

Decision

Energy price cap additional debt costs review decision

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| Publication date: | 23 February 2024 |
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This document sets out our decisions for a temporary adjustment to the price cap which will take effect from 1 April 2024, for 12 months. We will set the adjustment using a hybrid benchmarking approach (option 3 in our October 2023 consultation) and we will recover costs equally over direct debit and standard credit customers (no adjustment to prepayment meter customers). This would result in a £28 dual fuel bill increase for those customers affected.

In December 2023, we consulted on our proposals for making a temporary adjustment to the cap from April 2024 using a float and true-up process. We had previously sought views from stakeholders about making an adjustment and set out in our October consultation the various options for the approach to an adjustment.

We have carefully considered all responses to both the December 2023 and October 2023 consultations, and we have addressed the main points from them where relevant below. We have published non-confidential responses on our website.

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Foreword

Energy prices are falling following two years of extraordinary price rises. Today's announcement of a new headline cap level of £1,690 from April 2024 is 12% lower than the current cap level and 58% below the peak we observed in winter 2022/23. However, prices remain around 50% higher than before the crisis and even when taking into account wage growth over the period, energy accounts for a 50% higher share of household disposable income than before the crisis.

Government support helped to mitigate affordability issues while the gas crisis was at its height, but we have nevertheless seen debt levels rise as people struggle to meet the costs of higher bills, not just in energy but across other sectors too. Our latest data shows there are £3.1 billion of debt & arrears across the domestic energy market (as of December 2023), an increase of over £1 billion since the start of 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. New measures within the set of consumer standards rules we have introduced include greater prescription on what we mean by offering debt repayment plans at the earliest opportunity and considering offering temporary debt repayment holidays, where appropriate. We have also tightened the protections for involuntary prepayment meter installations.

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.

Any increase to a price cap allowance is something Ofgem takes very seriously. We are acutely aware of the potential compounding effects of price increases on the existing debt problem, so this decision allocates costs equally over direct debit and standard credit customers to minimise the increase on overall debt levels in the system. Allocating costs equally between standard credit and direct debt yields the lowest cost on average to vulnerable customers and the lowest equity weighted costs across all customers.

This increase is a temporary allowance as uncertainty remains over the eventual scale of debt related costs in this period. We do not yet know how much of the debt in the system customers will eventually repay. This allowance is set at our best view of the

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eventual cost. If the adjustment is too low, it could result in consumers experiencing a more significant bill increase when we review costs in April 2025 if bad debt costs crystallise at a higher level this winter than previously estimated.

On balance, we consider using a hybrid option to benchmark the allowance will continue to protect consumers from the full extent of bad debt costs now and in the future and strike a balance between allowing suppliers to recover their efficiently incurred costs and enabling them to provide immediate support to customers who are struggling to pay their bills and effectively manage their debt. 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 and how we recover these costs over customers with different payment types.

We remain 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. So, we'll be stepping back to look at issues surrounding debt and affordability across the market for struggling consumers and announcing this soon.

Executive Summary

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

The cap includes a number of allowances for the costs a supplier faces, such as wholesale costs, network costs and operating costs. Within these various costs, we provide allowances for debt-related costs, including costs of bad debt, debt administration and working capital.

We understand that this is a very worrying time for many customers given the cost of living pressures that impact affordability of energy and other bills. We are particularly mindful of the impact changes in the cap have on customers who are already facing payment difficulties and have kept this at the forefront of our decision making.

We have observed increasing levels of debt, in energy and other bills, with current energy debt and arrears totalling £3.1bn (as of Q4 2023), an increase of over £1bn since the start of 2023. These high debt levels in turn mean that greater proportions of outstanding bills may never be repaid. We have reviewed suppliers' debt-related costs to determine whether the cost for an efficient supplier has materially and systematically deviated from the allowances within the cap.

Our analysis suggests that costs have materially diverged from the existing allowances in the cap and that this problem is likely to persist due to the ongoing cost of living crisis. We have decided to make a temporary adjustment to the cap for additional debt-related costs incurred from April 2022 to March 2024, using an estimate for this winter. We will set an initial float allowance from April 2024 for a 12-month period and aim to deliver a true-up process by April 2025 that takes into account the most up to date information on industry costs and could result in either a positive or negative adjustment to the allowance.

Given the scale of ongoing concern around growing levels of bad debt across this winter and also the likely persisting effect of bad debt beyond this winter, we have decided to set the allowance using a hybrid benchmarking approach (weighted average for bad debt costs and lower quartile for debt administration and working capital costs) as discussed

in our October consultation. This results in an adjustment of £28 per direct debit and standard credit customer.¹

This is an increase compared to our previous position set out in our December 2023 consultation. We consider this approach better reflects the balance between efficiency and the support we require suppliers to offer customers. In reaching our decision, we need to balance both the short and longer-term interests of consumers. While it is in customers' short-term interests to keep the adjustment as low as possible, too low an adjustment would likely result in exposing consumers to a much higher price increase as part of the true-up process and gives rise to risks of other short and longer-term detriments. This scenario has the potential to lead to a distortion of the market, and could impact suppliers' ability to meet our financial resilience standards, which could lead to higher costs for default tariff customers overall.

Increasing levels of bad debt are not just being influenced by energy prices, but are also being driven by wider non-energy cost of living challenges. This means that on balance these costs are less likely to be within a supplier's control. However, the hybrid approach still allows an efficiency incentive for bad debt costs while allowing an even greater efficiency incentive for costs they have more direct control over, such as debt administration and working capital costs.

We have decided the adjustment will be recovered equally over direct debit and standard credit customers, with zero recovery over pre-payment customers. We recognise although a higher number of low income households pay by direct debit, this approach will help to minimise the impact on payment methods with a higher proportion of vulnerable customers. We also estimate that it will also lead to a lower increase in debt as a result of this allowance when compared to alternative allocation options.

This decision results in a price cap adjustment of £28 for the typical dual fuel consumer. However, the COVID-19 bad debt true-up allowance will fall away from the cap this spring. This means the net debt related-cost increase in the cap from April 2024 will be £17 for the typical direct debit and standard credit consumer.

We aim to deliver the true-up, which may result in either a positive or negative adjustment, by April 2025, in which we may reconsider the stringency at which we benchmark costs and the allocation of costs over payment methods. By this time, we intend to have delivered Phase 2 of levelisation of payment methods (bad debt

¹ This figure is represented in the latest Typical Domestic Consumption Value (TDCV) of 2,700kW/h for electricity & 11,500kW/h for gas. This is otherwise referred to in the document below as £31 at price cap benchmark (3,100kW/h for electricity & 12,000kW/h for gas)

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levelisation) and the review of operating cost allowances, which seeks to establish a new enduring allowance for debt-related costs. We will consider the implications of both these work areas more closely as part of the true-up approach.

1. Our decision-making process

Decision-making stages

| Date | Stage description |
|------------------|---|
| 18 April 2023 | Stage 1: Call for Input |
| 28 June 2023 | Stage 2: Update letter on debt-related costs review |
| 12 October 2023 | Stage 3: Policy Consultation |
| 15 December 2023 | Stage 4: December Consultation |
| 23 February 2024 | Stage 5: Decision |

Related publications

1.1 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>

1.2 The main documents relating to this consultation are:

- February 2024 – Decision on adjusting standing charges for prepayment customers: <https://www.ofgem.gov.uk/publications/decision-adjusting-standing-charges-prepayment-customers>
- December 2023 – Energy price cap: additional debt-related costs review consultation: <https://www.ofgem.gov.uk/publications/energy-price-cap-additional-debt-costs-review-consultation>
- 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>
- 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>

Publication overviews

- 1.3 This document outlines our decision whether to include a temporary adjustment to the price cap to account for additional debt-related costs. This decision follows our consultation published in December 2023.
- 1.4 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.
- 1.5 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 extending to cap periods 10a (April - June 2023) and 10b (July – September

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>

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)

- 1.6 We have issued four RFIs to capture new data and to be able to calculate net debt costs from cap periods 8-10b. Each additional RFI has collected an additional 3 months of data. The October 2023 RFI collected data from January 2017 - September 2023.
- 1.7 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 Credit⁴ (ASC);
 - Revenue;
 - Customer accounts.

April 2023 Call for Input on debt-related costs

- 1.8 We began consulting on debt-related costs as the sudden and unexpected impact of the COVID-19 pandemic on some customers' incomes, alongside large-scale government restrictions on debt collections resulting 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.
- 1.9 Given the context of the wholesale price crisis, we published a Call for Input in April 2023 to seek views on our initial considerations and options around debt-related costs.⁵
- 1.10 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.

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>

June 2023 update letter on debt-related costs review

- 1.11 We published an interim update letter on 28 June 2023 on our review.⁶ This set out that, given the data and evidence we had received at that point, we considered there was not a material or systematic gap between the allowance within the 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.
- 1.12 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 bad debt arising from the provision of additional support credit (ASC) for 12 months initially from cap period 11a (October - December 2023).⁸ This increased the debt-related costs allowances for PPM customers. In our current decision, we are adjusting debt-related costs for credit customers only.

October 2023 additional debt-related costs allowance policy consultation

- 1.13 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.
- 1.14 Under the Tariff Cap Act 2018⁹ ('the 2018 Act'), we are required to exercise our functions with a view to protecting existing and future domestic customers paying standard variable and default rates. In doing this, we must have regard to a number of factors including: the need to incentivise suppliers to improve their efficiency and customers to switch to different supply contracts, setting the cap at a level that enables suppliers to compete effectively and the need to ensure that suppliers who operate efficiently are able to finance their licensed activities. Suppliers' financeability includes their ability to secure investment.

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

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

⁷ Ofgem (2023), Price cap – December 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 Domestic Gas and Electricity (Tariff Cap) Act 2018

- 1.15 One of the ways we protect the consumer interest is to assess what the efficient costs of a notional supplier would be and allow the recovery of those costs. This is with a view to customers paying no more than is necessary to ensure suppliers' financeability whilst at the same time, putting beyond doubt their ability to offer appropriate help and support to customers facing debt problems. In the real world, of course, it is the case that suppliers (even profitable ones) can fail due to cash flow and liquidity problems. This is a risk that suppliers and investors and properly responsible for (and should be exposed to). However, supplier exits from the market via a Supplier of Last Resort (SoLR) or Special Administration Regime (SAR), can increase costs for all customers.¹⁰
- 1.16 The purpose of the price cap is not to prevent such failures – the 2018 Act requires us to set only one cap for all suppliers – not separate caps for individual suppliers according to each of their particular circumstances. However, in setting the price cap, one of the matters we consider in the round, in the interests of consumers, is the likelihood of increasing or decreasing the risk of SoLRs/SARs occurring. This is especially important when we are considering the timing of our decisions.
- 1.17 In the October 2023 consultation, 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 to determine the size of any adjustment. These were, lower quartile, weighted average and in, Option 3,¹¹ a combination of the two, which is the same as the hybrid approach that we have now decided to adopt. Since some debt-related costs had 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 across consumer groups based on their payment type (standard credit, direct debit, and PPM), including with reference to the approach taken in our COVID-19 true-up decision,¹² and

¹⁰ Ofgem (2023), Additional debt-related costs allowance policy consultation. <https://www.ofgem.gov.uk/publications/additional-debt-related-costs-allowance-policy-consultation>

¹¹ Ofgem (2023), Additional debt-related costs allowance policy consultation. <https://www.ofgem.gov.uk/publications/additional-debt-related-costs-allowance-policy-consultation>

¹² 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>

discussed how this allocation interacted with the outcome of the consultation on levelisation of payment methods. This consultation also set out the case for trueing 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.

December 2023 additional debt costs review consultation

1.20 The December 2023 consultation set out and considered a number of options on key policy elements such as the introduction of a temporary allowance, a float and true-up process, our estimation of existing allowances, our benchmarking costs, and how the allowance should be allocated.

1.21 We used the responses to our October policy consultation¹³, as well as analysis from our most recent RFI (covering Q3 2023 costs) to support our proposals set out in the December consultation.

1.22 We received 16 responses from energy suppliers, consumer groups, charities, an industry stakeholder, and a report submitted by an economic consultancy on behalf of two suppliers. We also received 618 responses from individuals, making it a total of 634 responses from all stakeholders.

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1.23 We have taken those responses into account and have actively considered the correct approach to take in the light of all the information that we have. In this document, we set out our decision on introducing an additional 12-month temporary allowance into the price cap for additional debt-related costs. We consider it necessary to introduce the allowance in a timely manner by April 2024 based on our analysis of supplier data which has shown a material divergence from existing allowances, and which we do not expect to level off in the near term (winter period 2023/24). We have used estimates of additional debt-related costs in the April 2024 cap to set the initial float allowance. This will be accompanied by consideration of whether a true-up adjustment is needed in April 2025.

¹³ Ofgem (2023) Additional debt-related costs allowance policy consultation. <https://www.ofgem.gov.uk/publications/additional-debt-related-costs-allowance-policy-consultation>

General feedback

1.24 We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

- Do you have any comments about the overall quality of this document?
- Do you have any comments about its tone and content?
- Was it easy to read and understand? Or could it have been better written?
- Are its conclusions balanced?
- Did it make reasoned recommendations?
- Any further comments.

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

2. Introduction

Section summary

In this chapter, we provide an overview of our key decisions and an introduction to other related work.

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')¹⁴.
- 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.
- 2.3 The cap sets the maximum amount a supplier can charge default tariff customers for energy. It varies based on several different parameters, including fuel type, benchmark consumption, electricity meter type, regional differences and payment method.

¹⁴ Domestic Gas and Electricity (Tariff Cap) Act 2018.
<https://www.legislation.gov.uk/ukpga/2018/21>

2.4 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 Many consumers continue to struggle with paying their energy bills. Our latest data shows that current level of debt and arrears across the market stood at £3.1 billion as of December 2023.

2.6 We have seen an increase in bad debt over 2023 as customers feel the impact of wider cost of living pressures and following the end of the Energy Bill Support Scheme and EPG (for broad bill support, not specific support for PPM customers) in March 2023, which was introduced as part of a support package at an unprecedented level to help households and businesses.

2.7 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.

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.

2.9 In October and December 2023, we consulted on introducing a temporary allowance via a float and true-up process, how the allowance should be allocated, our estimation of existing allowances, and our approach to benchmarking costs. In December 2023 we proposed a benchmarking approach using a lower quartile benchmark for all three categories of costs.

2.10 We have received stakeholder feedback on our consultations and have taken them into consideration. This document sets out our decision to adjust the cap for additional debt-related costs as well as other key policy elements including a benchmark for the allocation of costs, the treatment of PPM moratorium costs, inclusion of a forecast for winter 2023/24, and whether to uplift any initial allowance for inflation or the cost of capital.

Structure of this decision document

2.11 This decision document is split into seven chapters and five appendices:

- Chapter 1: Our decision-making process;
- Chapter 2: Introduction;
- Chapter 3: Setting a temporary adjustment;
- 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: Other decisions;
- Appendix 4: Annex 8 methodology and model changes;
- Appendix 5: Levy option.

Overview of key decisions

- 2.12 We have decided to introduce a temporary adjustment to the price cap for additional debt-related costs covering April 2022 to March 2024 only. This includes a forecast of winter 23/24 costs as well as the costs of the PPM moratorium.
- 2.13 We have decided to implement this by setting a float allowance in April 2024, which will be recovered by suppliers through the energy price cap over a 12-month period. We aim to carry out a true-up exercise by April 2025.
- 2.14 We have considered stakeholder feedback on our proposal, and following internal review and assessment, we have decided to adopt a hybrid benchmarking approach (Option 3 in the December 2023 consultation). This is a change to our proposal set out in the December 2023 consultation in which we expressed a minded-to position towards Option 1.
- 2.15 We have decided to not uprate the adjustment for inflation. We will also not be uprating the adjustment for cost of capital.
- 2.16 We have decided to allocate cost recovery equally among direct debit and standard credit customers, with zero recovery across PPM customers.
- 2.17 We have decided to allow recovery of the costs:
- Proportionally over gas and electricity bills (48/52% split respectively)

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- Through the unit rate only with no increase in the standing charge
- Equally over single rate and multi-register customers

Interaction with other workstreams

- 2.18 There are interactions between this decision on additional debt-related costs allowance and the implementation of the levelisation of payment methods policy and the review of operating cost allowances.
- 2.19 There are also interactions between this decision and the decision to introduce a temporary allowance for bad debt associated with ASC in August 23. In the ASC decision, we introduced an initial 12-month allowance for ASC bad debt from October 2023. With the operating costs review not expected to conclude until April 2025, the ASC allowance will cease to be included in the price cap from Oct 2024. This provides us with the following options: temporarily extend the ASC allowance for winter 24/25, introduce a new ASC allowance or do nothing. We will keep this under review and consult later this year on the future of the ASC allowance.
- 2.20 We want to step back and look at the issue of affordability in the round to make sure we understand how all the pieces interact, and will be announcing this soon.

Levelisation of payment methods

- 2.21 We are moving forward with our decision to levelise prices across payment methods, and will implement this in 2 phases:
- Phase 1 – Levelise PPM and DD standing charges (including ASC bad debt)
 - Phase 2 – Levelise wider debt-related costs between DD and SC customers.
- 2.22 The interaction between levelisation and debt-related costs is most material through our considerations on cost allocation between customers on different payment methods.
- 2.23 Phase 2 of our levelisation decision will not be in place at the timing of the initial float (April 2024) but is planned for implementation by April 2025. Thus, it will be in place by the time of the true-up (April 2025). We will consider the interaction with how we allocate costs at the true-up.

Operating cost review

- 2.24 As set out in our May 2023 Call for Input, we are conducting a review of the operating cost-related allowances in the price cap, including the core operating costs, Smart Metering Net Cost Change (SMNCC) and the payment method

uplift.¹⁵ The intention of the review is to consider whether changes to these allowances are appropriate, and if the allowances still reflect the efficient costs a notional efficient supplier may incur.

- 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 would consider how the debt-related costs allowance is set on an enduring basis, with a decision currently expected in April 2025. We intend to publish a policy consultation for the operating cost review in April 2024, in which we will discuss potential options for setting the enduring allowance.
- 2.26 On that basis, our decisions in this document relate to an additional debt-related costs allowance for the period spanning April 2022 to March 2024. All of these decisions require careful balances in their context, and it is not the case that we would decide the same approach is the best in the round as part of those wider and longer term reviews.

¹⁵ Ofgem (2023), Price cap - Call for Input on the Operating Cost Allowances Review.
<https://www.ofgem.gov.uk/publications/price-cap-call-input-operating-cost-allowances-review>

3. Setting a temporary adjustment

Section summary

In this chapter we will discuss the key decision on whether to introduce a temporary adjustment, this will include a decision on: Whether to make an adjustment to the cap from April 2024 and how long the allowance should last for, What time period the allowance should cover, Whether to make the adjustment using the float and true-up approach, and Whether to include all debt-related costs in our allowance.

Context

- 3.1 In our October and December 2023 consultations, we set out the case for making an adjustment where efficient debt-related costs had materially and systematically departed from allowances.
- 3.2 In our December 2023 consultation we proposed setting an initial estimate and trueing up the estimate later (float and true-up approach), rather than setting an allowance now with no true-up, or delaying the adjustment to set it on an ex-post basis.
- 3.3 We also considered a number of other areas including: treatment of PPM moratorium costs, inclusion of a forecast for winter 2023/24, whether to uplift any initial allowance for inflation, and the conversion of costs using current TDCV.
- 3.4 We have analysed responses to our December 2023 consultation and other stakeholder submissions. We set out our decisions and considerations below.

Decisions

- 3.5 We have decided to make an adjustment to the cap for additional debt-related costs covering April 2022 to March 2024, and to include all the debt-related costs in the calculations, including any costs related to the PPM moratorium. Our analysis of supplier data (including clarifications received since the December 2023 consultation) 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 have decided 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. We will carry out an update (true-up) on the initial allowance to align the costs and allowances. We will share data through a disclosure process when carrying out the true-up review.

- 3.7 We have collected data for costs over the period April 2022 to September 2023. To improve transparency following some supplier concerns, we have shared some data with suppliers on an individual basis. We do not anticipate the debt situation to materially improve over the winter, so we have decided to roll forward the Q3 2023 net debt-related cost data to set an allowance for October 2023 to March 2024. This float does not include an allowance for costs from April 2024.
- 3.8 We have decided for this adjustment to be recovered over a 12-month period and to not adjust for inflation, or the cost of capital. We are not using a levy mechanism. The justifications on which this decision is based are discussed in the annex.
- 3.9 We have decided to maintain our position of allocating the current allowance according to benchmark consumption values.¹⁶

Stakeholder comments

- 3.10 There were 16 stakeholders who discussed our temporary adjustment. Nine suppliers, two charities, two consumer groups, one economic consultancy, one industry body and one external stakeholder. Individual consumers felt that it was not fair for them to have their bills increased to pay for those who are in debt and were generally against an allowance (618 contacted us).
- 3.11 Four of these suppliers supported the introduction of a slight temporary adjustment to the price cap to account for debt-related costs. One of these suppliers was more supportive of commenting on the proposals set out in the December 2023 consultation as they represented a shift from the preferred proposals set out in the policy consultation.
- 3.12 Three suppliers agreed for the adjustment to be introduced but voiced concerns. One of these concerns was that we have understated bad debt costs, and we may harm competition by not reflecting different payment method mix amongst suppliers. The second supplier raised several concerns that need to be addressed prior to the implementation of the allowance. The third supplier thought there may be a threat of under-recovery before any true-up occurs.
- 3.13 One consumer group stated they understood the need for protection, but raised concerns that there wasn't any evidence that the additional funding is justified.

¹⁶ Benchmark consumption values are (electricity 3,100 kWh, gas 12,000 kWh) (see Table 4.2 for more information)

One charity stated they supported the allowance, but considered it should be undertaken fairly across the differing payment methods.

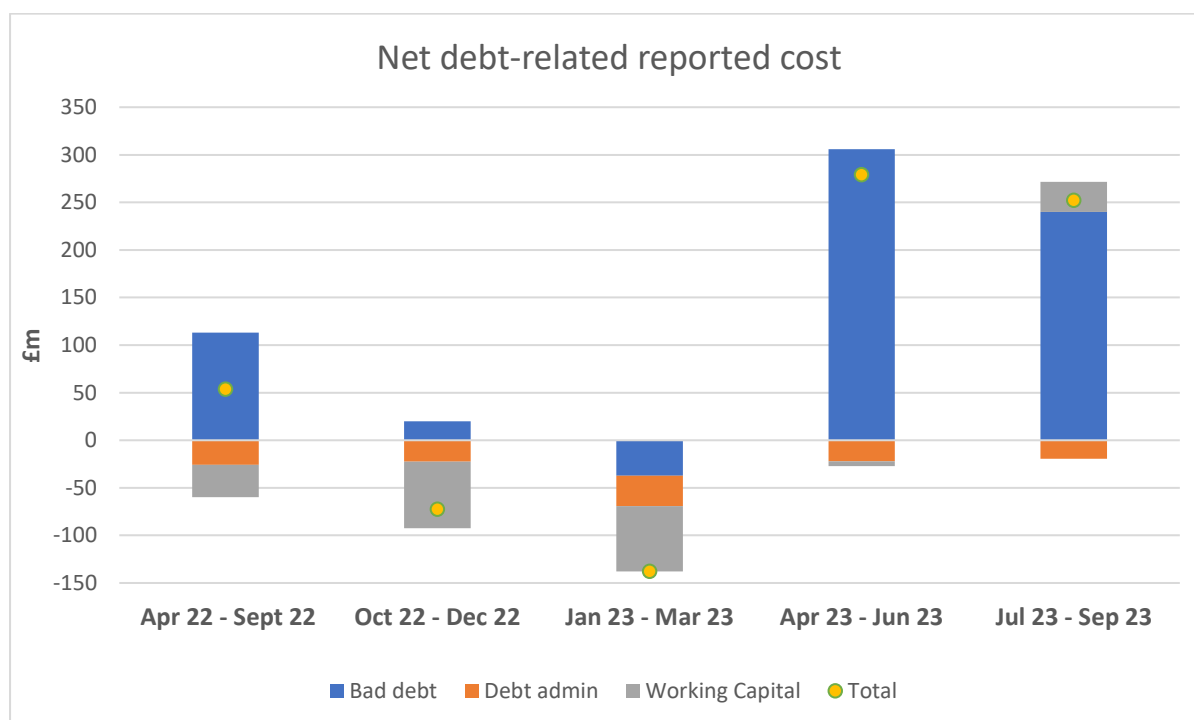
- 3.14 Two respondents, an industry body and charity, stated their support for government intervention into energy debt to prevent an additional allowance being put onto consumers. Two suppliers responded stating they support the industry body's response to our consultation, therefore adding to the comments in favour of government intervention.
- 3.15 The economic consultancy and external stakeholder acknowledged the need to address the issue of debt-related costs but raised concerns surrounding the price cap and our methods.
- 3.16 Finally, one consumer group was opposed to the introduction of the temporary additional allowance, partly because of the concerns that it will become a permanent allowance.

Considerations

Overall debt assessment

- 3.17 Our analysis of supplier's reported cost data, using the latest RFI issued in November 2023 suggests that debt costs have been rising in recent periods, and that this has led to reported costs of bad debt being higher than allowances, which hasn't been fully off-set by an over-allowance elsewhere in the cap.
- 3.18 Figure 3.1 shows that over April 2022 – March 2023 there was a relatively small difference between bad debt reported costs and the allowance, fluctuating between an over-allowance and an under-allowance. We consider the over-allowance in cap period 9b was likely driven by government support packages (which are no longer in place) which reduced levels of non-payment. The allowances were high during these periods because they were based on the cap level, rather than the EPG level which determined customer bills. Following this period, there has been an increase in bad debt and reported costs have begun to depart from allowances in the other direction.

Figure 3.1 – Net debt-related costs over cap period 8-10b¹⁷



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

3.19 Over the entire period covered by the chart above, there has been an over-allowance of debt administration costs and from April 2022 to June 2023 an over-allowance of working capital costs. We consider the government support in the earlier cap periods will have had an 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.

3.20 This trend of debt-related reported costs and under/over-allowances sets the context for the decisions we have reached.

Setting an adjustment covering all the debt-related costs

3.21 When deciding whether to make adjustments to the cap, we apply a test to consider whether an issue is both material and systematic. In our 2018 price cap decision we explained that for a cost impact to be systematic it would need to be

¹⁷ 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 zero line represents the current allowance. The price cap moved to quarterly updates from cap period 9a which is represented by the change from 6 months to 3 months in the second column. Net costs = costs – allowances. Total = sum of all three debt-related costs.

unforeseen, clear, material, and necessitate changes.¹⁸ 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.¹⁹

- 3.22 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. Having considered the data on debt related costs as well as other industry indicators such as debt and arrears data, price cap levels and economic data as well as consultation responses. We do not believe that debt-related costs in the industry will drop significantly below the allowance values.
- 3.23 Our systematic and material test is a high threshold for making changes to the cap. The rising costs generated by the increase in debt levels across the market have met our requirement to consider an adjustment.
- 3.24 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 started involuntary PPM until 8 January 2024, meaning bad debt continued to accrue in winter 2023/24 from customers who might otherwise have moved to PPM.²⁰ To remove this under-allowance in the period we are considering for this temporary allowance, would require a material over-allowance. We have no reason to expect this to occur and therefore consider the impact on debt related costs is systematic. With both aspects of our test met, we consider it appropriate to adjust the cap with a temporary additional allowance to allow suppliers to recover their efficient debt-related costs.

¹⁸ Ofgem (2018), Default tariff cap: decision – overview, paragraph 3.16.

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

¹⁹ 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>

²⁰ This is discussed further at 3.41. 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>.

See also list of energy suppliers that can install involuntary PPM.

Ofgem (2024), Check energy suppliers that can install prepayment meters without household permission.

<https://www.ofgem.gov.uk/information-consumers/energy-advice-households/check-energy-suppliers-can-install-prepayment-meters-without-household-permission>

- 3.25 While suppliers generally agreed that an additional allowance was required, most consumer groups and charities opposed making an adjustment to the cap, which would increase costs for customers. Individual consumers felt that it was not fair for them to have their bills increased to pay for those who are in debt (618 contacted us). They thought that they are not being rewarded for routinely paying their bills in full and on time despite the cost-of-living crisis. Some consumer groups highlighted that many of the adjustments we have recently made to the cap have increased the level, which they said was favouring suppliers.
- 3.26 One charity wanted more transparency from suppliers on debt write-offs and how customers would be affected. Two consumer stakeholders wanted more focus from us on how to reduce the level of energy debt. Two consumer stakeholders said the allowance should be applied equitably. One said suppliers should recover efficiently incurred costs if suppliers' methods of estimating bad debt have been reviewed. One consumer stakeholder wanted evidence that not increasing the price cap would risk supplier failure.
- 3.27 We are continuing our work to help energy consumers that get into debt and how we can increase support for them. We are aiming to deal with this allowance equitably and have considered this in deciding on the payment method allocation, discussed below. Further review of suppliers' actual bad debt costs will be conducted during the true-up (which we intend to carry out by April 2025).
- 3.28 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. We consider the change in risk of supplier failure and its associated costs to customers. We also aim to ensure that suppliers can meet their efficient costs of supplying energy under the price cap, aside from questions of supplier failure. 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.²¹
- 3.29 In relation to debt-related costs specifically, we have been working with suppliers to ensure they treat customers facing debt issues fairly.²² Suppliers must comply with all regulatory obligations. As part of a wider review on affordability, we will

²¹ As set out in Ofgem's Forward Work Programme 2023-24 on p.15.

<https://www.ofgem.gov.uk/publications/202324-forward-work-programme>

²² For example, Energy UK published 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.

be launching a Call for Input where we will be going out to the whole energy sector to help us better understand the impact of debt, high prices, affordability policy and support measures. However, under the Act, we must have regard to the ability of an efficient supplier to finance its licensed activities.

- 3.30 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 year. Many are already experiencing increasingly problematic levels of debt, in energy and other bills, with current energy debt and arrears totalling around £3.1 billion.
- 3.31 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. An allowance that is set too low can prevent the recovery of a notional supplier's efficient costs. A low allowance also affects the ability of actual suppliers to build up earnings and attract finance and investment leading to lower quality outcomes for customers.
- 3.32 In setting this adjustment, we have sought to reduce the impact on customers by making the adjustment temporary, taking a relatively stringent benchmark approach while reducing the scale of any later true-up adjustment, and considering how those costs are recovered between different customers. We discuss this in Chapters 5 and 6.
- 3.33 We have considered our proposals in the round of how we set the cap and have decided that an adjustment is appropriate for these circumstances. We explain how we will keep this balance under review in the float and true-up section.

Comments on the implementation

- 3.34 Some suppliers stated that particularly at the float stage not all debt-related costs should be included in the allowance (e.g. other costs should only be considered through the operating costs review) and working capital costs are unexpected and shouldn't be included as business as usual. It was also suggested that the material and systematic test may not be met on some of the individual costs, and that where this was the case for the Covid debt costs these cost categories were excluded from the float. Another supplier, and industry body said the PPM restart will lead to increases in administration costs. Once involuntary PPM activity resumes from January 2024, administration costs will rise, and the supplier expected them to exceed the current allowance.

- 3.35 Given the interactions between each of the debt-related costs it is sensible to consider them together. We are considering all the costs that suppliers face due to consumers not paying bills, growing consumer debt, and eventually having to write off some of that debt. We consider these costs on an aggregate basis. Looking at these debt-related costs together, we have decided that given the large divergence between costs and allowances, the material and systematic test is passed and the data is suitably reliable to be included in the float. The data we have seen does not show that debt administration costs are increasing and that this increase will affect the period of this temporary adjustment. However, this can be reviewed at true-up.
- 3.36 We do not see a clear reason to exclude debt administration and working capital costs from the float. 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 Some stakeholders stated that if debt administration costs were included these should not be apportioned between fixed tariff and default tariff customers based on total customers because most of these costs are related to default tariff customers and particularly standard credit customers (who are more likely to be default tariff customers). It was also suggested that the administration and working capital costs would be driven by outlier suppliers.
- 3.38 Suppliers have not provided evidence on tariff split to enable us to quantify these points for this float. If more data is available that can help apportion these costs, we will give more consideration to this at true-up. We have borne in mind that there will be an opportunity to look at the questions based on the actual data in due course, but our view is that it is necessary to take some steps in the interim before the full data is available, which is why we have decided on a float and true up approach.

PPM moratorium costs

- 3.39 In early 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.²³ The conditions set out in the Code have been incorporated into the Standard Licence Conditions (SLCs).²⁴ All energy suppliers have to follow them.

- 3.40 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 February 2023 – September 2023. This shows customers face payment difficulties more widely.
- 3.41 Three suppliers met the restart conditions and were able to install involuntary PPM in January 2024.²⁵ It is important to note that as suppliers meet restart conditions, this does not guarantee that they will immediately restart involuntary PPM installations at similar levels to before the moratorium, or that it will immediately influence bad debt levels.
- 3.42 Consumer groups 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. One consumer stakeholder considered that including PPM moratorium costs was immoral and that this meant suppliers were not being punished for the wrongdoing. Suppliers disagreed with excluding the costs of the PPM moratorium. They said doing so would not allow an efficiently run supplier to recover its costs.
- 3.43 The £25m per month PPM moratorium cost will be included in the suppliers' bad debt costs that are considered when calculating 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 efficient costs even where they had met their

²³ We refer to this as the PPM Moratorium.

²⁴ 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>

²⁵ Ofgem (2024), Check energy suppliers that can install prepayment meters without household permission. <https://www.ofgem.gov.uk/information-consumers/energy-advice-households/check-energy-suppliers-can-install-prepayment-meters-without-household-permission>

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.

Using a float and true-up approach

- 3.44 Most respondents were in favour of setting an initial float followed by a later true-up exercise.
- 3.45 A supplier suggested float and true-up for an initial 12 month period. Another supplier agreed, urging the true-up to happen quickly to impact the same customers. A third supplier would prefer us to make an interim one-off ex-ante uplift to the cap that falls away once the findings from the operating costs review is implemented. They felt that the true-up would be an onerous process raising questions about bad debt in 2024 and have difficulty reconciling long-term costs. An industry association said that there would be a large, complex, contested, and therefore, likely delayed true up risking a significant impact on suppliers. They added that “most of our members see no other option in the short term than utilising a float and true-up, given the urgency of the issue”.
- 3.46 A supplier stated our true-up approach was too uncertain and not consistent with giving suppliers sufficient funding or importantly confidence that such funding will be provided. A consultancy on behalf of two suppliers stated “Ofgem has not made any clear commitments to how its true-up mechanism will work, and even whether it will apply one, to adjust the uplift to the price cap to cover outturn, efficiently incurred debt-related costs. While Ofgem states that it would consider a true-up process in case the float and outturn costs do not “materially” align, it does not explain what the materiality threshold would be, nor provides any details around how it would envisage carrying out the true-up.”
- 3.47 One supplier suggested an additional adjustment for bad debt costs incurred in 2024/2025 should be made in either the July or October price cap periods.
- 3.48 We have decided a float and true-up approach is preferable to the alternative two options 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 from the allowance we provide now.
- 3.49 A float and true up approach is an established regulatory tool which seeks to smooth out adjustments to allowances during periods of uncertainty, such as in the case of debt related costs in the current economic environment. This is

different from an ex post facto adjustment of an allowance in a previous price cap period, based on a review of differences between allowance and actual costs. The true-up may result in a negative or positive adjustment to a future price cap allowance for debt-related costs than has been provided in this float decision.

- 3.50 Under the 2018 Act, we must have regard to the impact of our decisions on factors such as competition, financeability and investability, when making a true-up assessment, and so those factors will be assessed in the round against all other factors, including protecting customers.
- 3.51 We have decided to implement the float in April 2024. This is preferable to delaying the allowance to allow more time to pass. A delay would increase the time between when suppliers incur the costs and when they recover them. A float allowance now helps ensure resilient suppliers who are able to deal with unexpected shocks, something which has been increasingly necessary in recent years. We will be able to consider if any interim adjustments may be appropriate before April 2025 once we have gathered more data.
- 3.52 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.
- 3.53 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. A timely true-up ensures a closer link between the consumption that generated the costs and the consumers that pay for the allowance. Lastly, we must also take into account the trade-off between timeliness and accuracy, and seek to strike an appropriate balance. We will consult on the true-up process later in 2024.

Setting costs for Winter 23/24

- 3.54 In our December 2023 consultation we proposed incorporating 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 this period and there are no government support schemes of the scale of EPG and

- EBSS. We consider it likely that we would see a continuation of under-allowances as shown in recent cap periods in Figure 3.1.
- 3.55 We do not have data on the debt-related costs in this period. We do have Q4 data on the overall level of debt and arrears that shows a continuation of the trend. Therefore, for the purpose of setting a float, we proposed 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.
- 3.56 Some suppliers said that the proposed forecast was too low. These suppliers said we should have used a winter period for the forecast rather than a low consumption summer quarter. One supplier also said the forecast should be increased for the extra administrative costs of the PPM restart. Suppliers felt debt-related costs would be higher than our forecast.
- 3.57 It is true winter will have greater consumption (so greater bad debt) but it will also have greater price cap allowances including debt related costs allowances that suppliers will receive in line with the higher energy spending. It is not clear that net debt-related costs have been or will be larger in winter than in summer. This was not the case in winter 2022/23 (probably due to government support with EPG and EBSS) and using the winter data would have resulted in a lower (and unrepresentative) forecast for this winter. There are cases where winter consumption is not billed or fully reflected in bad debt provisions until the summer quarters.
- 3.58 The impact of the cost of living crisis and the PPM restart on debt related costs this winter are also uncertain. We do not consider that the forecast we proposed for this winter is unreasonably low.
- 3.59 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 . 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 could lead to competitive distortions in the market, as further discussed in chapter 5.
- 3.60 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 suppressing 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.

- 3.61 We have decided to maintain the method for including a forecast for winter 2023/24 as we outlined in our December consultation (and above). We note that the change to hybrid benchmark has increased the modelled costs and so has increased the forecast. For the true-up the debt-related costs for winter 2023/24 will be based on actual data.

Treatment of costs from April 2024

- 3.62 Several suppliers thought that the additional allowance for debt-related costs should cover the period after April 2024. Suppliers stated that the price cap should meet suppliers' efficient costs and that the cost of living crisis and its ongoing effects on consumers have not gone away and there is not the same government support for consumers during winter 2023/24 as there was last winter.
- 3.63 Suppliers noted potentially increased debt administration costs after the PPM restart and future uncertainty given energy prices were remaining above pre-gas crisis levels. In the December (2023) consultation we noted that the operating cost review would adjust the price cap for enduring debt-related costs, but some suppliers noted that these operating costs review would not cover the costs in April 2024.
- 3.64 As we have noted above, it is very difficult to predict the path of future net debt related costs and what impact these may have on the additional allowance. We have included a forecast for this winter based on what we know about the wider economic and consumption situation when issuing this decision. Predicting further into the future without recent bad debt data is more difficult. There was no consensus on how best to forecast debt-related costs (either for winter 2023/24 or for April 2024 onwards). Given this uncertainty we have not included any forecast for debt-related costs for April 2024 in the float. We will be able to consider if any interim adjustments may be appropriate before April 2025 once we have gathered more data.

Uprating for inflation, cost of capital and consumption patterns

- 3.65 We received stakeholder feedback regarding uprating the allowance for inflation or cost of capital, to reflect the time value of money and delay in cost recovery.
- 3.66 Three suppliers were in favour of uprating the float allowance to account for inflation. One supplier, the economic consultancy, the industry body and external stakeholder were in favour of uprating the float by alternative approaches such as: uprating the float by cost of capital.

- 3.67 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.
- 3.68 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 have decided not to make an adjustment for inflation or the cost of capital.
- 3.69 The under-recovery of debt is concentrated in the most recent quarters, reducing the time difference between the costs and allowance. Additionally, with over-recovery in the earlier periods in the review – the combination of these factors tends to cancel each other out making a correction for inflation immaterial at this point. We may consider an inflation adjustment when carrying out the true-up if we deem the impact to be material.
- 3.70 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.
- 3.71 The option to uprate the allowance for inflation or the cost of capital can be reviewed at the true-up stage. This is consistent with our approach to the COVID-19 true-up, in which we accounted for inflation in the true-up, but not at the float.
- 3.72 One supplier said that the assumed number of default tariff customers for April 2024 to March 2025 is too high as customers on default tariffs are reducing which will lead to a supplier shortfall because the allowance will be recovered over a smaller customer base. The customer accounts from the October 2023 RFI is the most up to date information we have at the time of this decision and we consider is the most appropriate measure of customer numbers to use in our calculations for the float.
- 3.73 A different supplier expressed that net costs are calculated at £ per customer level but then converted into legacy TDCVs rather than the current consumption

values, leading to under-recovery. We do not consider that there is a material difference between average customer consumption and legacy TDCVs.

- 3.74 As part of the true-up process we will take into consideration if there has been a material change in the number of default tariff customers or consumption between when the allowance is set and fully recovered.

Disclosure of models and data

- 3.75 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.
- 3.76 An industry body said that suppliers were not clear how their data has been used. They said a putback process similar to the wholesale cost review was necessary and should be used if time allows. They also requested that we share the allowances model with suppliers early as part of the operating costs review.
- 3.77 A supplier said disclosure was required to minimise errors in interpretation. They also supported a putback process and early sharing of the models so that materiality can be assessed, and these are considered for the operating cost review. They noted they had found previous errors in some policy proposals. They considered that a review should include industry wide data (e.g. sample selection and issues of data comparability). They felt there was no risk of accidentally disclosing confidential information. They asked us to commit to full disclosure at true-up and requested we share ranges for the bad debt allowances now.
- 3.78 Another supplier was concerned by the lack of transparency in relation to the models making it difficult to provide sufficient feedback. They requested we share the models immediately. One supplier stated that a more stringent benchmark approach requires more transparency to support such a decision, but to avoid delaying the float we should provide a data room during the true-up. One supplier wanted more data on the payment mix for each of the suppliers that had been used in our benchmark.
- 3.79 We carried out further stakeholder engagement with individual suppliers in January 2024 to check for significant errors in how we have used their data. We consider that this exercise combined with the information we have published enables stakeholders to make meaningful comments on our approach and

methodology for setting a float. In the consultation, we published our step-by-step calculations estimating the allowances and costs in the appendices. We also included summary statistics of the data to show the range and spread between suppliers.

- 3.80 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.
- 3.81 We are also not disclosing suppliers' individual data as part of this float (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 decision would give sufficient information. These modelling details apply to all of the benchmark and consultation options discussed. We have also used the consultation document to provide more clarifications and details of our methodology.
 - 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 of leakage of confidential data – for example that information is spread further than envisioned. Even undertakings from professional advisors do not fully mitigate the risk of sensitive information being directly, or indirectly shared between competitors.
- 3.82 We have noted the comments that have been made about the value of further disclosure. We plan to undertake a disclosure process including a confidentiality ring as part of the true-up process as we did in the COVID-19 true-up.

4. Estimation of existing allowance

Section summary

In this chapter we will set out our decision on how we estimate the current debt-related costs allowance which is used to baseline costs.

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 costs 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.²⁶

Decisions

- 4.4 We have maintained our approach to calculating the allowance that was outlined in the December 2023 policy consultation. That methodology is repeated here.
- 4.5 We estimated 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.
- 4.6 Where we need to use 2018 data to apportion allowances, we used the most precise data from 2018 where available. When apportioning allowances without

²⁶ 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>

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precise 2018 data, we maintained as much consistency as possible between the approaches to different allowances.

- 4.7 We have decided to keep the same level of stringency in our specific debt-related cost allowances, as there was 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 cap²⁷

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

²⁷ This table has been 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.²⁸
- 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.²⁹ 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 will 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.

²⁸ 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.

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

Stringency

4.15 We have decided 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.³⁰ 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 have decided 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 and can be considered an equally efficient benchmark when estimating the notionally efficient supplier.³¹ We therefore propose to average the data from these two benchmark suppliers to produce a combined estimate.

³⁰ We benchmarked operating costs at the lower quartile minus £5.

³¹ 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>

- 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 have decided 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.³² A weighted average reflects the relative scale of suppliers in the market; thus, it is the best way to average the benchmark suppliers. We will apply this weighted average approach consistently across both estimates that relate to operating cost benchmarks.
- 4.22 We have decided 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 will 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.
- 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

³² 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>

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.³³ 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.³⁴
- 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 (ASC) bad debt costs introduced an additional allowance for bad debt arising from the provision of 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.³⁵ 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).

³³ The PPM uplift is a part of the payment method uplift that captured additional PPM costs relative to direct debit.

³⁴ As explained in the notes to the table, the TDCVs used in the price cap have changed over time.

³⁵ 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)³⁶

| | | 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.

³⁶ 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).

Stakeholder comments

- 4.31 One supplier agreed Ofgem should account for non-efficiency factors in its sampling criteria. They considered this consistent with our aim of estimating the efficient costs of a notional supplier.
- 4.32 One charity believed there should be transparency over the level of write-offs so that stakeholders can see the impact that this significant extra funding for debt-related activity is having.
- 4.33 One consumer group thought we should review all the approaches to estimating bad debt and, where methods are identified that are likely to overstate bad debt, exclude those suppliers from the benchmarking.
- 4.34 Another supplier thought a one-size-fits-all efficiency incentive based on a sample of suppliers with significantly different customer mixes is not appropriate.

Considerations

- 4.35 As noted in chapter 3, many suppliers wanted greater transparency of the models (including the model for estimating the existing allowance). These suppliers felt that they were unable to properly comment on the validity of our estimation methods until this information was made available. We did provide some additional detail to individual suppliers in January 2024, but this only allowed suppliers to check we had applied our methodology as planned, not to check the validity of this methodology.
- 4.36 We have decided to maintain the method outlined in the December consultation for estimating the existing allowances. We will revisit this methodology during the true-up consultation process where we plan to set up a confidentiality ring to allow stakeholders' advisers to inspect our model.

5. Calculating and benchmarking costs

Section summary

In this chapter we provide a summary of the debt-related costs metrics for the three components (bad debt, debt-related administrative and working capital costs). We then discuss our decision on how to benchmark costs.

Context

- 5.1 Through this review, we considered whether efficient costs have materially and systematically deviated from the allowances in the cap. We evaluated our benchmarking approach against the criteria of protecting customers and the assumption of targeting efficiency, while incentivising suppliers and sustaining financial resilience.
- 5.2 The cap varies by a number of parameters (eg, fuel type and payment method). When setting a benchmark for debt-related costs, one aspect we considered is whether the underlying costs vary by these parameters, while excluding outliers. For example, whether the propensity to build debt is related to a customer's payment method or fuel type.
- 5.3 As these variations in costs can be driven by different parameters, we continue to set the cap using a bottom-up cost assessment using different benchmarking approaches for different allowances within the cap, while controlling for costs driven by factors other than efficiency.
- 5.4 Debt-related costs varying across payment methods, combined with ongoing cost of living pressures, may mean certain customers are more likely to accrue bad debt - particularly standard credit customers. Therefore, to mitigate the impact of non-efficiency factors in our benchmarks, we assessed costs linked to customer base differences regarding payment methods, such as proportion of customers paying by standard credit.
- 5.5 In this chapter we explain our rationale for benchmarking costs. We consider that our approach to benchmarking has allowed us to set an appropriate float for the additional debt related costs incurred between April 2022 and March 2024. All of these decisions require careful balancing in their context, and it is not the case that we would necessarily decide the same approach is the best in the round as part of those wider and longer-term reviews.

Decisions

- 5.6 We have decided to set a hybrid benchmark, one of the options discussed in our October 2023 consultation.³⁷ This is a change from our minded to approach from our December consultation where we proposed to benchmark at the lower quartile. In current market circumstances, we consider this approach better reflects the balance between the need to create incentives for suppliers to improve their efficiency and support suppliers in providing the help they are required to offer customers in financial difficulties. This may also help to minimise the extent of any future variations as part of the true up process, that might impact both customers and suppliers.
- 5.7 We have decided to benchmark total net costs across cap periods 8-11b rather than considering each cap period individually. This is because provisions are refined over time so debt-related costs are interrelated between cap periods. This approach is consistent with our proposal from the December 2023 consultation.
- 5.8 When benchmarking debt-related administrative and working capital costs at a lower quartile, we exclude suppliers with a non standard customer base to ensure a representative allowance.
- 5.9 This decision provides a benchmark value of £26 per customer. In Chapter 6 we discuss how we allocate this cost to direct debit and standard credit customers only – which translates to an adjustment of £31 per typical direct debit and standard credit customer at benchmark consumption.

Calculating net costs

- 5.10 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, which is then used in this chapter as a baseline to benchmark for total net costs.
- 5.11 We have used suppliers' data collected from the October 2023 debt-related costs RFI to calculate the adjustment value. We requested debt-related costs data from January 2017-Septemehr 2023 from suppliers with at least 100,000 default tariff

³⁷ The hybrid approach uses a weighted average benchmark for bad debt, and a combined lower quartile benchmark for debt-related administration and working capital costs.

customers. We requested the following data split by fuel, tariff, and payment method:

- Bad debt charge;
- Debt-related administrative costs;
- Working capital costs;
- Revenue;
- Customer accounts.

Choice of benchmark

5.12 Part of our decision-making when setting price cap allowances is to conduct a benchmarking process to compare a supplier's performance (eg its costs) against a measure of sector wide performance, while acknowledging that we can only set one cap across industry based on the efficient costs of a notional supplier.

5.13 When choosing a benchmark approach, we acknowledge the repercussions cost of living pressures can have on our assessment. Under these circumstances we have developed a view on the level of costs that will likely enable suppliers to finance their activities.

Calculating bad debt costs

5.14 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 debt costs each supplier faced for each cap period. 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 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 calculate the weighted average net bad debt cost per cap period.³⁸
- Median/Lower quartile: for each supplier in our sample, we calculated the net bad debt costs per default tariff customer account using cap period 10b customer numbers. We then took the 50th percentile and 25th percentile

³⁸ 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.

supplier for each cap period to calculate the median and lower quartile respectively.³⁹

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 ⁴⁰ |
| Lower quartile | 1 | -8 | -3 | 2 | 7 | 10 ⁴¹ |

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.

5.15 We estimate that there was an under-allowance for bad debt regardless of which benchmark is selected. Both under a weighted average and at the median the under-allowance is equal to £26 per typical dual fuel customer, whereas at a lower quartile it is lower - which partly reflects different provisioning methodologies and payment method splits.

5.16 Cap periods 8-9b included significant government support (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

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

5.18 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-

³⁹ For the purpose of these cap periods 8 – 10b columns, 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.

⁴⁰ 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).

⁴¹ N.B: total lower quartile ≠ sum of cap 8-10b lower quartile since we select one lower quartile supplier in the overall column (rather than a different lower quartile supplier for each cap period).

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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.

5.19 There has consistently been an over-allowance of debt-related administrative costs from cap period 8-10b and there is limited variance over time relative to bad debt which is shown by a lower proportionate difference between the benchmarks.

Working capital costs

5.20 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 this is divided by the number of customers in cap periods 8-10b;⁴²
- 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.⁴³ 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

⁴² 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.

⁴³ 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.

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.

5.21 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.

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.

Benchmark options

5.22 Since our October 2023 policy consultation, we have considered three options as set out below:⁴⁴

- **Option 1: lower quartile:** For each supplier in our sample, we would calculate their net cost per customer and then take the 25th percentile supplier based on a restricted sample.
- **Option 2: weighted average:** this would provide larger weight to suppliers with more customer accounts.

⁴⁴ Ofgem (2023), Additional debt-related costs allowance policy consultation, paragraph 7.30. <https://www.ofgem.gov.uk/publications/additional-debt-related-costs-allowance-policy-consultation>

- **Option 3: Hybrid:** This option would separate the benchmarks for each debt-related cost. We benchmark bad debt at the weighted average based on the full sample, while benchmarking debt-related administrative and working capital costs at a combined lower quartile based on a restricted sample.

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 ⁴⁵ | 14 | 35 | -14 | -8 |
| Weighted average | 36 | 47 | -7 | -4 |
| Hybrid ⁴⁶ | 26 | 47 | -10 | -11 |

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

Stakeholder comments

- 5.23 Seven of the nine suppliers who responded to our December 2023 consultation disagreed with our proposed benchmark and suggested that we use the weighted average approach.
- 5.24 One supplier said that we had not presented evidence to suggest that suppliers were over-provisioning, therefore, a weighted average approach should be adopted. This minimises the likelihood of putting a particularly large true up on the bill in 2025.
- 5.25 One supplier said that we have been too aggressive in past allowances and this additional allowance does not provide sufficient funding for suppliers to recover their efficiently incurred costs.
- 5.26 One supplier and one consumer group supported our consultation position of using a lower quartile benchmark to incentivise suppliers to be proactive in controlling their debt related costs. One of these stakeholders emphasised that

⁴⁵ The combined lower quartile benchmark is calculated using the restricted sample.

⁴⁶ The hybrid option benchmarks bad debt at a weighted average, and the other debt-related costs (debt-related administrative and working capital costs) at the lower quartile (combined) using the restricted sample. In the December 2023 consultation we presented the hybrid option restricting the sample. Following our decisions in this chapter the lower quartile part of the hybrid benchmark benchmarks costs using a restricted sample which increases the benchmark from £24 to £26.

suppliers are capable of influencing, if not controlling fully, the level of and cost of recovering debt and that setting the allowance using this approach will keep the impact of the float on customers manageable.

- 5.27 One supplier said that we should continue with our original hybrid proposal to adopt an average benchmark for bad debt and lower quartile for debt-related administrative and working capital costs.
- 5.28 One consumer group thought that a lower quartile would be appropriate to ensure efficiency and protect consumers against suppliers' overestimating bad debt. Two charities acknowledged that any increase in the price cap will likely increase the level of debt in the market. One consumer group was against any allowance.

Considerations

Stringency of benchmark

Timing of cost recovery

- 5.29 Industry responses to our December 2023 consultation expressed concern about the growing level of debt they estimate over this winter, which they indicate is causing increased pressure on both consumers and suppliers. They express concern that our estimate of bad debt costs for this winter is too low and that consumers will face a significant price increase when these higher levels of bad debt provisions are taken into account as part of the true-up. It was also suggested that a low float amount would lead to a complex true-up process with significant customer bill volatility.
- 5.30 Debt & arrears have been continuing to increase in the early part of this winter and the expectation is that this will continue as debt levels start to align with increased usage across the winter months.⁴⁷ Increasing debt & arrears incurred across this winter could leave more customers struggling to repay debt further into 2024, putting pressure on both consumers and industry.⁴⁸ The price cap is falling from April and while this is welcome we do not currently know if this will help to significantly reduce the debt already accumulated as customers financial resilience has been reduced. This topic will be explored more in our upcoming debt and affordability call for input.

⁴⁷ Historical trend indicates debt & arrears seasonal increase in spring:
<https://www.ofgem.gov.uk/publications/debt-and-arrears-indicators>

⁴⁸ Our latest data shows there are £3.1 billion of debt & arrears across the domestic energy market (as of December 2023), an increase of over £1billion since the start of 2023.

- 5.31 Under the 2018 Act, we are required to exercise our functions with a view to protecting existing and future domestic customers and have regard to a number of factors including: creating incentives to improve supplier efficiency and customer switching, setting the cap at a level that enables suppliers to compete effectively and the need to ensure holders of supply licences can finance their activities. All the factors set out in the 2018 Act affect the long-term interests of customers, and so whilst we are not required to achieve all of these, we do need to be mindful of them when setting an accurate temporary float allowance.
- 5.32 While it would be in customer’s short-term interests to keep the adjustment as low as possible, an adjustment too low would likely expose customers to a much higher price increase during the true-up phase.
- 5.33 Furthermore, widening the gap between when suppliers incurred these costs and when they ultimately recover them is likely to lead to competitive distortions in the market for two reasons. Firstly, it could create an artificial difference between non-price cap tariffs and the price cap which could lead to greater costs for default tariff customers overall. This is because default tariff customers would be paying for backdated costs which we expect would have already been priced into fixed tariffs.
- 5.34 Secondly, true-up costs would be recovered over fewer customers if the number of default tariff customers reduces between now and the true-up, ultimately increasing the cost per customer for remaining default tariff customers. We consider that delaying cost recovery would not be in the long term interest of consumers.
- 5.35 We acknowledge the potential for asymmetry in considerations between downward and upward adjustments. In line with the 2018 Act, we will have regard to the impact adjustments may have on supplier incentives to improve their efficiency and compete for customers and customer incentives to switch suppliers. Downward adjustments may have different impacts on these factors than upward adjustments.
- 5.36 We consider the hybrid approach as set out in our October 2023 consultation strikes an appropriate level of stringency, by helping to minimise the value of future true-up and therefore impact on bills, while helping to mitigate competitive distortions in the market.

Supplier financeability

- 5.37 Concerns raised by stakeholders on the proposed allowance included the potential for it to stress the industry due to lack of ability to price in costs or recover them

under the cap, risking suppliers' financial resilience. Stakeholders indicated that a delayed recovery would increase the market risk suppliers were willing to take to generate a return. Further they stated that the proposed allowance would be too low and result in supplier losses which should be addressed with a float that reflects median industry costs.

- 5.38 We consider that it is important that the notional supplier is able to fund its efficient costs to support customers, and a low adjustment now would delay cost recovery adding more pressure on the industry through increased working capital costs. A float which is set too low could reduce suppliers' ability to make a fair return and to meet our expectations on financial resilience standards which could ultimately lead to suppliers exiting the market, increasing costs for consumers.
- 5.39 Volatility in suppliers' profits could contribute to wider undermining of investor confidence in the market. It could also lead to consumer mistrust if a misaligned cost recovery, due to a low float and significant true-up adjustment, was mistaken for excess profits.

Efficiency

- 5.40 Industry responses to our consultation process showed concern that wider economic pressures are impacting levels of indebtedness. They indicated that suppliers have limited control over these costs and setting a benchmark without taking this into account is likely to mean that efficiency savings will never bring the average debt costs down to lower quartile levels. It was also mentioned that a 'one-size-fits-all' efficiency incentive is not appropriate when it is based on a sample made up of suppliers with varying customer bases. Consumer groups typically preferred either no allowance or a lower quartile highlighting the need to maintain efficiency targets. One stakeholder said that our benchmarking assumes inefficiency in the energy market.
- 5.41 The wider cost of living crisis has put pressure on household finances, meaning families are increasingly struggling to pay their bills. Government schemes last winter, such as the Energy Price Guarantee and the Energy Bills Support Scheme, provided direct support for energy consumers. However, these support mechanisms have not been in place this winter. With the wider cost of living crisis putting pressure on household finances, there is a likelihood that families will continue to struggle paying their bills across this winter.
- 5.42 The increasing levels of bad debt across the industry are not just being influenced by energy prices, but are also being driven by wider non-energy cost of living pressures which have been reducing customers financial resilience. We consider

that on balance these bad debt costs are less likely to be within a suppliers' control and are also driven by non-efficiency factors such as payment method, however efficiency in debt practices will still play some part in how suppliers manage debt.

- 5.43 When setting the benchmark, we aim to take into account the variation between suppliers' costs driven by factors other than efficiency. We consider that the low quartile element of the hybrid approach controls for non-efficiency factors by considering the impact of suppliers with a more typical breakdown of payment methods (ie by restricting the sample).
- 5.44 One supplier said that we need to be conscious of the messaging the benchmark choice would send to the industry as suppliers which prioritise efficiency may take a more aggressive debt recovery approach.
- 5.45 We broadly agree that a more stringent benchmark may encourage supplier efficiency which in turn will encourage suppliers to recover more debt by pursuing more aggressive debt collection practices. The relationship between how cap leniency and efficiency is complex and is something that we intend to explore in our wider work on debt and affordability. However, regardless of which benchmark we select we expect suppliers to adhere to the licence conditions when recovering debt.
- 5.46 We consider that the hybrid approach provides the right balance between incentivising suppliers to become more efficient while providing the support we require suppliers to offer customers. While not as stringent as the lower quartile approach for bad debt costs, we consider the hybrid approach, which we set out in our October 2023 consultation, incentivises suppliers to reduce costs in areas where they have more direct control, such as debt administration and working capital costs which are benchmarked based on a lower quartile approach.
- 5.47 We recognise that suppliers will have different provisioning methodologies (e.g. the level of optimism on recovery a supplier builds into its assumptions) and in the float situation there is a risk that a lower quartile is affected by suppliers' provisioning methods rather than cost differences. Further we do not want to inadvertently provide suppliers with an incentive to be more pessimistic to affect our assessment of costs, this is something which we will review at the true-up.
- 5.48 We consider that this benchmark choice has been selected based on the current novel market conditions and ongoing cost of living pressures which have increased debt and arrears in the market. In such manner, we struck a balance by applying different benchmarks to costs driven by non-efficiency factors (ie,

costs out of suppliers' control) and other costs that show a stronger link with the suppliers' efficiency.

- 5.49 We will reevaluate the appropriate benchmark during the true-up phase. We consider all of these decisions require careful balancing, and it is not the case that we would necessarily decide the same approach is the best in the round as part of those wider and longer-term reviews. The nature of float and true-ups is to provide some initial cash to help manage uncertainty, but ultimately we need to get as close to a notional efficient set of costs as possible. It is therefore particularly appropriate to review the approach to benchmarking as part of the true-up phase.

6. Allocation of the allowance

Section summary

In this chapter, we discuss how we have decided to allocate costs among different payment methods.

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.⁴⁹ To that extent the cap currently includes an uplift for standard credit customers for debt-related costs of £130 per typical customer.⁵⁰ 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 debit 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.⁵¹
- 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.⁵² We also decided to allocate current reported PPM debt-related costs to credit

⁴⁹ Ofgem (2018), Appendix 8 – Payment method uplift.

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

⁵⁰ 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>

⁵¹ Ofgem (2018), Appendix 8 – Payment method uplift, paragraph 2.39.

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

⁵² 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.⁵³

- 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.⁵⁴ 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.⁵⁵
- 6.5 We need to consider how to split any allowance between the different payment methods and in our December 2023 consultation, we proposed to allocate the costs to direct debit and standard credit customers only.

Decisions

- 6.6 We have decided to allocate the costs of the additional allowance equally on credit customers whose payment method is either direct debit or standard credit. This would increase bills for direct debit and standard credit customers by £31 per typical dual fuel customer at benchmark consumption.

Stakeholder comments

- 6.7 A total of nine stakeholders that responded regarding the allocation of the allowance: six suppliers, one consultancy and two charities.
- 6.8 Of the nine respondents, three suppliers and the charities agreed with our minded-to approach to allocate the allowance equally between direct debit and standard credit customers on a unit rate basis. They favoured this to better reflect where costs were incurred and deemed it the fairest option for customers. However, one supplier caveated that they see a float spread across standard credit and direct debit as a backwards step.

⁵³ 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>

⁵⁴ 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.

⁵⁵ Ofgem (2023), Allowance for additional support credit bad debt costs.

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

- 6.9 Three suppliers disagreed with equal allocation. These suppliers supported the cost reflective allocation option to prevent competitive distortions in the market and said that a levelisation reconciliation mechanism would be warranted to prevent suppliers from losing out.
- 6.10 The economic consultancy was opposed to equal allocation as it is inconsistent with our obligation to cover retail licensees' efficient costs, and will lead to windfall gains and losses for suppliers.

Options

- 6.11 We considered three options for how to allocate costs by payment method in our December 2023 consultation:
- Equal allocation: equal allocation of credit costs on direct debit and standard credit, while allocating zero costs to PPM bills.
 - Reported cost allocation: allocating costs to the payment method which suppliers reported these costs on.
 - Allowance allocation: allocating costs based on the payment method splits of the existing debt-related costs allowance in cap period 11a.
- 6.12 Table 6.1 shows the impact on the payment method cap levels using the hybrid benchmarking approach which was discussed in Chapter 5. 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 increases the differential between direct debit and standard credit payment methods. The allowance allocation option scales the costs on an equivalent basis to the current debt-related costs allowance.
- 6.13 The allowance allocation option was introduced as a new option in our December 2023 consultation, however stakeholders did not engage with this option.
- 6.14 We have analysed the impact of these allocation options on different customer groups in Chapter 7 and explain how we have calculated the allocation options in Appendix 2.

Table 6.1: Options for allocating the allowance between payment methods

| | Equal allocation | Allowance allocation | Reported cost allocation |
|-----------------|-------------------------|-----------------------------|---------------------------------|
| Direct debit | 31 | 15 | -23 |
| Standard credit | 31 | 75 | 171 |
| PPM | 0 | 11 | 57 |

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

Considerations

Customer impact

- 6.15 Two charities believed that the proposal to recover costs equally over direct debit and standard credit customers, with zero recovery over PPM customers would be the least bad option and would have the least impact on fuel poor households.
- 6.16 Alongside our December 2023 consultation, we are still mindful of the impact our decision will have on customers on each payment method given affordability concerns. The evidence presented below highlights that a higher proportion of standard credit and PPM customers are vulnerable relative to direct debit.
- 6.17 If there are however a greater number of vulnerable customers who pay by direct debit, an equal allocation approach will lead to a smaller impact per customer and prevent a substantial increase in standard credit bills.
- 6.18 Debt accrual varies by payment method and is typically the highest among standard credit customers as this payment method allows for greater debt since customers paying by this payment method may not have regular repayments in place.

Table 6.2: Fuel poverty statistics by household (electricity and gas) 2022⁵⁶

| Method of Payment⁵⁷ | 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 |

- 6.19 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 direct debit. However, of all households in fuel poverty, the majority are direct debit. Allocating costs equally between standard credit and direct debit yields the lowest cost on average to vulnerable customers and the lowest equity weighted costs across all customers.
- 6.20 It is important to recognise that some consumers do not have the same level of choice when selecting their payment methods, for example many PPM customers may not have actively selected that payment method for a positive reason.
- 6.21 The data supports the case for protecting vulnerable consumers and implementing a fair approach, our decision yields the lowest cost on average for vulnerable customers.

Data limitations

- 6.22 One supplier recognised that customers may change their payment method, however it stated that it records costs according to a customer’s current payment method and it believes that we should recognise nuances when concerning any data limitations.

⁵⁶ 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>

⁵⁷ DD = direct debit, SC = standard credit, PPM = prepayment meter.

- 6.23 As we have explained previously, ideally, we would want the data to report customers bad debt based on the payment method at the point of billing (ie the point at which the debt first accrued), rather than the customers' current payment method (which may have changed since the first accrual) because bad debt allowances are built up at the point of consumption.
- 6.24 We expect that a significant amount of debt is accrued on a payment method which is different from the customer's current one which creates uncertainty around how accurate the reported cost allocation option would be. We do not consider that the evidence is strong enough to allocate fully based on the raw supplier data available because of this.

Impact on debt levels

- 6.25 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. The allowance will also increase bills for customers who can currently pay their bills, which will potentially move some people into debt.
- 6.26 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.
- 6.27 Consumer research noted that higher relative prices on standard credit customers can heighten the risk of standard credit customers incurring further debt, which would in turn increase the total debt in the market and result in greater debt-related costs to be met by customers as a whole. We consider that standard credit alone is a poor proxy for bad debt as direct debit customers can also generate bad debt and there are real advantages to all customers for it to be shared more equally by direct debit and standard credit customers.
- 6.28 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.⁵⁸ 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.

- 6.29 An increase in the debt-related costs allowance would increase bad debt by £1.1m under the equal allocation option, £3.1m under the reported cost allocation option, and £1.7m under the allowance option, resulting in higher costs to consumers.
- 6.30 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 £5.2m under the equal allocation option, £7.8m under the allowance option and, £14.3m under the reported cost allocation option.

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

| | Equal allocation | Allowance allocation | Reported cost allocation |
|--------------------------|-------------------------|-----------------------------|---------------------------------|
| Bad debt | £1.1m | £1.7m | £3.1m |
| Working capital | £5.2m | £7.8m | £14.3m |
| Total debt-related costs | £6.3m | £9.6m | £17.5m |

- 6.31 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.
- 6.32 Our assessment is based on debt levels across all domestic consumers from Q3 2023,⁵⁹ and only considers those consumers already in debt and therefore does not account for the impact on debt for consumers not already in debt.
- 6.33 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

⁵⁸ We have followed the same method for our analysis as used in the Impact Assessment conducted by the Levelisation team in their statutory consultation. 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>

⁵⁹ Ofgem (2023), Debt and arrears indicators. <https://www.ofgem.gov.uk/publications/debt-and-arrears-indicators>

customer for each payment method under each allocation option, we calculated the impact each allocation option would have on the total amount of debt.

6.34 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.

6.35 In order to estimate the elasticity, we collected data on Household Debt Inequalities from ONS.⁶⁰ This gave us descriptive statistics on the proportion of people with debts, going from no debt and arrears only to four major types of debt. We estimated that on average, customers in debt would dedicate 40% of their additional income to repay their energy debt.

6.36 We assess that the additional allowance will increase total debt by £42.3m under the proposed equal allocation option, £116.3m under the reported cost allocation option, and £63.7m under the allowance option.

6.37 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. It is possible however, that the marginal impact may be greater from a further increase in debt.

Debt incurred on PPMs

6.38 In previous consultations we treat PPM customers separately as they build up less debt than credit customers. Given PPM customers top-up their meter and pay as they use energy it is much more difficult for them to build up arrears and debt to the extent that a credit customer could do. Therefore when setting this allowance we take the view that substantive debt sitting on PPM customer accounts was likely to have been originated while the customer was on a different payment method.

6.39 One supplier said that by excluding PPM from this allowance risks creating a perverse incentive on suppliers to provide an energy payment option which may be inconsistent with a customer's best interests, opting to leave a customer in credit mode to secure the debt-related cost allowance.

⁶⁰ 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/householddebttinequalities/2016-04-04>

- 6.40 We consider that suppliers' will still be incentivised to move customers to a PPM if it is in their best interest because a PPM can reduce the risk of further debt build up, which for an individual customer in debt is likely to be a larger cost than the benefit from the allowance. A supplier should explore which payment methods are appropriate to the individual circumstances of each customer. Further we consider that our decision to not allocate any costs to PPM is based on evidence suggesting that it is much more difficult for PPM customers to accrue debt than customers on other payment methods.
- 6.41 Recently we provided a PPM specific allowance to allow suppliers to recover their bad debt costs associated for PPM customers associated with Additional Support Credit worth approximately £9 per customer. We do not think it is appropriate to allocate additional costs to PPM customers as part of this debt review as we consider it likely that many PPM customers with debt on their meters will have incurred it before transferring to a PPM.

Supplier impacts

- 6.42 Some suppliers raised that under the equal allocation option there will be competitive distortions as costs are being smeared across payment methods leading to an over-recovery of costs by suppliers with a higher proportion of direct debit customers. One asked that we set a clear policy direction for allocating allowances more cost reflectively using levelisation once the mechanism is in place.
- 6.43 One supplier said that a reconciliation process must be implemented to ensure that suppliers are able to recover their efficient costs and, in its absence, we should implement costs in a cost reflective manner. A different supplier opposed any reconciliation mechanism.
- 6.44 An economic consultancy representing two suppliers said that data limitations do not justify failing to control for payment method and Ofgem's statutory duty requires it to remunerate efficient costs to protect customers' long term interests and efficient suppliers.
- 6.45 This consultancy added that a levelisation and reconciliation mechanism would resolve our concern over fairness.
- 6.46 Under the Act, we must have regard to the ability of an efficient supplier to finance its supply activities. This does not mean that we are required to achieve this in all cases. We consider that moving towards a hybrid benchmark will enable

suppliers to better recover their efficient costs while equal allocation will protect existing and future customers.

- 6.47 We consider that any reconciliation mechanism at this stage would not be proportionate for the temporary allowance being introduced, however we are committed to considering this at the true-up stage if unit rate levelisation is in place.
- 6.48 Further, the levelisation decision published today does not include the implementation detail for Phase 2 levelisation and reconciliation. The implementation of Phase 2 levelisation in the cap models, and the detailed design of a unit rate reconciliation mechanism, depend on further industry work which cannot be delivered for April 2024. A further consultation on the implementation of Phase 2 levelisation in the cap models will be performed prior to its implementation.⁶¹
- 6.49 We expect that by the time we consult on the true-up process we will have further understanding of how Phase 2 levelisation will be implemented and we will reconsider its interaction with payment method allocation; however given volumetric levelisation is not available now we are unable to implement this allowance with a reconciliation mechanism.

⁶¹ Stakeholders will be consulted on unit rate reconciliation through the enabling code modification process in due course.

7. 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 decisions, 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 and decision process, we conducted impact analysis on the options for benchmarking and allocating costs.
- 7.3 We carried out three assessments of the impacts of introducing an initial float 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.

Supplier financial impact analysis.

- 7.4 As we set out in Chapter 3, we decided to implement an adjustment for additional debt-related costs in April 2024. In doing so, we decided to use a hybrid benchmark 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).

Stakeholder comments

- 7.5 One charity and one consumer group responded with concerns about our proposals.

- 7.6 The consumer group questioned us regarding customer bases, possible over-correction of the price and our considerations when setting the cap.
- 7.7 They stated that we may need to look at the profitability of SVT customers, rather than customers of default tariffs. Their main concerns were a possibility of high supplier profits due to over-correction of the cap, and that we are disincentivising suppliers to be better at managing their costs.
- 7.8 The charity acknowledged that although this allowance may be necessary, they do not believe this solves the problem of mounting debt and it will increase the level of debt in the market.

Considerations

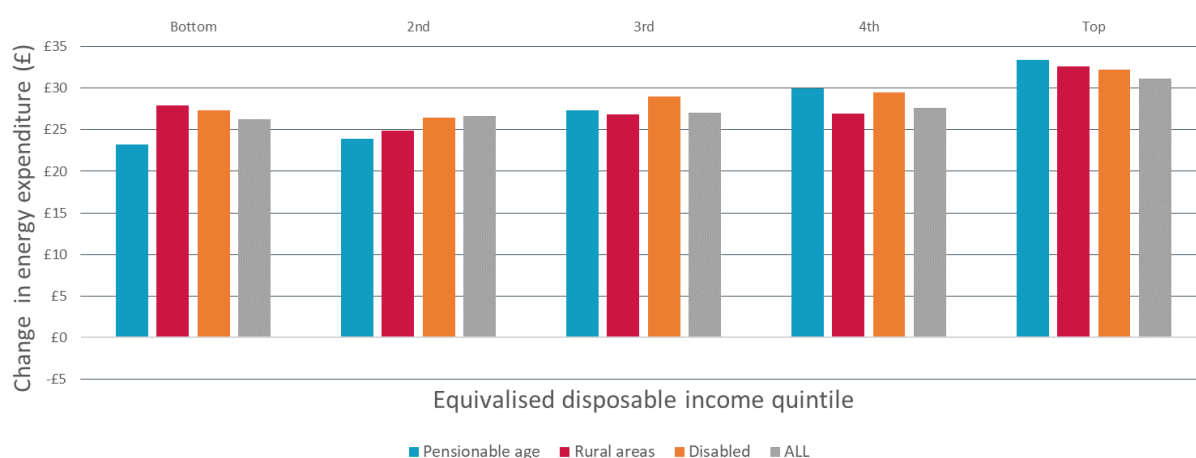
- 7.9 We understand that it is important to consider the impact of price cap changes on a range of customers and households. We have updated the impact analysis in this chapter to reflect the decision that we have made.

Bill impact analysis

Distributional analysis

- 7.10 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 decision to introduce a hybrid 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

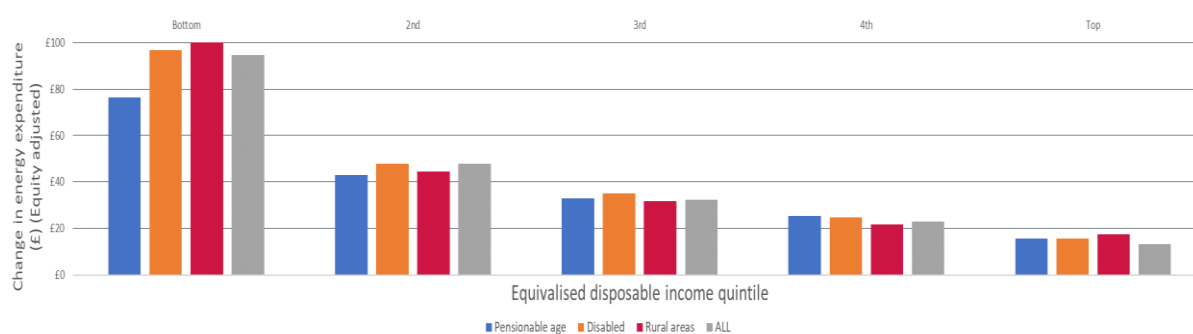


The bar graph shows the change in energy expenditures with the introduction of the additional debt related costs allowance. This uses equal allocation among credit

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.

7.11 The impact on the typical annual consumer bill will amount to £26.⁶² 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.

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 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.

7.12 Figure 7.2 shows the equity-weighted bill impacts. The application of weights on the energy consumption profiles arises from the economic principle of diminishing marginal utility of income – or equivalently diminishing marginal returns to utility – according to which 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.⁶³ In equity-weighted analysis, financial benefits/costs for lower income households are given a higher social value than the equivalent benefits/costs for higher income households. Distributional weights have been

⁶² Total debt per customer regardless of payment type recovery. As discussed in Chapter 6, this £26 per customer is proposed to be equally allocated as £31 per credit (direct debit or standard credit) customer and £0 to PPM.

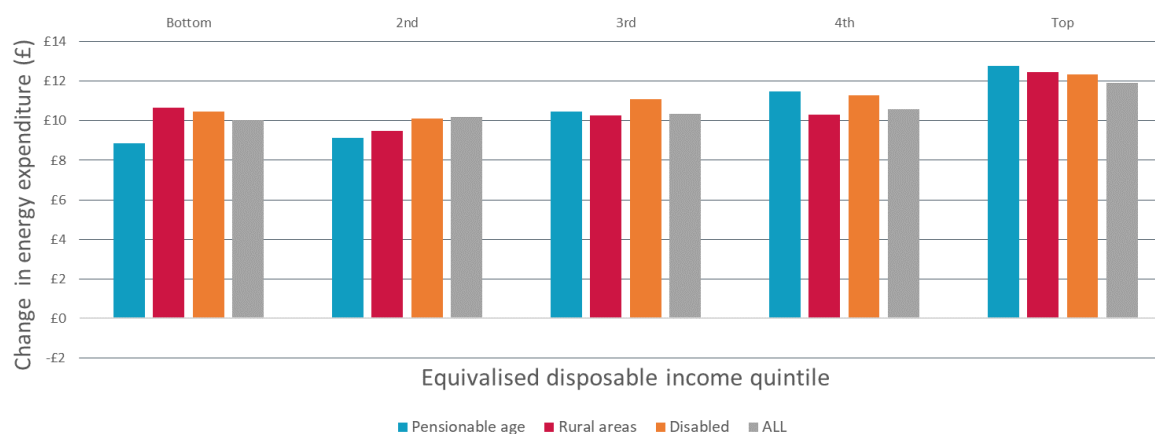
⁶³ The weights reflect the marginal utility of each income quintile. This can also be done by adjusting the bill impacts for each income quintile in the archetype-type, giving the monetary equivalent of how all consumers perceive the impact on their income.

applied to equivalised household disposable income deciles in line with the Green Book guidance published by HMT.⁶⁴

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

7.14 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 hybrid (£26) as we have decided. Figure 7.3 shows the incremental impact it would have (in £) on each income quintile with the alternative decision on the benchmark approach. This indicates that a broadly similar impact will be experienced across the consumer types analysed.

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

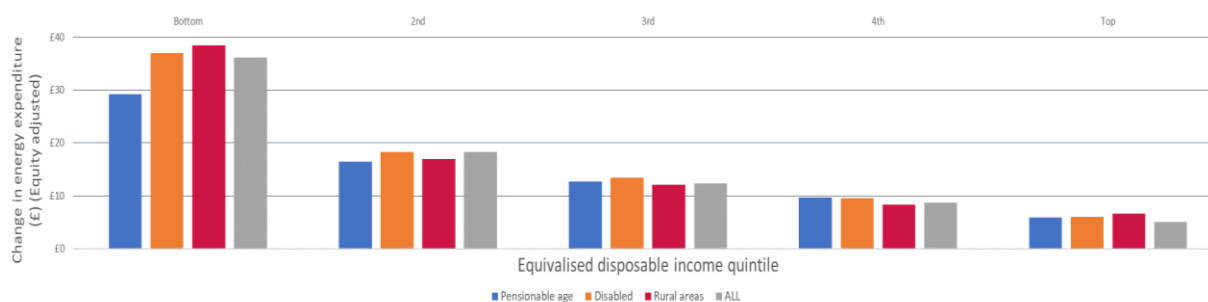


The bar graph shows the change in energy expenditures under the counterfactual of moving the benchmark from hybrid to a weighted average approach. This uses equal allocation among credit customers for pensionable age, rural area, disabled, and all customers. It assumes equal income distribution among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

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

⁶⁴ See Annex 3 of HM Treasury (2022), The Green Book. <https://www.gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-government/the-green-book-2020>

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 hybrid 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.

7.16 When we consider distributional weights, the impact of moving from the hybrid 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

7.17 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.

7.18 Relevant protected characteristics include age, disability, race and sex (see para 7.23 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.

- 7.19 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 various requirements on us under the 2018 Act to protect existing and future customers on default tariffs, which include the vulnerable).
- 7.20 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

- 7.21 We are aware that an increase in bills will likely have a negative short-term impact on customers, and particularly 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.
- 7.22 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 received 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 started to receive in cap period 11a.

- 7.23 The Centre for Sustainable Energy created 13 archetypes 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.⁶⁵ We have analysed the impact on these 24 different archetypes in income order from lowest income (A1) to highest income (J24).
- 7.24 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 introduction of an additional debt-related costs allowance. We compare the three allocation options in the analysis below.
- 7.25 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 £14 and £38 per household (with the higher cost per household affecting a relatively high income archetype).⁶⁶ The allowance option has less variation than the equal option and costs households between £16 and £36 but increases the cost to some low-income archetypes.⁶⁷ The reported cost option has an impact between -£25 and +£61, with the high impact on one of the first 12 archetypes and the -£25 affecting one of the middle income archetypes.
- 7.26 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.
- 7.27 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

⁶⁷ Ofgem consumer archetypes <https://www.ofgem.gov.uk/energy-policy-and-regulation/measuring-impact-our-policy-decisions> . Superseded archetypes can be found at Ofgem (2020), Ofgem Energy consumer archetypes - Final report. <https://www.ofgem.gov.uk/publications/impact-assessment-guidance>

⁶⁶ 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.

⁶⁷ These are not shown in the table.

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the allowance allocation option (and even more for the reported cost allocation option) than for equal allocation.

7.28 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

7.29 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 £16 and £75 across the archetypes (with the lowest impact on the highest income archetype and the highest impact on the second-lowest income archetype). The allowance allocation has an impact of between £15 and £128 (again the highest impact is on the second-lowest income archetype). Cost-based allocation would represent a net benefit to some middle and high-income archetypes but would have a perceived impact of £231 on a low-income archetype. Moving from the equal allocation to an alternative option adds between £11 and £168 to the equity-weighted impact of the lowest income archetypes.

7.30 Archetypes A1 - 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.

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), £ ⁶⁸ | Vulnerable (max), £ | Vulnerable (min), £ |
|---------------|--------------|-----------------|-----|------------------|----------------------------------|---------------------|---------------------|
| Equal Credit | 31 | 31 | 0 | 41 | 58 | 75 | 35 |
| Allowance | 15 | 75 | 11 | 44 | 70 | 128 | 26 |
| Reported Cost | -23 | 171 | 57 | 51 | 102 | 231 | -41 |

7.31 Overall, equal allocation across credit customers has the lowest customer impact (both in terms of weighted average impact on vulnerable customers and total

⁶⁸ These columns considering the impact on vulnerable consumers are also 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).

equity-weighted assessment across all customers). The reported cost allocation option has the highest cost for vulnerable and equity-weighted customers.

Supplier impact analysis

- 7.32 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. These impacts can be reviewed and potentially corrected as part of the true-up when the effects of levelisation will also be clearer.
- 7.33 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 consider 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.
- 7.34 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 forecasting losses.
- 7.35 Suppliers overall gain from having the additional allowance. The equal allocation additional allowance 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 0.2 and 1.5 percentage points compared to not having any additional allowance.
- 7.36 The allowance option would have had a more consistent impact on individual suppliers' profitability closing the gap between the forecast and allowed returns by between 0.4 and 1.1 percentage points compared to not having an additional allowance. The cost option would decrease the profitability of some suppliers (by up to 0.3 percentage points) while closing the profit gap of others by up to 3 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.

7.37 We do not consider our recommendation of equal allocation to pose any immediate risks to any suppliers and consider the potential financial risks to suppliers tolerable given the ad-hoc and temporary nature of the adjustment. There is also a benefit in suppliers receiving the certainty of a float now, compared to merely waiting for a potential ex-post 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 Reported 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 | £3 | £9 | £11 | £34 |
| 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 | £10 | £36 | £54 | £113 |
| A3 | off gas; low income; high electricity consumption; retired; couples and single adults | £11 | £40 | £45 | £168 |
| 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 | £5 | £17 | £21 | £67 |
| B5 | low income; mains gas; 65+ retirees; semi-detached; owner occupied; not early adopters; low electricity consumption; WFP eligible | £5 | £18 | £15 | £54 |
| 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 | £7 | £27 | £21 | £80 |
| 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 | £12 | £45 | £25 | £96 |
| C8 | lower middle-income; couples/single adults; full-time employed/retired; mains gas; private rented; low fuel consumption | £6 | £22 | £12 | £47 |
| C9 | lower-middle income; large families; couples/single mothers; private/local authority rented; BAME; mains gas; good EPC; high fuel consumption; prepayment meter | £2 | £3 | £4 | £7 |

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| | | | | | |
|------------|--|------|------|------|------|
| D10 | lower-middle income; mains gas; couple/single adult woman; retired 65+; not early adopters; WFP eligible; high gas consumption | -£4 | -£15 | -£8 | -£27 |
| D11 | middle income; single child families; mains gas; good EPC rating; average consumption; prepayment meter | £4 | £14 | £9 | £28 |
| D12 | middle income; families; couple or single-mother; disability benefits; CWP eligible; WHDS eligible; prepayment meter; high gas/electric consumption | -£17 | -£57 | -£27 | -£94 |
| E13 | average income; electric heating; purpose-built flats; single child families; good EPC rating; low levels of engagement; BAME | £6 | £30 | £10 | £47 |
| E14 | middle income earners; electric heating; communal heating; purpose-built flats; young couples/single adults; BAME; good EPC rating; well-educated; low market engagement | £9 | £32 | £13 | £50 |
| F15 | middle income; no children; couples/single adults; owner-occupied; terraced; low gas/electricity consumption; not early adopters | £6 | £20 | £7 | £26 |
| F16 | middle income; large families; full-time or self-employed; electric heating; high electricity consumption | £2 | £7 | £4 | £11 |
| G17 | upper-middle income; no children; homeowners; rural and urban; 50% not adopters; bulk LPG heating; renewable systems; employed and retired mix | £8 | £25 | £10 | £31 |
| G18 | upper-middle income; no children; rural; poor EPC rating; oil heating; not early adopters | -£2 | -£6 | -£3 | -£11 |
| H19 | upper-middle income; no children; 45+ years old; self-employed; unconventional housing; unknown EPC; oil heating; renewable systems | -£3 | -£11 | -£4 | -£18 |
| H20 | high income; single child families; ECO eligible; full-time employment; early adopters | -£4 | -£15 | -£4 | -£14 |
| I21 | high income; no children; full-time employment; mains gas; average fuel consumption; large disposable income | -£3 | -£10 | -£3 | -£10 |
| I22 | high income; no children; full-time employed; detached; mains gas; high gas consumption; large homes | -£12 | -£43 | -£9 | -£34 |
| J23 | high income; large families; mains gas; ECO eligible; high gas consumption; large homes | -£13 | -£44 | -£9 | -£31 |
| J24 | highest income; families; rural; large homes; highest electricity consumption; poor EPC rating; ECO eligible; oil heating | £7 | £19 | £4 | £11 |

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

Appendices

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Appendix 1 – Calculation steps for existing debt allowance

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.⁶⁹

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.

⁶⁹ 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.⁷⁰
- 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 direct debit working capital.

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

Debt-related administrative cost

Payment method uplift (PAAC)

⁷⁰ 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>

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 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.⁷¹ 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.⁷²

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.

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

⁷¹ Table 7 from [Appendix 9.8](#).

⁷² See paragraphs 116 to 118 of Appendix 9.8.

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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 revenue⁷³ 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.⁷⁴
- 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**).

$$\text{Net bad debt cost}_{i,j,q} = \text{Bad debt}_{i,j,q} - \text{Bad debt allowance}_{i,j,q}$$

- ii) We then divided this delta by the total domestic default tariff customer accounts in cap period 10b⁷⁵ 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

⁷³ 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.

⁷⁴ 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.

⁷⁵ 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**):

$$\begin{aligned} & \text{Total debt related administrative costs}_{i,j} \\ &= \frac{\text{Debt related administrative costs}_{i,j}}{\text{Total customer Accounts}_{i,j}} \\ & \times \text{Total default tariff customer accounts}_{i,j} \end{aligned}$$

- 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.

$$\begin{aligned} & \text{Net debt related administrative cost}_{i,j} \\ &= \text{Debt related administrative cost}_{i,j} \\ & - \text{Debt related administrative cost allowance}_{i,j} \end{aligned}$$

- 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 three⁷⁶ RFI questions.

A2.14 For working capital costs, we began 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}

$$\begin{aligned} &= \left(\frac{AR_{i,j}^{\text{Beginning of period}} + AR_{i,j}^{\text{End of period}}}{2} \times 10\% \times \frac{\text{Days}_j}{365} \right) \\ &\quad - \left(\frac{AP_{i,j}^{\text{Beginning of period}} + AP_{i,j}^{\text{End of period}}}{2} \times 10\% \times \frac{\text{Days}_j}{365} \right) \end{aligned}$$

- iii) This step is repeated for non-customer working capital before adding together both the net customer⁷⁷ working capital cost and non-customer⁷⁸ working cost for each supplier (**i**), and cap period (**j**) such that:

Working capital cost_{i,j}

$$\begin{aligned} &= \text{Net customer working capital cost}_{i,j} \\ &\quad + \text{Net non—customer working capital cost}_{i,j} \end{aligned}$$

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

⁷⁶ In our RFI we requested data on accounts receivables, accounts payables and net non-customer working capital.

⁷⁷ Suppliers will employ working capital which relates to timing differences between incurring costs and customer payments (e.g. due to customers paying in arrears), we refer to this as customer working capital.

⁷⁸ Suppliers also employ working capital elsewhere in their business (e.g. relating to the timescales for paying firms who provide them with services) which we refer to as non-customer working capital.

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- 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.

$$\text{Net working capital cost}_{i,j} = \text{Working capital cost}_{i,j} - \text{Working capital cost allowance}_{i,j}$$

- 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:

$$\text{Net Debt - related cost}_i^{WA} = \left(\frac{\sum \text{Debt related cost}_i - \sum \text{Debt related cost allowance}_i}{\sum \text{Customer accounts}_{cap 10b}} \right) \times 2$$

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).

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- 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.⁷⁹

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.⁸⁰ 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.

Hybrid

- A2.27 The hybrid approach takes a weighted average for bad debt and a (combined) lower quartile for debt administration and working capital costs.
- A2.28 We derive the weighted average for bad debt according to the calculations outlined above.
- A2.29 For both debt admin and working capital costs, we used the lower quartile estimate according to the calculations outlined above.
- A2.30 The hybrid benchmark is the summation of the weighted average for bad debt and the lower quartile for both debt admin and working capital costs.

⁷⁹ Revenue splits by payment method are required to estimate each suppliers' debt-related costs allowance since it is not uniform across payment methods.

⁸⁰ The formula used for this calculation is the INC QUARTILE Excel function as follows: = QUARTILE.INC (cost per dual fuel customer,1)

A2.31 As with the lower quartile estimate, we use a restricted sample of 6 suppliers which is equal to 82% of the default tariff market.

Allocation methods

A2.32 We calculated the benchmark in line with the previous section. This gave us an allowance estimate of £26 per typical dual fuel customer based on the hybrid benchmark approach, 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

A2.33 The reported cost allocation approach allocates the hybrid 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.

A2.34 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 hybrid 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.

A2.35 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 £26 per dual fuel customer allowance.

A2.36 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.

A2.37 We have detailed our calculation below. Firstly, we multiplied the hybrid benchmark allowance (26) by the number of default tariff customers for each payment method in cap period 10b.

A2.38 This was then divided by the sumproduct of net bad debt costs (at a weighted average) and customers for each payment method.⁸¹ This yielded a scaling

⁸¹ I.e.; -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.

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factor of 98%. 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 £26 hybrid benchmark figure is allocated between payment methods (and not total cost recovery).

A2.39 Finally, we multiplied the 98% scaling factor by the net bad debt breakdown for each payment method (**q**)

$$\text{Additional allowance}_q^{\text{Reported cost method}} = 0.98 \times \text{Net bad debt}_q^{\text{WA}}$$

Where;

$$0.98 = \frac{26 \times \sum \text{Customers}_{q, \text{Cap } 10b}}{\sum (\text{Net bad debt}_q^{\text{WA}} \times \text{Customers}_{q, \text{Cab } 10b})} = \frac{\text{Cost recovery}_{\text{All debt-related costs}}^{\text{LQ}}}{\text{Cost recovery}_{\text{Bad debt}}^{\text{WA}}}$$

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 | -23 |
| Standard credit | 175 | 171 |
| PPM | 58 | 57 |

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

Allowance method

- A2.40 The allowance option apportions the additional allowance based on the current debt-related costs allowance payment method split.
- A2.41 We use the same method as above to calculate the scaling factor for this allowance method, however we compare the hybrid approach cost recovery with the debt-related cost allowance cost recovery.
- A2.42 Similar to the above, we multiplied the hybrid approach 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.
- A2.43 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

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costs cap allowances (annualised, £ per typical dual fuel customer at benchmark consumption) as shown in Table 4.2.

A2.44 This provided us with a scaling factor of 59%, which was then multiplied by the current debt-related costs allowance for each payment method (**q**) to calculate the additional allowance.

$$\text{Additional allowance}_q^{\text{Allowance method}} = 0.59 \times \text{DRC allowance}_q$$

Where;

$$0.59 = \frac{26 \times \sum \text{Customers}_{q, \text{Cap } 10b}}{\sum (\text{DRC allowance}_q \times \text{Customers}_{q, \text{Cap } 10b})} = \frac{\text{Cost recovery}_{\text{All debt-related costs}}^{\text{LQ}}}{\text{Cost recovery}_{\text{DRC allowance}}}$$

Table A2.2 Additional allowance allocation using the allowance method

| | Debt-related costs allowance | Additional allowance – allowance method |
|-----------------|-------------------------------------|--|
| Direct debit | 26 | 15 |
| Standard credit | 129 | 75 |
| PPM | 19 | 11 |

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

Equal allocation

A2.45 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 £26 figure.

A2.46 We multiplied the hybrid allowance estimate across all debt-related costs by the total number of dual fuel customer to get a total allowance.

A2.47 We then divided this amount by the number of standard credit and direct debit customers, to get a cost per customer.

A2.48 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.

$$\text{Additional allowance}_{\text{Credit}}^{\text{Equal allocation}} = 26 \times \frac{\text{Customers}_{\text{Cap } 10b}^{\text{Total}}}{\text{Customers}_{\text{Cap } 10b}^{\text{Credit}}} = 31$$

Appendix 3 – Other decisions

Decision to allocate costs unequally between gas and electricity

- A3.1 In our December policy consultation,⁸² we considered two options for allocating costs among fuel type:
- Allocate cost recovery equally over electricity and gas customers.
 - Allocate costs proportionately between fuel type.
- A3.2 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 £15.90 per typical electricity customer, and £14.67 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 £30.57.
- A3.3 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.
- A3.4 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.
- A3.5 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 incurred costs.

⁸² Ofgem (2023), Additional debt-related costs allowance policy consultation <https://www.ofgem.gov.uk/publications/additional-debt-related-costs-allowance-policy-consultation>

Decision to allocate to the unit rate only

- A3.6 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.
- A3.7 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.⁸³ 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.
- A3.8 Of the six respondents, three suppliers and the charity agreed with our minded-to approach to allocate the allowance equally between direct debit and standard credit customers on a unit rate basis. One stakeholder acknowledged that allocating the costs over the unit rate only will disproportionately impact higher consumption customers.
- A3.9 One charity widely acknowledges that apply costs to energy costs either through standing charges or price capped unit rates is regressive in that it impacts disproportionately on those with the lowest incomes, living in the poorest accommodation. They believe the proposed approach is the least worst option
- A3.10 Another charity group agree with the proposal to recover through the unit rate only. They believe the proposed approach is the most progressive. Based on the options outlined in the previous consultation, the approach outlined here will have the least impact on fuel poor households.

⁸³ 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>

A3.11 A consumer group agreed that the balance between standing charges and unit rates should be left to the ongoing standing charge review. As it remains true that debt covers the whole energy bill and so cannot be attributed to either unit rate and standing elements, the current approach of applying across the bill should be continued.

A3.12 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: 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.

A3.13 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.

A3.14 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.

A3.15 Alternatively, we could allocate the whole allowance to the standing charge element of the cap only. This would be consistent with the ASC decision⁸⁴, 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.

A3.16 Overall, we have decided to allocate the allowance over the unit rate as it's simpler to implement and it has a relatively minimal enduring distributional impact given the temporary nature of the adjustment.

⁸⁴ 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>

Decision on how to allocate costs equally among meter type

- A3.17 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.
- A3.18 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.
- A3.19 Adding in uncertain assumptions which we cannot evidence to create a differential meter type unit rate would likely be complex and may create inaccuracies.
- A3.20 We have therefore decided 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).

Decision to include costs in Annex 8

- A3.21 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.⁸⁵ We have not received views from stakeholders around alternative methodologies for including these costs in the cap.
- A3.22 Alongside this consultation, we have published Annex 8, and detailed the methodology behind this model in Appendix 4.

⁸⁵ 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>

Appendix 4 - Annex 8 methodology and model changes

- A4.1 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).
- A4.2 We have not changed the structure of Annex 8 model, only added inputs based on our decision.
- A4.3 A revised version of Annex 8 has also been published alongside this decision.

Tab '3n DRC'

- A4.4 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'

- A4.5 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'

- A4.6 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.
- A4.7 Table 1a, A9:B12, inputs the dual fuel cost per customer with respect to payment method from tab '3n DRC'.
- A4.8 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.
- A4.9 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

A4.10 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 based on our proposal in Chapter 6.

Appendix 5 – Levy option

A5.1 In this appendix, we will explain our decision to not proceed with an alternative levy option until levelisation is in place.

Context of alternative mechanisms

A5.2 As noted earlier, suppliers have different quantities of customers on the different payment types, including the 'Do Not Install' category, leading to different degrees of control suppliers can have over their customers' debt. Therefore, in our December 2023 consultation, we opened the discussion to explore alternatives about a levy mechanism.

A5.3 While some stakeholders opposed a specific levy to mutualise debt for 'Do Not Install' customers, most stakeholders supported our proposal to explore this further by considering certain observations.

Stakeholder responses

A5.4 We received responses from five suppliers related to the use of a levy mechanism, with one supplier disagreeing with this option, another supplier that supported it and three suppliers holding an impartial position towards it.

A5.5 One supplier disagreed with the use a levy to account for the cost of debt associated with customers where there is a 'Do Not Install' prohibition on prepay meter install under warrant, as this does not incentivise suppliers to engage with customers and help them manage their debt. Also, this supplier disagreed that Ofgem have left an open discussion about special allowances through the true up.

A5.6 The three suppliers holding an impartial position towards the levy stated the challenge to implement this mechanism and encouraged Ofgem to come to an evidence-based decision. One of these suppliers reiterated the consideration of a levy approach to address two key potential moral hazards (ie, customers moving to fixed tariffs and avoiding costs or suppliers unable to fully recover costs through customers moving to other suppliers) as the market reopens and increased switching levels resume.

A5.7 The other two suppliers that hold impartial positions towards the use of a levy suggested us to consider suppliers' different pooling of customers and payment methods to ensure efficient management of customer debt through incentives (eg, communication strategies, feedback tools and signposting). This, as one of these two suppliers mentioned, is a challenge because suppliers' inaccessibility

to the income and financial circumstances of their customers. Also, they suggested that any levy mechanism should not be based on individual suppliers' actual debt positions but instead remain a notional level that reflects potential supplier divergence of customer types. These suppliers suggested the efficient recovery cost for all customers through Government intervention, such as financial support to vulnerable households who need protection.

- A5.8 One supplier agreed with the consideration of a levy mechanism allowing suppliers to recover the actual bad debt costs incurred in respect of 'Do Not Install' customers. Also, it suggested a levy will strengthen competition and consumer protections for the benefit of all consumers, and incentivised avoidance of the more distressing non-PPM debt collection methods.

Considerations

- A5.9 We do not intend to proceed with the implementation of a levy mechanism until levelisation takes place in particular because the temporary allowance is not material enough to warrant a separate mechanism. Also, we acknowledge the support from stakeholders to explore this option further while recognising there is no broad agreement on this mechanism.
- A5.10 We reiterate that the underlying principle of the cap lies on the estimated costs incurred by a notional supplier and our requirement to set a single cap level across suppliers as the cap is not designed to 'true-up' the actual costs of individual suppliers. Therefore, it is important for future decisions to reflect the degree of control suppliers can have over debt-related costs – including the debt associated with 'Do Not Install' customers,⁸⁶ in relation to which we considered supplier financeability when making that decision. It is still not clear how a levy mechanism would fit in our statutory framework, while the price cap in contrast is an existing mechanism which allows suppliers to recover efficient debt-related costs of energy supply and therefore can be adjusted for changes in those costs.
- A5.11 The interaction between levelisation and debt-related costs is most material through our considerations on cost allocation between customers on different payment methods. However, given the interaction between the proposal of

⁸⁶ Our cost benefit analysis supports the implementation of the Code of Practice into licence and guidance for 'do not install' consumers. We modelled several policy options, covering different methodologies and assumptions about future debt cost and the behaviour of consumers in response to our proposals. Although there is a wide range of possible outcomes, in most circumstances the benefits exceed the cost by a considerable margin.

Ofgem (2023), Involuntary prepayment meter decision.

<https://www.ofgem.gov.uk/publications/involuntary-prepayment-meter-decision>

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levelisation of bad debt between standard credit and direct debit customers, we do not discard entirely the possibility of a levy as a long-term approach to manage debt across the industry.