

Consultation

Levelling the cost of standing charges on prepayment meters

Publication date: 25 August 2023

Response deadline: 22 September 2023

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We are consulting on options for adjusting standing charges for customers on Prepayment Meters (PPM) by socialising (or 'levelising') prices across payment methods which would make them more equal or equitable (but less cost-reflective). We seek views from stakeholders with an interest in price protection for domestic consumers. We particularly welcome responses from suppliers, consumer groups and charities, the general public and any other stakeholders.

This policy consultation outlines the case for levelisation of PPM standing charges and other wider payment method differentials (hereafter 'levelisation') and associated considerations, along with a supporting Impact Assessment and model. It also includes proposals and considerations for the individual aspects of how levelisation may operate as well as options for a supplier reconciliation process to support levelisation.

Once the consultation is closed, we will consider all responses. To facilitate transparency, we will publish non-confidential responses alongside the next steps on our website at [ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you would like your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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Executive Summary

For a long time, energy customers on different payment methods have paid different prices for the same tariffs. Since the Default Price Cap ('cap')¹ was introduced in 2019, Ofgem has typically followed the principle of cost reflectivity in setting the allowances and costs to consumers. This approach has usually led to Pre-Payment Meter (PPM) and Standard Credit (SC) customers paying more for their energy than equivalent customers paying through Direct Debit (DD). This practice is also common for tariffs that sit outside of the price cap in the open market, such as fixed rate tariffs.

Currently, most energy customers are on Standard Variable Tariffs covered by the cap. The recent increase in wholesale energy costs and energy bills has resulted in an increase to the differences paid by customers of each energy bill payment method. Taken together, with broader concerns about PPM practices and whether PPM customers are being treated fairly, we have undertaken a review to consider whether this cost reflectivity, may have caused unintended consequences to PPM customers, and if this is a case for PPM levelisation, particularly on the standing charge. We are also considering whether there is a case to reduce the differential between SC and DD based on specific costs relating to bad debt.

The government has requested² we report by autumn 2023 on the regulatory options to remove cost premiums associated with the PPM payment method, to be ready for any implementation once the Energy Price Guarantee (EPG³) ends in March 2024. In our Forward Work Programme, under the priority of ensuring prices are fair, we committed to working with the Department for Energy Security and Net Zero (DESNZ) to develop policy options to enable the 'levelisation' of pricing for customers on PPMs.⁴

In April 2023, we published a Call for Evidence (CfE⁵), asking for views and evidence on the need for a levelisation process between energy bill payment methods. We also asked for views on how we could levelise particular aspects of charges and presented our initial analysis on consumer and distributional impacts. We also requested views on the potential mechanisms through which reconciliation between suppliers may be undertaken, with consideration of the impacts on competition and the ability of suppliers

¹ Domestic Gas and Electricity (Tariff Cap) 2018. <https://www.legislation.gov.uk/ukpga/2018/21/contents>

² HM Treasury (2023), Spring Budget. <https://www.gov.uk/government/publications/spring-budget-2023/spring-budget-2023-html>

³ Department for Energy Security & Net Zero (2023), Energy Price Guarantee. <https://www.gov.uk/government/publications/energy-bills-support/energy-bills-support-factsheet-8-september-2022>

⁴ Ofgem (2023), 2023/24 Forward Work Programme. <https://www.ofgem.gov.uk/publications/202324-forward-work-programme>

⁵ Ofgem (2023), Levelisation of payment method cost differentials: a call for evidence. <https://www.ofgem.gov.uk/publications/levelisation-payment-method-cost-differentials-call-evidence>

to finance their activities.

The majority of respondents to the CfE supported the introduction of a levelisation process. Many of the respondents outlined support due to higher degrees of vulnerability found with PPM customers and the need to eliminate PPM standing charge premiums due to the specific issues around debt build up during periods of low demand or self-disconnection. There was also broad support for inclusion of elements of SC costs within levelisation, and for the introduction of a reconciliation process to support levelisation between suppliers and ensure a proportional impact on the market.

This consultation sets out our case for an enduring and market-wide (both within and outside of the cap) 'levelisation' process for rebalancing some of the costs customers face across payment methods. We seek views on our underlying considerations for levelisation, as well as our initial position to levelise PPM and DD standing charges and the costs of bad debt related to Additional Support Credit (ASC⁶) and to consult on levelising specific debt-related costs across all payment methods, reducing the SC and DD cost differential. We are also seeking views on our proposed reconciliation process between suppliers for supporting levelisation.

We consider that the risk of higher charges on PPM, specifically from standing charges, raises the potential for further customer debt, self-rationing and/or disconnection. We therefore consider there to be benefits to removing the standing charge differential between customers of these payment methods. However, we note that the Impact Assessment shows overall benefit for consumers and the market to be finely balanced.

We are calling on views and evidence from all interested parties to help us shape our approach to levelisation, including our case for change and considerations for levelisation, how we could levelise and through which means. We particularly welcome responses from consumer groups and charities, energy suppliers and industry bodies. We would also welcome responses from other stakeholders and the public. We set out specific questions in the relevant chapters of this document and in **Appendix 1**. We are seeking written comments to these questions by **22 September 2023**. Please send comments to priceprotectionpolicy@ofgem.gov.uk. We will consider all responses and publish our final proposals and statutory consultation in autumn 2023 followed by a decision early 2024.

⁶ Ofgem (2023), Allowance for additional support credit bad debt costs.
<https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs>

1. Introduction

Chapter summary

We set out what we are consulting on, the consultation process and how to respond within this chapter. It also provides an overview of each of the sections in the document as well as related publications.

- 1.1 Against the backdrop of the cost-of-living crisis, there has been public concern around Prepayment Meters (PPM) and concerns over the premiums in which customers pay for using a specific payment method. In January, we flagged concerns relating to PPM practices and whether these customers are treated fairly.⁷ Following the investigation of forced installation practices, we have also launched a new Code of Practice for involuntary PPM installations.⁸
- 1.2 In the government's Spring Budget, the Chancellor committed to removing the differential between PPM and Direct Debit (DD) tariffs via the Energy Price Guarantee (EPG) until March 2024. The EPG temporarily uses taxpayer funding to levelise PPM tariffs against DD tariffs until March 2024.
- 1.3 The government has supported our ongoing work to review PPM costs and has asked Ofgem to report to the Chancellor regarding any additional regulatory options for ending the PPM standing charge premium by autumn 2023, ready for implementation in April 2024.⁹
- 1.4 We recently published a Call for Evidence (CfE) seeking stakeholder views on the levelisation of payment method cost differentials which closed on 18 May 2023; the responses are available on the Ofgem website.¹⁰ Our CfE used illustrative examples to demonstrate how we could levelise aspects of charges such as unit rates and/or standing charges as well as options on how a reconciliation mechanism could work. The CfE sought views on our approaches to levelisation, which were presented alongside our initial analysis on consumer impacts by payment method, with a focus on distributional impacts.

⁷ Ofgem (2023), Tackling inappropriate energy supplier prepayment meter practices. <https://www.ofgem.gov.uk/news-and-views/blog/tackling-inappropriate-energy-supplier-prepayment-meter-practices>

⁸ Ofgem, Involuntary PPM - Supplier Code of Practice. <https://www.ofgem.gov.uk/publications/involuntary-ppm-supplier-code-practice>

⁹ HM Treasury (2023), Spring Budget. <https://www.gov.uk/government/publications/spring-budget-2023/spring-budget-2023-html>

¹⁰ Ofgem (2023), Levelisation of payment method cost differentials: a call for evidence. <https://www.ofgem.gov.uk/publications/levelisation-payment-method-cost-differentials-call-evidence>

- 1.5 In addition to this, we hosted a workshop with stakeholders on the reconciliation mechanism in July 2023. This mechanism would prevent suppliers from substantially profiting or losing from the implementation of levelisation. Without a reconciliation mechanism, there could be a risk to the stability of suppliers with a higher proportion of customers using one payment method or another.
- 1.6 We received 20 responses to our CfE from a range of stakeholders. These included responses from 9 energy suppliers, 1 industry group, 8 charities and consumer groups and 2 from individuals. Eighteen respondents were in support of the need for levelisation, with 2 against it. There were 9 responses in support of a need for a reconciliation mechanism with 1 stakeholder disagreeing.

What are we consulting on?

- 1.7 The purpose of this policy consultation is to seek views on the case for levelisation, our considerations for levelisation and our initial proposals for how and what to levelise relating to payment method cost differentials as well as options for the reconciliation mechanism.
- 1.8 In Chapter 2, we outline Ofgem’s consumer objectives, the historical context for the different energy bill payment methods and the associated cost differentials of these. It also sets out how payment methods intersect with consumer vulnerability and the case for change.
- 1.9 In Chapter 3, we have set out our considerations, proposals and considerations for levelisation, and other areas of consideration that we had received feedback on, but that we are not proposing in this consultation.
- 1.10 In Chapter 4, we have set out proposals for a new payment reconciliation mechanism, which includes the context and need for a new mechanism, our proposals based on analysis and feedback from the recent CfE and stakeholder workshop. We have also identified four different approaches to the reconciliation of the levelisation costs and provided summaries of how these could work and the different implementation costs.
- 1.11 In Chapter 5, we have set out the interactions with other workstreams and next steps are discussed in Chapter 6.

Related publications:

- 1.12 The main documents relating to the cap are:
- Domestic Gas and Electricity (Tariff Cap) Act 2018:
<https://www.legislation.gov.uk/ukpga/2018/21>

- 2018 decision on the cap methodology ('2018 decision'): <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>
- Energy Prices Act 2022: <https://www.legislation.gov.uk/ukpga/2022/44>

1.13 The main documents relating to this consultation are:

- Levelisation of a payment method cost differentials: a call for evidence: <https://www.ofgem.gov.uk/publications/levelisation-payment-method-cost-differentials-call-evidence>
- Tackling inappropriate energy supplier prepayment meter practices: <https://www.ofgem.gov.uk/news-and-views/blog/tackling-inappropriate-energy-supplier-prepayment-meter-practices>
- Price cap – Call for Input on the allowance for debt-related costs: <https://www.ofgem.gov.uk/publications/price-cap-call-input-allowance-debt-related-costs>
- Price cap - Call for Input on the Operating Cost Allowances Review: <https://www.ofgem.gov.uk/publications/price-cap-call-input-operating-cost-allowances-review>
- Allowance for additional support credit bad debt costs: <https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs>

Consultation stages

1.14 This policy consultation is open between 25 August and 22 September. We will consider responses to inform our final proposals in November 2023.

Figure 1: Consultation stages

Stage 1 (Complete)	Stage 2 (Current)	Stage 3	Stage 4
Call for Evidence	Policy Consultation	Final Proposals & Statutory Consultation	Decision
April 2023	August 2023	November 2023	Early 2024

How to respond

1.15 We want to hear from anyone interested in this consultation. Please send your response to priceprotectionpolicy@ofgem.gov.uk on or before 22 September 2023.

1.16 We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

1.17 We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

1.18 You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.19 If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.20 If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

1.21 If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

1.22 We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?

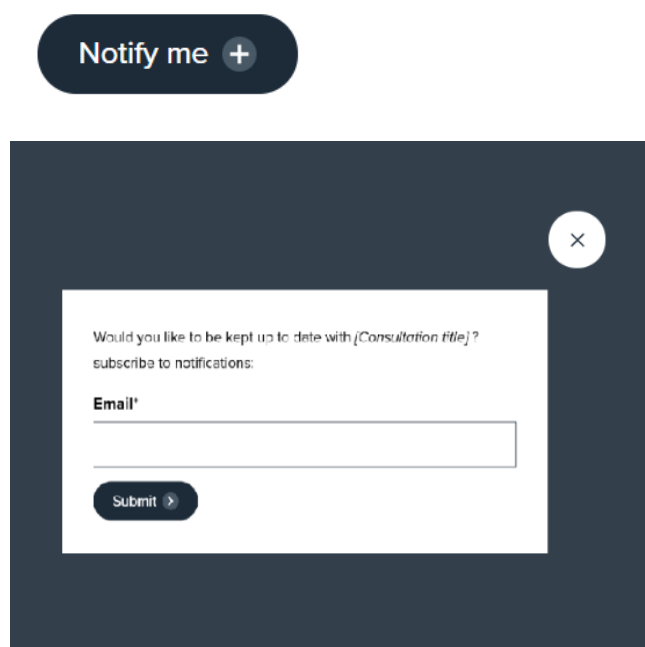
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website.

[Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations)



The image shows a dark blue button labeled "Notify me" with a plus sign icon. Below it is a dark blue modal window with a white background. The modal contains the text: "Would you like to be kept up to date with [Consultation title]?" followed by "subscribe to notifications:". There is an "Email" label above a text input field. At the bottom of the input field is a dark blue button labeled "Submit" with a right-pointing arrow icon. A white close button with an 'x' icon is in the top right corner of the modal.

Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

Upcoming > **Open** > **Closed** (awaiting decision) > **Closed** (with decision)

2. Case for Change

Chapter summary

We describe Ofgem’s consumer objectives, the historical context for the different energy bill payment methods and the associated cost differentials of these. It also sets out how payment methods intersect with consumer vulnerability. Finally, going on to discuss the case for change.

Questions

- 1) Do you have any views on our proposed case for the introduction of levelisation of payment methods?

Ofgem’s Consumer objectives and frameworks

- 2.1 The energy crisis and associated market volatility has put an unprecedented strain on energy consumers. Ofgem’s principal objective is to protect the interests of energy consumers, including having regard to the interests of vulnerable consumers (our ‘vulnerability duty’¹¹). Under our statutory framework we are required to carry out functions in the manner best calculated to further the principal objective wherever appropriate by promotion of effective competition between suppliers.¹² Additionally, Ofgem has general powers to amend standard licence conditions for gas and electricity suppliers under the Gas Act 1986¹³ and the Electricity Act 1989¹⁴.
- 2.2 In making decisions on cost allocation within the price cap, Ofgem must balance its principal objective to protect customers with the five duties to ‘have regard to’ under the Domestic Gas and Electricity (Tariff Cap) Act 2018¹⁵ and our wider vulnerability duties, including the Public Sector Equality Duty. This has given us cause, from time to time, to deviate from strict cost reflectivity.
- 2.3 Wider cost of living concerns and affordability issues, especially where they have an impact on tax and spend decisions, sit with government.
- 2.4 Our Consumer Interest framework sets out the various factors for consideration

¹¹ Our principal objective, and vulnerability duty, are contained in the Gas Act 1986 and the Electricity Act 1989. How we interpret and apply our vulnerability duty is also informed by other sources, such as the Equality Act 2010 and human rights law.

¹² Ofgem (2013), Our powers and duties. <https://www.ofgem.gov.uk/publications/our-powers-and-duties>

¹³ Gas Act 1986. <https://www.legislation.gov.uk/ukpga/1986/44>

¹⁴ Electricity Act 1989. <https://www.legislation.gov.uk/ukpga/1989/29/contents>

¹⁵ Domestic Gas and Electricity (Tariff Cap) 2018. <https://www.legislation.gov.uk/ukpga/2018/21/contents>

when undertaking an assessment or minded-to intervention, in line with Ofgem's objectives and obligations.¹⁶ These factors include Fair Prices, Resilience, Lost-Cost Transition and Quality and Standards. For the levelisation process, we are consulting on options to rebalance costs that customers face across payment methods. We therefore consider 'Fair Prices' to be the most relevant Consumer Impact factor for the levelisation process. We also consider the factors of 'Quality and Standards' and 'Resilience' to be relevant for the reconciliation process, so that suppliers can continue to invest in service and are adequately funded.

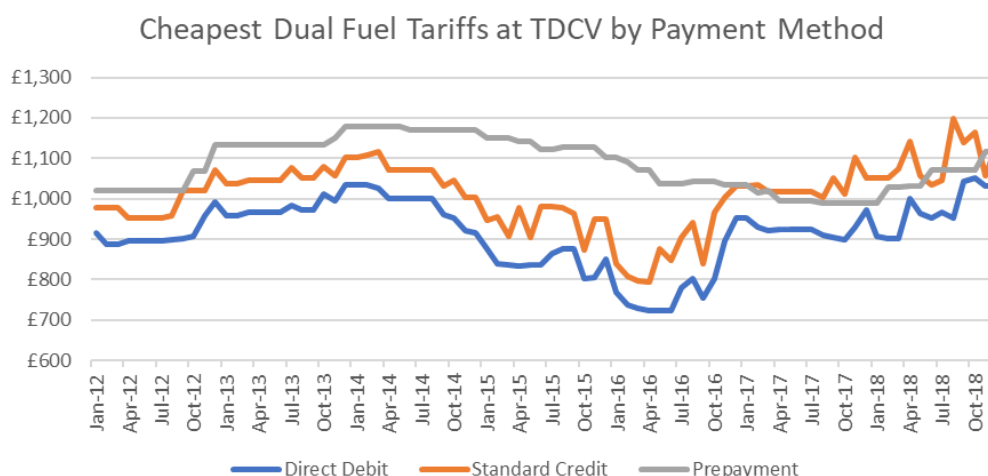
Historical differences between Payment Methods

- 2.5 Before the introduction of the price cap in 2019, the cost differences between payment methods (DD, PPM, SC) were largely set based on the costs to serve these customers, although these were not always reflected in full, with DD customers bearing some of the cost to serve for SC and PPM customers.
- 2.6 Historically, for PPM the installation and maintenance of a traditional (pre-SMART) PPM meter would typically result in higher costs to the supplier relative to DD, which were subsequently passed on to PPM customers. For SC, the higher administrative costs and bad debt (ie the cost of bills that are not paid and need to be written-off by the supplier) would then be passed onto SC customers, increasing their costs compared to PPM and DD.
- 2.7 **Figure 2** shows the cheapest dual-fuel tariffs in the six years prior to the introduction of the price cap, based on Typical Domestic Consumption Values (TDCV) at the time. The figure shows that over the period, DD was consistently the cheapest payment method available with notable savings over SC and PPM. SC was typically the second cheapest payment method in this period, with PPM typically being the most expensive, until 2017, when SC became the most expensive payment method for energy bills. This was due to the introduction of a prepayment safeguard tariff introduced by the CMA.¹⁷

¹⁶ Ofgem (2023), Forward Work Programme. <https://www.ofgem.gov.uk/publications/202324-forward-work-programme>

¹⁷ Ofgem (2017), Prepayment price cap: 1 October 2017 to 31 March 2018. <https://www.ofgem.gov.uk/publications/prepayment-price-cap-1-october-2017-31-march-2018>

Figure 2: Cheapest Dual-Fuel Tariffs by Payment Method (2012-2018) at Typical Domestic Consumption Values



Payment Methods under the Price Cap

Default Price Cap

- 2.8 The default price cap (the 'cap') was introduced on 1 January 2019, with the aim to protect existing and future default tariff customers, by ensuring that less engaged consumers pay a fair price for their energy. The cap is set out in legislation through the 2018 Act.
- 2.9 The cap sets a maximum price that energy suppliers can charge consumers for each kilowatt hour (kWh) of energy used and the standing charge, with separate cap levels for electricity and gas. The cap is predominantly calculated on cost-reflectivity principles and reflects the efficient costs of a notional supplier. The cap value is set based on an established methodology, using inputs from a combination of components, including:
- Wholesale energy costs
 - Network costs
 - Policy costs
 - Supplier operating costs
 - VAT
- 2.10 The principle of cost reflectivity is important for a number of reasons:
- Price cap tariffs should be broadly comparable with non-capped tariffs with equivalent characteristics, allowing customers to choose between the cap and open market tariffs.

- Substantive variations between the cap level and the wider market for some groups of customers could lead to customers and/or suppliers seeking to arbitrage price differences with unpredictable consequences.
- If efficient suppliers cannot earn normal profits from a group of customers due to unrecoverable cost differences, they may be incentivised not to acquire these customers, or provide substandard service to them.
- We have a duty under the 2018 Act to have regard to the ability of suppliers to finance their activities, specialist suppliers with large numbers of one group of customers may not be able to recover their efficient costs.

2.11 Ofgem has typically followed the principle of cost reflectivity in setting the cap allowances and costs to consumers. However, there are instances where we have updated the cap on a non-cost reflective basis, in customers' interest such as:

- In our 2018 decision on the price cap,¹⁸ we calibrated the price cap benchmark at nil consumption at a level in line with prior industry practice to protect low volume consumers from substantially increased standing charges.
- In the same decision, we spread some of the costs of serving SC customers across the entire market, when setting the payment method uplift for SC and DD customers. SC customers have higher costs on average, but a significant fraction of this relates to bad debt, which is a cost incurred by certain individual customers who don't pay their bills. SC customers who do pay their bills don't have higher bad debt costs than DD customers. The decision could be seen as not reflecting the costs of serving SC customers as a group – but means that the bills for SC customers who do pay their bills are a better reflection of their own costs.¹⁹
- In our August 2020 decision²⁰ we decided to maintain the tariff differential on the grounds that it would protect PPM customers (which we considered a particularly vulnerable group), consistent with our primary obligation of consumer protection (see §4.37).

¹⁸ Ofgem (2018), Default tariff cap: decision, Appendix 1 – para 1.5.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

¹⁹ Ofgem (2018), Default tariff cap: decision, Appendix 8 – para 3.48.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

²⁰ Ofgem (2020), Protecting energy consumers with prepayment meters.

<https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumers-prepayment-meters>

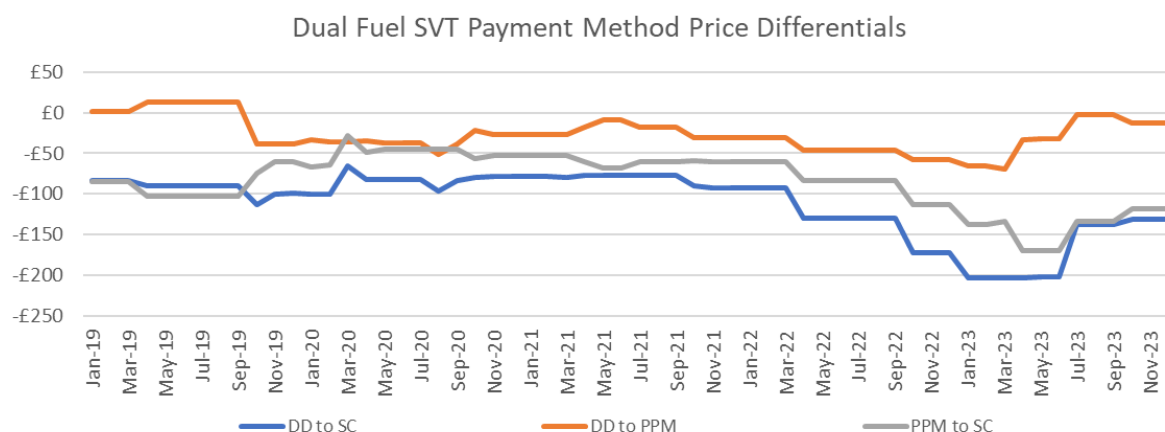
- 2.12 The cap value for a given period is communicated for a typical domestic consumer with medium energy use,²¹ and will vary depending on several factors including:
- The customer’s network region²²
 - The customer’s electricity meter type used (Single rate/multi-rate)
 - The payment method used by the customer (DD, PPM or SC)
- 2.13 Since the cap was introduced, the underlying methodology has been updated where appropriate, in the consumer interest. In 2021/22, the methodology was updated in response to the energy crisis and market volatility, by moving from a 6-monthly cap to a 3-monthly cap, reducing the notice period (announcement to date of effect) from 2 months to 25 working days and updating how backwardation costs are modelled.²³
- 2.14 Following the introduction of the cap in 2019, the weighted average tariff prices for each payment method under the cap have continued to differ due to different allowances and cost to serve assumptions. Between Oct’ 2019 and Sept’ 2022, the differentials between the three payment methods have been fairly stable for a typical dual fuel consumer, with DD approximately £100 cheaper than SC, PPM approximately £50 cheaper than SC and DD approximately £50 cheaper than PPM. More recently, the differentials between PPM and SC and DD and SC have increased to approximately £150 and £200 respectively as overall average bills have increased, primarily as a result of the energy crisis and due to the scaling effect of this on the differentials. **Figure 3** shows the price differential trends by payment method since the cap was introduced, based on TDCV.

²¹ Ofgem, Average gas and electricity use explained. <https://www.ofgem.gov.uk/information-consumers/energy-advice-households/average-gas-and-electricity-use-explained>

²² Energy Networks Association (ENA), Who’s my network operator? <https://www.energynetworks.org/customers/find-my-network-operator>

²³ Ofgem (2022), Price cap – Decision on changes to the wholesale methodology. <https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology>

Figure 3: Dual Fuel Price Differential Trends by Payment Method at Typical Domestic Consumption Values



UNC Modification 840

- 2.15 In April 2023, Uniform Network Code (UNC) modification 0840 was approved by Ofgem.²⁴ From October 2023, this modification will see adjustments to the inputs for the price cap, by equalising the Unidentified Gas (UIG) allocation for PPM and non-PPM sites. UIG is the difference between the amount of gas that entered the system and the amount of gas measured off the system once shrinkage has been accounted for. Reasons for this difference include theft, meter not fs, shipper-less and unregistered sites. UIG applies only to gas cap levels (including the gas component of dual fuel).
- 2.16 A higher proportion of UIG costs are currently assigned to PPM, than DD and SC customers. As a result of UNC modification 0840, the difference between PPM and DD payment methods is anticipated to be lower for gas as the UIG allocation is shared equally across the unit rate element. The modification is enduring and so it will apply to the rates paid by customers for both Standard Variable Tariffs under the price cap ('capped tariffs') and Derogated Standard Variable Tariffs or Fixed Rate Tariffs ('non-capped tariffs').

Bad debt associated with Additional Support Credit

- 2.17 In June 2023, Ofgem consulted on introducing a specific allowance, for 12 months initially, to the cap for bad debt associated with Additional Support Credit

²⁴ Ofgem (2023), Decision to approve Uniform Network Code (UNC) 840: Equalisation of prepayment and non-prepayment AUG factors. <https://www.ofgem.gov.uk/publications/decision-approve-uniform-network-code-unc-840-equalisation-prepayment-and-non-prepayment-aug-factors>

(ASC).²⁵ ASC is defined within the supplier Standard Licence Conditions and in practice is credit provided by energy suppliers to PPM customers, typically in a vulnerable situation, who may have exhausted alternative options (ie emergency or friendly hours credit which are generally applied automatically to PPMs) to avoid self-disconnection. We have now published our decision,²⁶ alongside this document, to introduce a specific allowance into cap from 1 October 2023, for 12 months initially, for bad debt costs associated with ASC.

- 2.18 In practice, we do not expect this allowance to lead to PPM customers paying more on their bills than comparable direct debit (DD) customers in 2023/24. This is because at the Spring Budget, government made a commitment to align charges for comparable DD and PPM customers using the EPG until the end of March 2024, to ensure that PPM customers no longer pay a premium for their energy costs. Therefore, as long as the PPM price cap level remains higher than the equivalent DD level for the remainder of 2023/24, we expect the additional cost of this allowance will be funded by government, not PPM customers.
- 2.19 From April 2024, the cost of the remainder of the allowance will fall directly to customers, and we set out our initial proposal in Chapter 3 of this document on how the allowance will interact with our levelisation proposals.

Evidence on consumer vulnerability

- 2.20 Ofgem research on the recent energy market impacts on consumers has shown that there are marked differences in the level of vulnerability between those who pay by different payment methods.²⁷ Of the consumers surveyed, proportionally, a higher percentage of households that pay for their energy by PPM say they are recipients of government benefits (62%) than SC (48%) and DD (31%). However, of the total number of benefit recipients, DD remains the most popular payment method overall (59%) compared with SC (25%) and PPM (15%).
- 2.21 Additionally, the research shows that among DD and SC customers, over half are worried about falling behind on their energy bill because their cost of energy is going up. This is higher among SC customers (62%) than DD customers (54%).

²⁵ Ofgem (2023), Price cap – Statutory consultation on introducing an allowance for bad debt associated with Additional Support Credit. <https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-introducing-allowance-bad-debt-associated-additional-support-credit>

²⁶ Ofgem (2023), Allowance for additional support credit bad debt costs <https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs>

²⁷ Ofgem (2023), Consumer Impacts of Market Conditions survey - Wave 3: <https://www.ofgem.gov.uk/publications/consumer-impacts-market-conditions-survey-wave-3-novdec-2022>

Concerns are higher still among PPM customers, with 75% worried about being able to top up because of rising energy costs.

- 2.22 The same research also shows that consumers paying by PPM are more likely to exhibit one or more of the characteristics of vulnerability (disabled, chronically sick, of pensionable age, on low income and living in rural areas) with the exception of pensionable age, however the total number of vulnerable individuals/households paying by DD is far higher due to DD being the most popular payment method.
- 2.23 PPM customers are more likely to be households with incomes lower than the UK median. Research from Citizens Advice shows that a third of PPM customers disconnected at least once in the last year as they could not afford to top up. A fifth of PPM customers who had self-disconnected said they had disconnected for more than 24 hours at least once. Just under a fifth of customers in vulnerable circumstances (18% of households included a disabled person or someone with a long-term health condition) were disconnected for more than two days at least once.²⁸ Self-disconnecting or rationing, can also affect customer health or mental wellbeing.²⁹

Evidence on consumer payment method choice

- 2.24 Our research has also shown that only 55% of consumers are aware that costs vary by payment method, with even less aware of which payment methods are cheaper or more expensive. Consequently, there is a bias towards consumers considering their own payment method to be most cost-effective or cheapest.
- 2.25 While the cost of different payment methods is an important driver for choice in payment method, it was not the main justification for consumers. Consumers primarily selected DD as this was considered to be the most convenient (49%), while consumers primarily chose SC due to the perceived additional control provided by being able to pay on receipt (41%). Consumers paying by PPM noted that the ease of budgeting was the primary driver for choosing this payment method (42%).
- 2.26 Lastly, it's important to recognise that some consumers do not have the same level of choice when it comes to selecting payment methods. For example, our

²⁸ Citizens Advice (2023), Kept in the dark – the urgent need for action on prepayment meters. <https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Kept%20in%20the%20dark%20-%20the%20urgent%20need%20for%20action%20on%20prepayment%20metersV2.pdf>

²⁹ Ofgem (2023), Statutory Consultation – Involuntary PPM, Chapter 2. <https://www.ofgem.gov.uk/publications/statutory-consultation-involuntary-ppm>

research found that 36% of PPM customers selected a negative or passive reason for paying by PPM, including because 'this was the default' (22%) or 'my supplier made me' (11%). Such scenarios are typically due to a combination of factors such as personal financial pressures, low credit ratings, supplier enforcement, or limitations imposed on the property. As PPM is typically more expensive than DD, these consumers may be required to pay higher costs.

The case for change

- 2.27 In January 2023, we highlighted concerns relating to practices for PPM customers, and whether customers were being treated fairly. This has led to action by Ofgem, in line with our principal objective and consumer interest framework, including the introduction of a new Code of Practice for involuntary PPM installations.³⁰
- 2.28 As outlined in this chapter, when the price cap was introduced, the price differential typically focused on achieving efficient costs, through inputting cost-to-serve differences for each payment method, with some adjustment. As a result, the cost paid by customers has varied depending on each payment method, with PPM and SC customers typically paying more than DD customers during each cap period. This difference has generally increased over the past two years as average bills have subsequently increased, primarily as a result of the energy crisis and due to the scaling effect of this on the differences.
- 2.29 We consider that cost reflectivity through the price cap has generally provided benefits to consumers, allowing for costs to be set reflecting the cost to serve for efficient suppliers. However, in the case of PPM customers, we note this has also resulted in unintended consequences, specifically higher standing charges for PPM consumers. Customers are more likely to be forced onto this payment method by their supplier as a result of debt. There are inherent risks relating to standing charges, as this cost cannot be avoided by reducing usage. A high standing charge can consequently adversely affect customer health and mental wellbeing, in addition to raising the risk that PPM customers ration or self-disconnect due to financial issues. Due to the higher standing charge applying to PPM compared to DD, this can compound these issues for these consumers.
- 2.30 We anticipate that upcoming changes to the UNC will reduce some of the current payment difference between payment methods for gas customers, but we

³⁰ Ofgem (2023), Involuntary PPM - Supplier Code of Practice.
<https://www.ofgem.gov.uk/publications/involuntary-ppm-supplier-code-practice>

consider there to remain a risk to low demand PPM customers of paying more than equivalent DD customers. From April 2024, once the EPG support provided by the government comes to an end, the ASC bad debt allowance will increase the standing charge for PPM customers, unless this is addressed through our levelisation policy.

- 2.31 Feedback provided through our recent CfE outlined overall strong support for the introduction of a levelisation process. Respondents typically highlighted the disproportionate cost impact on PPM and SC customers as the primary reason, noting this was unfair on these customers. Ofgem’s principal objective in carrying out its regulatory function is to protect the interests of energy consumers. It includes having regard to the interests of particular groups of customers, including vulnerable consumers. Wider issues of energy affordability for consumers, however, are a matter for the government.
- 2.32 Respondents to our CFE also pointed to the lack of choice for some customers (particularly those on PPMs). Additionally, respondents noted the issue with affordability, highlighting a higher proportion of PPM customers are vulnerable and/or in fuel poverty than SC or DD, with the energy crisis escalating this issue. **Chapter 3** provides a more detailed breakdown of response feedback by category.
- 2.33 To help consider the case for change, we have undertaken a draft Impact Assessment (IA) in **Appendix 2**. The assessment considers the evidence for levelisation and the options under consideration. These options are then assessed in accordance with Ofgem’s principal objective, including consideration of the impacts on specific groups of consumers, suppliers and competition.
- 2.34 Our initial proposal is for the introduction of a market-wide levelisation process, with a supporting reconciliation process. This process would levelise the standing charges of PPM and DD customers, to make these more equitable and share the cost of bad debt (ASC). We consider that the structural problem of higher standing charges on PPM as a consequence of cost-reflectivity, raises the potential for further customer debt and rationing or disconnection, which can subsequently result in harm to consumer health and/or wellbeing. Our initial view is there may be benefits to moving away from cost-reflectivity in this instance, by introducing levelisation to remove the standing charge differential between customers of these payment methods.
- 2.35 Rather than introducing these changes through the price cap, a market-wide design mitigates the potential harm from introducing differences between the cap

level and the wider market for one group of customers and the reconciliation process allows suppliers, including specialist suppliers, to recover more cost-reflective charges than if levelisation were introduced without reconciliation.

2.36 However, while the introduction of levelisation may benefit PPM customers by reducing their standing charges, this may also ultimately result in higher standing charge costs to DD customers. Our draft IA shows that the overall impacts and benefits to consumers and the market are finely balanced, and we would welcome views within **Chapter 3** for additional evidence.

2.37 We are also consulting on an incremental option to use levelisation to share specific debt-related costs more evenly across all three payment methods. Our draft IA shows very little net benefit, suggesting this may be better tackled by government through cost-of-living measures.

3. Levelisation proposals and considerations

Chapter summary

We set out our considerations and proposals for levelisation; this includes an initial preference to levelise PPM standing charges against DD, with reconciliation mechanism to end the standing charge differential. We also set out an option for consultation relating to SC levelisation based on specific debt-related costs in the payment method adjustment from the price cap.

We also highlight some other areas of consideration that we had received feedback on through our CfE, but that we are not proposing in this consultation.

Questions:

- 2) Do you have any views on our proposed policy considerations for levelisation? Are there any additional ones we should consider?
- 3) Do you agree with our initial preference to levelise PPM and DD Standing Charges?
- 4) Do you think we should also levelise the bad debt charges across PPM, DD and SC, which would reduce the differential between SC and DD? Please provide any evidence/data that may benefit consumers as a whole.
- 5) How should we ensure that levelisation transfers are correctly applied to customers on tariffs not covered by the cap (ie uncapped)?
- 6) Do you agree with our proposal not to levelise across regions?
- 7) Do you agree with our proposal not to target levelisation?
- 8) Should we set new licence conditions to ensure suppliers pass the costs/benefits through to all customers?
- 9) Do you have any views on our other considerations?

Introduction and considerations

3.1 As outlined in Chapter 2, we consider there to be a case for introducing levelisation to mitigate the unintended harms as a result of higher standing charges for PPM customers. To address the issues, risks and consequences of levelisation, we have set out the following considerations of which to apply to how levelisation could operate and to protect the interest of consumers:

- The levelisation process would need to be designed to work on an enduring basis, through the price cap or through an alternative reference/relative price cap, to identify the payment method cost differentials that would need to be levelised. Levelisation would be applied to cap and non-

cap tariffs. In the event that the cap is substantially changed, we would consult on alternative benchmarks to use.

- Due to the usage characteristics of the different payment methods and inability for some customers to choose a payment method, PPM standing charges should be equal to or less than DD.
- We should consider whether to allocate debt costs more broadly within payment methods.
- To ensure that suppliers are incentivised to offer services to customers on all payment methods, they should expect to be able to recover notionally efficient costs irrespective of the proportion of customers they have on each payment method.
- The process will need to be designed to be agile to allow for adjustments as a result of the outputs from other interlinked workstreams.

3.2 This chapter considers the potential approaches to levelisation which would best deliver against these considerations. We have explored several levelisation options which we presented in our CfE in April, to which are set out in more detail in **Appendix 4**. In this chapter, we propose our initial preferences, supported by a draft IA in **Appendix 2**.

3.3 When considering how to undertake levelisation of payment methods, there are several variables for consideration, including:

- **Payment Method:** There are three different payment methods which can be levelised in different sequences (eg PPM can be levelised with DD and then SC can be levelised with the new DD charge type) or all together (which would result in all three being equal across the charge type. Within our analysis, we have considered different sequences of levelisation to test different outcomes for each payment methods.
- **Charge types:** There are two components of the price cap through which levelisation can occur: unit rates and standing charges. These can be considered individually or together.
 - (1) Unit rates – by levelising unit rates, the savings, or costs from levelisation of each payment method would be larger or small depending on consumption.
 - (2) Standing charges – by levelising standing charges, costs or savings would be constant regardless of consumption, as the standing charge applies to

all, although this would typically benefit low consumption customers the most.

- **Extent of levelisation:** We can choose to fully or partially levelise between payment methods, ie remove the payment method differential or reduce it. Within partial levelisation, we could consider this on a proportional basis (for example, remove 50% of the differential) or levelise specific components where there is a different allowance under each payment method, such as the bad debt charge.
- **Scope:** The scope of the consultation is not necessarily restricted to (or dependent on) customers covered by the price cap, with uncapped tariffs also included within the reconciliation process. This is primarily to help mitigate the risk that uncapped DD contracts become artificially lower than capped, resulting in migration away from capped and an increasingly small pool of customers on the cap paying for levelisation. This would allow for a more enduring and resilient process that could operate outside of the price cap.

Options Summary

3.4 We have considered three options as set out below. Our initial proposal is that we proceed with Option 2, to levelise the new ASC bad debt allowance (on the PPM standing charge) across all payment methods and levelise PPM and DD standing charges. We are also consulting on whether to levelise specific debt-related costs across all payment methods (Option 3) in addition to Option 2, which would reduce the SC and DD cost differential. The options are set out below, including a 'do nothing' option:

- **Option 1 - Do nothing:** No levelisation between payment methods.
- **Option 2 – Levelise PPM & DD standing charges and levelise ASC bad debt costs:** Our initial proposal is to fully levelise PPM and DD standing charges and levelise the PPM ASC (discussed in Chapter 2³¹) across all payment method standing charges, supported by a reconciliation mechanism (discussed in Chapter 4). This will end the standing charge differential so that all consumers on DD and PPM pay the same standing charge rate. We are minded to focus on standing charge levelisation as PPM unit rates are now

³¹ Ofgem (2023), Allowance for additional support credit bad debt costs.
<https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs>

cheaper than DD due to UNC 0840, which equalised unidentified gas allocations.

- **Option 3 - Option 2 plus levelise debt-related costs:** We are also consulting on, in addition to Option 2, the levelisation of specific debt-related costs in the payment method adjustment across all payment methods. This would reduce the cost differential between SC and DD.

Considerations

Option 1 - Base Case

- 3.5 To provide an illustrative example of how we would perform levelisation, this do-nothing approach acts as our base case, showing the cost differences of each option. We use the cap levels for cap period 11a (October - December 2023) as our base case. The unit rates and standing charges for this cap period are shown below in Table 1.

Table 1: Option 1 - Cap Period 11a Unit Rates and Standing Charges

Fuel Type	Energy Charge Type	DD	PPM	SC
Single Rate Electricity	Unit Rate (p/kWh)	27.35	26.92	28.79
Single Rate Electricity	Standing Charge (£/day)	0.53	0.60	0.60
Gas	Unit Rate (p/kWh)	6.89	6.67	7.25
Gas	Standing Charge (£/day)	0.30	0.40	0.35
Multi Register Electricity	Unit Rate (p/kWh)	26.26	25.91	27.64
Multi Register Electricity	Standing Charge (£/day)	0.53	0.60	0.60

- 3.6 The cap levels at TDCV for cap period 11a, are shown below in Table 2.

Table 2: Option 1 - Cap Period 11a Cap Levels

	DD	PPM	SC
Single Rate Electricity (2900 kWh)	£988	£1,001	£1,054
Gas (12000 kWh)	£935	£948	£998
Dual Fuel	£1,923	£1,949	£2,052
Multi Register Electricity (4200 kWh)	£1,298	£1,308	£1,380

- 3.7 The resulting cap levels and adjustment values are illustrative. When performing levelisation, we will use the approach as set out in the levelisation model detailed in **Appendix 3**, to calculate the levelised cap level and adjustment value to be reconciled.

3.8 On balance, we do not recommend a do-nothing approach (Option 1). This option would not address the inherent problems resulting from higher standing charges for PPM consumers, nor help address the issues to consumer health or wellbeing associated with higher standing charges. We therefore consider there to be benefits to reducing the standing charge differential between customers of these payment methods.

Option 2 - Levelise PPM & DD standing charges and levelise ASC bad debt costs

3.9 Ofgem, as well as the public, are concerned with the greater burden of higher standing charges put on PPM consumers compared to DD consumers. There is a risk of PPM customers curtailing or self-disconnecting due to the cost of energy bills, or debt from standing charges. PPM customers are also less likely to have a choice of payment method, with over 11% of PPM customers being on PPM due to a combination of personal financial pressures of supplier enforcement. In addition, we note that a higher percentage of PPM customers are recipients of benefits than other payment methods and more likely to be households with incomes lower than the UK median. Historically PPM customers have paid more for their energy than equivalent DD customers.

3.10 Our preferred option is to levelise PPM and DD standing charges and levelise ASC bad debt across all payment method standing charges. This is our initial proposal because:

- Removes the PPM and DD standing charge differential, while minimising increased costs to DD customers.
- Standing charges (not unit rates) are typically the cause of higher PPM tariffs.
- Levelisation of PPM standing charge and ASC bad debt reduces bills for PPM consumers and reduces the impacts of inherent risks associated with PPM standing charges, such as the likelihood of further debt, self-disconnection or rationing of energy.
- It only impacts standing charges, simplifying the reconciliation mechanism (discussed in **Chapter 4**), which supports deliverability for April 2024.
- As shown in our draft IA, this option is unlikely to have a material effect on competition. From a consumer perspective, levelisation would widen the pool of potential tariff types that a consumer would consider affordable.

- 3.11 We are treating the ASC bad debt allowance independently from enduring bad debt allowances as it is an initial 12-month allowance and applies to the standing charge.
- 3.12 We propose only levelling PPM and DD standing charges (and not SC) due to the risk that fully removing the SC and DD differential would remove the financial incentive for customers to stay on or move to DD. Migration of DD customers onto SC would have material cost implications for suppliers as SC customers have both greater fixed costs and generate greater debt-related costs, which would increase costs for consumers. We would expect suppliers to continue to engage customers and encourage them to move to and stay on DD.

Capped tariffs

- 3.13 Levelising PPM to DD standing charge (and not unit rate) and levelising ASC bad debt results in the following unit rates and standing charges (Table 3) and associated cap levels at TDVC (Table 4):

Table 3: Option 2 - Cap Period 11a Unit Rates and Standing Charges

Fuel Type	Energy Charge Type	DD	PPM	SC
Single Rate Electricity	Unit Rate (p/kWh)	27.35	26.92	28.79
Single Rate Electricity	Standing Charge (£/day)	0.55	0.55	0.60
Gas	Unit Rate (p/kWh)	6.89	6.67	7.25
Gas	Standing Charge (£/day)	0.31	0.31	0.35
Multi Register Electricity	Unit Rate (p/kWh)	26.26	25.91	27.64
Multi Register Electricity	Standing Charge (£/day)	0.55	0.55	0.60

Table 4: Option 2 - Cap Period 11a Cap Levels

	DD	PPM	SC
Single Rate Electricity (2900 kWh)	£992	£980	£1,055
Gas (12000 kWh)	£942	£915	£999
Dual Fuel	£1,934	£1,895	£2,054
Impact	+\$11	-\$54	+\$1
Multi Register Electricity (4200 kWh)	£1,303	£1,288	£1,381
Impact	+\$5	-\$20	+\$1

- 3.14 Levelising in this way results in an increase to the DD and SC dual fuel cap levels and a decrease to the PPM dual fuel cap level. PPM becomes the cheapest

payment method with the differential between SC and DD reducing from £129 to £120 for dual fuel. SC remains significantly more expensive for both fuels.

- 3.15 If the PPM standing charge is already lower than DD, we would not perform this stage of levelisation to increase the PPM standing charge. One stakeholder highlighted the importance of this in their response to the CfE.
- 3.16 Suppliers would, of course, be free to offer tariffs with either standing charges or unit rates below the level of the cap as long as they followed our established compliance processes.

Uncapped tariffs

- 3.17 Suppliers would be responsible for setting rates for customers not covered by the price cap, however in line with the considerations of levelisation, we would introduce conditions in the SLCs such that the standing charge component for PPM tariffs should be the same or lower than that of equivalent DD tariffs.

Stakeholder views on option 2:

- 3.18 Most respondents to our CfE showed strong support for the introduction of levelisation and a supplier reconciliation mechanism. The general consensus was that PPM customers should not be paying a premium above the cost incurred by DD customers.
- 3.19 Many of the respondents shared these views because of the higher degrees of vulnerability found with PPM customers, the need for a fairer market and to eliminate the higher PPM standing charge.
- 3.20 However, some respondents noted the negative effect on vulnerable consumers paying through DD, and the additional cost or regulatory burden that the work will impose on the industry will outweigh any benefits.
- 3.21 One respondent to our CfE highlighted, higher standing charges have a more harmful impact than higher unit rates due to the prevalence of rationing and self-disconnection. Another stakeholder highlighted the additional implementation simplicity of focussing on standing charges for the implementation. Not all respondents agreed, however, with some respondents calling for levelisation of both standing charge and unit rate to simplify consumer understanding and protect those that cannot reduce their high usage. A further stakeholder said that we should apply any levelisation cost to the unit rate so that customers can manage additional costs through changes in consumption.
- 3.22 We acknowledge the impact our proposals may have on those on lower income brackets in both the DD and SC customer bases and believe that our initial

proposal should minimise the extent to which consumers may be affected. Our initial proposal outlines minimal intervention that would achieve the aims of the case for change, without unduly increasing DD and SC prices. As our analysis shows, PPM customers are more likely to be vulnerable than those specifically on DD and SC and have taken these points into consideration through our distributional analysis (as part of our draft IA). All but three respondents emphasised the need to bring down PPM levels and welcomed our approach.

Risks

- 3.23 As highlighted by stakeholders in response to our CfE, the key risk associated with this option is higher standing charge costs to DD customers. Our draft IA shows that the overall impacts and benefits to consumers and the market are finely balanced, and we would welcome views within Chapter 3 for additional evidence.

Option 3 - Option 2 plus levelise debt-related costs

- 3.24 Currently, there are different allowances for bad debt in the SC and DD payment method uplift. Bad debt incurred by SC customers is shared between all SC customers with part of the costs assessed for SC being allocated to DD, and bad debt incurred by DD customers is shared between all DD customers.
- 3.25 We are consulting on, levelising the bad debt allowance in the payment method uplifts, across all consumers proportionately, in addition to the levelisation of PPM and DD standing charges and bad debt related to ASC set out in Option 2.
- 3.26 Levelisation would be achieved by making an equivalent adjustment to give the effect of removing the bad debt allowance in the payment method uplift and spreading proportionally between all consumers.
- 3.27 Bad debt is currently charged through both unit rate and standing charge. For this option, this would mean redistributing proportionally between standing charge and unit rate. As this option impacts both unit rate and standing charge, there are further delivery implications (relative to Option 2), increasing the risk of non-delivery for April 2024.
- 3.28 We would only consider levelisation of bad debt costs in addition to (and not instead of) levelisation of ASC bad debt and PPM and DD standing charges (Option 2). Taken together, the resulting changes to unit rates and standing charges are shown in Table 5 and the resulting cap levels are shown in Table 6:

Table 5: Option 3 - Cap Period 11a Unit Rates and Standing Charges

Fuel Type	Energy Charge Type	DD	PPM	SC
Single Rate Electricity	Unit Rate (p/kWh)	27.46	27.30	28.08
Single Rate Electricity	Standing Charge (£/day)	0.55	0.55	0.59
Gas	Unit Rate (p/kWh)	6.86	6.89	7.20
Gas	Standing Charge (£/day)	0.32	0.32	0.34
Multi Register Electricity	Unit Rate (p/kWh)	26.49	26.26	26.53
Multi Register Electricity	Standing Charge (£/day)	0.55	0.55	0.58

Table 6: Option 3 - Cap Period 11a Cap Levels

	DD	PPM	SC
Single Rate Electricity (2900 kWh)	£996	£994	£1,029
Gas (12000 kWh)	£938	£943	£990
Dual Fuel	£1,934	£1,937	£2,019
Impact	+£11	-£12	-£33
Multi Register Electricity (4200 kWh)	£1,314	£1,305	£1,326
Impact	+£16	-£3	-£54

- 3.29 Both DD and PPM cap levels increase relative to Option 2, however the PPM cap level under this option is still cheaper than our base case (Option 1). The differential between SC and DD is reduced further to £85.
- 3.30 While there are lower barriers to moving between DD and SC, some customers may not be able or willing to switch. This option protects those customers but overall has less of a positive impact on PPM customers, while increasing costs to DD more than Option 2. Additionally, the added complexity of this option incurs a delivery risk for April 2024, while the case is less clear on delivery of benefits to consumers as a whole. We welcome stakeholder feedback on Option 3 and our assessment.
- 3.31 For uncapped tariffs, as with Option 2, suppliers will be responsible for setting tariff levels. However, in line with the considerations of levelisation, the standing charge component for PPM tariffs should be the same or lower than that of equivalent DD tariffs. We note that levelisation of unit rates however would likely complicate the process and any associated compliance requirements. We are

open to views on how suppliers can demonstrate they are passing through reconciliation to uncapped customers.

Stakeholder views on option 3:

- 3.32 In response to our CfE, multiple suppliers highlighted that cost allocation between payment methods is not an exact science and stated that there is already a level of bad debt cost mutualisation in the cap. Multiple suppliers proposed that we should review the underlying differences in efficient costs to serve and efficient profit levels for different types of customers before performing levelisation. Their expectation of this review was that it would result in a greater allocation of bad debt to SC customers, and a reduction in the efficient level of Earnings Before Interest and Tax allowance (EBIT) for PPM customers (due to lower capital requirements). We are reviewing the methodology for the payment method uplift allowance (including bad debt costs) in our operating cost review. If this results in changes to the cap calculation, these would be reflected in the pre-levelisation cap levels and therefore it would be reflected in reconciled quantities.
- 3.33 Seven consumer groups and three suppliers were supportive of including SC levelisation. They thought that the tariff differential between DD and SC is too large and there is a risk of significantly disadvantaging customers who do not use DD as a payment method. While some argued for partial levelisation to maintain a DD incentive, others felt that we should fully levelise between payment methods, with some noting that the convenience of DD maintains the incentive to stay on DD in the absence of a price differential.
- 3.34 The primary rationale stakeholders provided for full levelisation were based on protection of vulnerable consumers, and fairness. They highlighted that there are significant numbers of vulnerable households experiencing fuel poverty, including many disabled households, that are paying via SC.
- 3.35 Some respondents commented on the argument that cost differentials are needed to incentivise switching to/remaining on DD, both in support of it and to disregard it:
- In support: Several suppliers stated that the incentive is required to manage industry costs. One supplier argued that a cost differential of over £100 would be needed to incentive customers to remain on DD, another thought £80 would be appropriate. Some respondents went further to suggest we should explore broad regulatory options to incentivise DD.
 - In opposition: One respondent highlighted that choice of payment method is not always a customer's choice, another stated that vulnerable consumers

chose SC as a way of controlling how much money they pay and when and a lack of trust in energy suppliers managing their direct debits. Another highlighted the lack of consumer awareness that different payment methods, especially SC, cost different amounts.

- 3.36 The remaining suppliers had differing views on including levelisation of SC, with most expressing a preference for partial levelisation, with some opposed to including any form of SC levelisation. Two respondents commented that we should consider, more broadly, the role of SC in the retail market as provides little additional functionality above DD and may result in increased industry costs.
- 3.37 One supplier commented that the additional system costs of levelising SC would likely outweigh the benefits. Another commented that we should only proceed with SC levelisation as long as it does not negatively impact/delay implementation of PPM levelisation.
- 3.38 Overall, we consider there to be more risk and complexity associated with Option 3, compared to Option 2, such as reducing positive incentives for switching from SC to DD/PPM. The instances of payment specific issues, such as self-disconnection are more prominent to PPM customers than SC, while there are bigger barriers for PPM customers to changing payment method. We welcome stakeholder feedback on Option 3 and our assessment.

Risks

- 3.39 Levelising bad debt costs, and reducing the SC/DD differential as a result, will remove some of the incentive for customers to switch to DD or remain on DD. The potentially larger number of customers on SC tariffs that levelisation may drive could increase the likelihood of debt-related costs, leading to more customers building up problematic levels of debt and impacting supplier financeability. We are not proposing full levelisation of SC costs in order to maintain the DD incentive, although we recognise that this incentive is weakened under any form of SC levelisation.

Impact assessment

- 3.40 A draft IA is presented in **Appendix 2**. In this section, we provide a summary of the IA, including the key outputs that have led us to our initial views with respect to levelisation.
- 3.41 **Impacts on consumers:** Under Options 2 and 3, levelisation benefits PPM (and SC for Option 3) consumers and disadvantages DD (and SC for Option 2)

consumers financially. The benefits and disadvantages identified are summarised below.

- Increasing consumer tariff and payment method choice by increasing the pool of tariffs and payment methods that consumers may consider affordable. This could help consumers manage their finances more effectively.
- Making the standing charge for PPM and DD the same simplifies tariff choice for consumers through making tariffs more comparable.
- Potential reduction of self-disconnection as those most at risk, PPM customers, would pay lower standing charges.
- Our research has shown that consumers paying by PPM are most likely to exhibit one or more of the characteristics of vulnerability with the exception of pensionable age (and rurality, for which we have limited data, but will assess further and include in our final IA). However, in absolute terms, as a result of DD being the most prevalent payment method currently amongst the general population, most vulnerable individuals/households pay via DD.
- Under Option 3, levelisation results in all consumers paying for the bad debt costs associated consumers in debt. For Option 2, there are no usage-based distributional impacts as only the standing charge is affected. For Option 3, higher consumption will increase or decrease the impacts of levelisation (further detail on this can in found in **Appendix 2**).

- 3.42 **Impacts on suppliers:** If we proceed with levelisation, our minded to recommendation is to include a reconciliation mechanism, therefore there should be little direct impact on supplier financeability or profits. There may be a small cost increase resulting from scheme administration costs, and for Option 3, potentially an increase in debt-related costs should many consumers move to SC due to the reduced differential. Conversely, there may be a potential reduction in costs (eg bad debt costs) resulting from lower bills for consumers with heightened vulnerability characteristics. The initial supplier response to our CfE suggested a preference of simplicity over accuracy of any reconciliation mechanism. We are consulting on the frequency of reconciliation payments to determine the ideal balance between effort/overhead and potential risk to suppliers' financial stability.
- 3.43 **Impact on competition and innovation:** Our overall assessment is that both Options 2 and 3 are unlikely to have a material effect on competition and innovation. This is owing to the very small impact on annual bills that either levelisation option is expected to have and limited evidence that different payment type tariffs may act to constrain each other in the first place.

Other Considerations

Discounted Proposals

3.44 Our CfE presented different ways in which we could levelise costs across payment methods. We provide an overview of these options, a summary of stakeholder feedback, and our rationale for discounting each option in **Appendix 4**.

Scope of levelisation

3.45 **Option 2:** Our initial preference is to:

- Levelise all capped customer bills through adjusting the cap level.
- Levelise uncapped contracts through introduction of a licence condition requiring suppliers to offer the same standing charge on equivalent DD and PPM tariffs.

3.46 Uncapped tariffs are within scope to mitigate the risk that capped PPM (and SC) tariffs become materially cheaper than suppliers are able to offer on uncapped contracts (as the variable tariffs are subsidised by DD and the uncapped contracts are not).

3.47 **Option 3:** We are considering what would be required, in addition to the licence condition that would be introduced under Option 2, to levelise the bad debt contribution of fixed term contracts.

3.48 Both capped and non-capped account numbers will be used in the reconciliation mechanism. Our expectation is that suppliers would reflect the costs/benefits associated with levelisation in their tariff pricing, resulting in a reduced payment method differential between non-capped tariffs.

3.49 We are considering whether we should formalise this expectation through a principles-based licence condition. We welcome stakeholder views on how this should be formulated.

3.50 Four respondents to our CfE commented on including fixed term contracts in levelisation. Two were supportive of including fixed term contracts in the recovery of the costs of levelisation and two were supportive of payment method levelisation of fixed term contracts, so that suppliers would still be able to offer competitive fixed term SC and PPM tariffs. One respondent commented that it would be inappropriate to levelise between default and fixed term contracts. We consider that a market-wide design is important, as it mitigates the potential harm from introducing differences between the cap level and the wider market for one group of customers and the reconciliation process allows suppliers, including

specialist suppliers, to recover more cost-reflective charges than if levelisation were introduced without reconciliation.

Targeted Levelisation

- 3.51 We also considered targeting levelisation based on vulnerability characteristics, such as those in receipt of WHD. The advantage of this approach is that it reduces the total value to be redistributed, therefore reducing the bill impact to DD customers, while targeting support at eligible consumers.
- 3.52 We had six responses to our CfE that raised targeted levelisation, and none supported the approach. They considered that it would be too complicated to accurately identify and target vulnerable customers. One response highlighted that targeted levelisation is out of our jurisdiction, as the default tariff cap is not an affordability measure, and the best way for this to be implemented would be through a social tariff.
- 3.53 We have decided against targeting levelisation to customers in vulnerable situations. Ofgem’s principal objective in carrying out its regulatory function is to protect the interests of energy consumers. It includes having regard to the interests of particular groups of customers, including vulnerable consumers. This is why we are considering harms encountered by customers that may result from the nature of the payment methods used. However wider issues of energy affordability for consumers are a matter for the government.

Compliance

- 3.54 For capped tariffs, the result of levelisation is updated, levelised, cap levels. Therefore, compliance will be assessed through the existing price cap compliance processes.
- 3.55 **Option 2:** As we would likely introduce a licence condition change that requires suppliers to offer the same standing charge on equivalent DD and PPM tariffs, and/or to reflect, we would likely take the following approach to compliance:
- Use existing price cap compliance timelines.
 - Require suppliers to submit all non-capped tariffs offered during the relevant period, grouping tariffs by equivalent tariffs that only vary by payment method.
 - We define equivalent tariffs as tariffs that are offered:
 - On the same day
 - In the same region

- For the same fixed period

3.56 **Option 3:** We welcome stakeholder views on how we can assess compliance against the principle that bad debt costs should be borne by all customers. We would be interested in views on how we could ensure that the transfers under Option 3 are applied to non-capped customers, particularly with regard to relevant Licence Conditions.

Regional levelisation

3.57 Currently, standing charges and unit rates vary across regions throughout the UK on both capped and uncapped tariffs. These are driven primarily through regional variation in network charges and reflect the different cost to serve consumers in different locations.

3.58 Three respondents to our CfE asked us to consider regional price variations as part of our levelisation approach. One supplier, for example, highlighted that Scottish consumers pay the highest level of standing charges in the UK, with the exception of those in North Wales and Mersey, while fuel poverty rates in Scotland stand at 25% compared with 13% in England.

3.59 We do not recommend the introduction of a single national cap. The cheapest region currently at TDCV is the East Midlands, with the most expensive being North Wales & Mersey. The current range of regional differences is £105 for DD, £101 for PPM and £111 for SC. Maintaining regional cap levels would result in the following range of impacts following Option 2 levelisation.

Table 7: Impact of Option 2 on Regional Cap Levels

Region	DD	PPM	SC
North Wales & Mersey	£2,000 (+£14)	£1,957 (-£51)	£2,120 (+£1)
East Midlands	£1,890 (+£9)	£1,851 (-£56)	£2,009 (+£1)

3.60 In contrast, the introduction of a national cap would remove any regional variation and result in the following range of impacts.

Table 8: Impact of Removing Regional Cap Level Variation without levelisation

Region	DD	PPM	SC
North Wales & Mersey	£1,923 (-£63)	£1,949 (-£58)	£2,052 (-£67)
East Midlands	£1,923 (+£42)	£1,949 (+£42)	£2,052 (+£44)

3.61 The advantages of implementing a national cap include simplified customer messaging/understanding, as all customers would be subject to the same tariff values, and the elimination of regional differentials, limiting the ability of

suppliers to differentiate between in-region legacy customers and those acquired through competition.

- 3.62 We however propose not to remove regional differences as it would increase the complexity to reconcile, increase delivery mechanism costs and it would not be delivered in time for April 2024. This is also in contrast to market reforms considering more locational and temporal variation in tariffs. We therefore consider this as outside of scope for this policy consultation but is under wider consideration in our future market design workstream.

Smart PPMs

- 3.63 Increasingly, smart PPM meters are being utilised over traditional meters. These do not require the infrastructure investment that traditional PPM meters do. As such, the cost to serve customers on smart PPMs is significantly lower than those on traditional PPMs.
- 3.64 Several respondents commented on smart PPM levelisation, all of whom are supportive of smart PPM installation. In particular, they consider that smart PPMs should be the cheapest payment method type to incentive smart PPM take up. One respondent commented that legacy PPM infrastructure costs should be socialised between all customers. Another commented that the cost to serve smart PPM customers should be the benchmark for efficient cost to serve all PPM customers. Smart PPMs have the lowest cost to serve of all payment methods to suppliers. Consumers also potentially benefit from smart PPMs as they allow customers to switch between payment methods more easily meaning a greater pool of tariffs are available to them.
- 3.65 A couple of these respondents stated that smart PPMs should be the default PPM meter used by suppliers. They stated that we should introduce a cost difference between PPM and smart PPMs to create an incentive to switch/stay on smart PPM.
- 3.66 Currently, we do not identify smart PPMs as an independent payment method in the price cap methodology and we do not calculate a separate cap level for it. We are considering the role of smart PPM meters through our operating cost review. If this results in changes to the cap calculation, these would be reflected in the pre-levelisation cap level and therefore reflected in reconciled quantities. If this results in more structural change to the cap, we will consider how this interacts with levelisation.

- 3.67 In future, if we consider it appropriate to introduce smart PPM as a separate payment method with its own cap level, we will consider how this could/should be levelised.

Social tariff

- 3.68 Our CfE raised the question of a social tariff, a discounted tariff targeted to specific customers who would struggle to pay the true cost of their energy usage. We had seven respondents raise the topic of a social tariff, with a couple of responses asking if we could use a social tariff alongside levelisation to target specific groups.
- 3.69 Whilst we acknowledge these responses that call for a social tariff and how this could be achieved, this is a matter for government

4. Payment reconciliation process options and considerations

Chapter summary

We provide details of the levelisation reconciliation mechanism. A reconciliation mechanism is required to prevent suppliers from significantly gaining or losing from the implementation of levelisation. Reconciliation options that do not include a redistribution mechanism may result in small gains or detriments to suppliers.

Due to the short timeframes for implementation of our levelisation policy, driven by the end of the EPG in March 2024, we plan to appoint our preferred reconciliation mechanism operator shortly, in order that they can meet the required deadline, in the event we proceed with some form of levelisation.

Questions

- 10) What are your views on the reconciliation mechanism, the type of mechanism, invoicing cadence, and mechanism operator?
- 11) Do you have any views on our preferred approach of a fixed reconciliation amount to reconcile standing charges levelisation and a volumetric reconciliation amount based on estimated consumption to reconcile unit rate levelisation?
- 12) Do you agree that all domestic customers should be included within the reconciliation mechanism?
- 13) Can you provide an estimate of implementation and ongoing costs on your organisation of the different levelisation options and approaches?
- 14) Do you have any comments on potentially phasing the implementation of the reconciliation mechanism?
- 15) What considerations should we take to tariffs that exist prior to the implementation of levelisation?
- 16) Are there any other financing impacts on your organisation that we have not considered as part of Chapter 4 or the IA?
- 17) Are there any other considerations for the reconciliation mechanism we have not explored?

Context

- 4.1 To assess the impact of levelisation on individual suppliers' stability, we have modelled the impact of the levelisation options, set out in Chapter 3, on suppliers without a reconciliation mechanism. We have considered four theoretical suppliers

to illustrate this impact. Each of these hypothetical suppliers has the same total number of consumers, but with different proportions of consumers by payment methods as shown in **Table 9**.

Table 9: Proportion of consumers by payment methods for hypothetical suppliers

	DD	PPM	SC
Supplier 1	33%	33%	33%
Supplier 2	90%	5%	5%
Supplier 3	5%	90%	5%
Supplier 4	5%	5%	90%

4.2 The percentage impact on revenue is provided within **Table 10**. In both cases, the supplier with a majority of DD consumers experiences an increase in revenue whereas the supplier with a majority of PPM and SC consumers experiencing a decrease in revenue. This could pose a significant risk to PPM and SC supplier stability if levelisation is implemented without a reconciliation mechanism. For example, a supplier with a greater proportion of PPM consumers would incur the costs associated with serving those customers but may not be able to recover these due to the reallocation of those costs onto DD consumers. Conversely, suppliers with higher-than-average DD consumer base would be able to charge, in total, excess of their cost to serve. It could additionally disincentivise suppliers from providing non-capped tariffs and investing in customer service to attract SC and PPM consumers.

Table 10: Option impacts on supplier revenues

Supplier	Option 2 Revenue Impact	Option 3 Revenue Impact
Supplier A	-0.7%	-0.6%
Supplier B	0.4%	0.4%
Supplier C	-2.5%	-0.6%
Supplier D	-0.05%	-1.5%

Reconciliation Mechanism Options

4.3 In the CfE, we presented three potential options which could be used to reconcile the costs associated with reconciliation. They were building a new mechanism, using network charges or using a supplier of last resort (SoLR) style mechanism. Under the first option, we could introduce a new, custom built, mechanism run by a third party to manage reconciliation of costs between suppliers. Alternatively, an additional component for all domestic customers could be introduced on network charges to be disbursed to support PPM and SC customers. This additional charge would feed directly into the price cap calculation for consumers.

Instead, similar to SoLR, suppliers could claim reasonably incurred costs directly because of levelisation.

- 4.4 Current approaches to reconciliation were provided within the CfE. The types of mechanisms (reconciliation by difference or levy and disbursement), their frequency, reconciliation, whether they were fixed or volumetric and who they were administered by were also provided for comparison.

Stakeholder views

- 4.5 In response to our CfE, we received a large majority support for a reconciliation mechanism. Many respondents stated that levelisation cannot proceed without a reconciliation mechanism. However, one respondent stated that reconciliation is fraught with moral hazard and such a mechanism should also be avoided to “compensate” individual suppliers that have higher than average levels of per customer bad debt. Considering that the reconciliation mechanism will continue to allow competition to occur; the cap will be set at an appropriate level for customers to be incentivised to choose more efficient payment methods without certain groups of consumers becoming unprofitable to supply.
- 4.6 In response to the question on what similar reconciliation mechanisms are currently being used and could be implemented, one supplier suggested SoLR and one consumer group mentioned both SoLR and network charges mechanisms. The supplier suggested we use the SoLR template to introduce a levy, whereas the consumer group agreed that SoLR and network charges mechanisms would not be appropriate. This is due to the complexity of the mechanisms, coupled with the timeliness of the reconciliation mechanism.
- 4.7 We had five responses regarding the introduction of a levy mechanism to reconcile costs. Three were in support because a simple levy for all energy customers would equate to a simple solution. We could use the template of SoLR to create the levy and then use the levy as a reconciliation mechanism. The two against a levy considered that using a levy to implement levelisation would be unnecessary and if we were to introduce a levy, the burdens would outweigh the positives.

Reconciliation Mechanism Proposal

- 4.8 We are minded to introduce a new mechanism, run by an existing industry party, for the reconciliation of levelisation costs to avoid distorting supplier competition. The advantage of building a new mechanism is that it is bespoke, it can use existing industry experience of similar data, billing and credit expertise. It should

still be possible to design, build test and implement a mechanism in time for April 2024, particularly under Option 2. Delivery risks increase under Option 3.

- 4.9 We have discounted using network charges because of complexity involved with the number of parties and reopening existing funding. The use of a SoLR style levy has also been discounted due to the complexity of this model as well as various other factors. As Ofgem has no money raising powers, the new mechanism will be supplier funded, not government funded. Maintaining payment method differentials should continue the incentives for customers to be on the most efficient payment method for their circumstances.
- 4.10 We propose implementing a reconciliation by difference mechanism that should be invoiced a month in arrears rather than using a levy and disbursement process. This should limit the impact on supplier's capital costs by having a small period between when the costs are incurred and recovered. No other mechanism types were identified in response to the CfE.
- 4.11 Four different approaches to the reconciliation of levelisation costs have been identified;
1. A fixed reconciliation amount (p/day).
 2. A volumetric reconciliation amount (p/kWh) based on estimated consumption.
 3. A volumetric reconciliation based on deemed consumption and reconciled to actual consumption. This approach would also require a payment method flag to be held by central systems for allocation and reconciliation.
 4. A daily reconciliation and volumetric reconciliation.
- 4.12 Each approach could be used to redistribute the daily cost amounts (standing charge) or the variable amounts (the unit rate) or both. We have identified three existing industry third parties who could feasibly be the operator for the approaches. They are RECCo, Xoserve and Elexon. RECCo would be able to provide a solution for the first two approaches and Option 2 for both gas and electricity. Xoserve would be able to provide a gas solution for all the solutions but would need to hold the payment method information at a supply point level for Approach 2 and 3. Elexon would be able to provide a solution for electricity for Approaches 1, 2 and 3. Elexon currently do not hold differences in payment method for balancing mechanism units, therefore suppliers would need to register sites according to payment method with their data aggregators in order to be able to provide a solution for Approach 2 and 3.

4.13 Indicative costs to implement based on high level requirements for the first, second and third reconciliation approach for the three levelisation options (as set out in chapter 3) were provided by RECCo, Xoserve and Elexon, requested from suppliers and estimated by Ofgem as part of our IA. Operators and suppliers will be invited to confirm final costs based on low level design requirements at a later date. A summary of the cost for each of the 3 options for levelisation and the different approaches to these are presented in the **Table 11** below.

Table 11: Summary of indicative costs for selected participants for each option and approach

Option	RECCo	Xoserve	Elexon	Suppliers	Ofgem
Option 1	£0	£0	£0	£0	£0
Option 2 Approach 1	£400k – 600k implementation. £300K – 500k ongoing operational.	£200k implement. £150k ongoing	£150k implement. £225k ongoing.	None provided	5 FTE implement. 2 FTE ongoing.
Option 2 Approach 2	400k – 600k implementation. £300K – 500k ongoing operational.	£500k implement. £150k ongoing.	£200k implement. £350K ongoing.	None provided	5 FTE implement. 2FTE ongoing.
Option 3 Approach 1	n/a	£200k implement. £150k ongoing.	£150k implement. £225k ongoing.	None provided	5 FTE implement. 2 FTE ongoing.
Option 3 Approach 2	n/a	£500k implement. £150k ongoing.	£200k implement. £350K ongoing.	None provided	5 FTE implement. 2 FTE ongoing.
Option 3 Approach 3	n/a	£550k implement. £150k ongoing.	£300k implement. £400k ongoing.	None provided	5 FTE implement. 2 FTE ongoing.

-
- 4.14 We welcome any implementation costs that stakeholders could provide for the options and approaches described above to assist in the full IA.
- 4.15 We are proposing that a fixed reconciliation amount is used to calculate the redistribution of standing charge costs and a volumetric reconciliation based on estimated consumption is used for the variable amount. This volumetric amount will not be reconciled to actual consumption. This provides a fair balance between complete accuracy of the charging and the costs of building a system and providing appropriate data to calculate the charges.
- 4.16 All domestic supply points, including non-capped tariff and derogated customers, should be subject to the reconciliation amount. This is to not give any perverse incentives to suppliers to price fixed price contracts between the levelised and reference price cap. If fixed price contracts were excluded, then the levelisation amounts would need to fall on a smaller number of standard variable customers. There may be a slight increase in the price that non-capped DD tariffs are offered at as a result of being included in levelisation, while there may be reductions to non-capped PPM tariffs as a result. Consideration will need to be made to existing fixed price contracts during transition.

How will the mechanism work?

- 4.17 Our initial view is that a payment mechanism identifier should be reported to the reconciliation mechanism operator to have a central record of the payment method. Ofgem can calculate a levelised standing charge and unit rate cap for each payment method and fuel and region for each payment method on a quarterly basis. Ofgem can also calculate the reconciliation rate per region, fuel, by standing charge and unit rate by substituting the levelised cap from the default price cap. This should be provided to both suppliers and the reconciliation mechanism operator.
- 4.18 The reconciliation mechanism operator should calculate the reconciliation amounts monthly by multiplying the supply point count or estimate consumption for each supplier, fuel and payment method by the rate for the appropriate payment method. We considered a less frequent reconciliation calculation cadence like the mechanism under Low Carbon Contracts Company (LCCC); however, we consider that a monthly frequency provides the right balance between administration costs and cost exposure from lack of reconciliation.
- 4.19 A mutualisation process would be required to cater for any non-payment or supplier market exits. A dispute process will also be required for suppliers to

query charges. A neutrality mechanism will also be required to distribute any residual funds within the schemes at an appropriate cadence.

- 4.20 To underpin the mechanism, we will introduce appropriate Supplier Licence Conditions to report payment method (and any other relevant) information to the reconciliation mechanism operator. When reporting to Ofgem, suppliers will also need to provide assurance of the rates that customers are charged. Proportionate audits of supplier systems may be required to ensure that no customer is being overcharged and to validate the payment method reporting.
- 4.21 We welcome any views on the detail of how the mechanism could work, and we will continue to engage with stakeholders. We would also welcome any views on the possibility of delivering a phased implementation, with the fixed (standing charge) element of the solution being implemented in advance of any volumetric solution to help ease delivery risks by April 2024.

How will payments be made to energy customers?

- 4.22 Payments will not be paid directly to energy customers but will be paid between their suppliers via the reconciliation mechanism. Customers will not receive any direct payments but will see changes to the tariff levels that suppliers can charge them.

Appointment

- 4.23 Due to the limited amount of time to implement levelisation, we will look to appoint an operator of the reconciliation mechanism shortly.

Proposal summary

- 4.24 A summary of our preferred approach for implementing the new mechanism is provided in Table 12.

Table 12: Reconciliation Mechanism proposal summary

Topic	Proposal
Mechanism	New mechanism will be implemented
Type of mechanism	Reconciliation by difference
Standing Charge Reconciliation	Based on a daily rate adjustment
Unit Rate Reconciliation	Reconciliation will be based on estimated consumption and not adjusted to actual consumption
Invoicing Cadence	Monthly
Levelised price cap calculation	Ofgem

VAT considerations

- 4.25 During the design phase, consideration will need to be given to whether levelisation is taxable and therefore if VAT should be applied to the charges.

5. Interactions with other workstreams

Chapter summary

We discuss our interactions with other Ofgem workstreams, including our work with the Operating cost review, Debt-related costs review and Involuntary PPM installation.

- 5.1 As outlined in our CfE in April 2023, the levelisation workstream has interactions with other Ofgem workstreams, primarily looking at aspects of the Price Cap and more broadly. These workstreams include the Operating Cost Review, Debt-related Costs Review and Review of Involuntary PPM Installations.
- 5.2 We are actively working with these workstreams to ensure the implementation of any levelisation policy is consistent with the necessary requirements of these and other related workstreams.

Operating cost review

- 5.3 As outlined in the Price cap – Programme of Work: Update in April,³² Ofgem is launching a review of the cost-related allowances in the price cap, including:
- The Core operating costs allowance - a supplier's own costs of retailing energy;
 - The Smart Metering Net Cost Change (SMNCC) allowance - net cost of installing and operating smart meters as part of the transition for the smart meter rollout; and
 - The Payment Method Uplift (PMU) - allowances for the additional costs of serving customers who pay by different payment methods.
- 5.4 There are several reasons why we think a review of the operating cost allowances would be appropriate at this stage, including the age of the data used to set the allowances and the number of changes the market has gone through since the allowances were set.
- 5.5 The operating costs review aims to consider whether changes to the allowances are appropriate and whether the allowances continue to reflect the efficient costs a notional efficient supplier may incur. We are considering:
- Market changes;

³² Ofgem (2023), 2023/24 Forward Work Programme. <https://www.ofgem.gov.uk/publications/202324-forward-work-programme>

- Regulatory changes; and
- Up to date data and benchmarks.

5.6 We expect that any changes to the operating cost allowance to be complementary to levelisation. As the operating cost review is scheduled to be delivered after we would implement levelisation, we would update levelisation accordingly following the operating cost review decision.

5.7 Should the review result in structural changes to the price cap, such as changing the way that bad debt is assigned in the PMU, we would assess whether our levelisation calculations need to be changed in response. Even in a scenario where bad debt is levelised by an equivalent amount to that calculated in the PMU, our current approach/model should still accommodate this.

If the review results in the standing charge for PPM being made lower than the DD standing charge, we would not perform levelisation. This principle is explained in Chapter 3.

Debt-related costs review

5.8 We have been undertaking a review of debt-related costs, with a view to considering whether we should make an adjustment to the debt-related costs allowance in the price cap. During this review, we have gathered a range of evidence, including through Requests for Information (RFIs) sent to suppliers, and a Call for Input (CFI), published in April 2023, seeking views from all stakeholders.

5.9 We published an interim update letter on 28 June 2023 on our review. This set out that given the data and evidence we had received at that point, we considered that there was not a material or systematic gap between the allowance within the cap for debt-related costs and actual costs. We said we had therefore decided not to consult on a price cap adjustment for credit debt-related costs this summer. We have since issued a further RFI to suppliers, and are considering the evidence now.

5.10 We had, however, seen significant evidence of a material increase in non-repayment of ASC provided to PPM customers. We published a consultation in parallel setting our proposals to introduce an initial 12-month allowance for bad

debt associated with ASC given to PPM customers.³³ Our decision to introduce a specific allowance for ASC bad debt, which is being published alongside this document, is summarised in Chapter 2.

- 5.11 As outlined in Chapter 3, we are consulting on the inclusion of bad debt associated with ASC within the levelisation process from April 2024.

Involuntary PPM installation

- 5.12 In January 2023, we announced a package of work focused on PPM. As well as investigating reports of poor supplier practice, we are also reviewing relevant licence conditions and guidance to consider what else they should cover to further protect consumers, particularly vulnerable consumers.

- 5.13 Following our Call for Evidence in February, we launched a Code of Practice, which has been agreed with suppliers.³⁴ The Code sets out strengthened protections for the most vulnerable customers for whom PPM may not be a safe option, alongside standards for those customers who are currently on PPM or may be moved to PPM.

- 5.14 It works in tandem with existing licence rules and guidance, and its goals are:

- to ensure that customers, especially vulnerable customers, are protected and that PPMs are only used where safe and reasonably practicable;
- to recognise that PPM is a valid payment option for many customers, and should be retained as an option where safe and reasonably practicable for the customer; and
- to deliver high standards and protections for all PPM customers, for example through the promotion of smart PPM.

- 5.15 These changes are complementary to our levelisation work and tackles a different angle to consumer protection. It will ensure proper process is followed prior to suppliers involuntarily installing PPMs. This workstream will ensure that those on PPM (whether they were involuntarily installed or not) pay reasonable charges.

³³ Ofgem (2023), Price cap – Statutory consultation on introducing an allowance for bad debt associated with Additional Support Credit. <https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-introducing-allowance-bad-debt-associated-additional-support-credit>

³⁴ Ofgem (2023), Involuntary PPM - Supplier Code of Practice. <https://www.ofgem.gov.uk/publications/involuntary-ppm-supplier-code-practice>

6. Next steps

- 6.1 We welcome any written comments by 22 September 2023, sent to priceprotectionpolicy@ofgem.gov.uk. Please include detail and supporting evidence in your comments wherever possible. As part of your comments, please explain how any suggested approaches would be deliverable in practice. We will carefully consider stakeholder feedback following the close of this policy consultation.
- 6.2 There will also be further opportunities for stakeholders to provide input on our approach as our work on levelisation progresses. Our next step in the publication process will be to publish a statutory consultation in November 2023 and a decision in early 2024.
- 6.3 Once we have considered comments from stakeholders and continued development of our approach, we will consider further stakeholder engagement.

Appendices

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Appendix 1 – List of Consultation Questions

Chapter	Question
Chapter 2: Case for change	1) Do you have any views on our proposed case for the introduction of levelisation of payment methods?
Chapter 3: Levelisation proposals and considerations	2) Do you have any views on our proposed policy considerations for levelisation? Are there any additional ones we should consider? 3) Do you agree with our initial preference to levelise PPM and DD Standing Charges? 4) Do you think we should also levelise the bad debt charges across PPM, DD and SC, which would reduce the differential between SC and DD? Please provide any evidence /data that may benefit consumers as a whole. 5) How should we ensure that levelisation transfers are correctly applied to customers on tariffs not covered by the cap (ie uncapped)? 6) Do you agree with our proposal not to levelise across regions? 7) Do you agree with our proposal not to target levelisation? 8) Should we set new licence conditions to ensure suppliers pass the costs/benefits through to all customers? 9) Do you have any views on our other considerations?
Chapter 4: Payment reconciliation process options and considerations	10) What are your views on the reconciliation mechanism, the type of mechanism, invoicing cadence, and mechanism operator? 11) Do you have any views on our preferred approach of a fixed reconciliation amount to reconcile standing charges levelisation and a volumetric reconciliation amount based on estimated consumption to reconcile unit rate levelisation? 12) Do you agree that all domestic customers should be included within the reconciliation mechanism? 13) Can you provide an estimate of implementation and ongoing costs on your organisation of the different levelisation options and approaches? 14) Do you have any comments on potentially phasing the implementation of the reconciliation mechanism? 15) What considerations should we take to tariffs that exist prior to the implementation of levelisation? 16) Are there any other financing impacts on your organisation that we have not considered as part of Chapter 4 or the IA? 17) Are there any other considerations for the reconciliation mechanism we have not explored?

Appendix 2 – Draft Impact Assessment

This Appendix sets out our draft impact assessment (IA) of our levelisation proposals as set out in Chapters 3 and 4. It describes our intended approach including our initial views on the potential impacts that would arise from the introduction of levelisation, dependent on the chosen option(s). We will finalise our IA, alongside our final proposals in November.

Executive summary

- 2A.1 Our draft IA has assessed the impacts of three different options:
- Option 1 – do nothing.
 - Option 2 – levelise DD & PPM standing charges and levelise bad debt related to ASC.
 - Option 3 – Option 2 plus levelise debt-related costs.
- 2A.2 In addition, we have also considered the impacts of levelising with and without a reconciliation mechanism.
- 2A.3 Our draft IA shows that the benefits and costs of levelisation are finely balanced and the net effect of the impacts of levelisation on all consumers, as a whole, is yet to be determined. A cost-benefit analysis will be included in the final impact assessment. The underlying impact of levelisation for both Option 2 & 3 is that it benefits some consumers at the cost of others. Further analysis is needed to determine if the benefits outweigh the costs as a whole.
- 2A.4 The principal benefit for Option 2 is the reduction in harm associated with PPM customers building up debt during periods of low demand or self-disconnection. This is weakened in Option 3 by the reallocation of costs from SC customers back onto PPM. We also identify in Option 3 the risk of customers moving from DD to SC due to weakened incentives, potentially increasing bad debt costs as a whole.
- 2A.5 Our draft IA has shown that from a supplier perspective, levelisation results in some suppliers gaining additional revenue and others losing revenue. As a result, levelisation necessitates a reconciliation mechanism which would offset any gained or lost revenue.
- 2A.6 The benefits and costs identified for each levelisation option are summarised in Table 2A.1 below.

Table 2A.1: Summary of levelisation and reconciliation benefits and costs

Levelisation Options	Reconciliation Options	Benefits	Costs
Option 1	N/A	N/A	N/A
Option 2	Without reconciliation	<ul style="list-style-type: none"> • No reconciliation mechanism costs • PPM consumers pay less (£54) • Lowers PPM standing charge • Reduces the risk of PPM self-disconnection and the associated negative physical and emotional impacts 	<ul style="list-style-type: none"> • Significant supplier revenue impacts • DD & SC consumers pay more (£11 and £1 respectively)
	With reconciliation	<ul style="list-style-type: none"> • PPM consumers pay less (£54) • Lowers PPM standing charge • Reduces the risk of PPM self-disconnection and the associated negative physical and emotional impacts 	<ul style="list-style-type: none"> • DD & SC consumers pay more (£11 and £1 respectively) • Reconciliation mechanism implementation and ongoing costs to suppliers, Ofgem and existing industry party
Option 3	Without reconciliation	<ul style="list-style-type: none"> • No reconciliation mechanism costs • PPM & SC consumers pay less (£12 and £33 respectively) • Lowers PPM standing charge • Reduces the DD to SC differential from £129 to £85 	<ul style="list-style-type: none"> • Significant supplier revenue impacts • DD consumers pay more (£11) • Potential for consumers to switch to SC – increasing risk of bad debt
	With reconciliation	<ul style="list-style-type: none"> • PPM & SC consumers pay less (£12 and £33 respectively) • Lowers PPM standing charge • Reduces the DD to SC differential from £129 to £85 	<ul style="list-style-type: none"> • DD consumers pay more (£11) • Potential for consumers to switch to SC – increasing risk of bad debt • Reconciliation mechanism implementation and ongoing costs to suppliers, Ofgem and existing industry party

Rationale

What is the problem under consideration? Why is Ofgem intervention necessary?

- 2A.7 As a result of the cost reflective way in which the price cap is calculated and the way suppliers calculate their non-price cap prices, PPM and SC consumers have historically been charged more when compared to DD consumers, despite vulnerable consumers accounting for a higher proportion within these groups.
- 2A.8 There is a specific concern about the impact of higher standing charges on PPM customers relating to the accumulation of debt during periods of low demand or self-disconnection and the harms to health and wellbeing that stem from this.

What are the policy principles and intended effects including the effect of Ofgem's Strategic Outcomes?

- 2A.9 Ofgem's principal objective is to protect the interests of energy consumers, including having regard for the interests of vulnerable consumers (our 'vulnerability duty'). In line with Ofgem's principal objective and accounting for the issues described above, Ofgem have developed considerations which are set out in Chapter 3 of this document.

What are the policy options that have been considered, including any alternatives to regulation?

- 2A.10 When assessing how to respond to the issues described above, we have identified three levelisation options:
- Option 1: do nothing.
 - Option 2: levelise PPM and DD standing charges (only when PPM standing charges are more expensive than DD standing charges) and levelise the charge for bad debt associated with additional support credit (ASC) across all payment methods.
 - Option 3: Option 2 plus levelise debt related costs across all payment methods. This will have the effect of partially levelising SC.
- 2A.11 Due to the supplier impacts of the levelisation options detailed above, we have identified two supplier reconciliation options for consideration:
- Levelise without a reconciliation mechanism.
 - Levelise with a reconciliation mechanism.

Previous levelisation analysis

2A.12 We published a set of findings as part of our “Levelisation of payment method cost differentials: a call for evidence” in April 2023.³⁵ These findings included analysis on the impacts of a variety of levelisation cases or scenarios on consumers (including distributional impacts), suppliers and wider market effects. The summary of stakeholder responses as well as the rationale for discounting any previously considered cases or scenarios can be found in **Appendix 4**.

Scope and approach to this draft impact assessment

Scope

2A.13 This draft IA sets out the options Ofgem is considering for the design and implementation of levelisation and a proposed reconciliation mechanism. These options are based on analysis conducted to date, consumer insight and responses to the July 2023 debt-related costs Request for Information (RFI). Based on responses to this policy consultation, we will refine our analysis ahead of our final proposals and statutory consultation.

2A.14 This draft IA assesses the relative impact of the identified policy options measured against a baseline market position (the baseline scenario).

Approach

2A.15 Our approach to this draft IA is based on Ofgem’s current guidance on impact assessments.³⁶ We are considering the impacts described in the Table 2A.2.

³⁵ Ofgem (2023), Levelisation of payment method cost differentials: a call for evidence.

<https://www.ofgem.gov.uk/publications/levelisation-payment-method-cost-differentials-call-evidence>

³⁶ Ofgem (2020), Impact Assessment Guidance. <https://www.ofgem.gov.uk/publications/impact-assessment-guidance>

Table 2A.2: Structure of our draft impact assessment

Category	Sub-Category
Impacts on consumers	Direct financial impact on fixed and standard variable tariff (SVT) consumers
	Impact on vulnerable consumers
	Regional variations
	Distributional impacts
	Indirect impact due to suppliers' price responses
	Indirect impact on energy consumption
	Impact on consumer engagement and trust
	Other impacts
Impacts on suppliers	Direct impact on suppliers' revenues
	Direct impact on suppliers' costs
	Direct impact on suppliers' profits
	Direct impact on suppliers' cost of capital
Impact on competition and innovation	Impact on price competition
	Impact on non-price competition
	Impact on market entry and exit
	Impact on innovation
	Overall conclusions on competition impacts
Wider impacts	Impact on Ofgem costs
	Environmental impacts
	Security of supply
	Public Sector Equality Duty
Sensitivity analysis	Range of impacts by consumption
	Refined analysis using historic energy usage
	Variation in consumer payment method proportions

- 2A.16 We have considered the impacts in isolation, as well as the dynamics between the impacts that affect each group of stakeholders and the net impact across all stakeholders. As part of this consideration, we have assessed the interdependencies between impacts and to ensure there is no double-counting of impacts when aggregated.
- 2A.17 The draft IA takes account of intended impacts and, as far as possible, any potential risks, unintended consequences, and wider implications of the proposed options.
- 2A.18 Not all impacts can be fully quantified however we will ensure that our approach to measuring the individual areas of impact is proportionate, consistent, and transparent. Where sufficient data and evidence allows, we have assessed impacts quantitatively, assigning monetary values where appropriate.

2A.19 We have considered the relative costs and benefits of each option overall, as well as the extent to which the option is aligned to our proposed price protection objectives, and the matters to which Ofgem must have regard. This will inform our decision regarding our preferred option(s).

Baseline scenario

2A.20 Our baseline scenario against which any impacts of levelisation will be measured, are the published cap levels at Typical Domestic Consumption Value (TDCV) for charge restriction period (“cap period”) 11a, from 1 October 2023 to 31 December 2023. The unit rates and standing charges for this cap period are shown below in Table 2A.3.

Table 2A.3: Cap Period 11a Unit Rates and Standing Charges

Fuel Type	Energy Charge Type	DD	PPM	SC
Single Rate Electricity	Unit Rate (p/kWh)	27.35	26.92	28.79
Single Rate Electricity	Standing Charge (£/day)	0.53	0.60	0.60
Gas	Unit Rate (p/kWh)	6.89	6.67	7.25
Gas	Standing Charge (£/day)	0.30	0.40	0.35
Multi Register Electricity	Unit Rate (p/kWh)	26.26	25.91	27.64
Multi Register Electricity	Standing Charge (£/day)	0.53	0.60	0.60

2A.21 The cap levels for cap period 11a are shown in Table 2A.4 below.

Table 2A.4: Cap Period 11a Cap Levels

	DD	PPM	SC
Single Rate Electricity (2900 kWh)	£988	£1,001	£1,054
Gas (12000 kWh)	£935	£948	£998
Dual Fuel	£1,923	£1,949	£2,052
Multi Register Electricity (4200 kWh)	£1,298	£1,308	£1,380

2A.22 In addition to the cap levels above in Table 2A.4, our baseline scenario also represents all market outcomes under the price cap.

2A.23 Our draft IA evaluates the impact of our options against this baseline.

Risks, assumptions and limitations

Risks

- 2A.24 The consumer impacts calculated in this draft IA are based on TDCVs and therefore there is a risk that these impacts will vary based on actual consumption values.

Assumptions

- 2A.25 We have assumed in our main options analysis that the impacts within payment method groups are based on current TDCVs – 2,900kWh for single rate electricity, 4,200kWh for a multi register electricity and 12,000kWh for gas.

Limitations

- 2A.26 The vulnerability data we have used as part of this draft IA does not give a complete picture of vulnerability across the population. We have been able to interrogate vulnerability characteristics in isolation however this does not allow for a holistic assessment of the impacts of levelisation on the vulnerable population as a whole.
- 2A.27 In assessing the consumer impacts of levelisation, we have focused on the effects on individuals' finances, in particular additional expenditure or savings as a result of levelisation. The impacts of levelisation are heavily dependent on the baseline cap levels – our analysis is based on the price cap levels for cap period 11a.
- 2A.28 The distributional assessment is based on Office for National Statistics (ONS) data from 2017/18 so there is a risk that the results of this assessment are misaligned with present day data.

Summary of quantitative and qualitative assessment

Impacts on consumers

Direct financial impact on fixed and standard variable tariff (SVT) consumers

2A.29 We have considered the impact of the levelisation options on fixed and standard variable tariff consumers.

Option 1 – Do nothing

2A.30 Under Option 1, there are no consumer impacts as it is our baseline case. DD is the cheapest payment method. The large differential between SC & DD payment methods remains under this option.

Option 2 – Levelise PPM & DD standing charges and levelise ASC bad debt costs

2A.31 The impacts of this option for cap period 11a are shown in Table 2A.5 and Table 2A.6 below.

Table 2A.5: Option 2 - Unit Rates and Standing Charges

Fuel Type	Energy Charge Type	DD	PPM	SC
Single Rate Electricity	Unit Rate (p/kWh)	27.35	26.92	28.79
Single Rate Electricity	Standing Charge (£/day)	0.55	0.55	0.60
Gas	Unit Rate (p/kWh)	6.89	6.67	7.25
Gas	Standing Charge (£/day)	0.31	0.31	0.35
Multi Register Electricity	Unit Rate (p/kWh)	26.26	25.91	27.64
Multi Register Electricity	Standing Charge (£/day)	0.55	0.55	0.60

Table 2A.6: Option 2 - Cap Levels & Impacts

	DD	PPM	SC
Single Rate Electricity (2900 kWh)	£992	£980	£1,055
Gas (12000 kWh)	£942	£915	£999
Dual Fuel	£1,934	£1,895	£2,054
Impact	+£11	-£54	+£1
Multi Register Electricity (4200 kWh)	£1,303	£1,288	£1,381
Impact	+£5	-£20	+£1

2A.32 Under Option 2, PPM becomes the cheapest payment method which aligns with our policy intent. The large differential between SC & DD payment methods remains under this option.

Option 3 – Option 2 plus levelise debt-related costs

2A.33 The impacts of this option for cap period 11a are shown Table 2A.7 and Table 2A.8 below.

Table 2A.7: Option 3 - Unit Rates and Standing Charges

Fuel Type	Energy Charge Type	DD	PPM	SC
Single Rate Electricity	Unit Rate (p/kWh)	27.46	27.30	28.08
Single Rate Electricity	Standing Charge (£/day)	0.55	0.55	0.59
Gas	Unit Rate (p/kWh)	6.86	6.89	7.20
Gas	Standing Charge (£/day)	0.32	0.32	0.34
Multi Register Electricity	Unit Rate (p/kWh)	26.49	26.26	26.53
Multi Register Electricity	Standing Charge (£/day)	0.55	0.55	0.58

Table 2A.8: Option 3 - Cap Levels & Impacts

	DD	PPM	SC
Single Rate Electricity (2,900 kWh)	£996	£994	£1,029
Gas (12,000 kWh)	£938	£943	£990
Dual Fuel	£1,934	£1,937	£2,019
Impact	+£11	-£12	-£33
Multi Register Electricity (4,200 kWh)	£1,314	£1,305	£1,326
Impact	+£16	-£3	-£54

2A.34 Under Option 3, PPM becomes slightly more expensive than DD (albeit increasing in cost when compared to Option 2). The differential between SC & DD has reduced from £129 (baseline cap level) to £85.

Impact on vulnerable consumers

- 2A.35 Supporting and protecting consumers in vulnerable circumstances is a key priority for Ofgem and aligned with our statutory duty. In order to effectively support and protect vulnerable consumers, effective identification is important. Ofgem has a statutory duty to consider the needs of people with disabilities, who are chronically sick, of pensionable age, on low income or living in rural areas.³⁷
- 2A.36 Currently our impact assessment does not consider the impact on those consumers in rural areas due to a lack of data however this data will be available for inclusion in our final impact assessment.

Disability

- 2A.37 Ofgem research from November & December 2022 highlighted the proportion of households with one or more persons with any long-term illness, physical or mental health problem or disability.³⁸ The results of this research are summarised in Table 2A.9 below.

Table 2A.9: Consumer Insights Survey data on illness, physical or mental health or disability

Method of payment	Proportion of households with one or more persons with any long-term illness, physical or mental health problem or disability within group (%)	Proportion of total households with one or more persons with any long-term illness, physical or mental health problem or disability (%)
DD	29	65
SC	37	14
PPM	45	21

- 2A.38 The data shows that when we only consider those households that pay via PPM – 45% of those households have one or more persons exhibiting one or more of the characteristics described. However, when we consider all households with one or more person exhibiting one or more of the characteristics described, only 21% of those have households pay via PPM.
- 2A.39 We can see that households paying by PPM and SC are more likely to have one or more persons with a long-term illness, physical or mental health problem or

³⁷ Gas and Electricity Act (1968). <https://www.legislation.gov.uk/ukpga/1968/39/enacted>

³⁸ Ofgem (2023), Consumer Impacts of Market Conditions survey – Wave 3 (Nov/Dec 2022) <https://www.ofgem.gov.uk/publications/consumer-impacts-market-conditions-survey-wave-3-novdec-2022>

disability compared to DD: 45% and 37% for PPM and SC respectively compared to 29% for DD.

Pensionable Age

2A.40 Ofgem research from November & December 2022 highlighted the proportion of individuals aged 65 and over. The results are summarised in Table 2A.10 below.

Table 2A.10: Consumer Insight Survey data on individuals aged 65 and over

Method of payment	Proportion of individuals aged 65 and over within group (%)	Proportion of total individuals aged 65 and over (%)
DD	28	87
SC	17	9
PPM	6	4

2A.41 The data shows that when we only consider those individuals that pay via PPM – only 6% are aged 65 and over. This proportion is even smaller when we consider all individuals aged 65 and over – only 4% of all individuals aged 65 and over pay via PPM showing that amongst this vulnerability group, PPM is the least popular payment method. We can see that households paying by PPM and SC are less likely to be aged over 65 compared to DD: only 6% and 17% for PPM and SC respectively, compared to 28% for DD.

Fuel Poor (Low Income)

2A.42 Consumer research from the Department for Energy Security & Net Zero from 2022 shows that there are differences in the level of fuel poverty and vulnerability between consumers on different payment methods.³⁹ Proportionally, the percentage of households that are classed as fuel poor are higher for PPM and SC, than those that pay by DD for consumption of electricity and gas. However, of all households in fuel poverty, a much higher proportion pay by DD than those paying by SC and PPM. See Table 2A.11 for more information.

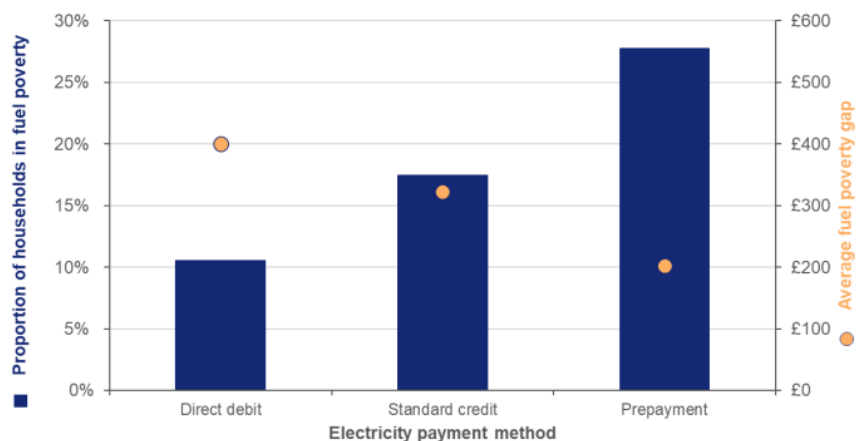
³⁹ Department of Energy Security & Net Zero (2023), Annual Fuel Poverty Statistics in England, 2023 (2022 data).
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1139133/annual-fuel-poverty-statistics-lilee-report-2023-2022-data.pdf

Table 2A.11: Fuel Poverty statistics by household (Electricity & Gas) 2022

Method of payment	Proportion of fuel poor households within group (%)	Number of households (thousands) - Fuel poor	Proportion of total fuel poor households (%)
Electricity - DD	11	1,989	61
Electricity - SC	18	426	13
Electricity - PPM	28	842	26
Gas - DD	10	1,631	50
Gas - SC	18	371	11
Gas - PPM	27	697	21
N/A - no Gas	20	558	17

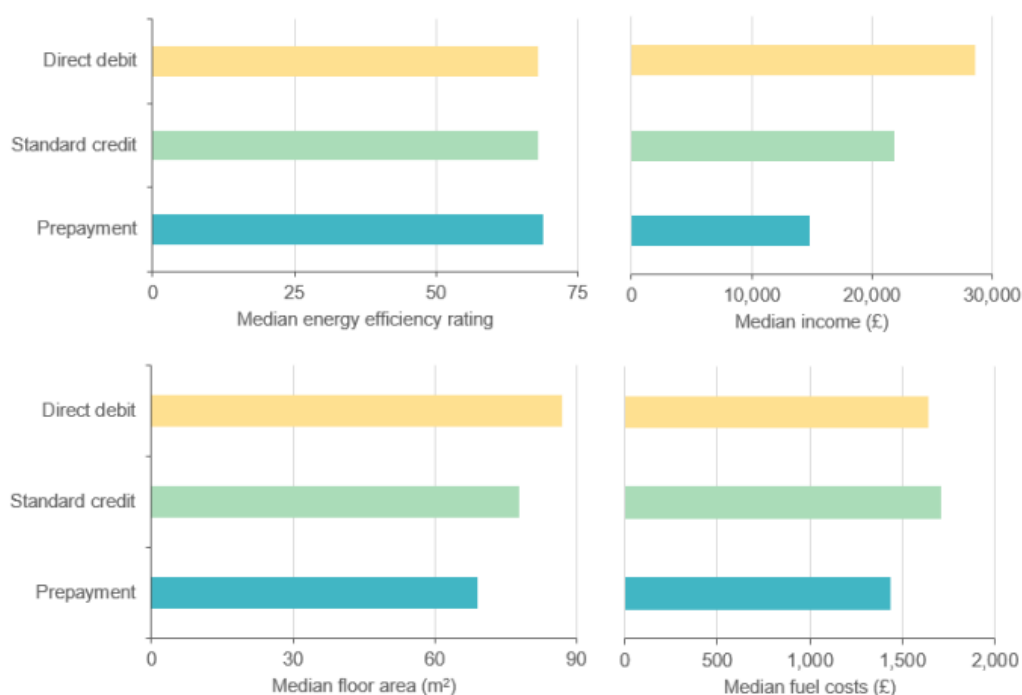
- 2A.43 In this context, government categorises “vulnerable” to mean a fuel poor household, as measured by Low Income Low Energy Efficiency (LILEE). As regulator, our duty extends beyond this to categorise definitions of vulnerability as described above. Although all households will be impacted as a result of levelisation, it is those categorised as vulnerable to whom Ofgem has a duty to give particular regard to as regulator.
- 2A.44 In 2022, a household was classified as low income if their equivalised income (less tax and National Insurance), after payment of housing and fuel costs, was less than £15,385 (60% of median income for all households). Households using a PPM electricity meter were more likely to be fuel poor, 38% compared with 11% for households paying by DD.
- 2A.45 Figure 2A.1 below shows that the share of households using a PPM electricity meter in fuel poverty is 27.8% compared to 10.5% for DD. Households with PPM electricity meters had the lowest median income of £14,856, driving high levels of fuel poverty, but the lowest fuel costs of £1,439 which contribute to this payment method having the lowest fuel poverty gap (the reduction in fuel costs needed for a household to not be in fuel poverty) of £202, compared with approximately £400 for DD households.

Figure 2A.1: Households that pay for their electricity by PPM have the highest proportion in fuel poverty but the lowest fuel poverty gap



2A.46 Figure 2A.2 below shows that households that pay for electricity by PPM tend to live in smaller properties, have lower than average median fuel costs and a much lower median income.

Figure 2A.2: Median energy efficiency rating, median income, median floor area and median fuel costs by payment method



Summary of Vulnerable Consumers Data

2A.47 The research and associated data presented above shows that consumers paying by PPM are most likely to exhibit one or more of the characteristics of vulnerability with the exception of pensionable age. However, in absolute terms,

as a result of DD being the most prevalent payment method currently amongst the general population, most vulnerable individuals/households pay via DD. For SC consumers, the proportions exhibiting one or more of the characteristics of vulnerability ranges from 17% for pensionable age to 37% for long-term illness, physical or mental health problem or disability demonstrating that significant numbers of SC consumers are also characterised as vulnerable.

- 2A.48 The fuel poverty gap is largest for DD, £400, compared with £322 for SC and £202 for PPM. The fuel poverty gap is largely driven by fuel costs (highest for SC at £1,709) and property size (largest for DD at 87m²).
- 2A.49 DD consumers have the highest median income (£28,610) and the second largest median fuel costs (£1,643), equivalent to 5.7% of median income. In contrast, PPM consumers have the lowest median income (£14,856) and the smallest median fuel costs (£1,429), equivalent to 9.6% of median income. SC consumers have a median income of £21,842 and the largest median fuel costs (£1,709) equivalent to 7.8% of median income.

At risk of self-disconnection

- 2A.50 Self-disconnection can occur to any consumer who has a PPM, although is likely to be more prevalent among consumers who are unable to afford their energy bills.
- 2A.51 Research from Citizens Advice shows that a third of PPM consumers disconnected at least once in the last year as they could not afford to top up.⁴⁰ This equates to more than 3 million people. Nearly 3 in 10 (27%) of those struggling to top up their PPM, over 850,000 people, are disconnecting from their energy supply at least once a week.
- 2A.52 One in 5 (19%) PPM consumers who had been disconnected from their energy supply in the past year said they had disconnected for more than 24 hours at least once. Nearly the same proportion (18%) of households which include a disabled person or someone with a long-term health condition were disconnected for more than 2 days at least once.
- 2A.53 Citizens Advice research found that 47% of those who self-disconnected cited negative impacts on their physical health and 63% on their emotional

⁴⁰ Citizens Advice (2023), Kept in the dark: The urgent need for action on prepayment meters. <https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Kept%20in%20the%20dark%20-%20the%20urgent%20need%20for%20action%20on%20prepayment%20metersV2.pdf>

wellbeing. Nineteen percent who had self-disconnected had not washed or showered as a result and 17% had skipped a meal. Twenty-five percent had to borrow money from friends or relatives. These disconnection effects are further exacerbated by regular or long disconnections.

Physical Impacts

- 2A.54 The main physical impact of feeling cold was experienced by 59% of all those reporting a negative impact. This was closely followed by having a dark home and not being able to wash.
- 2A.55 The physical impacts can be severe. There is a large body of evidence linking poor health outcomes with living in a cold, damp, and mouldy home.^{41 42 43}
- 2A.56 Research from the Institute of Health Equity sets out the implications on older people with lowered resistance to respiratory infections.⁴⁴ Cold conditions can exacerbate existing medical conditions including diabetes, certain types of ulcers and musculoskeletal and rheumatological conditions.
- 2A.57 Decreasing body temperature is associated with a build-up of markers for dementia and Alzheimer's in the brain. As people reach old age, body temperature lowers, and physiological thermoregulation becomes less effective.
- 2A.58 Cold temperatures can cause blood pressure to rise in older people, increasing the risk of strokes and other circulatory problems. Moreover, cold homes have been associated with lower strength and dexterity and exacerbated symptoms of arthritis, which can increase the risk of falls and unintentional injury.
- 2A.59 Further, mortality and excess winter deaths are increased due to the impact of cold conditions on chronic conditions and an increase in circulating winter viruses. The leading cause of excess winter deaths in England are respiratory and cardiovascular diseases, dementia and injuries, all of which are exacerbated by living in a cold home.

⁴¹ WHO (2018), Housing and health guidelines. <https://apps.who.int/iris/handle/10665/276001>

⁴² Public Health England (2014), Fuel poverty and cold home-related health problems. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/355790/Briefing7_Fuel_poverty_health_inequalities.pdf

⁴³ National Institute for Health and Care Excellence (2015), Excess winter deaths and illness and the health risks associated with cold homes. <https://www.nice.org.uk/guidance/ng6>

⁴⁴ Institute of Health Equity (2022), Fuel Poverty, Cold Homes and Health Inequalities in the UK. <https://www.instituteofhealthequity.org/resources-reports/fuel-poverty-cold-homes-and-health-inequalities-in-the-uk>

Emotional Impacts

2A.60 Citizens Advice also identified negative emotional impacts. Research found that the main emotional impact was financial stress, experienced by 27% of all those reporting a negative impact, which was closely followed by stress from the practicalities of topping up and feelings of shame and embarrassment.

Impacts of Levelisation Options

2A.61 As a result of Option 2 & 3, PPM cap levels are reduced, reducing the risk of self-disconnection and self-rationing by increasing the amount of energy PPM consumers will be able to purchase for the same cost. For those consumers that are forced to self-disconnect, the reduction in the PPM standing charge will also mean they build up less debt compared with the “do nothing” (Option 1) approach. The reduction in bills has a greater benefit for this cohort than simply the financial benefit, it helps prevent the well documented negative impacts of self-disconnection and self-rationing.

Regional variations

2A.62 The energy price cap varies by region meaning the impacts of the levelisation options presented above will also vary by region. The baseline cap levels for cap period 11a for the most and least expensive regions, are shown in Table 2A.12.

Table 2A.12: Most and least expensive regional baseline cap levels for dual fuel at TDCV

Region	DD	PPM	SC
North Wales & Mersey	£1,986	£2,008	£2,119
East Midlands	£1,881	£1,907	£2,008

2A.63 The impacts of the levelisation Options 2 & 3 against the baseline cap levels are shown in Table 2A.13 & Table 2A.14 below.

Option 2 - Levelise PPM & DD standing charges and levelise ASC bad debt costs

Table 2A.13: Option 2 - Levelisation impacts against baseline cap levels

Region	DD	PPM	SC
North Wales & Mersey	£2,000 (+£14)	£1,957 (-£51)	£2,120 (+£1)
East Midlands	£1,890 (+£9)	£1,851 (-£56)	£2,009 (+£1)

2A.64 For Option 2, there is a range of impacts between regions (within payment methods) of between £0 and £5 at TDCV, demonstrating that there is little to no variation between regions.

Option 3 - Option 2 plus levelise debt-related costs

Table 2A.14: Option 3 - Levelisation impacts against baseline cap levels

Region	DD	PPM	SC
North Wales & Mersey	£1,998 (+£12)	£1,997 (-£11)	£2,082 (-£37)
East Midlands	£1,891 (+£10)	£1,893 (-£14)	£1,976 (-£32)

2A.65 For Option 3 there is a range of impacts between regions of between £2 and £5 at TDCV, demonstrating that there is little variation between regions.

Distributional impacts

We have considered the distributional impacts relevant to the levelisation options proposed. Within this, we have considered the relative impact on lower and higher consumption groups. In doing so, we have considered the impact on consumers in vulnerable circumstances, including the impact relative to their household income. We have used Ofgem’s consumer archetypes which are described in Table 2A.15 below.⁴⁵

⁴⁵ Centre for sustainable energy (2020), Ofgem energy consumer archetypes: Final Report. https://www.ofgem.gov.uk/sites/default/files/docs/2020/05/ofgem_energy_consumer_archetypes_-_final_report_0.pdf

Table 2A.15: Consumer Archetypes

Archetype	Key Words	% on DD	% on SC	% on PPM	Households (m)
A1	High incomes, owner occupied, working age families, full time employment, low consumption, regular switchers.	80	11	8	2.8
A2	High incomes, owner occupied, middle aged adults, full time employment, big houses, very high consumption, solar PV installers, care for the environment.	80	11	8	2.9
B3	Average incomes, retired, owner occupied - no mortgage, lapsed switchers, late adopters.	76	10	13	3.7
B4	High incomes, owner occupied, part-time employed, high consumers, flexible lifestyles, environmental concerns.	76	10	13	2.3
C5	Very low income, single female adult pensioner, non-switchers, disconnected (no internet or smart phones).	60	14	25	1.9
D6	Low income, disability, fuel debt, disengaged, social housing, BME households, single parents.	68	13	18	1.5
D7	Middle aged to pensioner, full time work or retired, disability benefits, above average income, high consumers.	76	10	13	1.2
E8	Low income, young household, part-time work or unemployed, private or social renter, disengaged non-switchers.	68	13	18	2.4
E9	High income, young renters, full time employments, private renters, early adopters, smart phones.	76	10	13	3.1
F10 (off gas)	Middle aged to pensioners, full time work or retired, owner occupied, higher incomes, oil heating, rural, RHI installers, late adopters.	76	10	13	1.9
G11 (off gas)	Young couples or single adults, private renter, electric heating, employed, average income, early adopter, BME background, low engagement.	76	10	13	1.5
H12 (off gas)	Elderly, single adults, very low income, medium electricity consumers, never-switched, disconnected, fuel debt.	60	14	25	0.6
H13 (off gas)	Off gas, low income, high electricity consumption, disability benefits, over 45s, low energy market engagement, late adopters.	68	13	18	0.5

2A.66 Archetypes can be further grouped into the average household income band within that archetype. The average income bands and associated archetypes are shown in Table 2A.16 below.

Table 2A.16: Archetypes by Average Income

Archetype	Average Income	Households (m)
A1	£48,000	2.9
A2	£54,600	3.7
B3	£28,600	2.3
B4	£40,600	1.9
C5	£15,200	1.5
D6	£18,100	1.2
D7	£34,000	2.4
E8	£23,400	3.1
E9	£37,000	1.9
F10 (off gas)	£38,900	1.5
G11 (off gas)	£30,200	0.6
H12 (off gas)	£14,500	0.5
H13 (off gas)	£22,000	2.9

Option 1 – Distributional Impacts

2A.67 Since Option 1 is the “do nothing” option, there are no impacts to the current cap levels and therefore no distributional impacts as a result.

Option 2 & 3 – Distributional Impacts

Table 2A.17: Option 2 & 3 - Distributional Impacts

Archetype	Option 2	Option 2	Option 2	Option 3	Option 3	Option 3
	DD	SC	PPM	DD	SC	PPM
	Average impact per household (£)/ Impact as % of annual income (%)	Average impact per household (£)/ Impact as % of annual income (%)	Average impact per household (£)/ Impact as % of annual income (%)	Average impact per household (£)/ Impact as % of annual income (%)	Average impact per household (£)/ Impact as % of annual income (%)	Average impact per household (£)/ Impact as % of annual income (%)
A1	+11/0.02	+1/0.00	-54/0.11	+12/0.03	-34/0.07	-16/0.03
A2	+11/0.02	+1/0.00	-54/0.10	+11/0.02	-51/0.09	+14/0.03
B3	+11/0.04	+1/0.00	-54/0.19	+11/0.04	-40/0.14	-2/0.01
B4	+11/0.03	+1/0.00	-54/0.13	+11/0.03	-43/0.11	+0/0.00
C5	+11/0.07	+1/0.01	-54/0.36	+11/0.07	-30/0.20	-15/0.10
D6	+11/0.06	+1/0.01	-54/0.30	+12/0.07	-40/0.22	-8/0.04
D7	+11/0.03	+1/0.00	-54/0.16	+11/0.03	-44/0.13	+0/0.00
E8	+11/0.05	+1/0.00	-54/0.23	+12/0.05	-38/0.16	-10/0.04
E9	+11/0.03	+1/0.00	-54/0.15	+12/0.03	-34/0.09	-14/0.04
F10 (off gas)	+11/0.03	+1/0.00	-54/0.14	+18/0.05	-47/0.12	-28/0.07
G11 (off gas)	+11/0.04	+1/0.00	-54/0.18	+18/0.06	-44/0.14	-30/0.10
H12 (off gas)	+11/0.08	+1/0.01	-54/0.37	+16/0.11	-35/0.24	-34/0.24
H13 (off gas)	+11/0.05	+1/0.00	-54/0.25	+18/0.08	-44/0.20	-29/0.13

- 2A.68 For Option 2, as shown in Table 2A.17 above, the distributional impacts are the same across all archetypes. This is due to the levelisation steps within Option 2 affecting only standing charges.
- 2A.69 For Option 3, the distributional impacts vary depending on the archetype. This is due to the levelisation steps within Option 3 affecting unit rates and standing charges and therefore the consumption values assigned to each archetype affect the level of impact between them.
- 2A.70 For Option 3, the impact is smaller for those archetypes that consume less energy and larger for those archetypes that consume more energy.
- 2A.71 For Option 2, the lowest DD income groups will incur larger increases, that equate to approximately 0.07% of their annual income, compared to 0.02% in the highest income groups. Additional costs incurred for SC customers are roughly equal across all archetypes (0-0.01%).
- 2A.72 However, the same lower income PPM groups will make greater savings (0.30-0.37% of their annual income), compared to the highest income groups (0.10-0.13%).
- 2A.73 Similarly for Option 3, the lowest DD income groups will incur larger increases, that equate to between 0.07 and 0.11% of their annual income, compared to 0.03% in the highest income groups.
- 2A.74 However, the same SC groups will make larger savings (0.20-0.24% of their annual income), compared to the highest income groups (0.07-0.11%). Those lower income PPM groups will also make (smaller) savings (0.10-0.24% of their annual income), which are larger than the highest income groups (0.01-0.03%).
- 2A.75 There is an average of 1.06m households in the three lowest income groups, compared to 2.8m in the three highest. As a result, our analysis highlights that higher income households are disproportionately impacted since there are more of them than lower income households.

Indirect impact due to suppliers' price responses

- 2A.76 As discussed in the main policy consultation, it is possible that the introduction of levelisation and the associated impacts may result in a change in the pricing behaviour by suppliers for those tariffs outside of the price cap (un-capped tariffs).
- 2A.77 For these tariffs, suppliers may increase prices to cover any unrecoverable costs of supplying other consumers and/or to earn additional margin. For Option 2 this risk could be mitigated by introducing an SLC requiring suppliers to offer the same or lower standing charges for PPM customers compared to DD customers on equivalent tariffs.
- 2A.78 By reducing the cap level for PPM under Option 2 and PPM and SC under Option 3, the number of tariffs consumers might consider affordable may increase thereby improving consumer choice. This could help consumers manage their finances more effectively.

Indirect impact on energy consumption

- 2A.79 Option 1 will have no impact on energy consumption since this is the "do nothing" option.
- 2A.80 Option 2 changes the standing charges consumers will pay with each payment method but leaves unit rates unchanged; decreasing standing charges for consumers paying by PPM and increasing them for DD. Whereas Option 3 changes both standing charges and unit rates; decreasing standing charges for PPM and SC but increasing them for DD, whilst increasing the unit rate for DD and PPM but decreasing it for SC.
- 2A.81 We would expect consumer demand to respond differently to changes in standing charges and unit rates. With respect to unit rates, where they are lowered, such as for SC under Option 3, marginal energy use has become cheaper and we would expect consumers to increase demand subject to their price elasticity of demand, and vice versa.
- 2A.82 With respect to standing charges, where they are lowered but unit rates remain unchanged, such as for PPM under Option 2, consumers will face the same marginal price of energy and so will not necessarily increase their consumption directly subject to their price elasticity of demand, as they may for a change in unit rate. Instead, any impacts on demand may occur through changes in

disposable income. By lowering the standing charge consumers paying by PPM will have more disposable income left and so may choose to spend some of that on energy.

- 2A.83 Energy consumption is relatively price and income inelastic. That is to say that it is not very responsive to changes in price and income. Taking into consideration both the price and income effects of changes to unit rates and standing charges and assuming income and price elasticities as estimated in the literature, we may expect that DD electricity consumers to decrease consumption by 0.3% under Option 3, PPM electricity consumers to increase consumption by 0.02% under Option 2, PPM electricity consumers to decrease consumption by 0.2% under Option 3, and for SC electricity consumers to increase consumption by 0.2%. For all other options and fuels, we would expect to see no changes in consumption.
- 2A.84 All of these calculated effects are close to 0 given the relatively small change in charges, the fact much of the levelisation is via standing charges and the relative inelasticity of energy use.
- 2A.85 Some consumers may however set themselves budgets for energy usage, especially for payment methods such as PPM where consumers can be much more aware of their energy use. Where this is the case, consumers may change their consumption in proportion to the change in energy costs. For consumer paying by PPM this could amount to a 1.6% increase in electricity demand and a 3% increase in gas demand under Option 2.

Impact on consumer engagement and trust

- 2A.86 In response to our CfE, a number of stakeholders commented on how levelisation has the potential to improve consumer trust in the retail energy market and improve consumers relationships with their supplier. They gave a variety of reasons for this:
- 2A.87 There is little consumer awareness of payment method price differentials. Levelisation aligns the market to the majority of consumers understanding, preventing them from being unaware that they are not on the cheapest tariff for them and losing trust in their supplier if and when they realise.
- 2A.88 Levelisation also aligns the market to what consumers view as being fair, improving their trust in the market and their supplier. In a focus group held by

one respondent to our CfE, majority of attendees felt that any extra costs associated with payment methods should be spread between all consumers.

2A.89 Levelisation reduces the cost difference between payment methods and therefore reduces the salience of cost, an important factor that consumers must consider when deciding which payment method to choose. This may make engagement in the energy market more accessible for some.

2A.90 One reason provided for why consumers chose SC is to take control back from their supplier in whom they have lost trust. Through partial SC levelisation proposed in Option 3, we may support, and not penalise, some consumers to feel as though they are taking control of their energy, supporting consumer engagement in the market.

Other impacts

2A.91 For those consumers in debt to their suppliers, and eligible to be involuntarily moved to PPM, our Options 2 and 3 make it more likely that PPM remains a viable option by not only reducing the PPM cap level but also by ensuring that the PPM cap level is no more expensive than the DD cap level. This will benefit those consumers at risk of self-disconnection and prevent and protect against the detrimental effects on health and wellbeing of living without gas or electricity.

Impacts on suppliers

Direct impact on suppliers' revenues

- 2A.92 Levelisation is achieved by taking from one set of payment method consumers and giving to another/others. From a consumer perspective there will be winners and losers as a result. From a supplier perspective, depending on the make-up of their consumer base, there will also be winners and losers.
- 2A.93 In order to avoid financial difficulty for suppliers as a result of levelisation, we are proposing a reconciliation mechanism whereby any additional revenue is returned and any lost revenue recouped (as discussed in **Chapter 4**).
- 2A.94 We have invented four hypothetical suppliers, each with a different ratio of DD, PPM and SC consumers to illustrate the supplier revenue impacts associated with each levelisation option.
- 2A.95 For our analysis, we have assumed that each hypothetical supplier has 1 million consumers and the number of consumers on DD, PPM and SC will vary for each supplier depending on the applied payment method proportions.
- 2A.96 In order to calculate the revenue impact, we calculate the revenue associated with Option 1 and use this as our baseline. We then calculate the revenue associated with Option 2 & 3 and calculate the difference relative to the baseline revenue.
- 2A.97 The rationale for a reconciliation mechanism can be seen below based on the revenue impacts for hypothetical suppliers with varying ratios of DD, PPM and SC consumers across Option 1, 2 & 3.

Option 1 – Do nothing

Since Option 1 is the “do nothing” option, there are no impacts to suppliers as a result.

Option 2 – Levelise PPM & DD standing charges and levelise ASC bad debt costs

Table 2A.18: Option 2 - Hypothetical Supplier Revenue Impacts

Supplier	DD	PPM	SC	Revenue Impact	% Impact
Supplier 1	33%	33%	33%	-£14.1m	-0.7%
Supplier 2	90%	5%	5%	£6.9m	0.4%
Supplier 3	5%	90%	5%	-£48.2m	-2.5%
Supplier 4	5%	5%	90%	-£1.1m	-0.05%

Option 3 – Option 2 plus levelise debt related costs

Table 2A.19: Option 3 - Hypothetical Supplier Revenue Impacts

Supplier	DD	PPM	SC	Revenue Impact	% Impact
Supplier 1	33%	33%	33%	-£11.3m	-0.6%
Supplier 2	90%	5%	5%	£7.9m	0.4%
Supplier 3	5%	90%	5%	-£12.1m	-0.6%
Supplier 4	5%	5%	90%	-£29.7m	-1.5%

- 2A.98 The revenue impacts shown above for each of the identified options would be realised in the absence of a reconciliation mechanism.
- 2A.99 As shown, Supplier 2 has a large proportion of DD consumers and therefore benefits the most from both Option 2 and 3. In contrast, as a result of Option 2, Supplier 3 has the largest proportion of PPM consumers and therefore loses the most revenue. Similarly, as a result of Option 3, Supplier 4 has the largest proportion of SC consumers and therefore loses the most revenue.
- 2A.100 In order to avoid benefiting suppliers or forcing suppliers into financial difficulty, a reconciliation mechanism is proposed. The revenue impacts will vary depending on the cap level at the time and the consumer base of the supplier. The ratio of payment methods within a supplier will also determine whether a supplier benefits or loses as a result of levelisation.

Direct impact on suppliers' costs

- 2A.101 We expect supplier administration costs to increase as a result of levelisation. The exact cost is associated with the design and implementation of the reconciliation mechanism and any ongoing monitoring and support.

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- 2A.102 Any additional administration costs associated with levelisation will likely be passed on to consumers and therefore the impact of this will likely be a small increase in fixed and standard variable tariffs.
- 2A.103 Other impacts on supplier costs are unclear. We expect the primary impact to result from changes in suppliers' consumer base payment method split:
- 2A.104 In Option 2, PPM becomes the cheapest payment method. We have assessed the impact of levelisation is unlikely to drive material volumes of switching between different tariff types and provided more detail in the competition and innovation section below. Despite this, and to illustrate the effect, if a large scale migration of DD and SC consumers onto PPMs were to occur, there could be a material reduction in working capital required and therefore in supplier cost.
- 2A.105 Similarly for Option 3, if consumers were to move to SC as the DD/SC differential increases, there may be an increase in bad debt.
- 2A.106 There will also be costs associated with the reconciliation mechanism, which will be administered by an existing industry party. The rough order of magnitude cost estimates for implementation and ongoing support are shown in Table 2A.20 below.

Table 2A.20: Cost estimations for reconciliation mechanism implementation and support

Option	RECCo	Xoserve	Elaxon	Suppliers	Ofgem
Option 1	£0	£0	£0	£0	£0
Option 2 Approach 1	£400k – 600k implementation £300K – 500k ongoing operational	£200k implement. £150k ongoing.	£150k implement. £225k ongoing.	None provided	5 FTE implement. 2 FTE ongoing.
Option 2 Approach 2	£400k – 600k implementation £300K – 500k ongoing operational	£500k implement. £150k ongoing.	£200k implement. £350K ongoing.	None provided	5 FTE implement. 2 FTE ongoing.
Option 2 Approach 3	400k – 600k + implementation £300K – 500k ongoing operational	£550k implement. £150k ongoing.	£300k implement. £400k ongoing.	None provided	5 FTE implement. 2 FTE ongoing.
Option 2 Approach 4	400k – 600k ++ implementation £300K – 500k ongoing operational	£800k implement. £150k ongoing.	£300k implement. £400k ongoing.	None provided	5 FTE implement. 2FTE ongoing
Option 3 Approach 1	n/a	£200k implement. £150k ongoing.	£150k implement. £225k ongoing.	None provided	5 FTE implement. 2 FTE ongoing.
Option 3 Approach 2	n/a	£500k implement. £150k ongoing.	£200k implement. £350K ongoing.	None provided	5 FTE implement. 2 FTE ongoing.
Option 3 Approach 3	n/a	£550k implement. £150k ongoing.	£300k implement. £400k ongoing.	None provided	5 FTE implement. 2 FTE ongoing.

Direct impact on suppliers' profits

2A.107 In the presence of a reconciliation mechanism, supplier profits should not be materially impacted as a result of levelisation.

Direct impact on suppliers' cost of capital

2A.108 For those suppliers that lose out as a result of levelisation, there is a risk that if reconciliation payments are not timely and to the expected level, this could place undue pressure on a supplier and in extreme cases, result in them exiting from the market.

2A.109 We are consulting on the frequency of reconciliation payments to determine the ideal balance between effort/overhead and risk to suppliers' financial stability.

Impact on competition and innovation

Impact on price competition

- 2A.111 It is possible under either Option 2 or 3 that levelisation could have a positive impact on competition insofar as it widens the pool of potential tariff types that a consumer would consider affordable. In particular, a consumer may consider SC (under Option 3) and PPM tariffs (under Options 2 & 3) that they would not otherwise be willing or able to pay for. However, we do not expect this effect to be large. This is because the impact of levelisation on bills is small as a proportion of the total bill paid. For example, we estimate that the impact for a TDCV PPM consumer is 1% of their annual bill under Option 2 and 3% under Option 3. Given the latest evidence on switching elasticities in the energy sector (which show that switching is relatively inelastic), we consider the bill impact of levelisation is unlikely to drive material volumes of switching between different tariff types.
- 2A.112 Under Option 3, levelisation of prices across SC and DD tariffs may lead to a reduction in price-related competition across different payment methods, as tariff differentials are minimised, prices converge and price competition itself is lessened. However, the extent to which levelisation could have a negative impact on price competition, in practice, depends on the extent to which the different payment methods acted to constrain each other in the first place. This, in turn, depends in part on the extent to which consumers view different payment methods as close substitutes.
- 2A.113 Qualitatively, the different payment methods have different product characteristics with DD being likely viewed as the most convenient payment method. In contrast, PPM and SC methods may provide an easier way for consumers to budget and manage their expenditure. The fact that a price differential of 7% exists and was maintained between payment methods, may be an indicator of a lack of substitutability between payment methods and suggest consumers do not view the products as close substitutes.

Impact on non-price competition

- 2A.114 We do not expect there to be significant impacts on non-price competition under Option 2. To the extent that levelisation does result in a reduction in price-related competition across different payment methods under Option 3, this may lead to an enhanced emphasis on non-price related parameters of competition such as consumer service parameters (eg ease of contact, ease of

managing bills and ease of making payments). Suppliers may develop their consumer service offerings in response to try to compete for consumers who prefer a particular payment mechanism and may seek to differentiate their product offering in this way.

Impact on market entry and exit

- 2A.115 We do not expect there to be significant impacts on market entry and exit under Option 2. Insofar as levelisation under Option 3 makes SC tariffs a more viable option for consumers who would otherwise use DD tariffs, and results in material volumes of switching from DD to SC it may increase the size of debt related costs for suppliers with respect to their SC products. To the extent that this ultimately represents an increased costs for suppliers, it could deter entry to (or investment in) the market or precipitate exit from the market for marginal participants.
- 2A.116 It is not possible to quantify, ex-ante, the materiality of this possible increase in debt-related costs. However, firstly we note that it would require material volumes of switching, which as explained above, is unlikely to occur as a response to the decrease in price differentials between DD and SC. Secondly, we note that it is debt that becomes bad that primarily drives increased cost to suppliers and there is no evidence to suggest that levelisation would drive an increase in bad debt in the same proportion to the number of consumers who switch from DD to SC tariffs.
- 2A.117 The primary drivers of bad debt are the cost of energy to consumers and consumers' income and deprivation status, rather than the total amount of consumers with debt per se. Furthermore, we have previously observed that consumers that struggle to pay their bills are likely to move from DD to SC tariffs anyway. As such, levelisation would simply accelerate that shift for consumers who are struggling with debt rather than causing the increase in debt itself.
- 2A.118 A further potential impact on market entry and exit under both Options 2 and 3 derives from the fact that the majority of fixed term tariffs are DD tariffs; as of April 2023, 93% of fixed term tariffs were DD compared to 7% for the SC and 0% of the PPM payment methods. Levelisation therefore closely represents a reduction in SVT prices at the expense of an increase in fixed term tariff prices.
- 2A.119 This relative price effect could give rise to potential competition effects in the case of new entrants and/or challenger brands that have a larger proportion of fixed term tariff (and therefore DD tariff) consumers and a relatively limited

back book of SVT consumers, compared to the more established and incumbent suppliers. As noted in the paragraphs above, however, the asymmetric impact on tariffs for challenger suppliers is not expected to be large due to the relatively small impact of levelisation as a proportion of consumers' annual energy bills.

Impact on innovation

- 2A.120 As described with non-price parameters of competition, to the extent that levelisation does result in a reduction in price-related competition across different payment methods under Option 3, this may lead to an enhanced emphasis on other parameters of competition. This may include innovation in how products are provided, for example with respect to consumer service platforms and consumer contact channels.
- 2A.121 For Option 2, levelisation may also support innovation through promoting the uptake of smart meters. Although we don't expect these options to drive material volumes of switching between different tariff types, switching to PPM would be the most likely since PPM would be consistently the cheapest payment method available. As well as the capital requirement advantages already discussed, this could support the uptake of smart meters as the majority of new PPM installations are smart.

Overall conclusions on competition impacts

- 2A.122 While there are theoretical impacts on competition arising from Option 3, and to a lesser extent Option 2, which could potentially affect competition in both positive and negative ways, our initial assessment is that both options are unlikely to have a material effect on competition. This is owing to the very small impact on annual bills that either levelisation option is expected to have and limited evidence that different payment type tariffs acted to constrain each other in the first place.

Wider impacts

Impact on Ofgem costs

- 2A.123 We have assessed how the levelisation options would impact the staff required to implement, calculate and monitor the levelisation policy.
- 2A.124 Under the existing cap, Ofgem regularly reviews and updates the various allowances that form the cap methodology. Introducing levelisation would add

an additional step to this process which at present we have determined to be of minimal cost impact.

2A.125 In order to support the required system changes, including design, test, build and implementation stages associated with levelisation, Ofgem have initially estimated a resource profile of 5 FTE to support implementation and 2 FTE for ongoing support.

Environmental impacts

2A.126 Ofgem do not foresee any environmental impacts associated with the levelisation or reconciliation options presented in this policy consultation.

Security of supply

2A.127 Ofgem do not foresee any security of supply impacts associated with the levelisation or reconciliation options presented in this policy consultation.

Public Sector Equality Duty

2A.128 Ofgem has a legal duty to consider the impact of our policies on people with protected characteristics under the Public Sector Equality Duty (PSED).⁴⁶ The main objective of the PSED is to:

1. Eliminate discrimination, harassment, victimisation and any other conduct that is prohibited by or under this Act.
2. Advance equality of opportunity between persons who share a relevant protected characteristic and persons who do not share it.
3. Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

2A.129 Our assessment is that the main objective of this policy (Ofgem's vulnerability duty) overlaps with the PSED for the following portrayed characteristics: age and disability. Our assessment of benefits identifies the impact of our policy in these groups and it therefore covers our requirement to do an Equalities Impact Assessment.

2A.130 Our levelisation policy meets the PSED objectives as our initial preferred approach is to levelise ASC bad debt and levelise PPM and DD standing charges

⁴⁶ Ministry of Justice (2012), Public sector equality duty.
<https://www.gov.uk/government/publications/public-sector-equality-duty>

(Option 2), alongside a reconciliation mechanism. This will remove the standing charge differential between PPM and DD.

- 2A.131 By removing the standing charge differential between DD & PPM, we are supporting those at greater risk of self-disconnection and reducing the additional debt incurred whilst disconnected.
- 2A.132 The inclusion of a reconciliation mechanism means that any additional revenue is returned by suppliers, and any lost revenue is recouped, minimising any adverse impact on supplier financial stability. This helps to ensure the shift in costs does not negatively impact suppliers. However, it is possible that the introduction of levelisation and the associated cost impacts to suppliers may result in a change in the pricing behaviour by suppliers for uncapped tariffs and/or non-default fixed term contracts. As a result of levelisation, it is possible that suppliers who would otherwise price below the cap level, may increase tariff prices to the level of the cap.
- 2A.133 For other protected characteristics such as race, religion, or sexual orientation, we have not identified any potential for discrimination or adverse impacts. Some of the distributional impacts on these groups are included implicitly, where relevant, in the distributional impacts reported in Table 2A.17.

Sensitivity analysis

2A.134 There are a range of different factors that will affect the impacts of levelisation. In this section we look at some of these factors individually to determine their effects.

Range of Impacts by consumption

2A.135 Our analysis has so far assumed that all consumers use the same amount of electricity (2,900 kWh) and gas (12,000 kWh) irrespective of payment method.

2A.136 The current TDCVs for low, medium and high users are shown in Table 2A.21 below, and the values we have used in our analysis are highlighted.

Table 2A.21: TDCVs by Fuel Type

Fuel Type	kWh	TDCV
Gas	Low	8,000
	Medium	12,000
	High	17,000
Electricity: Profile Class 1	Low	1,800
	Medium	2,900
	High	4,300
Electricity: Profile Class 2	Low	2,400
	Medium	4,200
	High	7,100

2A.137 The analysis presented below highlights the range of impacts by fuel type and payment method for a range of consumptions from low to high (as defined in Table 2A.21 above).

Option 2 – Levelise PPM & DD standing charges and levelise ASC bad debt costs

2A.138 Under Option 2, the impacts vary by payment method but not by consumption as this option only affects standing charges and not unit rates.

Option 3 - Option 2 plus levelise debt related costs

2A.139 Under Option 3, the impacts vary by payment method and consumption due to this levelisation option impacting both unit rates and standing charges.

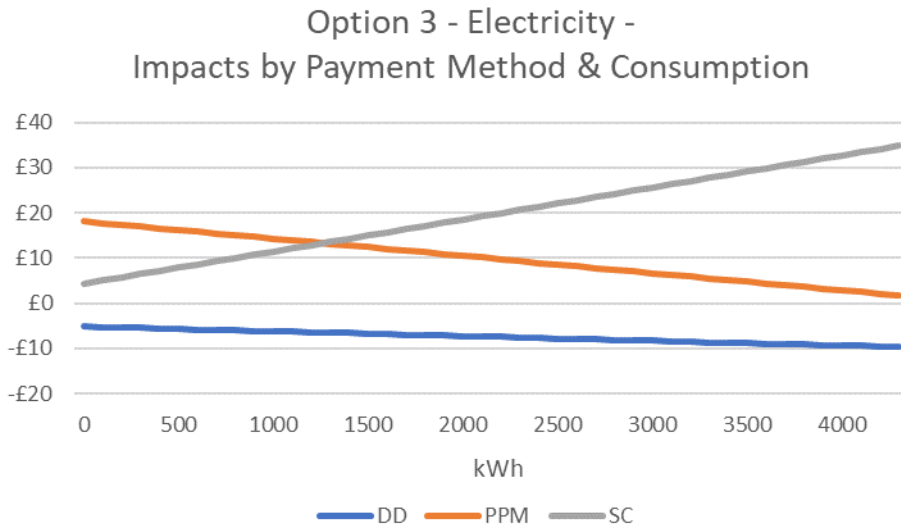
2A.140 Under Option 3, the following trends hold for electricity (see Figure 2A.3 below).

2A.141 The additional cost to DD consumers increases as consumption increases.

2A.142 The savings for PPM consumers decrease as consumption increases.

2A.143 The savings for SC consumers increase as consumption increases.

Figure 2A.3: Option 3 – Electricity - Impacts by Payment Method & Consumption



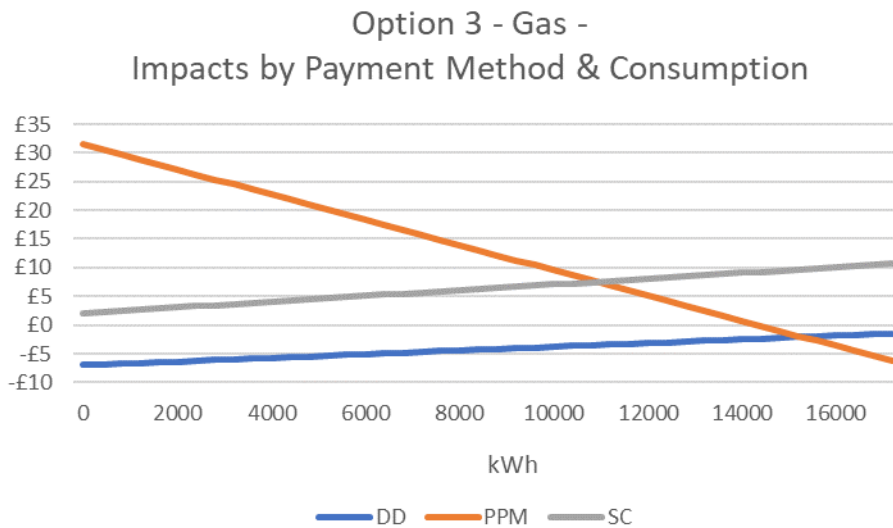
2A.144 Under Option 3, the following trends hold for gas (see Figure 2A.4 below):

2A.145 The additional costs to DD consumers decrease as consumption increases.

2A.146 The savings for PPM consumers decrease as consumption increases.

2A.147 The savings for SC consumers increase as consumption increases.

Figure 2A.4: Option 3 – Gas - Impacts by Payment Method & Consumption



Refined analysis using average historic energy usage

2A.148 In order to refine our analysis further, we have considered the impact on payment methods based on historic actual energy usage data.

2A.149 By taking the historic yearly averages for DD, PPM and SC consumers, we are able to determine individual TDCVs for each fuel type and payment method. This provides a more refined view of the levelisation impacts between payment methods.

2A.150 Table 2A.22 below shows the average TDCVs by fuel type and payment method between May 2022 and April 2023. This is taken from the supplier data provided as part of the July 2023 RFI on debt-related costs, hereafter referred to as “adjusted” TDCVs.

Table 2A.22: Adjusted TDCVs by Fuel Type & Payment Method

Fuel Type	DD	PPM	SC
Electricity (kWh)	3,399	2,793	2,961
Gas (kWh)	11,372	7,387	9,811

Option 2 – Levelise PPM & DD standing charges and levelise ASC bad debt costs

2A.151 Table 2A.23 below shows the cap levels and associated impacts for Option 2 levelisation, accounting for the adjusted TDCVs. Since Option 2 does not affect unit rates, the impacts are the same regardless of consumption.

Table 2A.23: Option 2 - Cap Levels & Impacts with Adjusted TDCVs

	DD	PPM	SC
11a Cap Level (Adjusted TDCV)	£2,016	£1,612	£1,912
11a Cap Level (Post-Levelisation)	£2,027	£1,558	£1,913
Impact	+£11	-£54	+£1

Option 3 – Option 2 plus levelise debt related costs

2A.152 Table 2A.24 below shows the cap levels and associated impacts for Option 3 levelisation, accounting for the adjusted TDCVs. Adjusting for average consumption within payment method groups shows that PPM customers save £21 more when compared to a TDCV of 2900kWh. SC customers save £12 more and DD customers spend £8 more.

Table 2A.24: Option 3 - Cap Levels & Impacts with Adjusted TDCVs

	DD	PPM	SC
11a Cap Level (Post-Levelisation)	£2,035	£1,579	£1,867
Impact	+£19	-£33	-£45

Variation in consumer payment method proportions

2A.153 The proportion of consumers paying by different payment methods has a direct effect on the impacts of levelisation based on our current model. In support of our analysis, we have assessed the range of proportions present in the market over the last five years to use as a means of calculating a range of impacts from levelisation. This data is aggregated from Tariff and Customer Account RFIs over the same period. We have chosen two scenarios, representing the minimum (Scenario 1) and maximum (Scenario 2) DD proportions over the last five years. These have been summarised in Table 2A.25 below, alongside the proportions used in the current model.

Table 2A.25: Payment Method Proportions

	DD	PPM	SC
Baseline	68.4%	13.9%	17.7%
Scenario 1	65.7%	15.4%	18.9%
Scenario 2	69.7%	13.9%	16.4%

2A.154 The effects of levelisation with the proportions described above have been summarised in **Table 2A.26** below.

Table 2A.26: Option 2 - Impacts of levelisation by payment method proportions

	DD	PPM	SC
Current	+£10	-£54	+£2
Scenario 1	+£12	-£53	+£2
Scenario 2	+£10	-£54	+£2

2A.155 The results show that although there is variation in the impacts of levelisation when varying payment method proportions, the impacts within payment methods are relatively small, ranging from £0 to £2 (between the current and Scenarios 1 & 2). This suggests that in the absence of a major shift in the current payment method proportions, this variable is unlikely to have a material effect on the impacts of levelisation.

Appendix 3 - Levelisation Model

- 3A.1 Alongside this consultation, we have published our draft model should we proceed with levelisation.⁴⁷ The levelisation model uses the outputs (cap levels) from the price cap methodology as inputs and is therefore a separate process to the price cap methodology.
- 3A.2 We have used data collected from the Tariff and Customer Accounts RFI for April 2023 (requested on a quarterly basis). We use this data to calculate the proportion of customers across the different payment methods within regions, which are used as an input to the model.
- 3A.3 To support understanding of the process, this Appendix provides a step-by-step guide to the model:

Option 1 – Base case

- Start with the published cap levels for period 11a which include adjustments for UNC0840 and additional support credit (ASC) bad debt.
- Multiply unit rates by TDCV and standing charges by 365 days to generate annual cap levels.

Option 2 – Levelise ASC bad debt and levelise PPM & DD standing charges

- Start with the base case values.
- Remove the daily ASC uplift from the PPM standing charge cap level across each fuel type.
- Calculate the total daily PPM ASC bad debt allowance standing charge for electricity and gas by distributing the PPM ASC bad debt allowance standing charge for electricity and gas, across all payment methods based on the ratio of PPM customers (dividing across total population).
- Add the re-distributed standing charges back to the previously adjusted DD, PPM and SC standing charges.
- Multiply unit rates by TDCV and standing charges by 365 days to calculate updated cap levels.
- Calculate the difference between DD & PPM standing charges (following the adjustment for the PPM ASC bad debt allowance).

⁴⁷ Ofgem (2023), Published regional model. <https://www.ofgem.gov.uk/publications/levelling-cost-standing-charges-prepayment-meters>

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- Distribute the difference between DD & PPM standing charges to update DD & PPM standing charges. (If the PPM standing charge is lower than the DD standing charge, then no adjustment to the standing charges is made at this stage.)
 - Take unchanged rates and adjusted standing charges for DD and PPM – multiply unit rates by TDCV and standing charges by 365 days to calculate updated cap levels.

Option 3 – Option 2 plus levelise debt-related costs

- Start with the DD/PPM levelised values from Option 2.
- Take bad debt contribution unit rates and standing charges at TDCV and set bad debt contribution for PPM to £0 to give adjusted bad debt cost contributions.
- Calculate the re-distributed bad debt unit rate and standing charge contribution across SC, DD and PPM – same rate applied across all payment methods by apportioning customer split (%) by payment method against individual bad debt rates.
- Remove the bad debt cost contributions from the unit rates and standing charges from levelised values from Option 2.
- Add the new re-distributed bad debt cost contributions to the adjusted SC, DD and PPM standing charge and unit rates.

Multiply unit rates by TDCV and standing charges by 365 days to calculate updated cap levels.

Appendix 4 – Summary of responses to our Call for Evidence

4A.1 Our CfE presented different ways in which we could levelise costs across payment methods with illustrative examples of how each case could work.⁴⁸ We have produced many different cases as to how we could levelise across payment methods. In our CfE we presented and requested stakeholder feedback on five cases:

- **Case 1:** Levelise DD, PPM & SC standing charges.
- **Case 2:** Levelise PPM standing charges to DD then levelise SC bad debt through unit rates and standing charges to DD.
- **Case 3:** Levelise DD, PPM & SC unit rates and standing charges.
- **Case 4:** Levelise PPM & DD standing charges, and finally SC & DD unit rates.
- **Case 5:** Levelise PPM & DD standing charges, and partially levelise SC & DD unit rates.

4A.2 We are progressing, through this consultation, with Case 2. This means that Cases 1, 3, 4 and 5 have been discounted. We provide stakeholder feedback against each of these cases, and our primary reason for discounting the case, below.

4A.3 One respondent believed none of the cases matched their exact view and therefore proposed a sixth case, which would levelise PPM and DD unit rates and standing charge retaining a differential between SC and DD.

4A.4 Another stated that all the cases were flawed as the cap is not, in its current form, perfectly cost reflective.

Case 1 - Levelise DD, PPM & SC standing charges

4A.5 Case 1 results in an increase DD costs, whilst lowering PPM and SC costs. PPM becomes the cheapest payment method and SC remains the most expensive payment method, but with a smaller differential.

⁴⁸ Ofgem (2023), Levelisation of payment method cost differentials: a call for evidence. <https://www.ofgem.gov.uk/publications/levelisation-payment-method-cost-differentials-call-evidence>

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- 4A.6 Two respondents disagreed with Case 1 as the impact on bills was small so changing the cap methodology and introducing a reconciliation mechanism did not seem proportionate.
- 4A.7 We discounted Case 1 for the same reason. This case, in comparison to Case 2, has less of an impact on the differences in which customers would pay for their bills, with the changes in these costs being less than our initial preference.

Case 3 - Levelise DD, PPM & SC unit rates and standing charges

- 4A.8 Case 3 increases DD and PPM costs whilst lowering SC costs. This would make the cap level for each different payment method equal at TDCV.
- 4A.9 One respondent agreed with Case 3, believing it was the best option. This was because individuals on low incomes had told them they wished to see more equitable treatment. They also believed that further support should be provided to vulnerable and low-income customers through a social tariff.
- 4A.10 Two respondents stated that Case 3 should be avoided as it results in increased PPM costs, unjustifiable on the basis of their vulnerability and cost to serve.
- 4A.11 We decided against Case 3, as this would increase PPM charges, which the majority agreed would not be preferable and could increase the level of bad debt related costs due to more consumers moving to SC.

Case 4 - Levelise PPM & DD standing charges, and finally SC & DD unit rate

- 4A.12 Case 4 increases DD costs whilst lowering PPM & SC costs. In this case, PPM would be the cheapest payment method and SC the most expensive, however, the differential against DD would reduce. This case showed that whilst levelising SC unit rates results in more savings for SC, it results in much higher DD costs compared to Case 1 (where only standing charges are levelised).
- 4A.13 Four respondents stated that Case 4 was their preferred case to take forward. One said it is because this case reduces costs for PPM and SC customers and that the resulting DD increase is an inevitability. Two stated that this case would be the fairest option for the most vulnerable customers, whilst the other respondent believed Cases 2 and 4 are worth further consideration.
- 4A.14 This case showed that whilst levelising SC unit rates results in more savings for SC, it results in much higher DD costs, therefore have discounted this case.

Case 5 - Levelise PPM & DD standing charges, and partially levelise SC & DD unit rates

- 4A.15 Case 5 increases DD costs whilst lowers PPM & SC costs. In this case PPM is the cheapest payment method and SC is the most expensive payment method but the differential against DD is smaller compared to the baseline. This case shows that by partially levelising the unit rate difference, SC customers can make similar savings to PPM whilst reducing the cost to DD customers compared to Case 4.
- 4A.16 Two respondents responded regarding Case 5. One stated that they see this option as unfair on vulnerable customers on DD as this case makes it cheaper for PPM over DD, and therefore proposed a sixth case to take forward. The sixth case they have proposed was benchmarked against Case 5, with both DD and PPM carrying very little debt cost and believe that, therefore, customers should not be faced with different costs because of their chosen payment method. The other suggested that Case 5 makes such little difference that it is not worth changing the price cap methodology for.
- 4A.17 By following our consideration-based approach outlined in **Chapter 3**, we discounted this approach because of the higher DD costs to our initial preference and the larger differential between DD and SC.

Appendix 5 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, “Ofgem”). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. ie a consultation.

4. With whom we will be sharing your personal data

We may share consultation responses with officials from the Department of Energy Security and Net Zero and HM Treasury.

5. For how long we will keep your personal data, or criteria used to determine the retention period

Your personal data will be held for 6 months after the project, including subsequent projects or legal proceedings regarding a decision based on this consultation, is closed.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it

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- ask us to restrict how we process your data
 - get your data from us and re-use it across other services
 - object to certain ways we use your data
 - be safeguarded against risks where decisions based on your data are taken entirely automatically
 - tell us if we can share your information with 3rd parties
 - tell us your preferred frequency, content and format of our communications with you
 - to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas

We have taken all necessary precautions to ensure that your rights in term of data protection will not be compromised by this.

8. Your personal data will not be used for any automated decision making

9. Your personal data will be stored in a secure government IT system

10. More information

For more information on how Ofgem processes your data, click on the link to our "[ofgem privacy promise](#)".