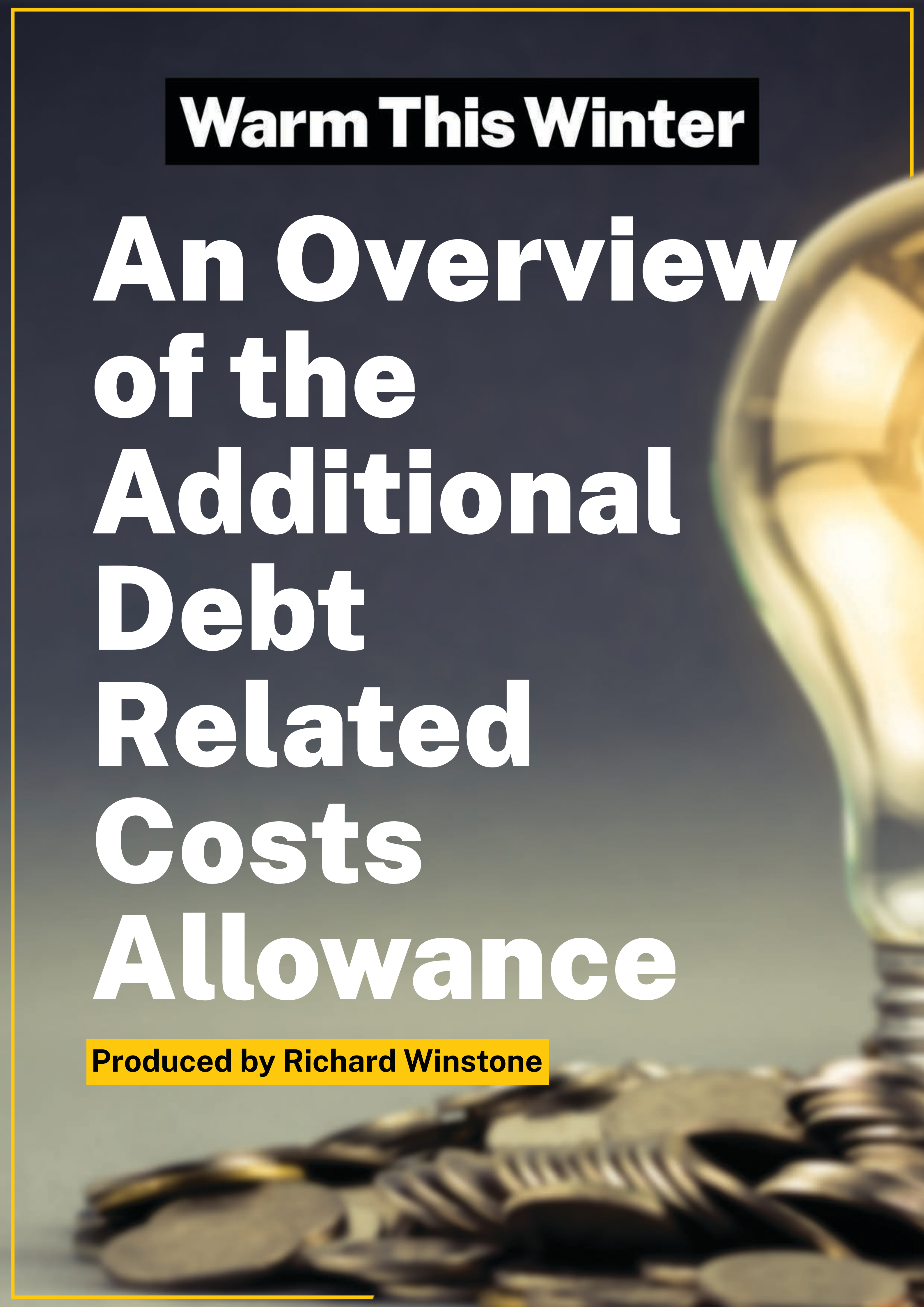

Warm This Winter

An Overview of the Additional Debt Related Costs Allowance

Produced by Richard Winstone

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Executive summary

The report below highlights key issues with Ofgem's treatment of debt-related costs in the price cap. The key information raised from this report is as follows:

- From April 2024 to March 2025, consumers will pay a total of £1.3bn toward debt-related costs.
- Ofgem's new additional debt-related costs allowance accounts for £0.7bn of the £1.3bn to be paid and is indicated to become a permanent fixture on our bills from April 2025.
- Ofgem do not know how much of the current price cap is attributed to debt-related costs, they are guessing, and they are estimating how much debt-related costs will be from October 2023 – March 2024 and adding that estimate to our bills.
- The new debt-related costs allowance explicitly allows energy suppliers to recoup the costs of the moratorium on involuntary prepayment meter installations, estimated to have increased debt in the industry directly by around £300m between February and December 2023.
- Whilst there is £3.1bn in debt in the energy industry, energy suppliers are sitting on approximately £7bn of consumer credit balances.
- Of the £3.1bn in debt, £0.9bn is already being paid off in some form of payment plan (including involuntary prepayment meters).
- Around 35% of the remaining £2.2bn in arrears was incurred between Q1 2023 and Q4 2023, whilst the moratorium on involuntary prepayment meter installations was in place.
- As of yet, no investigation has been completed by Ofgem into the illegal practices that led to the moratorium, so consumers are the only ones paying for the breach in regulations by suppliers.
- This is the second new debt-related allowance coming into effect in the last six months, with Ofgem adding approximately £70m to consumer bills in October 2023 through the Additional Support Credit (ASC) bad debt allowance.
- Ofgem state that some of the latest allowance will go towards "write-offs" from supplier's income statements, but no answer has been given as to whether these write-offs actually come off of the customer accounts or whether their debts are sold to debt collection agencies.

Questions to Ofgem

- How much of the £1.3bn will actually be used to support consumers by writing the debt off of their accounts?
- How much "bad-debt" are energy suppliers claiming each year, and how much of that bad debt is actually written off of customer accounts?
- What rules are in place to ensure that energy suppliers use this money to aid struggling households?
- How do you justify passing the cost of the moratorium, designed to protect consumers from the illegal practices of energy suppliers, on to consumers without having concluded any investigations nor implemented any sanctions to offending suppliers?

A report on Ofgem's latest debt-related cost allowance

The cost to consumers

On 23 February 2024 Ofgem announced a decision to add a temporary allowance to the price cap[1], to allow suppliers to recoup additional debt-related costs incurred from April 2022 through to March 2024, using an estimate of costs incurred in winter 2023/24.

This allowance is being set at £28 per customer per year, for all customers on a standard variable tariff (a.k.a. default tariff) that pay for their energy bills either via direct debit or standard credit. No additional cost is being given to prepayment meter customers, therefore we expect this allowance to give suppliers an estimated £700m additional revenue between April 2024 and March 2025, using Ofgem's estimate of 25 million non-prepayment meter customers on SVTs[2].

The price cap currently already has bad debt provisions, but according to Ofgem's own words *"… we are unable to directly identify an apportionment between debt-related costs and non-debt-related costs in some specific allowances, (such as operating costs). We therefore must estimate it."*[3] They go on to say that "*the significant data challenges … require us to make complex estimations, based in part on judgement and assumptions, across several individual allowances.*"[4] Therefore, it is not possible for us to verify if the price cap efficiently covers debt related costs or not. Ofgem's summary of the debt related allowances in the price cap for January – March 2024 are as follows[5]:

- Direct debit (DD) customers: £26.13 (1.3% of the total cap level)
- Standard credit (SC) customers: £134.13 (6.1% of the total cap level)
- Prepayment meter (PPM) customers: £19.52 (0.9% of the total cap level)

It is worth noting that these are the only figures given by Ofgem in their decision document and are at benchmark consumption (3,100kWh for electricity and 12,000kWh for gas) rather than at current TDCVs. At benchmark consumption levels, this new allowance will add £31 of debt-related costs to the price cap for direct debit and standard credit customers[6]. No addition will be made to PPM customers. Going forward I will use the following estimates for TDCV levels of existing debt related costs in price cap period 11b:

- Direct debit (DD) customers: £21.96
- Standard credit (SC) customers: £112.71
- Prepayment meter (PPM) customers: £16.40

From 1 October 2023, an allowance for additional support credit bad debt costs was added to the price cap for prepayment meter customers[7]. This allowance is for £8.77 but was covered by the government under the Energy Price Guarantee (EPG) until the end of March, and is estimated to have impacted public spending by £16m between October 2023 and March 2024 (an even £8m for Q4 2023 and Q1 2024[8]). Originally, Ofgem intended this cost to be split across all payment types from April 2024 as part of their levelisation workstream, but the levelisation work has now been split into 2 phases and the debt-related work will not occur until the winter of 2024[1]. With the Government's EPG coming to an end on 31 March 2024, the £8.77 ASC bad debt related allowance will fall onto the bills of PPM customers.

Simultaneously, the COVID-19 true-up costs for bad debt will be falling away the bills of direct debit and standard credit customers from 1 April 2024, a decrease of £11[9].

In summary, from April 2024 to March 2025, there will be over £730m additional being paid to energy suppliers, on top of the pre-existing bad debt allowances being paid. Looking at the current price cap, using the estimated 4 million PPM customers in the UK, around £66m will be paid by PPM customers to account for bad debt related costs. Ofgem state there are 25 million customers on non-PPM meters in the UK[2] and, using figures taken from Ofgem's call for input on levelising payment type cost differentials, around 10% of these are SC customers with the remaining 22.5 million being direct debit customers[10]. Therefore, there is another £494m of debt allowances being paid annually by direct debit customers and £282m being paid by SC customers.

Finally, remembering that £11 of COVID 19 true-up bad debt related costs will be falling off of the bills of DD and SC customers, we see a reduction of £275m going to debt related costs going forward.

Therefore, the conservative total of annual debt related costs in the price cap comes to over £1.3bn for the year from April 2024 to March 2025. This information is summarised in the below table.

Total Bad Debt Allowances (BDA) April 2024 to March 2025

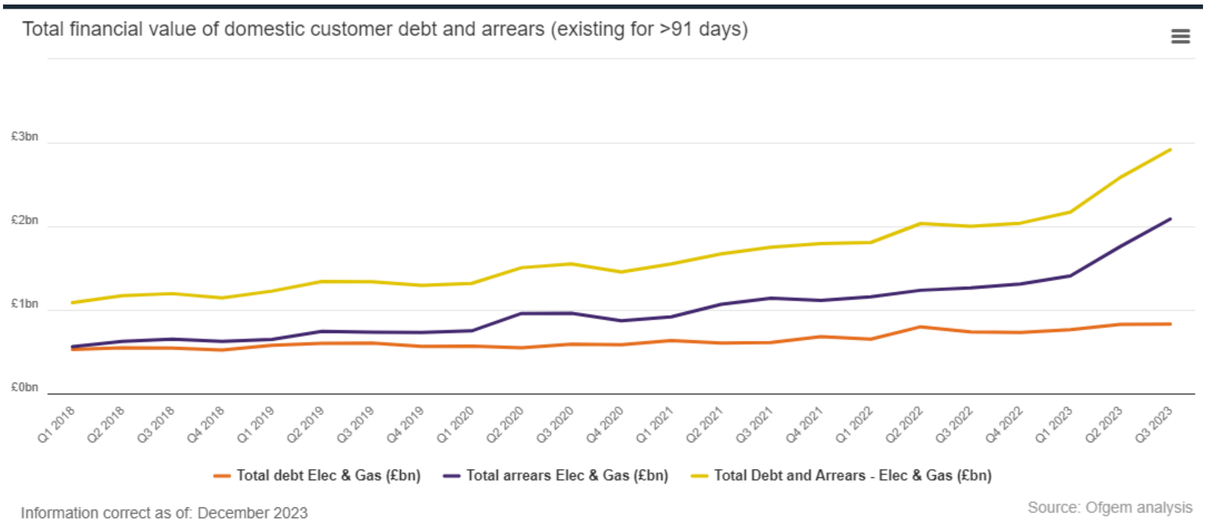
Payment type	Customers	New ASC BDA	New BDA	Total new BDA	Existing BDA	Total existing BDA	Covid-19 BDA removal	Total BDA
DD	22.5m	£ -	£ 28.00	£630m	£ 21.96	£494m	-£247.5m	£876.5m
SC	2.5m	£ -	£ 28.00	£70m	£ 112.71	£282m	-£27.5m	£324.5m
PPM	4m	£ 8.77	£ -	£35m	£ 16.40	£66m	£ -	£101m
Total	29m			£735m		£842m	-£257m	£1,302m

Is this additional allowance really needed?

Ofgem's decision document on this allowance states there is currently £3.1bn[11] in debt in the industry, up from £2bn at the beginning of 2023. Ofgem are using the term "debt" as a broad term to refer to all debt and all arrears more than 90 days due, this means that not all £3.1bn of the “debt” referred to by Ofgem is really bad debt. Below are the definitions of debt and arrears taken from Ofgem[12].

> Customers in arrears are customers who owe a debt to their supplier, but do not yet have a debt repayment arrangement in place.
>
> Customers in debt have entered a formal arrangement with their supplier to repay outstanding debts, including all prepayment (PPM) customers repaying a debt, and non-PPM customers on debt repayment arrangements extending beyond 91 days/13 weeks.

According to data taken from Ofgem’s website the huge increase in debt during 2023 comes from customers in arrears, not debt, as you can see from the graph below[12].



From Q1 2018 through to Q3 2023, total debt has risen from roughly £0.5bn to £0.8bn, but in the same period arrears have risen from around £0.5bn to around £2.1bn. The sharpest increase in arrears occurs in Q1 2023, which coincides with the temporary moratorium on involuntary prepayment meter installations, following the news that certain suppliers were illegally force-fitting prepayment meters in the homes of vulnerable people. This moratorium has now been lifted and the majority of suppliers have reached Ofgem’s criteria for restarting involuntary prepayment meter installations[13], meaning we are likely to see these arrears declining.

According to Ofgem, around £25m per month of additional debt has been accrued between February and September 2023 due to the moratorium[14], with Ofgem expecting costs associated with the moratorium to be higher in winter 2023. Therefore, a large chunk of the increased debt is due to the moratorium, over £275m between February and December 2023.

The allowance is in place as uncertainty remains over the eventual scale of the debt related costs[9], and there is no certainty over the debt related costs from the 23/24 winter period, so this allowance is a guess to cover a guess. It is being set as a float and true up allowance, meaning there will be another review around April 2025 of the costs incurred from April 22 to Mar 24 and a “true-up” allowance will be placed thereafter if it is warranted. This could be an increase or a decrease to the price cap.

As it stands, the justification for this increase is flimsy, the lack of clarity on the existing bad debt related allowances makes it uncertain how much consumers are already paying and Ofgem have put in place no obligation on suppliers to ensure the additional debt related allowances are given to customers, so we are unlikely to see £700m worth of benefit. Furthermore, it looks as though Ofgem are intending to move this increased allowance to the operating costs element of the price cap on a permanent basis from 2025.

This allowance is designed to be temporary but debt-related costs will form part of the operational allowance review occurring in 2024. Just as when Ofgem put a temporary ringfencing allowance in the cap in 2023 and then made it permanent as part of the EBIT allowance review later that year, we are likely to see a similar thing with this temporary debt allowance being made permanent via the operational cost allowance review. Indeed, Ofgem state in their decision document for the additional debt allowance that "*we intend to have delivered … the review of operation cost allowances, which seeks to establish a new enduring allowance for debt-related costs.*"[9] It is likely that consumers will see little benefit going forward to paying increased bills as a permanent part of the debt related cost allowance.

Where does the money go?

According to Ofgem's documentation, the "debt-related costs" are comprised of three main cost categories[1]:

- bad debt,
- debt related administrative costs and;
- working capital.

According to the analysis provided by Ofgem, there has been (and will continue to be) a severe under-allowance for the bad debt element of the debt-related costs and a smaller over-allowance of both debt-related administrative allowance and working capital allowance.

Whilst Ofgem do not explicitly break down the make-up of this £28 new debt-related costs allowance, they do provide the following breakdown of historic under/over allowances in the price cap for periods 8 to 10b[15]:

- Bad debt – under-allowance of £47
- Debt related admin costs – over-allowance of £10
- Working capital costs – over-allowance of £11

According to Ofgem: "*The largest debt-related cost relates to the value of bills which are never paid. This cost is reflected in suppliers' accounts through the bad debt charge, which is an entry in the income statement. Suppliers make estimates (known as provisions) for the amount which will never be paid. They then adjust these estimates over time, and eventually finalise them through write-offs. The other debt-related costs are debt administration costs (the administrative costs to suppliers from dealing with customers in debt) and working capital costs (day-to-day costs relating to the operation of a business).*"[16]

The problem is that Ofgem does not dictate how much of the bad debt related allowances should be used to write off consumer debts. There is no regulation around it, instead the supplier gets to decide this themselves.

There is also no explanation as to what a “write off” is. There are two different forms of write-off from an energy suppliers’ perspective. The first is an accounting version, where the supplier adds a “bad-debt” element to their income statement for debts they expect never to retrieve, but this does not mean the debt has been forgiven. The second form is writing off the debt from customer accounts. Just because a supplier puts a certain financial figure for bad debt on their income statement, it does not mean that the supplier has forgiven that much debt on customer accounts, they can and do continue to chase customers for that money and then report it as income in future periods if they are able to retrieve any additional income.

Each year around £375m is paid out in Warm Home Discounts, which is funded by suppliers and mandated by the Government. Many suppliers have also signed up to The Winter 2023 Voluntary Debt Commitment, in which the suppliers commit to treating customers in debt fairly, offering financial assistance to those in need, helping customers achieve lower bills, ensuring bills are accurate and supporting a national communications campaign. However, no precise figures for write-offs are given, these supportive measures also extend to non-domestic customers and the amount of funding that goes towards these schemes is significantly less than the £1.3bn consumers will be paying for debt-related costs.

About the author

In 2022, Richard Winstone led a change.org petition with 350,000 signatures urging Ofgem to alter the EBIT formula in the price cap calculation. As part of Over50sMoney, Richard's work then evolved to regular engagement with Ofgem on consultations and creating explanatory videos to simplify consultations, resulting in 10,000 responses sent to Ofgem. He now runs a YouTube channel, The Regulator Guy, which aims to broaden consultation participation. Future plans include expanding consultation engagement and supporting various campaigns to increase consumer input in regulatory processes.

THE REGULATOR GUY

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