ofgem
Making a positive difference
for energy consumers

Suppliers, consumer groups and
other interested parties

Email: priceprotectionpolicy@ofgem.gov.uk

Date: 25 February 2025

Dear stakeholder,

Decision to extend the additional debt related costs adjustment allowance

As part of the Operating Costs review consultation in December 2024,[1] we published our minded-to position to extend the additional debt related costs adjustment allowance ('Float') until the implementation of the operating costs review or until September 2025, whichever is sooner. The purpose of this document is to confirm our decision to proceed with this proposal.

In April 2024 we introduced a temporary allowance within the price cap (the cap).[2] This allowed suppliers to recover debt related costs incurred during the period April 2022 to March 2024 that were over and above the existing permanent cap allowances. This temporary allowance will ultimately be replaced by a new enduring allowance for debt-related costs through the operating costs review. We expect to implement the operating cost review later this year and this extension is intended to bridge the gap as suppliers have continued to incur efficient costs above what is allowed for by the permanent debt-related costs allowance.

We are extremely mindful of the impact costs have on consumers. We consider it in consumers' interests that prices reflect the efficient cost of supplying energy. This includes the costs of customer debt incurred, much of which relate to supporting customers facing payment difficulty. This extension is intended to achieve this while smoothing the profile of the overall debt allowances within the cap. We intend to continue to monitor these costs closely across

[1] Ofgem (2024), (Appendix 6) https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-and-debt-allowances-consultation
[2] Ofgem (2024), https://www.ofgem.gov.uk/decision/energy-price-cap-additional-debt-costs-review-decision

industry and review any material and systematic change in costs as part of a wider debt true-up review.

We are acutely aware of the challenges faced by consumers, with wider cost of living pressures affecting some consumers ability to pay energy bills. We have separately consulted on whether there is a case for the introduction of a debt relief scheme to provide support to customers who may be struggling to repay debt built up during the gas crisis. The aim of this would be to bring down the record levels of customer debt and arrears in the domestic energy market.

Introduction

While the energy market has stabilised and the cap has fallen since the highs experienced during the peak of the gas crisis, energy bills remain significantly higher than pre-crisis levels. Along with wider cost of living pressures, this has resulted in a significant rise in the amount of energy debt owed by customers.

Getting into debt 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. In most sectors, debt-related costs are generally recovered from paying customers, and as such have always been part of the cap. Since 2022, there has been a material and systematic change in these costs, compared to what is allowed for in the permanent debt-related costs allowances in the cap.

This led us to introduce a temporary allowance for the efficient additional debt related costs incurred between April 2022 and March 2024. We implemented a 'Float & True-up' approach, where we would set an initial Float using estimates, and review once the latest data was available. This Float allowance was set at £28 per typical dual fuel customer on the cap and was implemented in April 2024 for a period of 12 months, which would come to an end in March 2025 without intervention.

Separate to this decision, we have been carrying out a review of the wider operating cost allowances within the cap, which aims to set a new forward-looking allowance for debt-related costs. This is currently planned to be implemented from July 2025 at the earliest.

Our latest data shows that while aggregated debt-related costs (bad debt charge, debt-related administrative costs and associated working capital costs) are trending downwards from their peak in 2023, they still remain materially above the level of existing permanent cap allowances. Continued high levels of debt & arrears across industry may also indicate suppliers continue to incur additional debt-related costs across the remainder of 2024/2025 financial year, albeit at a considerably slower rate than in 2023.

This raises the issue of a potential 'allowance gap' across the 2024/2025 financial year, where suppliers are still incurring additional levels of debt costs from April 2024 until the implementation of the operating costs review. It also raises the issue of a potential step down in allowances in April 2025 after the current Float allowance rolls off, followed by a step up in July 2025 (at the earliest), due to the implementation of the operating costs review.

Statutory Duties

We set the cap with reference to the 2018 Act which requires us to put in place and maintain the licence conditions which give effect to the cap. The objective of the Act is to protect current and future default tariff customers. We consider protecting customers to mean that prices reflect underlying efficient costs. In doing so, we must have regard to five matters: the need to create incentives for holders of supply licences to improve their efficiency; the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts; the need to maintain incentives for domestic customers to switch to different domestic supply contracts; the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence; and the need to set the cap at a level that takes account of the impact of the cap on public spending.

The requirement to have regard to the five matters identified in section 1(6) of the Act does not mean that we must achieve all of these. In setting the cap, our primary consideration is the protection of existing and future customers who pay standard variable and default rates. In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often, a balance must be struck between competing considerations. In setting the cap, we may not make different provisions for different holders of supply licences. This means that we must set one cap level for all suppliers.

We're also required to have regard to the Growth Duty. In performing this duty, Ofgem must consider the importance of the promotion of economic growth and ensure any regulatory action we take is necessary and proportionate.

Decision

Having considered all stakeholder representations to our December 2024 operating costs review consultation which are relevant to the extension of the Float, along with our latest analysis, we have decided to maintain our consultation minded-to position to extend the Float at its current level until the implementation of the operating costs review or until September 2025, whichever is sooner.

Summary of responses

We received eight responses from industry and one response from a consumer advocate. All industry respondents were in favour of extending the Float given the risks around the emerging allowance gap and temporary step change in debt allowance.

One supplier said that not extending the Float would leave an allowance gap unmanageable for the market to absorb and would eventually increase costs and administrative burden across suppliers and consumers. This supplier also stated the importance of taking into consideration the timing of the operating costs review implementation when deciding on the Float allowance end date. Another supplier said that extending the Float will ensure efficient suppliers cover their additional bad debt costs resulting from the ongoing elevated levels of bills.

The consumer advocate did not agree with our proposal to extend the Float as there was no stipulation for suppliers to use the debt-related costs allowances to clear debt from consumers, referring to the current increase of consumers' debt. They said that debt-related cost allowances should be removed because they put pressure on consumers who are financially struggling, while simultaneously increasing energy bills for everyone and consequently pushing more people into debt.

Although not the focus of this consultation process, most of the industry respondents requested that we review the benchmarking methodology at the True-up stage, with a couple of suppliers requesting changing it for this decision, generally arguing that a weighted average approach should be adopted. One supplier suggested that an increase in the size of the allowance now would help to mitigate the impact of future increases, while another supplier commented on the impact of financing the cost of deferred shortfalls. Another supplier suggested both the float allowance and enduring allowance should be set on the same methodological basis.

Two suppliers said that our current allocation of the allowance used in the float creates a competitive disadvantage to suppliers with a greater proportion of standard credit customers, and a levelisation mechanism would be a more cost-reflective approach to implement. Another stated their concern that the headroom within the cap is too small to cushion the under-recovery from equal allocation.

Overall, we understand that suppliers are primarily concerned about the potential size of the allowance gap for the 2024/2025 financial year. This concern stems from their disagreement with the benchmarking methodology and allocation of the allowance used in the Float.

We have considered these areas of stakeholder feedback in the sections below.

Float extension considerations

We consider it to be in consumers' interests that the prices paid for energy reflect efficient costs of supplying that energy. The cost of unpaid bills is a real cost that is to a significant degree outside of suppliers' control.

As set out in our operating costs review December 2024 consultation, we consider that suppliers may be continuing to incur additional debt-related costs across 2024/2025 financial year, albeit at a considerably slower rate than in 2023. Overall, we continue to observe high levels of debt and arrears across industry. The latest data suggests total debt and arrears has reached just over £3.8 billion in quarter 3 2024. This is an increase of around £2 billion 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.

These increases have been driven by factors including wider cost of living issues putting strain on household finances, which in turn is putting pressure on customers' ability to pay. There is some indication of 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. Although this metric does not relate directly to the debt costs a supplier incurs, it does give a broader picture of the wider debt landscape across industry and frames the ongoing concern around the impact of non-payment on both industry and consumers.

Data collected from industry has been used to assess where efficient costs have materially and systematically deviated from the allowance in the cap. As set out in our December consultation, total debt-related costs saw a significant increase from the end of 2022 and remained at a high level across 2023. A downward trend in total debt-related costs has emerged throughout 2024, however it is too early to suggest a return to historical pre-crisis levels.

Our analysis set out in our December consultation suggests that since April 2024, suppliers have still been incurring costs above what is allowed for by the existing permanent debt allowance in the cap. With our hybrid benchmark approach, from April 2024 to September 2024, suppliers have been under-recovering costs by about £195 million. Since carrying out this analysis we have received the latest industry data for Q4 2024. It was not possible to include this data in our analysis in time for this publication, however initial assessment of the most recent quarter indicates a continued under-recovery of costs across the winter period albeit at a slower rate than across the original float period.

We have decided to extend the Float until the operating costs review is implemented or until September 2025, whichever the sooner. This will be extended at the current level of £31 per dual fuel customer at benchmark consumption[3] and will apply for direct debit and standard credit customers only. We are aware of the interaction between the end of the Float extension and the implementation of the enduring debt allowance as part of the operating costs review. We consider that allowing an extension potentially out to September 2025 accommodates time for a later implementation of the operating costs review, if required.

It is uncertain how costs will develop across the period prior to the implementation of the operating costs review. However, we consider the emergence of this 'allowance gap' may lead to a material and systematic change in costs and that extending the current Float allowance will help toward mitigating the impact it might have.

We estimate that the amount industry could recover through the price cap due to this extension may be in the region of £120 million if the operating costs review is implemented in July 2025.[4] We consider the risk of overcompensating suppliers through the extension to be low, given the levels of under-recovery observed so far within the 'allowance gap'. While it is possible suppliers may experience under-recovery, we note that our recent assessment of the Float allowance was that suppliers over-recovered our benchmark by around £55 million in the period April 2022 to March 2024. We intend to take these factors into consideration as part of a broader true-up review of the various debt elements.

We do not consider it would be in consumers' interest to temporarily reduce the debt-related cost allowance in the cap, because it is likely that such a step down would increase under-recovery, which could later result in increased bills were a further ex-post adjustment considered necessary. Smoothing the profile of debt allowances in this way would help to limit the impact of these costs on consumers, by avoiding costs being recovered in a future winter period with traditionally higher levels of consumption.

In response to points raised by the consumer advocate about the removal of the debt-related cost allowance from the cap, the debt allowance within the cap is intended to enable suppliers

[3] 3,100 kWh for single rate electricity and 12,000 kWh for gas.
[4] 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

to recover the costs associated with non-payment, as is normal commercial practice. While Ofgem enforces strict rules around how suppliers work with and support customers in debt, it is important to retain incentives on both customers and suppliers to try and reduce the amount of debt that is ultimately written off – as these costs still need to be met and higher write-offs would see debt allowances increase further.

It should be noted that we have separately consulted, and are considering responses, on whether there is a case for the introduction of a debt relief scheme to provide direct financial support to energy customers who accrued debt on energy bills during the energy crisis and may be struggling to repay. The aim of such a scheme would be to bring down the record level of consumer debt and arrears in the domestic retail energy market and would form a wider package to reform the approach to energy debt.[5]

General considerations

While this decision is concerned with the Float extension, respondents to the December consultation also communicated their concern around the methodology of the Float allowance. We recognise industry concerns around the emerging allowance gap and ongoing debt-related costs. However, we do not consider it appropriate at this stage to review the methodology either for the extension period or on a backward-looking basis. As set out in Appendix 6 of our December consultation,[6] we still consider the current hybrid benchmarking approach and equal allocation across credit customers to be appropriate for the purposes of a temporary adjustment to the existing allowance for debt-related costs.

We acknowledge the supplier comment stating that the methodological basis for this allowance should be consistent with the enduring allowance for debt as part of the operating costs review. However, we consider the benchmarking approach selected for the Float allowance was based on the novel market conditions and cost of living pressures which had increased debt and arrears in the market. Therefore, the Float was, and remains, a temporary adjustment to the existing allowances for debt-related costs, recognising that there were additional costs relative to the allowances at the time, rather than a wholesale review of the stringency of the underlying debt-related cost allowances. Even with an extension, we still view the float as a temporary measure to address historical costs which we plan to replace with an enduring allowance. We therefore consider that our assessment of historical debt-related allowances should be carried out within its own context.

[5] Ofgem (2024), https://www.ofgem.gov.uk/consultation/resetting-energy-debt-landscape-case-debt-relief-scheme
[6] Ofgem (2024), (Section 2.22 – 2.25) https://www.ofgem.gov.uk/sites/default/files/2024-12/Appendix_6_Review_of_additional_debt_adjustments.pdf

We acknowledge that any review of the float methodology requires careful balancing. As uncertainty remains over the eventual scale of debt-related costs we intend to keep these costs under review as new data becomes available. It is worth noting that the scope of this decision is necessarily limited by the scope of the wider operating costs review and the timeline for implementation.

We acknowledge the supplier comment that an increase now would mitigate possible future impacts on future bills, including due to any potential change in float allowance methodology. However, there is significant uncertainty around the eventual scale of under-recovery, including due to uncertainty over how costs may develop over the remainder of the allowance gap. Likewise, any methodology change is only a possible outcome of a review. We consider our assessment of historical and current debt costs versus allowances (set out above) does not at this stage put us on a clear trajectory to requiring further upward or downward revisions to allowances. Therefore, we consider it appropriate at this stage to take forward our minded-to position for the extension and to review our approach to the methodology as part of a broader true-up at later stage. We would also note that we generally prefer that float allowances are conservative so as to reduce the likelihood of over-compensation requiring future downward adjustments. We do not consider the float extension decision as the appropriate place to review cost allocation (including levelisation), however we intend to discuss this further as part of our operating cost decision and may review further at true-up stage.

In relation to allocation of the allowance, suppliers commented on our statement in the consultation that the headroom allowance could mitigate the impact on suppliers with different customer bases. We do not respond here to the comments that one supplier made about the sufficiency of the headroom allowance, as reviewing the headroom allowance is out of scope for this workstream. We accept that the headroom allowance is the same across suppliers (as noted by one supplier) and so cannot eliminate the relative revenue impacts on particular suppliers from allocation decisions. However, the headroom allowance could still mitigate the risk of a supplier’s revenues being insufficient to cover its notional efficient costs as a result of allocation decisions.

Our role under the Act means we must have regard to the ability of an efficient supplier to finance its supply activities. Even though we are not required to achieve this in all cases, we consider that extending the Float with its current methodology and allocation of allowance enable suppliers to better recover their efficient costs (relative to not extending the float) while protecting existing and future consumers. We consider the ability of suppliers to recover efficient costs in these circumstances to be in the customer interest because customers would pay no more than is necessary to support suppliers’ financeability, while mitigating the risk of customers bearing the costs of unplanned market exits. At the same time, the allowance would support suppliers to offer the appropriate help and support to customers facing debt problems.

We recognise that different methodology options would result in different impacts on suppliers' finances. This includes the impact of allocation decisions on suppliers with different customer bases. At this stage, we highlight that methodology options would also have impacts on the level of protection for customers, including different groups of customers. This would create trade-offs. We consider that a true-up would allow us sufficient time to consider these judgements which are the subject of extensive discussion in our operating cost review consultation.

One supplier said that delayed recovery would increase financing costs, and that we should recognise these costs in the allowance. We recognise that suppliers will have recovered money through the float allowance at a later point than when they incurred costs. However, as noted above, there is uncertainty about the scale of under-recovery. We consider that the need for, and value of, any financing adjustment is best addressed at the true-up stage, when we can consider the full evidence on timing differences between costs and allowances.

We acknowledge the consumer advocate's concerns around the debt allowances increasing bills and putting further pressure on consumers. When setting the float allowance we were acutely aware of the potential compounding effects of price increases on the existing debt problem, so we decided to allocate costs equally over direct debit and standard credit customers only, to minimise the increase on overall debt levels in the system. In doing so, at the time we estimated that this yielded the lowest cost on average to vulnerable customers and the lowest equity weighted costs across all customers. More information on the bill related impacts associated with the Float allowance, along with our public sector equality duty assessment, can be found in our impact analysis within the February 2024 debt-related cost review decision.[7]

<u>True-up review</u>

We currently intend to conduct a broad true-up of the various debt elements within the cap when we have greater clarity on the materiality of debt-related costs in the 2024/2025 financial year and across the full period of potential under-recovery prior to the implementation of the operating costs review. Also, we intend to consider interactions with other workstreams around any potential debt relief scheme.

[7] Ofgem (2024), (Chp 7) https://www.ofgem.gov.uk/sites/default/files/2024-02/Energy-price-cap-additional-debt-costs-review-decision.pdf

As part of the wider operating costs review consultation, we undertook a disclosure process to provide stakeholders with underlying information needed to understand and engage with the matters being consulted on. Advisers were able to view our detailed debt related cost models and provide comment. As part of this process, we received queries seeking clarification and comments relating to model accuracy which we are still analysing. Any substantive issues raised in relation to model accuracy may be factored into our considerations (depending on the outcome of our own analysis) as part of the wider true-up review.

Additional Support Credit (ASC)

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. Due to the change in implementation of the operating costs review, we published a decision in August 2024 to extend the ASC allowance until the operating costs review is implemented in 2025.[8]

Implementation of extension

In terms of implementing the Float extension in the price cap, we will continue to use 'Annex 8 - methodology of adjustment allowance', as previously consulted on and set out in our decision in February 2024. We have published an amended version of the model alongside this letter showing the changes that will be made in order to extend the Float across April 2025 to June 2025. If the operating costs review is not implemented for July 2025, we will continue to use Annex 8 to extend the Float across July 2025 to September 2025, but no further.

We note that Annex 8 is not one of the models that we would ordinarily update as part of an interim charge restriction period (ie cap periods which commence in July and January) in line with our decision to move to a quarterly price cap.[9] However, upon reviewing the responses to this consultation, we consider that it is in consumer interests to ensure that the float extension falls away at the earliest opportunity once the operating cost review takes effect. We therefore consider it appropriate to update Annex 8 from July, if required, despite this cap period being an interim charge restriction period.

Yours faithfully

Daniel Newport

Deputy Director, Retail

---

[8] Ofgem (2024), https://www.ofgem.gov.uk/decision/decision-extension-additional-support-credit-bad-debt-cost-allowance

[9] Ofgem (2022), https://www.ofgem.gov.uk/decision/price-cap-decision-changes-wholesale-methodology