Consultation

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Energy Price cap: Additional debt costs review 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 set out our proposals for making a temporary adjustment to the cap from April 2024 using a float and true-up process. We propose to set the adjustment using a lower quartile benchmarking approach and recover the costs equally over direct debit and standard credit customers (no adjustment to prepayment meter customers). This would result in a £16 dual fuel bill increase for those customers affected.

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 want to be transparent in our consultations.

We will publish the non-confidential responses we receive alongside a decision on next steps on our website at 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

Energy prices peaked in 2022, reaching their highest historical level due to economic recovery following the pandemic and the war in Ukraine. Since then, prices have come down but remain high compared to historical levels.

Last year, the government provided significant support measures for households to help with their energy bills. It provided an unprecedented over £40 billion support (to households and businesses) through measures such as the Energy Bill Support Scheme and Energy Price Guarantee. While these measures helped to mitigate affordability issues while the gas crisis was at its height, we have nevertheless seen debt levels rise as people struggle to meet the costs of higher bills. It is not just energy that has been affected, debt levels have also been rising in other credit markets. Our latest estimate shows there are £2.9 billion of arrears across the domestic energy market (by the end of Q3 2023), an increase of £0.3 billion since Q2 2023.

We understand the distress that rising debt in energy has on people. We have taken steps to ensure those in debt are treated sensitively and fairly. Measures include the new set of consumer standards rules we have introduced (eg suppliers should offer debt repayment plans at the earliest opportunity and consider offering temporary debt repayment holidays, where appropriate) and the tightening of the rules on forced prepayment meter installations. In addition to this, we have convened 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. These Debt Commitments sit alongside our work, to include more Additional Support Credit to avoid self-disconnection and levelling the cost of standing charges on prepayment meters.

Nonetheless, rising debt levels create costs for suppliers. In other markets, higher costs are usually met by increased prices for all customers (eg in the water market, Ofwat considers bad debt as part of the residential retail element of the price controls for water companies). In the energy market, the price cap limits what suppliers can charge customers on default tariffs. In setting the cap, we are required to have regard to an efficient supplier's ability to finance its costs of supplying energy and where those costs have changed relative to the cap allowances, we will consider whether to make an adjustment. It is important that the price cap reasonably reflects the actions suppliers are taking to help customers in payment difficulty and debt.

We have analysed the costs suppliers have faced for debt-related costs against the allowances provided through the cap (over April 2022 – September 2023 and an estimate of October 2023 – March 2024) and have determined that there is a material

and systematic net under-allowance of costs. We are proposing to introduce a temporary increase to the price cap allowance.

We understand that increasing costs for customers at this time has the potential to compound the indebtedness of customers facing payment difficulties, so we have taken an approach designed to minimise this impact as this is in line with our duty to protect default tariff customers as a whole. We propose to take a tight approach to benchmarking costs for the float by setting a lower quartile benchmark. We are also proposing to allocate costs equally over direct debit and standard credit customers as this reduces the increase on overall debt levels in the system by allocating less of the cost to those already in payment difficulties (relative to the other considered options).

We remain very concerned about the amount of debt in the system and the risk that it will increase further. We do not think that this adjustment is the answer to the debt problem in isolation. We propose to review this temporary allowance and will do so in light of, amongst other things, actual levels of consumer debt, the stringency by which we set it (whether the lower quartile approach remains appropriate) and how we recover these costs over customers with different payment types. We aim to review this temporary adjustment by April 2025.

The deadline for submitting views on the considerations contained in this consultation is 17 January 2024.

We are also looking at alternative policy responses to the debt issues, beyond the cap, and will seek views from stakeholders in early 2024 on approaches for dealing with bad debt. Any potential options should meet the following initial requirements:

- Customers in debt are adequately protected and treated fairly by suppliers, providing the required level of support;
- Protect all customers by ensuring the fairest allocation of debt costs across different customer groups;
- Suppliers remain incentivised to manage their bad debt costs efficiently whist protecting vulnerable customers;
- The costs of bad debt are shared fairly;
- The price cap reasonably reflects the actions suppliers have to, and should be, taking towards customers in payment difficulty and debt and suppliers are not disincentivised from retaining vulnerable customers who are at risk of falling into debt; and
- The approach is proportionate and practical.

Consultation process

Section summary

This chapter provides an overview of this consultation and lists related publications. We also set out the consultation process for this work area.

What are we consulting on?

1.1 This consultation seeks views on our proposal to introduce a temporary adjustment to the default tariff cap ('the cap') for additional debt related costs. The document is split into seven chapters and five appendices:

- Chapter 1: Consultation process;
- Chapter 2: Introduction;
- Chapter 3: Case for a temporary adjustment for debt-related costs;
- Chapter 4: Estimation of existing allowances;
- Chapter 5: Calculating and benchmarking costs;
- Chapter 6: Allocation of the allowance;
- Chapter 7: Impact analysis;
- Appendix 1: Calculation steps for existing debt allowances;
- Appendix 2: Calculation steps for additional debt-related costs;
- Appendix 3: Annex 8 methodology and model changes;
- Appendix 4: Rationale for excluding original payment method allocation;
- Appendix 5: Privacy notice on consultations.

Summary of proposals

1.2 In this consultation, we consider that the rising debt levels have led to greater costs for a notionally efficient supplier above what the cap allows for. We provide a summary of our proposals below and explain our rationale and considerations through this consultation. We propose to:

- Set an initial allowance (float) now and true-up it up at a later date once we have updated cost information (aim to be complete by April 2025). (Chapter 3)
- Estimate the cost over October 2023 – March 2024 using the data from Q3 2023 and benchmark debt-related costs across suppliers using a lower quartile approach for the initial float. (Chapter 5)
- Recover costs equally over direct debt and standard credit customers, with zero recovery over PPM customers. (Chapter 6)

- Recover costs (Chapter 6):

  (1) proportionally over gas and electricity bills (48/52% split respectively)

  (2) through the unit rate only

  (3) Equally over single rate and multi-register customers

- The level of the adjustment would be £16 per standard credit and direct debit customer (at benchmark consumption)[1], recovered over 12 months (April 2024 – March 2025).

Related publications

1.3 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

1.4 The main documents relating to this consultation are:

- November 2023 – Changing standing charges for prepayment meters and debt-related costs across payment methods https://www.ofgem.gov.uk/publications/changes-prepayment-meter-standing-charges-and-other-debt-costs
- October 2023 – Additional debt-related costs allowance policy consultation https://www.ofgem.gov.uk/publications/additional-debt-related-costs-allowance-policy-consultation
- 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

[1] We set the cap at benchmark consumption (3,100 kWh electricity and 12,000 kWh Gas). The equivalent adjustment amount is £15 for typical domestic consumption (2,700 kWh electricity and 11,500 kWh gas).

- 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

1.5 This consultation is open from 15 December 2023 until 17 January 2024. We will consider all responses to inform our decision, which we intend to publish in February 2024.

1.6 We have been conducting a review of debt-related costs.[2] 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.[3] In addition, we hosted a workshop with consumer groups and charities during the CFI window. Following this, we published a policy consultation in October 2023.

1.7 Subsequently, we issued a third and a fourth RFI in July and October 2023 respectively to gather evidence from energy suppliers on their debt-related costs over cap periods 10a (April - June 2023) and 10b (July – September 2023). We have used evidence received as part of the CFI, RFIs and other stakeholder engagement, to inform our ongoing review of debt-related costs.

Requests for information (RFIs)

1.8 We have issued four RFIs to capture new data as it becomes outturn and to be able to calculate net debt costs from cap periods 8-10b. Each additional RFI has

[2] 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.
[3] 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

collected an additional 3 months of data. The October 2023 RFI collected data from January 2017 - September 2023.

1.9 In our RFIs we have requested information covering the following topics:

- Bad debt
- Debt-related administrative costs
- Working capital costs
- Prepayment meter (PPM) installation policy changes on bad debt
- Additional Support Credit[4] (ASC) (RFI)
- Revenue
- Customer accounts

April 2023 Call for Input on debt-related costs

1.10 We began consulting on debt-related costs as the sudden and unexpected impact on some customers' incomes, alongside large-scale government intervention which resulted from the COVID-19 pandemic had created additional debt-related costs. We considered these costs to be material, and that suppliers were unable to recover these additional costs through the existing cap methodology.

1.11 We published a Call for Input in April 2023 to seek views on our initial considerations and options around debt-related costs.[5]

1.12 We received 13 responses from energy suppliers, trade associations, consumer groups and charities, and 1969 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

1.13 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 cap for debt-related costs and actual costs. We said we had therefore decided not to consult on a cap adjustment for credit debt-related costs in summer 2023.

[4] This was only requested in the April 2023 RFI.
[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

1.14 We had, however, seen significant evidence of a material increase in the value of ASC provided by suppliers to PPM customers that was not repaid, and therefore published a 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]

October 2023 additional debt-related costs allowance policy consultation

1.15 We consider that it is in the interest of customers to allow a supplier to recover its notionally efficient costs, as it ensures that that they are adequately funded for the services they provide in order to offer help and support to customers facing debt problems. 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 could increase costs for all customers.[9]

1.16 The October 2023 policy consultation set 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.

1.17 We outlined how we calculated suppliers' debt-related costs and the cap's aggregate debt-related cost allowance, and we also discussed the merits of different benchmarking approaches (eg 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 might not have been complying with existing rules, we also discussed whether and how we should account for those costs in any allowance.

1.18 We also explained how costs could be allocated between payment methods, including with reference to the approach taken in our COVID-19 true-up

[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
[9] Ofgem (2023), Additional debt-related costs allowance policy consultation. https://www.ofgem.gov.uk/publications/additional-debt-related-costs-allowance-policy-consultation

decision,[10] and discussed how this allocation interacted with the outcome of the consultation on levelisation of payment methods. This consultation also set out the case for truing up costs at a later stage after an initial float, while setting out that the operating costs review would consider how an enduring allowance would be set.

1.19 We received 23 responses from energy suppliers, trade associations, consumer groups, charities and a committee. We received 243 responses from individuals, 217 of which were part of a consumer campaign and 80,000 signatories from a petition website.

How to respond

1.20 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.

1.21 Please send your response to priceprotectionpolicy@ofgem.gov.uk on or before 17 January 2024.

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

Your response, data and confidentiality

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

1.24 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.

[10] 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

1.25 If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 5.

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

General feedback

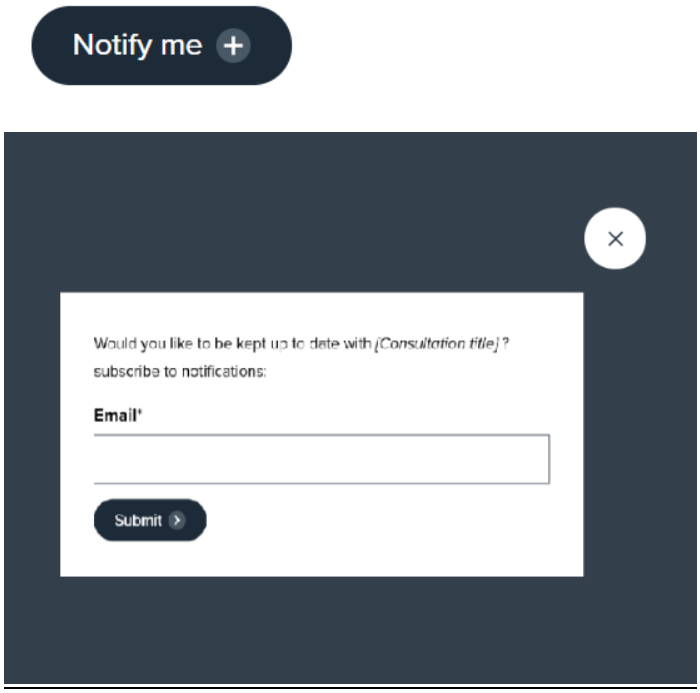
1.16. We believe that consultation is at the heart of good policy development. We welcome any comments about how we have run this consultation. We would also like to get your answers to these questions:

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

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

How to track the progress of the consultation

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



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)

1.27 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.

1.28 Please send your response to priceprotectionpolicy@ofgem.gov.uk on or before 17 January 2024.

Introduction

Section summary

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

Background

The default tariff cap

2.1 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 provided for in legislation through the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the 'Act').[11]

2.2 We are required to exercise our functions under the Act with a view to protecting existing and future domestic customers who pay standard variable tariffs and default tariff rates (together we refer to these as default tariffs). 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.[12]

2.3 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

[11] Domestic Gas and Electricity (Tariff Cap) Act 2018. https://www.legislation.gov.uk/ukpga/2018/21

[12] 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)).

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

2.4 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, electricity meter type, regional differences and payment method. 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.

Current economic situation

2.5 We are now entering the third winter since the energy crisis and many consumers continue to struggle with paying bills. We have seen arrears rise over the recent months with our latest data showing a current level across the market of £2.9 billion as of September 2023. This is an increase of £0.3 billion on our previous estimate in Q2 2023.

2.6 We are beginning to observe the conversion of arrears into debt-related costs. In particular, we have seen an increase in bad debt in more recent quarters as customers feel the impact of wider cost of living pressures and following the end of the Energy Bill Support Scheme in March 2023, which was introduced as part of a support package at an unprecedented level to help households and businesses.

2.7 The Government announced wider support measures in the Autumn statement, including a reduction to National Insurance Contributions, an increase in the National Living Wage and policies on particular benefits (eg uprating working age and pensioner benefits, and Local Housing Allowance).[13] While these measures will support the incomes of millions of low income households, we are still acutely aware of the difficulty customers continue to face.

[13] HM Treasury (2023), Autumn Statement 2023. https://www.gov.uk/government/publications/autumn-statement-2023/autumn-statement-2023-html

2.8 The cap is intended to reflect the efficient cost of supplying energy to customers, to ensure customers face a fair price. As part of this, we update the cap to reflect material and systematic changes in costs. In this consultation, we consider whether and to what extent we should adjust the cap for additional debt-related costs. While any adjustment does come as an increase in bills in the short term, it is also beneficial for customers. It means the price cap reasonably reflects the actions suppliers are taking to help customers in payment difficulties and debt.[14] In addition, by improving resilience, it reduces the risk of supplier failure. Supplier failure can increase bills in the near term as costs are recovered over energy bills and potentially reduce investability and competition in the long term.

2.9 We understand how worrying the current situation is for customers and the difficulties they are currently facing. We have been mindful of this when putting forward our proposals and our consideration of the available options.

Debt-related costs – definition and overview

2.10 Payment difficulties for customers mean that 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 costs. This means all customers pay for the cost of bad debt incurred by customers who do not pay.

2.11 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.

2.12 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. Write-offs can take some time to crystalise as

[14] Energy UK recently set out a number of Voluntary Debt Commitments aimed at supporting customers, particularly those who need it most. 14 suppliers have signed up to these commitments.
Energy UK (2023), The Winter 2023 Voluntary Debt Commitment.
https://www.energy-uk.org.uk/publications/the-winter-2023-voluntary-debt-commitment/

suppliers attempt to recover the debt. However, suppliers begin to incur costs (ie working capital costs) when a customer first stops paying, after which a provision is made for bad debt when repayment is no longer expected.

2.13 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

2.14 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, the debt-related costs allowance is now significantly greater than it was several years ago, given increases in the overall cost of energy.

2.15 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 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.

2.16 We estimate that for cap period 11b (January – March 2024), 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 11b (January - March 2024). We explain our estimates further in Chapter 4 and Appendix 2.

2.17 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.[15]

[15] 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

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 Energy Bills Support Scheme (EBSS) and Energy Price Guarantee (EPG).

Interaction with other work areas

2.18 There are interactions between this debt-related cost review, the implementation of the levelisation of payment methods policy and the review of operating cost allowances.

Levelisation of payment methods

2.19 In November 2023, we published a consultation which outlines options to levelise prices across payment methods.[16] We are consulting on three options:

- Option 1 - Do nothing: No levelisation
- Option 2 – Levelise PPM and DD standing charges (including ASC bad debt)
- Option 3 – Option 2 plus levelise debt-related costs (between direct debit and standard credit customers).

2.20 We propose proceeding with option 3, with a transitional arrangement whereby direct debit and PPM standing charge levelisation would be introduced from April 2024. Development of the unit rate levelisation for debt-related costs would be introduced (at the earliest) from October 2024.

2.21 Our income weighted analysis, supported by our consumer research, indicates that option 3 may benefit consumers the most. Option 3 would also produce the largest decrease in bad debt costs, which could constitute a material benefit to the market.

2.22 There is a clear link between levelisation and this debt-related cost review if we were to proceed with option 3. The interaction is most material through our considerations on how we allocate costs between customers on different payment methods. We may prefer different allocation options depending on if levelisation of bad debt was to be in place – we elaborate more on this in Chapter 6.

2.23 For the purposes of setting a float adjustment in this review, we are working on the assumption that levelisation option 3 will not be in place. This is due to

[16] Ofgem (2023), Changes to prepayment meter standing charges and other debt costs. https://www.ofgem.gov.uk/publications/changes-prepayment-meter-standing-charges-and-other-debt-costs

differences in timing between setting an initial float as part of this review (aimed for April 2024 for 12 months) and introducing levelisation option 3 (October 2024 at the earliest).

2.24 Should we proceed with option 3 levelisation and introduce it in time for a true-up exercise for this debt-related cost review, then we will consider the interaction with how we allocate costs at that stage.

Operating cost review

2.25 An adjustment resulting from this review of debt-related costs is intended to be temporary and ad-hoc in nature. The ongoing operating cost review will consider how the debt-related costs allowance is set on an enduring basis, with a decision currently expected in winter 2024/25. We intend to publish a policy consultation for the operating cost review in early 2024, in which we will discuss potential options for setting the enduring allowance.

2.26 On that basis, our considerations and options in this consultation relate to an additional debt-related costs allowance for the period spanning April 2022 to March 2024. They do not pre-judge any allocation or benchmarking methodologies used in the operating costs review, nor elsewhere in the cap.

Debt-related costs

2.27 As we set out in the following chapter, we propose to carry out a true-up on the float estimate we set for April 2024. We propose to implement the true-up for April 2025. This will allow enough time to pass to collect updated cost information, develop our approach for the true-up process, and run a multi-stage consultation process with sufficient time for a disclosure exercise should we deem it necessary.

2.28 Additionally, we expect the operating cost review to have concluded by then and an approach to unit-rate levelisation to be clear should we proceed with it. Given the interaction with both areas highlighted above, we can take these into account for the true-up.

Disclosure of models and data

2.29 A few suppliers raised concerns regarding the transparency of our consultation process. They wanted greater transparency including being able (via a confidentiality ring) to review the data received and the impact of various benchmarks or benchmarking decisions. There were also some concerns over

commenting on particular elements of our approach before being provided access to the underlying model.

2.30 We consider that the information we have published sufficiently allows stakeholders to make meaningful comments on our approach and methodology for setting a float. In this consultation, we have published our step-by-step calculations estimating the allowances and costs in the appendices. We have also included summary statistics of the data to show the range and spread between suppliers at the end of Chapter 5.

2.31 We are not publishing suppliers' individual data because it is confidential to each supplier and given its commercial sensitivity, we do not consider it possible to publish such information.

2.32 We are also not disclosing suppliers' individual data (for instance in a confidentiality ring where participants employed economic advisors). This is because of the following main reasons, among others:

- Taking into consideration the nature of this review for setting a float, we consider the explanation of our methodology provided in this consultation would given sufficient information for meaningful consultation.
- For advisors to fully comment on other suppliers data, we would likely need to disclose the supplier data as well as a significant amount of correspondence where we have sought clarifications and resubmissions. This would go beyond the scope of a typical disclosure exercise we would consider carrying out;
- Sharing confidential and commercially sensitive information comes with inherent risks – for example that information is spread further than envisioned. Even undertakings from professional advisors does not fully mitigate the risk of sensitive information being directly, or indirectly shared between competitions.

2.33 We will reconsider our stance on disclosure as part of the true-up process to determine whether it is necessary to undertake a disclosure process including a confidentiality ring. We would welcome any stakeholders' comments regarding the incremental value of disclosure of data for the true-up process, beyond what we have provided here.

Setting a temporary adjustment

Section summary

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

Context

3.1 In our October 2023 consultation, we set out the case for why we may consider an adjustment where efficient debt-related costs had materially and systematically departed from allowances.

3.2 We considered a number of options relating to how we could set an adjustment, including: setting an initial estimate and truing up the estimate later (float and true-up approach), setting an allowance now with no true-up, and delaying the adjustment to set it on an ex-post basis.

3.3 We also considered a number of other areas such as: alternative mechanisms such as a levy to mutualise debt-related costs, treatment of PPM moratorium costs and whether to uplift any allowance for inflation.

3.4 We have analysed our latest RFI (covering Q3 2023 costs) and responses to our October 2023 consultation. We set out our proposals and considerations below.

Proposals

3.5 We propose to make an adjustment to the cap for additional debt-related costs covering April 2022 to March 2024, and to include the costs of the PPM moratorium. Our analysis of supplier data suggests that costs have materially diverged from the existing allowances, and we do not expect this to net-off in the medium term.

3.6 We propose to make the adjustment using a float and true-up approach. We will set an initial estimate of the additional costs in the April 2024 cap and review whether outturn costs align to our float. Where they do not materially align, we would consider carrying out an update (true-up) on the initial allowance.

3.7 We have collected data for costs over the period April 2022 to September 2023. We do not anticipate the debt situation to materially improve over the winter, so we propose to roll forward the Q3 2023 net debt-related cost data to set an allowance for October 2023 to March 2024.

3.8 We propose this adjustment to be recovered over a 12-month period and do not propose to uprate the adjustment for inflation.

3.9 We do not propose to pursue a levy mechanism for our April 2024 implementation. However, we leave the option open for further consideration in the context of levelisation.

Summary of responses

3.10 We received nine responses from suppliers, twelve from consumer groups and charities and two from industry bodies on whether we should make a temporary adjustment to account for additional debt-related costs.

3.11 Generally, suppliers and industry bodies were in favour of an adjustment and consumer groups and charities were against an adjustment. Consumer groups and charities generally opposed the inclusion of PPM moratorium costs within our adjustment. We received 243 responses from individuals, most of whom broadly endorsed or directly referenced a consumer group's opposition to the proposals.[17] A number of individuals raised additional points while objecting to the proposals, including that an adjustment to the allowance prioritises the interests of energy suppliers over consumers.

3.12 We also received a petition which had approximately 80,000 signatories asking Ofgem not to increase customers bills. It said that government-backed help should pay for energy debt.

3.13 11 respondents were in favour of a float and true-up approach. Some stakeholders said we should carry out a true-up once we have fully robust data. Several stakeholders said we should consider further adjustments before the true-up and/or a forward-looking allowance in the float.

3.14 Seven suppliers and two industry bodies said we should uprate any adjustment for either inflation or cost of capital. Three stakeholders said we should not uprate any allowance.

3.15 There was broadly equal support for using the price cap as the mechanism to deliver an adjustment versus using an alternative mechanism (eg a levy). While some stakeholders opposed a specific levy to mutualise debt for 'Do Not Install' customers, most respondents supported our proposal to explore this further.

[17] A large proportion of individual responses highlighted their support for the aforementioned consumer group's overall response, the main position of which was to oppose any allowance.

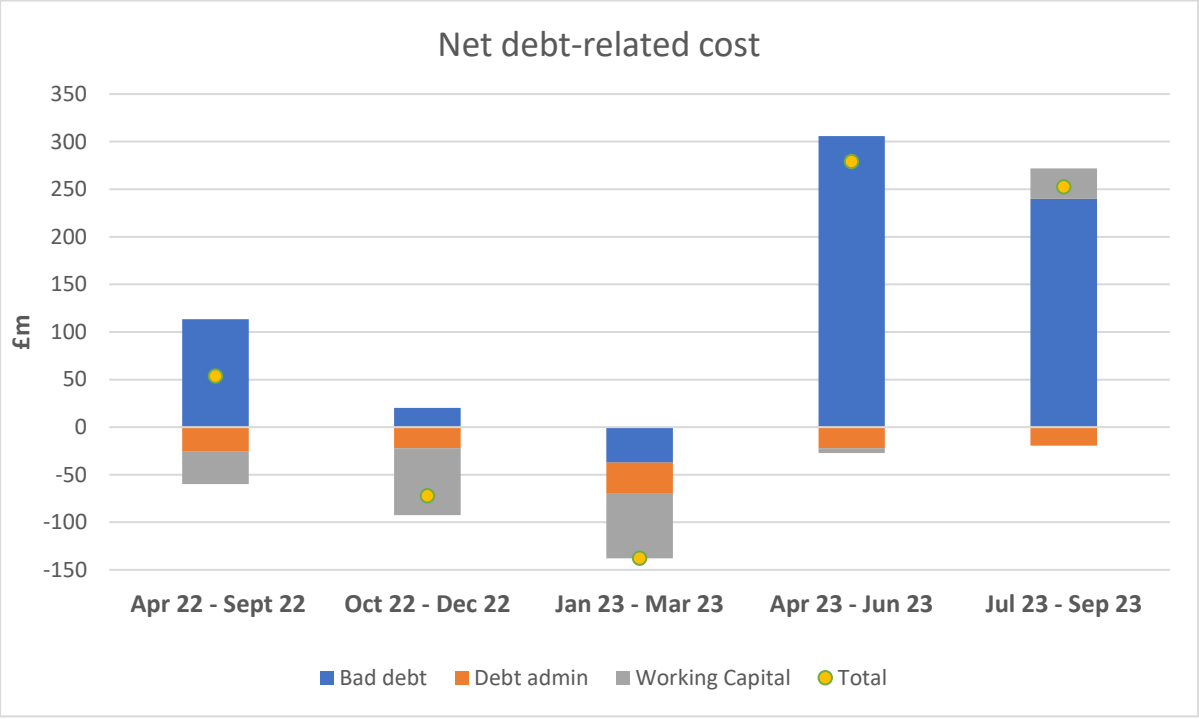
Considerations

Overall debt assessment

3.16 Our analysis of supplier cost data, using the latest RFI issued in November 2023 suggests that debt costs are rising in recent periods, and that this has led to an under-allowance of bad debt, which hasn't been fully off-set by an over-allowance elsewhere in the cap.

3.17 Figure 3.1 shows that over April 2022 – March 2023 there was a relatively small difference between bad debt and the allowance, fluctuating between an over-allowance and an under-allowance. We consider the over-allowance in cap period 9b is driven by government support packages (which are no longer in place) which reduced levels of non-payment. Following this period, there has been an increase in bad debt and costs have begun to depart from allowances.

Figure 3.1 – Net debt-related costs over cap period 8-10b[18, 19]



The bar graph shows the net debt-related cost from April 2022 to September 2023.

[18] Apr 22- Sep 22, cap period 8; Oct 22-Dec 22, cap period 9a; Jan 23 - Mar 23, cap period 9b; Apr 23 - Jun 23, cap period 10a; Jul 23 - Sep 23, cap period 10b.
The price cap moved to quarterly updates from cap period 9a which is represented by the change from 6 months to 3 months the second column.
[19] Total = sum of all three debt-related costs.
The price cap moved to quarterly updates from cap period 9a which is represented by the change from 6 months to 3 months the second column.

3.18 Over the entire period covered by the chart above, there has been an over-allowance of debt administration costs and only up to the most recent period an over-allowance of working capital costs. We consider the government support in the earlier cap periods will have had on impact on working capital costs by guaranteeing a level of revenue for suppliers over the period in a timelier manner. This is why we see a swing in the working capital over/under allowance over time.

3.19 This trend of debt-related costs and under/over-recovery sets the context for the positions we put forward over this consultation.

Setting an adjustment

3.20 When deciding whether to make adjustments to the cap, we apply a test to consider whether an issue is both material and systematic. We have used this test previously, such as in the adjustments we made for additional wholesale costs and as part of the decision on the COVID-19 true-up process. [20]

3.21 Based on our analysis of suppliers' costs outlined in Figure 3.1, we have determined that debt-related costs have materially diverged from the debt-related allowances in the cap. We have no evidence to suggest debt-related costs in the industry will drop significantly, objectively or below the allowance values.

3.22 Our systematic and material test is a high threshold for making changes to the cap methodology. We consider the rising costs generated by the increase in debt levels across the market to have met that our requirement to consider an adjustment.

3.23 We are not aware of any pending government support programs similar to those that were in place last year (eg the Energy Bill Support Scheme [EBSS] and Energy Price Guarantee [EPG]), which we noted earlier may have been suppressing debt-related costs. Additionally, no suppliers have met the restart conditions at the time of writing, meaning related bad debt continues to accrue.[21] To negate this under-allowance in the medium-term would require a material over-allowance. We do not have a reason to expect this to occur and therefore

[20] Ofgem (2022) Price Cap – Decision on possible wholesale cost adjustment, https://www.ofgem.gov.uk/publications/price-cap-decision-possible-wholesale-cost-adjustment
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

[21] This is discussed further at 3.42. Details of our decision following the introduction of a moratorium which suppliers voluntarily signed up to.
Ofgem (2023) – Involuntary prepayment meter decision, https://www.ofgem.gov.uk/publications/involuntary-prepayment-meter-decision

consider the impact is systematic. With both aspects of our test met, we consider it appropriate to adjust the cap.

3.24 Most consumer groups and charities opposed making an adjustment to the cap, which would increase costs for customers. Some highlighted that many of the adjustments we have recently made to the cap have increased the level, favouring suppliers.

3.25 Our approach to setting the cap is that we aim to reflect the efficient cost of supplying energy to customers, ensuring customers pay a fair price. Allowing recovery of efficient costs is an important part of building a resilient market, that enables sustainable competition, innovation and investment – to the ultimate benefit of customers.[22]

3.26 In relation to debt-related costs specifically, we have been working with suppliers to ensure they treat customers facing debt issues fairly.[23] Suppliers must comply with all regulatory obligations. However, under the Act, we must have regard to the ability of an efficient supplier to finance its licensed activities.

3.27 We are mindful that achieving this can lead to an increase in costs to customers, which could worsen the already challenging circumstances of some customers this winter. Many are already experiencing increasingly problematic levels of debt, in energy and other bills, with current energy debt and arrears totalling around £2.9 billion.

3.28 However, without making an adjustment for debt-related costs, there is a risk to suppliers' financial situations which at worst could lead to supplier failure, the costs of which would be passed on to consumers via mutualised costs.

3.29 In setting this adjustment, we have sought to reduce the immediate impact on customers by making the adjustment temporary, taking a relatively stringent initial benchmark approach and considering how those costs are recovered between different customers. We discuss this in Chapters 5 and 6.

3.30 We have considered our proposals in the round of how we set the cap and have determined that proposing an adjustment is appropriate for these circumstances.

[22] As set out in Ofgem's Forward Work Programme 2023-24 on p.15. https://www.ofgem.gov.uk/publications/202324-forward-work-programme

[23] For example, Energy UK recently publish a set of voluntary commitments that were developed with Ofgem and Citizens Advice. The new commitments set out additional actions that energy suppliers will take, above regulatory obligations, to support customers in payment difficulty.

We will keep this balance under review depending on how the debt situation continues to evolve.

Using a float and true-up approach

3.31 Most respondents were in favour of setting an initial float followed by a later true-up exercise. One supplier proposed that the float should only consider bad debt costs and exclude debt administration and working capital. Two suppliers did not believe debt-related administrative or working capital costs should be in scope of this review. Two stakeholders suggested we should adjust the float with more up-to-date/robust data when it becomes available and ahead of any final true-up.

3.32 With respect to carrying out the true-up, a few stakeholders suggested we carry out a true-up once we have the full data, with one suggesting the timing should depend on the operating cost review. Some suggested either October 2024 or April 2025 as an appropriate time for a true-up. Stakeholders generally agreed with carrying out a single true-up exercise. However, one stakeholder did consider the ASC true-up should be treated separately.

3.33 We consider a float and true-up approach is preferable to the alternative two options we considered in our October 2023 consultation (delaying the adjustment or not carrying out a true-up). The macroeconomic situation remains uncertain as does the debt situation, a true-up at a later stage reduces the impact of outturn debt costs differing to the allowance we provide now.

3.34 We do not consider it preferable to delay the allowance and allow more time to pass. This would increase the time between when suppliers incur the costs and when they recover them. This helps ensure resilient suppliers who are able to deal with unexpected shocks, something which has been increasingly necessary in recent years.

3.35 Furthermore, providing an adjustment at a later stage could lead to a larger adjustment and spike in bills if the debt situation were to persist. Therefore, we consider it preferable to provide a float in April 2024 and true up later rather than accumulate any over/under-allowance over a longer period in hope for improved accuracy.

3.36 We do not see a clear reason to exclude debt administration and working capital costs from the float at this stage. The float is intended to be an estimate of costs and we consider the data is of sufficient quality for this purpose. This still leaves the option open to further refine our data collection for when we carry out the true-up exercise. We discuss this further in Chapter 5 on benchmarking costs.

3.37 At this stage, we propose to set the float based on the data we have collected so far. We would not have time to collect further data for more recent periods (eg Q4 2023) and be able to consult on what impact that would have on an adjustment in time for the April 2024 cap period. We discuss setting an adjustment for October 2023 – March 2024 below.

3.38 We currently aim to deliver the true-up process by April 2025. When setting the timings for the true-up, there are factors we will need to consider. These are mainly: (1) the interaction with other workstreams (eg the operating cost review and levelisation of payment methods) and (2) the time it takes for updates to provisions to stabilise and debt to be written off. We would seek to ensure enough time has passed to take a meaningful update on costs, and that our positions on other interacting policy areas were clear. Lastly, we must also take into account the trade-off between timeliness and accuracy, and seek to strike an appropriate balance.

Setting costs for Winter 23/24

3.39 Some stakeholders suggested we set a forward-looking element to the initial float, with one stating this would avoid the need for potential retrospective uplifts, and serve to limit the impact of the true-up and introduce bill volatility for customers. Another stated that the nature of a float and true-up mechanism meant any float should include an estimate of forward-looking costs which will be trued-up with better data.

3.40 One supplier supported the extension of our analysis to another quarter (Q4 2023) of costs within any adjustment. However, they, and an industry body, stated that the indicative data used is misleading and could lead to sub-optimum decisions, stating that we appear to have disproportionately relied on the first two RFIs which were likely heavily impacted by the EPG and EBSS.

3.41 On a related note, one response said we should implement an ad hoc interim adjustment to the float if there was a clear divergence between actual costs being incurred and the initial float allowance.

3.42 We consider it would be appropriate to incorporate an estimate of costs over October 2023 – March 2024 when setting an initial float. It is unlikely that the debt situation and macroeconomic factors will substantially improve over the period and so we consider it likely we would see a continuation of under-allowances as shown in recent cap periods in in Figure 3.1.

3.43 Failure to factor in costs from the winter period would likely lead to a larger adjustment needed when we come to true-up the costs as we would be effectively assuming that there was not an over/under-allowance for the winter period. This could potentially lead to a higher spike in customer bills rather than more of the costs being spread throughout the 12 month adjustment period which amongst other things makes it harder for customers to budget.

3.44 As mentioned above, we will not have time to collect updated data for the period by the time we make our decision in February 2024. Therefore, for the purpose of setting a float, we propose to use a simple estimation approach of taking the Q3 2023 costs for the benchmark and rolling these forward to cover Q4 2023 and Q1 2024.

3.45 We consider that setting a float based on a recent cap period is a reasonable approach in an uncertain economic environment. This also reduces the risk of estimates being influenced by previous government support supressing debt. We recognise that debt-related costs may change over time, but we do not consider there is an alternative method to estimate future changes more robustly with the data we have available.

PPM moratorium costs

3.46 Earlier in 2023, we became aware of serious issues in the way some energy suppliers approached Involuntary Prepayment Meter (PPM) installations. In response, suppliers agreed to pause involuntary PPM installations and, agreed to sign up to the Involuntary PPM Code of Practice ('Code'), developed through detailed discussions with suppliers and consumers groups.[24] The conditions set out in the Code have been incorporated into the Standard Licence Conditions (SLCs).[25] All energy suppliers have to follow them.

3.47 Our analysis of supplier data suggests that the moratorium created around £25m per month of additional debt-related costs between February 2023 and September 2023. There is the possibility of larger and uncertain costs in Q4 2023 and over 2024, given the higher demand in winter. To note, the PPM moratorium is not the only source of bad debt – it represents only 19% of bad debt over

[24] We refer to this as the PPM Moratorium.
[25] As of 8 November 2023 [following decision made on 13 September 2023]. An up to date version of the conditions can be found on our website.
Ofgem (2023), Licences and licence conditions.
https://www.ofgem.gov.uk/energy-policy-and-regulation/industry-licensing/licences-and-licence-conditions

February 2023 – September 2023. This shows customers face payment difficulties more widely.

3.48 Suppliers have not yet met the restart conditions so the moratorium is still in place and is likely to remain until early 2024. It is important to note that as suppliers meet restart conditions, this does not guarantee that they will immediately restart involuntary PPM installations, nor will they do so at similar levels to before the moratorium, or that it will immediately influence bad debt levels.

3.49 Consumer groups, charities and a committee opposed the inclusion of the PPM moratorium costs in a float. They thought that the costs of failing to comply with industry rules should be borne by suppliers and also said that customers should not have to pay for measures that were brought in to protect them. They also referenced the voluntary nature of the PPM moratorium as a reason why the costs should not be passed on to customers.

3.50 An industry body said that if we had evidence of suppliers in breach of their license conditions, then overstated costs should not be included in any adjustment.

3.51 Suppliers disagreed with excluding the costs of the PPM moratorium. They said that it would be difficult to exclude these costs from the overall bad debt figures, and doing so would not allow an efficiently run supplier to recover its costs. One consumer group noted that we recently increased the EBIT margin in the cap and it recommended that costs incurred as a result of the PPM moratorium should be funded by this increase.

3.52 We do not propose to exclude the £25m per month PPM moratorium cost in the initial float allowance. Our investigation on supplier practices is still ongoing, there have not been any judgements made or published regarding non-compliance at this stage. Given that we can only set one cap level across suppliers, excluding these costs would risk suppliers not recovering their efficient costs even where they had met their obligations. For this reason, we consider it appropriate to let any non-compliance be dealt with via Ofgem's compliance and enforcement functions, rather than the blunt tool of a price cap adjustment.

3.53 We do not consider that these costs should be funded through the increased EBIT margin as that decision was made to reflect the increased costs of a notional supplier to finance its activities and not costs in scope here.

3.54 Excluding these costs from the float could also significantly reduce the incentives for suppliers to sign up to similar voluntary commitments in future, particularly where they considered there was a risk of under-recovering efficient costs.

Uprating the allowance for inflation or cost of capital

3.55 Three suppliers and two industry bodies were in favour of uprating the float allowance to account for inflation. Four suppliers were in favour of uprating the float but considered alternative approaches such as: uprating by cost of capital, or uprating the float by inflation and the true-up by cost of capital.

3.56 Three stakeholders disagreed with uprating the float. One mentioned they thought this could be captured by the true-up exercise and we should not uprate a temporary adjustment. Another said that if reductions to the cap have never been uprated for inflation, then neither should any increase to the cap. The third stated that if firms are sufficiently resilient to withstand any shortfall this winter, then there is no need to uprate for inflation.

3.57 There may be a case to consider whether we adjust for inflation to account for the real value of money between when costs were incurred and when the allowance was provided. However, for the purposes of setting a float we do not propose to make an adjustment for inflation. The under-recovery of debt is concentrated in the most recent quarters, reducing the time difference between the costs and allowance. We may consider an inflation adjustment when carrying out the true-up if we deem the impact to be material.

3.58 We do not think it is appropriate to uprate the allowance by the cost of capital. Working capital for payment in arrears will be covered by the working capital component of debt-related costs. Although there will still be a timing difference between when suppliers incur costs in other debt-related cost areas and when they receive money through the float, the cap is not intended to align the timing of revenue and costs. Suppliers should have sufficient facilities to manage working capital as part of their normal business.

Alternative mechanisms

3.59 In our October 2023 consultation, we discussed alternative approaches to using the price cap to make an adjustment. This included a levy mechanism to mutualise bad debt across suppliers, particularly for the 'Do Not Install' group (DNI). As noted earlier, we can only set a single cap level, however suppliers have different proportions of customers in the DNI category for reasons beyond

their control. Therefore, it is appropriate to consider a potential specific levy in this case.

3.60 Two suppliers suggested different levy mechanisms to recover general bad debt costs across suppliers. There was support across all categories of stakeholders for exploring a specific mechanism focussed on DNI customers, generally this was in the form of a specific levy but other suggestions included treasury-funded future social tariff or a 'help to repay' scheme.

3.61 There was minor opposition to exploring a mechanism to recover costs arising from DNI customers, though this seemed to be based on a misunderstanding that we were suggesting to recover costs exclusively over DNI customers.[26]

3.62 We do not intend to pursue introducing a levy mechanism for April 2024. This would be a significant undertaking in both resource and process. However, at this stage, we are not discounting the possibility as a longer-term approach to managing debt across the industry.

3.63 We have some reservations regarding a levy that mutualises bad debt. There is a risk it reduces incentives for suppliers to efficiently manage their debt processes, both in collection and incentivising customers to more cost-efficient payment methods. This could also ultimately lead to extra costs for those customers who do pay their bills.

3.64 Given the interaction with the proposal of levelisation of bad debt between standard credit and direct debit customers, we consider it appropriate for us to consider any levy proposals in context of any decisions we take on levelisation.

[26] For clarification, a DNI levy would not mean recovering costs exclusively from DNI customers. It would be a method to recoup these costs across all customers, and suppliers recovering costs based on how many such DNI levy customers they have. Please note, this is only intended to characterise the general idea and does not reflect any Ofgem position on any such levy or how it would operate.

Estimation of existing allowances

Section 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).

Introduction and context

4.1 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 each debt-related cost, and combine or aggregate these into an estimate of the overall debt-related costs allowance.

4.2 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 unable to directly identify an apportionment between debt-related costs and non-debt-related costs in some specific allowances, (such as operating costs). We therefore must estimate it.

4.3 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.[27]

Proposals

4.4 We have maintained our approach to calculating the allowance that was outlined in the October 2023 policy consultation. That methodology is repeated here.

4.5 We propose to estimate the overall debt-related cost 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.

[27] 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

4.6 Where we need to use 2018 data to apportion allowances, we propose to use the 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 approaches to different allowances.

4.7 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.

4.8 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

4.9 The table below provides a visual summary of which debt-related costs constitute part of existing specific allowances.

Table 4.1: Key on where debt-related costs allowances are included in the cap[28]

		Price cap components			
Debt-related cost components	**Payment method**	**Operating cost**	**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

[28] This table has altered since the policy consultation to note that certain costs are included in part of the price cap, but the methodology has not changed. The boxes for debt admin SC and PPM have been ticked for operating costs because the PAAC is in addition to the underlying costs.

Methodological choices

4.10 The significant data challenges, as set out above, require us to make complex estimations, based in part on judgment and assumptions, across several individual allowances.[29]

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

- Consistency: How far to retain methodological consistency between a) specific allowance estimates and b) the 2018 price cap setting approach
- Stringency: Whether the efficiency expected will be the same across all the specific individual allowances included within the overall debt-related costs allowance.
- Suppliers: Which suppliers' data to use for the estimated proportions and how to combine this data.

Consistency

4.12 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, the operating cost allowance is based on top-down benchmarking.[30] 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.

4.13 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.

4.14 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.

[29] 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.
[30] Indirect costs are costs that do not directly scale with increased sales.

Stringency

4.15 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.[31] For EBIT, the approach is a weighted average.

Suppliers

4.16 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 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.

4.17 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 (compared to using data from all suppliers).

4.18 We propose to maintain consistency across all three estimates by always using the data from the benchmark suppliers for each cost area. This ensures our estimation reflects the data that was used for calculating each of the price cap allowances.

4.19 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, 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.[32] We therefore

[31] We benchmarked operating costs at the lower quartile minus £5.
[32] Ofgem (2020), Decision on reviewing smart metering costs in the default tariff cap, Technical annex, paragraph 5.49 noted that two suppliers near the operating costs benchmark have similar total operating costs.
https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap

propose to average the data from these two benchmark suppliers to produce a combined estimate.

4.20 After determining which suppliers' data to use, we need to consider how to combine these (benchmark) suppliers' data. We could use either a simple average or a weighted average of the two. A weighted average gives more importance to larger suppliers than a simple average by weighting against customers numbers.

4.21 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 as in the true-up for COVID-19 costs.[33] 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.

4.22 We propose to use the benchmark suppliers, and a weighted average (based on 2017 customer numbers) of the benchmark suppliers where available, when determining proportions for the estimation of the allowances. Once the allowances for 2018 have been estimated, these are projected forwards updating for cap values and inflation as with the other cap allowances.

4.23 To calculate the amount of bad debt allowance within the operating cost allowance, we propose to use a weighted average of the two benchmark supplier's debt costs.

Allowance values

4.24 A detailed description of how each of the allowances is calculated is in Appendix 1.

4.25 The bad debt charge is included in the operating cost and payment method uplift allowances. We estimate the amount included for the bad debt charge in operating costs by looking at the bad debt charges for the two suppliers closest to the operating cost benchmark. The payment method uplift allowance includes a specific element for bad debt, so we can use this directly.

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

4.26 Working capital consists of the payment method uplift and EBIT allowances. The payment method uplift already includes specific element for working capital. We estimate the amount included for working capital within the EBIT allowance, using information from the payment method uplift to help us estimate this.

4.27 Debt administration costs are part of the payment method uplift and operating costs allowances. We use the benchmark supplier for the payment method uplift. We use the two operating cost benchmark suppliers.

4.28 The PPM uplift can be used to adjust the PPM costs for all of the debt-related costs. We calculate the bad debt for PPM customers.[34] We do not add on any additional working capital or debt administration costs for PPM customers.

4.29 The estimated allowance values (based on the methodology described here) for each cap period (8 to 11b) are below. The allowances for each component at benchmark consumption are given, as well as the total.[35]

4.30 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:

- Our August 2023 decision on allowance for Additional Support Credit bad debt costs introduced an additional allowance for bad debt arising from the provision of 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 during cap period 11a-12b.[36] This means the debt-related costs allowances have been increased for PPM customers.
- 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).

[34] The PPM uplift is a part of the payment method uplift that captured additional PPM costs relative to direct debit.
[35] As explained in the notes to the table, the TDCVs used in the price cap have changed over time.
[36] Ofgem (2023), Allowance for additional support credit bad debt costs. https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs

Table 4.2: Debt-related costs cap allowances (annualised, £ per typical dual fuel customer at benchmark consumption)[37]

		Cap 8	Cap 9a	Cap 9b	Cap 10a	Cap 10b	Cap 11a	Cap 11b
Bad Debt	DD	21.44	36.72	43.90	34.36	22.69	21.21	22.16
Bad Debt	SC	78.95	140.37	169.18	130.30	83.21	77.00	80.86
Bad Debt	PPM	0.06	-0.03	-0.03	-0.11	-0.11	6.78	6.78
Working Capital	DD	-7.37	-13.23	-16.06	-12.32	-7.78	-7.16	-7.53
Working Capital	SC	34.51	62.23	75.13	57.53	36.31	33.47	35.22
Working Capital	PPM	3.31	5.99	7.18	5.45	3.39	3.15	3.34
Debt Administration	DD	10.19	10.71	10.71	11.14	11.14	11.50	11.50
Debt Administration	SC	16.00	16.81	16.81	17.48	17.48	18.05	18.05
Debt Administration	PPM	8.33	8.75	8.75	9.10	9.10	9.40	9.40
All Allowance	**DD**	**24.27**	**34.20**	**38.55**	**33.18**	**26.05**	**25.55**	**26.13**
All Allowance	**SC**	**129.47**	**219.41**	**261.11**	**205.31**	**137.00**	**128.52**	**134.13**
All Allowance	**PPM**	**11.70**	**14.71**	**15.90**	**14.45**	**12.39**	**19.34**	**19.52**
Price cap	DD	2,027	3,653	4,414	3,381	2,134	1,978	2,080
Price cap	SC	2,160	3,873	4,675	3,588	2,275	2,110	2,217
Price cap	PPM	2,074	3,710	4,491	3,424	2,135	2,002	2,109
Allowance %	**DD**	1%	1%	1%	1%	1%	1%	1%
Allowance %	**SC**	6%	6%	6%	6%	6%	6%	6%
Allowance %	**PPM**	0.6%	0.4%	0.4%	0.4%	0.6%	1.0%	0.9%

Notes: These values are at benchmark consumption (electricity 3,100 kWh, gas 12,000 kWh) – this is different to the TDCV (Typical Domestic Consumption Value) at which we announce the cap as part of our press material. 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 and 11b includes £8.77 for ASC.

[37] This table is the same as the table (6.2) in the October 2023 policy consultation, except it has data added for cap 11b. The table here is based on benchmark consumption to align with those price cap values used in the price cap model, so the price cap figures here are the dual fuel (including VAT) price cap figures from the published model (historical level tables).

Summary of stakeholder responses

4.31 Two suppliers raised concerns relating to the appropriateness and simplicity of our calculations, saying that the data we had was not precise enough to allow an accurate estimate and we should adopt a more cautious approach, such as a weighted average.

4.32 One consumer group thought our methodology was reasonable, but found it unclear how it related to the information in figure 4.1 of the consultation.

Considerations

Accuracy of our allowance estimates

4.33 Two suppliers raised concerns with our estimates, stating there were a number of issues within them. Such as: the benchmark supplier for operating costs may not be appropriate for debt-related costs and our cost calculations being too simplistic and not transparent as to why we have calculated our costs at supplier level. Due to the uncertainties in the estimation, it was suggested the weighted average should be used and that a lower quartile would require more accurate data.

4.34 One supplier agreed with our approach to estimating the allowance for this as it is a temporary adjustment, but highlighted a need for a different approach for a more permanent measure.

4.35 One consumer group believes the overarching methodology we showed was reasonable, however, it was unclear how this methodology or the table given translated to the information provided in figure 4.1.

4.36 The methodology provided in this chapter and Chapter 6 of our October 2023 consultation are used to determine the input values which determine our estimate of suppliers' debt-related costs allowances. The debt-related costs allowance is represented by the orange bars in Figure 4.1 of our October 2023 consultation. We subtract the debt-related costs allowances from reported costs to calculate the costs suppliers incurred beyond the cap allowance.

4.37 Suppliers said it may not be appropriate for debt-related costs and our cost calculations being too simplistic and not transparent as to why we have calculated our costs at supplier level.

4.38 We do not consider our approach has been overly (or insufficiently) influenced by the impact of government support between cap 9a and 10a. We have looked at the actual debt-related costs of suppliers in all the periods that we are considering (those after the gas price increase and after the Covid-19

adjustment). Where we have considered a forward-looking adjustment, we will use data from cap 10b that was not affected by the EBSS or EPG.

4.39 We have selected benchmark suppliers to be representative and not outliers for these estimates. We have estimated the allowances using the best data we have for each of the debt-related costs and consider that the data for all three costs is of a sufficient standard to be used for this purpose. Further detail on our approach will be outlined in the following chapters.

ASC existing allowance

4.40 One supplier commented on our approach to the ASC additional allowance, including the setting of the baseline and the inclusion of a contribution towards ASC bad debt costs from the price cap headroom allowance. These issues will be considered within the ASC true-up process.

Wider allowance

4.41 One supplier said that it would like to see an alternative approach adopted as part of an enduring solution under the operation costs review. A different supplier said that the need to estimate the existing debt-related cost allowance exposes a flaw in the price cap methodology.

4.42 We acknowledge that the current set up of the debt-related costs allowance within the price cap does not make it simple to estimate them, however the operating costs review will consider how an enduring basis how debt-related costs allowance will be included in the cap with a decision currently expected in winter 2024/25. For the purpose of identifying a baseline to compare costs to, we consider that estimating the overall debt-related cost allowance is the most robust approach.

4.43 Two suppliers said that they would not be able to carry out a review of our approach to estimating the allowance until we share the model which estimates the allowances.

4.44 As we discussed in Chapter 2, we consider that there is enough information in this chapter and Appendix 1 for stakeholders to engage in the methodology, which we have undertaken to estimate the debt-related costs allowances, which are used to baseline costs.

4.45 One supplier noted the limitations in terms of the data availability to estimate the allowance, increasing the risk that we benchmark against an unrepresentative

number. As such it said that we should use a weighted average to account for potential inaccuracies in the allowance.

4.46 We do not consider that limitations in the data quality to estimate the debt-related costs allowances should decide which benchmark we use when comparing costs against allowances. This would not be in customers interest of customers and potentially overestimate the adjustment for setting a float. We discuss our considerations for benchmarking in the following chapter.

4.47 A consumer group is concerned about an over allocation of debt-related costs in cap period 9a and 9b. They believe that there has been a significant over allocation of costs during this period due to not considering the impact of UK Government schemes to subsidise energy bills.

4.48 We have considered government support packages as part of our calculations and allowances; so we do not agree that this may be causing the small over-allowance. To estimate the debt-related costs allowances we used supplier revenue which included EPG revenue. This captured the full allowance rather than just the allowance related to what customers paid at the time.

Calculating and benchmarking costs

Section 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.

Context

Calculating net costs

5.1 Through this review, we seek to consider whether efficient costs have materially and systematically deviated from the allowances in the cap. To assess whether this has been the case, we compare suppliers' costs to the provided allowances.

5.2 There are two calculation elements to our analysis: (1) estimating the debt-related cost allowances provided through the cap; and (2) estimating the costs suppliers have incurred. In the previous chapter, we set out our approach for estimating the debt-related cost allowances in the cap.

5.3 We have used data from the latest RFI (October 2023) to calculate and benchmark costs.

Assessing suppliers' debt-related costs

5.4 We have used data collected from the October 2023 debt-related costs RFI to calculate the value of the proposed adjustment. We requested debt-related costs data from January 2017 – September 2023 from suppliers with at least 100,000 default tariff customers.

5.5 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.

5.6 Over the course of the bad debt review we have requested data from suppliers four times through mandatory RFIs and have collected data from 12 suppliers.[38] We have performed checks on the data against suppliers' previous submissions to identify unexplained anomalies and we have compared breakdowns against other suppliers for consistency.

5.7 We have held bilateral meetings with suppliers to discuss data submissions and written responses. Overtime this has led to resubmissions from numerous suppliers, in particular in relation to the working capital question following our October 2023 consultation.

5.8 We have included 10 suppliers out of a possible 12 in our overall sample.[39] Two suppliers were excluded as they were not able to accurately apportion revenue data by payment method. Revenue splits by payment method are required to estimate each suppliers' debt-related costs allowance, since it is not uniform across payment methods.

5.9 In our October 2023 consultation, we provided a breakdown of each debt-related cost net of the allowance for cap periods 8-10b. In the following section, we outline how we used data from the October 2023 RFI to calculate each of the three debt-related costs. In Appendix 2 we explain our calculations in more detail.

5.10 Some of the individual cap period numbers do not match equivalent tables in our October 2023 consultation for three reasons. 1. we now subtract the allowance away from the cost rather than the cost from the allowance which means that the direction has reversed, 2. we now subtract suppliers' specific allowance from their costs, whereas in the October 2023 consultation we subtracted the weighted average allowance, 3. we now divide all cap periods' data by cap period 10b customer numbers rather than each cap periods own customer numbers to allow comparison.

5.11 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.

Calculating bad debt costs

5.12 We began by taking the difference between a supplier's bad debt charge and the level of allowance that a supplier would have received to calculate the net bad

[38] The purpose of each additional RFI was to collect 3 extra months of outturn data.
[39] This is before restricting the sample which is discussed later in this chapter.

debt costs each supplier faced for each cap period. Note in the case of bad debt, this was mostly an under-allowance as Figure 3.1 shows. We then took the following steps to calculate a number of statistical metrics:

- Weighted average: for each individual cap period 8-10b we summed up the net bad debt costs across all suppliers within our sample. We then divided the net bad debt costs by the total number of default tariff customer accounts in cap period 10b to determine the weighted average net bad debt cost per cap period.[40]
- Median/Lower quartile: for each supplier in our sample, we calculated the net bad debt costs per customer account using cap period 10b customer numbers. We then took the 50th percentile and 25th percentile supplier for each cap period to calculate the median and lower quartile respectively.[41]

Table 5.1: Net bad debt costs by benchmark and cap period

	Cap period 8	**Cap period 9a**	**Cap period 9b**	**Cap period 10a**	**Cap period 10b**	**Overall**
Weighted average	4	1	-2	13	10	26
Median	5	1	-1	12	9	26[42]
Lower quartile	1	-8	-3	2	7	10[43]

Note: £ per typical dual fuel default tariff customer. Positive number signals under-allowance. This table does not include a forecast and is for illustrative purposes.

5.13 There is high variability in bad debt costs for suppliers, as can be seen by the wide dispersion between the weighted average and lower quartile. We estimate that there was an under-allowance for bad debt, at £26 per typical dual fuel customer on a weighted average basis. At the lower quartile, however, the under-allowance is significantly lower, equal to £10 per typical dual fuel customer.

[40] We used cap period 10b default tariff customer accounts as an estimate for the current number of customer accounts that any allowance would be recovered over.
[41] For the purpose of these tables, we took a simple lower quartile, ie selecting one lower quartile supplier(s) per cap period, rather than one supplier to be the lower quartile supplier for all columns.
[42] N.B: total median ≠ sum of cap 8-10b median since we select one total median supplier (rather than a different median supplier for each cap period).
[43] N.B: total lower quartile ≠ sum of cap 8-10b lower quartile since we select one total lower quartile supplier (rather than a different lower quartile supplier for each cap period).

5.14 This partly reflects suppliers' different provisioning methodologies (eg the level of optimism on recovery a supplier builds into its assumptions). It could also reflect the differences in their payment method mix and we expect that a supplier with a higher than average proportion of direct debit customers to have lower costs, thus making it more likely to be selected as the lower quartile supplier in our sample.

5.15 Cap periods 8-9b included significant government interventions such as the EBSS and EPG, leading to a discontinuity between the level of under/over allowance in cap periods 8-9b and 10a-10b.

Calculating debt-related administrative costs

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

5.17 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 the debt-related administrative cost per customer is equal between default tariff and fixed tariff customers, but is a necessary assumption for the approach.

Table 5.2: Net debt-related administrative costs by benchmark and cap period.

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

Note: £ per typical dual fuel default tariff customer. Positive number signals under-allowance. This table does not include a forecast and is for illustrative purposes.

5.18 The table above shows that there has consistently been an over-allowance in debt-related administrative costs from cap period 8-10b, regardless of which benchmark is chosen. There is less variance over time relative to the bad debt charge, with debt-related administrative costs remaining fairly stable over the period. As these costs are more stable across suppliers, this may indicate there is a smaller impact from variations in suppliers' approaches or customer bases.

Working capital costs

5.19 To calculate the net working capital costs:

- First, we take the average accounts receivables / payables at the start and end of the period
- This is multiplied by the cost of capital assumption of 10% and then divided this by the number of customers in cap periods 8-10b;[44]
- We then calculated the net working capital cost figure per customer by subtracting the accounts payables from accounts receivables;
- Finally, we scaled the net working capital cost 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.[45] The non-customer working capital cost is included since the EBIT allowance encompasses it. Suppliers will employ working capital which relates to timing differences between incurring costs and customer payments (eg due to customers paying in arrears). We refer to this as customer working capital. Suppliers also employ working capital elsewhere in their business (eg relating to the timescales for paying firms who provide them with services), which we refer to as non-customer working capital.

5.20 We then followed the same steps as described in the bad debt charge section to calculate the benchmark costs for working capital costs. However, 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, to enable consistent comparison to the allowance, which is calculated for default tariff customers only.

[44] 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.
[45] 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.

Table 5.3: Net working capital costs by benchmark and cap period.

	Cap period 8	Cap period 9a	Cap period 9b	Cap period 10a	Cap period 10b	Total
Weighted average	-2	-3	-3	0	1	-7
Median	-2	-3	-3	-1	2	-7
Lower quartile	-4	-4	-4	-1	0	-13

Note: £ per typical dual fuel default tariff customer. Positive number signals under-allowance. This table does not include a forecast and is for illustrative purposes.

5.21 The table above indicates that there has consistently been an over-allowance for working capital costs up to cap period 10a, under most metrics. However, we have seen a change in cap period 10b where the data suggests an under-allowance on a weighted average and median basis and no divergence in allowance for the lower quartile. When looking across the entire period, the overall impact is an over-allowance under all statistical measures.

5.22 Some suppliers have resubmitted working capital data since our October 2023 policy consultation. This led to us clarifying with other suppliers about their non-customer working capital position. As a result, data revisions led to a decrease in a couple of suppliers' working capital costs, which in turn reduced the weighted average working capital costs causing an over-allowance when using a weighted average benchmark.

Benchmark options

5.23 In our policy consultation, we considered three options as set out below:

- **Option 1: A benchmark at the lower quartile:** For each supplier in our sample, we would calculate their net 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. We would benchmark bad debt at the weighted average, while benchmarking debt-related administrative and working capital costs at a lower quartile. Our initial preference as set out in our October 2023 policy consultation was for this option. This was because it retains flexibility and may better account for

the different trends in the three cost components of debt-related costs. Also, we considered 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.

5.24 There are other factors we must consider when benchmarking costs, such as: whether we benchmark the three debt-related costs together and whether we benchmark we period individually.

5.25 As we discussed in Chapter 3, we are proposing to set the float to cover October 2023 – March 2024 based on rolling forward the data from cap period 10b (July 2023 – September 2023). For the purposes of benchmarking, we roll forward cap period 10b under allowance into cap periods 11a and 11b before benchmarking the total cost.

Table 5.4 – Options for benchmarking net debt-related costs

	Overall	**Of which bad debt**	**Of which debt-related administrative costs**	**Of which working capital costs**
Lower quartile	11	29	-14	-4
Weighted average	36	47	-7	-4
Hybrid	24	47	-8	-14

Note: Benchmark options include forecasted allowance for cap periods 11a-11b. £ per typical dual fuel default tariff customer. Positive number signals under-allowance.

5.26 The table above shows the lower quartile calculated on the full sample of suppliers. In the considerations section, we discuss the impact of restricting the sample of suppliers.

Proposals

5.27 We propose to set a lower quartile benchmark over the combined additional debt-related net costs of total debt-related costs. We consider that this is more appropriate than an average or hybrid benchmark, as it will keep the float allowance stringent and allows us to consider the three types of costs together. We consider this will protect default tariff customers in line with the objective of

the Act, whilst allowing a supplier to recover its efficient costs and maintaining incentives for effective debt management.

5.28 We also propose to benchmark total net costs across the periods rather than considering each cap period individually given that provisions are refined over time, so debt-related costs in different cap periods are interrelated.

5.29 For this particular float adjustment, we are aware of the potential impact for non-efficiency factors to influence a lower quartile calculation, so we have excluded suppliers with a particularly unusual customer base on the basis we can only set a single cap level for a notional supplier.

5.30 These proposals give a benchmark value of £14 per customer once the sample is restricted.

Summary of stakeholder responses

5.31 All suppliers who responded to our October 2023 consultation supported an average benchmark. One of these suppliers said that we should consider a flat average approach alongside a weighted average.

5.32 Two suppliers recommended that we didn't include debt admin due to data issues, low materiality and it adding unnecessary complexity. One of these suppliers would prefer working capital costs to be excluded as well. Whereas the other supplier stated that if we are to include working capital costs, then we should dismiss the option of using the median or lower quartile deviations in our analysis.

5.33 We received little engagement in benchmarking from consumer groups and charities, however it is worth noting that consumer groups and charities opposed setting an adjustment. Of those that did engage, one supported a hybrid approach, and another said that efficiency should be defined at lower quartile unless there is compelling evidence to move away from this. It did accept that there is more evidence to move away from lower quartile for bad debt.

5.34 Opposition to the hybrid approach from suppliers focused around:

- 1) the absence of one overarching consistent approach to benchmarking for each debt-related cost component, which one stakeholder described as 'cherry-picking';
- 2) this allowance adjustment addresses costs that have *already* been incurred, or are being incurred, so a more stringent benchmark cannot incentivise efficiency; and
- 3) it creates an unachievable benchmark for any supplier, as discussed below.

5.35 A number of respondents also emphasised the need for us to consider the impact of customer mix on the benchmarking options, to avoid benchmarking unrealistically at a supplier with a high proportion of direct debit customers who would be expected to have lower debt-related costs.

Considerations

Stringency of benchmark

5.36 The benchmark metric is a tool for setting the stringency at which we intend to set the allowance. Over the course of the cap, we have used a number of approaches. For example, when setting the operating cost allowance and payment method uplift in 2018 we benchmarked costs at the lower quartile reflecting we were setting a cap that incentivised efficiency and increased protection to customers. Since then, we have deviated at times from using a lower quartile benchmark, for example we set the COVID-19 adjustment based on a weighted average, reflecting the novel and uncertain nature of the situation.

5.37 In setting this initial float, we must balance a number of factors including: the level of protection for customers, allowing suppliers to recover efficient costs for example for resilience, continued incentives for suppliers to effectively manage debt and supporting investability in the sector. These factors ultimately all affect customers.

5.38 We consider that using a lower quartile approach to set the float strikes the best balance in this situation. It reduces the immediate impact on customers' bills, noting a weighted average approach would further increase bills by £24. The approach also allows suppliers to begin recovering additional efficiently incurred costs, which will improve resilience, particularly where suppliers are forecasting losses. It also maintains incentives for suppliers to effectively manage debt, including taking actions such as trying to move customers back to cheaper payment methods (eg from standard credit to direct debit).

5.39 We note the supplier comment that these costs are historical. However, suppliers can still take actions to manage debt-related costs efficiently in future cap periods. We therefore consider that we should be cautious about sending signals which might reduce suppliers' incentives to effectively manage debt.

5.40 Suppliers have previously said that retrospective downward adjustments to the cap creates regulatory uncertainty. We are not expressing a position on this feedback here. However, taken on its own terms, this feedback would suggest that it would be preferable to reduce the likelihood of downward adjustments, by

setting the float in a more stringent manner even if we were to reconsider the approach to benchmarking in the true-up.

5.41 While this approach does depart from the benchmark approach taken for the COVID-19 adjustment, we consider the current situation is less novel and has a greater interaction with suppliers enduring approach to dealing with debt-related costs. Suppliers should have built up additional processes to manage spikes in debt-related costs after COVID-19. We therefore do not think the approach taken for the COVID adjustment sets a definitive precedent for this circumstance.

5.42 We will revisit the benchmark approach both in the true-up for this debt-related cost review and in the operating cost review, where we intend to review the enduring allowances in the cap. This would allow us to consider whether a different level of stringency is preferable.

5.43 One supplier said that adopting a lower quartile risk under-investment in debt management process which could lead to unintended consequences.

5.44 We consider that suppliers have an incentive to invest in their own debt management processes which could enable them to improve efficiency and recover additional costs relative to the allowance, whist supporting customers in need.

5.45 One supplier highlighted their concerns that there seems to be a significant risk of under-recovery across the industry, given recent cost of living pressures and bad debt costs. It said given the consultation was initiated to recognise supplier challenges due to deteriorating patterns of customer payment, this consultation process should result in a higher overall allowance.

5.46 Despite the ongoing cost of living pressures which has increased debt and arrears in the market, we still consider a stringent benchmark would be appropriate to incentivise efficiency. Our proposed additional allowance is based on the data provided by suppliers.

5.47 One supplier said that we should consider the industry when benchmarking. It said that it could be preferrable to use a flat average, given the market has two large suppliers which could give an outsized impact.

5.48 We consider that a flat average would be less preferable than a weighted average because it is more affected by outliers. At the end of this chapter, we have included box and whisper plots to show the net debt-related costs and within these it also displays both the mean and median.

Benchmarking across costs and cap periods

5.49 Four suppliers said that the three debt-related cost components were interlinked and argued that a weighted average across each component (option 2) was the only way to deal with the interplay between these cost components.

5.50 While we consider that debt-related costs are linked and that suppliers spending more money in one area could reduce costs in another area, we do not consider that a weighted average approach is the only option to account for this interlinkage.[46] Using a combined lower quartile approach, where we would select one benchmark supplier based on suppliers' total costs, rather than benchmarking each debt-related cost on its own. This would ensure that we were accounting for interlinkages between a supplier's debt-related costs.

5.51 A similar point applies to benchmarking costs over the cap periods. Provisions in one period may be related to provisions in other periods, particularly as a supplier would refine its position over time. For example, a supplier might expect a high level of non-payment and set provisions accordingly, then may refine this position down in the following period. If we were to benchmark each period individually, we would risk capturing optimism in each period and setting a benchmark that may be unachievable by an efficient supplier across the period.

Cost of capital

5.52 Three stakeholders referenced the recent EBIT margin decision, stating that the cost of capital should be set at 12.3% (as opposed to the current 10%) when calculating the over or under allowance in 2022/23.[47] One response argued that Ofgem used historical data from the same time period as the bad debt RFIs to determine the higher cost of capital in that decision.

5.53 The revised EBIT cost of capital was implemented from 1 October 2023 (cap period 11a onwards) so it is not in force for the period of costs which are currently in scope of this review.[48]

[46] Such as higher administrative costs reducing bad debt costs.
[47] Ofgem (2023), Amending price cap methodology for Earnings Before Interest and Tax (EBIT) allowance decision. https://www.ofgem.gov.uk/publications/amending-price-cap-methodology-earnings-interest-and-tax-ebit-allowance-decision
[48] Ofgem (2023), Amending price cap methodology for Earnings Before Interest and Tax (EBIT) allowance decision. https://www.ofgem.gov.uk/publications/amending-price-cap-methodology-earnings-interest-and-tax-ebit-allowance-decision

5.54 Therefore, we do not consider it is appropriate to deviate away from the 10% cost of capital, given historically the cost of capital in the cap was set using a 10% cost of capital. During the true-up phase, we will consider whether to use the updated cost of capital for costs associated with cap periods 11a onwards.

Inclusion of forecasted costs

5.55 We considered the following methods for how to include forecasted costs in our benchmark calculation:[49]

- Include forecasted winter 23/24 costs prior to benchmarking (proposed option);
- Benchmarking cap periods 8-10b costs, then add in forecasted cost for the benchmark supplier(s);
- Benchmark cap period 8-10b costs, then separately benchmark forecasted costs.

5.56 We are proposing to use the cap period 10b net debt-related cost as an estimate for the costs in cap period 11a and 11b. This is inherently an approximation due to changes in the cap level and demand profile.

5.57 When considering the options for including these costs in the benchmark, we are therefore seeking to use a reasonable approximation, reducing the impact of individual suppliers' provisioning approaches for cap 10b. This is desirable because provisions in different cap periods are not independent of each other, meaning that a supplier's provision in cap period 10b will be affected by its provisions in previous cap periods.

5.58 We propose to adopt option 1, because this avoids considering cap period 10b costs in isolation. It is therefore least likely to be distorted by differences in provisioning approaches.

Controlling for customer base characteristics

5.59 Differences in the make-up of suppliers' customer base can have an impact on their costs, which can be in part out of their control. These can be factors such as the number of vulnerable customers and the proportion of customers on different payment methods. For example, when setting the operating costs allowance in 2018, we discussed the impact of the number of priority services register (PSR)

[49] In each option, we forecasted the cap period 11a-11b net cost to be equal to the net cost in 10b for each debt-related cost.

customers and the number of paper billing customers on suppliers' operating costs.

5.60 We have identified through the RFI data and supplier feedback that debt-related costs are likely to be in part related to payment method. In particular, those associated with standard credit customers are likely to be significantly greater than other payment methods.

5.61 This is intuitive given standard credit customers pay in arrears, which causes higher working capital costs and the lack of automatic payments increases the risk of non-payment and eventual bad debt. When serving direct debit customers, customers generally pay money in advance, which means that direct debit customers can at times generate a working capital benefit, particularly in the summer when energy consumption is lower than monthly payments. Direct debit payments are automatic, which reduces the likelihood of non-payment and in turn means reduces direct debit working capital costs relative to standard credit.

5.62 However, we note that cancellations of direct debit or non-payment under direct debit will trigger a move to standard credit for that customer. This may lead to costs being allocated to standard credit customers and an underrepresentation of costs for direct debit customers.

5.63 Setting a lower quartile is more sensitive to the relative ordering of suppliers' costs relative to using a weighted average, so simply adopting a lower quartile benchmark across all 10 suppliers in our sample could benchmark costs at a supplier with a high proportion of customers which are less costly to serve (ie non-efficiency factors), such as more direct debit customers.

5.64 We consider therefore that, if we were to select a lower quartile benchmark, then we will consider the impact of payment type mix on our benchmarking methodology. This will account for some of the variation between suppliers' costs which is driven by factors other than efficiency.

5.65 In the table below we present two combined lower quartile benchmarks. The standard lower quartile benchmark includes all 10 suppliers within our sample whereas the restricted benchmark has a more stringent sampling criteria which only the 6 largest suppliers within the sample. We consider that the 6 largest domestic energy suppliers have a more typical mix of payment methods than other suppliers. It would also avoid us benchmarking at a non-typical supplier for example a PPM specialist.

5.66 We propose using the restricted lower quartile benchmark and setting an allowance at £14 per typical dual fuel customer. The lower quartile supplier that

sets the benchmark in the restricted sample is reflective of the market and has an average mix of payment method. In Chapter 7, we discuss how we propose to allocate this among payment method.

Table 5.5: lower quartile benchmarks

	Overall	**Of which bad debt**	**Of which debt-related administrative costs**	**Of which working capital costs**
Lower quartile	11	29	-14	-4
Restricted lower quartile	14	35	-14	-8

Note: Benchmark options include forecasted allowance for cap periods 11a-11b. £ per typical dual fuel default tariff customer. Positive number signals under-allowance.

5.67 The final three columns represent how much of the lower quartile is made up by each debt-related cost, using the benchmark supplier(s) cost breakdowns to show stakeholders how much of the overall benchmark cost is from bad debt, debt-related administrative and working capital costs.

Box and whisker plots

5.68 We have included a box and whisker plot below for each debt-related cost and one which shows the overall net cost. Each box and whisker show the range of net costs. The box indicates the interquartile range (75th percentile minus 25th percentile), the median is represented by a horizontal line and simple average by a cross. Please note that the scales do not align between charts.

5.69 Bad debt makes up a most of the net costs in our adjustment. As the chart shows, restricting the sample for bad debt removed outlier suppliers (on either side of the distribution) providing further evidence that there is an interaction between bad debt and payment method. This has the intended impact of reducing the variance in the sample.

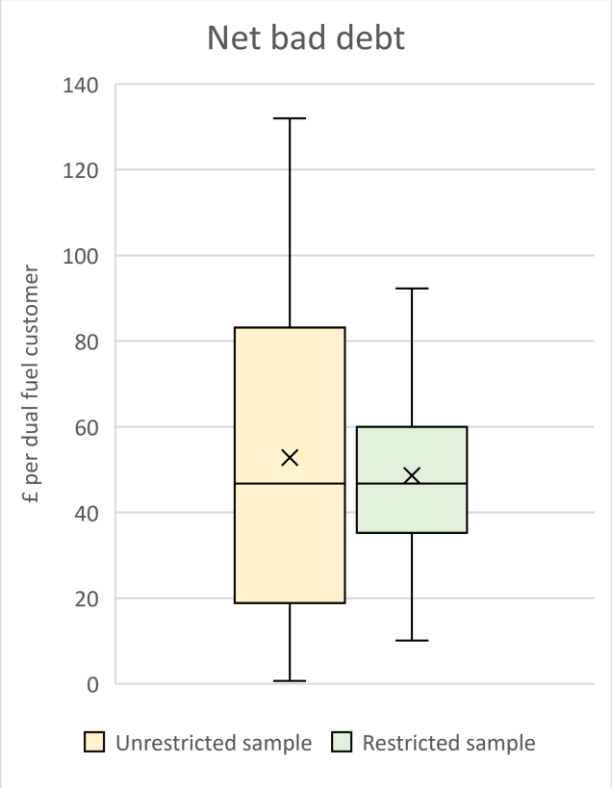
5.70 Whereas when looking at debt-related administrative costs, the box and whisker plots does not significantly change between sampling choice, showing that the variation in outcomes between suppliers is less likely to be driven by payment method or company size.

5.71 There is more variation in working capital costs, restricting the sample reduces that variance but reduces the lower quartile estimate of working capital. This

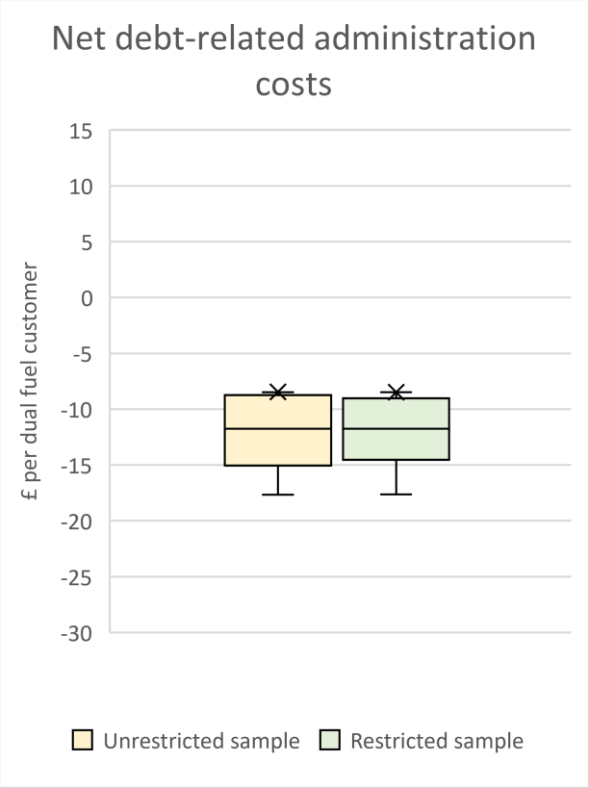
suggests that other factors, beyond payment method and supplier size, affect the variation in outcomes between suppliers. We consider that this is acceptable because the remaining suppliers reflect the characteristics (in terms of payment method and supplier size) of the majority of the market. We also do not consider that the variation in working capital costs is important in itself, because we are proposing to benchmark on the combined debt-related costs. The level of working capital over-allowance is smaller in absolute terms than the under-allowance on debt.

5.72 We consider that our approach to benchmarking helps us to set an appropriate float and mitigates the risk of understating efficient costs. The bottom right box-plot shows that restricting the sample on the combined costs reduces the spread of costs and increases the lower quartile estimate in the way we would expect. Additionally, benchmarking combined costs still yields a larger adjustment than benchmarking each of the costs individually, so we are confident we are not creating an unachievably low benchmark.

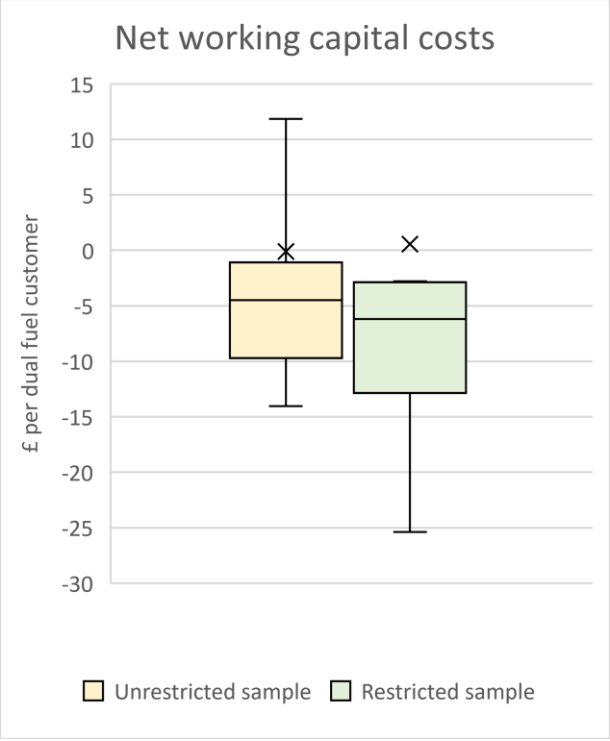
Figure 5.1 – Box plots of the debt-related costs



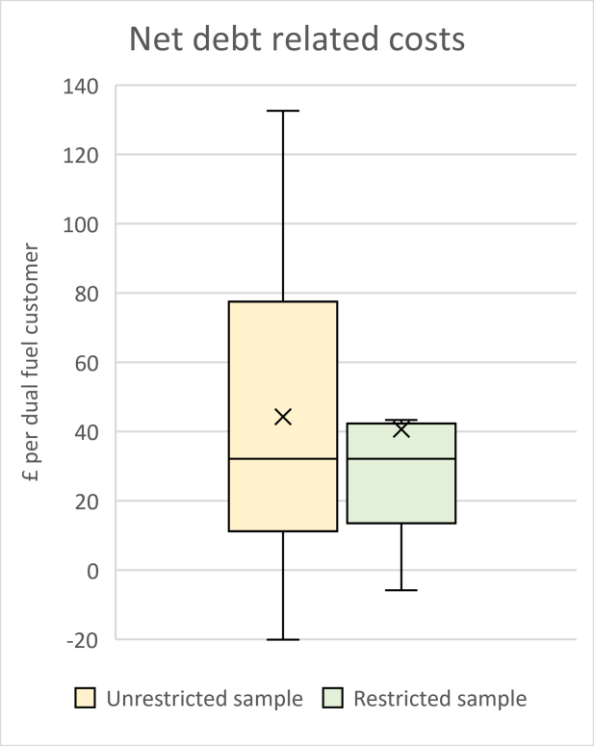
Full sample weighted average for bad debt is £47



Full sample weighted average for DAC is -£7



Full sample weighted average for WC is -£4



Full sample weighted average for net DRC is £36

The above four box plot graphs show the spread of data for the following net costs: bad debt, debt-related administration, working capital and debt-related costs.

Allocation of the allowance

Section summary

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

Context

6.1 The cap varies by a number of parameters (eg fuel and payment method). When setting the allowance for debt-related costs, one of the things we consider is whether the underlying costs vary by these parameters. For example, whether the propensity to build debt is related to a customer's payment method or fuel type.

6.2 In our 2018 decision on payment method uplift, we determined that payment method may be one driver of debt-related costs.[50] To that extent the cap currently includes an uplift under standard credit customers for debt-related costs of £130 per typical customer.[51] However, when setting this differential in 2018 for the enduring payment method allowances, we decided to reallocate some of the costs reported for standard credit customers to direct debt because allocating all additional costs to standard credit customers would have resulted in a larger differential than the level seen in the market at the time the cap was set.[52]

6.3 More recently, 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 considered that we needed to strike a balance when applying cost-sharing across credit customers as at an individual level, we said that a standard credit customer who pays their bill is not more responsible for higher debt-related costs than a direct debit customer who pays their bills.[53] We also decided to allocate current reported PPM debt-related costs to credit

[50] Ofgem (2018), Appendix 8 – Payment method uplift.
https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[51] SC = £2,058; DD = £1,928 at current 2023 TDCV.
Ofgem (2023), Energy price cap level: 1 January 2024 to 31 March 2024.
https://www.ofgem.gov.uk/publications/energy-price-cap-default-tariff-1-january-31-march-2024
[52] Ofgem (2018), Appendix 8 – Payment method uplift, paragraph 2.39.
https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[53] Ofgem (2023), Decision on the true-up process for COVID-19 costs, paragraph 6.25.
https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs

customers, due to evidence that the vast majority of PPM debt was accrued originally on credit meters.[54]

6.4 PPM customers can incur debt when they receive ASC which is a fixed amount of credit provided to domestic customers in a vulnerable situation when that domestic customer's PPM credit runs low or runs out, to ensure continuity of supply or return on supply.[55] This is typically of low value, and we introduced an initial 12-month allowance for expected ASC bad debt in cap period 11a worth approximately £9 per typical PPM customer.[56]

6.5 As we have identified, the difference between debt-related costs 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. We also need to consider how the allowance is recovered over fuels, electricity meter types and on standing charge or unit rate.

6.6 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.

Data limitations

6.7 We collected data on debt-related costs split by payment method. However, we identified some limitations in how suppliers were able to allocate costs in their submissions over payment type.

6.8 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) because bad debt allowances are built up at the point of consumption against a future risk. However, the majority of suppliers have confirmed they do not hold data at the point of billing, only data on the customers' current payment

[54] 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
[55] ASC is only one type of PPM credit under the licence. Customers will typically be able to request emergency or friendly hours credit to avoid self-disconnection first which is usually much lower than ASC. Under the gas and electricity supplier SLCs, suppliers are required to give other forms of credit as well. Emergency credit is a fixed amount of credit provided to customers when their meter runs low, or runs out, to ensure continuity of supply. Friendly hours credit is provided overnight, at weekends and public holidays, when top up points may be closed, and a customer's PPM runs low or runs out.
[56] Ofgem (2023), Allowance for additional support credit bad debt costs.
https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs

method. This is likely to over-allocate costs to PPM customers and standard credit customers because customers can move onto these payment methods when they get into payment difficulties.

6.9 One desirable feature for allocation could be to reflect which payment methods costs were incurred on. To the extent that this is our aim, we would need to take into account the data limitations when deciding how to allocate costs.

6.10 Additionally, some suppliers were unable to allocate non-customer working capital costs between payment methods.

Proposals

6.11 We propose to allocate the costs of the additional allowance equally (ie the same pound per typical customer uplift) on credit customers, those whose payment method is either direct debit and standard credit, while allocating zero cost to PPM customers. This would increase direct debit and standard credit bills by £16 at benchmark consumption.

6.12 We propose to allocate all the costs of the allowance only on to the unit rate with no increase in the standing charge.

6.13 We propose to equally allocate between fuel types proportionally to the breakdown of the cap period 11b cap level for gas and electricity. This means we allocate 48% of the adjustment to gas and 52% to electricity.

6.14 We propose to keep the same total cost recovery between single and multi-register electricity meter types. This means suppliers recover £8 per customer account from both single and multi-register customers at benchmark TDCV.[57]

6.15 We propose to use the existing cap adjustment allowance ('Annex 8 – Adjustment allowance methodology') to include this additional debt-related costs allowance in the default tariff cap.

6.16 We propose to review the allocation of costs as part of the true-up exercise, particularly if we proceed with levelisation of bad debt and it is in place the true-up.

[57] N.B: A typical dual fuel customer with two customer accounts (ie one electricity and one gas) would pay £16 over the 12-month recovery period.

Options

6.17 The main options we have considered for this consultation for allocating the adjustment over payment methods are below. We also explain the calculations behind them in Appendix 2:

- Equal allocation: 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. This was known as Option 1 in the October 2023 consultation.
- Reported cost allocation: Allocate costs to the payment method which suppliers reported those costs on. This was known as Option 5 in the policy consultation.
- Allowance allocation: Allocate the additional allowance across payment methods in the same proportion as the existing debt-related costs allowances in cap period 11a. This is a new option relative to our October 2023 consultation.

6.18 Table 6.1 shows the impact on the cap levels per payment method. The equal allocation option has the greatest impact on direct debit customers but minimises the impact on standard credit and PPM. By comparison, the reported cost allocation option yields a significant bill increase for standard credit and PPM customers. The allowance option provides some middle ground between these two, keeping the PPM and standard credit impact relatively small but still a significant increase to standard credit customers – we've analysed the impact of this on different groups of customers in Chapter 7.

Table 6.1 - Options for allocating costs between payment methods

Payment method	Equal allocation (proposed)	Allowance action	Reported cost allocation
Direct debit	£16	£8	-£12
Standard credit	£16	£40	£90
PPM	£0	£6	£30

Note: £ per typical dual fuel customer at Benchmark Consumption. Positive number signals an under-allowance and increase to the cap.

Streamlining options

6.19 In this section we focus on options 1 and 5 from the policy consultation, given stakeholder support as well as the new allowance option. In Appendix 4 we discuss feedback on options 2-4.

Summary of stakeholder responses

6.20 The equal allocation option received the most support from suppliers, consumer groups and charities, with only minimal support expressed for other options. Respondents supported this option as it reduces the impact on PPM customers, standard credit customers and fuel-poor households the most. They also commented that this option would be fair.

6.21 Two suppliers favoured the reported cost allocation option as this option will is closest to reality and would minimise competitive distortions. They also noted that the COVID-19 decision should not be seen as a precedent as it smears costs among payment methods.

6.22 Five respondents agreed with allocating the other debt-related costs evenly. Nine disagreed, with some arguing costs should be allocated between credit customers only. Another respondent said debt-related costs should be allocated progressively to protect fuel poor households/low-income consumers

Considerations

Payment method allocations

6.23 The question of cost allocation in this context is important. Debt accrual is highest among standard credit payment type. By its very nature, this method allows for greater debt by granting credit to customers that may not have a regular repayment in place. In setting out an approach for allocating costs between payment methods, we seek to achieve the following outcomes:

Minimise the additional impact on the total level of debt across customers.

Protect existing and future customers on default tariffs as per our aim in the Act, and where possible consider protection for those in vulnerable situations.

Customer impacts

6.24 Respondents supported equal allocation for various reasons, including: PPM users not contributing to bad debt, the ASC bad debt decision was introduced to address debt which can be incurred on a PPM, it doesn't result in an unfair burden to standard credit customers, and it reduces the impact on fuel-poor households the most.

6.25 Four respondents said no approach should result in the addition of costs to PPM customers.

6.26 One respondent said they were unable to consider the options as there has been no levelisation decision to date. This response also noted options 1 to 4 were likely to exacerbate issues around cost-reflectivity in the price cap.[58]

6.27 We are mindful of the impact our decisions have on customers, particularly as affordability remains to be a key challenge. This is one of the key reasons for proposing an equal allocation approach, which reduces the impact on both standard credit and PPM customers relative to the other options.

6.28 Evidence suggests a higher proportion of standard credit and PPM customers are vulnerable relative to direct debit.[59] However, to note there are a higher number of vulnerable customers who pay by direct debit. While we cannot avoid an impact on vulnerable customers, an equal allocation approach leads to a smaller impact per customer.

Table 6.2: Fuel poverty statistics by household (electricity and gas) 2022[60]

Method of Payment[61]	**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

6.29 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.

[58] We go into more detail on options 2-4 in Appendix 4.
[59] In particular, it can be seen from the archetype analysis in chapter 7 that the lower income archetypes are more likely to use standard credit or PPM than the higher income archetypes.
[60] 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
[61] DD = direct debit, SC = standard credit, PPM = prepayment meter.

6.30 As shown in the table above, 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.

6.31 Our proposal to use the equal allocation option yields the lowest cost on average to vulnerable customers and the lowest equity weighted costs across all customers. We elaborate on our impact analysis in the impact assessment which is in Chapter 7.

Impact on debt levels

6.32 When setting this adjustment, we seek to minimise the compounding effect on debt levels as much as possible. Allocating the majority of debt costs to standard credit customers may worsen the overall debt situation by focusing the increase on the group of customers where non-payment has been most prevalent, increasing the cycle of debt and the impacts on standard credit customers who do pay their debt.

6.33 In contrast, equal allocation would allocate a greater proportion of the adjustment to direct debit customers. All of these customers have, at least at some point, been paying regularly therefore have a greater track record of regular repayments, this is likely to reduce the risk of knock-on increases in debt. Additionally, all credit customers have the ability to build up debt and direct debit customers can become standard credit customers when they have repayment difficulties so equal allocation may be appropriate.

6.34 We have performed analysis to estimate the additional impact on debt levels as a result of increasing the cap via this additional debt-related costs allowance based on the payment method allocation options.[62] We define total debt as money owed, with or without a repayment plan, for greater than 91 days. We define bad debt as money owed that is not repaid or has no plan for repayment within 91 days, and thus has gone bad.

6.35 An increase in the debt-related costs allowance would increase bad debt by £0.6m under the equal allocation option, £1.7m under the reported cost allocation option, and £0.9m under the allowance option, resulting in higher costs to consumers.

[62] We have followed the same method for our analysis as used in the Impact Assessment conducted by the Levelisation team in their statutory consultation. Changing standing charges for prepayment meters and debt-related costs across payment methods (ofgem.gov.uk)

6.36 As a result of increasing the debt-related costs allowance, we assess that working capital requirements will increase for suppliers. Using a 12.3% cost of capital we estimate that the additional allowance will increase working capital by £2.7m under the equal allocation option, £4.1m under the allowance option and, £7.5m under the reported cost allocation option.

Table 6.3 – Impact of allocation options on bad debt and working capital costs

	Equal allocation (proposed)	Allowance allocation	Reported cost allocation
Bad debt	£0.6m	£0.9m	£1.7m
Working capital	£2.7m	£4.1m	£7.5m
Total debt-related costs	£3.3m	£5m	£9.2m

6.37 Among the different allocation options, the equal allocation option results in the lowest increase in total debt levels, whilst the reported cost allocation option presents the greatest increase in total debt levels. We outline the approach we took to calculate these impacts below.

6.38 Our assessment is based on debt levels across all domestic consumers from Q3 2023,[63] and only considers those consumers already in debt and therefore does not account for the impact on debt for consumers not already in debt.

6.39 Our approach was to first identify the total amount of debt and the number of customers in debt for each of the payment methods. Using the cost per dual fuel customer for each payment method under each allocation option, we calculated the impact each allocation option would have on the total amount of debt.

6.40 For those consumers paying more, we assumed the entirety of the additional cost would contribute towards the total amount of debt. For those consumers paying less, we calculated an elasticity of debt repayment and assumed a portion of any savings would contribute towards the total amount of debt.

6.41 In order to estimate the elasticity, we collected data on Household Debt Inequalities from ONS.[64] This gave us descriptive statistics on the proportion of people with debts, going from no debt and arrears only to four major types of

[63] Ofgem (2023), Debt and arrears indicators.
https://www.ofgem.gov.uk/publications/debt-and-arrears-indicators
[64] Office for National Statistics (2016), Household Debt Inequalities: Wealth in Great Britain, July 2012 to June 2014, Table 16.
https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/debt/articles/householddebtinequalities/2016-04-04

debt. We estimated that on average, customers in debt would dedicate 40% of their additional income to repay their energy debt.

6.42 We assess that the additional allowance will increase total debt by £21.8m under the proposed equal allocation option, £61.3m under the reported cost allocation option, and £33.4m under the allowance option.

6.43 Based on previous RFI data, bad debt has historically been 3% of total debt levels, on average which represents the amount of debt a supplier expects that it will not collect.

Debt incurred by PPM customers

6.44 We treat PPM customers separately as they build up much less debt than credit customers. PPM customers top-up their meter and pay as they use energy, therefore non-payment on the group can ultimately lead to self-disconnection rather than building up arrears to the same extent a non-PPM customers could. Therefore, any substantive debt sitting on a PPM customers account was likely to have originated while that customer was on a different payment method.[65]

6.45 There are processes in place for suppliers to provide support to customers that cannot afford to pay their bills. One common type of support is Additional Support Credit, where suppliers can provide fixed amount of credit to a domestic customer in a vulnerable situation when that domestic customer's PPM credit runs low or runs out, to ensure continuity of supply or return on supply (as we discussed previously, there are also other types of credit but these are likely to be less significant than Additional Support Credit). There is a risk that a supplier is unable to recover the credit provided to a PPM customers and this can lead to bad debt costs for customers.

6.46 We considered this risk in our decision on an allowance for Additional Support Credit in the cap. We decided that an adjustment to the cap was appropriate to allow suppliers to recover bad debt costs for PPM customers associated to Additional Support Credit. We provided an approximate £9 allowance allocated solely to PPM customers.

6.47 For these reasons, we do not think it is appropriate to allocate significant costs to PPM customers as part of this debt review. As mentioned earlier in the chapter, there are also limitations in how suppliers have allocated costs between payment

[65] This statement may not be true to each individual customer.

methods that lead us to believe there may be an over-allocation to PPM customers in the reported costs.

Supplier impacts

6.48 One supplier said that if costs are not passed through to customers based on the reported costs option then a reconciliation mechanism should be used to ensure suppliers receive the costs which they incurred.

6.49 We acknowledge that equally allocating costs means that a supplier with an average mix of customers across payment methods recovers the notional allowance, but those with a higher than average proportion of standard credit or PPM customers would under-recover the notional allowance (the opposite applies to those with lower than average).

6.50 One supplier argued that option 2 was most suitable as standard credit customers have the greatest propensity to accrue bad debt. One consumper group favoured option 4.

6.51 One supplier preferred the reported cost allocation as it avoids smearing standard credit debt onto direct debit customers' bills which would avoid exacerbating competitive distortions. One supplier stated that adopting any option other than reported cost allocation amounts to levelisation of costs, and that would require a reconciliation mechanism for suppliers to recover actual costs.

6.52 Under the Act, we must have regard to the ability for an efficient supplier to finance its supply activities. This does not mean we are required to achieve this in all cases and we are not required to act (or not act) so as to protect any one supplier. However, we have consistently recognised the impact supplier failure can have on customers through mutualisation of costs, so we do consider the impact of our decisions on supplier financability and weigh-up the likelihood of failure as one factor in our decision making.

6.53 Our analysis of supplier financial information suggests that our proposal of allocating costs equally does not put any particular suppliers at risk of failure while the adjustment is in place (April 2024 – March 2025). In general, providing an allowance will provide a boost to suppliers' financial position relative to providing no allowance, therefore our proposal still improves resilience.

6.54 For suppliers with above average PPM customers, as we discuss above, it is unlikely PPM customers build the same level of debt as non-PPM customers. To address debt built up on Additional Support Credit provided, these suppliers will benefit from the £9 ASC allowance we have provided.

6.55 Unlike our proposals on levelisation of payment method, we are not proposing to introduce a reconciliation mechanism as part of our proposal to recover costs equally across direct debt and standard credit customers. We consider that this would be disproportionate for a temporary adjustment which is less material on an enduring basis than our proposals on levelisation. However, we intend to reconsider the approach we take to allocating costs across payment methods when we carry out the true-up exercise when the levelisation reconciliation process may be in place.

6.56 By the time we carry out the true-up exercise, we expect to have clarity on implementation of levelisation of bad debt costs. If levelisation of bad debt (option 3) is in place for the true-up exercise then we will consider the further interaction between that and how we recover bad debt over payment methods.

Other debt-related costs

6.57 Two suppliers did not agree debt-related administrative or working capital costs should be in scope of this review. One stated that if they were to be included, costs should not be allocated uniformly as it would disproportionately benefit suppliers with large direct debit customer base, and said a levelisation mechanism would be appropriate. The other respondent thought if they were included then they should be apportioned the same way as the bad debt charge to avoid additional complexity.

6.58 For the reasons listed above, we still consider that the other debt-related costs should be allocated evenly among credit customers in the same way which bad debt is. Given suppliers were in general unable to consistently separate the other debt-related costs by payment method, we would have to allocate them based on assumptions.

Allocating costs between unit rate and standing charge

6.59 We expect bad debt and working capital costs to vary by consumption. The level of debt a customer builds or the amount a customer pays in arrears will be relative to their bill size, and therefore their overall consumption. We reflect this in the cap by setting the allowance for bad debt and working capital as a percentage of the other cap components. This means in the existing allowance, most of the allowance is recovered through the unit rate and a small element is recovered through the standing charge. The debt admin costs are more flat in nature, the level of a customer's debt may not have such a clear impact on the steps taken to recover it. In the existing allowance, debt admin costs are applied to the standing charge within the payment method uplift.

6.60 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.[66] 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.

6.61 We are considering the following options for allocating costs between the unit rate and standing charge:

- 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 (proposed): 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.

6.62 The majority of stakeholders supported allocating all the allowance onto the unit rate. The reasons for support included: reducing the impact on low-usage customers; bad debt risk tends to scale with usage levels making it fairer to apportion on the unit rate; and the need to ensure that whatever apportionment method is adopted is suitable or robust enough based on expected interactions with other workstreams (namely, levelisation). One respondent expressed concern that adding an allowance to the standing charge would compound the regressive effect of such changes and may distort competition between suppliers who charge standing charges and those who do not.

6.63 One consumer group stated that the costings throughout the document that reflect a typical dual fuel consumer do not take proper account of single fuel or small household consumers, for whom any increase in electricity unit, or particularly daily standing charges, will have a disproportionate impact

6.64 Four suppliers offered alternate allocation. The first supplier stated that applying the adjustment to only the standing charge is only viable if prepay is excluded from this debt allowance. However they did say that if this is not going to be the case, then it should be applied to the unit rate. Another was explicitly in favour

[66] 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

of using the current apportionment of the cap between the nil and benchmark consumption. Whilst the third supplier mentioned that debt is incurred across the whole bill covering both the standing charge and unit rate. The fourth supplier suggested we go a step further and proposed that for gas a heavier weighting should be placed on the standing charge, since gas consumption is more uncertain and dependent on temperature and related demand for heating.

6.65 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. Therefore, we are proposing to allocate the allowance over the unit rate only.

6.66 However, as the allowance will be introduced into the cap in a period of lower consumption (ie summer), it would marginally delay supplier recovery for the element of debt that relates to standing charges.

6.67 Alternatively, we could allocate the whole allowance to the standing charge element of the cap only. This would be consistent with the ASC decision,[67] 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.

6.68 Overall, we propose to allocate the allowance over the unit rate as we have support from stakeholders, it's simple to implement and it has a relatively minimal enduring distributional impact given the temporary nature of the adjustment.

Fuel type allocation

6.69 In our October policy consultation, we consider two options for allocating costs among fuel type:

- Allocate cost recovery equally over electricity and gas customers.
- (proposed) Allocate costs proportionately between fuel type.

[67] 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

6.70 Several responses supported apportioning the allowance evenly between fuel types. One reason given in favour of this approach was that it was most likely to prevent an undue impact to one category of customer of any cost increase.

6.71 There were some alternative approaches suggested. One respondent proposed apportioning the allowance to gas only and argued that all environmental levies are already apportioned on electricity. Another suggestion was to apportion on unit rate for both fuels, however a temporal weighted approach should be used for gas where heavier weighting is applied in quarter two and three (typically lower-usage periods).

6.72 Debt-related costs (and in particular bad debt and working capital) are likely to be incurred proportionately to the split between gas and electricity within a customer's bill. Therefore, we propose to allow recovery of the allowance proportionately to the gas and electricity split of the dual fuel cap level. We calculate this allowance using the TDCV split between gas and electricity during cap period 11b. This split is determined by evaluating the proportion of each fuel type contribution to the overall TDCV cost. From this we get that electricity accounts make up for 52% of the total, while gas represents 48%. This results in an allowance of £8.36 per typical electricity customer, and £7.71 per typical gas customer at benchmark consumption. For a typical dual fuel customer (ie one with both an electricity and gas account) the allowance will be equal to £16. The approach to splitting between fuels is a minor proposal given it isn't so different from an equal 50% split.

6.73 This approach is in line with how the underlying debt-related cost allowances are set in the payment method uplift (applied as a percentage of the cap separately for gas and electricity) and the approach we took when setting out the COVID adjustment.

6.74 We do not consider that it would be appropriate to apportion all cost recovery to gas only. Given there is evidence to suggest that customers will incur debt-related costs in proportion to their bill level for each fuel with respect to consumption apportioning the full allowance to gas only would not be in line with debt-related costs build up.

6.75 Allocating costs to gas would likely prevent cost recovery for suppliers which have a lower percentage of gas customers or a higher percentage of single-fuel electricity customers than the market average, which could prevent a supplier from recovering its efficiently incurred costs.

Meter type allocation

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

6.77 Most respondents said that costs should be allocated equally across electricity meter types.

6.78 We did not request supplier data submitted in our RFI to be broken down by meter type to keep our RFI proportionate, and therefore we do not have evidence about debt-related cost differences between meter types. This means we cannot directly control for any differences directly in the data.

6.79 Adding in uncertain assumptions which we cannot evidence to create a differential meter type unit rate would likely be complex and may create inaccuracies.

6.80 We therefore propose to take a simple approach of setting the level of the adjustment equal for both single and multi-register electricity meter customers at benchmark TDCV. This means that both groups of customers will incur the same cost on average (though the unit rate for multi-register customers will be slightly lower as they have a higher typical consumption).

How to adjust the cap

6.81 We consider that using the 'Annex 8 - adjustment allowance methodology' model is the simplest and most flexible method for including this one-off allowance in the cap. This approach is consistent with previous one-off adjustments, such as the ASC or COVID-19 true-up allowance.[68] We have not received views from stakeholders around alternative methodologies for including these costs in the cap.

6.82 Alongside this consultation, we have published a draft version of Annex 8, and detailed the methodology behind this model in Appendix 3.

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

Impact analysis

Section summary

In this chapter we assess the impact of our proposals to introduce an initial 12-month debt-related costs allowance in the cap. This includes distributional analysis.

Context

7.1 As outlined in Chapter 2, we must exercise our functions with a view to protecting existing and future consumers who pay standard variable and default rates. In doing so we must have regard to the five matters identified in section 1(6) of the Act in our decision-making process.

7.2 In reaching our key proposals, we have been mindful of the trade-offs between consumers' interests in minimising the immediate impact of energy bills and ensuring resilient suppliers who can efficiently manage risks and support a competitive market to the benefit of customers. As part of our consultation process, we conducted impact analysis on the options in this consultation for benchmarking and allocating costs.

7.3 We carried out three assessments of the impacts of introducing an additional allowance for debt-related costs from cap periods 12a-13b (April 2024 – March 2025):

- Bill impact analysis: we evaluated the potential impact on bills for the introduction of an additional bad debt allowance and for a counterfactual impact of taking a different benchmark approach.
- Equality Act impacts: we assessed the potential impact on groups based on protected characteristics and income levels.
- Supplier financial impact analysis.

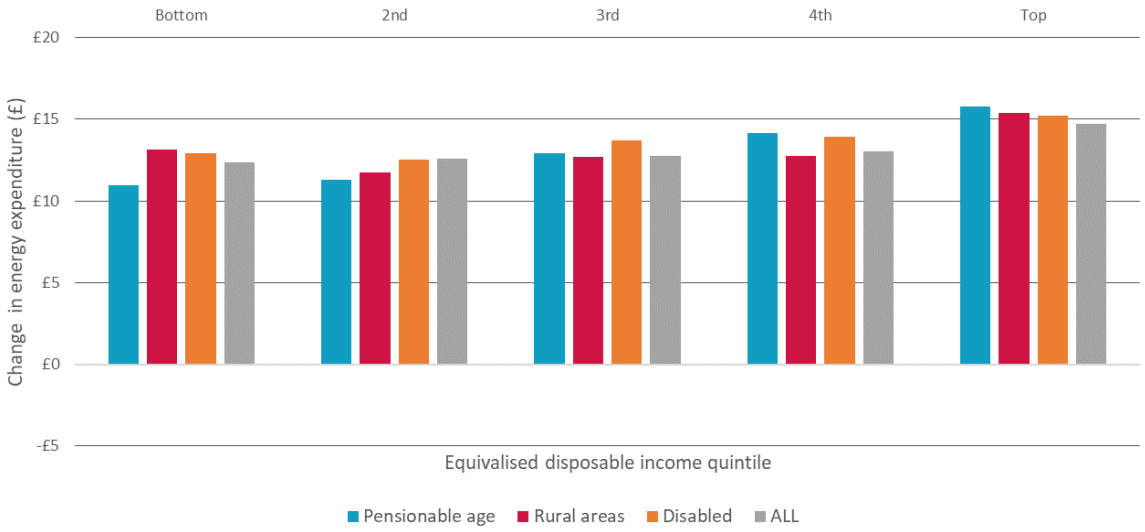
7.4 As we set out in Chapter 3, we propose to implement an adjustment for additional debt-related costs in April 2024. In doing so, we propose to benchmark at lower quartile rather than weighted average (Chapter 5) and allocate costs equally across direct debit and standard credit rather than the two other allocation options set out (Chapter 6).

Bill impact analysis

Distributional analysis

7.5 We have carried out a distributional analysis of introducing an additional debt-related costs allowance to customer energy bills. This analysis indicates the impact of our proposal to introduce a lower quartile benchmark approach. Figure 7.1 breaks down the impact on annual consumer bills across equivalised disposable income quintiles.

Figure 7.1: Impact of the increased additional allowance on bills, by categorical group and equivalised income quintile

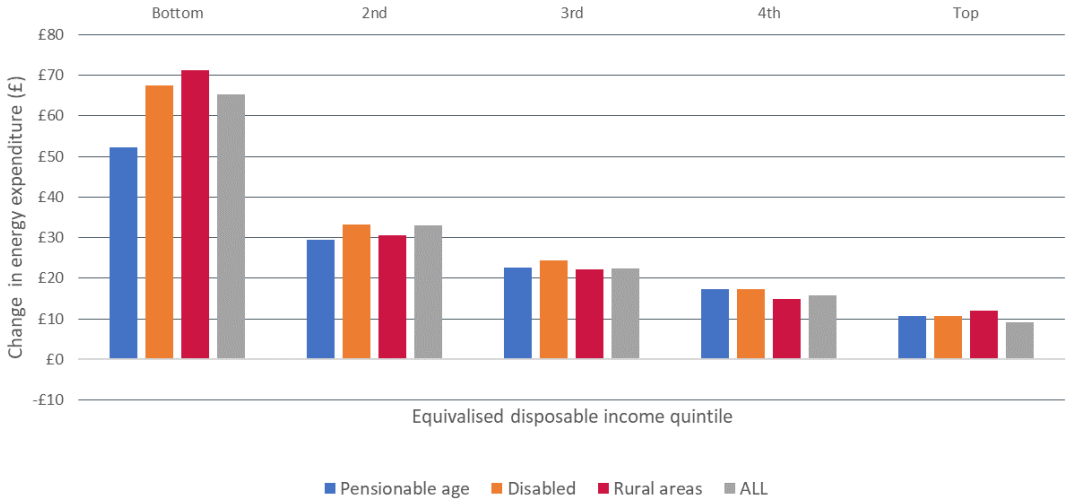


The bar graph shows the change in energy expenditures with the introduction of the proposed additional debt related costs allowance. This uses equal allocation among credit customers for pensionable age, rural area, disabled, and all customers. It assumes equal income distribution among payment methods. It indicates that all customers will face a similar impact from the additional costs allowance.

7.6 The impact on the typical annual consumer bill will be to increase it by £14.[69] A broadly similar impact will be experienced across the consumer types analysed. Those with lower incomes will see a lower absolute increase and those with higher incomes will see a higher increase.

[69] Total debt per customer regardless of payment type recovery. As discussed in Chapter 6, this £14 per customer is proposed to be allocated as £16 per credit (direct debit or standard credit) customer and £0 to PPM.

Figure 7.2: Impact of the increased additional allowance on bills, by categorical group and equivalised income quintile (equity-adjusted results)



The bar graph shows the change in energy expenditure (equity-adjusted results) with the introduction of the proposed additional debt related costs allowance. This uses equal allocation among credit customers for pensionable age, rural area, disabled, and all customers. It assumes equal income distribution among payment methods. It indicates that those in the equivalised bottom income quintile would incur the highest costs.

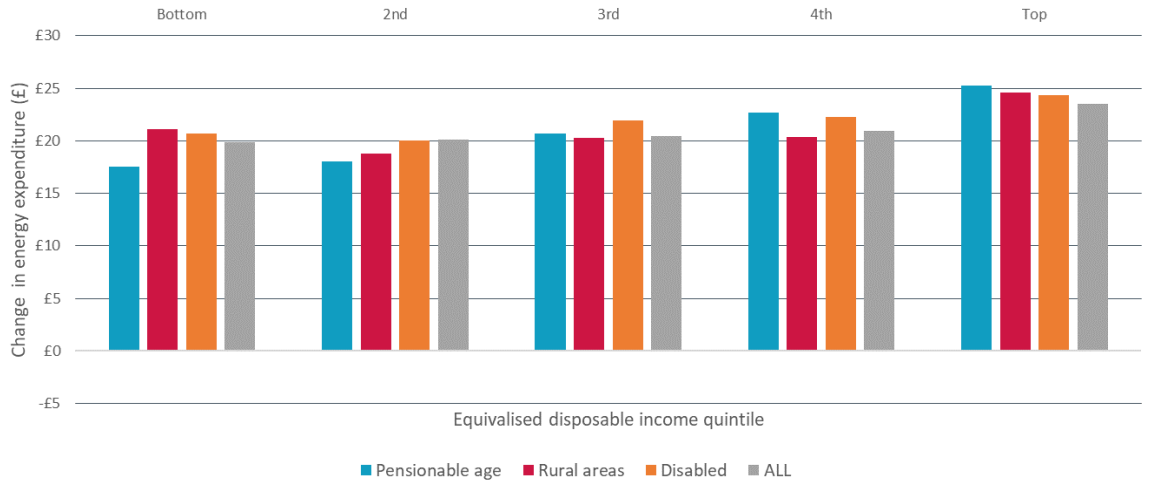
7.7 Figure 7.2 shows the impact with the bill impacts equity-weighted. This accounts for the economic principle of diminishing marginal utility of income i.e. that the value of an additional pound is higher for a low-income recipient and lower for a high-income recipient. Equity-weighted pound values therefore represent the perceived impact on the household, rather than an actual financial impact.[70]

7.8 Viewing the impact from an equity-weighted perspective, indicates that those on lower incomes would experience the greatest relative increase in bills.

7.9 We have also assessed the impact on consumers if the additional allowance was set at the weighted average (£36) compared to being set at the lower quartile (£14) as we propose. Figure 7.3 shows the incremental impact it would have (in £) on each income quintile if we changed our proposal on the benchmark approach. This indicates that a broadly similar impact will be experienced across the consumer types analysed.

[70] The weights reflect the marginal utility of each income quintile. This can also be done by adjusting the bill impacts for each income decile in the archetype-type, giving the monetary equivalent of how all consumers perceive the impact on their income.

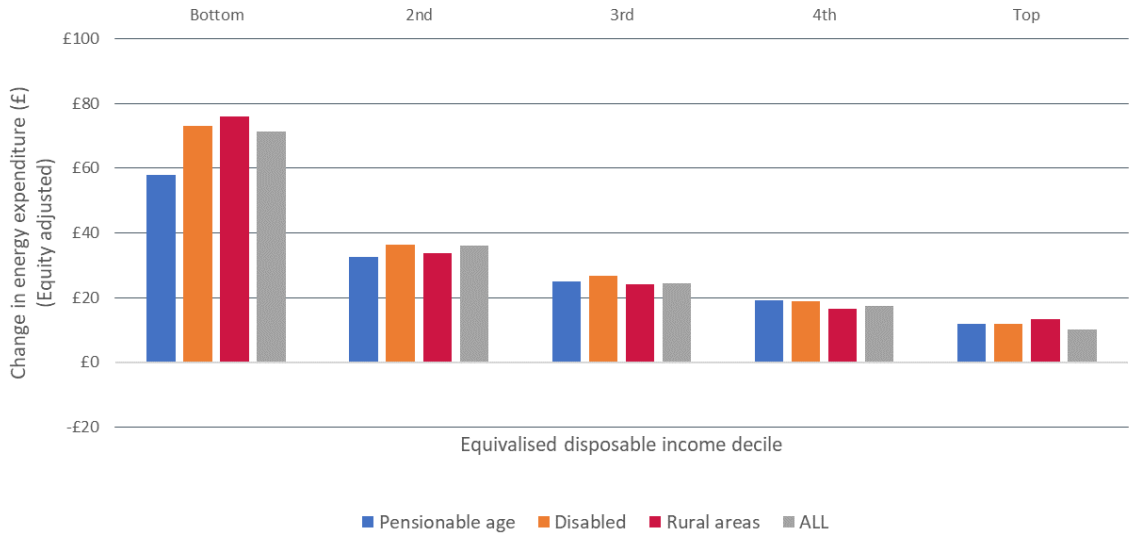
Figure 7.3: Impact of the change in benchmark approach, by categorical group and equivalised income quintile



The bar graph shows the change in energy expenditures under the counterfactual of moving the benchmark from lower quartile to a weighted average approach. This uses equal allocation among credit customers for pensionable age, rural area, disabled, and all customers. It assumes equal income distribution among payment methods. It indicates that all customers would face a similar impact from the choice of benchmark.

7.10 Figure 7.4 shows the impact of the same change in benchmark with the bill impacts equity-weighted.

Figure 7.4: Impact of the change in benchmark approach, by categorical group and equivalised income quintile (equity-adjusted results)



The bar graph shows the change in energy expenditure (equity-adjusted results) under the counterfactual of moving the benchmark from lower quartile to a weighted average

approach using equal allocation among credit customers for pensionable age, rural area, disabled, and all customers. It assumes equal income distribution among payment methods. It indicates that those in the equivalised bottom income quintile would incur the highest costs.

7.11 When we consider distributional weights, the impact of moving from the lower quartile benchmark to the weighted average benchmark would be significant in terms of costs on customers, particularly for low-income customers. We discuss the impact on groups with protected characteristics below.

Public sector equality duty assessment

Overview

7.12 Under the Equality Act 2010 (the 2010 Act), we are required, when exercising any of our public functions, to have due regard to:

- The need to eliminate discrimination, harassment, victimisation or any other conduct that is prohibited under the 2010 Act;
- The need to advance equality of opportunity between persons who share a relevant protected characteristic and persons who do not share it; and
- The need to foster good relations between persons who share a relevant protected characteristic and those who do not share it.

7.13 Relevant protected characteristics include age, disability, race and sex (see paras 7.14 below). This public sector equality duty is in addition to the requirement under the 2018 Act to consider how our policies or decisions affect default tariff customers protected under that Act.

7.14 In the charts above, we assess the impact on customers who are disabled or chronically sick, of a pensionable age, of low incomes, and/or residing in rural areas. (Whilst these groups are not explicitly referred to in the 2018 Act in the same way as they are under the Gas Act 1986 and Electricity Act 1989, they partly overlap with the protected characteristics under the 2010 Act and we also consider assessing the impact on these groups is appropriate and beneficial, given the requirement on us under the 2018 Act to protect existing and future customers on default tariffs, which include the vulnerable).

7.15 The charts above show a similar absolute financial impact across the different groups we took into consideration. The main exception is customers of pensionable age in the bottom quintile, where the impact is slightly less. This could reflect that these customers have lower consumption than the average

customer in the same quintile. When financial impacts are equity-weighted, the income quintile is the most important factor determining the perceived level of financial burden resulting from the policy change, rather than the protected characteristic.

Allocation option

7.16 We are aware that an increase in bills will likely have a negative impact on customers and in particular those at the lower end of the income distribution scale. For the purposes of measuring the impacts on different groups of customers, we have chosen to focus on the options for allocating costs across customers with different payment types. We consider these options will have the greatest distributional impacts across customers.

7.17 We have considered three allocation options which we discussed earlier in Chapter 6:

- Equal allocation to credit customers: None of the additional allowance is charged to PPM customers. The same allowance is applied to direct debit and standard credit customers.
- Reported cost allocation: Allocate costs to the payment method which suppliers reported those costs on (we use suppliers reported payment method allocations for bad debt and apply these to all debt-related costs).
- Allowance allocation: This allocates the additional debt-related costs allowance in proportion to the existing debt-related costs allowance that suppliers are receiving in cap period 11a. This reflects the allowance for each of the three debt-related costs and includes the Additional Support Credit allowance (ASC) that suppliers have started to receive.

7.18 The Centre for Sustainable Energy created 13 archetypes (these were last updated in 2020) using the data on energy consumption of the remaining protected characteristics (age, disability, race and sex) and other common socio-economic characteristics (income, employment status). Each archetype represents a typical GB household. We have refreshed these consumer archetypes, to create 24 archetypes.[71] We have analysed the impact on these 24

[64] Ofgem consumer archetypes (to be published Jan '24). Superseded archetypes can be found at Ofgem (2020), Ofgem Energy consumer archetypes - Final report. https://www.ofgem.gov.uk/publications/impact-assessment-guidance

different archetypes in income order from lowest income (A1) to highest income (J24).

7.19 In doing so, we have implicitly considered the impact on a subset of vulnerable consumers (specifically those on low incomes), by weighting impacts relative to their household income. Our analysis is based on the scenario of introducing an additional debt-related costs allowance. We compare the three allocation options in the analysis below.

7.20 For each option we produced the per-household pound cost (or benefit) of the policy for each of the 24 archetypes. Across the archetypes, the equal allocation option costs between £7 and £20 per household (with the higher cost per household affecting a relatively high income archetype).[72] The allowance option has less variation than the equal option and costs households between £9 and £18 but increases the cost to some low-income archetypes.[73] The reported cost option has an impact between -£1 and +£32, with the high impact on one of the first 12 archetypes and the -£1 affecting one of the higher income archetypes.

7.21 Table 7.2 below shows the description of each of the archetypes along with the incremental impact on that archetype of moving between the allocation options. In particular, the effect of moving from the equal allocation to the other allocation options for each of the absolute and equity-weighted (later columns) values. This is not the full impact of the adjustment under these options.

7.22 The disaggregated impacts described above were used for the first two columns listed in Table 7.2 below. It can be seen that low-income households pay more for the allowance allocation option (and even more for the reported cost allocation option) than for equal allocation.

7.23 We have modelled the proportions of each archetype that use each payment method with different levels of energy consumption. The impacts of different allocation options will therefore vary between archetypes.

Analysis

7.24 The archetype impacts are income-weighted to produce the impacts listed in the last two columns of Table 7.2. Using this equity-weighted approach, equal allocation has an impact per household of between £11 and £48 across the archetypes (with the lowest impact on the highest income archetype and the

[72] These are not shown in the table. These are the impacts of the individual allocation options. The table shows the difference between the options not the absolute impact of the options.
[73] These are not shown in the table.

highest impact on the lowest income archetype). The allowance allocation has an impact of between £11 and £75 (again the highest impact is on the lowest income archetype). Cost-based allocation would represent a net benefit to a high-income archetype but would have a perceived impact of £138 on the lowest-income archetype. Moving from the equal allocation options to an alternative can add between £27 and £91 to the equity-weighted impact of the lowest income archetype.

7.25 Archetypes A1 - B4, B5, C7, D10, and D12 have markers of vulnerability. These can be combined in a weighted average (WA) (by number of households across these archetypes). It is also useful to look at the range (max and min) in per customer impacts for the different vulnerable archetypes.

7.26 If all customer numbers were calculated on precisely the same basis the total cost of each option would be equal (because each policy is designed to recover the same total cost from all consumers). All options are designed to recover the same amount. The small difference in costs[74] does not change the intuition (eg the equal allocation option gives the lowest impact).

Table 7.1 – Table of customer impacts by allocation option in £ per dual fuel customer

Option	Direct debit	Standard credit	PPM	Equity Weighted£	Vulnerable (WA), £[75]	Vulnerable (max), £	Vulnerable (min), £
Equal (credit)	16	16	0	27.0	12.7	16.9	7.9
Allowance	8	40	6	29.7	13.3	16.0	11.5
Reported Cost	-12	90	30	36.2	14.6	31.0	2.8

7.27 Overall, it can be seen that equal allocation across credit customers has the lowest customer impact (both in terms of weighted average impact on vulnerable customers and total equity-weighted assessment across all customers).[76] The

[74] These are not shown in the table.
[75] These columns considering the impact on vulnerable consumers are not equity-weighted. The max and min are the average impact over one of the vulnerable archetypes (within that archetype some individual customers will have an impact that is greater or lesser than this archetype average).
[76] It can be seen that for the vulnerable archetypes the allocation option has a lower maximum impact than the other options. However, the average impact on the vulnerable category is higher for this option compared to the equal allocation option.

reported cost allocation option has the highest cost for vulnerable and equity-weighted customers.

Supplier impact analysis

7.28 An equal allocation approach does create differential impacts between suppliers. Those with a higher-than-average proportion of customers on standard credit (or PPM) may under-recover their costs and those with higher-than-average proportion on direct debit may over-recover.

7.29 We have considered the percentage point impact on supplier forecast profits of picking the equal allocation and allowance allocation approach, relative to the reported cost allocation approach. This considered impacts due to variations in the payment mix between suppliers. It did not take into account variations between any individual supplier's own costs and notionally efficient costs. While we represent the impact on suppliers in terms of profit, this may not represent an overall increase in supplier returns relative to the situation before the wholesale price crisis.

7.30 Based on current forecasts, we expect suppliers to be profitable on average over financial year 2024. However, on average this is unlikely to exceed our estimation of supplier EBIT calculated in the cap. We note some suppliers are forecasted to make losses.

7.31 Suppliers overall gain from having the additional allowance. The equal allocation additional allowance option will partially close the gap between the forecast profitability (EBIT) of the main suppliers (during April 2024 to March 2025) and the allowed returns, by between 0.1 and 0.8 percentage points compared to not having any additional allowance.

7.32 The allowance option would have a more consistent impact on individual suppliers' profitability closing the gap between the forecast and allowed returns by between 0.2 and 0.6 percentage points compared to not having an additional allowance. The cost option would decrease the profitability of some suppliers (by up to 0.2 percentage points) while closing the profit gap of others by up to 2 percentage points compared to not having an additional allowance. Suppliers will have incurred different costs depending on the payment mix of their customers. Thus, the suppliers may prefer either equal allocation or reported cost allocation depending on their customer base.

7.33 We do not consider our recommendation of equal allocation to pose any immediate risks to any suppliers and consider it tolerable given the ad-hoc and temporary nature of the adjustment.

Table 7.2: Impacts by Consumer Archetypes

Archetype	**Characteristics**	Equal to Allowance	Equal to Reported Cost	Equity Weighted, Equal to Allowance	Equity Weighted , Equal to Cost
A1	lowest income; mains gas; retired; 75+ years old; single adults; owner-occupied/local authority; urban; not early adopters; no internet connection; below poverty line	£5	£18	£27	£90
A2	low income; housing association/local authority; retired/unoccupied; couples and single adults; disability benefits; mobility disability; 45-64 years old; prepayment meter; below poverty line	£5	£20	£23	£91
A3	off gas; low income; high electricity consumption; retired; couples and single adults	£2	£5	£8	£23
B4	low income; electric heating; communal heating; retired/unoccupied; 45+ years old; purpose-built flats; owned/local authority; disability benefits; below poverty line; Cold Weather Payment (CWP) eligible; Warm Home Discount scheme (WHDS) eligible; high electricity consumption; poor Energy Performance Cert. (EPC) rating; not early adopters	£4	£15	£15	£55
B5	low income; mains gas; 65+ retirees; semi-detached; owner occupied; not early adopters; low electricity consumption; WFP eligible	-£2	-£7	-£5	-£20
B6	low income; purpose-built flats; couples/single adults; large age range 25-75+; low scheme eligibility; mains gas; good EPC rating; low gas consumption	£3	£11	£13	£45
C7	lower-middle income; mains gas; average fuel consumption; disability benefits; retired/unoccupied; 55+ years old; 50% mobility disability; 13% wheelchair users; high scheme eligibility; not early adopters	-£2	-£8	-£5	-£18

C8	lower middle-income; couples/single adults; full-time employed/retired; mains gas; private rented; low fuel consumption	£2	£8	£6	£22
C9	lower-middle income; large families; couples/single mothers; private/local authority rented; BAME; mains gas; good EPC; high fuel consumption; prepayment meter	£5	£19	£11	£42
D10	lower-middle income; mains gas; couple/single adult woman; retired 65+; not early adopters; WFP eligible; high gas consumption	-£4	-£14	-£8	-£31
D11	middle income; single child families; mains gas; good EPC rating; average consumption; prepayment meter	£6	£22	£11	£44
D12	middle income; families; couple or single-mother; disability benefits; CWP eligible; WHDS eligible; prepayment meter; high gas/electric consumption	£5	£20	£9	£39
E13	average income; electric heating; purpose-built flats; single child families; good EPC rating; low levels of engagement; BAME	£3	£12	£7	£25
E14	middle income earners; electric heating; communal heating; purpose-built flats; young couples/single adults; BAME; good EPC rating; well-educated; low market engagement	£2	£7	£5	£15
F15	middle income; no children; couples/single adults; owner-occupied; terraced; low gas/electricity consumption; not early adopters	-£2	-£6	-£3	-£13
F16	middle income; large families; full-time or self-employed; electric heating; high electricity consumption	£3	£9	£4	£14
G17	upper-middle income; no children; homeowners; rural and urban; 50% not adopters; bulk LPG heating; renewable systems; employed and retired mix	£1	£2	£2	£5
G18	upper-middle income; no children; rural; poor EPC rating; oil heating; not early adopters	£0	-£2	-£1	-£5
H19	upper-middle income; no children; 45+ years old; self-employed; unconventional housing; unknown EPC; oil heating; renewable systems	£4	£11	£5	£16

H20	high income; single child families; ECO eligible; full-time employment; early adopters	-£4	-£14	-£4	-£15
I21	high income; no children; full-time employment; mains gas; average fuel consumption; large disposable income	-£3	-£12	-£3	-£11
I22	high income; no children; full-time employed; detached; mains gas; high gas consumption; large homes	-£2	-£8	-£2	-£11
J23	high income; large families; mains gas; ECO eligible; high gas consumption; large homes	-£5	-£19	-£5	-£17
J24	highest income; families; rural; large homes; highest electricity consumption; poor EPC rating; ECO eligible; oil heating	£4	£10	£3	£8

The table shows the 24 consumer archetypes that Ofgem use. The numbers in the first column indicate the impact (£) of moving from the equal option to the allowance option. The second column indicates the impact of moving from the equal option to the reported cost option. The third column indicates the impact of moving from the equal option to the allowance option (equity-weighted £ values). The fourth column indicates the impact of moving from the equal option to the reported cost option (equity-weighted £ values).

Appendices

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Appendix 1 – Calculation steps for existing debt allowances

A1.1 We consider separately each of the price cap allowances that contain an element of the debt-related costs 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.[77]

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). We used this data to set the operating cost benchmark. We have used this data to calculate an estimate of the bad debt charge, based on the two suppliers closest to the operating cost benchmark. We take a weighted average of the debt-related costs for the two suppliers. This estimate does not account for the £5 efficiency factor that would have a very small impact.

A1.3 To calculate the estimated allowance for operating costs in each cap period, we index the 2017 value with inflation.

Payment method uplift (PAP)

A1.4 There is a specific line for bad debt in the Payment method Adjustment Percentage (PAP) allowance. We therefore can calculate this and do not need to estimate the allowance.

Working capital

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.

[77] Electricity values are for single-rate customers.

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

i) 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.[78]

ii) 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.

iii) This gives weighted average working capital as a proportion of revenue.

iv) We then translate this to a cost of working capital by applying a cost of capital. We use the 10% cost of capital used historically in the cap.

A1.7 The 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. When estimating 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 the cost of working capital (as a percentage of revenue) to the cap level excluding these components in each cap period.

A1.9 Payment method uplift (PAP)

A1.10 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.

A1.11 We can therefore calculate the amount included in each cap period without carrying out estimation.

[78] 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

Debt-related administrative cost

Payment method uplift (PAAC)[79]

A1.12 We use suppliers' responses to the payment method uplift RFI to look at the cost line for bad debt administration.

i) We use the percentage of the additional costs of paying by standard credit that this represents.

ii) We use the benchmark supplier from the payment method uplift calculation. The choice of using benchmark suppliers is consistent across individual allowances (ie operating costs and PAAC, although different suppliers set the benchmark for each component of the price cap).

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

Operating costs

A1.13 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). However, unlike for bad debt, we do not have this data split by payment method. We therefore use the operating cost RFI data to estimate debt-related administrative costs as a percentage of overall operating costs (rather than estimating an absolute cost as for the bad debt charge). To avoid undue complexity in the calculations, we calculate these cost lines as a proportion of reported indirect costs, rather than the adjusted costs used for benchmarking.

i) 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.

(1) We use operating cost benchmark suppliers for these estimates.

(2) 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.

ii) We therefore calculate the amount to subtract in order to remove the impact of costs relating to standard credit customers. (While we apply the

[79] PAAC is the fixed element of the payment method uplift.

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 standard credit 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).

iii) 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).

Ie 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

PPM uplift

A1.14 The PPM uplift is an estimate of the overall additional costs of serving PPM customers. The CMA calculated this as part of the PPM specific price cap that it produced following the Energy Market Investigation in 2016.

A1.15 The CMA used several approaches to inform its calculation of the PPM uplift. The Energy Market Investigation final report contains a table that relates to one of the CMA's approaches.[80] 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.[81]

A1.16 We calculate the bad debt charge as a percentage of the total cost under the CMA's granular approach. We then apply this percentage to the PPM uplift in each cap period.

[80] Table 7 from Appendix 9.8.
[81] See paragraphs 116 to 118 of Appendix 9.8.

Other costs within the PPM uplift

A1.17 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 within the CMA's PPM uplift.

A1.18 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.

A1.19 Given the points above, we therefore do not seek to estimate working capital and debt administration costs in the PPM uplift.

Appendix 2 – Calculation steps for additional debt-related costs

A2.1 In this appendix we explain the method which was used to calculate the debt-related costs additional allowance described in Chapter 5.

A2.2 Further we explain the different benchmarking approaches and how we allocated costs between payment methods.

Data request

A2.3 We have used data collected from the October 2023 debt-related costs RFI to calculate the additional debt-related costs. We requested data from January 2017– September 2023 across all debt-related costs. This included data on bad debt, debt-related administrative costs, working capital costs, revenue and customer accounts. We requested each of these items to be split by fuel type, tariff type, and payment method.

A2.4 We sent the RFI out to the 12 domestic suppliers who had at least 100,000 default customer accounts in cap period 9b.

Overview

A2.5 In this appendix, we explain how we arrive at the key high-level figures presented in Chapter 5 and 6.

A2.6 To do this, we start by calculating the net cost to suppliers per cap period, using allowance estimates (outlined in Chapter 5 and Appendix 1) and cost data received from the October 2023 RFI submission. These net costs are then estimated on a £ per dual fuel customer level, and used in our benchmarking and cost allocation exercises, which are explained further in this appendix.

Allowance calculations

A2.7 For each supplier, we input monthly revenue and customer accounts with respect to fuel type and payment method for default tariffs only. The following steps were carried out:

i) The allowance for debt-related costs within the cap at nil consumption (as calculated based on the explanations in Appendix 1) was multiplied by the total number of customer accounts with respect to fuel and payment method.

ii) We calculated the portion of monthly revenue[82] that is not attributable to standing charges (non-standing charge revenue) with respect to fuel and payment method. We did this by multiplying standing charge (the cap at nil consumption) by the number of customer accounts for each supplier and subtracting it from revenue.

iii) We calculate based on Appendix 1 what percentage of non-standing charge revenue is the debt-related costs allowances. We then multiply this percentage with non-standing charge revenue to work out the unit rate element of the allowance.[83]

iv) The unit rate and standing charge allowance elements were summed up which provided the allowance for each debt-related cost with respect to payment method, fuel type and cap period.

Net debt-related cost data

A2.8 For each debt-related cost, we used input data received from suppliers' October 2023 RFI submission to calculate the costs per cap period.

A2.9 Before we compare the costs with the specific allowance, first we need to clean the bad debt, debt-related administrative and working capital costs.

Net bad debt costs

A2.10 The following steps were carried out:

i) We subtracted the allowance (within the price cap) per cap period from the default tariff bad debt costs for each supplier (**i**), cap period (**j**) and payment method (**q**).

$$Net\ bad\ debt\ cost_{i,j,q} = Bad\ debt_{i,j,q} - Bad\ debt\ allowance_{i,j,q}$$

ii) We then divided this delta by the total domestic default tariff customer accounts in cap period 10b[84] for each supplier and payment method.

iii) To get the dual fuel cost per customer for each supplier, we multiplied the number of customers by 2, as we assume that each customer holds an

[82] We requested that suppliers submit revenue including EPG revenue and VAT. For suppliers' revenue figures which were not inclusive of VAT, we multiplied their revenue by 1.05.
[83] The allowance percentages are derived from using each debt-related cost allowance as percentage of cap unit rates for Electricity and Gas per payment type. For example, Bad Debt allowance has 6 percentages: for direct debt electricity / gas unit rates, standard credit electricity / gas unit rates and prepayment meter electricity / gas unit rates. We calculate these percentages by dividing the allowance (from Appendix 1) by the unit rate element of the cap.
[84] We used the average number of customer accounts in cap period 10b for this.

electricity and a gas account with their energy supplier. We note that this assumption is a minor simplification, as there are some single fuel customers (particularly for electricity).

Net debt-related administrative costs

A2.11 Some suppliers were unable to consistently separate debt-related administrative costs by tariff type. This means that for all suppliers we have data on total debt-related administrative costs across all tariff customers, which we needed to convert into an estimate for debt-related administrative costs on default tariffs. Therefore, we scale all debt-related administrative down by the proportion of customers on default tariffs.

i) For each supplier, we summed up the total costs and divided by the average number of customer accounts in each cap period. This average is calculated as the average of monthly customers across all months in a given cap period. Thus, an average of the total number of customers over 3 or 6 months, depending on the length of the cap period.

ii) We calculate the total cost for each supplier (**i**), and cap period (**j**):

$$Total\ debt\ related\ administrative\ costs_{i,j} = \frac{Debt\ related\ administrative\ costs_{i,j}}{Total\ customer\ Accounts_{i,j}} \times Total\ default\ tariff\ customer\ accounts_{i,j}$$

iii) Implicitly this means that we assume the debt-related administrative cost per customer is equal between default and fixed tariff customers.

A2.12 Finally to calculate the cost per customer, we followed similar steps to bad debt:

i) We subtracted the allowance (within the price cap) per cap period from the default tariff debt-related administrative costs for each supplier (**i**) and cap period (**j**). Suppliers were not able to consistently breakdown debt-related administrative costs by payment method, so our calculation focused on all payment methods.

$$Net\ debt\ related\ administrative\ cost_{i,j} = Debt\ related\ administrative\ cost_{i,j} - Debt\ related\ administrative\ cost\ allowance_{i,j}$$

ii) We then divided this delta by the total domestic default tariff customer accounts in cap period 10b for each supplier and multiplied it by 2 to determine the cost per typical dual fuel customer.

Net working capital costs

A2.13 Working capital data needs to be combined before it could be compared with the allowances given, because we requested it over three[85] RFI questions.

A2.14 For working capital costs, we begun by calculating the average of accounts receivables. We did this by taking the average of accounts receivables at the beginning of the cap period and accounts receivables at the end of the cap period. We repeated this step for accounts payables as well.

A2.15 Then we multiplied this by the cost of capital assumption used for working capital of 10%. We also multiplied it by the fraction of the year covered by each cap period to represent that the working capital costs are only related to 6 or 3 months. This gave us a working capital cost.

i) We have included a simplified formula below (where I = supplier, and j = cap period, AR = accounts payables, AP = accounts payables and 10% is the cost of capital)

ii) We calculate the net customer working capital cost for each supplier (**i**), and cap period (**j**):

$$Net\ customer\ working\ capital\ cost_{i,j}$$
$$= \left(\frac{AR_{i,j}^{Beginning\ of\ period} + AR_{i,j}^{End\ of\ period}}{2} \times 10\% \times \frac{Days_j}{365}\right)$$
$$- \left(\frac{AP_{i,j}^{Beginning\ of\ period} + AP_{i,j}^{End\ of\ period}}{2} \times 10\% \times \frac{Days_j}{365}\right)$$

iii) This step is repeated for non-customer working capital before adding together both the net customer[86] working capital cost and non-customer[87] working cost for each supplier (**i**), and cap period (**j**) such that:

$$Working\ capital\ cost_{i,j}$$
$$= Net\ customer\ working\ capital\ cost_{i,j}$$
$$+ Net\ non\text{—}customer\ working\ capital\ cost_{i,j}$$

iv) We then divided this figure by the number of customers accounts.

[85] In our RFI we requested data on accounts receivables, accounts payables and net non-customer working capital.
[86] Suppliers will employ working capital which relates to timing differences between incurring costs and customer payments (eg due to customers paying in arrears), we refer to this as customer working capital.
[87] Suppliers also employ working capital elsewhere in their business (eg relating to the timescales for paying firms who provide them with services) which we refer to as non-customer working capital.

v) We multiplied the working capital cost per dual fuel customer by the number of default tariff customers, scaling up by the average number of customers on a default tariff per cap period in the same method used for debt-related administrative costs as described above.

A2.16 Finally, to calculate the net cost per customer, we followed similar steps to bad debt:

i) We subtracted the allowance (within the price cap) per cap period from the default tariff debt-related administrative costs for each supplier (**i**) and cap period (**j**). Suppliers were not able to consistently breakdown debt-related administrative costs by payment method, so our calculation focused on all payment methods.

$$Net\ working\ capital\ cost_{i,j} = Working\ capital\ cost_{i,j} - Working\ capital\ cost\ allowance_{i,j}$$

ii) We then divided this delta by the total domestic default tariff customer accounts in cap period 10b for each supplier and multiplied it by 2 to determine the cost per typical dual fuel customer.

Benchmarking

Weighted average

A2.17 Using the allowance and costs calculated in the above sections, we performed analysis to derive benchmarks for each debt-related cost. We take the net cost delta of each supplier per cap period, sum it up for a given cap period, and divide it by the total number of customer accounts in cap 10b).

A2.18 The formula is as follows, we divide the sum of net debt related costs for each cap period (**i**) by the sum of customer accounts in cap period 10a which is then multiplied by 2:

$$Net\ Debt - related\ cost_i^{WA} = \left(\frac{\sum Debt\ related\ cost_i - \sum Debt\ related\ cost\ allowance_i}{\sum Customer\ accounts_{Cap\ 10b}}\right) \times 2$$

A2.19 We multiply the number of customer accounts in each cap period by 2, to account for customer's electricity and gas accounts, and arrive at a cost per dual fuel customer.

A2.20 This cost is a summation of historic costs (cap period 8-10b) plus an estimated cost for the upcoming cap periods 11a (Oct – Dec 2023) and 11b (Jan – March 2024).

A2.21 The forecast was assumed to be a simple rollover of cap 10b's under-allowance for each debt-related cost, that this would roll forward into the cap periods 11a and 11b.

A2.22 For the sample selection, 10 suppliers were included, and 2 suppliers were excluded from the sample. The two suppliers were excluded as they were not able to accurately apportion revenue data by payment method.[88]

Lower quartile

A2.23 To identify the lower quartile supplier, we began by calculating a net cost per dual fuel customer for each supplier across all debt-related costs (combined).

A2.24 This cost is a summation of historic net costs (cap period 8-10b) plus a forecast cost for the upcoming cap periods 11a (Oct – Dec 2023) and 11b (Jan – March 2024).

A2.25 The forecast was assumed to be a simple rollover of cap 10b's under-allowance for each debt-related cost, that this would roll forward into the cap periods 11a and 11b.

A2.26 To identify the lower quartile supplier who serves as the benchmark, we performed a calculation to find the 25th percentile of costs.[89] This gives us a lower quartile allowance estimate of £14 per typical dual fuel customer using a restricted sample of 6 suppliers which is equal to 82% of the default tariff market.

Choosing a combined benchmark over a separate benchmark

A2.27 When choosing the lower quartile benchmark, we have the option of selecting a lower quartile supplier for each specific debt-related cost (separate), or selecting a uniform lower quartile supplier across all debt-related costs (combined).

A2.28 We chose a combined benchmark by summing up the cost per dual fuel customer across all debt-related costs (historical and forecast for winter 23/24 period), and then identifying the supplier with the lower quartile of total debt-related costs.

[88] Revenue splits by payment method are required to estimate each suppliers' debt-related costs allowance since it is not uniform across payment methods.
[89] The formula used for this calculation is the INC QUARTILE Excel function as follows: = QUARTILE.INC (cost per dual fuel customer,1)

A2.29 Where the lower quartile value falls between 2 suppliers, we interpolate between these two suppliers to find a final figure.

Allocation methods

A2.30 We calculated the benchmark in line with the previous section. This gave us an allowance estimate of £14 per typical dual fuel customer based on the lower quartile benchmark which we then allocated across the different payment methods. The following section outlines the three options that we have set out to allocate that additional debt-related cost allowance estimate.

Reported Cost Allocation method

A2.31 The reported cost allocation approach allocates the lower quartile cost based on the payment methods which suppliers reported those costs on. Since bad debt was the only debt-related cost suppliers were able to consistently break down, we use figures from that to calculate how we could recover costs between the different payment method options.

A2.32 To do this we calculate a scaling factor which is applied to the net bad debt split at a weighted average. By dividing the total lower quartile cost recovery by the total weighted average net bad debt cost recovery, we get an equivalent scaling factor. Finally the scaling factor is multiplied with the net bad debt breakdowns at a weighted average to calculate individual payment method breakdowns.

A2.33 This keeps the desired cost recovery equivalent between each allocation option meaning that the variation between payment methods will ensure total cost recovery remains in line with the £14 per dual fuel customer allowance.

A2.34 We need to scale the net bad debt breakdown down because suppliers were not able to consistently breakdown debt-related administrative and working capital costs by payment method, so we use the net bad debt breakdown as a proxy for all debt-related costs. Further, we consider using the weighted average allocation is the most appropriate way to allocate the lower quartile figure to avoid over-reliance on one supplier's allocation method.

A2.35 We have detailed our calculation below. Firstly we multiplied the lower quartile allowance (14) by the number of default tariff customers for each payment method in cap period 10b.

A2.36 This was then divided by the sumproduct of net bad debt costs (at a weighted average) and customers for each payment method.[90] This yielded a scaling factor of 51%. The calculation only produces one scaling factor (rather than one per payment method), to ensure that weighted recovery across payment methods equals the recovery of the benchmarked cost. This means that we only change how the £14 lower quartile figure is allocated between payment methods (and not total cost recovery).

A2.37 Finally, we multiplied the 51% scaling factor by the net bad debt breakdown for each payment method (**q**)

$$Additional\ allowance_q^{Reported\ cost\ method} = 0.51 \times Net\ bad\ debt_q^{WA}$$

Where;

$$0.51 = \frac{14 \times \sum Customers_{q,Cap\ 10b}}{\sum(Net\ bad\ debt_q^{WA} \times Customers_{q,Cab\ 10b})} = \frac{Cost\ recovery_{All\ debt-related\ costs}^{LQ}}{Cost\ recovery_{Bad\ debt}^{WA}}$$

Table A2.1 Additional allowance allocation using the reported cost allocation method

	Net bad debt (weighted average)	**Additional allowance – reported cost method**
Direct debit	-24	-12
Standard credit	175	90
PPM	58	30

Note: £ per typical dual fuel default tariff customer. Positive number signals under-allowance.

Allowance method

A2.38 The allowance option apportions the additional allowance based on the current debt-related costs allowance payment method split.

A2.39 We use the same method as above to calculate the scaling factor for this allowance method, however we compare the lower quartile cost recovery with the debt-related cost allowance cost recovery.

[90] Ie; -24 multiplied by the number of direct debit default tariff customers in cap period 10b plus 175 multiplied by the number of standard credit default tariff customers in cap period 10b plus 58 multiplied by the number of standard credit default tariff customers in cap period 10b.

A2.40 Similar to the above, we multiplied the lower quartile allowance estimate across all debt-related costs by the number of default tariff customers under each payment method to get a total allowance under each payment type.

A2.41 We then divided this number by the estimated total debt-related costs allowance (ie the individual debt-related costs allowance multiplied by the number of customers on each payment method). We take figures from the debt-related costs cap allowances (annualised, £ per typical dual fuel customer at benchmark consumption) as shown in Table 4.2.

A2.42 This provided us with a scaling factor of 31% which was then multiplied by the current debt-related costs allowance for each payment method (**q**) to calculate the additional allowance.

$$Additional\ allowance_q^{Allowance\ method} = 0.31 \times DRC\ allowance_q$$

Where;

$$0.31 = \frac{14 \times \sum Customers_{q,Cap\ 10b}}{\sum (DRC\ allowance_q \times Customers_{q,Cab\ 10b})} = \frac{Cost\ recovery^{LQ}_{All\ debt-related\ costs}}{Cost\ recovery_{DRC\ allowance}}$$

Table A2.2 Additional allowance allocation using the allowance method

	Debt-related costs allowance	**Additional allowance – allowance method**
Direct debit	26	8
Standard credit	129	40
PPM	19	6

Note: £ per typical dual fuel default tariff customer. Positive number signals under-allowance.

Equal allocation

A2.43 In the equal allocation option, the additional allowance is equally allocated across standard credit and direct debt customers, setting the cost on prepayment meter customers to zero. We do this by scaling up the £14 figure.

A2.44 We multiplied the lower quartile allowance estimate across all debt-related costs by the total number of dual fuel customer to get a total allowance.

A2.45 We then divided this amount by the number of standard credit and direct debit customers, to get a cost per customer.

A2.46 For this calculation, we used customer numbers from our October 2023 RFI, and we included the 10 suppliers discussed above which is equal to 89% of the default tariff market.

$$Additional\ allowance_{Credit}^{Equal\ allocation} = 14 \times \frac{Customers\ _{Cap\ 10b}^{Total}}{Customers\ _{Cap\ 10b}^{Credit}} = 16$$

Appendix 3 – Annex 8 methodology and model changes

A3.1 In this appendix we summarise the modifications to 'Annex 8 – methodology for adjustment allowance' of standard licence condition 28AD of the electricity and gas supply licences (SLC28AD).

A3.2 A revised version of Annex 8 has also been published alongside this decision.

Tab '3n DRC'

A3.3 New tab created to input the dual fuel debt-related adjustment per customer split by payment type. Cells A9:B12 include figures calculated using our analysis of supplier data from the October 2023 debt-related costs RFI.

Tab '3f Cap levels'

A3.4 Cells A17:D20 and A33:D36 updated to include cap period levels from 10a - 11b figures for both gas and electricity.

Tab '2g debt-related cost adjustment'

A3.5 New tab created to calculate the costs included in the cap adjusted for the 11b price cap level using the gas and electric split. The adjustment value from tab '3n DRC' is expressed per dual fuel customer. We need to allocate this to individual fuels. In line with our proposal, we intend to do this in proportion to the relative bill sizes in cap period 11b. This tab uses the cap 11b figures from tab '3f cap levels' and uses a split to find the proportion that gas and electric make up the total benchmark consumption.

A3.6 Table 1a, A9:B12, inputs the dual fuel cost per customer with respect to payment method from tab '3n DRC'.

A3.7 Table 1b inputs the cap period 11b figures from tab '3f Cap levels' and table 1c calculates the percentage of TDCV costs that are made up by gas and electricity.

A3.8 Table 1d then uses the percentage cost split to adjust the debt-related costs figures inputted in table 1a to show the cost differential between gas and electric customers in table 1d by payment types, benchmark metering arrangement and benchmark annual consumption.

Tab '1a Adjustment Allowance

A3.9 Cells AI13:AL264 have been updated to draw in the debt-related cost, charge restriction region, benchmark metering arrangement, payment method and 28AD charge restriction period from cells E38:E55 in tab '2g debt-related cost

adjustment'. This allowance has been included in Annex 8 for April 2024 – March 2025 (cap periods 8-10b) based on our proposal in Chapter 6.

Appendix 4 – Rationale for excluding original payment method allocation options

October 2023 consultation options for allocating costs

A4.1 In this consultation, we set out three options for allocating costs across payment methods. These include: (1) equal allocation over DD and SC customers (proposed) (2) allocating in line with the current allowances and (3) allocating in line with the reported data. We set out considerations for these options in Chapter 6.

A4.2 In our October 2024 consultation, we set out three other allocation options. These included:

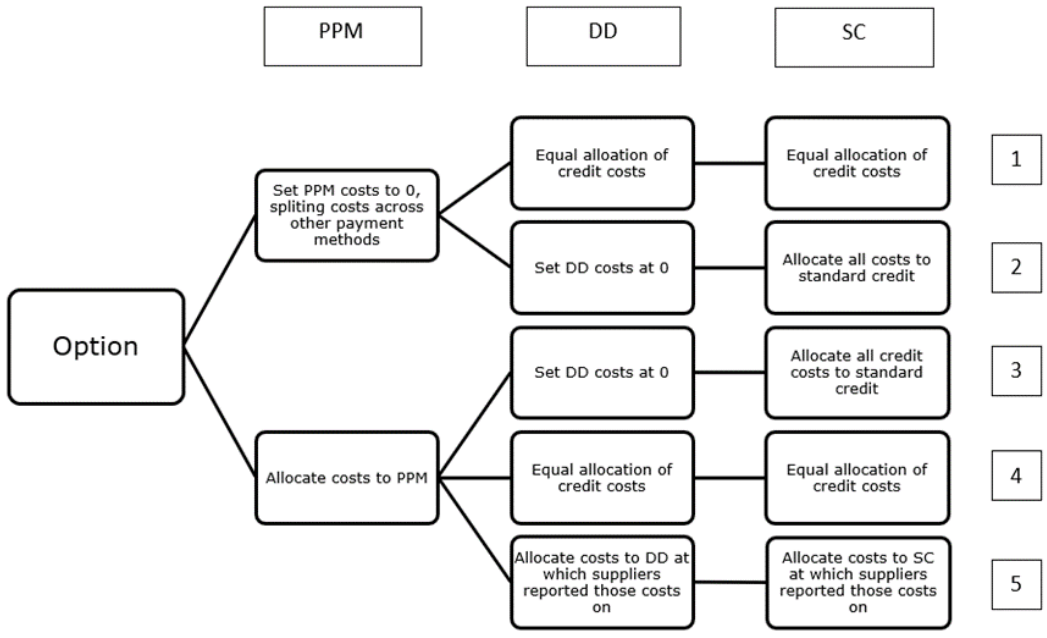
i) Option 2: allocate all costs to standard credit while setting direct debit and PPM costs to zero.

ii) Option 3: separate credit and PPM costs, while allocating all credit costs to standard credit only and none to direct debit.

iii) Option 4: separate credit and PPM costs, while equally allocating credit costs on to direct debit and standard credit.

A4.3 Option 1 and 5 from the October consultation are the same as the equal allocation and reported allocation options in this consultation. The below figure sets out the flow of choices that generate each option.

Figure A4.1: Bad debt payment method allocation breakdown



A4.4 We summarise the payment method allocation options below:

i) 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.

ii) Option 2: allocate all costs to standard credit while setting direct debit and PPM costs to zero.

iii) Option 3: separate credit and PPM costs, while allocating all credit costs to standard credit only and none to direct debit.

iv) Option 4: separate credit and PPM costs, while equally allocating credit costs on to direct debit and standard credit.

v) Option 5: allocate costs to the payment method which suppliers reported those costs on.

Considerations

A4.5 Very few respondents to our consultation expressed any support for options 2, 3 or 4. Most respondents supported the two extremes. For instance, option 1, that gave the greatest increase in cost to direct debit customers, particularly for suppliers with more direct debit customers. Alternatively, option 5, that gave the greatest increase in costs for standard credit (and PPM) customers, particularly for supplier with more of these customers.

A4.6 One supplier did support option 2 as it allocated a greater level of cost to standard credit, the group they deemed to have the largest propensity to incur bad debt and also did not impact PPM, keeping in line with the policy intent of levelisation between PPM and direct debt standing charges. They stated that it would be appropriate to introduce a levelisation mechanism to ensure suppliers receive fair recovery from smearing costs in the cap (we address this in chapter 6).

A4.7 We do not consider that there is particular merit in retaining options 2-4, for the reasons set out in the subsequent paragraphs. We have also taken into account the limited support for these options. We have therefore decided to discard these options, as this simplifies the option set for this consultation. We consider that the option space within Chapter 6 provides a good range of the possible approaches.

A4.8 Options 3 and 4 would lead to a significant increase in costs for PPM customers. In the case of option 4, this increase would be greater than for direct debit and

standard credit. In Chapter 6, we outlined that limitations in the supplier data are likely to over-allocate costs to PPM customers, so relying on the underlying data to allocate costs to PPM may lead to PPM customers being overcharged. We therefore consider that it would be difficult to justify these options.

A4.9 Option 2 provides a middle option that doesn't allocate any costs to PPM and keeps the additional cost impact on direct debit to zero. This has the largest impact on standard credit after option 5. We consider the allowance option set out in chapter 6 to be a better alternative to option 2. It aligns more closely with the current approach we take within the price cap methodology, whilst still reducing the impact on PPM and standard credit relative to the reported data approach (option 5).

Appendix 5 – Privacy notice on consultations

Personal data

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

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

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

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

2. Why we are collecting your personal data

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

3. Our legal basis for processing your personal data

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

4. With whom we will be sharing your personal data

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

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

Your personal data will be held for six 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".