Appendix 6 – Review of additional debt adjustments

Contents

1. Introduction

Context

1.1 Debt-related costs are generally recovered from paying customers and as such have always been part of the cap. The existing permanent cap allowances for debt-related costs were developed in 2018. Rather than a distinct debt allowance, these are split across a complex combination of allowances, which cover bad debt write offs/provisions, debt administrative and working capital requirements.

1.2 Since 2022, there has been a material and systematic change in these costs compared to the permanent cap allowances. This led us to introduce a temporary float allowance for the efficient additional debt-related costs incurred between April 2022 and March 2024. We based this float on a combination of actual data, between April 2022 and September 2023, and estimates of the levels of additional debt-related costs between October 2023 and March 2024.

1.3 This allowance is backwards looking (ex-post) as it is being recovered through bills between April 2024 and March 2025. It amounts to around £31 per dual fuel customer for Direct Debit and Standard Credit customers.[1] We set this level based on a "hybrid" benchmark. In this case meaning that we used bad debt costs on a weighted average industry basis but for debt-related administrative costs and working capital we used lower quartile benchmarks.

1.4 In the February 2024 additional debt costs review decision, we set the adjustment allowance as a "float allowance" and indicated that we would carry out a review of whether a true-up adjustment was needed when actual data was available, likely in late 2024.[2] This process would consider the most up to date information on industry costs and could result in either a positive or negative adjustment to the allowance.

1.5 The float allowance was set to be recovered equally from Direct Debit and Standard Credit customers only. PPM customers do not generally incur bad debt, because they pay in advance.

1.6 However, PPM customers can incur bad debt in some circumstances, including when suppliers issue Additional Support Credit (ASC) to mitigate the risk of PPM customers going off supply. In October 2023 we also implemented the additional

[1] At cap benchmark consumption (3,100kWh for single rate electricity and 12,000kWh for gas).
[2] Ofgem (2024), Energy price cap: additional debt costs review decision, paragraph 3.6 https://www.ofgem.gov.uk/decision/energy-price-cap-additional-debt-costs-review-decision

support credit (ASC) allowance within the price cap. This was set at £9 per typical PPM customer per year. This allowed for the costs associated with ASC bad debt that had become a material and systematic cost incurred by suppliers. This was initially set on a temporary basis until the operating costs review was implemented. In June 2024 we carried out a review of the ASC allowance and set out our proposals to extend this allowance until the operating cost review is implemented. We confirmed this position in our August 2024 decision.[3]

1.7 As part of our review of the operating cost allowances, we set out to replace the existing allowances with a new set of consolidated debt allowances, which we now aim to introduce from July 2025. While the float allowance is a temporary backwards-looking adjustment for the historic costs associated with non-payment, we intend to implement a new forward-looking allowance for debt-related costs as part of the operating costs review, which is set out in detail in Appendix 2.

Purpose of this review

1.8 The purpose of this appendix is to communicate our review of the float allowance, reviewing the latest industry data and setting out our proposals regarding the need for any true-up at this stage.

1.9 With ongoing concerns around high levels of non-payment of debt, we are aware that suppliers may also potentially be incurring a higher level of costs than reflected in the underlying cap allowances in the period between April 2024 and the implementation of the operating cost review. We discuss this alongside our proposals around the risk of a temporary step down in debt allowances in the cap.

1.10 In addition to our overall debt-related costs review, in this paper we also communicate an update of the latest trends of the ASC bad debt and the ASC allowance.

Summary of our proposals

1.11 We consider that the additional debt adjustment allowance implemented in April 2024 was set at a broadly appropriate level and no material adjustment is needed for the period between April 2022 and March 2024. We therefore do not propose to implement a true-up adjustment exercise at this time.

[3] Ofgem (2024), Decision on extension to additional support credit bad debt cost allowance, page 10 https://www.ofgem.gov.uk/decision/decision-extension-additional-support-credit-bad-debt-cost-allowance

1.12 Due to emerging evidence of further under-recovery of debt related costs in Q2 and Q3 2024, we propose to extend the current additional debt adjustment allowance (float) until the operating cost review is implemented or September 2025, whichever is sooner.

1.13 We intend to conduct a broader true-up exercise at a point when we are better able to assess the full period of potential under-recovery (up to the implementation of the operating cost review) alongside potential interactions with wider interventions on debt.

1.14 We consider that the ASC allowance implemented in October 2023 continues to be broadly appropriate and we do not propose to implement an adjustment of the allowance at this time.

Structure of the paper

1.15 The structure of the remaining document is set out below:

- **Chapter 2 – Additional debt allowance review.** In this chapter we set out our review of the industry data and the float we set for the additional debt allowance adjustment.
- **Chapter 3 – Float extension and allowance gap.** In this chapter we discuss the latest data and the impact of wider interactions, along with our proposals for the extension of the float allowance.
- **Chapter 4 – Additional support credit.** In this chapter we set out our latest view of the allowance for ASC bad debt costs.

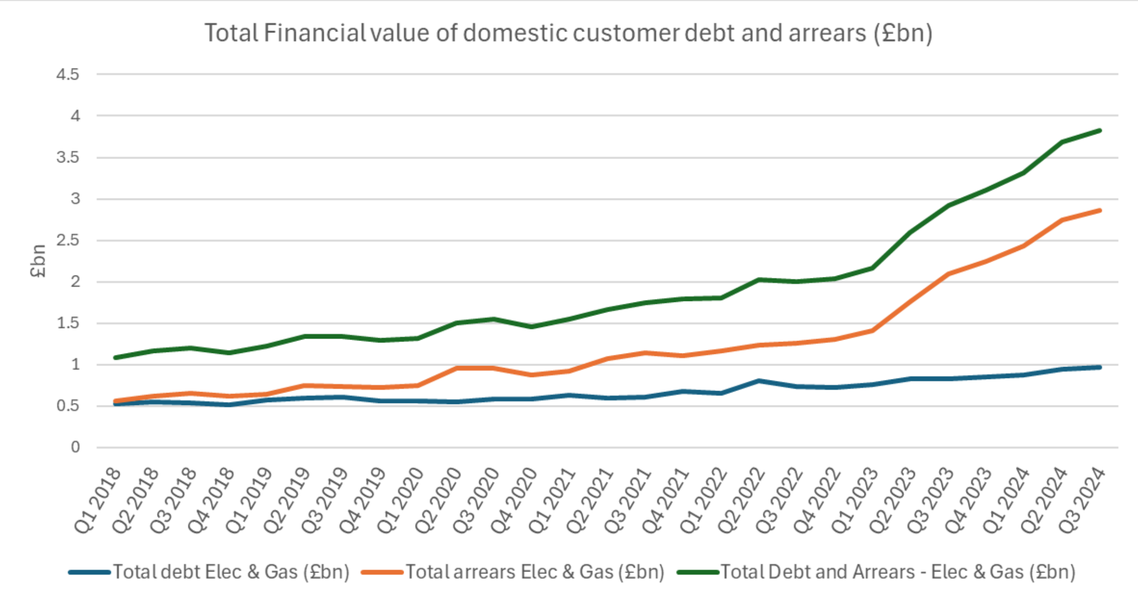
2. Additional debt allowance review

Debt and arrears data

2.1 We have reviewed debt-related costs based on the latest data provided by industry. We also regularly monitor the levels of debt and arrears of domestic customers, which helps us to understand the overall context for bad debt.

2.2 The latest debt and arrears data is published on our data portal.[4] This shows the latest Debt & Arrears data from the Social Obligations Reporting (SOR) data reported by industry, which can also be seen in figure 2.1. This data represents all domestic consumers covering all payment methods.

Figure 2.1: Total value of debt & arrears



2.3 Overall, we observe a significant increase since summer 2022 across most debt and arrears-related parameters. For example, total financial value of domestic customer debt and arrears is now at around £3.8bn, an increase of around £2bn since the start of 2022. This is a combination of both 'Debt', where there is a repayment plan in place for the debt to be repaid, and 'Arrears' where customers do not yet have a debt repayment plan in place.

2.4 The average amount of money owed by households in arrears has reached £1,568 for electricity and £1,324 for gas in Q3 2024, up by 32% for both

[4] Ofgem (2024), Debt and Arrears Indicators. https://www.ofgem.gov.uk/publications/debt-and-arrears-indicators

electricity and gas compared to Q3 2023. Households with a debt repayment plan in place owe around half of this amount but we have seen a smaller increase in the number of such households across the same period.

2.5 These increases have been driven by wider cost of living issues putting strain on household finances, which in turn is putting pressure on customers' ability to pay. The combined number of domestic accounts in debt and arrears has broadly stabilised over the last year, indicating that the ongoing growth in total debt and arrears is being driven by consumers already struggling with their bills.

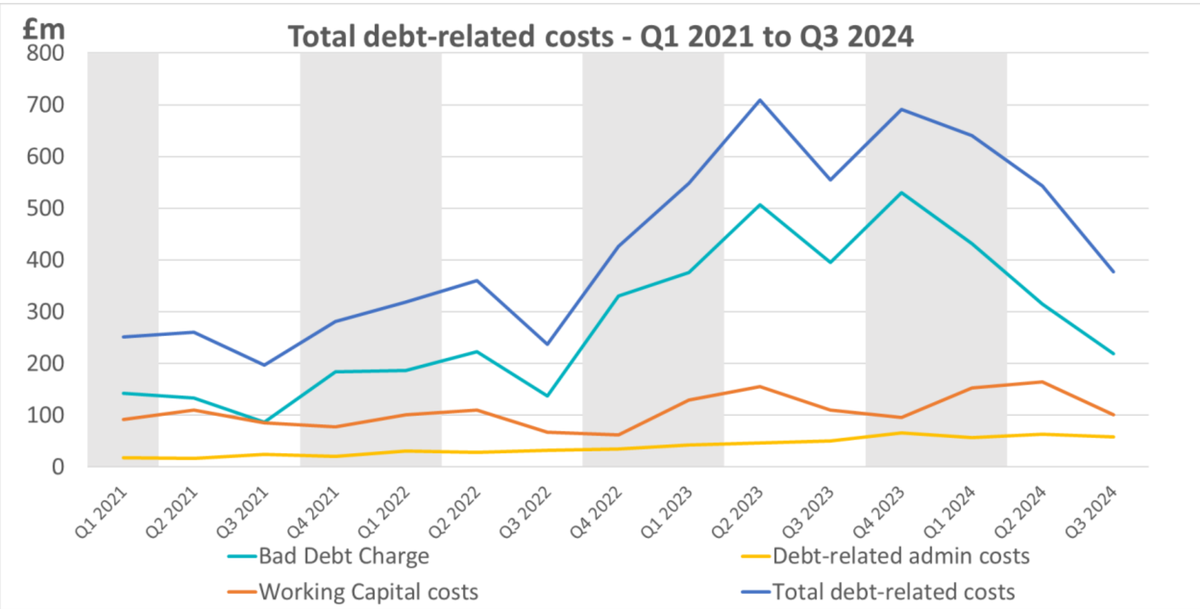
2.6 The latest Q3 data is showing a slowdown in the rate of increase. However, it's still too early to suggest that levels of debt and arrears might be starting to level off, especially entering into a winter season with higher usage potentially leading to a seasonal increase in non-payment.

Latest debt-related cost data

2.7 Through this review we have used suppliers' data collected from the October 2024 debt-related costs RFI to assess where efficient costs have materially and systematically deviated from the allowances in the cap.

2.8 We requested debt-related costs data from January 2017-September 2024 from suppliers with at least 100,000 default tariff customers.

Figure 2.2: Total debt-related costs - Q1 2021 to Q3 2024



The graph shows the debt-related costs for all tariff types and payment methods from the latest debt-related cost RFI. Working capital costs are based on customer and non-

customer working capital. The grey areas represent winter seasons.

2.9 Figure 2.2 shows the total debt-related costs over time, using the latest RFI submissions from industry. Our analysis of suppliers' reported cost data suggests that debt-related costs saw a significant increase from the end of 2022 and remained at a high level across 2023.

2.10 Observing the latest data we note a significant downward trend in bad debt has emerged throughout 2024, with a quarterly average decrease of 25% across industry. Despite this drop in bad debt costs so far in 2024, we are aware of the volatile nature of bad debt costs. The trajectory of recent months may simply indicate the extraordinary levels of write-offs and provisions that occurred in 2023, rather than suggesting that debt costs are headed back towards historical pre-crisis levels. This view is uncertain but is supported by the debt and arrears data described above which has continued to increase at a concerning rate across most of 2024.

2.11 We are also mindful that debt costs in any given period can be subject to revisions and that final bad debt costs will only be fully known once all debt repayments have been accounted for in the data.

Assessment of float allowance

2.12 To set the debt-related cost float allowance, we used data collected from industry on both actuals and estimates. Here we discuss this latest data and the implications for the period from April 2022 until March 2024.

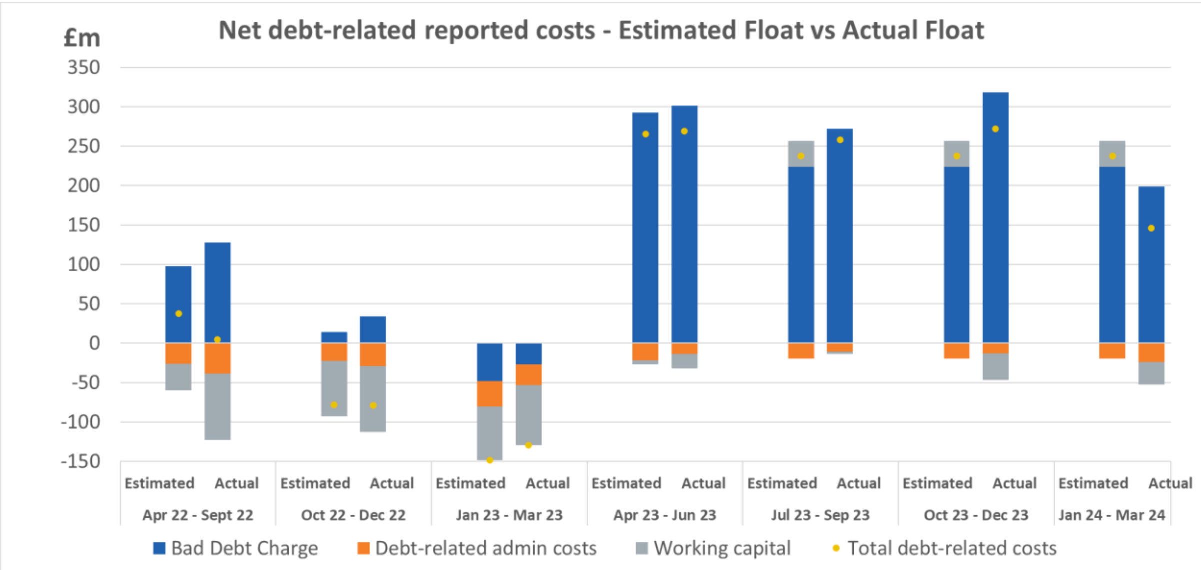
2.13 When setting the float allowance our analysis suggested that costs had materially and systematically diverged from the existing allowances.

2.14 Using the latest industry data, we have been able to update the estimated values for winter 2023/24 with actual data. Our analysis suggests that the float allowance has been broadly in line with the actual additional costs incurred by suppliers in the period Q2 2022 to Q1 2024 (Cap 8 to Cap 11b).

2.15 Figure 2.3 indicates the net cost impact on suppliers between April 2022 and March 2024, considering the existing debt allowances in the cap. In our additional debt review decision, we noted that the existing debt allowance in the cap had over-allowed for both debt administration costs and working capital costs, particularly in winter 2022/23. It was also noted that we considered the government support in these cap periods will have had an impact on working capital costs by guaranteeing a level of revenue for suppliers over the period in a timelier manner. This may be why we see a swing in working capital costs over time.

2.16 Up to March 2023 there was a relatively small difference between the bad debt reported costs and the allowance, fluctuating between an over-allowance and an under-allowance. We consider the over-allowance in cap period 9b was likely driven by government support packages which temporarily reduced levels of non-payment and may have repaid some debt for some customers.

Figure 2.3: Net debt-related costs - Cap 8 to Cap 11b[5]



The graph compares the estimated and actual net debt-related costs from April 2022 to September 2023.

2.17 Figure 2.3 also highlights the differences between the net costs used to inform the float allowance that we set out in our February decision, and the net costs when we adjust for the latest actual industry data. This latest data set used also includes reconciliations of the historic periods.

2.18 This indicates that the actuals received in our latest RFI broadly correspond with the figures used to set the float allowance. While the latest data shows an

[5] Apr 22- Sep 22, cap period 8; Oct 22-Dec 22, cap period 9a; Jan 23 - Mar 23, cap period 9b; Apr 23 - Jun 23, cap period 10a; Jul 23 - Sep 23, cap period 10b, Oct 23 - Dec 23, cap period 11a; Jan 24 - Mar 24, cap period 11b. The zero line represents the current allowance. Net costs = costs – allowances. Total = sum of all three debt-related cost components.

increase in total costs across the second half of 2023, this is more than offset by decreases in other periods such as Q1-24.

2.19 From July 2023 there has been a swing in working capital costs from under to over-recovery. We understand this may be driven by lower reported costs for both customer and non-customer working capital.

2.20 When replicating the benchmarking methodology to assess the impact of the actuals across the period, this would produce a revised float allowance value of just over £28 per dual fuel customer per year.[6] Comparing this to the float of nearly £31 per dual fuel customer per year implemented in the cap means the latest data is indicating a potential difference of around -£2.50 per dual fuel customer per year.

2.21 Although the most recent data indicates an over-allowance, we do not propose to implement a true-up at this stage. We consider the materiality is such that implementing a downward adjustment to the cap is not appropriate at this stage, especially in context of Q2 and Q3 2024 data which we discuss later. We, therefore, propose to delay and extend the true-up, until we have more certainty around debt costs in 2024/25 and the impact of wider interactions. Such an exercise would look to true-up over a period from April 2022 and we will establish an end-date in due course, once we have a settled view on the interventions that we would be looking to collectively true-up.

Approach to assessing the float

2.22 To assess the float level above, we have continued to use the methodology set out in our February decision, which we still consider to be appropriate. This consists of the hybrid benchmarking approach, discussed in our October 2023 consultation.[7]

2.23 In Appendix 2, we are proposing a weighted average benchmark for debt-related costs when setting the forward-looking allowance. We do not consider that this requires us to use a weighted average benchmark when assessing the float allowance. The float allowance was a temporary adjustment to the existing allowances for debt-related costs, two of which are based on a lower quartile benchmark. The purpose of the float was to recognise that there were additional

[6] £ per typical dual fuel customer at benchmark consumption.
[7] The hybrid approach uses a weighted average benchmark for bad debt, and a combined lower quartile benchmark for debt-related administration and working capital costs.

costs relative to the allowances at the time, rather than a wholesale review of the stringency of the underlying debt-related cost allowances. We therefore consider that our assessment of historical debt-related allowances should be carried out within its own context.

2.24 The float was also allocated equally across direct debit and standard credit customers only, which we still consider is an appropriate cost allocation for the purposes of this temporary adjustment. In Appendix 2, we are proposing to allocate the forward-looking debt-related cost allowance between payment methods in a way which maintains the existing differentials. This includes setting a higher allowance for standard credit compared to direct debit. We consider that this is consistent with the float methodology as the current differential between payment types is based on an aggregate view of the existing permanent and temporary allowances (including this float allowance split equally between standard credit and direct debit).

2.25 Further, a temporary allowance has a smaller impact on the financeability of suppliers than an ongoing allowance. We recognise that there are some additional debt-related costs associated with serving standard credit customers, so setting an even allocation on a forward looking basis would risk underfunding suppliers with an above average proportion of standard credit customers. We consider that the financial impacts of equal allocation for the temporary allowance can be absorbed by suppliers, taking into account allowances like headroom.

3. Float extension and allowance gap

3.1 The additional debt costs review set an ex-post adjustment allowance (float allowance), to allow for the additional costs incurred within a specific period, between April 2022 and March 2024. This temporary allowance is due to fall away from the cap in March 2025.

3.2 The operating costs review intends to introduce a forward-looking allowance for debt-related costs which will be implemented from July 2025 at the earliest.

3.3 While we have seen reported debt-related costs trending downwards across 2024, they remain above the level of existing permanent cap allowances. With levels of debt and arrears in industry continuing to increase across 2024, suppliers may be continuing to incur additional debt-related costs across 2024/2025, albeit at a considerably slower rate than in 2023.

3.4 This leaves us with two issues to consider:

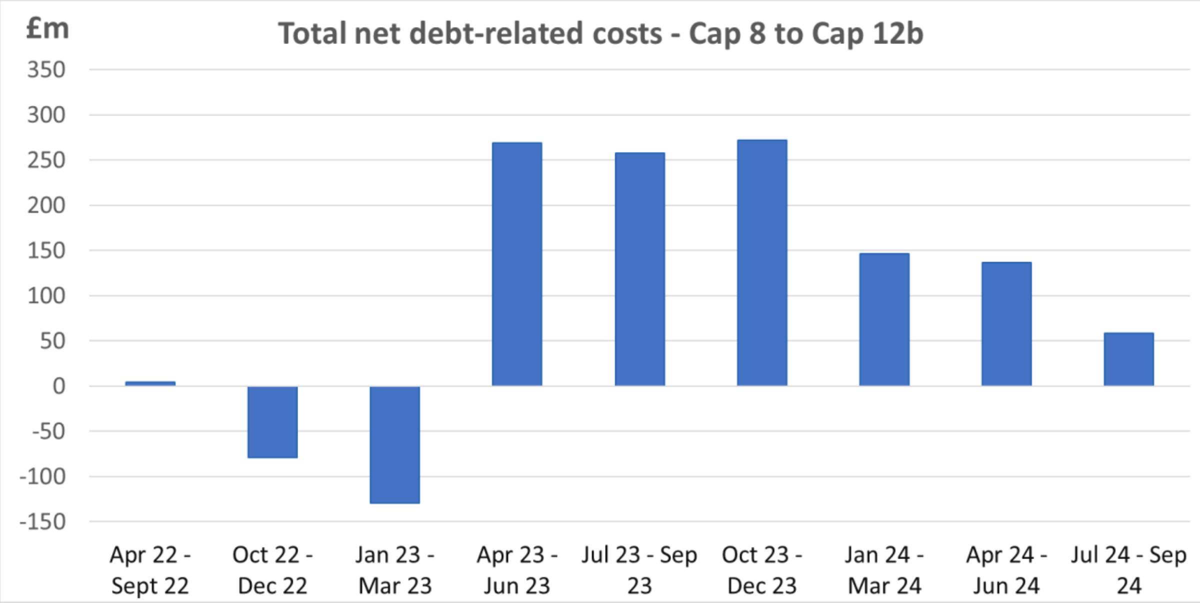
- A potential 'allowance gap' across 2024/2025 (ie for consumption between April 2024 and July 2025), as levels of historically high debt-related costs may continue prior to the implementation of the operating costs review;
- A potential step down in allowances in April 2025, followed by a step up in July 2025 (at the earliest), due to the delay in the operating costs review.

3.5 We do not have data on this full period yet, and consider it premature to reach definitive conclusions. However, we do have data on Q2 and Q3 2024. Figure 3.1 indicates the total net debt-related costs impact on industry, taken from the latest RFI submissions. This takes into account the existing underlying debt allowance in the cap, to work out the net impact on industry. This shows the emerging impact of debt-related costs across 2024.

3.6 This analysis is conducted on a total aggregate cost basis. We do not consider that the cap necessarily needs to compensate suppliers for the total of these costs – particularly given they are costs over-and-above the existing lower quartile allowance. However, they offer a useful insight into the ongoing under-recovery of costs in the financial year-to-date 2024/25.

3.7 From the highest point at the end of 2023 with about £270m impact on industry, we can see a declining trend across 2024, where the impact was around £60m between July – September 2024. Although this may be suggesting a reduction in the impact of debt across industry, we are aware that the nature of debt provisioning is such that it takes time for debt write-offs to crystalise, meaning it may take time for the costs associated with debt to be fully reconciled. The current high levels of debt and arrears across the market may also indicate an ongoing issue.

Figure 3.1: Total net debt-related costs - Cap 8 to Cap 12b[8]



3.8 Currently, from April 2024 to September 2024, suppliers have been under-recovering costs by about £195m, with most of this incurred in Q2 2024. We won't have access to Q4 2024, Q1 2025 and Q2 2025 data until next summer, so will not know until then how the cost impact across the full period will outturn.

3.9 It is uncertain how costs will develop across the remainder of this period. There may be an upward movement in costs due to seasonal effects across winter, however, a downward movement toward cost levels more traditionally observed may also result. It is worth noting that in normal conditions it is expected that costs would vary quarter-on-quarter, between under- and over-recovery, which we would expect to even out over time.

3.10 With the implementation of the forward looking debt allowance not occurring until July 2025 at the earliest, there would be a step down in the cap with a likely subsequent step up when the operating cost review is implemented, creating a temporary impact.

[8] Apr 22- Sep 22 = cap period 8. Oct 22-Dec 22 = cap period 9a. Jan 23 - Mar 23 = cap period 9b. Apr 23 - Jun 23 = cap period 10a. Jul 23 - Sep 23 = cap period 10b. Oct 23 - Dec 23 = cap period 11a. Jan 24 - Mar 24 = cap period 11b. Apr 24 - Jun 24 = cap period 12a. Jul 24 - Sep 24 = cap period 12b. The zero line represents the current allowance. Net costs = (costs – allowances). Total = sum of all three debt-related costs.

3.11 We propose to extend the current float allowance until the implementation of the operating costs review (or September 2025, whichever is sooner). This will smooth the profile of the overall debt allowances within the cap.

3.12 We consider that doing so will also help toward mitigating the impact of any potential emerging allowance gap across 2024/25. We estimate the recovery industry could receive through the price cap due to this extension may be in the region of around £120m if the Operating Cost Review is implemented in July 2025.[9]

3.13 This compares to a £195m total under-recovery to date. As such we consider the risk of such an approach over-compensating suppliers for the entire period of potential under-recovery to be small. While it may result in some continued under-recovery, we note that our assessment of the "float" was that suppliers over-recovered our benchmark by around £55m.

3.14 We do not consider it would be in consumers' interests to temporarily reduce the allowances in the cap, where it is likely that such a step down would increase under-recovery, which we would later need to address through further ex-post adjustment.

3.15 Given the uncertainty on how costs across 2024/25 will actualise, along with wider interactions around any potential debt relief scheme, we are proposing to delay and extend the true-up exercise until we have more clarity on the size of the allowance gap and the interaction between any potential debt relief scheme and the cap.[10] We intend to take our proposed extension of the float into account within any future true-up review.

[9] This figure is based on seasonal recovery through the cap in period 14a. It is calculated by multiplying the adjustment allowance for each fuel type by the number of SVT customers and weighting for seasonality in consumption.
[10] Ofgem (2024) Resetting the energy landscape: the case for a debt relief scheme www.ofgem.gov.uk/consultation/resetting-energy-debt-landscape-case-debt-relief-scheme

4. Additional support credit

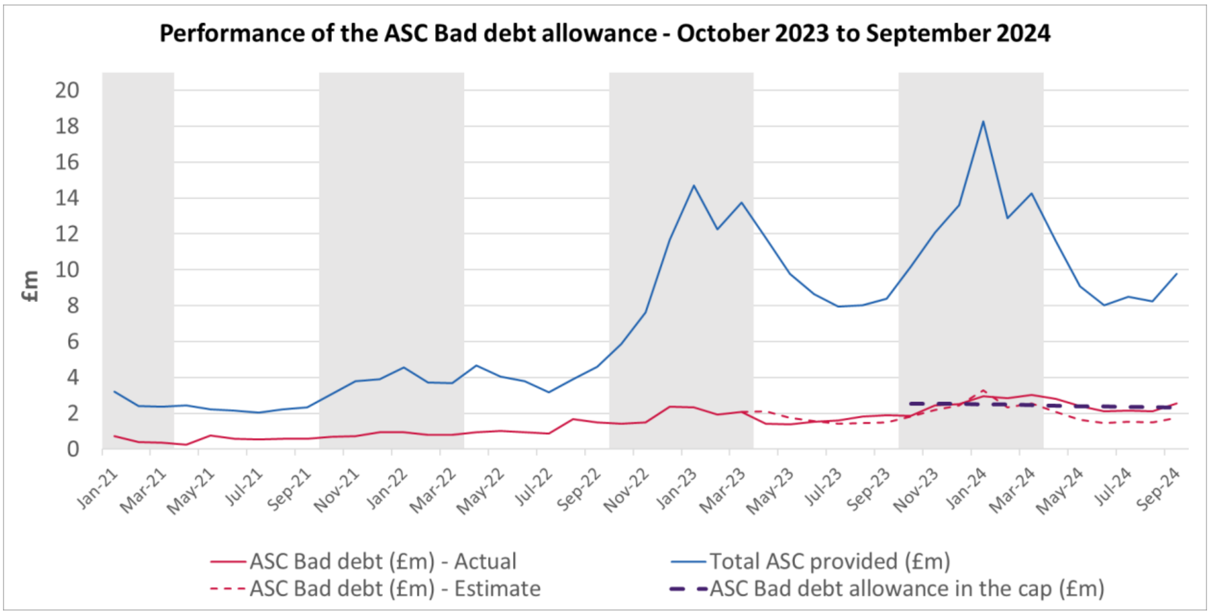
4.1 In October 2023, we introduced a temporary ASC allowance into the cap worth £9 per dual fuel customer per year. The allowance was intended to ensure suppliers could recover the expected costs associated with ASC bad debt on an ex ante basis. We initially set this allowance for a period of 12 months, until the operating costs review would consider the appropriate allowances going forward.

4.2 Due to the delay to the operating costs review, we published our decision in August 2024 to extend the allowance until the review of the operating cost allowances is implemented in 2025.

4.3 Since then, we have received the latest data that covers the first full year of the allowance.[11] We carried a review of the industry performance and observed that costs have not deviated significantly from the allowance. When setting the ASC allowance, we estimated the allowance required considering different factors, such as the cost of living crisis and affordability issues, that could reasonably increase demand for ASC. Overall, we continue to expect PPM customers to request ASC proportional to the cost of their energy consumption, increasing their demand in the winter period and plateauing in the summer months. This in turn will affect the level of associated ASC bad debt.

[11] October 2023 to September 2024

Figure 4.1: Performance of the ASC Bad debt allowance - October 2023 to September 2024



4.4 Figure 4.1 shows the historic increasing trend of ASC issued. It also shows the actual ASC bad debt compared to the ASC allowance in the cap. This indicates that the actual ASC bad debt over the period in question has broadly aligned to the ASC allowance. We continue to see both the level of ASC issued and the associated bad debt following a typical seasonal trend, with levels of both increasing across last winter and falling back again in summer. It is reasonable to consider a potential increase of ASC insurance this Winter 2024/25. Therefore, our latest analysis suggested that our decision to extend the existing ASC allowance for ASC bad debt has been appropriate to allow suppliers to recover these costs. This will help suppliers to continue to support PPM customers, including those who are vulnerable, and ensure they remain on supply.

4.5 It is worth noting that our analysis is based on actual data from ASC issuance provided to customers and provisional ASC bad debt cost data. The final ASC bad debt will only be fully known once all ASC repayments have been accounted for in the data. However, we consider that the most appropriate expectation of future ASC debt related costs broadly aligns to the level provided for in the current ASC allowance value of £9 per typical PPM customer.

4.6 As part of our analysis of ASC we also reviewed the overall context of debt concerning PPM customers. We observed that the proportion of domestic PPM customers repaying debt to their supplier has dropped slightly to 55% from 58%

in Q2 2024 from Q1 2024. For gas, the same proportion has fallen to 52% from 56% between the same quarters.

4.7 As indicated above we consider that the ASC allowance has been appropriately set, and it is likely it will continue to be appropriate for Winter 2024/25. However, we will continue to monitor data on actual costs incurred over the period of the ASC allowance, particularly over winter 2024/25, and will take this into account as part of any wider debt related true-up.