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British Gas response to supplier objections: a call for evidence

Dear Andy,

British Gas is fully supportive of a market that ensures consumers can easily and confidently change their energy supplier and have been working closely with Ofgem and industry towards a faster switching process. We therefore welcome this opportunity to input into Ofgem's review of the objections process.

When assessing whether any reform of the ability to object to a customer transfer is beneficial and/or necessary, it is important to consider the following questions, which we have explored in the detail of our response:

a) the impact of any reform on customers;
b) the rationale and benefits provided by the prevailing objections process and whether circumstances have changed sufficiently to justify reform;
c) any distributional impacts or material costs associated with reform, particularly given Ofgem's statement that it will not "pursue policies that involve significant imposition or redistribution of costs among consumers"[1];
d) the impact of reform on the ability of suppliers to manage and recoup debt, any impacts upon competition and market entry;
e) the specific characteristics of the energy market relative to other markets and whether a different approach to customer transfers is justified; and
f) the different characteristics of the domestic and business supply markets and the suitability of reform options for those markets.

Given these considerations, we have concluded that it is difficult to make a case that the benefits to customers of removing the objections process outweigh the potential disbenefits of uncontrolled bad debt, increased use of security deposits, increased credit checking, higher prices, refusals to offer terms and a greater requirement for prepayment meter installation.

However, in the domestic market, we think there is benefit in exploring the potential to widen the application of the debt assignment process, and to streamline it to make it work within the same or next day switching process. We would like to work with Ofgem to explore this possibility.

We do not think the same opportunity exists in the nom domestic market where we have concluded that any objections reform only presents downsides, particularly for those non-domestic consumers that have limited free cashflow or those that are less creditworthy. As the level of debt in the non-domestic market is often significant, allowing a capped amount of debt to transfer on a change of supplier is unlikely to be a feasible solution as it will only a capture a small proportion of the market.

[1] Ofgem Forward Work Programme 2015-16

Our responses to the specific questions posed in the call for evidence are appended to this letter. We have provided a separate appendix for both the non-domestic and domestic sectors. Where a response is applicable to both sectors it has been signalled clearly. If you have any questions please contact Tabish Khan in the first instance at Tabish.khan@britishgas.co.uk.

Yours sincerely,

Sharon Johnson
Director of Regulatory Affairs

Appendix: Evidence relating to non-domestic consumers

This appendix refers specifically to non-domestic consumers, though many of the points raised below are also applicable to domestic consumers. Where our views differ, they have been clearly set out in the domestic appendix.

Does the ability to object work for or against consumer interest?

Objections facilitate suppliers' recovery of debt by preventing customers from leaving until they have paid off their debt. Objections also enable suppliers to offer long term fixed price contracts as they ensure customers honour their contractual commitments. Therefore, objections are vital to reducing risk and cost to all suppliers which would otherwise manifest in higher charges to customers.

In particular regarding debt objections, these rights ensure a greater rate of debt recovery for suppliers and this prevents large amounts of debt being socialised across our wider customer base. If British Gas was unable to object to a customer leaving while in debt, or within their contracted period, then the customer may not pay back their outstanding debt or any relevant exit fees thus forcing British Gas to increase the operational costs of debt collection.

This cost and the increased risk of debt would mean that British Gas would have to either absorb these costs and / or seek to pass it on to our wider customer base.

The current objections mechanism is a cost-effective method of balancing the objectives of, (a) maintaining the supply of an essential service, (b) minimising the risk and cost of non-payment, (c) keeping prices low, and more generally (d) protecting consumers' interest overall.

Ofgem question: Is the existence of any objections regime consistent with an energy market in which all customers should be able to switch supplier readily?

Yes.

Whilst we recognise that objections will halt some customers' switching processes, where they do not pay their debt or are bound by contractual conditions which they signed up to, we believe this impact is outweighed by the benefits of having objections as a part of the switching process. Overall, we believe that removing the objections process would be contrary to customers' interests for the reasons set out below.

In the absence of the objections process, the alternatives will act as a constraint to switching. Indebted customers are typically less able to pay, i.e. typically can't pay rather than won't pay. Removing the ability to object for debt would likely mean that these customers are asked to pay a security deposit up front in order to switch supplier, whilst at the same time still owing money to their previous supplier.

If the customer is not able or unwilling to provide a security deposit, they may find that no supplier is willing to offer them terms, or at least not affordable terms, thereby impacting the customer's ability to switch. Under the current arrangement, an objection for debt would allow these customers to pay their debt off over a longer period of time (via a payment plan) to their current supplier. This is likely to be a more affordable option than requiring a lump sum for a significant security deposit upfront in order to enter into a new contract.

We also consider that the removal of the ability to object for debt would have negative impacts on competition. The increased bad debt risk would likely deter companies from entering the market thus reducing all customers' choice of supplier, and could impact existing players differently and arbitrarily depending on their prevailing customer base. Suppliers who currently have more debt-laden customers, for reasons outside of their control, may be more severely financially impacted than others. The resulting impact on competition would not enhance a customer's ability or options to switch.

Ofgem question: Does the objections regime place sufficiently strong incentives on suppliers to proactively identify customers who may be struggling to pay and at risk of falling into debt?

Yes.

British Gas monitors payments and bills to identify customers falling into debt or struggling to pay. We then offer them advice, directing them to independent support services such as Business Debtline, and we offer extended payment plans. We assess customers' credit worthiness regularly and determine their risk of defaulting on a bill payment so that if this happens then British Gas can treat that customer accordingly and help them repay any debts owed. Disconnecting customers is only carried out as a last resort.

Recovering debt in a sustainable manner is extremely important to British Gas. It ensures that we maintain a strong customer relationship and it also decreases our costs as following-up unpaid debts with court proceedings and warrants is both costly to us and can irreparably damage the customer relationship.

Ofgem question: Do non-domestic suppliers comply with objection requirements and do they move their customers inappropriately onto more expensive rates?

British Gas has rigorous controls in place to ensure that we are fully complying with our objection obligations. Following our well publicised licence breach in this area, we have made sure that we have robust processes and controls in place to ensure we are fully compliant.

When we do object to a customer switching it is either because there is outstanding debt or they have given insufficient notice to leave in accordance with their contract. The price the customer is charged does not change as a consequence of an objection being raised - the price they pay before and after the objection is the same whether the objection is raised for contractual reasons or because of debt.

At the end of a fixed term contract a customer's price will change unless they negotiate a new fixed term contract or they move to a different supplier. The prices we offer a customer are the same if no attempt at withdrawal has been made, or if we have objected to a customer leaving supply on grounds of debt.

<u>What will be the impact of the proposed reform options?</u>

The non-domestic energy market is highly competitive and objecting to a customer transfer is a mechanism that enables suppliers to offer the most attractive propositions to customers.

British Gas considers the current objections process to be a low cost and effective way of managing credit risk and therefore it is important that it remains in place. Any change to the status quo will require substantial system and operational changes with both capital and operating cost implications. These changes would be felt by all market participants and so the associated costs will ultimately flow through to consumers.

Ofgem question: What will be the impact of abolishing debt objections in the non-domestic market?

The ability to object for debt gives certainty to suppliers that a customer cannot accrue a significant debt and leave their supplier without paying it. This certainty allows suppliers to provide lower prices and keep bad debt contingency costs as low as possible.

For business customers, current debt recovery rates are [redacted] for small and medium sized enterprises (SMEs) and over [redacted] for industrial and commercial (I&C) customers. As a proxy for what would happen if we were not allowed to object for debt, we can use recovery rates for debts with customers who have left us, i.e. debts on final bills. For these debts the recovery rates are [redacted] for SME and [redacted] for I&C customers. This clearly shows the marked difference in debt recovery between a customer who remains on supply and a customer who is allowed to leave.

Another proxy can be drawn to illustrate what would likely happen to Bad Debt levels if the ability to object for debt was removed. As a proportion of revenue by product type from 2013, Bad Debt on fixed term contracts was [redacted], whereas for Deemed customers, where we are unable to object for debt, the Bad Debt rate was [redacted]. While Deemed customers are not a direct proxy for customers in general, this marked difference in Bad Debt rate does provide clear evidence of the direction absolute Bad Debt levels are likely to take if objections are removed.

If the ability to object to debt were removed, then a supplier is likely to implement some or all of the following risk mitigation options:

a) Larger and more frequent use of security deposits to address the risk of a customer incurring a debt and leaving before they pay it off;
b) Higher prices that reflect the increased risk and level of bad debt,
c) Refusal to offer terms to higher credit risk customers or customers who have not paid off their debt with a previous supplier, and
d) A greater number of disconnections to avoid debt continuing to accrue.

These impacts will affect all customers, including those who pay their bills on time, and therefore is likely to act as a barrier to switching.

The increased risk of removing objections for debt may also act as a barrier to entry and a barrier to growth for new suppliers, who typically require greater cashflow certainty due to their smaller size and financing arrangements.

Ofgem question: What will be the impact of abolishing all contractual objections in the non-domestic market?

The business energy market has evolved to meet customer demand and has resulted in [redacted] of British Gas customers electing to go on to fixed term fixed price contracts. Suppliers are able to offer the cheapest prices to customers by agreeing a fixed term for the contract. If there is certainty that a customer will honour the full term of their contract it allows the supplier to buy the energy in advance and so hedge any wholesale cost risk.

Removing the ability to object for contractual reasons will undermine the fixed term market, remove some of the most popular customer propositions and result in higher prices for many customers.

If the ability to object was removed where a customer had provided insufficient notice or where they were in a fixed term period, then a supplier is likely to implement some or all of the risk mitigation options highlighted in our previous answer on the impacts of abolishing debt objections. In addition to those options, suppliers are also likely to require larger and more frequent use of security deposits in return for offering a fixed price over an extended fixed term to mitigate any hedging exposure if the customer was to leave mid-term.

Removing objections may also impact the energy performance market as some of these propositions are tied into fixed term contracts and are reliant on certainty to deliver the lowest cost solutions to customers. This market often involves the installation of equipment with no payment required upfront, with the cost being recovered through monthly instalments based upon measured savings in energy consumption. This may not be possible if there is no longer a market for fixed term energy contracts as the two are usually offered to customers as a package. Many customers prefer to have one relationship for energy supply and energy performance and this may no longer be viable if long term fixed contracts were to carry a large amount of financial risk.

Third party intermediaries can also be reliant upon customers fulfilling the full length of their contract, as their commission is often linked to the supplier receiving payments throughout the length of the customer contract. Removing the ability to object for contractual reasons would therefore reduce the predictability of cash flow for third parties, who may react by requiring larger commissions from customers upfront thus acting as an additional barrier to switching.

Other parties may also be impacted by a reduction in fixed term contracts. Generators and traders also contract and operate to meet the demand for fixed term fixed price contracts. If the ability to object for contractual reasons was removed then these parties would also be impacted and may have to change their hedging and forecasting strategies.

In summary, if objections for contractual reasons are removed it will constrain the products and propositions available in the market which may mean customers are not able to choose products and propositions that are best suited to their specific requirements. This intervention has the potential to significantly impinge innovation and significantly harm a highly competitive market resulting in detriment to both consumers and suppliers.

Ofgem question: What other options should we consider, for example from other British or international markets?

In most markets where a customer does not pay upfront and in full for a good or service, the supplier of that good or service is able to withhold or withdraw supply. This ability acts as an incentive for customers to pay for what they use, and protects the supplier from the risk of non-payment. Suppliers in those markets are thus able to offer goods and services more cheaply than they would otherwise have done if they had to incorporate the extra risk premium into their prices.

Electricity and gas are unlike many other products in this regard; they are an essential service, whether that be to heat or power a home or run a business, which should be provided at the most competitive price possible and only removed as a last resort. Both of these points should be taken into account when comparing the GB energy market with other markets.

There is risk in drawing comparisons from markets where customer churn is lower than the competitive GB energy market, or where there are fewer suppliers. As switching levels in these markets are low the impact of removing the ability to object to debt would be also lower and this would not be an appropriate comparison.

There is also a risk in drawing comparisons with markets where disconnection is used earlier in the debt path to incentivise customer payment and minimise supplier losses. For example, some European countries[2] allow for an energy customer to be disconnected if they have not paid their debt, and in many of these cases the customer may well have to pay a reconnection fee to their supplier or network operators if they wish to come back on supply. In many of these countries suppliers are also able to terminate a supply contract, forcing the customer to find another energy supplier. We consider both these practices to be worse for consumers than what currently occurs in Britain.

In markets where the ability to object for debt has never existed, companies knew the risks at market opening and will have reflected this in their investment outlook and decisions. By introducing reform to objections after the market has opened, Ofgem would fundamentally change the basis on which companies operate and finance their activities. It would be prudent to only draw comparisons with markets where the right to object for debt has existed and has been subsequently removed. Ofgem should also consider the impact of reform on investment in the sector and its duty to ensure that licensees can finance their activities.

Ofgem question: What will be the impact of allowing debt to transfer on a change of supplier?

The ability to transfer debt on a change of supplier will prove difficult as many business customers can accrue large debts; debt levels even for micro-business/SME customers can be substantial. Many suppliers would not want to take on such a large debt upon a change of supply, especially if the gaining supplier had limited cash flow or a smaller balance sheet.

If there was a cap on the transfer of debt then reform may capture only a minority of customers. This is likely to result in the implementation costs becoming disproportionate, given the lack of discernible benefit.

Ofgem question: What would be the impact of abolishing objections relating to erroneous transfers?

There is insufficient information within Ofgem's document for us to assess the full impact of this option. It is important that any change does not prohibit a supplier from objecting to a transfer if the customer, or the supplier believes the customer, is being transferred erroneously.

[2] Countries such as Austria, Czech Republic, Netherlands, Norway and Sweden.

Ofgem question: What would be the impact of abolishing Green Deal related objections?

Suppliers do not object for Green Deal debt, only if a customer with a Green Deal has a debt on their energy supply. Therefore we do not consider this as an option that is separate from abolishing objections for debt, and our response to that question is equally applicable here.

Ofgem question: What would be the impact of abolishing objections for related metering points?

There are a number of reasons why electricity customers can have more than one meter point administration number (MPAN), these include:

- where they have an auxiliary load on a separate electricity circuit; therefore more than one MPAN is needed to record the usage on separate registers before they are entered into settlement and used for billing, and
- where a premise or site is supplied by more than one meter point.

In both these instances it is in the customer's interest that the supplier is able to object if only one of a set of related metering points is allowed to transfer. If this ability was not available then the customer may not be able to choose to have a switched load tariff (e.g. Economy 7) or one contract for the entire site – both of these options are likely to be cheaper and easier to manage for the customer than any alternative proposition.

The amount of objections due to related metering points is low - circa 2% of total objections - however removing this ability would hinder the effective operation of the market and would detrimentally impact customers. Moreover, given its infrequent but important use, we do not see it as a material blocker to switching and therefore strongly recommend that this ability is retained.

<u>When should any objections reform be implemented?</u>

We do not believe there is any evidence to indicate the status quo arrangements have any detrimental effect on consumers, but there are considerable proof points to the contrary. Therefore, we do not consider that any objections reform should be implemented in the non-domestic market.

If however a compelling case for objections reform can be made then the following hurdles need to be fully taken into account:

- Triggering a change to the objections for debt process at the point a smart meter is installed may inadvertently create an incentive on suppliers to delay installing smart meters, as the installation will become linked with a more risky and costly approach to debt management.

- It will be impracticable and inappropriate to alter terms in existing customer contracts and so to protect consumer trust, implementing any new process must be aligned to contract start or renewal.

- Existing fixed term contracts have been priced based on the existing market arrangements, and therefore any objections reform should become active after those fixed term periods have concluded. Without the ability to object to transfers of these customers, whose consumption we have hedged in the wholesale market, suppliers could be significantly financially exposed pending the ability to close-out those trading positions.

- Any change to objections that allows debt to transfer on a change of supplier will necessitate changes to suppliers' billing systems and operational processes. Therefore if objections reform proceeds, it should be considered as part of Ofgem's Target Operating Model work programme to discover whether efficiencies in implementation can be achieved.

- The Competition and Markets Authority's (CMA) Market Investigation is ongoing. Before proceeding beyond this Call for Evidence, Ofgem should ensure that the CMA's investigation does not impact on this area, thus avoiding any dual or conflicting regulation.

Appendix: Evidence relating to domestic consumers

In this appendix we have only provided responses where either (a) the questions relate specifically to the domestic market (b) our response is different to our response for the non-domestic market, and/or (c) we have points to add to our non-domestic response. We have clearly indicated where responses fall into the latter category.

Ofgem question: Is the existence of any objections regime consistent with an energy market in which all customers should be able to switch supplier readily?

Yes. See non-domestic response for key points of principle.

Our non-domestic response refers to suppliers refusing to offer terms and we note that this is not permitted under a domestic supply licence and therefore British Gas would not refuse to offer terms to a domestic customer.

Whilst we accept that the ability to object to a change of supplier provides a barrier to switching, it is worth noting that some indebted customers switch onto a cheaper tariff and [redacted] of customers objected to for debt subsequently pay off their debt and switch to another supplier.

Ofgem question: How many domestic customers, following an objection:

- **are provided with energy efficiency and debt management advice**
- **decide to switch to a cheaper tariff with the same supplier**

In line with our obligations British Gas ensures that following an objection all customers receive debt and energy efficiency advice so that they have options to better manage debt and reduce their energy usage. The numbers below set out how many customers received this advice following an objection, over the previous three years:

[redacted]

We also allow customers to transfer between tariffs irrespective of how much debt they have and below are the figures for the last three years of customers who switch to a cheaper tariff after an objection:

[redacted]

This is not a large percentage of customers but it does demonstrate that switching tariff with the existing supplier is an option available to customers.

Ofgem question: Does the objections regime place sufficiently strong incentives on suppliers to proactively identify customers who may be struggling to pay and at risk of falling into debt?

Yes. See non-domestic response for key points.

In the domestic sector there are organisations such as StepChange that we can refer customers to who can provide further guidance on debt and energy efficiency to customers, both over the phone and in face to face sessions.

We would also add that we have not disconnected a domestic customer for debt since February 2010.

What will be the impact of the proposed reform options?

British Gas would like to work with Ofgem and industry to try to design an objections process for domestic customers that meets the criteria set out in our covering letter.

Ofgem question: What will be the impact of abolishing domestic debt objections?

See non-domestic response for key points.

It may be possible to use the recovery of final debt (i.e. for a customer who has left us) as a proxy for the ability to recover debt without an available objections process. For residential customers the recovery rate for customers we are able to object to is circa [redacted]. But for final bills this recovery rate drops to circa [redacted].

Removing the ability to object for debt without transferring the debt would remove a control against serial switching, where a customer keeps changing supplier to avoid paying bills without facing the risk of disconnection (which is only used as a last resort). It is a risk that is more relevant for the domestic sector where fewer customers have opted to be tied into fixed term contracts. This is a serious risk that we have also flagged in our response to Ofgem’s consultation on the change of supplier Target Operating Model.

What will be the potential impact of allowing debt to transfer on a change of supply?

The transferring of debt option put forward by Ofgem should be explored further to consider the impact on supplier cash flow of customers switching to or away from a supplier (a) at all and (b) within a short timeframe, and the ability to introduce a quick and customer friendly process that operates within the Target Operating Model framework for “next-day switching”.

If the ability to transfer debt to the winning supplier was introduced, then high volumes of customer transfers may have more negative consequences for suppliers than we see today. For example, if debt transfers alongside customer accounts in a collective switch the gaining supplier may take on a large amount of debt within a short space of time, with detrimental impacts on its financial position. Becoming suddenly more indebted could impact supplier cash flow, the ability of the supplier to borrow money and its credit rating.

This issue is not specific to collective switching and is also likely to impact supplier cash flow when a large amount of customers come to the end of a fixed term contract or a popular new proposition is launched.

We note that there is currently a debt assignment protocol (DAP) in place, which enables prepayment customers to transfer debt of up to £500 on a change of supply. The DAP to date has seen limited take up so far, and this is likely to be because it is a complex process for the customer and does not automatically assume that debt can transfer between suppliers.

We are working with other suppliers through Energy UK to improve the current DAP and this may address the reasons why there has been limited take up to date.

If we are to consider allowing debt to transfer for all customers, then a more streamlined process than the current DAP would be needed. We further note that any improvement or successor to the DAP will need to be compatible with the Target Operating Model work taking place to implement change of supplier reform.

Ofgem question: What other options should we consider, for example from other British or international markets?

See non-domestic response for key references to other types of markets.

In order to gain insight into the potential impact of removing the ability to object for debt in a domestic market, a useful comparator is the UK water sector, where the ability to disconnect for debt existed and was subsequently removed in 1999.

We encourage Ofgem to investigate the impact of these reforms on debt levels in the water industry and on water prices charged to consumers.

Based on some initial research, it is our understanding that by 2005 the amount of customer debt in the domestic water sector had increased 17% and aged debt by 71%. This meant that bills needed to rise to recover this extra money. If removing the ability to object for debt had the same magnitude of impact in the GB domestic energy sector, then this would result in a significant amount being recovered from the wider customer base.

Ofgem questions: What will be the impact of smart meters on suppliers' ability to manage credit risk and the implications of this for suppliers' right to object?

Smart meters will enable suppliers to more proactively manage customer debt, for example we will be able to better determine when customers may be getting into payment difficulties. Following earlier identification of payment difficulties, suppliers will be able to take steps to offer customers advice that may lead to customers changing their behaviour and accruing less debt than they otherwise would have done. Suppliers may also be able to switch the customer's smart meter to prepayment mode, with the customer's prior agreement or notification, and this would reduce their ability to get into debt. It is in suppliers' interest to help customers reduce their exposure to debt as it will remove the costs of having to recover this debt and should ultimately ensure greater customer satisfaction.

However, smart meters will not remove the root causes of customer indebtedness, such as the ability of customers to pay their bills, which is related to their personal circumstances and not the behaviour of an energy supplier. Irrespective of whether and how swiftly suppliers can identify any problems that customers may be experiencing in paying their bills; suppliers still have a limited ability to resolve the underlying issues causing the debt to accrue.

With the rollout of smart meters, British Gas will continue to offer debt and energy efficiency advice to customers and refer them to advice agencies when it is appropriate to a customer's particular needs.

Ofgem question: Will smart metering remove the need for objections for related metering points?

Some electricity customers have two meter point administration numbers (MPANs) where they have an auxiliary load on a separate electricity circuit; two MPANs are needed to record the usage on two separate registers before they are entered into settlement.

This circumstance is likely to disappear once smart meters are installed, as the meter will be capable of interfacing with two separate circuits using one meter and one MPAN.

However, related metering points may still be needed for innovative propositions that may be offered in the future. For example, if a customer has two auxiliary loads (i.e. a storage heater and an electric vehicle) both operating at the same time but on separate rates, then two MPANs would be needed to ensure the customer data is entered into settlement correctly.

As dual MPAN arrangements may facilitate innovative tariffs and less than 1% of all objections are due to related metering points, we do not see it as a material blocker to switching and therefore recommend that this ability is retained.

<u>When should any objections reform be implemented?</u>

We would like to work with Ofgem to determine whether any improvements to the existing objections regime may be made. The hurdles identified in our non-domestic response would also apply here and they would need to be addressed before any reform is implemented.