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Dear Leonardo

We are writing in response to your consultation on the true up process for Covid 19 costs. This submission is non-confidential and may be published on your website. We structure it around the chapters in the working paper.

Chapter 3: Bad debt costs

We think it is important that any revision to the cap resulting from this process is proportionate. You currently appear to envisage the potential for multiple true ups, with reference to 'a first true-up in cap period 9 (October 2022- March 2023)' appearing to pave the way for subsequent true-ups. The initial floats allowed for bad debt costs amounted to £23.69 for a typical dual fuel customer in cap period 6 and £8.86 in cap period 7. While the scale of the true-up is not yet known, as you have not yet carried out the information gathering exercise to support it, it may therefore be possible that it could be in the low single digit pounds, or possibly pence, per household. It may not be appropriate to carry out multiple true-up rounds if the scale of any correction is nugatory. Indeed, you may wish to rule out carrying out any true-up at all if the final sum involved is small. This may be preferable to creating a precedent for very small value corrections necessitating re-opening the price cap.

In the event that any true-up is for a much larger amount, the impacts of this should be taken into account when determining the timing of any cost recovery from consumers. You currently envisage a first true-up, covering cap periods 4-6, taking place in cap period 9, covering next winter (October 2022 - March 2023). As you are aware, household energy use is much higher in winter months and evidence of payment distress and its societal consequences (i.e. people living in cold homes) are more pronounced at that time of year. Sustained high prices in wholesale markets are starting to suggest that the cap will already be set at a high level for that period. In the event that the true-up process results in a determination to recover substantially more revenue from consumers, we think you should consider either moving that cost recovery period to a subsequent summer cap period, or spreading it over several cap periods, to mitigate the bill shock it may cause.

Your consultation suggests two possible approaches to determining additional bad debt costs associated with the pandemic: a cumulative bad debt charge approach that effectively re-uses existing supplier management accounts; or a bottom-up approach which would try to build a picture of debt from supplier information requests. The description of these two approaches suggests that the latter might be more accurate but would likely be more burdensome on both suppliers and Ofgem. The consultation does not give any indication of the relative costs of the two approaches, nor of the likely scale of any true-up, and in the absence of that information it is not possible for us to reach a view on whether it is proportionate to take the 'lighter touch' cumulative bad debt charge approach.

We note that the data provided by suppliers is likely to be unaudited and that you propose to reserve the right to check the figures you have been given against future audited figures. This appears sensible to us. We also note that past management accounts will have been audited, and think you should seek upfront assurance that past audits of management information that you are using have not identified any issues.

The cumulative bad debt approach relies upon supplier judgements when making provisions for bad debt. This includes provisions that will be made in future periods (until September 2022). As the consultation recognises, this means that new provisions may reflect impacts on the risk of bad debt due to factors other than the pandemic, such as the current high energy prices. Suppliers should be required to provide commentary on the judgements made and any changes made to provision methodologies (compared to that used in the benchmark period). Ofgem should reserve the right to ignore or adjust provisions where the judgement is not sufficiently justified or the methodology used has changed.

Your suggestion to use a minimum of 12 months of historic data to establish a baseline level of bad debt costs appears reasonable to us, as does the choice of the periods October 2018 - March 2019 and April 2019 - September 2019 to provide that baseline, although we note that the price cap (for standard credit and direct debit customers) was introduced halfway through the former period. It is possible that its introduction may have changed how suppliers apportion bad debt between different groups of consumers.

We agree with your proposal to seek to differentiate between bad debt attributed to prepayment customers and that associated with other payment methods, in order to appropriately attribute these costs.

Chapter 4: Other debt related costs

We do not support your proposals concerning other debt related costs.

Debt-related administrative costs

You highlight that the issue of debt-related administrative costs has already been consulted on twice, with supplier responses initially failing to be of adequate quality to calculate a figure, and then subsequently providing data that suggested these costs were not material:

> *'In our February 2021 decision on the float, we decided not to include an adjustment for debt-related administrative costs. This was because of the poor quality of the data received from our voluntary RFI. In our August 2021 decision on the float for cap period seven, we also decided not to include an adjustment for debt-related administrative costs. This was because the lower quartile benchmark for the incremental debt-related administrative costs for credit and PPM customers for cap period seven was not material.'*

Given these past conclusions, we do not understand why this category of costs is being consulted on for a third time. Suppliers have already had adequate opportunity to evidence any case for additional funding of this type.

Working capital

You highlight that *'data and discussions with suppliers suggest that there has been an increase in late payments due to COVID-19. We understand that delayed payments will impact suppliers' cash flow and create a financial need for suppliers (one example may be the financial need to raise more capital), which in turn has a cost.'*

This is entirely logical, but does not appear to take into account the differing ways in which suppliers fund their working capital. Several recent supplier failures have highlighted a dependence on consumer credit balances to provide working capital.[1] Suppliers vary considerably in how they fund their day to day operations, but models that encourage consumers to build up credit balances are not unusual. Ofgem's own work has found that as much as £1.4 billion was held in surplus credit balances in October 2018.[2]

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[1] For example, the largest supplier to fail thus far, Bulb, appeared to be inflating the levels of customers' direct debits beyond a level that would be needed to cover their consumption in the months before its demise. The administrator for the second largest to fail, Avro Energy, has stated publicly (in its November 2021 proposals) that 'The Company had no external funding or security over its assets and was financed through working capital generated from its trading operation.'

[2] 'Ofgem reforms could see credit balances of around £1.4bn automatically returned.' Ofgem, 17 March 2021.

Given how pervasive the use of consumer credit balances to fund day to day operations has been, we think it would be perverse to introduce some kind of charge on consumers for the recovery of suppliers' working capital. In effect this would result in the unwarranted penalisation of some consumers, who unwittingly lent interest-free working capital through their credit balances, that they are then asked to pay an interest charge on through the price cap.

We recognise that the situation does vary from supplier to supplier, and that not all will have been funding their operations in this way. But some have, and Ofgem is only allowed to set a single price cap for all suppliers,[3] it cannot differentiate between suppliers. We do not think Ofgem has put forward an adequate case for making all consumers pay additional monies towards suppliers' working capital.

Chapter 5: Benchmarking

The consultation indicates the proposed approach can not remove the impact of higher energy prices on the propensity of customers to incur debt under this approach. This indicates that the level of bad debt arising from the pandemic may be overstated. This should be considered when deciding whether average or lower-quartile costs should be used when setting the benchmark.

Yours sincerely

Rich Hall

Richard Hall
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[3] Section 2(2) of the Domestic Gas and Electricity (Tariff Cap) Act 2018.