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Marcus McPhillips
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Ofgem
10 Canary Wharf
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Dear Marcus,

STATUTORY CONSULTATION ON INTRODUCING AN ALLOWANCE FOR BAD DEBT ASSOCIATED WITH ADDITIONAL SUPPORT CREDIT

We welcome the opportunity to respond to this statutory consultation on introducing an allowance for bad debt associated with Additional Support Credit (ASC).

We recognise suppliers' role in supporting vulnerable customers when they are at risk of self-disconnection and the value of ASCs in mitigating this risk. We have seen demand for ASCs increase and expect this to continue over the coming winter given high energy bills and the wider cost-of-living crisis. We see these ASC payments (and the associated bad debt) as an efficient cost and support Ofgem's proposal to introduce a mechanism to enable suppliers to recover such costs.

Our comments on the statutory consultation are provided in Annex 1 and our key points are as follows:

<u>Need for a levy-based approach</u>

Ofgem is proposing to allow suppliers to recover ASC bad debt costs via a price cap allowance based on the weighted average of ASC costs across suppliers. A problem with such a 'one size fits all' approach is that suppliers have widely varying customer bases with different levels of need for ASCs and different likelihoods of repaying the resulting debt. Suppliers whose prepayment customers are more financially vulnerable than average will under-recover (and vice versa), creating significant competitive distortions. To best support customers with ASCs, suppliers should receive support that is proportionate to the need of their customer bases. We note that Ofgem had committed to reviewing alternatives to the cap for efficient recovery of debt related costs but has "*not identified an appropriate mechanism, or consensus of views*"[1]. Ofgem should move quickly to consult on appropriate methods of compensation to fully explore the options

[1] [Price cap – Update on debt-related costs review | Ofgem]

and consider industry consensus. This should include a levy or other bespoke mechanism to compensate individual suppliers for their efficient ASC bad debt costs.

<u>ASC bad debt allowance and incentives</u>

In the absence of a levy or more bespoke approach, we agree that the best alternative cost-recovery measure would be to introduce an allowance into the PPM price cap. However, we are concerned that Ofgem's proposed float and true-up ASC allowance may not adequately incentivise suppliers to provide the level of ASC support to their customers that Ofgem intends.

We propose an alternative approach that will better encourage efficient spend based on efficient costs without counteracting incentives. We suggest that suppliers are required to report on the difference between actual ASC bad debt incurred and money received through the allowance, with any excess in receipts being paid into the supplier's vulnerability fund. This should ensure that suppliers are better incentivised to spend the allowance.

<u>Level of ASC allowance</u>

We further consider that is important that the allowance is adequate to deliver its goal of allowing suppliers to deliver ASCs to customers. We consider that ASC bad debt is less likely to get repaid than general PPM bad debt and as such propose Ofgem uses at least the high scenario of £17.90 per customer. Given the uncertainty, we propose that Ofgem issues a targeted RFI to gather more up-to-date information on trends in ASC payments and bad debt incurred. The risk of miscalculating the allowance would be that suppliers' funds are inadequate to last the full year and are used up in the initial winter period.

Please contact me or my colleague Dena Barasi if you would like to discuss this further.

Yours sincerely,

Richard Sweet
Director of Regulatory Policy

Annex 1

STATUTORY CONSULTATION ON INTRODUCING AN ALLOWANCE FOR BAD DEBT ASSOCIATED WITH ADDITIONAL SUPPORT CREDIT – SCOTTISHPOWER RESPONSE

1. Alternative to the price cap to support customers with ASCs

Ofgem is proposing to compensate suppliers for the bad debt costs associated with ASC payments via a price cap allowance. We do not consider that a price cap allowance is an equitable means of compensating suppliers. Each supplier will have a different prepayment meter customer base with varying propensities to request ASCs and accrue bad debt. Giving each supplier a uniform allowance, regardless of their customer mix, will inevitably create winners and losers and introduce competitive distortions between suppliers. Ofgem should reconsider the price cap allowance approach in favour of a levy mechanism, which would support suppliers and their customers more effectively.

We note that Ofgem previously committed to reviewing alternatives to the cap for efficient recovery of debt related costs but states it has "*not identified an appropriate mechanism, or consensus of views*"[1]. We believe Ofgem has concluded prematurely on this issue and should consult with more detail on appropriate methods of compensation to fully explore the options and consider industry consensus. The options should include a levy or bespoke mechanism to compensate individual suppliers for their efficient ASC bad debt costs.

2. Supplier incentives to make ASC payments

Suppliers have a licence obligation to provide ASC payments in certain circumstances and their discretion as to whether to make ASC payments is therefore constrained. However, notwithstanding these licence obligations, we think that suppliers will in general have a reasonable degree of latitude as to how generous (or otherwise) their ASC policy is.

If Ofgem's intention through this new allowance is to provide better support for vulnerable customers on PPMs, it is important that Ofgem creates the right incentives for suppliers to offer more generous ASC payments. One of the drawbacks of a 'one size fits all' price cap allowance is that suppliers receive the allowance revenue regardless of how many ASC payments they make. The value of ASC payments made (and resulting bad debt) may be captured in a final true-up exercise, but even then, the impact on an individual supplier is diluted through the calculation of a weighted average. This means that, other things being equal, suppliers still have an incentive to minimise ASC payments and the associated bad debt costs.

We believe that the incentives on suppliers could be better aligned with Ofgem's objectives if:

- Suppliers are required to report each year on the value of ASC payments and associated bad debt incurred;
- Where the cost of ASC bad debt is less than revenue received via the price cap allowance (net of any true-up adjustment), the supplier is required to pay the difference into the supplier's vulnerability fund.

[1] Price cap – Update on debt-related costs review | Ofgem

- Where the cost of the ASC bad debt (net of any true-up adjustment) is greater than the allowance, consideration should be given for the 'overspend' to be carried forward to future years (if the allowance becomes enduring).

The ability to carry forward 'overspend' would help mitigate the risks associated with seasonality, where suppliers may "use" most of their ASC allowance early in the winter period and then feel constrained to limit their ASC payments later in the year. This risk is higher if the allowance is fixed and based on a weighted average using data that is not up to date and therefore does not reflect the latest conditions.

3. Should allowance apply to unit rate or standing charge?

The Energy Price Guarantee (EPG) scheme, which aligns the amount PPM customers pay to the DD cap, is due to run until March 2024. Thereafter we assume that PPM rates will continue to be levelised, possibly via some new mechanism such as consulted on recently by Ofgem[1].

Although the EPG scheme currently provides discounts only to PPM unit rates, we understand DESNZ is considering amending the scheme so that it applies the discount to the standing charge element only from October 2023.

Depending on how DESNZ decides to apply the EPG discount from October, it may make more sense for the ASC bad debt allowance to be applied to the standing charge rather than the unit rate.

4. Methodology for setting ASC bad debt allowance

We have the following comments on Ofgem's ASC bad debt allowance methodology:

<u>Weighted average</u>

We agree it is appropriate to calculate a weighted average across suppliers.

<u>Scaling Factors</u>

Ofgem uses analysis of previous years' debt growth to forecast ASCs and ASC bad debt for the twelve months April 2023 to March 2024. Ofgem projects these figures in three different scenarios, using 'scaling factors' influenced by the observed multiplier difference in ASC and ASC bad debt between 2021/22 and 2022/23.

We agree with this approach for total ASCs issued. But we do not agree with the approach to bad debt provisions since, in our experience, debt for ASCs (as a subset of debt for PPM customers) is less likely to be repaid than PPM debt in general. This is because households requesting ASCs will in most cases be in a much weaker financial position than the generality of PPM customers, in particular if these households have existing debt. As such we consider that provision for bad debt for ASCs should be higher than that for other customers on PPMs.

On that basis we think Ofgem should use at least its high scenario, with a higher provision rate for ASC debt, leading to a £17.90 per customer ASC allowance.

However, given the uncertainty of these estimates, we propose that Ofgem issues a targeted RFI to gather more up-to-date information on trends in ASC payments and bad debt incurred.

[1] Call for evidence on levelising payment type cost differentials (ofgem.gov.uk)

The risk of miscalculating the allowance would be that suppliers' funds are inadequate to last the full year and are used up in the initial winter period.

Time period

In paragraph 11, Appendix 1, Ofgem describes how it calculates the bad debt provision rate using weighted average ASC and ASC bad debt data for Oct 22 – Sep 23. We have concerns about the use of a mixed set of actual data (Oct 22 – Mar 23) and forecasted data (Apr 23 – Sep 23) to calculate the bad debt provision rate for two reasons:

- The scaling factors are only applied to months Apr 22 – Sep 22 to calculate forecast data for Apr 23 – Sep 23. Demand for ASCs and its associated bad debt is cyclical, peaking in the winter months. Therefore, using actual data for the winter period and uplifting the summer period twice[2] may underestimate the impact. We consider that Ofgem should issue a short term RFI focused on the issue of ASC levels and ASC bad debt and update accordingly.

- Ofgem calculates the bad debt provision rate using a weighted average but does not discuss how or whether it forecasted customer numbers for the period Apr 23 – Sep 23.

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[2] first from April - September 22 to April - September 23 then to April - September 24