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for energy consumers

Suppliers, Consumer Groups and
other interested parties

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Dear Stakeholder,

Decision to extend the allowance for Additional Support Credit bad debt costs

We published a consultation letter on 14 June 2024 proposing to extend the existing allowance in the default tariff cap ('the cap') for bad debt costs associated with Additional Support Credit (ASC) given to prepayment meter (PPM) customers.[1]

The purpose of this document is to set out our decision to extend the current allowance for ASC bad debt, from 01 October 2024.

In October 2023 we introduced a temporary adjustment allowance into the price cap to allow suppliers to recover efficient costs associated with ASC bad debt, which is due to come to an end in September 2024.[2] This allowance was introduced due to the recent cost of living pressures driving up the amount of ASC being provided to customers, which in turn has seen an increase in the amount of ASC bad debt (ASC that is not ultimately repaid by customers). Our analysis suggests suppliers are still incurring additional costs associated with supporting customers through ASC, and that the current allowance is set at an appropriate level to recover these costs for a notionally efficient supplier. It is reasonable to consider, based on observable trends in debt and arrears, that a similar demand for ASC and therefore level of costs incurred is likely to continue into next winter.

It is important that suppliers are able to recover the efficient costs of supporting their customers this winter.

[1] Ofgem (2024), Additional support credit extension consultation [Additional Support Credit extension | Ofgem]
[2] Ofgem (2023), Allowance for additional support credit bad debt costs (Decision). [Allowance for additional support credit bad debt costs | Ofgem]

We have therefore decided to extend the allowance until the outcome of the review of operating cost allowances is implemented in 2025. This review will consider the appropriate recovery of costs associated with bad debt on an enduring basis.[3]

As part of this decision, we have carefully considered all responses to our consultation and have addressed the main points, where relevant, further below. Responses are published on the consultation page.

Introduction

For more than two years, households across Great Britain have been feeling the effects of the global cost of living crisis, and this has placed increased strain on people's ability to afford the energy they need. While the energy market has stabilised and the cap has fallen further, energy bills remain significantly higher than pre-crisis levels.

Getting into debt or arrears can be harmful to the individual customer. It also generates additional costs and can be detrimental to the market and broader customer base, particularly if it reaches unsustainable levels. With the price cap in place for default tariff customers (and currently covering most energy customers), these issues surface through the cap.

While the issue of increasing debt and arrears is a concern to the wider market, the issue of self-disconnection is of particular concern, negatively impacting potentially some of the most vulnerable customers. ASC is an important mechanism provided to PPM customers who request it and who may have exhausted alternative options (i.e. emergency or friendly hours credit) to help avoid self-disconnection. ASC exists to help customers, including those who are vulnerable, to stay on supply, reducing the physical and emotional harm that can result from self-disconnection.

In our analysis, we have, as expected, observed both higher issuance levels of ASC, and a higher value of ASC being issued than in previous years. This suggests that more PPM customers are struggling to pay their energy bills and are being supported through the availability of ASC.

While ASC is repayable, some of it is unrecoverable by energy suppliers and is therefore ultimately written off as bad debt. We refer to this as 'ASC bad debt'. In August 2023, we

[3] Ofgem (2024), Price cap - call for input on operating costs allowance review. [Price cap - call for input on the operating cost allowances review | Ofgem]

published a decision which introduced a temporary ASC allowance into the price cap, worth £8.77 per dual fuel PPM customer per year. This allowance was intended to ensure suppliers could recover the expected costs associated with ASC bad debt on an ex-ante basis.

The allowance for ASC bad debt within the price cap was introduced for 12 months from October 2023 to September 2024. This was planned to be in place until the review of the operating costs within the price cap is completed and any resultant measures are implemented.

However, given that we currently expect to complete the implementation in 2025, there will be a gap in the allowance for costs associated with ASC bad debt until the review is completed. This presents us with the question of what we do with any allowance for ASC bad debt during this period. In our June consultation letter, we set out three possible options:

- **Do nothing** – let ASC bad debt allowance in the cap end in September 2024
- **Extend** – Extend the current ASC bad debt allowance
- **Review** – Extend and refine the amount of the ASC bad debt allowance using latest data

Do nothing

The allowance for ASC bad debt costs was set based on the expectation that ASC bad debt costs would be material and systematic. In our analysis, we have observed this to be the case, and as levels of debt and arrears remain high and rising, expect it to continue to be so for at least this winter.

Under the Domestic Gas and Electricity (Tariff Cap) Act 2018 we are required to have regard to the ability of efficient suppliers to finance their licensed activities.[4] Not allowing for the costs associated with ASC bad debt beyond September 2024 would mean the price cap would be unlikely to reflect efficiently incurred costs, until the outcome of the operating costs review is implemented. If the cap level were not to reflect efficient costs, it is reasonable to consider the risk that consistent application of best practice in relation to ASC may be adversely affected. The impact of this would be to affect PPM customers who need ASC, including those in vulnerable circumstances. However, it is important to note that

[4] Domestic Gas and Electricity (Tariff Cap) Act 2018

suppliers are, regardless of the cap level, obliged to provide ASC in line with the relevant Standard License Conditions (SLCs).

Extend

As discussed above, we expect wider cost of living issues to continue to put pressure on households' ability to pay their energy bills. We consider it was in the consumer interest to introduce this allowance, given the benefits of ASC for the most vulnerable consumers. Extending the current allowance would continue to best support suppliers to assist vulnerable consumers through issuing appropriate levels of ASC beyond September 2024.

We consider, through our 'analysis' section later in this paper, that the ASC allowance currently in the cap has been broadly in line with costs incurred. Our latest view of the data across winter 2023/2024 indicates ASC bad debt provisions have not deviated materially from our estimation when setting the allowance. Given the steady increase in debt and arrears across the broader market, there is no clear reason to assume that the winter of 2024/25 should be significantly different.

Review

Similar to the 'Extend' option, this would include extending an ASC allowance, but with the additional step of refining the amount of the allowance using the latest data. This option could potentially provide a benefit in terms of accuracy of the allowance. However, 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. We used the available data at the time, and waiting for more data would have been unlikely to increase insight, as it would relate to the summer period. Furthermore, waiting on the availability of further data to inform a decision would have created a hiatus in allowance.

Any benefit to this approach would likely be marginal and given the anticipated review of the Operating Costs allowances, there are risks around re-opening a methodology that would only be implemented for a limited period of time and we do not consider this exercise would be proportionate to the benefits that might be realised relative to the second option discussed above. We will, in any case, continue to monitor data on actual costs incurred compared to allowances and review the appropriateness of the allowance if we consider there is a material and systematic change in costs.

Consultation responses

On 14 June 2024, we published a consultation letter on extending the existing allowance within the cap for ASC bad debt. The consultation was open until 12 July 2024. We received ten responses to this consultation, which we discuss below.

General overview of responses

The majority of stakeholders were broadly in agreement with the intention to extend the current allowance for ASC bad debt until the outcome of the operating cost review is implemented, which aims to provide a more enduring solution for wider bad debt in the cap.

A number of suppliers stated that the extension was essential as it ensured that suppliers are able to recover these costs, and so can continue to support vulnerable customers and ensure they remain on supply.

We stated in our June consultation letter that ASC bad debt has become a material cost to suppliers, due to increased levels of ASC being issued. The higher issuance of ASC suggests that more PPM customers are struggling to pay their energy bills. So, we consider extending the allowance would continue to best support suppliers, so as to continue to assist vulnerable customers to stay on supply.

One supplier, who was not in favour of extending the allowance, argued that uplifting the cap to address ASC bad debt costs incorrectly accepts that debt is outside a supplier's control.

Ofgem is supportive of suppliers taking proactive steps to mitigate debt, but there are inherent risks of bad debt when issuing ASC. The volume of ASC issued will be partly driven by suppliers' consumer bases. We consider it is overall in the consumer interest to introduce this allowance given the benefits of ASC. We are clear that suppliers are, regardless of the cap level, obliged to provide ASC in line with the relevant SLCs. However, we consider that if the cap level does not reflect efficient costs, it is reasonable to conclude that consistent application of best practice in relation to ASC may be adversely affected, particularly in view of the increased ASC-related obligations on suppliers.

Transparency and Monitoring

One consumer group, who supported an extension, stated there needs to be transparency over how much ASC is being given and written off, and whether suppliers are over – recovering, relative to the support they are giving. Another consumer group, which also supported an extension, stated that strong measures and monitoring are needed to ensure this allowance is being used effectively to drive the benefit and protections for consumers that it was designed to deliver. One supplier accepted that it is important that the ASC bad debt allowance is being used effectively. They also stated that Ofgem should understand that alternative mechanisms may be in place which also mitigate the risk of self-disconnection.

We stated in our June consultation letter that our aim is to ensure that the allowance for ASC bad debt is being used effectively by suppliers to drive the consumer benefits it was designed to deliver. Suppliers will attempt to recover costs owed, and ASC bad debt costs would be higher if they did not do so. We also state in the Monitoring and Compliance section of this decision, that Ofgem's ASC and Self-Disconnection (SD) review will assess supplier compliance with SLCs surrounding ASC provision and SD monitoring for PPM customers. We will also continue to monitor levels of total ASC issued along with ASC bad debt as part of our routine gathering of industry costs associated with bad debt.

Two suppliers, who expressed support for an extension, commented on the need for appropriate clarity and notice if any deviation in timings or future review of the allowance occurred, related to either the interaction with the operating costs review or change in ASC costs incurred.

The aim is for the extension to the ASC allowance to remain in place until the operating costs review considers a more enduring solution for wider bad debt within the cap. We will monitor this interaction over time, along with ASC costs as part of our routine monitoring and will endeavour to provide timely clarity if needed.

Future reviews

Another supplier, who supported an extension, strongly urged Ofgem to undertake a true-up exercise for both periods, from October 2023 to September 2024, and for the extension period of the allowance.

As set out in our June consultation letter, we intend to review the need for a true-up of the ASC allowance from October 2023 to September 2024. It is worth noting that the timing of any true-up review is dependent on the availability of suitable data that allows for an appropriate analysis of costs incurred during the period in question. In relation to the extension of the ASC allowance for bad debt costs, we will continue to monitor ASC costs over time as with other costs and review the appropriateness of the allowance if we consider there is a material and systematic change in costs.

Consideration of allowance

Two suppliers disagreed with the original methodology set out in our August 2023 decision for calculating the allowance for the ASC bad debt adjustment. They questioned to what extent a baseline allowance for ASC within the cap existed prior to the setting of the adjustment allowance and its consideration as part of the ASC adjustment allowance.

We set out the rationale for the baseline in our previous ASC decision. For the immediate extension decision, we consider the same rationale applies and it is appropriate and consistent to maintain the same calculation approach.

Analysis and Rationale for Decision

We have been reviewing ASC bad debt and other debt-related costs based on the latest data provided by industry. We regularly observe the levels of debt and arrears of domestic customers, which help us to understand the overall context of bad debt.[5] We discuss below how the latest data shows that both have risen since we set the ASC bad debt allowance, likely being driven by the wider cost of living crisis resulting in some customers facing affordability challenges. We also assessed the performance of the current ASC bad debt allowance introduced in October 2023 against suppliers' latest ASC bad debt provisions data.

Recent trends of debt and arrears

The latest debt and arrears data for Q1 2024 is now published on our data portal.[6] This data represents all domestic consumers covering all payment methods. It shows a material increase since the end of Q4 2022 across most debt and arrears-related parameters. For example, total financial value of domestic customer debt and arrears, average debt level

[5] Taken from both the Monthly Household RFI and Debt Related Costs RFI
[6] Ofgem (2023), Debt and Arrears Indicators.
Debt and Arrears Indicators | Ofgem

where there is no arrangement to repay the debt (arrears), number of accounts in arrears where there is no arrangement to repay the debt and the proportion of customers repaying a debt to their supplier, among other parameters.

We have observed seasonally high levels of debt persisting into Q1 2024. Previously, debt generally fell towards the end of the year when customers were billed for the warmer months, and then rose in the spring as customers fell into arrears following higher energy usage during the winter months. This change could have been driven by higher retail prices and increasingly difficult financial circumstances faced by households.

From Q1 2023 to Q1 2024, total domestic energy debt and arrears has increased by 53% from roughly £2.2bn to £3.3bn. The number of domestic electricity customers in debt and arrears rose from roughly 1.5m in Q1 2023 to 1.7m in Q1 2024 and for domestic gas customers from 1.3m to 1.4m over the same period. The average value of customer debt increased by 28% for domestic electricity accounts and 38% for gas between Q1 2023 and Q1 2024.

Specifically for PPM customers, the proportion of domestic PPM customers repaying debt to their suppliers has increased significantly. By Q1 2024, this has risen to 57%, an increase of about 10 percentage points since Q1 2023.

<u>Recent trends of ASC issuance and non-repayment ASC levels</u>

We set the initial ex-ante allowance for ASC bad debt based on anticipated costs of ASC bad debt between October 2023 and September 2024.

The data we use from industry gives us a view of costs associated with ASC for up to the end of March 2024. This indicates an increase in ASC issuance levels offered by suppliers to PPM customers, and an increase in the value of ASC provided per application compared to the previous year. This is likely due to affordability pressures associated with both high energy bills and wider cost of living pressures.

The ASC data we have gathered continues to show an increasing year on year trend of ASC being issued. We estimate that the level of ASC issued increased by 162% between 2022/23 and 2023/24, with a broadly commensurate increase in suppliers' provisions for ASC bad debt of 133% between the same periods.

Trends in the level of ASC issued and ASC bad debt both exhibit seasonality, with higher levels of ASC requested in the winter before levelling off in the summer. This is likely due to higher levels of energy demand during the winter. Since we began recording ASC data, on average the value of ASC issued has increased by 102% from the winter 2021/22 to the winter 2023/24, and the value of ASC bad debt has increased on average by 92% between the same periods.

Performance of the ASC Bad debt allowance – October 2023 to March 2024

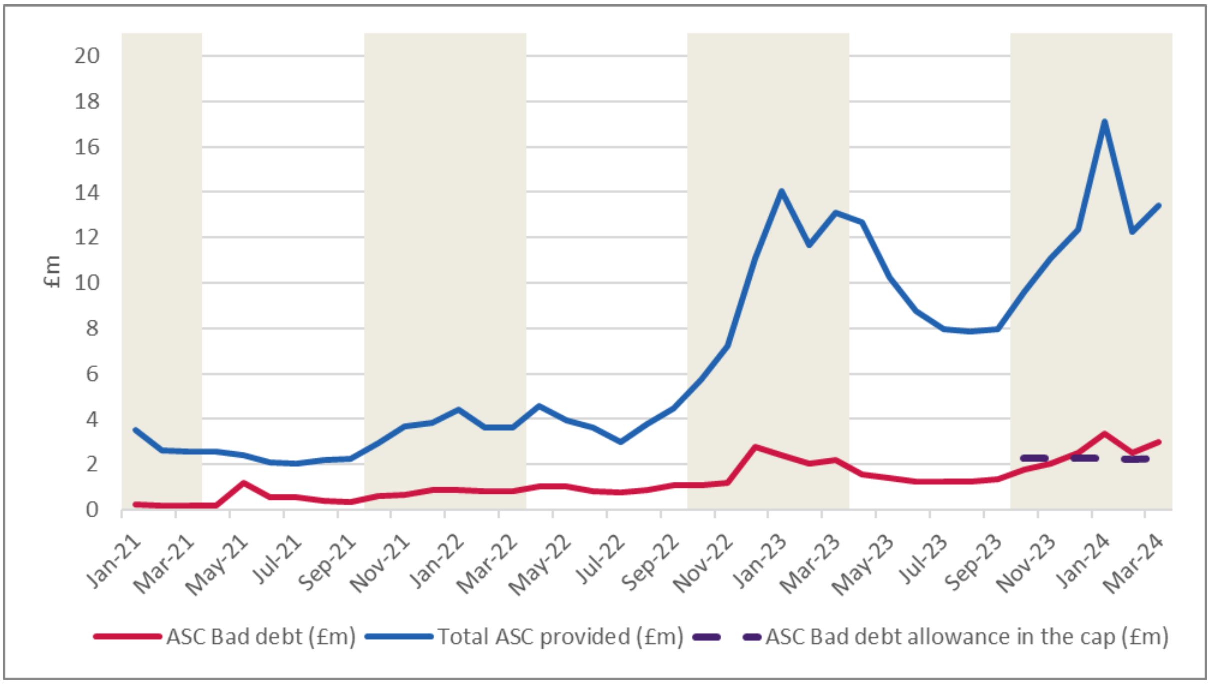

Figure 1 - Estimated impact of total ASC issued & ASC bad debt provisioned

Figure 1 shows the increasing trend in total ASC issued and non-repayment of ASC levels. The ASC bad debt over the winter of 2023/24 broadly aligns to the allowance in the cap. It is likely the level of ASC issuance and the level of associated bad debt will follow typical seasonal trends by decreasing in summer 2024, potentially increasing again through winter 2024/25.

The above analysis is based on actual data up to and including Q1 2024. It was not possible to include the most recent Q2 2024 actual data in our analysis in time for this publication, however initial assessment of Q2 data indicates that it is in line with the above analysis.

It is worth noting that the data used for this analysis is based on actual data from ASC issuance provided to customers and provisional ASC bad debt cost data. The final ASC bad debt cost 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 bad debt allowance value of £8.77 per typical PPM customer.

Overall consideration of the ASC analysis

The provisional ASC bad debt data we received currently supports the allowance set in our August 2023 decision as being an appropriate estimate of costs incurred across winter 2023/2024. There is uncertainty around how levels of bad debt will materialise over time. However, given the trends and analysis set out above we consider it reasonable to expect ASC levels to continue to be higher than historical levels beyond September 2024. This means the costs associated with ASC bad debt will likely continue to be material and systematic. We consider the current ASC allowance continues to be appropriate to address the efficiently incurred costs associated with ASC bad debt.

Decision

Having considered all the stakeholder representations in our June consultation, along with our latest data and analysis, we have decided to maintain our consultation minded-to position and extend the existing ASC allowance for ASC bad debt, at its current level, so that it continues from the end of the current allowance in September 2024 and remains in place until the outcome of the operating cost review is implemented.

Implementing the allowance

In our June consultation letter, we stated we would continue to use 'Annex 8 - methodology of adjustment allowance', as set out in our decision in August 2023.[7] We have decided to continue to use 'Annex 8 - methodology of adjustment allowance', as set out in our decision in August 2023, to calculate the specific ASC bad debt allowance.

We consider this to be the simplest and most flexible method for including this allowance in the price cap. We have published a finalised version of the model alongside this decision.

[7] Ofgem (2023), Annex 8, adjustment allowance methodology.
Allowance for additional support credit bad debt costs | Ofgem

Monitoring and compliance

In our June consultation letter, we stated that we have engaged with suppliers on their provision of ASC to understand any barriers to issuing the allowance, as well as alternative mechanisms that may be in place which also mitigate the risk of self-disconnection.

Ofgem's Additional Support Credit (ASC) and Self-Disconnection (SD) review has commenced via an RFI and will assess supplier compliance with SLCs concerning ASC provision and SD monitoring for PPM customers. The review aims to understand whether self-disconnection is being monitored sufficiently by suppliers, and whether suppliers are sufficiently fulfilling their obligations to provide support that prevents self-disconnection. The review is a focused thematic review and not a Market Compliance Review.

We also intend to explore which further measures may be appropriate to ensure the allowance is used effectively, and more broadly, continues to drive best practice in relation to ASC and debt management by suppliers.

Interaction with other workstreams

As outlined in our June consultation letter, there are interactions between the ASC bad debt allowance and a range of other Ofgem workstreams. This includes our work on the Operating Costs review and Levelisation.

<u>Operating Costs review</u>

As outlined in our August 2023 decision, we introduced the ASC allowance to the cap for 12 months initially whilst the ongoing operating costs review considered whether it should provide a more enduring allowance for PPM customers.

Any review of the ASC bad debt allowance to determine whether a true-up is necessary, may be considered as part of the development of the Operating Costs review.

<u>Levelisation</u>

In the August 2023 decision, we stated that the decision on the ASC allowance for bad debt has important interactions with the Government's Energy Price Guarantee (EPG). The EPG aligned charges for comparable direct debt (DD) and PPM customers to ensure that those on PPMs did not pay a premium for their energy costs where the PPM price cap level was higher than the equivalent DD level.

Since April 2024, Ofgem has introduced the levelisation mechanism which adjusts the standing charge costs between PPM and DD customers, so that PPM customers do not pay a premium, following the conclusion of the Government's EPG support.[8] As the ASC Allowance is on the standing charge element of the PPM cap, ASC costs are spread across both PPM and DD customers through this mechanism. This means that the cost of ASC extension will continue to be shared across DD and PPM customers.

Affordability and debt

In March 2024, we issued a Call for Input (CfI) on Affordability and Debt in the domestic retail market. [9] The CfI was issued to understand several aspects of the affordability and debt challenge. These include its size, its impact across all parties, whether it is a temporary or enduring and systematic feature of the market, and whether we have the right policy and regulatory tools to protect those in debt and struggling to pay their bills on an enduring basis. We want to develop solutions that ensure a sustainable, investable market that protects and supports those customers in debt in a compassionate way.

Kind regards,

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[8] Ofgem (2024), Decision on adjusting standing charges for prepayment customers. Decision on adjusting standing charges for prepayment customers | Ofgem
[9] Ofgem (2024), Affordability and debt in the domestic retail market – a Call for Input. Affordability and debt in the domestic retail market – a Call for Input | Ofgem