

Consultation

Additional debt-related costs allowance policy consultation

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This is part of our consultation process for assessing any additional debt-related costs allowance in the default tariff cap. We are seeking views from people with an interest in the level of the default tariff cap. We particularly welcome responses from suppliers and consumer groups. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses.

We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you want 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

On 19 July 2018, the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the 'Act') came into force. This legislation required the Gas and Electricity Markets Authority (GEMA) to design and implement the default tariff cap.

We introduced the default tariff cap ('the cap') on 1 January 2019, which protects households on standard variable and default tariffs (which we refer to collectively as 'default tariffs'). The cap ensures that default tariff customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy.

Overview of current consumer debt levels

Given the rise in wholesale energy prices and wider cost of living pressures since the pandemic, customers have been getting into greater levels of arrears and debt on their energy bills. This is a very worrying time for many customers experiencing increasingly problematic levels of debt, in energy and other bills, with current energy debt and arrears totalling over £2.6bn. These high debt levels in turn mean that greater proportions of outstanding bills may never be repaid.

In preparation for this winter, we are working with industry and consumer groups to ensure consumers in debt are protected and get the support they need. We have brought together stakeholders to encourage the sector to raise standards this winter and welcome Energy UK's Winter 2023 Voluntary Debt Commitment as a result of this engagement. Energy UK's Voluntary Debt Commitments show the sector is pulling together to address the debt challenge. These Debt Commitments sit alongside our work, including providing more Additional Support Credit to avoid self-disconnection, levelling the cost of standing charges on prepayment meters, improving standards around the involuntary installation of prepayment meters (PPM), strengthening consumer standards, and the increased monitoring of near-time indicators of debt.

Overview of how debt-related costs are treated in existing cap allowances

Some debt on energy bills cannot be recovered and is ultimately written off by energy suppliers. This is referred to as bad debt, and all energy suppliers accumulate some bad debt. It is usual for businesses in many industries, not just energy, to make an ongoing provision for bad debt, and to cover this cost through the pricing of their goods and services where competition allows them to. Therefore, the cap provides an allowance to account for these bad debt provisions and other debt-related costs.

The debt-related costs allowance within the cap consists of three cost types (bad debt charge, debt-related administrative costs and associated working capital costs). It broadly scales linearly with the overall level of the cap. The allowance is therefore

significantly greater now than it was several years ago, due to increases in wholesale energy prices. The allowance varies significantly by payment type: we estimate that for cap period 11a (October – December 2023), the allowance for debt-related costs represents approximately 6% of typical dual fuel standard credit bills, 1% of typical dual fuel direct debit bills and 1% of typical dual fuel PPM bills.

Overview of debt-related cost review

We have been carefully monitoring the evolution of debt-related costs relative to price cap allowances for an extended period of time, including tracking the impact of exceptional developments such as the gas price crisis and government interventions like the Energy Price Guarantee (EPG) and Energy bills support scheme (EBSS) and the PPM moratorium.

As outlined in our last update letter in June 2023,¹ the review's first two requests for information (RFIs), covering data from April 2022 to March 2023, suggested that there was no material under or over-allowance for bad debt and debt administration costs in 2022/23. However, due to insufficient data and inconsistent supplier treatment of government support packages, we were not able to consistently assess working capital costs at that time. We therefore committed to gather further data for Q2 2023 through a third RFI, including on working capital, and to consult on a potential price cap adjustment if that RFI found evidence of a material deviation between costs and allowances.

Following our analysis of this third RFI, we have seen evidence of a gap between costs and the existing cap allowance in cap period 8-10a (April 2022 - June 2023). We are therefore issuing a policy consultation on whether we should adjust the price cap to account for these deviations between costs and allowance. We also propose to include another quarter of costs in scope of any adjustment (cap 10b; Q3 2023), and therefore we issued a fourth RFI covering Q3 2023 data in early October.

We consider that it is in the interest of customers to allow suppliers as a whole to recover efficiently incurred costs, as it ensures that they are adequately funded for the services they provide. Without adequately funding suppliers for these costs, it could risk supplier exits via a supplier of last resort (SoLR) or special administration regime (SAR) which would increase costs for all customers.

¹ Ofgem 2023, Update on debt-related costs review.
<https://www.ofgem.gov.uk/publications/price-cap-update-debt-related-costs-review>

Key considerations

This policy consultation sets out our considered options on key policy elements such as the value of the allowance, how to ensure our benchmarks only include efficiently incurred costs, and the timing of any adjustment within the cap.

We outline how we have calculated suppliers' debt-related costs and the cap's aggregate debt-related cost allowance, and we also discuss the merits of different benchmarking approaches (e.g. lower quartile and weighted average) to determine the size of any adjustment. As some debt-related costs have resulted from the moratorium on involuntary PPM installations, which was introduced in early 2023 following evidence that suppliers may not have been complying with existing rules, we also discuss whether and how we should account for those costs in any allowance.

We also explain how costs could be allocated between payment methods, including with reference to the precedent set by our COVID-19 true-up decision, and discuss how this allocation interacts with the outcome of the consultation on levelisation of payment methods.² This consultation also sets out the case for truing up costs at a later stage after an initial float, while setting out that the operating costs review will consider how an enduring allowance will be set.

The deadline for submitting views on the considerations contained in this consultation is **2 November 2023**. A comprehensive question list is included in the first section.

² Ofgem (2023), Levelling the cost of standing charges on prepayment meters.
<https://www.ofgem.gov.uk/publications/levelling-cost-standing-charges-prepayment-meters>

1. Consultation questions

Chapter summary

This chapter sets out the questions in this consultation.

1.1 Below we list the questions in this consultation:

- 1 Do you consider that we should make a temporary adjustment to the price cap to account for additional debt-related costs?
- 2 Do you think that suppliers cost due to the moratorium on involuntary PPM installation should be included in the adjustment?
- 3 Do you agree that any adjustment should be made using the existing price cap mechanism, rather than a bespoke levy or other new mechanism?
- 4 Do you have any views on whether it would be appropriate to explore a specific levy mechanism for DNI ('do not install') customers? This would be separate to any adjustment for additional debt-related costs.
- 5 Do you agree that we should make an initial float adjustment in April 2024, followed by a later true-up? Do you agree it should be included within the cap for a 12 month period? Do you agree that this allowance should be temporary only?
- 6 Should the debt-related costs allowance, if introduced for the April 2024 price cap, be subject to a later true-up, and if so, when should this adjustment occur?
- 7 Do you agree that we should carry out only one wider debt-related costs true-up?
- 8 Should the float allowance be uprated to account for inflation, or should we make no additional adjustments?
- 9 Do you agree with the proposed overarching methodological approach for estimating the existing debt-related costs allowance, and using it to determine whether there has been an over or under-allowance for debt-related costs in 2022/23?
- 10 Do you have any other suggestions of alternative methodologies or other factors we should consider for how to calculate the debt-related costs over or under-allowance in 2022/23?
- 11 Do you agree that we should consider each debt-related cost (bad debt, debt-administrative costs, and working capital costs) in scope of this review?
- 12 Which, if any, of the benchmarking options do you favour?
- 13 Do you have any views on which payment method allocation option would be preferable?
- 14 Do you agree with us allocating other debt-related costs (debt-related administrative and working capital costs) uniformly across payment method?
- 15 How should we apportion any debt-related costs allowance over the unit rate and standing charge elements of the cap only?

16 How should we apportion any debt-related costs allowance between fuel and meter types?

2. Consultation process

Chapter summary

This chapter summaries our consultation process and other related publications.

What are we consulting on?

- 2.1 This policy consultation seeks views on our proposals for introducing an initial allowance to the default tariff cap (the cap) for debt-related costs.
- 2.2 This document is split into nine chapters:
- Chapter 1: Consultation questions;
 - Chapter 2: Consultation process;
 - Chapter 3: Introduction;
 - Chapter 4: Case for a temporary adjustment for debt-related costs;
 - Chapter 5: Float and true-up approach;
 - Chapter 6: Calculation of the existing allowance;
 - Chapter 7: Calculating and benchmarking costs;
 - Chapter 8: Allocation of the allowance;
 - Chapter 9: Interaction with other workstreams.

Related publications

- 2.3 The main general 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>
- 2.4 The main documents relating to this consultation are:
- August 2023 - Allowance for additional support credit bad debt costs <https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs>
 - June 2023 - Update on debt-related cost review: <https://www.ofgem.gov.uk/publications/price-cap-update-debt-related-costs-review>

- May 2023 - Call for Input on the Operating Cost Allowances Review
<https://www.ofgem.gov.uk/publications/price-cap-call-input-operating-cost-allowances-review>
- April 2023 - Call for Input on the allowance for debt-related costs:
<https://www.ofgem.gov.uk/publications/price-cap-call-input-allowance-debt-related-costs>
- April 2023 - Levelisation of payment method cost differentials: a call for evidence:
<https://www.ofgem.gov.uk/publications/levelisation-payment-method-cost-differentials-call-evidence>
- August 2022 - notice to delay COVID-19 true-up decision and work on debt-related costs
<https://www.ofgem.gov.uk/publications/price-cap-notice-delay-covid-19-true-decision-and-work-debt-related-costs>
- April 2022 - Price cap and Market Stabilisation Charge changes
<https://www.ofgem.gov.uk/publications/price-cap-and-market-stabilisation-charge-changes>

Consultation stages

- 2.5 This is a policy consultation which is open from 12 October 2023. We will consider all responses to inform our statutory consultation, which we intend to publish this winter.
- 2.6 We have been conducting a review of debt-related costs.³ In January and April 2023, we issued two Requests for Information (RFIs) to gather evidence from energy suppliers on their debt-related costs. We also published a Call for Input (CFI) in April 2023 to seek views on our initial considerations and options around all debt-related costs.⁴ In addition, we hosted a workshop with consumer groups and charities during the CFI window.
- 2.7 Subsequently, in July 2023 we issued a third RFI to gather evidence from energy suppliers on their debt-related costs up until the end of cap period 10a (April - June 2023). We have used this evidence received as part of the CFI and

³ We refer to this as the 'wider' review as we are considering all debt-related costs, including those from non-PPM or credit payment methods.

⁴ Ofgem (2023), 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>

RFIs, and other stakeholder engagement, to inform our ongoing review of debt-related costs.

- 2.8 We have recently issued a fourth RFI earlier this month to request data covering cap period 10b (July – September 2023).

April 2023 Call for Input (CFI) on debt-related costs

- 2.9 We published a Call for Input (CFI) in April 2023 to seek views on our initial considerations and options around debt-related costs.⁵
- 2.10 We received 13 responses from energy suppliers, trade associations, consumer groups and charities, and almost 2,000 responses from individuals as part of a consumer campaign. In addition, we hosted a workshop with consumer groups and charities during the CFI window.

June 2023 update letter on debt-related costs review

- 2.11 We published an interim update letter on 28 June 2023 on our review.⁶ This set out that, given the data and evidence we had received at that point, we considered there was not a material or systematic gap between the allowance within the price 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.
- 2.12 We had, however, seen significant evidence of a material increase in the value of additional support credit (ASC) provided by suppliers to PPM customers that was not repaid, and therefore published a statutory consultation on ASC bad debt costs in June 2023.⁷ We subsequently published a decision in August 2023, introducing an allowance for ASC bad debt costs for 12 months initially from cap period 11a (October - December 2023).⁸

⁵ Ofgem (2023), 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>

⁶ Ofgem (2023), Price cap - Update on debt-related costs review.

<https://www.ofgem.gov.uk/publications/price-cap-update-debt-related-costs-review>

⁷ 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>

⁸ Ofgem (2023), Allowance for additional support credit bad debt costs.

<https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs>

How to respond

- 2.13 We want to hear from anyone interested in this consultation. We welcome views on any of the options and considerations discussed in this consultation, including on the value, methodology and implementation of the proposed allowance for debt-related costs.
- 2.14 Please send your response to priceprotectionpolicy@ofgem.gov.uk **on or before 2 November 2023**.
- 2.15 We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

- 2.16 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.
- 2.17 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.
- 2.18 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 in Appendix 2.
- 2.19 If you wish to respond confidentially, we'll keep the 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

2.20 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:

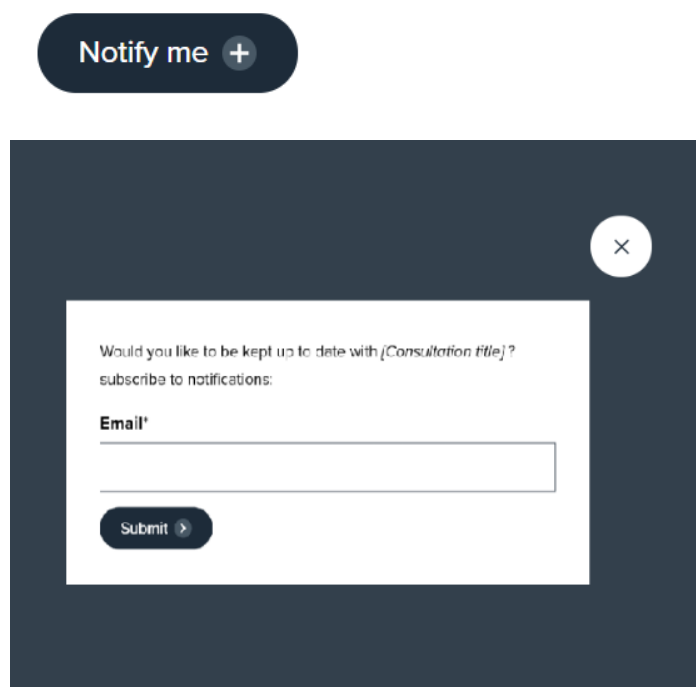
- Do you have any comments about the overall process of this consultation?
- Do you have any comments about its tone and content?
- Was it easy to read and understand? Or could it have been better written?
- Were its conclusions balanced?
- Did it make reasoned recommendations for improvement?
- Any 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)



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).

3. Introduction

Chapter summary

This chapter provides background for our approach to introducing an additional allowance to the cap for debt-related costs.

Background

The default tariff cap

- 3.1 The cap was introduced on 1 January 2019 and protects existing and future domestic customers on standard variable and default tariffs (which we refer to collectively as 'default tariffs'), ensuring that customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy. The cap is set out in legislation through the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the 'Act').⁹
- 3.2 Under the Act, we must have regard to five matters when setting the cap:
- the need to create incentives for holders of supply licences to improve their efficiency;
 - the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
 - the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
 - the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence;
 - the need to set the cap at a level that takes account of the impact of the cap on public spending.¹⁰
- 3.3 The requirement to have regard to the five matters identified in section 1(6) of the Act does not mean that we must achieve all of these. In setting the cap, our primary consideration is the protection of existing and future customers who pay default tariffs. In reaching decisions on particular aspects of the cap, the weight

⁹ Domestic Gas and Electricity (Tariff Cap) Act 2018.
<https://www.legislation.gov.uk/ukpga/2018/21>

¹⁰ Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6)(e) as inserted by Schedule 3 to the Energy Prices Act 2022. In performing the duty under section 1(6)(e) we must have regard to any information provided by the Secretary of State, or any guidance given by the Secretary of State on this matter (section 1(6A)).

to be given to each of these considerations is a matter of judgement. Often, a balance must be struck between competing considerations.

- 3.4 The cap sets the maximum amount a supplier can charge default tariff customers for energy. It varies based on a number of different parameters, including fuel type, benchmark consumption, meter types, regional differences and payment methods. We calculate the cap using a bottom-up assessment of a notionally efficient supplier's costs (ie we calculate each cost component individually and then add them together) and set it to reflect the notionally efficient energy supply costs. We calculate the cap using a bottom-up assessment of a notionally efficient supplier's costs (ie, we calculate each cost component individually and then add them together) and set it to reflect the notionally efficient energy supply costs. In the aggregate, this approach ensures our benchmark (and cap) reflects the underlying efficient costs of supplying customers with energy.

Debt-related costs – definition and overview

- 3.5 Some energy bills are never paid, and therefore ultimately have to be written off by energy suppliers. This is referred to as bad debt, and all energy suppliers accumulate some bad debt. It is usual for businesses in many industries, not just energy, to make a provision for bad debt and to cover this through the pricing of their goods and services. The cap therefore provides an allowance to account for these efficient costs. This means all default tariff customers pay for the cost of bad debt incurred by customers who do not pay.
- 3.6 The term 'bad debt' is commonly used as an overarching term to refer to all debt-related costs. However, for clarity in this document, we use 'debt-related costs' when referring to the three components of the costs (bad debt charge, debt-related administrative costs and associated working capital costs) and name the individual component when referring to it specifically.
- 3.7 The largest debt-related cost is bad debt. This cost is reflected in suppliers' accounts through the bad debt charge, which is an entry in the income statement. Suppliers make estimates (known as provisions) for the amount which will never be paid. They then adjust these estimates over time, and eventually finalise them through write-offs.
- 3.8 The other debt-related costs are debt administration costs (the administrative costs to suppliers from dealing with customers in debt) and working capital costs (the cost to suppliers of raising capital for day-to-day operations and funding customers paying in arrears).

Debt-related costs in the cap

- 3.9 The cap currently includes an allowance for the three debt-related costs. The allowance broadly scales linearly with the overall level of the cap. Therefore, it is now significantly greater than it was several years ago, given increases in the overall cost of energy.
- 3.10 The allowance varies significantly by payment type. From the initial design of the cap and our subsequent work on COVID-19 related debt, we know debt-related costs are significantly higher on average for standard credit customers than direct debit or PPM customers. This is partly due to the nature of payment types; PPM and direct debit customers pay for their energy in advance of consumption, or at least simultaneously, and payment is taken automatically by energy suppliers. Whereas, standard credit customers pay in arrears and bill payment is not automatic.
- 3.11 We estimate that for cap period 11a (October – December 2023), debt-related costs represent approximately 6% of typical dual fuel standard credit bills, 1% of typical dual fuel direct debit bills, and 1% of typical dual fuel PPM bills. The overall debt-related cost allowance is split between the unit rate and the standing charge, with the standing charge proportion counting for around a third of the overall allowance in cap period 11a (October – December 2023). We explain our estimates further in Chapter 6.
- 3.12 We are required to set a single cap level across suppliers and the cap is not designed to ‘true-up’ the actual costs of individual suppliers. However, we adjusted the cap to reflect additional debt-related costs during the cap periods corresponding with the main COVID-19 period (cap periods 4-7, April 2020 – March 2022), given the exceptional and market wide impacts of the pandemic.¹¹ This review of costs between April 2022 and March 2024 (inclusive) is also motivated by exceptional factors, including the gas price crisis, and government interventions such as the EBSS and EPG.

¹¹ Ofgem (2023), Price Cap – Decision on the true-up process for COVID-19 costs. <https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs>

4. Case for a temporary adjustment for debt-related costs

Chapter summary

In this chapter we consider the option of introducing a temporary adjustment for debt-related costs.

Questions:

Q1: Do you consider that we should make a temporary adjustment to the price cap to account for additional debt-related costs?

Q2: Do you think that suppliers cost due to the moratorium on involuntary PPM installation should be included in the adjustment?

Q3: Do you agree that any adjustment should be made using the existing price cap mechanism, rather than a bespoke levy or other new mechanism?

Q4: Do you have any views on whether it would be appropriate to explore a specific levy mechanism for DNI ('do not install') customers? This would be separate to any adjustment for additional debt-related costs.

Context

- 4.1 In June 2023, we decided not to consult on a price cap adjustment for credit debt-related costs, as there was no evidence at that time of a material or systematic gap between the existing aggregate allowance in the cap for the debt-related costs allowance and actual costs.¹²
- 4.2 We then issued a third RFI in July 2023, to collect data on suppliers' debt-related costs up to June 2023. In this RFI we asked suppliers questions focusing on four main areas: bad debt, debt-related administrative costs, working capital costs, and the PPM moratorium.

Introduction and considerations

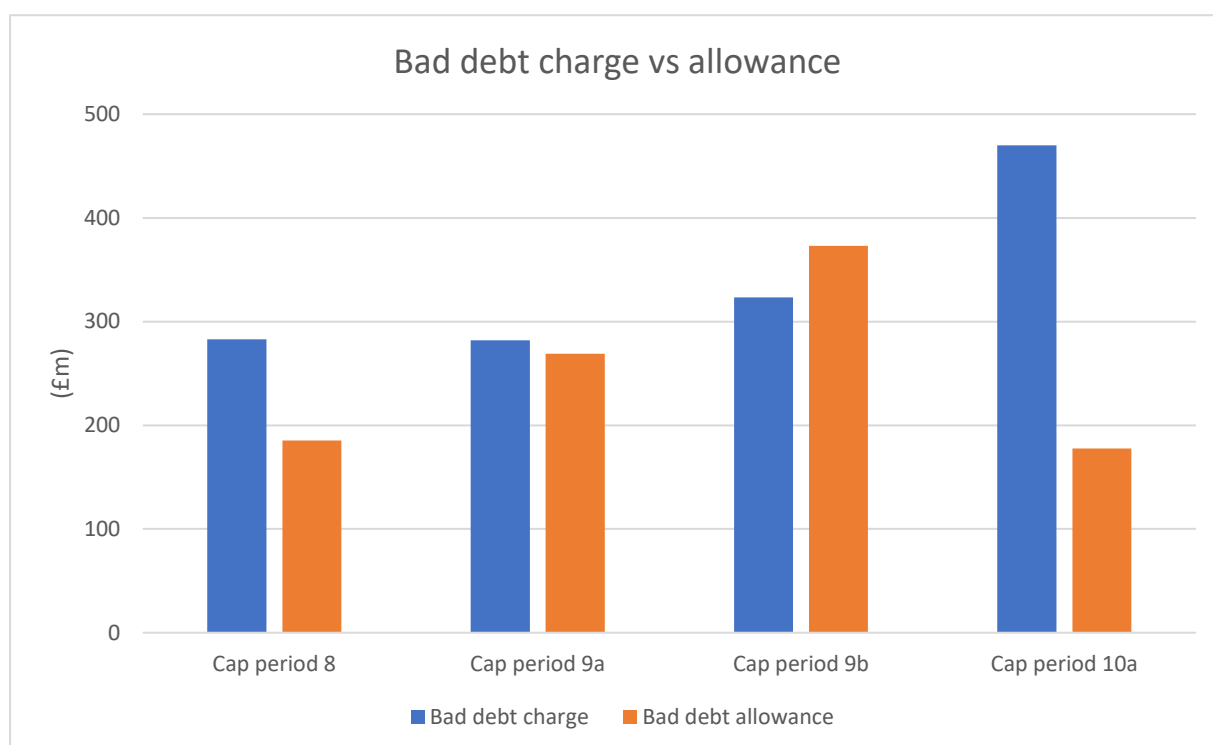
Overall debt-related costs assessment

- 4.3 Through our July 2023 RFI, we have seen evidence of a divergence between debt-related costs (on a weighted average basis) and the existing price cap

¹² Ofgem (2023), Update on debt-related costs review.
<https://www.ofgem.gov.uk/publications/price-cap-update-debt-related-costs-review>

allowances across cap periods 8-10a (April 2022 – June 2023). This was predominantly caused by increased bad debt costs in cap period 10a (April – June 2023) which can be seen in the chart below. These increased bad debt costs in cap period 10a could partly reflect that government support packages were no longer mitigating the impact of underlying bad debt pressures.

Figure 4.1: Total bad debt costs vs bad debt allowance in £m across all payment types between cap period 8 and 10a



The bar graph shows the change in bad debt levels from cap period 8 to 10a.

- 4.4 Based on this analysis, we are considering the option of whether or not to introduce a temporary allowance into the cap for debt-related costs, from April 2024, for an initial period of 12 months.

Costs related to the moratorium on Involuntary PPM installations

- 4.5 We expect suppliers to use involuntary PPM as a last resort, and there are already rules in place to protect the most vulnerable customers who may be switched to a PPM. Central to those rules is that suppliers should not install a PPM where it would not be safe and reasonably practicable for the customer (for example if they have a dependency on electrically powered medical equipment).
- 4.6 However, we saw evidence in 2022 and 2023 that suppliers may not always have been complying with the rules in place at the time when involuntarily

moving customers to PPM. In response, in February 2023 we agreed a voluntary moratorium on involuntary PPM installations and smart meter remote mode switches with suppliers.¹³ That moratorium remains ongoing.

4.7 As part of our debt-related costs RFIs (in January, April and July) we have gathered data from suppliers on how much of the debt-related costs incurred have been directly caused by the moratorium on involuntary PPM installations and related policy changes. We have also gathered data on the expected level of these costs in future.

4.8 These figures indicate that the moratorium and related policy changes created around £25m per month of additional debt-related costs between February 2023 to June 2023, with further significant costs expected in the second half of 2023.

Material and systematic costs

4.9 We have considered whether these increased costs are material and systematic for the purposes of the cap.

4.10 In our 2018 decision on the design and implementation of the cap, we said: "if in the future we consider there are material systematic issues that require correction, we might modify the licence. The Act includes a specific provision for us to make supplemental modifications to the licence conditions. This would allow us to make any changes required to correct how the cap was updated if it systematically and materially departed from an efficient level of costs". We also said: "The type of specific systematic errors for which we would adjust the cap would need to be unforeseen, clear, material, and necessitate changes".¹⁴

4.11 We have applied this test when considering changes to the cap. As set out in our November 2021 wholesale consultation: "We broadly consider the case for amending the cap methodology against the test of whether a change in the costs facing suppliers is material and systematic, considering the market as a whole".¹⁵

¹³ Ofgem (2023), Energy regulator outlines next steps on forced Prepayment Meter (PPM) installations.

<https://www.ofgem.gov.uk/publications/energy-regulator-outlines-next-steps-forced-prepayment-meter-ppm-installations>

¹⁴ Ofgem (2018), Default Tariff Cap decision – Overview, paragraphs 3.14 and 3.16.

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

¹⁵ Ofgem (2021), Price Cap: Consultation on the potential impact of increased wholesale volatility on the default tariff cap, page 34, paragraph 4.16.

<https://www.ofgem.gov.uk/publications/price-cap-consultation-potential-impact-increased-wholesale-volatility-default-tariff-cap>

4.12 Given our recent assessment, we consider the current under-allowance for bad debt in cap period 10a (April – June 2023) to be material, and unlikely to be offset by any over allowance in the medium-term. Our analysis therefore suggests that an additional temporary allowance for debt-related costs might be necessary, depending on which benchmark is selected.

Options summary

Adjustment of the allowance

4.13 The options we have considered are:

- **Option 1: Introduce a temporary adjustment to the allowance;**
- **Option 2: Make no temporary adjustment to the allowance.**

4.14 Given ongoing consumer financial affordability issues and the wider macroeconomic slowdown, suppliers could experience further deviations between their debt-related costs and allowances this winter, leading to an aggregate under-allowance by the end of the review period (March 2024, inclusive).

4.15 We consider it is in customers' interests to ensure there is a provision to recover efficient debt-related costs of energy supply. Without such a provision, any increases in debt-related costs could ultimately have negative implications for suppliers' financial situations and the service they offer to customers.

4.16 We also consider that any allowance should be temporary in nature as a policy response to exceptional factors, such as high gas prices. Any enduring change to the cap for debt-related costs is being considered as part of the forward-looking operating costs review.

Q1: Do you consider that we should make a temporary adjustment to the price cap to account for additional debt-related costs?

Accounting for costs related to the moratorium on Involuntary PPM installations

4.17 We consider it is in consumers' interests, including vulnerable consumers, to ensure that suppliers fully adhere to our requirements, guidelines and directions, including in relation to the involuntary PPM moratorium. This will be particularly important in the coming winter, given continued affordability pressures.

4.18 While ensuring compliance with requirements and guidelines, we also need to consider whether efficient costs associated with that compliance are recognised within the cap.

- 4.19 We consider that a notable minority of the additional debt-related costs that suppliers have incurred since the start of cap period 8 (April 2022) have been created by the moratorium on involuntary PPM installations and related policy changes. This moratorium and related changes have been introduced due to poor supplier practices and potential breaches of our rules.
- 4.20 The price cap should reflect efficient costs. A supplier who has been in breach of standard licence conditions historically may see a larger increase in debt-related costs due to the moratorium, compared to other suppliers. Such a supplier may have made greater use of involuntary PPM installation, and the moratorium could lead to upward reassessments of previous provisions.
- 4.21 In this case, using the suppliers' data could lead to us overstating efficient debt-related costs in the cap periods following the moratorium. We therefore are considering whether to fully reflect PPM moratorium costs in any future debt-related costs allowance.

Q2: Do you think that suppliers cost due to the moratorium on involuntary PPM installation should be included in the adjustment?

Mechanisms to recognise changes in efficient debt-related costs

- 4.22 The price cap adjustment mechanism remains the preferred approach to allow for additional efficient debt-related costs from default tariff customers. It remains the duty of suppliers to consider their own policy towards recovering costs on non-cap tariffs, including in the event of the cap no longer being in place.
- 4.23 We consider that other mechanisms such as bespoke levies to allow for additional debt-related costs are less optimal when undertaken market-wide / across all consumers. This consideration includes our concern that a market wide levy may discourage suppliers from operating efficiently in their debt collection practices, with a levy instead socialising the costs of inefficiency and putting upward pressure on the price cap. This would not be in consumers' interests.
- 4.24 In addition, there are practical challenges associated with creating a bespoke levy, as this would take time and resources to develop, test and implement. The price cap in contrast is an existing mechanism which already allows suppliers to recoup efficient debt-related costs of energy supply and therefore can be swiftly adjusted to changes in those costs.

- 4.25 We also note that our decision on whether to allow an adjustment in the cap is different to any decision on how it is allocated within the cap, including its interaction with levelisation (discussed in more detail in Chapters 8 and 9).

Q3: Do you agree that any adjustment should be made using the existing price cap mechanism, rather than a bespoke levy or other new mechanism?

- 4.26 While opposed to a levy mechanism for market-wide debt-related costs, we are aware of a recent supplier proposal to focus a levy on the debt costs associated with customers who are ruled out of scope of a PPM installation for debt ('do not install' customers or DNI). This is justified by the supplier on the basis that different suppliers have different numbers of DNI customers, which leads to competitive distortion if these costs are covered by the price cap (which must be the same level across all suppliers).
- 4.27 Having a levy mechanism to reconcile these costs would take time and resources, not only to develop but also to operate. However, there is an argument that it would also incentivise suppliers to offer better quality of service to DNI customers, by ensuring they are assessed properly and that non-PPM debt collection methods are appropriate.
- 4.28 This supplier proposal is very recent, and therefore we have not considered it extensively within Ofgem. We recently made a decision on involuntary prepayment meters, and in that context, we considered efficient costs would be passed on to consumers through the price cap if it led to a material and systematic deviation between efficient costs and the existing price cap allowances for debt-related costs. Therefore, we do not think that such a mechanism is necessary to support the wider involuntary PPM policy. We are, however, open to considering whether such a levy mechanism could be in the interest of consumers due to, for instance, any benefits to competition and service for these customers.
- 4.29 Any levy introduced would be separate to any adjustment for debt-related costs (the main subject of this consultation) and therefore, if introduced, would apply to a later timeframe. However, given the overlap between the two issues, we wanted to take the opportunity to gather stakeholders' views through this consultation engagement.

Q4: Do you have any views on whether it would be appropriate to explore a specific levy mechanism for DNI ('do not install') customers? This would be separate to any adjustment for additional debt-related costs.

5. Float and true-up approach

Chapter summary

In this chapter we explain the options as to when an allowance could take effect, and for how long it could last.

Questions:
Q5: Do you agree that we should make an initial float adjustment in April 2024, followed by a later true-up? Do you agree it should be included within the cap for a 12 month period? Do you agree that this allowance should be temporary only?
Q6: Should the debt-related costs allowance, if introduced for the April 2024 price cap, be subject to a later true-up, and if so, when should this adjustment occur?
Q7: Do you agree that we should carry out only one wider debt-related costs true-up?
Q8: Should the float allowance be uprated to account for inflation, or should we make no additional adjustments?

Context

- 5.1 Our analysis so far has found that there was not a significant under (or over) allowance for debt-related costs in periods 8 to 9b (April 2022 - March 2023). However, there was an under-allowance for cap 10a (April - June 2023) on a weighted average basis.
- 5.2 The main component of debt-related costs are bad debt charges, which are accounting provisions by suppliers for expected future write-offs. These provisions are by their nature subject to change, for instance when they are audited.
- 5.3 Therefore, the final, actual debt-related costs incurred by suppliers for this period (April 2022 onwards) may only be known for certain in several years' time.

Options

- 5.4 **Lead option:** To introduce an initial allowance covering the period for which we have data (at the point of a statutory consultation), to be included in the cap between April 2024 to March 2025 (inclusive). This would be followed by a true-up review, reviewing the appropriateness of the initial allowance in light of

further data on debt-related costs, covering the full review period (April 2022 to March 2024 inclusive). This review would then consider whether it needs adjusting (“true-up”) in a future price cap.

- 5.5 **Alternate options:** a) There be no true-up at all (ie, the April 2024 allowance would be final). b) The initial allowance could be delayed becoming a single ex-post adjustment, from October 2024 at the earliest c) The allowance could be recovered over a longer (or shorter) period than 12 months.

Considerations

- 5.6 If we introduce a temporary allowance, there is still uncertainty around how actual debt-related costs will evolve this winter. One option for addressing this uncertainty could be through a ‘float and true-up’ approach.
- 5.7 Should the allowance be introduced through a ‘float and true-up approach’, this will allow us to adjust or ‘true-up’ our assessment at a later stage, once we have more information on outturn debt-related costs and how they relate to existing allowances.
- 5.8 We have previously used a ‘float and true-up’ approach to set an approximate allowance value for additional debt-related costs during the COVID-19 pandemic, and then we true-up the value once more information was available.¹⁶ We note that the COVID-19 float was based on forecast additional debt costs as a result of the pandemic. This is in contrast to any potential float in April 2024 which would be based on outturn costs. However, we still consider that a float is necessary because provisions are subject to future revisions.
- 5.9 The alternative option is an ex-post adjustment for costs from October 2024 at the earliest, which would have the benefit of using actual data. However, this would mean additional debt-related costs that were efficient would not be reflected in the price cap for a longer period of time, negatively impacting financial resilience. This delay could also lead to distortions where future customers cover costs incurred by existing customers, which may be particularly distortive if significant numbers of customers move from default tariffs to fixed tariffs in the interim period.

¹⁶ Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 3.16-3.17.
<https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap>

- 5.10 A 12-month recovery from April 2024 will ensure that the cost recovery more closely aligns with how the cap is calculated on an annual basis. It will also be consistent with our recovery of other allowances elsewhere in the cap which are typically recovered over a 12-month period and will mean that this allowance will be recovered after the COVID-19 allowance has been recovered.¹⁷
- 5.11 If we adopt a float and true-up approach, then we would still expect suppliers to be complying with their licence conditions and managing customers in debt appropriately, and we may take those factors into account in any true up.

Q5: Do you agree that we should make an initial float adjustment in April 2024, followed by a later true-up? Do you agree it should be included within the cap for a 12-month period?

- 5.12 The data that has been gathered from our debt-related costs RFIs has already been subject to some revision by suppliers, and there is wide variation in the costs incurred between different suppliers. This variation is partly caused by differences in payment methods (eg the proportion of customers that pay by standard credit). It is also significantly driven by the different assumptions suppliers make around the levels of non-payment, as seen through differing provisioning rates for debt of a particular age and payment type.
- 5.13 Differences in customer demographics and historic performance may mean it is appropriate for different suppliers to have distinct bad debt provisions. However, these differences can also be due to suppliers' diverse assessments of how economic factors (such as cost of living pressures) will affect ongoing debt collection and write offs.
- 5.14 Given the variability and forward-looking nature of these bad debt provisions, the correct level for any debt-related costs allowance is subject to significant uncertainty, particularly as the underlying cost data (bad debt charges) is open to revision when updated data is available.
- 5.15 This uncertainty about future debt and bad debt levels mean it is difficult to forecast costs, and any attempt would add substantial complexity to our calculation. From our monitoring of the market, we also do not consider that including forecasted future debt-related costs in any April 2024 float is necessary to have regard to supplier financeability.

¹⁷ Ofgem (2023), Decision on the true-up process for COVID-19 costs, paragraph 7.5.
<https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs>

5.16 We will not have actual data on the under (or over) allowance for debt-related costs in cap periods 11a and 11b until at least the October 2024 price cap. However, as above, that data could be subject to later revision throughout 2024 (and beyond) as suppliers gather new information on write-offs and how accurate their original provision rates were. Therefore, there is a potential trade-off between timeliness of any true-up, and its accuracy at reflecting efficient costs only.

Q6: Should the debt-related costs allowance, if introduced for the April 2024 price cap, be subject to a later true-up, and if so, when should this adjustment occur?

Scope of the true-up

5.17 In our August 2023 decision on an allowance for an additional support credit bad debt costs, we set a temporary allowance between cap period 11a-12b worth £8.77 per typical dual fuel customer. This allowance was ex-ante, so we stated that we intended to review it in 2024 to determine if a true-up would be necessary.¹⁸

5.18 If we carry out a true-up of wider debt-related costs, we consider that we should combine the two true-ups into one review. We consider that this would allow a more coherent true-up, and also avoid imposing the burden on stakeholders of engaging with multiple true-up consultation processes.

Q7: Do you agree that we should only carry out one wider debt-related costs true-up?

Inflation

5.19 There is a timing difference between when the costs in scope of this review were incurred by suppliers, and when any float allowance would be implemented in the cap.

5.20 Such a timing difference may generate costs for suppliers, including costs related to the value of money. Therefore, we need to consider whether it would be appropriate to uprate any allowance by the change in inflation rate between when the costs were incurred and when they are recovered by suppliers.

- **Option 1:** Uprate any float allowance to account for inflation.

¹⁸ Ofgem (2023), Allowance for additional support credit bad debt costs, paragraph 5.7. <https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs>

- **Option 2:** Do not uprate any float allowance to account for inflation.

- 5.21 We consider that suppliers will have tools to manage temporary cashflow issues in normal circumstances, and that adjusting for inflation at the float stage would add complexities into the allowance calculation.
- 5.22 We also consider that accounting for inflation would be more appropriate at the true-up stage when we set the final allowance. This is because while the float is setting an initial estimate of costs for suppliers, we typically err on the side of caution before we true-up costs later using actual data.
- 5.23 Not uprating the float allowance to account for inflation would also be consistent with the COVID-19 float allowance.

Q8: Should the float allowance be uprated to account for inflation, or should we make no additional adjustments?

6. Calculation of the existing allowance

Chapter summary

In this chapter we set out how we propose to estimate the existing overall adjustment allowance in the cap for each of the three debt-related costs (bad debt, working capital and debt-related administrative costs).

Questions:

Q9: Do you agree with the proposed overarching methodological approach for estimating the existing debt-related costs allowance, and using it to determine whether there has been an over or under-allowance for debt-related costs in 2022/23?

Allowance

Introduction and Context

- 6.1 Debt-related costs are accounted for in several different price cap allowances: the payment method uplift, operating costs, and EBIT (earnings before interest and tax). However, debt-related costs make up only part of the costs covered by each of these individual allowances. We therefore need to estimate the proportion of each individual allowance that relates to debt-related costs, and combine or aggregate these into an estimate of the overall debt-related costs allowance.
- 6.2 There are two main data challenges for any methodology to overcome. Firstly, the top-down nature of the benchmarking from the price cap's development in 2018 means we are not able to directly identify an apportionment between debt-related costs and non-debt-related costs in some specific allowances (such as operating costs). We therefore must estimate it.
- 6.3 Secondly, the granularity of cost data varies between these specific price cap allowances. For example, there is more detailed cost data in the payment method uplift than in the operating costs allowance.¹⁹

¹⁹ This operating cost data is being reviewed as part of our ongoing operating cost review. Ofgem (2023), Call for Input on the Operating Cost Allowances Review. <https://www.ofgem.gov.uk/publications/price-cap-call-input-operating-cost-allowances-review>

Proposals

- 6.4 We propose to estimate the overall debt-related cost allowance (“overall debt-related costs allowance”) in the price cap using the methodology outlined below, and in further detail in Appendix 1. This methodology includes proportions calculated based on weighted averages of the 2018 benchmark supplier data, to best align with how the price cap allowances were set in 2018.
- 6.5 Where we need to use 2018 data to apportion allowances, we propose to use the best (most precise) data from 2018 where available. When apportioning allowances without precise 2018 data we propose to maintain as much consistency as possible between the approach to different allowances.
- 6.6 We propose to keep the same level of stringency in our specific debt-related cost allowances as there is for the original existing price cap allowance.
- 6.7 We propose to use a weighted average of the benchmark suppliers where available to determine proportions for the estimation of the allowances.
- 6.8 The full disclosure process for the model that estimates these allowances is proposed to take place during 2024, alongside any true-up.

Overview of allowances

- 6.9 The table below provides a visual summary of which debt-related costs are covered in which specific allowances.

Table 6.1: Key on where debt-related costs allowances are included in the cap

		Operating costs	EBIT	Variable element of payment method uplift (PAP)	Fixed element of payment method uplift (PAAC)
BD charge	DD	✓		✓*	
BD charge	SC			✓	
BD charge	PPM				✓
Working Capital	DD		✓**	✓***	
Working Capital	SC		✓**	✓	
Working Capital	PPM		✓**		✓
Debt Admin	DD	✓			
Debt Admin	SC				✓
Debt Admin	PPM				✓

*Levelising SC costs

**average level

***negative represents subtraction from average

Notes: Columns are price cap allowances; rows are categories of debt-related costs that we are estimating (Bad debt charge (BD Charge), working capital, and debt administration costs (Debt Admin)), split by payment method (DD, Direct debit; SC, Standard Credit; PPM, Pre-payment meter).

Methodological choices

6.10 Significant data challenges require us to make complex estimations, based in part on judgment and assumptions, across several individual allowances.²⁰

6.11 There are three first-order methodological choices to make:

1. Consistency: How far to retain methodological consistency between a) specific allowance estimates and b) the 2018 price cap setting approach

²⁰ The calculations for these debt-related costs allowances are outlined in Appendix 1. This section focuses on the key judgements, and the appendix sets out further detail on the calculations.

2. Stringency: Whether the efficiency expected will be the same across all the specific individual allowances included within the overall debt-related costs allowance.
3. Suppliers: Which suppliers' data to use for the estimated proportions and how to combine this data.

Consistency

- 6.12 One challenge is that when the price cap was designed, the cost data used was not specific to debt-related costs. For example, the operating cost allowance was based on operating costs per domestic direct debit customer. Specifically, while in 2018 we gathered more detailed data on the breakdown of suppliers' indirect costs,²¹ the operating cost allowance is based on top-down benchmarking. This means that there is no specific cost line for bad debt within the operating cost allowance, and we did not need to decide in 2018 how the operating cost allowance should be apportioned between different cost lines.
- 6.13 The same challenge applies to the EBIT allowance and the fixed element of the payment method uplift (the Payment method Adjustment Additional Cost (PAAC)). However, we have precise cost data for bad debt in the variable element of the payment method uplift (PAP). Where available, this cost-based data is the best and most suitable data to use for calculating the allowance.
- 6.14 We propose to use the best or most precise data from 2018 where available, and to maintain consistency between the approach to different individual allowances where precise data from 2018 is not available.

Stringency

- 6.15 We propose to keep the same level of stringency between the individual allowances and the estimated proportion related to debt-related costs in the price cap: for operating costs and the payment method uplift a lower quartile was used.²² For EBIT, the approach is a weighted average.

Suppliers

- 6.16 We can either use all suppliers' data or only the data from the benchmark suppliers. A simple approach would be to look at the supplier (or suppliers) closest to the benchmark. However, with top-down benchmarking, the

²¹ I.e. costs that do not directly scale with increased sales.

²² We benchmarked operating costs at the lower quartile minus £5.

benchmark suppliers are chosen based on their overall efficiency level. This does not mean that the supplier was equally efficient for all sub-components. The benchmark is just a number, and it does not mean that the price cap has incorporated all features of that supplier into the allowance.

- 6.17 The price cap is designed to provide allowances that cover the costs of a notionally efficient supplier. We set overall price cap allowances in 2018 using data from benchmark suppliers where appropriate. We therefore consider that it is preferable to use data from the same suppliers, when available, to estimate debt-related costs, as this may better reflect the debt-related costs of a notionally efficient supplier.
- 6.18 We propose to maintain consistency across all three estimates by always using the data from the benchmark suppliers for that cost area. This ensures our estimation reflects the data that was used for calculating each of the price cap allowances.
- 6.19 We use data from two 'benchmark' suppliers where there are two similar suppliers, which mitigates the risk of an individual supplier having unrepresentative costs for a particular line. As noted in our previous publications,²³ the two suppliers nearest the operating cost benchmark have similar total operating costs to each other and can be considered an equally efficient benchmark when estimating the notionally efficient supplier. We therefore propose to average the data from these two benchmark suppliers to produce a combined estimate.
- 6.20 After determining which suppliers' data to use, we need to consider how to combine these (benchmark) suppliers' data. A weighted average would use data from the same suppliers as used to calculate the benchmark. This is straightforward (where the data is available). A weighted average gives more importance to larger suppliers than a simple average.
- 6.21 We propose to use a weighted average (rather than a simple average) to combine the data of the two suppliers closest to the benchmark for operating costs. A weighted average has been used in previous price cap calculations such

²³ Ofgem (2020), Decision on reviewing smart metering costs in the default tariff cap, Technical annex, paragraph 5.49.
<https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap>

as our February 2023 true-up for COVID-19 costs.²⁴ A weighted average reflects the relative scale of suppliers in the market; thus, it is the best way to average the benchmark suppliers. We propose to apply this weighted average approach consistently across both estimates that relate to operating cost benchmarks.

- 6.22 We propose to use the benchmark suppliers, and a weighted average of the benchmark suppliers where available, when determining proportions for the estimation of the allowances.

Allowance values

- 6.23 The estimated allowance values (based on the methodology described here) for each cap period (8 to 11a) are below. The allowances for each component at typical domestic consumption values (TDCV) are given, as well as the total.

- 6.24 The allowances are different for each payment type. There are also additional supplementary allowances that should be accounted for when considering PPM customers' debt-related costs:

1. Our August 2023 decision on allowance for additional support credit bad debt costs introduced an additional allowance for Additional Support Credit (ASC) into the PPM price cap from cap period 11a. This ASC allowance is reflected in the table below and is worth £8.77 per typical PPM customer from cap period 11a-12b.²⁵ This means the debt-related costs allowances have been increased for PPM customers.
2. The same decision estimated that in 2022/23, £1.82 of temporary support for ASC bad debt per PPM customer costs would have been temporarily covered by the large contemporaneous rise in the headroom allowance. This figure therefore has been added to the estimated allowance for PPM bad debt in cap periods 8-10b (as the decision decided that these additional costs should not be covered prior to October 2023, when the new allowance was introduced).

²⁴ Chapter 5 of the Technical Annex, section starting at paragraph 5.21 headed 'Considerations – Adjusting for different 'efficient' benchmark definitions'.
[Technical annex to reviewing smart metering costs in the default tariff cap: August 2020 decision \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/technical-annex-to-reviewing-smart-metering-costs-in-the-default-tariff-cap-august-2020-decision)

²⁵ Ofgem (2023), Allowance for additional support credit bad debt costs.
<https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs>

Table 6.2: Debt-related costs cap allowances (annualised, dual fuel at TDCV)

		Cap 8	Cap 9a	Cap 9b	Cap 10a	Cap 10b	Cap 11a
Bad Debt	DD	20.85	35.67	42.55	33.33	22.05	19.73
Bad Debt	SC	76.75	136.37	163.99	126.39	80.87	71.44
Bad Debt	PPM	0.01	-0.08	-0.08	-0.15	-0.15	6.67
Working Capital	DD	-7.15	-12.81	-15.53	-11.92	-7.54	-6.62
Working Capital	SC	33.56	60.50	72.87	55.84	35.30	31.05
Working Capital	PPM	3.24	5.86	7.01	5.33	3.32	2.95
Debt Administration	DD	10.04	10.55	10.55	10.97	10.97	11.09
Debt Administration	SC	15.85	16.65	16.65	17.31	17.31	17.64
Debt Administration	PPM	8.18	8.60	8.60	8.94	8.94	8.99
All Allowance	DD	23.75	33.40	37.58	32.39	25.49	24.21
All Allowance	SC	126.16	213.52	253.51	199.55	133.48	120.13
All Allowance	PPM	11.43	14.38	15.53	14.12	12.10	18.62
Price cap	DD	1,971	3,549	4,279	3,280	2,074	1,834
Price cap	SC	2,100	3,764	4,533	3,482	2,211	1,959
Price cap	PPM	2,017	3,608	4,358	3,325	2,077	1,861
Allowance %	DD	1%	1%	1%	1%	1%	1%
Allowance %	SC	6%	6%	6%	6%	6%	6%
Allowance %	PPM	0.6%	0.4%	0.4%	0.4%	0.6%	1%

Notes: The TDCV for cap periods from 4 to 10b were electricity 2,900 kWh, gas 12,000 kWh. For 11a it is electricity 2,700kWh, gas 11,500kWh. The bad debt allowance for PPM in caps 8 to 10b includes £1.82 from the headroom allowance; and the bad debt allowance for PPM in 11a includes £8.77 for ASC.

Q9: Do you agree with the proposed overarching methodological approach for estimating the existing debt-related costs allowance, and using it to determine whether there has been an over or under-allowance for debt-related costs in 2022/23?

7. Calculating and benchmarking costs

Chapter summary

In this chapter we provide a summary of the debt-related cost metrics for the three components (bad debt, debt-related administrative and working capital costs). We then discuss options for how we could benchmark these costs.

Questions:

Q10: Do you have any other suggestions of alternative methodologies or other factors we should consider for how to calculate the debt-related costs over or under-allowance in 2022/23?

Q11: Do you agree that we should consider each debt-related cost (bad debt, debt-administrative costs, and working capital costs) in scope of this review?

Q12: Which, if any, of the benchmarking options do you favour?

Calculating Costs

Introduction and considerations

- 7.1 We have used data collected from the July 2023 debt-related costs RFI to calculate the value of the proposed adjustment. We requested debt-related costs data from January 2017 - June 2023 from suppliers with at least 100,000 default tariff customers.
- 7.2 We requested a range of metrics in our most recent RFI. To calculate the adjustment, we have used the following data split by fuel, tariff and payment method:
- Bad debt charge;
 - Debt-related administrative costs;
 - Working capital costs;
 - Revenue;
 - Customer accounts.
- 7.3 In the update letter on the debt-related costs review, we said that we were unable to consistently review working capital costs at that stage due to insufficient data and supplier assumptions on government support packages.²⁶

²⁶ Ofgem (2023), Update on debt-related costs review.
<https://www.ofgem.gov.uk/publications/price-cap-update-debt-related-costs-review>

We also noted that suppliers were not being consistent with their approach to including government support packages. In the July 2023 RFI, we therefore asked suppliers to provide the data both excluding and including EPG and EBSS payments.

- 7.4 In the following section, we outline how we used this data to calculate each of the three debt-related costs. We include indicative figures based on the data received to date under the review (April 2022 – June 2023).
- 7.5 Readers should note that the following indicative figures may not be the same as the figures that any future statutory consultation will be based on. This is because the statutory consultation could benefit from at least one additional quarter's worth of data (cap period 10b, Q3 2023). Therefore, the final figure could be higher or lower, depending on that additional data and any revisions.
- 7.6 Later in this chapter we outline the options for benchmarking costs and how we would seek to set an efficient benchmark, such that a notionally efficient supplier could recover their costs.

Bad debt

Calculation steps

- 7.7 We have taken the following steps for calculating the benchmark bad debt costs:
- Weighted average: for each individual cap period 8-10a, we summed up total bad debt charge and total number of customer accounts across all suppliers within our sample. We then divided the total bad debt charge by the total number of customer accounts for each individual cap period.
 - Lower quartile: for each supplier in our sample, we calculated the bad debt cost per customer account, and then took the 25th percentile supplier for each cap period.
 - Median: for each supplier in our sample, we calculated the bad debt cost per customer account and then took the 50th percentile supplier for each cap period.

Table 7.1: Bad debt cost by benchmark and cap period, net of the allowance

	Cap period 8	Cap period 9a	Cap period 9b	Cap period 10a	Total
Weighted average	-5	-1	3	-14	-17
Median	-3	6	3	-10	-3
Lower quartile	1	8	6	-2	14

Note: £ per typical dual fuel customer. Positive number signals an over-allowance.

7.8 There is high variability in bad debt costs for suppliers, as can be seen by the wide dispersion between the three potential benchmarks. As per paragraph 5.12 above, this partly reflects different supplier provisioning methods, and also differences in their payment method mix compared to the average supplier.

7.9 Our initial estimate is that there was an under-allowance in cap period 10a for bad debt, estimated at £14 per typical dual fuel customer on a weighted average basis.²⁷ At the lower quartile, however, the under-allowance is significantly lower, equal to £2 per typical dual fuel customer.

7.10 In cap period 8-9b, which included significant government interventions such as the EBSS and EPG, the relationship between costs and allowances is dependent on the benchmark chosen. A weighted average benchmark finds an under-allowance, whereas median and lower quartile benchmarks find an over-allowance.

Debt-related administrative costs

Calculation steps

7.11 We have followed the same steps as the bad debt charge to calculate the benchmark costs for debt-related administrative costs.

7.12 Some suppliers were unable to consistently separate costs by tariff type. Therefore, we have scaled down the total debt-related administrative costs by the proportion of customers on default tariffs, in order to estimate each supplier's cost for default tariff customers only. We note that this assumes that

²⁷ We describe this cost at a weighted average benchmark for illustrative purposes only.

the debt-related administrative cost per customer is equal between default tariff and fixed tariff customers.

Table 7.2: Debt-related administrative cost by benchmark and cap period, net of the allowance

	Cap period 8	Cap period 9a	Cap period 9b	Cap period 10a	Total
Weighted average	2	1	2	1	6
Median	3	2	2	2	9
Lower quartile	4	2	2	2	11

Note: £ per typical dual fuel customer. Positive number signals an over-allowance.

7.13 The table above indicates that there has consistently been an over-allowance from cap period 8-10a for debt-related administrative costs. This over-allowance is persistent regardless of which benchmark is chosen.

Working capital costs

Calculation steps

7.14 To calculate the net working capital costs:

- First we multiplied the average accounts receivables/ payables at the beginning and end of the period by the working capital assumption of 10%²⁸ and then divided this by the number of customers;
- We then calculated the net working capital figure per customer by subtracting the accounts payables from accounts receivables;
- Finally we scaled the working capital figure up by the number of default tariff customers.
- When calculating the working capital cost, we include both the customer and non-customer working capital costs.²⁹ The non-customer working capital cost is included since the EBIT allowance encompasses it.

²⁸ We use the 10% cost of capital as it is consistent with the cost of capital assumption used in debt-related cost elements of the cap during the period which these costs were incurred.

²⁹ We defined non-customer working capital as generated from the accounts payables minus the accounts receivables (excluding customer accounts) for the supply business excluding cash relating to trading, corporation tax balances and derivatives.

7.15 We then followed the same steps as described in the bad debt charge section to calculate the benchmark costs for working capital costs.

7.16 However, similar to debt-related administrative costs, some suppliers were unable to consistently separate costs by tariff type. Therefore, we have scaled down the total working capital costs by the proportion of customers on default tariffs to estimate each supplier’s cost for default tariff customers only. We note that this assumes that the working capital cost per customer is equal between default tariff and fixed tariff customers.

Table 7.3: Working capital cost by benchmark and cap period, net of the allowance

	Cap period 8	Cap period 9a	Cap period 9b	Cap period 10a	Total
Weighted average	-4	1	0	-2	-5
Median	1	1	2	1	4
Lower quartile	4	1	5	2	12

Note: £ per typical dual fuel customer. Positive number signals an over-allowance.

7.17 The table above indicates that working capital costs vary significantly among suppliers. If using a weighted average benchmark, there has been an under-allowance from cap period 8-10a for working capital costs. However, using a median or lower quartile benchmark, there has been a consistent over-allowance during that period for working capital costs.

7.18 We have analysed debt-related costs and notional allowances within the time of cap period 8 up until 10a. This analysis covers all three components of debt-related costs (bad debt, debt-administrative costs and working capital) from the beginning of April 2022 up until June 2023.

Q10: Do you have any other suggestions of alternative methodologies or other factors we should consider for how to calculate the debt-related costs over or under-allowance in 2022/23?

Scope of adjustment

7.19 We have analysed debt-related costs and notional allowances within the time of cap period 8 up until 10a. This analysis covers all three components of debt-

related costs (bad debt, debt-administrative costs and working capital) from the beginning of April 2022 up until June 2023.

- 7.20 As can be seen, the three components have different trends, and relate differently to the existing price cap allowances. A comparison of aggregate debt-related costs and allowances also shows a material and systematic gap between costs and the relevant allowance (although the direction of that gap depends critically on the choice of benchmark). Our lead option is therefore to include all debt-related costs in any adjustment allowance.

Q11: Do you agree that we should consider each debt-related cost (bad debt, debt-administrative costs, and working capital costs) in scope of this review?

Benchmarking costs

Introduction and considerations

- 7.21 For each debt-related cost we include within any future adjustment, we need to consider which benchmark would be appropriate to set costs at, that best meets our primary consideration of the protection of existing and future customers on default tariffs. In principle, we seek to set an efficient benchmark, such that the notionally efficient supplier could recover their costs.
- 7.22 When choosing between benchmarks, we must consider several factors that may affect debt-related costs, including those related to efficiency and non-efficiency. For instance, the level of control that suppliers have over these costs. Where suppliers have greater control, they have greater opportunity to improve the efficiency of costs, and as per paragraph 3.2, the need to create incentives for holders of supply licences to improve their efficiency is one of the matters we have regard to when setting the cap.
- 7.23 Conversely, costs may vary for reasons outside of suppliers' control. For example, costs may be affected by suppliers' customer bases. This would be an example of a non-efficiency factor.
- 7.24 Another example of a factor we consider is whether there are relevant existing precedents for how costs have previously been benchmarked within the cap. We consider the 2018 cap decision and the COVID-19 true-up decision to be the most relevant precedents to this review's decision on benchmarking.
- 7.25 These factors can individually support different benchmarks. Therefore, any final choice of benchmark necessarily is discretionary and involves judgment of the suitability of these and other factors.

Precedents

- 7.26 In our 2018 cap decision we benchmarked the payment method uplift using an overall lower quartile benchmark. We also set a near lower quartile (lower quartile minus £5) benchmark for operating costs. EBIT was based on cost information across suppliers, equivalent to a weighted average benchmark.
- 7.27 In the COVID-19 true-up decision, we decided to benchmark costs for all three debt-related costs at a weighted average benchmark. We considered that this was an appropriate efficient benchmark, given COVID-19 was a large and unexpected exogenous shock, which also impacted standard debt collection activities such as at-home visits. We considered that a notionally efficient supplier would not have expected such an event, and it would have impacted each supplier's existing processes in an unprecedented way.

Note on data

- 7.28 Some of our options for benchmarking require suppliers to submit accurate data across all three cost components. As one supplier has not yet submitted consistent working capital data, we have not included them in our calculation of any benchmarks presented in this chapter, to aid comparability across benchmark options. In addition, including partial data from some suppliers would not necessarily increase accuracy, given the potential interactions between debt-related costs.

Options summary

- 7.29 We have considered three options as set out below. Our initial view is that we would proceed with Option 3, to set a combination of benchmarks for the reasons set out in paragraphs 7.44 to 7.47 below.
- 7.30 The options we have considered are:
- **Option 1: A benchmark at the lower quartile:** For each supplier in our sample, we would calculate their cost per customer and then take the 25th percentile supplier.
 - **Option 2: an average benchmark:** this could be a weighted average benchmark which would provide larger weight to suppliers with more customer accounts. Another type of average benchmark would be the median.
 - **Option 3: Selecting different benchmarks for each debt-related cost:** This option would separate the benchmarks for each debt-related

cost. Our initial view is that this option would benchmark bad debt at the weighted average, while benchmarking debt-related administrative and working capital costs at a lower quartile.

Option 1 - A benchmark at the lower quartile

7.31 When calculating the lower quartile benchmark, we have two options of the type of lower quartile benchmark to select:

- **Combined:** Selecting one lower quartile supplier across debt-related costs
- **Separate:** Selecting a different lower quartile supplier across each debt-related cost.

7.32 An argument in favour of a separate benchmark is it's more straightforward to calculate. A theoretical argument against it is that it may lead to an unachievable level of efficiency, due to trade-offs between costs ie if a supplier invests less on debt administration, it may need to spend more on bad debt charges.

7.33 Conversely, an advantage of the combined benchmark is in theory it helps to ensure coherence between cost components, ensuring that any trade-offs between costs are appropriately considered.

7.34 To undertake a combined benchmark calculation of the lower quartile, we need to assess a uniform set of costs across suppliers. Therefore, they would need to have submitted good quality data for all three debt-related cost data sets. One supplier has not submitted consistent working capital data, so if we calculated the benchmark using a combined lower quartile benchmark, they would not be included in our final sample.

7.35 The table below outlines the figures for a lower quartile, using a combined benchmark.

Table 7.4: Option 1

	Bad debt	Debt-related administrative costs	Working capital	Total
Lower quartile	-19	12	10	3

Note: £ per typical dual fuel customer. Based on combined benchmark. Positive number signals an over-allowance.

7.36 The existing allowance within the cap is predominantly benchmarked on a near lower quartile basis (lower quartile minus £5). Therefore, as these costs are additional to that allowance, the benchmarking of that allowance should act as a

precedent for any additional allowance, to ensure efficiency factors continue to be accounted for.

- 7.37 While there is variability in debt-related costs between suppliers, this could be based on factors such as efficiency, company policy or customer mix. We therefore do not consider that a supplier with higher debt costs than the existing allowance should automatically have all of these costs reflected in the price cap. Otherwise, there is a risk of the allowance reflecting costs originating from inefficient or poor debt collection practices, which would be to the detriment of consumers. A lower quartile benchmark therefore incentivises suppliers to engage in efficient practices with prudent processes in place to manage additional risks.
- 7.38 In Chapter 4, we discussed that using suppliers’ full data could lead to us overstating efficient debt-related costs in the cap periods affected by the moratorium on involuntary PPM installations. If a supplier was in breach of the standard licence conditions, then we consider that they may have higher additional debt-related costs as a result of the moratorium, compared to a supplier who was adhering to the licence conditions.
- 7.39 Given it is likely that suppliers in breach of the licence conditions would have higher additional debt-related costs, setting the cost benchmark at the 25th percentile supplier (ie the lower quartile) could more appropriately reflect efficient costs.

Option 2 – An average benchmark

Table 7.5: Option 2

	Bad debt	Debt-related administrative costs	Working capital	Total
Weighted average	-17	6	-5	-16

Note: £ per typical dual fuel customer. Positive number signals an over-allowance.

- 7.40 A weighted average benchmark would set cost recovery at an average level. This implies that suppliers, on average, have been efficient. This benchmark would allow that each cost component was significantly affected by non-efficiency factors outside of a suppliers’ control. This for example could include macroeconomic factors, or elements of a suppliers’ individual customer base which they had limited or no control over.

- 7.41 Bad debt provisions are suppliers’ best estimate at a point in time of the amount of unrecoverable debt from their customer base. Naturally this means that these provisions will be subject to change from suppliers, as they partly depend on how optimistic or pessimistic a supplier is about future economic factors and debt collection.
- 7.42 It is therefore plausible that suppliers could make a downward provision for their bad debt charge, after the allowance had been introduced leading to a weighted average allowance which overstated true costs. This could reflect changes in economic factors, rather than suppliers’ original provisioning approaches being inaccurate.
- 7.43 As per paragraph 4.21, we also should consider how to reflect costs related to the moratorium on involuntary PPM installations. In addition to adding justification to usage of the lower quartile for bad debt costs, another option that could be employed is to deduct the estimated costs related to the moratorium (c.£25m per month) from the total recorded bad debt costs, and then use that revised figure to generate the weighted average for bad debt costs.

Option 3 - Selecting different benchmarks for each debt-related cost

Table 7.6: Option 3

	Bad Debt	Debt-related administrative costs	Working capital	Total
Weighted average	-17	N/A	N/A	-17
Lower quartile	N/A	12	10	22
Total	-17	12	10	5

Note: £ per typical dual fuel customer. Positive number signals an over-allowance.

- 7.44 An alternative option would be to assess each debt-related cost separately, using different benchmarking approaches to establish efficient costs depending on the extent to which cost variation between suppliers is out of their control.
- 7.45 This option retains flexibility and may better account for the different trends in the three cost components of debt-related costs outlined earlier in the chapter.
- 7.46 We note that there could be an argument to benchmark bad debt costs separately to debt-related administrative and working capital costs, given there may be a stronger argument for bad debt costs being affected, at least partly,

by factors (gas price crisis, wider cost of living) which are beyond the notionally efficient supplier's control.

- 7.47 Conversely, we consider that suppliers continue to have greater control over debt-related administrative and working capital costs, with variations between suppliers on these cost components therefore driven more by suppliers' commercial decisions and underlying efficiency in debt practices. On that basis, using a lower quartile approach for these two costs components maintains consistency with the existing allowances' focus on improving suppliers' cost efficiency.

Q12: Which, if any, of the benchmarking options do you favour?

8. Allocation of the allowance

Chapter summary

In this chapter we outline our approach to allocating debt-related costs to different payment methods.

Questions:
Q13: Do you have any views on which payment method allocation option would be preferable?
Q14: Do you agree with us allocating other debt-related costs (debt-related administrative and working capital costs) uniformly across payment method?
Q15: How should we apportion any debt-related costs allowance over the unit rate and standing charge elements of the cap only?
Q16: How should we apportion any debt-related costs allowance between fuel and meter types?

Introduction and Considerations

- 8.1 As we have identified, the difference between debt-related costs relative and existing allowances within the cap is likely to vary by payment method. We therefore need to consider how we should split any allowance between the different payment methods.
- 8.2 Ideally, the data we use would record bad debt on customers' payment method at the point of billing (ie the point at which the debt is first accrued), rather than customers' current payment method (which may have changed since that first accrual).
- 8.3 However, the majority of suppliers have confirmed they do not hold data at the point of billing, only data on the customers' current payment method. We therefore need to carefully consider how to allocate costs to best represent an accurate picture of cost accrual.
- 8.4 In our COVID-19 true-up decision, we decided to allocate costs equally across credit meter customers (ie the same pound uplift to the standard credit and direct debit caps). We also decided to allocate all PPM debt-related costs to

credit customers, due to evidence that the vast majority of PPM debt was accrued originally on credit meters.³⁰

- 8.5 When working out how we apportion costs across different payment methods, there are two key considerations: how to apportion costs to PPM customers, and how to apportion costs between credit customers.

PPM customers

- 8.6 The ASC debt-related costs review, which was decided in August 2023, found that while PPM customers may have debt originating from other payment methods they used previously, bad debt which originates from PPMs is primarily from the addition of ASC to the meter which is never repaid. As per Chapter 6, this ASC bad debt cost is set to be covered by a new allowance from October 2023.

- 8.7 As debt-related costs that are recorded on PPM tariffs predominantly relate to consumption while on previous payment methods, the key choice options for apportioning PPM customers are:

- 1) Set PPM cost to zero, and smooth over credit meters
- 2) Set PPM costs at the level seen in raw data

Credit Customers

- 8.8 Standard credit customers have the highest debt-related costs per customer of any payment type. The nature of standard credit payment (after consumption, at point of bill), mean that customers using this payment type will be able to create more debt than direct debit customers (automatic, simultaneous with consumption) and PPM customers (payment before consumption).

- 8.9 However, it is also the case that consumers who fall behind on their direct debits, can then transfer to standard credit. In our data (current payment method) this debt will count as standard credit debt, but ultimately was due to consumption as a direct debit customer.

- 8.10 Given these data limitations, the key choice options for credit customers therefore are:

³⁰ During April 2022 stakeholder meetings, suppliers told us that between 90-95% of the bad debt on PPMs was built up while the customer was on a credit meter. Ofgem (2023), Decision on the true-up process for COVID-19 costs, paragraph 6.14. <https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs>

- 1) Set split costs between direct debit and standard credit as they are in the raw data;
- 2) Set an even split across direct debit and standard credit;
- 3) Set direct debit to zero and put the remainder of costs onto standard credit.

Options summary

8.11 Combining the choice options in the sections above, we have created five lead options. These are included in Table 8.1 below, using indicative figures based on a weighted average benchmark for bad debt only.

Important Caveats

8.12 Please note that the table below is for indicative purposes only, and any final allowance could instead include:

- All three debt-related costs;
- An alternative benchmark e.g lower quartile;
- An additional quarter of data (July - September 2023).

8.13 Therefore, any future allowance will be based on different numbers to those below. These numbers are instead included to illustrate the significant variation in potential payment method allocations, to enable stakeholders to best consider the allocation between different types of credit customers, and PPM customers.

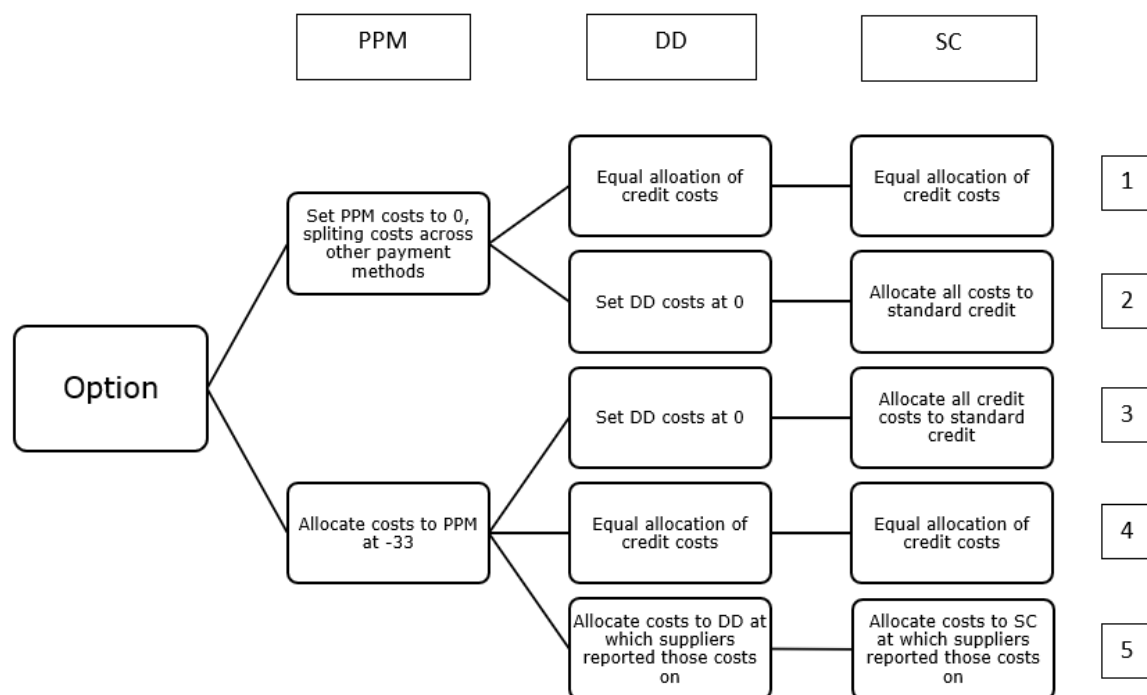
Table 8.1: Bad debt payment method allocation³¹ (weighted average benchmark) for illustration purposes only

	Option 1	Option 2	Option 3	Option 4	Option 5
DD	-18	0	0	-12	28
SC	-18	-79	-51	-12	-144
PPM	0	0	-33	-33	-33

Note: £ per typical dual fuel customer. Positive number signals an over-allowance.

³¹ DD = direct debit, SC = standard credit, PPM = prepayment meter.

Figure 8.2: Bad debt payment method allocation breakdown



8.14 We summarise the payment method allocation options below:

- Option 1: equal allocation of credit costs on direct debit and standard credit, while allocating zero cost to PPM. This is equivalent to the cost split used in the COVID-19 true-up.
- Option 2: allocate all costs to standard credit while setting direct debit and PPM costs to zero.
- Option 3: separate credit and PPM costs, while allocating all credit costs to standard credit only and none to direct debit.
- Option 4: separate credit and PPM costs, while equally allocating credit costs on to direct debit and standard credit.
- Option 5: allocate costs to the payment method which suppliers reported those costs on.

8.15 The levelisation workstream has an interaction with this payment method allocation. As discussed in the following chapter, decisions taken in that workstream could affect the actual consumer bill impact of any payment method allocation chosen by any debt-related costs adjustment. Therefore, when considering which of these payment method allocation options is preferable, stakeholders should therefore consider those interactions in the round.

PPM vs credit

- 8.16 As a starting point, in our COVID-19 true-up decision we set PPM costs to zero and allocated all debt-related costs which had been attributed to PPMs to credit customers only, given evidence received that the vast majority of PPM debt was accrued originally on credit meters.
- 8.17 This was (and remains) a limitation of our data collection, since debt is categorised on customers' current payment method, rather than where the debt was incurred on (at the point of billing). We still consider it unlikely that the costs suppliers have attributed to PPMs are an accurate representation of the total amount of debt incurred on a PPM. It is likely that many customers would have incurred debt on a credit meter before transferring to a PPM.
- 8.18 In August 2023, we published a decision on the allowance for additional support credit (ASC)³² bad debt costs. This decision will add an allowance in cap period 11a to the PPM cap only of approximately £9 per typical PPM customer.
- 8.19 As part of that review, we have heard from suppliers that ASC is the main way that PPM customers create new debt while on PPM payment methods. We also decided that the new ASC allowance should not cover costs in the periods prior to that allowance being introduced (ie. before October 2023), on the basis that these costs were not significant relative to the increased level of the price cap during that period. There is therefore justification for not attributing any extra debt-related costs above the existing allowance to PPM customers before October 2023, but instead setting that additional allowance to zero.

Within credit

- 8.20 In the COVID-19 true-up decision, we decided to equally allocate costs across credit customers, while setting PPM costs to zero. This is the most relevant precedent for allocation of any additional debt-related costs adjustment and is equivalent to Option 1 above. This option accounts for the fact that, at an individual level, a standard credit customer who pays their bill is no more responsible for higher debt-related costs associated with being on a standard credit meter than a direct debit customer who also pays their bill.

³² Additional support credit is a fixed amount of credit provided to a domestic customer in a vulnerable situation when that domestic customer's PPM credit runs low or runs out, to ensure continuity of electricity supply or return on supply some of which could turn into bad debt if not repaid.

- 8.21 We note that the cost for direct debit and standard credit customers would be greater under Option 1, than the weighted average bad debt cost of £17 per typical dual fuel customer which we presented in Table 7.1 because we are dividing the total cost by fewer customer as PPM customer accounts have been removed from the equation.
- 8.22 Option 5 shows an allocation without additional intervention from us to move costs. It would mean adding £144 per typical dual fuel customer to the standard credit cap and reducing the direct debit cap by £28. However, we consider that significant amounts of debt are accrued on alternative payment methods before crystallising; for example a customer could begin the debt process on a direct debit payment meter before moving to a standard credit meter (along with their debt). This would therefore justify not allocating costs fully based on the proportions found in the raw supplier reported data. The current allowance already includes an element of cost cross subsidy³³ between direct debit and standard credit customers so applying this option on payment method allocation would in effect 'true-up' our previous decision.
- 8.23 When considering the impact on consumers, it is important to consider the distribution of vulnerable customers who we could be applying an additional allowance to. 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.
- 8.24 As shown in the table below, the percentage of households that are classed as fuel poor is proportionally higher for PPM and standard credit, than for direct debit. However, of all households in fuel poverty, the majority pay by direct debit. This means that an option which adds costs to direct debit would likely increase costs for the largest number of fuel poor customers, who we must give particular regard to these customers.

³³ Ofgem (2018), Appendix 8 – Payment method uplift, Table A8.3: Breakdown of uplift figures for a dual fuel customer.
<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

Table 8.2: Fuel poverty statistics by household (electricity and gas) 2022³⁴

Method of Payment³⁵	Proportion of households in group who are fuel poor (%)	Number of households (thousands) – fuel poor	Proportion of all fuel poor households in payment group (%)
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

Q13: Do you have any views on which payment method allocation option would be preferable?

Other debt-related costs

8.25 In our July 2023 RFI, we asked suppliers to separate costs by payment method for debt-related administrative and working capital costs, as we wanted to assess if there any over or under allowance varied by payment method.

8.26 The majority of suppliers who submitted data were not able to split debt-related administrative costs by payment method. Therefore, consistent with the COVID-19 decision, we consider that any allowance attributed to debt-related administrative costs could be spread evenly across payment methods.

8.27 Most suppliers were able to separate customer working capital costs by payment method, but a few were unable to separate non-customer working capital costs by payment method. In the absence of alternative evidence about how the non-customer working capital could be split across payment methods, we consider that we could also only allocate working capital costs evenly among payment methods.

³⁴ DESNZ (2023), Annual fuel poverty statistics report: 2023.

<https://www.gov.uk/government/statistics/annual-fuel-poverty-statistics-report-2023>

<https://www.gov.uk/government/statistics/fuel-poverty-detailed-tables-2023-2022-data>

³⁵ DD = direct debit, SC = standard credit, PPM = prepayment meter.

Q14: Do you agree with us allocating other debt-related costs (debt-related administrative and working capital costs) uniformly across payment method?

Allocation across elements of the price cap Options

8.28 In this section, we are considering certain allocation questions:

- How to allocate the allowance between the unit rate and standing charge elements of the cap;
- How to allocate the allowance by fuel type;
- How to allocate the allowance to each electricity meter type.

Unit rate or standing charge

8.29 In the COVID-19 true-up decision, we allocated the additional allowance for debt-related costs across both the standing charge and the unit rate based on the proportional split between the unit rate and standing charge.³⁶ This was reflective of how debt is incurred, since a customer who does not pay their bills will incur debt on both the standing charge and unit rate element of the cap. The existing debt-related costs allowance in the price cap is contained in both the standing charge and unit rate element of the cap.

8.30 While the existing allowance and the Covid-19 true-up serve as important precedents, since any allowance proposed as part of this review will be based on the additional debt-related cost relative to the allowance, there could be merit in allocating costs differently:

- **Option 1:** Allocate any allowance between the standing charge and unit rate elements of the cap in the same proportions as total costs are currently recovered under the cap;
- **Option 2:** Allocate any allowance on the unit rate element of the cap only;
- **Option 3:** Allocate any allowance on the standing charge element of the cap only.

8.31 Allocating this allowance over the unit rate only (Option 2) would be possible given that debt typically scales proportionally with consumption, and additional debt (above existing allowances) will usually be related to consumption. Such an approach may also be in customers' interests, by avoiding a significant increase in bills for low consumption individuals. However, as the allowance will be

³⁶ Ofgem (2023), Decision on the true-up process for COVID-19 costs.
<https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs>

introduced into the cap in a period of lower consumption (ie summer), it would marginally delay supplier recovery.

- 8.32 Alternatively, we could allocate the whole allowance to the standing charge element of the cap only. This would be consistent with the ASC decision,³⁷ although that was a relatively unique decision, given its interaction with the government's commitment to remove the PPM premium until the end of March 2024 through the EPG.
- 8.33 We would expect suppliers to incur higher debt-related costs during the winter than summer, as this aligns with a period of higher energy consumption.³⁸ This means that allocating the whole allowance to the standing charge element of the cap only, could create a misalignment between how the costs were incurred and recovered.

Q15: How should we apportion any debt-related costs allowance over the unit rate and standing charge elements of the cap only?

Fuel type

- 8.34 We have two options for allocating costs among fuel type. We could either equally allocate cost recovery over electricity and gas customers, or alternatively, we could allocate costs unevenly between fuel types. Given absence of evidence, uneven allocations would require making uncertain assumptions. However, we do note that consumers build up debt proportional to their bill (ie in the winter months), and gas consumption is generally higher during winter. Therefore, there may be justification for a higher allowance on gas than electricity.
- 8.35 Given most customers are dual fuel, this choice should have a relatively limited impact on individual customers.

Meter type

- 8.36 The cap has two levels for electricity: one for single-rate meters, and another for multi-register meters. Multi-register meter customers tend to use more

³⁷ Ofgem (2023), Allowance for additional support credit bad debt costs, paragraph 5.15-5.17. <https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs>

³⁸ 75% of gas consumption is during the winter. 56% of electricity consumption is in the winter. Ofgem (2023), Annex 2 – Wholesale cost allowance v1.18, Tab 3b Demand. <https://www.ofgem.gov.uk/publications/energy-price-cap-default-tariff-1-october-31-december-2023>

energy on average,³⁹ so the typical consumption benchmark for the multi-register meter cap is set at a higher level of consumption.

- 8.37 We need to consider how to allocate costs for each meter type. One option is to allocate costs consistent with the COVID-19 true-up decision, where we adopted an equal allocation across electricity meter types (ie the same pound uplift to each electricity meter type). This was justified on the basis of protecting multi-rate customers from a sharp increase in their bills, and implementing it again it would protect the average multi-register customer from a larger increase in bills. Conversely, it would create a divergence between how additional debt is accrued (related to consumption levels) and allowed in the cap.
- 8.38 Alternatively, we could apply the same unit rate uplift to the cap for both single rate and multi-register electricity meter types. This would mean that consumers pay for this allowance in line with their rate of consumption.

Q16: How should we apportion any debt-related costs allowance between fuel and meter types?

³⁹ The typical domestic consumption value (TDCV) for a medium single-rate electricity customer is 2,700 kWh and for a multi-register customer it is 3,900 kWh. Ofgem (2023), Decision for Typical Domestic Consumption Values 2023. <https://www.ofgem.gov.uk/publications/decision-typical-domestic-consumption-values-2023>

9. Interaction with other workstreams

Chapter summary

In this chapter we set out the interaction between any debt-related costs allowance and other work undertaken by Ofgem.

Context

9.1 There are interactions between any debt-related costs allowance and a range of other Ofgem workstreams. This includes our work on levelisation of payment methods, the Operating Costs review, and wider debt practices.

Considerations

Levelisation

9.2 In August 2023, we set out options to levelise prices across payment methods.⁴⁰

9.3 Our initial preference (option 2⁴¹) is to levelise PPM and direct debit standing charges, and to levelise ASC bad debt costs. This would end the standing charge differential so that all customers on direct debit and PPM pay the same standing charge rate.

9.4 We also consulted on a further option (option 3), which is option 2 plus levelising debt-related costs. This option would reduce the standard credit and direct debit payment method differential by levelising those costs across all 3 payment methods.

9.5 While the workstreams are separate, if we decide to adopt option 3 or a similar variant, then any allowance we make under this consultation would be considered under the debt-related cost allowances covered by levelisation. This would affect the actual consumer bill impact of any payment method allocation we choose (discussed in Chapter 8), if the levelisation scheme is implemented from April 2024 onwards but we note that option 3 could incur a delivery risk for April 2024.⁴²

⁴⁰ Ofgem (2023) Levelling the cost of standing charges on prepayment meters.

<https://www.ofgem.gov.uk/publications/levelling-cost-standing-charges-prepayment-meters>

⁴¹ The options consulted on were: Option 1: Base Case (ie do-nothing); Option 2: Levelise PPM & DD standing charges and levelise ASC bad debt costs; Option 3: Option 2 plus levelise debt-related costs.

⁴² Ofgem (2023) Levelling the cost of standing charges on prepayment meters, paragraph 3.30.
<https://www.ofgem.gov.uk/publications/levelling-cost-standing-charges-prepayment-meters>

Operating costs review

- 9.6 As we have discussed elsewhere in this document, we are minded towards any allowance being temporary, and for an initial 12-months only. The ongoing Operating Costs review⁴³ will consider whether and how the debt-related costs allowance is set on an enduring basis, with a decision currently expected in winter 2024/25.
- 9.7 On that basis, our considerations and options here relate to an additional debt-related costs allowance for historical cap periods 2022/2023. They do not pre-judge any allocation or benchmarking methodologies used in the operating costs review, nor elsewhere in the cap.

Wider work on debt

- 9.8 Wholesale prices and the price cap are set to both be significantly lower than they were during winter 2022/23. However, strained household affordability due to the increased cost of living, and reductions in direct Government support with energy costs, mean that many households will again struggle to pay their energy bills this winter. Energy bill levels are not expected to be significantly lower than in winter 2022/23, and many customers now have more debt than last winter.
- 9.9 As part of our debt pathways work, we have convened groups and energy suppliers and pressed them to do all they can what more the sector could do to support consumers in vulnerable situations this winter. We welcome the efforts that many suppliers are making and recognise that there are limits to what industry can do to address the debt and affordability challenge. However, we also have high expectations on how customers in debt should be treated fairly and we will not tolerate sharp practices or aggressive debt recovery, particularly against the most vulnerable. We welcome Energy UK's Debt Commitments as a result of this engagement which commits suppliers to providing additional support and key actions to protect consumers in vulnerable situations this winter.

⁴³ Ofgem (2023), Call for Input on the Operating Cost Allowances Review.
<https://www.ofgem.gov.uk/publications/price-cap-call-input-operating-cost-allowances-review>

Appendices

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Appendix 1 - Estimation steps for Debt-related costs allowances

A1.1 Each of the price cap allowances that contain an element of the debt-related costs are considered separately to estimate the relevant amount. We then combine the amounts from each part of the price cap to produce an estimate of the aggregate allowance in the price cap for debt-related costs. These costs are each considered for each of direct debit, standard credit and PPM customers. This section discusses each of these steps in the calculation separately.⁴⁴

Bad debt charge

Operating costs

A1.2 We have data on the bad debt charge for direct debit customers as part of the detailed indirect cost information collected in 2018 (relating to 2017). This is the initial cap data. We have used this to calculate an estimate of the bad debt charge, based on the two suppliers closest to the operating cost benchmark. This estimate does not account for the £5 efficiency factor that would have a very small impact.

Payment method uplift (PAP)

A1.3 There is a specific line for bad debt in the PAP (Payment method Adjustment Percentage) allowance. We therefore can calculate this and do not need to estimate the allowance.

Working capital

A1.4 EBIT (based on the initial price cap EBIT methodology)

A1.5 Given that the working capital benefits of direct debit and the working capital costs of standard credit do not net out across suppliers' portfolios, there will be a net working capital impact. This forms part of the EBIT allowance.

A1.6 We do not have information on the amount relating to working capital in the EBIT calculation so this needs to be estimated.

⁴⁴ Electricity values are for single-rate customers.

- We take the initial cap working capital data that is used to calculate the PAP allowance. We use this since this is the best data available.⁴⁵
- Next, we take a weighted average of the direct debit and standard credit working capital data. To do this, we take a weighted average across payment methods and relevant suppliers. This is in a similar way to the weighted average percentages included in the payment method uplift model.
- This gives weighted average working capital as a proportion of revenue.

A1.7 EBIT analysis was based on a notionally efficient supplier (considering data from various sources), whereas the PAP data is for a particular selection of suppliers. For the selection of suppliers, even when trying to estimate an amount included in the EBIT allowance, we propose to use the same suppliers as the PAP analysis given the lack of a clear-cut alternative.

A1.8 Given that the EBIT allowance scales with other cap components (except headroom, VAT and EBIT itself), we can apply this percentage (from step 3) to the cap level excluding these components in each cap period.

Payment method uplift (PAP)

A1.9 The PAP allowance already includes specific lines for the standard credit working capital uplift and the downward adjustment for the difference between weighted average and DD working capital.

A1.10 We can therefore calculate the amount included in each cap period without carrying out estimation.

Debt-related administrative cost

A1.11 Payment method uplift (PAAC)

- We use suppliers' responses to the payment method uplift RFI to look at the cost line for bad debt administration.
- We use the percentage of the additional costs of paying by standard credit that this represents.
- We use the benchmark supplier from the payment method uplift calculation. The choice of using benchmark suppliers is consistent across

⁴⁵ Suppliers submitted data in 2018 that was used for the price cap decision. Ofgem (2018), Default tariff cap: decision – overview. <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

individual allowances (e.g., operating costs and PAAC, although different suppliers set the benchmark for each component of the price cap).

- We apply this percentage to the PAAC in each cap period, to provide the estimate of the costs included.

Operating costs

A1.12 Similar to the bad debt charge above, we have data from the initial cap operating cost RFI relating to debt-related administrative costs. (Internal collections, external collections and warrant costs). We use this to estimate these costs as a percentage of overall operating costs. For practicality we calculate these cost lines as a proportion of reported indirect costs, rather than the adjusted costs used for benchmarking.

- 1) We propose to apply the calculated percentage to the operating cost allowance in each cap period to provide an estimate of the costs included in the operating cost allowance.
 - a. We use benchmark suppliers for these estimates.
 - b. The initial cap operating cost RFI data relates to operating costs across domestic customers, whereas the operating cost allowance relates to direct debit customers only.
- 2) We therefore calculate the amount to subtract to remove the impact of costs relating to standard credit customers. We therefore calculate the amount to subtract in order to remove the impact of costs relating to standard credit customers. (While we apply the percentages from step 1 to a direct debit operating cost benchmark (i.e., after deducting the additional costs to serve for standard credit), the percentages from step 1 still include the impact of activities in relation to SC customers). The standard credit data comes from the PAAC calculations. This is done (in absolute values), after calculating the element included in PAAC (above in step 2).
- 3) The amount included in operating costs is equivalent to the weighted average level across payment methods, so we subtract the step 3 amount from the result of step 2 to reflect the difference between direct debit and

weighted average (in a similar way to the PAP working capital calculation which did not require estimation).⁴⁶

PPM uplift

A1.13 The PPM uplift is an estimate of the overall additional costs of serving PPM customers that was calculated by the CMA as part of the PPM specific price cap that was produced following the Energy Market Investigation in 2016.

A1.14 The Energy Market Investigation final report contains a table that relates to one of the CMA's approaches,⁴⁷ but this approach is the only one with data on the bad debt breakdown. This breakdown is reasonably granular. There is a specific line for the bad debt charge, but not for the other debt-related costs.⁴⁸

A1.15 For the bad debt charge,

- Calculate the bad debt charge as a percentage of the total cost under the CMA's granular approach.
- Then apply this percentage to the PPM uplift in each cap period.

Other costs within the PPM uplift

A1.16 For working capital and debt-related administrative costs, there does not appear to be data available to estimate what proportion (if any) these account for the CMA's PPM uplift.

A1.17 These costs are expected to be small. Given that PPM bad debt is low, debt-related administrative costs in relation to debt incurred on PPM in the initial cap should also be low. Working capital might be a small benefit to suppliers, given that PPM customers top up in advance of consumption (although by small amounts). This would need to be offset against any working capital costs from emergency credit.

A1.18 Given the points above, we therefore do not seek to estimate working capital and debt administration costs in the PPM uplift.

⁴⁶ *I.e.:* if Amount included in operating costs (WA) = DD * Proportion on DD + SC * Proportion on SC

Then: WA = DD * Proportion on DD + (DD + Amount included in PAAC) * Proportion on SC

And: WA = DD + Amount included in PAAC * Proportion on SC

So: DD = WA - Amount included in PAAC * Proportion on SC

⁴⁷ Table 7 from [Appendix 9.8](#).

⁴⁸ See paragraphs 116 to 118 of Appendix 9.8.

Appendix 2 - 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. i.e., a consultation.

4. With whom we will be sharing your personal data

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

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.
- 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.

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](#)".