. Adjusted to account for the higher numbers of electricity accounts, objections for gas are 14% more common than for electricity.

1.27 Over 80% of all debt objections were for customers paying by either a credit or prepayment meter. The proportions for each method remained similar: credit at 46-48%, direct debit at 11-12% and prepayment at 32-36%. Prepayment meter customers with a debt of less than £500 could switch successfully under the Debt Assignment Protocol but actual switching using this mechanism remained very low over the period.

*Debt of debt blocked customers and of those allowed to switch*

1.28 The average debt of debt blocked customers was £268 in 2013, £377 in 2014 and £418 in 2015.[7] This is consistent with market reports showing that total sector debt, and the cost of maintaining it, is increasing. Suppliers were also asked to provide data on the debt levels of customers who they allowed to switch with a debt.[8] Again, there was a trend of decreasing numbers of customers in debt with increasing debt.

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[6] The suppliers who provided data on this matter account for 98% of domestic customers for both electricity and gas. One supplier said it did not as a matter of policy raise debt objections.
[7] The suppliers whose data has been drawn on here account for 63% and 67% of domestic electricity and domestic gas customers respectively.
[8] The suppliers who provided comparable data (for debt below £1,000) account for 74% and 77% of domestic electricity and gas customers respectively. For debt over £1,000 the figures are drawn from data from suppliers that account for 60% of domestic electricity and 66% of domestic gas customers.

1.29 Many suppliers operate an informal threshold below which they allow the transfer of an indebted customer to proceed (ranging up to £200 per fuel, sometimes varying by payment type), while others take a case-by-case approach. However, suppliers do not always object when a customer's debt is higher than the supplier's own de minimis threshold.

1.30 The number of customers who were allowed to switch with a debt is higher than the number of objections raised. This is generally true across years and payment methods (apart from credit customers in 2013). As it appears that most customers who are objected to receive more than one objection, we estimate that the number of customers who switch with a debt is around 2-3 times the number of customers who are blocked.

1.31 We have compared the number of customers that experienced an objection when trying to switch, compared to the number of customers that were not blocked when they tried to switch with a debt at each level of debt[9]. The number of customers that were not blocked exceeds the number of customers who were blocked at lower levels of debt.

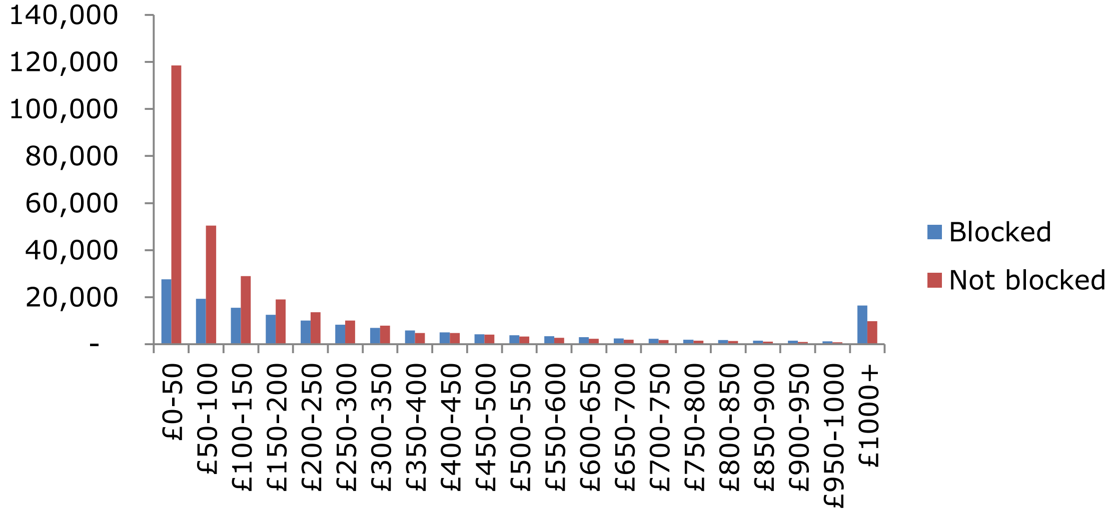
1.32 In 2013 and 2015, as debt increased it reached a level at which the number of blocked customers was higher than the number of customers that were not blocked. In 2013 this happened around the £200- £250 mark and in (January-September) 2015 it happened at around £350-£400 of debt.

1.33 In 2014 the two figures become equal at the £600-650 debt level but the number of customers that were blocked did not exceed the number that were not blocked until over the £1,000 mark (there is insufficient data for us to state the precise point at which this occurred). This appears to be because one of the large suppliers whose data informed this analysis did not object to any customers switching while it was updating its billing system.

1.34 Figure 1 below illustrates this for the first nine months of 2015.

[9] Only suppliers who answered both questions relevant to the analysis in this section in a way that enabled comparison are included. They include four of the six large domestic suppliers.

**Figure 1: Number of customers blocked and not blocked at different levels of debt - 2015**




1.35 Based on the comparable data submitted to us, it appears that 2-3 times as many customers are allowed to switch with a debt (typically 430,000 a year) than are blocked through debt objection (typically 170,000 a year). In other words, over 70% of indebted customers who want to switch are allowed to by their current suppliers. A customer with a debt level of £300–350 requesting to switch in 2015 was more likely to be allowed to switch by their supplier than not. Some customers with debts of more than £1,000 were allowed to switch.

*Internal switching rates*

1.36 The numbers of domestic customers switching to an alternative contract with their existing supplier after being debt blocked dropped significantly from 16,850 in 2013, to 4,968 in 2014 and a slightly higher figure of 6,569 in 2015 (across all fuel and payment types).[10] The number of customers switching to a different tariff after being debt blocked is highest for credit customers across both fuels and every year but one (for gas).

[10] This is based on data from 14 suppliers supplying 95% of the domestic gas and electricity market, two of which do not offer alternative contracts and one other of which does not object for debt. Thus, data from 11 suppliers (including the six largest) informed these statistics.

**Table 1: Estimated proportion of debt blocked customers switching to a cheaper tariff**

| Year | Customers switching to a cheaper tariff after being blocked | Estimated number of customers whose switch was blocked[11] | Proportion of estimated number of blocked customers |
|---|---|---|---|
| **2013** | 16,850 | 187,232 | 9.00% |
| **2014** | 4,968 | 142,849 | 3.48% |
| **2015** | 6,569 | 142,162 | 4.62% |

1.37 Based on suppliers' data, it appears that only about 5% of debt blocked customers switch to a cheaper tariff with their existing supplier. This in turn suggests that around 95% of debt blocked customers are potentially missing out on bill-reducing tariff deals from their own suppliers.

*Paying off the debt and switching supplier*

1.38 In our request for information suppliers were asked to provide figures on how long it took their customers to pay off their debt after being debt blocked. We asked suppliers to do this in relation to any customers they had debt blocked in one autumn month (November 2013) and one spring month (April 2014).

1.39 Based on the data provided by suppliers, it appears that just over half of the customers who were blocked in the two months selected for analysis had paid back their debt at the time of reporting (September 2015). Around 70% of those that had paid off their debt at the time of reporting did so within three months. Although the majority of those who did manage to pay off their debt paid it off within six months, for a large minority of customers it seems that the debt remained outstanding. PPM customers took longest to repay.

1.40 Suppliers were asked to provide information on the proportion of customers switching after paying off their debt and the time taken to do so. Some suppliers interpreted the question as time since the objection ('method 1') while others interpreted it as time since the debt was repaid ('method 2').

1.41 Of those customers that had paid off their debt (that is, just over half of the customers experiencing objections in those months), between 27% and 39% (depending on month and payment method) had switched supplier within a year of being blocked (using method 1) and 41% to 60% (depending on month and payment method) had switched supplier within a year of paying off the debt (using method 2). Debt blocked direct debit and credit customers had a higher rate of switching away from their existing supplier than PPM customers.

[11] Based on data from 16 suppliers.

*Advice to debt blocked customers*

1.42 Suppliers were asked to provide information about their policy on providing advice to debt blocked customers. As of September 2015, most of the suppliers took a similar approach to providing advice to all customers in debt, whether or not they attempt to switch. Only two suppliers said they had a specific policy on providing advice to debt blocked customers. The rest routinely offered advice to all their customers, debt blocked or not.

1.43 The way this advice is offered varied: some of the suppliers provided information on the debt objection letter. However, this generally consisted of signposting to literature that was already available elsewhere (usually via webpages or leaflets or an encouragement to contact a helpline or advisors).

1.44 Most of the suppliers said they offered advice on alternative payment methods and possible cheaper tariffs and also that energy efficiency advice is given. Around half of the suppliers said they made referrals to outside organisations. The most common of these were the Energy Saving Trust, Citizens Advice and StepChange.

*Debt objection letters*

1.45 Suppliers were asked to provide examples of the letters that they send to domestic customers when objecting to a transfer on grounds of debt. We received examples from 15 domestic suppliers.

1.46 Most suppliers' current objection letters offer help with difficulty paying and advice on energy efficiency. Many, but not all, say that they may be a different tariff or payment method available, although most assume the reader will automatically make the link between a different tariff /payment method and saving money in order to repay debts.

1.47 Many letters signpost to third party organisations for help on debt and energy efficiency, but some suppliers say their advisors can signpost if the customer phones them and do not provide details for these organisations in the letter. Two suppliers also asked for meter reads, which is useful where the amount of debt is based on estimates and could in reality be lower.

*Supplier errors*

1.48 Suppliers were asked to provide information about their policies on the interpretation of supply licence conditions 14(7) and 14(8) where there has been either a dispute or a supplier error. Sixteen out of the 17 suppliers provided an answer to this question. Ten suppliers explicitly stated that where there is a dispute or supplier error involved in the outstanding charge then they will not object to the debt. Another four suppliers did not go this far but did say that before objecting they would make full analysis of the reason for the debt existing, and update any estimated readings before objecting.

*Managing and recovering debt*

1.49 Suppliers were asked to provide details of their policy on recovering debt. The process of managing and recovering debt was broadly similar amongst the 16 suppliers who responded. The timescales over which steps were taken varied.

1.50 The general approach consists of a number of attempts to contact the customer and arrange an appropriate method and timescale to repay the debt. Several suppliers said that this action was triggered two weeks after issue of the bill, although for one supplier this time period was only nine days and for another it was 60 days. Generally, suppliers offered a range of payment methods. In particular, 15 suppliers said they offer a PPM to help the customer manage their energy use and repay their debt. In the event that a repayment agreement could not be reached, eight of the suppliers stated they would use a third-party debt collection agency (DCA).

1.51 The vast majority of suppliers said that they offer[12] advice and support to customers struggling with debt. This support was delivered both by the suppliers and by third party organisations. Eleven suppliers said that they offered energy efficiency advice and 11 suppliers also said they gave advice on the best tariffs. One supplier does not do this as it has only one contract available and thus no opportunity for switching, and another said that smart meters meant customers were automatically put on to the best tariff.

1.52 We note that although suppliers said they offered this advice, many were referring to the currently mandatory cheaper tariff messaging on bills. Five suppliers said they had a dedicated team to deal with those in debt or some form of trained collections personnel. Twelve suppliers referred customers to third party organisations for advice. Four suppliers had trust funds to which those who were experiencing particular hardships could apply for assistance.

1.53 In conversations with suppliers many noted that although they can attempt to contact customers, the customer must want to engage, otherwise contact attempts will not be effective. They also noted that the debt objection is an effective way to get the customer to engage, because the customer realises that without getting in touch they will be unable to switch supplier.

1.54 Several suppliers said they refer to StepChange, a free debt advice and debt management plan service. One supplier said they offer benefits checks (done by internal customer advisors) and another said they referred to Income Max, an independent organisation that carries out benefits checks.

*Using a prepayment meter (PPM) to recover debt*

1.55 15 suppliers provided information about their process for deciding when to install a PPM to recover debt. 14 suppliers said they had installed PPMs, with just one saying they had not done so. Two of the suppliers use PPMs for the majority of their customers. 11 of the suppliers said they installed PPMs when a customer repeatedly failed to pay their bills, with several suppliers having a monetary threshold for when PPMs were brought into use. Of those 11 suppliers, 10 mentioned that they make use of warrants to install the meters, and the other supplier did not mention the use of warrants.

[12] It should be noted that 'offer' may in practice represent little more than a mention in a debt-chasing letter of the service being available rather than a proactive attempt to contact the indebted customer with the specific intent of providing these services.

*Use of debt collection agencies and the courts*

1.56 16 suppliers provided information on their policy on use of debt collection agencies (DCAs) and the courts. Of those 16 suppliers, 15 said they used DCAs.[13] The level of debt at which a DCA was presumed to be financially viable was, for most of these suppliers, between £100 and £300.

1.57 11 suppliers responded on the use of the courts. Of these, two said they did not use them (in one case because they had few credit customers and in the other because it was not financially viable to do so). The level of debt required to make court action viable was higher than for DCA. One supplier said it was not willing to use the courts until the debt surpasses £1,000.

[13] The other supplier said it did not use DCAs as it had very low numbers of credit customers.

# 2. Methodology and approach for IA

2.1. Ofgem has published a set of consumer outcomes that drive its policy work. The relevant ones for the objections review are to deliver:

- lower bills than would otherwise have been the case
- better quality of service, appropriate for an essential service
- benefits for society as a whole, including support for those struggling to pay their bills.

2.2. The Impact Assessment will allow us to determine whether these outcomes are, on balance, best fulfilled by the current objections regime or by other, alternative arrangements. As noted in chapter 1, a key consideration has been whether the current arrangements could be improved so that domestic customers in debt are more easily able to get the best deal, while ensuring that suppliers can take appropriate steps to have debt repaid.

**Purpose of this Impact Assessment**

2.3. We have developed this Impact Assessment (IA) in line with Ofgem's Impact Assessment guidance.[14] The IA sets out the evidence base underpinning our decision that the current objections regime should remain as a feature of the switching process for domestic consumers. It aims to identify the full range of impacts, costs and benefits of the current regime on consumers and to highlight areas of concern with aspects of the existing debt objections regime.

2.4. The data we collected during the review did not specifically look at how well suppliers are complying with existing licence conditions on domestic debt objections. As such, we have not sought to quantify any detriment that might be arising from non-compliance. However, the data has enabled us to identify potential compliance issues in relation to the content of debt blocking letters. We address this in our decision letter and highlight next steps.

2.5. The choice of baseline and counterfactual in this IA follows the framework of an ex-post policy evaluation cost-benefit analysis[15]. The current regime acts as the baseline from which the costs and benefits of any alternative options are measured incrementally. The welfare standard assumed for this analysis is total consumer benefits taking into account the pricing and availability of tariffs in the short- and long-term. Long-term effects are a function of supplier and consumer behaviour and competition. We have considered consumer behavioural incentives in a market with a duty to supply domestic customers.

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[14] Ofgem, 'Impact Assessment Guidance', 1 October 2013: https://www.ofgem.gov.uk/publications-and-updates/impact-assessment-guidance.
[15] HM Treasury 'Green Book' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220541/green_book_complete.pdf.

**Evidence drawn on in this impact assessment**

2.6. Forecasting the future inevitably carries a significant degree of uncertainty. Our historic data cannot capture the full complexities of the energy market and in particular gauge precisely how parties will respond to changing signals. We have supplemented the evidence base with stakeholder engagement, surveys and the conclusions from our previous work on objections.

2.7. Our analysis is based on an assessment of the current state of the domestic market in relation to debt objections. In our analysis we tried, whenever possible, to identify any trends for objections over the period 2013-2015. We have also taken account of the potential changes in the market arising from the CMA remedies. The table below summarises their impact on objections.

**Table 2: CMA remedies and their potential impact on debt objections**

| Remedy | What it does | Impact on debt objections |
|---|---|---|
| Database | Database of domestic customers on default tariffs for more than 3 years. Suppliers can send marketing information to these customers | Should lead to increased switching by 'sticky' customers and more switching attempts by in-debt customers. Other things being equal, it would probably increase the number, if not necessarily the rate, of debt objections |
| Randomised Control Trials | Recommendation to Ofgem to carry out programme of trials to increase domestic consumer engagement. A clear path for trials and amendments. | The current debt objections regime depends on effective supplier communication with their customers. It is open to us in the future to use RCTs to improve the quality of debt objections letters. Better signposting of cheaper alternative tariffs to debt blocked customers could increase internal switching. |

2.8. As explained above, a possible limitation of the analysis would be where there is misuse of supplier objections. In using the data, we have assumed that the debt objections were raised legitimately for domestic customers that were in debt as defined in Standard Licence Condition 14. As noted above, the data we received has enabled us to identify areas in which compliance issues may be occurring. This has informed our views as to the necessary next steps.

***Balance of quantitative and non-monetary assessment***

2.9. We have endeavoured to quantify the impacts of our policy considerations where it is possible to derive robust estimates. For some areas of analysis, quantification of impacts was not possible, either because the impacts are intangible, difficult to measure, or adequate data was not available. Where this was found to be the case, we describe the non-monetary impacts to allow them to be considered in relation to the quantified costs and benefits. Such an approach is consistent with best practice guidance.

# 3. Impact of removing debt objections and introducing alternatives

3.1. In the next two chapters, we discuss the impact of removing domestic debt objections and introducing alternatives. This chapter considers the removal of the debt objections arrangements. Chapter 4 looks at two alternatives to debt objections: an extension of the Debt Assignment Protocol to all payment methods, and the introduction of a debt flagging system. Chapter 4 also sets out how aspects of the current arrangements might be improved if debt objections were to be retained.

3.2 The main source of data for the assessment of the options was suppliers' responses to our requests for information. This data was supplemented with bilateral conversations with many of the suppliers.

## Removal of domestic debt objections

3.3 Under this option we would remove the ability for domestic suppliers to prevent switching when the customer is in debt to the current supplier (ie, suppliers would still be able to object to erroneous transfers, or at the request of the customer, or where Related Meter Points have not all been transferred).

**Impact on customers' bills**

3.4 Suppliers were asked to estimate by how much their levels of uncollected debt would increase over the next five years if debt objections were abolished, and how this would affect customer bills. Some suppliers said they could not provide such a forecast (most small suppliers did not provide longer-term estimates). Some suppliers simply provided the final figure while others provided models showing their assumptions and calculations.

3.5 In a strongly competitive market, one might expect that some suppliers at least might prefer not to socialise these costs completely but to target them towards higher risk credit customers. However, this is not what suppliers have asserted in evidence to us. Two of the largest said they would target quarterly credit customers but the others who responded said bill increases would affect the whole customer base. The range of estimated increases varied widely (from £0.38p to £10 per customer after 1 year and from £1.80 to £52 per customer cumulatively over 5 years[16]) depending on the assumptions used by suppliers in their calculations.

**Table 3: Forecast increases in bills if debt objections were removed**

[16] Up to £72 cumulatively over five years for economy7 customers.

| Increase in tariffs? | Across whole customer base? | How much bills would increase in the first year? | How much bills would increase after 5 years |
|---|---|---|---|
| **Yes** | Yes | £2.57 for electricity, £2.21 for gas | |
| **Yes** | Yes | | £23.20 cumulatively over 5 years, £52.30 cumulatively over 5 years for second model |
| **Yes** | Yes | £3.19 per supply | No mention |
| **Yes** | Yes | 46p per annum | Unable to assess because there are unpredictable factors involved, in particular consumer behaviour |
| **Yes** | Yes | 7.26% | |
| **Yes** | No – just charge QCC customers | £6 for gas and £4 for electricity | £32 gas and £18 electricity cumulatively over 5 years |
| **Yes** | No – just Cash/cheque and PPM | £6 for dual fuel, if switching increases the rate will be higher | |
| **Yes** | No mention | Between £0.04p and £0.96p on the unit rate | £51.69 for standard electricity, £71.69 for E7 (cumulative over 5 years) |
| **Yes** | Yes | £0.38 per annum | £1.80 over 5 years |
| **Yes** | No mention | £3 | |

3.7 One large supplier provided relatively detailed forecasts based on two models that incorporated different assumptions. The first model assumed that the amount of live and final debt would increase and follow the same pattern as that in the water industry following the removal of ability to disconnect. The second model assumed that final debt would increase to roughly the same level as in the Irish energy market (where the old supplier cannot prevent a transfer on grounds of debt but the new one can if the debt is above a certain threshold). Under both sets of assumptions the supplier gave predictions at the higher end of the range set out at 3.5 and the table above.

3.8 For both models, increases in costs were divided into four categories: reduced recovery of existing debt, unrecovered debt from 'debt hoppers' (those that would not currently run up debts or switch, but learn that they can do so to their advantage under a system with no objections), revenue loss from outgoing debt hoppers (as these are customers who would have stayed with the same supplier and continued paying their bills if they did not have the option to debt hop), and revenue loss from incoming debt hoppers (as these are customers who would have stayed with their former supplier and paid their bills but who are now consuming energy and not paying for it).

3.9 Another large supplier chose the level of debt for the most recent full calendar year at the time of the request for information (2014) and two scenarios of increased switching activity leading to an increase in final debt. 2015 rates of final debt collection were applied to this final debt to obtain substantially increased levels of net debt post-DCA.

3.10 Several suppliers said that the main impact of abolishing debt objections would be to increase the amount of debt written off. One such supplier took the current value of debt at objection, and assumed that without debt objections these customers would switch away and the debt would move from being live debt to final debt. The amount written off was then based on the difference between collection rates for live debt and for final debt. Next, the effect of debt-hoppers was added. It was assumed that the numbers of people switching with a debt would increase as more people realised they could leave their debt behind. This supplier said that bad debt costs would rise at a faster rate in energy than water, due to its higher profile and higher bills. Over five years, this was predicted to lead to a £50 increase in a dual fuel bill, cumulatively over five years. The supplier expected to recover these costs from quarterly credit customers only.

**Impact on switching to cheaper tariffs by indebted customers**

3.11 From a limited number of suppliers' responses to the RFI we estimate that only just over half of customers who were debt blocked in selected months had paid off their debt 17 and 22 months later. Fewer than half of the customers who paid off their debt had subsequently switched, for those selected months (again based on a limited number of suppliers). Therefore, after 17 and 22 months, it appears that only around a quarter of debt blocked customers switch under the current arrangements.

3.12 The numbers switching to an alternative contract after being debt blocked dropped significantly from 16,850 in 2013, to 4,968 in 2014 before increasing slightly to 6,569 in 2015, across all fuel and payment types. A relatively small number of customers who are debt blocked switch to a cheaper tariff with their current supplier: we estimate around 5-10% in 2015.

3.13 Given that around 95% of customers who are debt blocked end up staying on the same tariff as they were on before, it seems likely that most debt blocked customers would have been able to get a better deal by switching supplier. This does not mean that they would necessarily maximise the savings potentially available in the market. It may also be the case that some of those who did not transfer to an alternative tariff with their current supplier did not want to be tied into a fixed tariff.

3.14 Switching by indebted customers would be likely to increase if debt objections were abolished. If every domestic customer who had been debt blocked switched supplier this would mean an increase of approximately 250,000 to 350,000 switches annually (counting one customer switching both gas and electricity as two switches). Removing debt objections would also encourage switching by consumers who have a debt but have not attempted to switch.

3.15 A further increase in switching could be caused by 'debt hoppers'. This is a category of consumers that could emerge if objections were removed and it became widely known that it was possible to run up a debt with one supplier and then move to another without having to pay the previous debt. This category of consumers would have the means to pay their energy bill but would choose not to. The emergence of this group would increase in switching numbers above the numbers discussed in the previous paragraphs but in the case of this group it would be an unwanted increase in switching as they are not switching to get a better deal but to avoid paying a debt.

3.16 A proportion of indebted customers are disengaged from the market or apprehensive about switching, so it is unlikely that all customers who have debt would switch if debt objections were removed. In addition, as we note below, suppliers would use other tools to manage their credit risk and some of these tools could dampen switching incentives (more credit vetting, increased use of security deposits). It is therefore difficult to estimate with confidence the extent of the increase in switching if debt objections were abolished.

**Impact on suppliers' credit management practices**

3.17 Suppliers currently have a range of tools to choose from to manage their credit risk: debt objections, credit referencing, security deposits, installation of prepayment meters, debt collection agencies and litigation. Suppliers have expressed concern that if the use of their current tools is restricted, they will be less able to manage their credit risk and prices will increase as a result. Other things being equal, one would expect that the removal of one tool would lead to increased use of other tools.

3.18 As noted above, some of these tools could dampen incentives to switching by indebted customers. This would be especially true for customers who are in debt with their existing supplier – arranging a security deposit of £150 may be difficult when in they have already run up a large debt.

3.19 One supplier said that a credit consumer who does not pay their bill for a year can have a debt of over £1,000, against which a security deposit of £150 is not meaningful. Against this is the likelihood that requiring security deposits of £150 might be expected to reduce the number of customers who go on to run up £1,000 debts in future.

3.20 Our view is that suppliers may increase the number of security deposits they request but would be more likely to seek to require risky consumers to take a PPM. Several suppliers said they would be likely to increase the speed of debt follow-up and increase PPM installation. However, in assessing the need for a PPM suppliers would need to bear in mind their obligations to offer affordable repayment plans and only to install PPMs as a last resort.

3.21 With increased smart metering, PPM usage is likely to increase regardless of our decision on debt objections. 'Pay as You Go' smart meters are more likely to be seen by consumers as useful and desirable items (without carrying the negative connotations that some consumers attach to existing PPMs). They also reduce suppliers' credit risk.

3.22 Under a system of debt objections, suppliers have greater control over debt repayment. Suppliers have obligations requiring them to engage proactively with customers who are at risk of going into debt and to agree payment plans in line with ability to pay principles. Reducing the number of customers in debt would reduce the number of debt objections.

**Impact on suppliers' approach to debt advice**

3.23 Suppliers have emphasised that in order to advise on debt they needed the customer to engage with them. The debt objection letter that tells the consumer that they cannot switch is currently viewed as a key way of getting the customer to engage, as is the threat of disconnection, and suppliers are concerned that without debt objections the customer would have less incentive to contact the supplier to discuss repayment.

3.24 On the other hand, if debt objections were to be removed, suppliers might chase debts at an earlier stage. It is possible that consumers would receive more offers of help and advice from suppliers at an earlier point in the process. However, it is not clear how many customers would respond positively to these offers if there were no incentive to repay in terms of a block to a switch.

3.25 As smart metering becomes more widespread suppliers will have more information about consumers' monthly consumption and may therefore be able to identify at an earlier stage where customers are falling into debt. There is still the issue of engaging the customer so that they take advantage of offers of help and support; smart meters could help if consumers use the new functionality to receive tailored messages from the supplier. However, having a smart meter does not make it certain that a customer will engage.

3.26 As noted above, suppliers' licence obligations to provide help and advice on debt management do not apply to people who owe them money but are not their customers. This means that increased switching by indebted customers could result in those customers having less recourse to sources of help and advice, and being pursued for the debt in a more aggressive way than if they were a customer of the supplier to which they owed money.

**Impact on suppliers' use of debt collection agencies and the courts**

3.27 Suppliers forecast that final debt (money owed by people who are no longer customers) would increase as a result of allowing customers to switch and leave their debt behind with the losing supplier. Suppliers cannot recover a debt by installing a PPM if the debtor is not their customer. They may have to turn to other means such as debt collection agencies (DCAs) and litigation.

3.28 The information provided by suppliers about their current practices shows that the level of debt required to make use of DCAs is around £100-£300 for most suppliers, with litigation costing considerably more. However, if credit risks change, suppliers may decide to pursue final debt through DCAs and litigation. However, we believe the more likely outcome is that suppliers will load uncollected debt costs onto their customer base.

**Impact on suppliers' bad debt levels**

3.29 Suppliers have estimated that their bad debt levels would increase significantly over the next five years if debt objections were removed. However, we received little by way of quantified evidence on bad debt levels. Estimates by suppliers of the amount that the increased bad debt would add to bills varied between 38p and £14.33 (£71.69 divided by 5 years) per year, depending on assumptions. Some suppliers did not wish to estimate this.

**Impact on competition and new entry**

3.30 New suppliers could be deterred from entering the market if levels of bad debt in the industry increased significantly . However, this depends on the set of credit management tools that remain available to them. If bad debt levels increased significantly, it may be that only new suppliers with smart PPM-only business models would enter the market, though they currently face the possibility of buying debt from other suppliers through the PPM DAP.

3.31 We do not quantify the impact of removing objections on the number of suppliers operating in the domestic market. To be able to do this we would need to understand the likely effects on competition and on the number of firms serving domestic customers. We would then need to estimate the value placed on this additional choice and tariff impact. We do not think we can do this robustly. In any case, we think it more likely that the increased credit risks to suppliers from removing objections would be reflected in tariff to customers and more rigorous terms of supply (security deposits, PPMs).

**Operational costs of removing domestic debt objections**

3.32 Identifying and raising objections is a mixture of automatic and manual operation. Suppliers need resources to manage the necessary IT systems. If objections were removed, changes would need to be made to suppliers' IT and to central industry systems (the latter set of costs could be mitigated if aligned with the introduction of the Central Registration System).

3.33 No modelling has been undertaken recently to isolate the impact of objections on these systems. However, analysis conducted in the context of the Switching Programme showed that existing objections process costs are a small part of overall registration/switching process system costs for any existing systems that include objections.

3.34 In late 2013, as part of the Switching Programme, Ofgem conducted an initial assessment of the costs of operating the current domestic and non-domestic objections arrangements and the potential costs of retaining them in a context of much faster switching. The costs of the objections process in the future will vary considerably depending on the solution chosen.

3.35 A central objections database is likely to be essential if customers are to be able to switch supplier at the start of the next day. Establishing and running such a database would have a net present value (NPV) cost of £90m from 2015-30. Alternatively, shortening the objection window to 1 or 2 days would have a NPV cost of around £10m over the same period. As noted above, these costs reflect all supplier objections and not just those for domestic debt.

3.36 These are costs over and above those that would be incurred by running the current objections process over this period. In 2013 suppliers estimated that this would cost £59m (all operating costs). Given the overriding objective of faster and more reliable switching, we expect the objections arrangements to become significantly more efficient. To that end the existing process may undergo substantial amendment (not limited to the options outlined above). Any changes will of course be the subject of a separate consultation process.

## Economic analysis of removing domestic debt objections

3.37 Our analysis assessed whether the savings to domestic gas and electricity consumers from removing debt objections are likely to be outweighed by the additional costs to suppliers associated with uncollected debt. Through the RFI we asked how these additional costs would increase consumer bills.

3.38 Using the data available to us, we estimated the aggregate energy bill savings (i.e. benefits) made by debt blocked customers if they were allowed to switch. Dividing the total benefit by the number of gas and electricity consumers gives the per customer bill increase that would give zero net benefit. This is the maximum bill increase consistent with producing a net benefit to domestic gas and electricity consumers as a whole.

3.39 Two figures for a bill saving from switching were used. The lower figure of £200 is from October 2015 research by the Department for Energy and Climate Change (DECC)[17], which shows that around half of GB's households could save this much. The second is from DECC's March 2015 'Power to Switch' campaign, for which the average saving for dual fuel switches was £312 per annum[18]. In June 2016 the differential was around £300. The analysis therefore remains valid.

3.40 The table below shows the range of estimated benefits based on these assumptions. It almost certainly overstates the benefits to formerly debt blocked customers from removing debt blocking. This is because it is highly unlikely that every unblocked switcher would optimise their bill savings as illustrated in the table. The figure for customers objected to in 2015 referred to elsewhere in this document covered only the first three quarters of 2015 and so here has been increased by a third to estimate the total over the full year. [19] The table does not include the potential benefits to indebted customers that had not previously attempted to switch.

**Table 4: Estimated benefits to debt blocked consumers if they had been allowed to switch**

| | Number of debt blocked customers (estimated) | Benefit of switching (lower estimate, £200 per customer) | Benefit of switching (higher estimate, £312 per customer) |
|---|---|---|---|
| **2013** | 187,232 | £37,446,400 | £58,978,080 |

[17] https://www.gov.uk/government/publications/household-energy-savings-through-switching-supporting-evidence/many-households-could-save-around-200-per-year-through-switching-energy-supplier-basis-for-claim.
[18] https://www.gov.uk/government/news/millions-saved-in-one-month-as-switching-energy-supplier-rockets.
[19] The figure of 142,162 from previous tables is for Jan-Sept, and so here this has been increased by a third to estimate the total number of customers objected to in the full year

| | | | |
|---|---|---|---|
| **2014** | 142,849 | £28,569,800 | £44,997,435 |
| **2015** | 189,549 | £37,909,867 | £59,708,040 |

3.41 Table 5 below takes the lower and higher estimate benefit figures from table 4 and divides them between the total number of domestic gas and electricity consumers in Britain to arrive at a lower and higher cost per domestic consumer where there would be no overall net benefit.

**Table 5: Bill increases for zero net benefit to domestic consumers as a whole**

| Point in range | Benefit to domestic consumers as a whole | Number of customers[20] (at Q3 2015) | Zero net benefit bill increase |
|---|---|---|---|
| **Lower** | £28,569,800 | 27,220,820 | £1.05 |
| **Higher** | £59,708,040 | 27,220,820 | £2.19 |

3.42 These estimates suggest that if removing debt objections led to an increase in customer bills above £2.19 there would be a net cost to domestic gas and electricity consumers. Most suppliers' estimates were higher than this. The lower estimate is based on the most conservative assessment of the savings available. On this basis the base case incremental benefit estimate is £28.5m per annum. A bill increase of £1.05 per customer would result in a net cost to domestic consumers as a whole. Only two of the 10 suppliers that provided estimates were lower than the estimate of £1.05 per consumer.

3.43 Removing debt objections would encourage switching by indebted domestic customers who had not previously tried to switch. This would increase the potential benefits. It is difficult to estimate the proportion of indebted customers that would switch supplier if debt objections were to be removed. There is, therefore, considerable uncertainty about the benefits that could arise. However, if indebted customers switched supplier at a similar rate as the general population and maximised the savings from doing so, it is likely there would be a net cost to domestic consumers as a whole.

3.44 It is therefore not clear that removing debt objections would benefit domestic customers as a whole. In addition, it is important to note that around 50% of the benefit of switching supplier could be achieved by switching to a new tariff with the same supplier. This is based on our understanding of the differences in tariffs offered by suppliers in late 2015. Internal switching would have a far lower impact on costs to other domestic consumers.

**Distributional impacts**

3.45 Ofgem has considered the distributional impact of removing debt objections as well as the net financial cost or benefit to domestic consumers. Informational asymmetries mean that, at present, suppliers cannot necessarily identify riskier customers with accuracy. As such, the additional risks from such consumers may be socialised across the customer base rather

[20] Using Ofgem's Supplier Obligation Report data for electricity customers, based on the assumption that every household has an electricity account but not all have gas accounts.

than be targeted on those who impose the risks. From the perspective of market efficiency, those incurring the costs should face these costs.

3.46 It may be that for customers who cannot pay, allowing the socialisation of costs and permitting the debt holder to transfer to a lower tariff would maximise social welfare. It is for this reason that we introduced the DAP for PPM customers and introduced obligations on suppliers to engage with their customers at risk of debt (as well as those who are in debt)in line with ability to pay principles, for example by agreeing realistic payment plans.

3.47 If, as a result of removing debt objections, more people did not pay their bills and other consumers' bills rose accordingly, this would represent a cross subsidy from those that pay to those that do not. This might be acceptable if all of the people who did not pay were in financial hardship and all of the people who did pay were comfortably well-off. However, this would be very unlikely to be the case.

3.48 Ofgem's Consumer Panel believed that customers who incur debt should be liable to pay it off before switching (unless a supplier was in error). The Panel supported retaining debt objections but encouraging suppliers to improve their communications with their indebted customers with a view to getting more of them on cheaper tariffs. This would ensure that repayment remained targeted on those in debt and it could enable faster repayment.[21]

3.49 Finally, there are some non-monetary costs to consumers who currently experience debt objections. If they were allowed to switch, leaving a final debt behind, they would lose the support that suppliers provide to help their customers manage their debt and they could experience a more aggressive pursuit of the debt.

[21] See Ofgem Consumer First Panel Year 6 wave 4 for further information.

# 4. Others options considered

4.1 We have considered two alternatives to debt objections: an extension of the Debt Assignment Protocol to all payment methods and a debt flagging system in which the new supplier is told that the switching customer has a debt which exceeds a certain threshold and so the supplier can cancel the switch.

4.2 In the light of our analysis of the impact of removing domestic debt objections, we have also considered whether aspects of the current process could be improved. In particular, we have assessed the scope for suppliers to improve their communications with debt blocked customers so as to facilitate their engagement with the market beyond simply repaying their debt. This is set out in our decision letter.

## An extended Debt Assignment Protocol

4.3 We have considered the impact of extending the Debt Assignment Protocol (DAP) from prepayment meter customers to all payment methods. Under the DAP, customers are able to switch as long as their debt is £500 or less. Ninety percent of the debt is transferred from the losing to the gaining supplier. Transfers under the current DAP have been very low - less than 500 in 2014 and less than 1,000 in Jan-Sept 2015.[22]

4.4 Over the period for which the data was obtained, the process involved the customer giving permission for data sharing between suppliers at the point that they request the switch. The DAP process required an objection to be raised first in the case where the Point of Acquisition model[23] is not used (or if the customer does not provide the relevant consent when switching). If the debt is above £500 the supplier is not obliged to take on the customer's debt.

4.5 As noted above, the DAP requires the gaining supplier to buy 90% of the customer's debt from the losing supplier up-front and then recover the money over time from the customer themselves. Suppliers have argued that - in the context of having to offer terms to domestic customers - an extended DAP would increase suppliers' exposure to debt in a way they could not control because they could not refuse to buy the debt of the customers that request a transfer. Although the level of debt that any individual customer could transfer would be limited (as with the current prepayment meter DAP), the number of customers that could transfer their debt would not be limited. Thus, the suppliers could not control the amount of debt they had to take on.

[22] Based on data from 16 suppliers that account for 98% of the domestic market.
[23] In April 2015 ten suppliers, including the six largest, adopted a Point of Acquisition (POA) model with an additional supplier doing so in July 2015. This model simplifies the switching process for customers by building the provision of information about the DAP and customer agreement to debt assignment in the event of a debt objection into suppliers' sales channels for all PPM customers.

4.6 Suppliers note that under the current DAP arrangements they have the certainty of being able to use a PPM to recover a debt over time (although they have to buy the debt up-front and recovery could take some time). If they have to take on the debt of credit customers as well, they are exposed to a much larger pool of customers whose debt they could be forced to buy, without the same PPM mechanism for recovering the debt. Suppliers have told us that in these circumstances they would be likely to accept customers under the DAP only if they agree to have a PPM installed or pay a security deposit. Suppliers may also tighten up their credit vetting practices.

***Impact on competition and new entry***

4.7 To the extent that an extended DAP would move existing debt levels around between suppliers, the main issue is the risk of some suppliers gaining a disproportionate share of the industry's debt. As switchers under the extended DAP should be moving to the suppliers with the lowest prices, suppliers would face a trade-off between offering the lowest prices to attract customers and gaining a disproportionate share of the industry's debt. This could cause a reduction in competitiveness as suppliers balance these pressures.

4.8 In recent years the number of suppliers active in the market has greatly increased. There is a risk that extending the DAP to all payment types could slow this welcome development. New suppliers could be required to take on a significant amount of debt across all payment methods and would only have a limited ability to control the level of debt they took on. Smaller suppliers would be the least likely to have the working capital to be able to operate with this level of debt and could face difficulties establishing a decent credit rating in a market where the risk of customer debt is, at least to some extent, outside their control.

4.9 As well as making debt levels more unpredictable for suppliers, debt assignment could reduce the incentive on customers to tackle their debts, because they know that they can still switch carrying a certain level of debt. This could lead to higher levels of debt across the industry and, in turn, higher prices.

4.10 Under an extended DAP, objections would still be required to cover cases where the customer has not allowed data sharing at the point of acquisition, or where the debt is higher than the DAP limit. It is likely that under an extended DAP, switching by indebted customers would rise as - depending on the threshold for transfer - a large proportion of consumers who are currently debt blocked would be able to go ahead with their switch (though, as noted, suppliers already allow a high proportion of switches at low debt levels to proceed). However, as mentioned above, the number of prepayment customers switching under the DAP is low compared to the number of objections for these customers (around 1% according to the data received from suppliers in September 2015).

### Impact on suppliers' approach to debt advice

4.11 In an extended DAP, 90% of the debt would be transferred to the current supplier. This means that the customer would have access to information and advice offered by their new supplier as they do under their current supplier. The incentive on the customer to engage would be unchanged. The impact would therefore be broadly neutral.

### Impact on suppliers' bad debt levels

4.12 It is difficult to make predictions about the potential level of bad debt under alternatives to debt objections. Under an extended DAP there could be some increase in bad debt as it is likely that a portion of the debt will stay behind with the losing supplier (as at present for the PPM DAP) and the incentive to pay the debt back in order to switch is lost. However the biggest debt risk for an extended DAP is likely to be that indebted customers could switch disproportionately to certain suppliers, leaving those suppliers with a much higher debt burden relative to others.

### Impact on wider industry changes

4.13 Suppliers have stated that the DAP as it stands would have to be improved considerably before it could be operational in a next-day switching world. The CMA, in its Final Report, recommended that Ofgem take appropriate steps to ensure that changes to the DAP are implemented by the end of 2016, and in particular in relation to objection letters, complex debt and multiple registrations. We will implement the CMA's recommendations in a manner consistent with next day switching. This work is the subject of separate consultation and development process.

## A debt flagging system

4.14 In Great Britain the incumbent supplier can object to a transfer. An alternative system would be to allow the gaining supplier to object to a transfer where the debt is above a certain level. We have considered the potential impact of introducing such a system in the British market, with particular reference to the debt flagging arrangements in the Irish gas and electricity market. In the Republic of Ireland, debt flagging was introduced in 2011. The threshold for domestic customers was €250.

4.15 A review of debt flagging in 2013 found that 8,461 flags were raised in the domestic sector (both gas and electricity) and 2,304 switches were cancelled as a result: 27% of flags led to a switch being rejected.[24] As a result of the review the threshold was reduced to €225 to increase the number of flagged transfers. We summarise the process below.

[24] Commission for Energy Regulation, Debt Flagging Review Information Paper, CER/13/135, June 2013 www.cer.ie/docs/000481/cer13135---debt-flagging-review-information-paper.pdf.

4.16 Where a domestic customer requests a switch and has arrears of €225 or more, which have been outstanding for 60 days or more from their bill due date, the losing supplier raises a flag that the gaining supplier can see. The gaining supplier knows there is a flag but does not know how much higher than the threshold the debt is, or for how much longer than 60 days the debt has been outstanding. The gaining supplier can refuse the switch but the losing supplier cannot block it. The debt stays with the losing supplier.

**Impact on domestic consumers**

4.17 A British debt flagging system would entail giving prospective suppliers the right to reject a new, indebted customer. Yet the requirement on suppliers to offer terms of supply to all customers is a key tenet of the current domestic energy market. A customer who is debt flagged may be refused by several suppliers and find themselves unable to leave their current supplier - essentially the same effect as under debt objections but potentially with more effort required from the customer. There is also a risk that many customers would actually stop trying after their first rejection.

4.18 If debt objections were replaced with a debt flagging system, the number of indebted customers switching would depend on the criteria used by gaining suppliers. If the debt was not transferred, gaining suppliers would have less incentive to reject a new customer. If gaining suppliers were allowed to use credit referencing and security deposits, or to insist on the installation of a PPM, then they would be more likely to accept the switch, but this could be less attractive for the customer and deter some from switching.

**Impact on competition**

4.19 Ireland has introduced a debt transfer system for PPM customers. This was first introduced only for customers who had PPMs installed as a result of financial hardship and then an extension to 'lifestyle' PPMs was proposed. Some suppliers suggested in evidence to us that this has led to a situation where PPM customers cannot debt hop but consumers with other payment methods can gamble on the possibility of debt hopping.

4.20 Conversely, where customers are accepted by the new supplier, they would leave the debt behind with the former supplier. Final debts are in general harder to collect than live debts as the customer is less engaged and so less likely to address the debt. On that basis a debt flagging system could lead to higher industry debt, which in turn could be expected to lead to increased prices for consumers. Among the responses from suppliers were two methods for estimating the increases. The increases based on water industry data were higher than those using Republic of Ireland data. There is considerable uncertainty therefore about these effects.

4.21 A debt flagging system may give new suppliers better control over debt than under an extended DAP. However, as noted above, their ability to enter the market will depend on the other credit management tools they are allowed to use, and again a smart prepayment-only model could be the only viable option for a new entrant.

### Impact on suppliers' credit management practices

4.22 Under a debt flagging system, the gaining supplier is less exposed to debt than under an extended DAP but, as the debt is left behind with the losing supplier, suppliers may become more active in chasing the debt. Currently, the debt objections process provides some incentive for consumers to engage with their supplier, which helps them to access debt advice and agreement of a reasonable repayment plan.

4.23 Suppliers have responsibilities towards their customers and offer considerable help to in-debt customers who engage with them. However, if the customer leaves these services are not available, and it is not clear what responsibilities the supplier then has towards the former customer who has the debt. The losing supplier may use more aggressive measures to chase a debt with a former customer after transfer to another supplier.

4.24 This may produce a worse situation for the ex-customer who, although they may have a cheaper tariff with the new supplier, is now being chased for debt by their former supplier with no offer of the help they would receive if they were still a customer of the losing supplier. Overall debt levels would still increase since final debt is less likely to be paid back, and costs would increase, leading to higher prices.

4.25 As with any extension of the DAP, it is likely that debt flagging would lead to an increase in the use of prepayment meters. This is because the removal of debt objections would require suppliers to change their approach to managing credit risk, and PPMs are an important tool in that.

### Suppliers' approach to providing debt advice

4.26 In a debt flagging system, the debt would be left behind and so customers would face the same issue of owing money to a supplier who is not their current supplier and so has fewer responsibilities towards them.

# 5. Summary and conclusions

**Impact of removing domestic debt objections**

5.1 If debt objections were removed, it is likely that there would be the following effects:

- an increase in bills (although estimates of the likely increase varied widely across suppliers)
- an increase in the amount of final debt, leading to increased debt management costs and greater use of other credit management tools in the customer acquisition process for all customers to protect the credit rating of the supplier from the increased risks of customer bad debt, such as an increase in PPM installations and to a lesser extent use of security deposits
- more aggressive approach to recovering debts from indebted ex-customers, who would typically no longer be offered the help available for existing customers nor enjoy the same regulatory protection.

5.3 The distributional impact of removing objections could be significant if suppliers recover increased debt costs from across their customer base. Only two suppliers said they would target these increases on the credit and PPM customers that cause them. In that event, domestic consumers in general would pay higher prices to cover the cost of those who do not pay their debts.

5.4 The cost impact on all customers is likely to be significantly greater than the benefits accruing to the indebted customers who would no longer be blocked. Our analysis suggests that if the financial benefits of removing debt objections to formerly debt blocked customers were to outweigh the financial costs, the extra costs across the consumer base would need to be:

- using the highest estimate of bill savings available to formerly debt blocked customers, the additional supplier costs associated with these changes should not exceed £2.19 per year per customer for energy consumers as a whole to lose out
- using the lowest estimate of bill savings available to formerly debt blocked customers, this figure reduces to £1.05.

5.5 Most suppliers' estimates of the likely bill increases in the absence of debt objections were higher than these figures. If we include switching by indebted customers who had not previously attempted to switch supplier, the potential benefits would clearly rise. However, some suppliers' estimates of the cost increases were significantly in excess of the potential benefits that could be achieved if such customers switched supplier at a similar rate as the general population and maximised their savings in doing so.

5.6 We therefore consider that on balance domestic customers benefit from the current debt objections arrangements. In reaching this conclusion we have also taken into account the view of the Consumer Panel that we should maintain debt objections but seek to improve suppliers' communication with indebted customers so as to increase internal switching rates.

5.7 There are a number of qualitative factors that cannot be quantified in a robust way. These are shown below with an assessment of their likely impact.

| **Non-quantified costs of removing debt objections** | **Impact** |
|---|---|
| Increased use of PPMs | Medium |
| Increased use of security deposits | Medium |
| Change in debt collection methods | Medium |
| Reduction in fixed tariff deals offered to some customers | Medium |
| Suppliers exit the market and new entry is deterred | Low |

5.8 The main unquantified benefit of removing debt objections is that it might increase the incentives on suppliers to target debt earlier. There is little quantified evidence on the impact on bad debt of removing objections, though virtually all domestic suppliers said debt would be harder to collect. By way of comparison, we see the monetised impact on tariffs of removing debt objections as being 'medium to high' (though this is of course uncertain).

**Impact of introducing debt flagging**

5.9 It is not clear that a system of debt flagging would improve the position of the debt blocked customer. From an indebted customer's perspective, the likely impact is that they will have to shop around for suppliers willing to take them on, with no guarantee that would happen. Given that around 70% of indebted customers are currently allowed by their suppliers to switch without objection, a debt flagging system could make their experiences worse. However, this would depend on the flag threshold level.

5.10 If debt-flagging were successful in enabling indebted customers to switch it could increase the risk of bad debt and indebtedness as customers increasingly saw indebtedness as something that can be walked away from. Debt flagging could lead to an increase in supplier costs and, as a result, to an increase in bills for all customers. In addition, it could also lead to an increase in credit management practices at the point of customer sign up, which would be likely to have a negative impact on the market experience of all consumers. It could also lead to more aggressive debt collection, such as DCAs and litigation, without the protections provided by the existing supplier.

**Impact of extending the Debt Assignment Protocol (DAP)**

5.11 The alternative approach of extending the DAP from PPM to any indebted customer seems unlikely to address any of the concerns associated with removing debt objections. Indeed, it could have serious impacts on market behaviour and the opportunities (and risks) for new entrants. Under an extended DAP, suppliers could lose control of the amount of debt they had to take on. This could result in suppliers only accepting credit customers under the DAP if they agree to have a PPM installed or pay a security deposit.

5.12 As switchers under the DAP would be moving to the suppliers with the lowest prices, those suppliers offering lower prices may find themselves with a disproportionate share of the industry's debt. This could cause a loss in competitiveness. The risk of ending up with a disproportionate share of the industry's debt could also deter new entrants, who would need to find additional capital to fund the debt they would be required to buy, without knowing the likely size of this debt.

**Improving suppliers' communications with debt blocked customers**

5.13 The low percentage of debt-blocked customers who switch to a better tariff with their existing supplier indicates that the consumer harm associated with missing out on bill-reducing tariff deals could be addressed more directly and proportionately. Our approach will be based on encouraging suppliers to make more effort to switch indebted customers onto better tariffs.

5.14 In particular, suppliers could become more effective at communicating the importance of tackling debt early and directly signposting to sources of help rather than promising direction if the customer gets in touch. In addition, suppliers could do much better in terms of advertising alternative tariff savings (and effect on debt repayment speeds) to debt blocked customers. Doing so could enable more indebted customers to reduce their debt more quickly with their existing supplier. This would avoid the detrimental impacts on consumers that would be likely to arise if debt objections were removed.

**Overall assessment**

5.15 Our overall assessment is that retaining debt objections is in the interests of domestic consumers. The net benefits to domestic customers of doing so are likely to outweigh the financial gains that indebted customers might accrue from changing supplier (at a similar rate as the general population). Most of these gains could be realised if these customers switched tariff with their existing supplier. To stimulate greater engagement by indebted domestic customers, suppliers should improve the quality of their communications, including debt objections letters. We set out details of how they should do this in our decision letter.