Appendix 2: Debt-related costs

Contents

1. Introduction

This chapter sets out the summary of our proposals along with background to debt-related costs and the previous approach to setting debt allowances in the cap. We also explore the case for change and how we now intend to set allowances going forward.

Purpose of this paper

1.1 Debt-related costs describe a selection of costs incurred by suppliers that are associated with non-payment of bills, known as bad debt, the administration of debt and costs associated with working capital. The price cap currently allows for debt-related costs within several different allowances. Debt-related costs are part of the wider basket of operating costs that a supplier incurs.

1.2 In our May 2024 policy consultation, we discussed how we aim to set a separate debt-related cost allowance, distinct from other elements of the operating cost allowance. We discussed options for which costs to include and how to include them, how we could benchmark costs across suppliers and how we could allocate costs across different groups of customers. We also discussed how we could set the allowance and update it over time.[1]

1.3 In this appendix we set out our proposals on these areas, having considered the comments received to our policy consultation.

Summary of our proposals

1.4 We propose to set a distinct ex ante allowance for debt-related costs within the wider basket of operating costs. This allowance will be set using the three components of debt-related costs.

1.5 We propose to set a weighted average benchmark for debt-related costs. In terms of baseline year, we propose to set this within a range using a combination of data across the latest 8 quarters, then taking into account the most recent industry data we will receive in Spring 2025.

1.6 We propose to allocate debt-related costs across payment methods based on the current payment method differential present in the cap. We propose to allocate costs between fuel types proportionately to supplier-reported revenue for the

[1] Ofgem (2024), Energy price cap operating cost allowances review, Chapter 4. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

most recent four quarters. We also propose equal allocation across electricity meter types and tariff types.

1.7 We propose to update the allowance over time similar to the status quo. This means updating bad debt costs and debt-related working capital costs (henceforth referred to as working capital costs) to scale in line with bill changes and debt administration costs in line with inflation (measured using CPIH). Working capital costs will also align with the cost of capital we use in the Earnings Before Interest and Tax (EBIT) allowance.

Structure of the paper

1.8 The structure of the remaining chapters is set out below:

- **Chapter 2 – Background & current approach.** In this chapter we set out the current approach for how debt-related costs are allowed for through the existing price cap methodology. We also set out the case for change.
- **Chapter 3 – Data and selection of cost components.** In this chapter we set out our proposals for how we select and measure cost components. We also discuss the data sources we propose to use and how we aim to select the appropriate sampling to use within our analysis.
- **Chapter 4 – Benchmarking approach.** In this chapter we set out our proposals on the selection of the baseline year and how we benchmark industry costs.
- **Chapter 5 – Allocating across customer groups.** In this chapter we set out our proposals for how we allocate costs across different parameters such as customer payment type and fuel type.
- **Chapter 6 - Update mechanism.** In this chapter we set out proposals for how we update the debt related costs allowance over time.
- **Chapter 7 – Methodology for estimating the allowance**. In this chapter we explain a detailed breakdown of the method used to calculate the debt-related cost allowance.

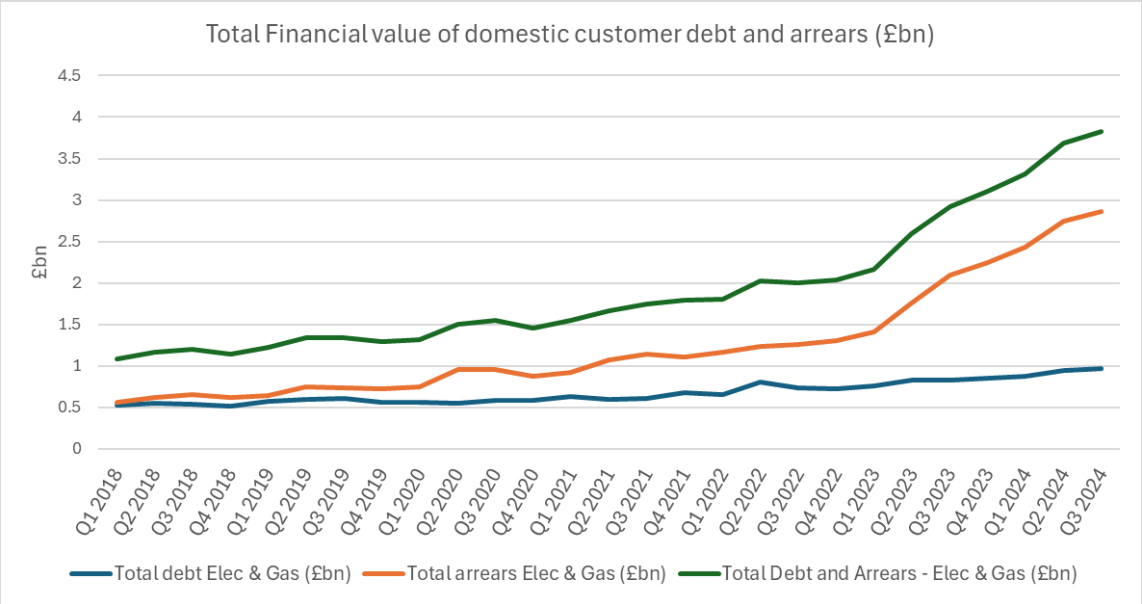
2. Background and current approach

In this section we provide an overview of what supplier debt-related costs are and how they are accounted for in the current price cap methodology. We then discuss our case for setting a separate debt-related cost allowance in the cap.

Context

2.1 Many consumers continue to struggle with paying their energy bills, due to wider cost of living pressures. Latest data shows that current levels of debt and arrears[2] across the market has continued to increase since 2022, and is now standing at around £3.8bn, which is an increase of nearly £2bn over the past two years.

Figure 2.1: Total debt and arrears over time



The graph shows the total amount of debt and arrears owed by domestic customers greater than 91 days. This data comes from the Social Obligations Reporting RFI, and can be found in our debt and arrears indicators data portal.[3]

2.2 Figure 2.1 indicates this increase in debt and arrears over the past couple of years. This has mainly been driven by increasing levels of arrears, with a less pronounced increase in debt across the same period of time. It is likely this growth in debt and arrears is being driven by households already behind on their

[2] Here, 'debt' is defined as those customers with a repayment plan in place and 'arrears' as those without repayment plans in place. Only debt and arrears existing for over 91 days are included.
[3] Ofgem (2024), Debt and Arrears Indicators. https://www.ofgem.gov.uk/publications/debt-and-arrears-indicators

bills. While the latest quarter of data has shown a slow down in the rate of increase, it is still too early to predict any emerging peak.

2.3 Some energy bills are paid late or not paid at all, and therefore ultimately have to be written off by energy suppliers. This is referred to as bad debt and all energy suppliers accumulate some bad debt. It is usual for businesses in many industries, not just energy, to make a provision for bad debt in their accounts and to cover this cost through the broader pricing of their goods and services. The price cap therefore provides an allowance to account for these efficient costs. This means all default tariff customers pay for the cost of bad debt incurred by customers who do not pay.

2.4 Suppliers incur debt-related costs as part of their operating expenses, and we divide these costs into three components:

- **Bad debt costs:** These are costs of write-offs and provisions in supplier's accounts from customers' energy bills that are never paid.
- **Debt-related administrative costs:** These are costs associated with suppliers' activities when dealing with customers in debt. These activities include (but are not limited to) sending out payment reminders, setting up repayment plans and, where appropriate and within tightly prescribed rules, carrying out warrant activity.
- **Working capital costs:** These are costs associated with suppliers raising capital for day-to-day operations and funding both customers making scheduled payments in arrears (eg quarterly payments on receipts of bills) and delayed payments.

2.5 The following illustrates how a supplier may typically incur these costs: a customer incurs debt when they stop paying for the energy consumed. When debt starts accumulating, suppliers incur debt-related administrative costs when they try to recover the debt. In parallel, suppliers will also incur short-term working capital costs to finance consumer debt. The amount of debt that is not eventually recovered is ultimately considered bad debt and is the largest element of debt-related costs.

2.6 The cost of bad debt is reflected in suppliers' accounts through the bad debt charge, which is an entry in the income statement. Suppliers make estimates (known as provisions) for the amount which will never be paid. They then adjust these estimates over time and eventually finalise them through write-offs. Write-offs can take some time to crystalise as suppliers attempt to recover the debt.

2.7 Different customer types tend to have different costs to serve. The majority of debt-related costs are associated with Standard Credit customers, meaning suppliers with more Standard Credit customers incur higher debt-related costs and Direct Debit customers typically have lower debt costs per customer. However, this does not mean all Standard Credit customers have high debt-related costs.

2.8 Within the past two years, we have observed an increase in total energy debt and arrears, as well as the number of customers who are in debt. We recognise the impact this has on consumers and we have launched a package of reviews to ensure our efforts support customers.[4] However, through the cap we also recognise that debt-related costs are a cost to suppliers which are at least in part outside their control. Under the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act'), we must have regard to suppliers' need to recover efficient costs.

2.9 This appendix focuses on the development of a new forward looking allowance for debt-related costs within the price cap methodology. It is worth noting that this review is separate to the work being carried out on the additional debt related cost 'float and true-up', covered in Appendix 6 of this consultation.

Previous approach to setting debt allowances

2.10 Debt-related costs are generally accounted for in existing price cap allowances through three inter-related components:

- **The operating cost allowance:** This captures the debt-related costs (bad debt costs and debt-related administrative costs) associated with the Direct Debit payment method and is applied as a baseline for other payment methods.
- **Earnings before Interest and Tax (EBIT) allowance:** This captures the working capital cost associated with customers paying in arrears. These costs are not differentiated by payment method but instead, are set using a common methodology across all payment methods.
- **Payment method uplift (PMU):** This allowance captures the additional costs associated with other payment methods, such as debt-related costs when

[4] Ofgem (2024), Resetting the energy debt landscape: the case for a debt relief scheme www.ofgem.gov.uk/publications/debt-strategy-reset-and-reform-customers-debt

compared with the Direct Debit baseline. For bad debt and debt-related administrative costs, the additional costs associated with serving Standard Credit customers are captured here. Furthermore, it adjusts the working capital allowance set in the EBIT allowance to reflect the cost differences between payment methods.

2.11 When we set the previous allowance for debt-related costs as part of our 2018 decision, we used data that we collected through our 2018 RFI. We calculated the bad debt cost using the bad debt charge, and we calculated the working capital cost by using the working capital requirement and applying the cost of capital from the 2018 EBIT decision. To estimate the allowance, we calculated the additional costs to serve a Standard Credit customer relative to a Direct Debit customer. We combined these costs across fuels and took a lower quartile benchmark.

2.12 To set the allowance across payment methods, we then allocated the additional costs between Standard Credit and Direct Debit payment methods. For example, while we allocated additional working capital fully to Standard Credit customers, we allocated 52% of the additional bad debt costs and debt-related administrative costs to Standard Credit and then spread the remainder over both Standard Credit and Direct Debit customers.[5]

2.13 We set the allowances for bad debt costs and working capital costs as a percentage which is applied to the rest of the cap 'core cost' components. We set the allowance for the additional administrative costs as a pounds per customer value.

How the allowance has been updated over time

2.14 Generally, the debt-related cost allowances are linearly scaled with the overall cap level, with the exception of the part of debt-related costs which is included within the core operating costs baseline and the fixed element of the payment method uplift, both of which are indexed to inflation (CPIH). We have observed an increase in the debt-related costs allowance in the cap, primarily due to the scaling effect driven by increasing wholesale costs.

[5] Ofgem (2018), Appendix 8 - Payment method uplift, paragraph 2.4. https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf

Table 2.1: Cap 13a debt-related cost allowances (annualised, £ per dual fuel customer at benchmark consumption)

		*Cap 13a allowance (exl AA)	*Cap 13a allowance (inc AA)
Debt-related cost allowances	Direct Debit	25	56
Debt-related cost allowances	Standard Credit	121	152
Debt-related cost allowances	PPM	10	19
Price cap level	Direct Debit	1,752	1,752
Price cap level	Standard Credit	1,871	1,871
Price cap level	PPM	1,743	1,743
Debt allowance as % of total price cap	Direct Debit	1.4%	3.2%
Debt allowance as % of total price cap	Standard Credit	6.5%	8.1%
Debt allowance as % of total price cap	PPM	0.6%	1.1%

Notes: *Additional adjustment allowances (AA) are in place in cap 13a. This table shows what the allowance would have been with and without the AA in place. See below for explanation of the AA. Cap 13a is the period between October to December 2024. Price cap levels are pre-levelisation and excluding VAT.

2.15 In April 2024 we implemented an additional adjustment allowance in the cap, as part of our decision on the additional debt costs review.[6] We set an additional debt adjustment allowance ('float allowance') of £31 per customer per year for a period of 12 months. In October 2023, we also implemented an adjustment allowance of £9 per customer per year for the costs associated with Additional

[6] Ofgem (2024), Energy price cap additional debt costs review decision. https://www.ofgem.gov.uk/decision/energy-price-cap-additional-debt-costs-review-decision

Support Credit (ASC) bad debt.[7,8] More discussion on these can be found in Appendix 6.

Case for change

Case for reviewing debt-related costs

2.16 With the wider cost of living crisis putting pressure on household finances and increasing levels of debt and arrears, this in turn means greater proportions of outstanding bills may never be repaid. This increase in non-payment leads to increased costs for suppliers.

2.17 We recognise the impact debt has on consumers. The wider debt strategy[9] work is a pathway for consumer focussed solutions, while the operating costs allowance is the primary route through which we assess and capture the costs suppliers incur to manage debt efficiently.

2.18 As part of the additional debt-related costs review, our analysis indicated that debt-related costs have diverged materially and systematically from the permanent price cap allowances over the period April 2022-March 2024 (cap periods 8-11b). This is discussed separately in Appendix 6. We have already taken action to address this period of under-recovery through a temporary 'float' adjustment allowance. However, we consider that the trend is continuing and so reform of the permanent allowances is now appropriate.

2.19 For context, the debt-related cost allowances built into the existing cap were set using data from 2017 as a baseline year. Since then there has been significant consolidation of the market structure, with large scale mergers and acquisitions. There have also been a number of supplier exits leading to further consolidation through the Supplier of Last Resort process. This means that the make-up of the data used along with the suppliers in the sample would likely be different to what would have been set previously.

[7] These adjustment allowance values are at price cap benchmark consumption level. The float allowance would be equivalent to £28 at latest typical domestic consumption value (TDCV).

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

[9] Ofgem (2024), Debt strategy reset and reform customers debt www.ofgem.gov.uk/publications/debt-strategy-reset-and-reform-customers-debt

2.20 Given external economic events such as the recent wholesale gas price crisis and subsequent cost of living crisis, along with structural changes to the market, we consider that reviewing debt-related costs in the cap is appropriate.

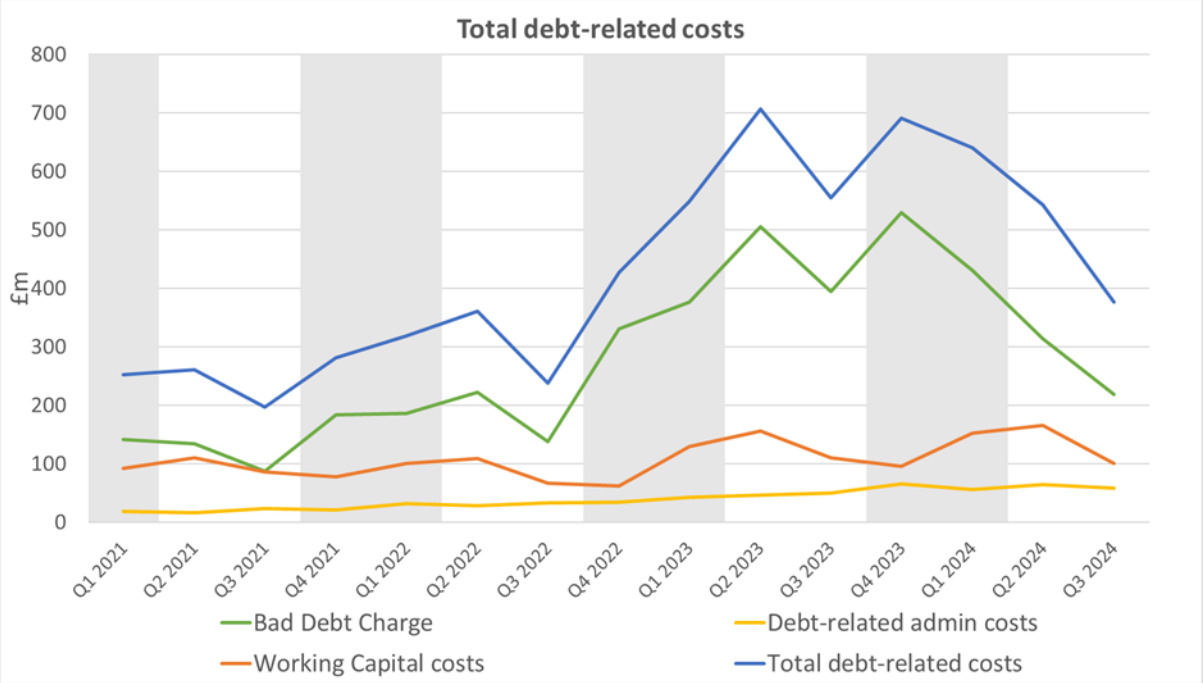
Case for setting a distinct debt-related cost allowance

2.21 Since the introduction of the cap, we have made several adjustments to the debt-related cost allowance in the form of a 'float and true up' approach. Firstly, related to additional costs incurred by suppliers due to the COVID-19 pandemic and more recently, the increase in debt-related costs following the gas crisis.

2.22 In light of these reviews, we consider it appropriate to isolate debt-related costs from the total operating cost allowances. This is due to several reasons which are outlined below:

- **Variability in the debt-related costs**: While other operating cost components are likely to be broadly stable over time, we consider debt-related costs to depend on consumer behaviour, economic circumstances and bill sizes, making them more likely to change as a result of external circumstances. Therefore, we may want to consider a different benchmarking approach and/or update methodology for debt-related costs (such as indexing the allowance to other cap components) compared to that used for core operating costs.
- **Impacted by supplier assumptions**: Suppliers may have various approaches to how they provision for bad debt that may impact reported costs. For instance, these may relate to different policies regarding how they manage debt built up over time, or how long they chase up bad debt before writing it off. Core operating costs reporting is broadly more consistent across industry. As a result, a differing approach between the components on the choice of baseline year may be appropriate.
- **Improves transparency**: A separate allowance would provide more transparency in the way debt-related costs are accounted for in the cap. It would be particularly beneficial if we needed to assess whether costs were materially and systematically different from the allowances (as we have previously done when considering if an adjustment is appropriate or not).
- **Flexibility to adjust**: If we are required to make any adjustments to the debt-related costs allowance in the future, setting a separate allowance would help make these adjustments easier.

Figure 21.2: Trend in supplier reported total debt-related costs



The graph shows the debt-related costs for all tariff types and payment methods from the latest debt-related cost RFI. The grey areas represent winter seasons.

2.23 Figure 2.2 indicates the progression of debt-related costs over time and in particular the variable nature of these costs. Debt-related costs incurred by suppliers have increased significantly since 2022, peaking in summer 2023 at well over twice the level seen in the previous year. A falling trend has since been seen across the first three quarters of 2024. This peak has been driven mainly by wider cost of living issues, putting pressure on households' ability to pay their bills. The increased debt and arrears can lead to increased levels of non-payment, which comes at a cost to suppliers. This variability due to external factors is one reason why it may be appropriate to treat debt-related costs separately to core operating costs.

3. Data and selection of cost components

In this section we set out our proposals for the data sources used to measure debt-related costs, and the sampling approach taken to set the new allowances. The proposals are across three main aspects: selection of cost components, the selection of data source and measure of cost, and sampling method.

Selection of cost components

Context

3.1 In our May 2024 consultation, we stated that when setting the allowance, we had the option to either maintain the current approach of including all three debt-related cost components (bad debt charge, debt-related administrative costs and working capital costs); or select a primary cost component that the allowance would be based on.[10]

Proposal

3.2 As discussed above, in the current approach there are three main components of debt-related costs. We propose to maintain the inclusion of all three of these in our assessment of the debt-related cost allowance.

Considerations

3.3 One supplier agreed that all debt-related costs should be included in the allowance. Another supplier said that the allowance should only include bad debt costs and debt-related administrative costs, and working capital costs should be included within the EBIT allowance.

3.4 While we acknowledge that working capital costs are included within the EBIT allowance, the modelled working capital estimate used to calculate the EBIT allowance does not vary by payment method.[11]

[10] Ofgem (2024), Energy price cap operating cost allowances review, paragraph 4.23. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

[11] Ofgem (2023), Price Cap - Decision on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance, paragraph 5.10. https://www.ofgem.gov.uk/decision/amending-price-cap-methodology-earnings-interest-and-tax-ebit-allowance-decision

3.5 Debt-related working capital costs vary by payment method. In particular, Standard Credit customers have higher working capital costs than other customers, because they pay in arrears. We therefore intend to maintain our initial proposal of aligning with the current approach of setting the debt-related costs allowance using all three cost components. To be clear, this would involve rebalancing between payment methods the working capital costs already included in the EBIT allowance, rather than adding to the total working capital costs included in the cap.

Selection of data source and measurement of costs

Context

3.6 We collect data on all three debt-related cost components across Ofgem workstreams. This includes the Request For Information (RFI) submissions that are collected by the Debt-Related Cost Review (DRC RFI); the RFI for Stress Testing for Financial Resilience (FRC RFI); and most recently, the RFI for the Operating Cost Review as part of our May 2024 policy consultation (Opex RFI).

3.7 In our policy consultation, we stated our intention to use the Opex RFI that collected data across the years of 2022 and 2023 to set the allowance. However, given the variability of debt-related costs over time, particularly the significant increase seen since 2022 (as shown in Figure 2.2), we carried out a reconciliation exercise across all three sources of data. This was to ensure that the data source used to set the allowance provided the necessary level of data quality, and the most accurate reflection of trends in bad debt.

3.8 Across the data sources, factors such as how bad debt is defined and measured, the frequency and time of collection, as well as the collection methodology, can provide different insights into bad debt components. Different sources may be more appropriate depending on the intended purpose. While it is difficult to achieve a perfect data quality across all factors, we focussed on ensuring the data used to set allowances was appropriately robust. To address this, a data reconciliation exercise was carried out to review the three data sources against

the data quality dimensions set out in the Government's Data Quality Framework:[12]

- **Consistency** – this is the degree to which values across the datasets do not contradict other values representing the same definition or entity. To first assess this, we reviewed all definitions and measures of cost components across the three data sources to identify differences and similarities. We then reconciled the definitions to ensure that when comparing values for each cost component across the datasets, they were representing the same definition of measurement.
- **Timeliness** – this is the degree to which the data is an accurate reflection of the period that they represent, and that the data and its values are up to date. To assess this, we reviewed the frequency of collection of the datasets, the point at which the dataset was collected and the point at which it was being used for setting the allowance.
- **Accuracy** – this is the degree to which the data matches reality and controls for bias where the data may not be representative of the relevant population. To assess this, we reviewed what type of customers and suppliers were in scope for each dataset.

3.9 Along with the three dimensions above, we also reviewed the measurement of each cost component across the data sources (ie how each cost component was being defined and measured in each RFI).

Proposal

3.10 In our May 2024 consultation we consulted on the different possible options for measuring cost components.[13] Our proposal is to use the following measures for each cost component:

- **Bad debt costs – Option A.2:** Profit and Loss charge incurred. Costs include write-offs and recoveries, movements in provisions and credit

[12] Government Data Quality Hub (2020), The Government Data Quality Framework, Data quality dimensions – how to measure your data quality. https://www.gov.uk/government/publications/the-government-data-quality-framework/the-government-data-quality-framework#Data-quality-dimensions

[13] Ofgem (2024), Energy price cap operating cost allowances review, paragraph 4.34. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

balance recognition.[14] This allows us to use reported data that has undergone an audit process and enables us to validate supplier data against the consolidated segmental statements or suppliers' statutory accounts. Nonetheless, we recognise that there will always be a degree of accounting judgement in the use of profit and loss account data, and that this will constrain the level of accuracy, albeit the data is audited.

- **Debt-related administrative costs – Option Hybrid:** include the external and internal collection, warrant costs and active charge categories, as well as any other debt-administrative related costs.
- **Working capital costs – Option C.1:** Net accounts receivable approach that uses supplier net accounts receivable (ie accounts receivable minus accounts payable) and applying the most recent cost of capital (from the EBIT decision) to estimate working capital costs. Using the EBIT cost of working capital assumes working capital requirements are financed fully (100%) through equity.

3.11 For the data source of these measures, we propose to use the DRC RFI. This is because it measures the cost components in line with the proposed measures above, and provides the most consistency in the data for each cost component.

3.12 Furthermore, the DRC RFI is carried out on a quarterly basis. It collects data dating back to 2017, which is either broken down by monthly or quarterly intervals depending on the cost component. This provides a relatively longer timespan than the other potential sources. The granularity of data helps us to assess the variable trends of each cost component, both historically and in the upcoming quarters. Consequently, this has given us more options in how to benchmark costs with respect to the choice of the baseline period (see discussion in Chapter 4).

Considerations

Measurement of costs – bad debt charge

3.13 Five stakeholders supported using the bad debt charge measure due to feasibility, practicality and comparability. Two stakeholders supported the bottom-up approach as it would not be directly influenced by supplier decisions, particularly

[14] Accounting standards (International Financial Reporting Standards (IFRS 9)) require entities to classify and measure financial liabilities and assets in their balance sheets.

estimates of bad debt provisions, as this can have a direct influence on the allowance they receive.

3.14 The bottom-up approach would collect supplier debt levels by debt characteristics (ie age of debt, payment method and live/final) and estimate the proportion of debt that is unlikely to be recovered. To estimate this proportion, we would use a combination of supplier provisioning approaches and historical data on supplier recoverability rates.

3.15 In our May 2024 consultation we considered using the bottom-up approach against the criteria of practicality, accuracy and comparability.[15] We deemed that, although adopting a bottom-up approach could provide a robust modelling framework, this would be difficult to implement in practice whilst establishing sufficient confidence in the level of accuracy, due to the complexity of the modelling required.

3.16 While we recognise that using bad debt provisions means that our allowances are influenced by suppliers' provisioning decisions, there are limits on the extent of this risk, and we do not consider that this risk would be substantially reduced by the implementation of a bottom-up modelling approach. We set out our reasons below.

3.17 There are several limits on the risks from provisioning. First, suppliers' provisioning judgements are constrained by accounting standards and the scrutiny of their auditors. Second, provisions cannot continually diverge from reality over time, because the bad debt charge in a given period will include revisions to previous provisions. Third, were we to incorporate data from a longer timeframe in our calculation of the baseline, this would further mitigate the impact of provisioning decisions in any particular period. Fourth, our proposal to use a weighted average benchmark (as discussed in Chapter 4) would further mitigate the impact of any individual supplier's provisioning decisions.

3.18 A bottom-up approach would still require assumptions on future recoverability. Suppliers' expectations of future recoverability (as embodied in their provisioning) would be a relevant source for us to consider. We therefore do not consider that a

[15] Ofgem (2024), Energy price cap operating cost allowances review, paragraph 4.38. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

bottom-up approach would be an entirely distinct approach which would remove the impact of suppliers' judgements.

Measurement of costs – debt administration

3.19 Four stakeholders supported using the hybrid approach as it balances prescriptiveness and flexibility to allow suppliers to report any additional costs. No stakeholders only favoured the prescribed or flexible approach.

Measurement of costs – working capital

3.20 Six stakeholders supported using net accounts receivable due to: the ability to split by payment method, comparability and it being an accurate measure. One stakeholder was against the reported working capital approach. Under the reported working capital approach (Option C.2 in our May 2024 consultation), we would request suppliers to report working capital costs directly and provide costs associated with differences in timings of payment.[16]

3.21 One stakeholder was in favour of using the same cost of capital as EBIT.

3.22 Most suppliers were able to provide working capital costs in the format required by the DRC RFI. However, a couple of suppliers found it difficult to split working capital costs by payment method or tariff type and exercised their judgment in allocating working capital costs in the DRC RFI.

Sampling

Context

3.23 Using the DRC RFI, a core sample of suppliers' data is selected to estimate the debt-related costs using the proposed measurement approaches outlined above. For this, we extended the use of the Government Quality Framework by establishing the following data quality dimensions as the exclusion criteria for sampling supplier data:

- **Completeness –** this describes the degree to which all relevant records exist in the dataset. For a dataset to be complete, the data set contains all the records that it should and all the essential values in a record are populated. To assess this across supplier data, we reviewed the extent to which each

[16] Ofgem (2024), Energy price cap operating cost allowance review, paragraph 4.37. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

supplier submitted all fundamental data entries across the three components of debt required in the DRC RFI.

- **Accuracy –** in line with the definition detailed above, this dimension was used to review the representativeness of supplier data submitted given the relevant population (ie default tariff customers).

Proposal

3.24 From the 11 suppliers that we received data submissions for under the DRC RFI, we propose to exclude three of them to select the core sample.

3.25 The three suppliers did not provide complete data for all three debt-related cost components of the bad debt charge, debt-related administrative costs and working capital costs. These suppliers therefore do not meet the data quality dimension of completeness.

3.26 One supplier operates a multi-utility model which is significantly different from other suppliers. It makes it challenging for them to accurately spilt their retail energy related costs from other costs. Therefore, it does not meet the data quality dimension of accuracy.

Considerations

3.27 Regarding accuracy, while the DRC dataset does have limitations and experiences outliers in submissions, we consider it to be representative of the default tariff market. It collects data from suppliers that have more than 100,000 default tariff type customers. This leads to submissions from 11 suppliers on average. We carry out periodic follow-up engagement regarding suppliers' individual DRC RFI submissions to control for outliers that could skew the data.

3.28 Following our reconciliation exercise, we identified discrepancies between cost component entries that suppliers had provided between the Opex RFI and the DRC RFI. This was particularly the case for payment method splits for the cost components. We carried out follow-up queries with suppliers and requested that where there were discrepancies due to error, different debt-related cost definitions or different methodologies adopted, the correct values would be submitted in our latest DRC RFI for October 2024. This ensured that the latest DRC RFI dataset would capture a more reliable version of the latest costs.

4. Benchmarking approach

In this section, we discuss our proposals, summarise stakeholder responses and consider how we intend to benchmark supplier costs. We focus particularly on the choice of baseline period and the benchmark metrics.

Context

4.1 The overall level of stringency would depend on two factors, namely the baseline period (given the significant variation in costs over time as presented in Figure 2.2) and the choice of the benchmark metric.

4.2 Debt-related costs currently in the cap sit across the operating costs allowance and the payment method uplift and is set using 2017 data (excluding additional adjustments).[17] The core operating costs allowance is set at the lower quartile level minus £5, and the payment method uplift at the lower quartile. These benchmarks were set to drive overall efficiency improvements in the operating costs of suppliers at the time.

4.3 In our policy consultation, we said we intended to use 2023 data to benchmark costs. Figure 2.2 in previous chapter shows that debt costs have been volatile over recent periods. For this reason, we have also considered several more options for the baseline period.

4.4 As discussed in the previous section, our proposal to use the DRC RFI data enables us to consider other baseline period options. To this extent, while we have examined costs in calendar years 2022 and 2023, we have focused on considering the following options for the baseline period:

- Option A.1: Last four quarters;
- Option A.2: Last eight quarters;
- Option A.3: A combination of the last four quarters and the last 8 quarters. Under this option, we would estimate the benchmark separately for the two periods and take the mid-point between the two.

[17] As discussed in Chapter 2, the EBIT allowance also includes debt-related costs. We do not mention the EBIT allowance here, as we did not set this using an equivalent judgement on stringency.

4.5 We note that the actual period considered under the three options above could be updated to incorporate the latest period of data available. The most recent RFI gathered data up to Q3 2024, therefore, for example, the last four quarters include data from Q4 2023 to Q3 2024. We would have data for more recent periods at the time of the decision, and the options at the time of developing our decision would reflect this.

4.6 In our May 2023 policy consultation, we considered the following benchmark metric options:

- Option B.1: lower quartile benchmark - the cost of the supplier that is at the 25th percentile in the sample applied to the three debt-related costs together;
- Option B.2: weighted average benchmark - the average cost across suppliers weighted by the number of customers in their portfolio across the three debt-related costs together.
- Option B.3: hybrid benchmark - setting different benchmark metrics for different debt-related costs. We could, for instance, set the bad debt component using a weighted average and the working capital and debt-related administrative costs using a lower quartile benchmark.

4.7 In addition to the distinct options above, we also noted in our policy consultation that the benchmarking may be conducted at any level (for example, between the lower quartile and the weighted average, including the median).

4.8 We set the cap at different levels across certain parameters (eg payment method and fuel type). We have cost data broken down by some of these parameters. Therefore, when benchmarking, we need to consider whether we benchmark costs at the parameter level (eg payment method) or at an aggregate level (ie benchmark at total costs).

Proposal

4.9 Given the recent volatility in debt data and uncertainty about future developments, we consider it important to ensure we are using the latest available evidence to inform our judgement of how to set ongoing allowances. In spring 2025 we will receive industry data with the latest quarter of debt-related costs. We propose to take this data into consideration for setting the baseline period, prior to making our decision. At this stage, we are therefore providing guidance on how we would look to use that data and a range which intends to capture our current uncertainty.

4.10 We are therefore consulting on 1) the methodology used for assessing costs and generating a range 2) the approach to the judgement required in choosing the appropriate baseline period and hence where in that range we should set allowance. It is therefore possible both that a) additional data may change the absolute level of the range and b) we may judge that on the balance of evidence we should set the allowance elsewhere within that range.

4.11 We define this range within two baseline options, both based on a combination of data from the most recent 2 years, which could be updated to incorporate the latest available data.

- The lower end of the range will use a baseline period made up of the most recent four quarters of data. Current data suggests this would be set at £71 per customer per year.
- The upper end of the range will use a baseline period made up of the most recent eight quarters of data. Current data suggests this would be set at £76 per customer per year.

4.12 Table 4.1 below presents the aggregate allowance under each baseline period.

Table 4.1: Aggregate £/dual fuel customer value of the baseline period options, for our proposed benchmark metric option

	Last 4 Quarters	**Last 8 Quarters**	**Combination of last 4 and 8 quarters**
Weighted average	£71	£76	£73
Period	Q4 2023- Q3 2024	Q4 2022-Q3 2024	Q4 2022-Q3 2024

Notes: Values are presented are at benchmark consumption (Electricity 3,100 kWh and Gas 12,000 kWh). These values are based on the latest RFI data available and are in June 2023 prices.

4.13 Our minded-to position at this time is to set an allowance in the mid-point of this range, which based on latest data would be £73 per customer per year. It is worth noting that the average debt costs across 2022 and 2023 combined results is a similar level of £73 per customer per year. These figures may change based on the latest data prior to decision as discussed above.

4.14 We propose benchmarking debt-related costs using a weighted average benchmark of total costs. We consider a weighted average benchmark to mitigate the risk of setting an achievable benchmark, enabling suppliers to recover their notionally efficient costs, which is in the interest of current and future customers.

Further, we consider it would enable suppliers to provide a wider range of support to customers in financial difficulties, improving customer service. We intend to set this benchmark at an aggregate level.

Summary of Stakeholder Responses

4.15 One stakeholder supported a lower quartile benchmark, seven suppliers supported a weighted average, and one stakeholder supported a hybrid option. We have not received any feedback on what baseline period to use.

4.16 Four stakeholders favoured benchmarking costs at an aggregate level, while five favoured benchmarking costs at a payment method level.

Considerations

Choice of the baseline period

4.17 We are setting an ex-ante allowance for the debt-related costs in the cap. Therefore, a key consideration when selecting the baseline period is whether the period is representative of expected future supplier costs.

4.18 Based on the data we gathered through the debt-related costs RFI, supplier costs have significantly changed over time (as presented in Figure 2.2). It suggests that, while debt-related costs remain higher than the historical average, they are lower compared to 2023, suggesting that costs may have peaked in 2023.

4.19 In contrast, the most recent data published by Ofgem on customer debt and arrears in the market suggests that the value of domestic customer debt and arrears is on an upward trajectory, with estimated total arrears for the third quarter of 2024 reported at c.£3.8 bn. This is presented in Figure 2.1. This is a 3.5% increase from the previous quarter (total debt and arrears were reported to be c.£3.7bn in the first quarter of 2024). This suggests that the risk of debt-related costs being above historical levels continues to remain.

4.20 Taken together, this information projects uncertainty of suppliers' future costs, but it looks increasingly likely that 2023 was a peak period for debt-related costs. We consider this likely because suppliers were reacting to the original price shock, the end of universal Government bill support and the moratorium on involuntary PPM installations. Such a combination is likely to have led to rapid changes in provisioning policy and large one-off write-offs. As we move away

from the crisis period[18], we are beginning to see that these impacts are starting to ease off, which might explain the decline in debt-related costs in recent periods (even though they remain elevated by historical norms). Therefore, we consider using 2023 as a baseline period is unlikely to be the best prediction of expected supplier costs going forwards and would not be appropriate to set a forward-looking allowance.

4.21 When setting a forward-looking allowance, we consider it important to use the latest data available while taking a view on which period of time is the most appropriate reflection of future costs. In spring 2025 we will receive industry data with the latest quarter of debt-related costs. We propose to take this into consideration for setting the baseline period, prior to making our decision. Given this uncertainty, we are proposing to set the allowance within a range as described above and detailed in table 4.1. We explain the calculation steps in more detail in Chapter 7.

4.22 Our final decision will be influenced by the latest available data. This could be used to update the range itself when incorporating further data. If we were to do so, then, when incorporating the latest spring 2025 data, this would mean Q4 2023 would be replaced by Q4 2024. Similarly, Q4 2022 would be replaced by Q4 2024 for the last 8 quarters approach.

4.23 While the impacts of new data are uncertain, we consider it is likely to be useful for stakeholders to understand our current expectations of how new data could affect the range if incorporated:

- We consider it likely that Q4 2024 data will be higher than Q3 2024, due to usual seasonal patterns.
- For the bottom end of the range, Q4 2024 would need be the same level as Q4 2023 for the new data to result in the same average across the last 4 quarters. This seems unlikely given recent trends so incorporating the latest data may bring down the lower end of the range.
- The top end of the range, Q4 2024 would need to be the same as Q4 2022 for the new data to result in the same average across the last 8 quarters. Given

[18] For example, some suppliers early this year were given the approval to resume involuntary PPM installation.
https://www.ofgem.gov.uk/press-release/ofgem-sets-out-prepayment-meter-expectations-energy-bosses-edf-octopus-and-scottish-power-meet-regulators-restart-conditions

that Q4 2022 data was only slightly higher than Q3 2024 it is plausible that new data could result in this upper end of the range increasing or decreasing.

4.24 New data and evidence could also mean moving within the range. For example, if we felt that the most recent data was strongly signalling that debt costs were continuing to fall and/or were reaching a new plateau we may decide that the lower-end of the range, driven by the last 4 quarters was the most appropriate choice of baseline. If data continues to be volatile or shifts upwards more than expected then we would be more likely to choose a baseline in the centre or potentially upper-end of the range.

4.25 We are also mindful of potential future changes in regulation that could impact supplier debt costs. For example, the possibility of implementing a potential debt relief scheme that could impact supplier debt costs.[19] Given the uncertainty in future debt costs, if we consider debt costs to materially and systematically deviate from the allowance, we may consider the possibility of ex-post adjustment, which could result in a positive or negative adjustment.

Choice of benchmark metric

4.26 There are four key considerations when assessing the options for benchmark metrics: (i) the role of efficiency and non-efficiency factors, (ii) the level of customer protection, (iii) the level of uncertainty, and (iv) supplier provisioning methodologies. We then set out our recommendation on the balance between these factors.

The role of efficiency and non-efficiency factors

4.27 As discussed in Appendix 1 of this consultation, when setting the cap, we must have regard to providing incentives for efficiency improvements and enabling a notionally efficient supplier to finance the activities authorised by the licence.

4.28 Variation in debt-related costs across suppliers is likely to be impacted by efficiency and non-efficiency factors (we introduce these concepts in Appendix 1). In our May 2024 policy consultation, we said that debt-related costs, to a certain extent, are explained by non-efficiency factors such as 1) suppliers' customer bases, 2) levels of discretionary support and 3) natural variation.[20]

[19] Ofgem (2024), Resetting the energy debt landscape: the case for a debt relief scheme www.ofgem.gov.uk/publications/debt-strategy-reset-and-reform-customers-debt

[20] Ofgem (2024), Energy price cap operating cost allowances review, paragraph 4.73. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

4.29 We analysed correlations between supplier debt costs and non-efficiency factors such as the proportion of customers in receipt of Warm Home Discount (WHD), the proportion of customers in the Priority Services Register (PSR) and the payment method mix to understand the extent to which these factors could influence supplier costs. We observed that supplier debt costs are likely to be positively correlated with the proportion of WHD and PSR customers. In contrast, we observed a somewhat weak positive correlation between costs and payment method mix.

4.30 While most stakeholders said that the payment method mix and proportion of vulnerable customers are key supplier-base characteristics that drive debt-related costs, two suppliers said that there are other observed and unobserved non-efficiency factors that could be driving debt-related costs (eg customer behaviour). This poses a general challenge in identifying and potentially quantifying non-efficiency factors when benchmarking costs, which is particularly critical when selecting a lower quartile benchmark, as we need to control for these factors to mitigate the risk of setting an unachievable benchmark.

4.31 In our May 2024 policy consultation, we said we could mitigate the impact of non-efficiency factors on the benchmark by either 1) restricting the sample or 2) applying a weighted average benchmark.[21] We consider controlling for non-efficiency factors through a sample restriction under a lower quartile benchmark metric leads to a less robust benchmark, because it reduces the sample further from 8 suppliers to potentially 5 suppliers.

4.32 Two stakeholders said a lower quartile would help drive efficiency improvements. The cap provides some incentives for efficiency, as suppliers can earn extra profit by outperforming the benchmark. However, we consider that a more stringent benchmark can sharpen efficiency incentives (eg if suppliers need to make efficiency improvements to make a normal rate of return).

4.33 Three suppliers said a lower quartile could also risk setting an unachievable benchmark due to non-efficiency factors, which could negatively impact supplier financeability. Based on our analysis above, we consider that there would be some risk to the financeability of a notionally efficient supplier from setting a lower quartile benchmark, which we do not consider would be in the best interests of current and future customers.

[21] Ofgem (2024), Energy price cap operating cost allowances review, paragraph 4.75. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

4.34 One supplier said that different debt-related cost components may have different drivers, therefore should be benchmarked differently. There is a possibility various cost components could have different drivers. However, we consider these costs are inversely correlated. For example, high debt-related admin costs could lead to lower bad debt charge and working capital costs, if spending more on collecting debt leads to faster and higher recovery of debt. Therefore, benchmarking these cost components separately could lead to an unachievable benchmark, particularly taking a lower quartile in one cost component. While we did benchmark costs separately in our February 2024 float decision, which set a temporary float adjustment in the cap for debt-related costs, we considered that this set an appropriate benchmark level based on the market circumstances at the time.[22]

Level of customer protection

4.35 We consider there are two elements to customer protection, namely, price protection (ie ensuring default tariffs reflect more closely the underlying costs of supplying energy) and non-price protection (ie customers receive the appropriate customer service standards).

4.36 A more stringent benchmark such as the lower quartile would reduce immediate costs to consumers, contributing to price protection.

4.37 In support of the lower quartile benchmark, a stakeholder said it would provide price protection, particularly in a case where suppliers overstate their bad debt costs. While a lower quartile would provide price protection in general, the bad debt charge (as discussed in Chapter 3) has undergone an audit process, which should limit the possibility of a supplier overstating the costs. Further, any excessive provisions made by suppliers in one period would be corrected in subsequent periods. This suggests that there is a limit to how much provisions can be inflated on an ongoing basis

4.38 Suppliers will remain subject to licence requirements about how they treat customers in payment difficulty. However, even while remaining compliant, there is some scope for suppliers to take different approaches to debt management. If a more stringent benchmark led to less customer-friendly practices, this would have an impact on customers in payment difficulty. This would reduce non-price protection.

[22] Ofgem (2024), Energy price cap additional debt costs review decision, paragraph 5.6. https://www.ofgem.gov.uk/decision/energy-price-cap-additional-debt-costs-review-decision

4.39 One supplier said that a lower quartile benchmark does not necessarily lead to worse support for customers in debt. It said that better customer service in general could prevent customers getting into debt and reduce the associated debt related costs (eg accurate billing could reduce the risk of unexpected high bills leading to debt issues). Conversely, two suppliers said a lower quartile could hinder the level of debt management, stating that it would set the customer service standard in line with the benchmark supplier. One said that it would significantly impact the service level if the benchmark were misrepresented.

4.40 We consider that, to some extent, the likelihood of a customer getting into debt could be explained by supplier actions. For example, actions such as frequent billing and sending payment reminders, identifying and recording customers in vulnerable situations to offer extra support, and support in reading meters could help minimise customers getting into debt.

4.41 However, the level of service required would depend on the customer's specific circumstances.[23] For example, while all customers would benefit from frequent billing and payment reminders, identifying customers in vulnerable situations and offering extra support would depend on the customer's specific characteristics.

4.42 Suppliers have different customer bases. Therefore, the type of service provided, and the associated costs would vary across suppliers. To the extent that some suppliers have customer bases with inherently higher debt costs, a more stringent benchmark could increase the risk of supplier failure. This would create potential costs to all customers as the costs of failure would be recovered from all energy bill payers.

4.43 On the contrary, we consider that a weighted average benchmark could enable suppliers with a higher-cost customer base to recover their efficient costs while providing the appropriate service level to customers. For suppliers with a lower cost customer base or with a higher level of efficiency, we consider a weighted average benchmark would enable suppliers to provide a wider range of support going beyond their licence obligation. However, it could be difficult to ensure that any additional allowance is used appropriately, where this depends on voluntary action.

[23] Ofgem (2024), Consumers' experiences of debt and affordability support from suppliers. https://www.ofgem.gov.uk/publications/consumers-experiences-debt-and-affordability-support-suppliers

4.44 Taken in the round, we consider that a weighted average benchmark delivers better consumer protection.

4.45 We recently published our consumer confidence framework that sets out our strategy and ambition to drive further improvements and culture change in customer service for domestic and non-domestic consumers.[24] This includes a drive for better debt support for customers. In this regard, we consider a weighted average benchmark could help finance future changes to customer service levels.

The level of uncertainty

4.46 The bad debt charge increased significantly from historical levels and has continued to change in recent periods. We expect debt-related costs to be volatile in the near term. As such, changes are likely to occur due to external factors (eg changes in affordability), changes in what suppliers are required to deliver (changes in regulatory requirements), and/or supplier activities (suppliers' providing additional support to customers in debt).

4.47 One supplier said taking a weighted average would allow for the uncertainty in the market. Whilst this is true for periods of uncertainty where the costs are increasing, this would lead to suppliers over-recovering costs if the costs follow a downward trend, which could have a detrimental impact on customers.

4.48 We consider the future trend in debt costs more uncertain than normal circumstances. This is due to costs being sensitive to customer affordability (driven recent energy crisis and wider macroeconomic factors) and potential changes to the regulatory environment. Given the uncertainty in future debt costs, if we consider debt costs to materially and systematically deviate from the allowance, we may consider the possibility of an ex-post adjustment, which could result in a positive or negative adjustment.

Provisioning methodology

4.49 We recognise that suppliers have different provisioning methodologies (eg the level of optimism about bad debt recovery a supplier builds into its assumption), and that these provisioning methodologies impact suppliers' costs and ultimately the benchmark we set.

[24] Ofgem (2024), Consumer confidence: a step up in standards. https://www.ofgem.gov.uk/publications/consumer-confidence-step-standards

4.50 There is a risk that the lower quartile benchmark is impacted by supplier provisioning methodologies (ie selecting a supplier that has an optimistic view relative to the entire market) potentially leading to an unachievable benchmark. Further, in periods of uncertainty, we consider that the differences in provisioning are more likely to vary as the reasonable range of accounting judgements would be wider.

4.51 We consider a weighted average benchmark to be able to mitigate these impacts to a certain extent, though there remains a risk if the market, on average, took a specific view that did not materialise.

4.52 We also consider that the impact of provisioning methodology on the benchmark, to an extent, could be mitigated by selecting a wider baseline period. The risk depends on the length of the baseline period considered. For instance, a baseline period of four quarters could be more susceptible to this risk than a baseline period of eight quarters.

4.53 One supplier said we should exclude suppliers from the benchmark sample if a supplier does not have an adequate provisioning methodology. We have not excluded suppliers from the sample based on their provisioning methodology. Provisioning methodologies will reflect accounting standards and are audited, which provides a level of confidence adequate to include them in our sample.

Benchmarking across parameters

4.54 As discussed in the May 2024 policy consultation, for benchmarking across parameters, we focus on payment methods, as payment methods are a likely driver of debt-related costs.[25]

4.55 One supplier supporting benchmarking at the payment method level said suppliers are best placed to make the appropriate cost allocations as opposed to Ofgem using theoretical splits. Similarly, another supplier said benchmarking at the aggregate level will move away from the principle of cost-reflectivity.

4.56 We assessed supplier-reported costs at the payment method level and observed, on average, a large variation in the cost per customer across payment methods (particularly high for Standard Credit and PPM). We consider that these costs are not cost-reflective as they do not reflect the underlying costs of serving a typical

[25] Ofgem (2024), Energy price cap operating cost allowances review, paragraph 4.83. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

customer in a given payment method. Therefore, we consider setting the allowance for payment methods using a bottom-up approach is not in the best interest of current and future customers as it would lead to disproportionately high allowances, particularly for Standard Credit customers. We discuss this in detail in the next chapter.

4.57 Three suppliers that supported benchmarking at the payment method level said this option would control for supplier payment method mix. We assessed the correlation between supplier overall debt costs and payment method mix. We did not observe a strong correlation between the two, and given the reasons above, we did not consider it would be in customers' interest.

4.58 Three suppliers that supported benchmarking at the aggregate level said that this approach would mitigate the impact of differences in allocation methodologies on the benchmark. Further, two suppliers said benchmarking at the payment method level and selecting a lower quartile benchmark could risk setting an overall benchmark that is unachievable in practice. We agree with suppliers' views that the benchmark cost at the payment method level would be impacted by suppliers' allocation methodologies, and it could risk setting an unachievable benchmark in practice, particularly under a lower quartile benchmark.

5. Allocating costs across customer groups

In this section we discuss how costs could be allocated between payment methods, fuel types (electricity and gas), electricity meter types (single rate and multi-register electricity meters) and tariff types (fixed tariffs and default tariffs).

Context

5.1 Given our proposal to benchmark costs at an aggregate level, we then need to consider how we allocate costs between various parameters. These include payment methods, fuel types (electricity and gas), electricity metering arrangements (single rate and multi-register electricity meters) and tariff types (Standard Variable Tariffs (SVT) and Fixed Term Contracts (FTC)). [26] In Chapter 5 of the overview document, we discuss our proposal on the allocation between consumption levels.

5.2 The approach taken does not affect the total level of costs recovered through the cap, but rather the way in which the costs are recovered among different types of consumers and levels of consumption.

Allocating costs across payment methods

5.3 In our May 2024 consultation, we consulted on various options on how we would allocate costs across payment methods. Following careful consideration (discussed later in the section), we have narrowed down the options (including an additional option – Option 2) as below:

- Option 1: Current differential – This option takes the current debt-related cost allowance per payment method and estimates the differential between each of Standard Credit and PPM relative to Direct Debit. We then allocate the benchmark costs across payment methods to maintain the estimated relative differential. See detailed methodology in Chapter 7.
- Option 2: Reported costs allocation - This option first estimates the weighted average costs per customer reported across the sample of suppliers under each payment method. We use these weighted costs to apportion the overall benchmark level.

[26] Cap levels vary across regions. Given our proposals on how we update some debt cost components (see discussion in Chapter 6), the debt-related cost allowance would vary across regions due to the fact that that overall bills vary by region.

- Option 3: Equal cost allocation (across Direct Debit, Standard Credit and PPM).

Table 5.1: Cost allocations under the allocation options

	Direct Debit	**Standard Credit**	**PPM**
Option 1:	£ 60	£ 156	£ 24
Option 2:	(£9)	£ 390	£22
Option 3	£73	£73	£73

Notes: All values at dual fuel costs per customer at the benchmark consumption level. The allowance presented is net of debt-related working capital allowance provided in EBIT proxied at £21 per dual fuel customer at the benchmark consumption level.

Proposals

5.4 We propose to allocate costs using option 1, the current differential approach. We consider this approach to balance the need to set an allowance that reflects the relative debt risks associated with a payment method against protecting paying customers in that method. This approach also provides the appropriate incentives to customers and suppliers.

Summary of stakeholder responses

5.5 Six suppliers supported using a reported cost allocation approach due to their view of this approach being cost reflective, feasible and the least complex. One supplier supported using a bespoke approach, stating that it is theoretically the best approach and the most cost reflective.[27]

Consideration

5.6 In selecting how to allocate costs, we need to consider the trade-off between customer protection, efficient cost recovery, and the signals it would create in the market. Whilst an equal allocation between payment methods may lead to a more equal balance of costs across different customers, this however might impact the recovery of efficient costs, potentially affecting supplier financeability and distorting competition in the market. This may not be in the best interests of current and future customers. Further, it may disincentivise customers to move

[27] We presented the bespoke approach option in the policy consultation, which we discuss later in this section.

away from inefficient payment methods. We discuss these trade-offs in more detail below.

Considering a reasonable and proportionate outcome

5.7 Bad debt costs stemming from a subset of customers are generally factored into the overall prices of energy. This means that other paying customers indirectly contribute to covering these costs. To this extent, bad debt costs have always involved allocating costs between customers.

5.8 Although, generally, Standard Credit customers have a higher propensity to fall into debt and incur debt-related costs, it does not mean that all Standard Credit customers incur high debt costs. Evidence from the customer survey suggests higher debt costs are likely incurred by a minority of Standard Credit customers.[28] Similarly, it does not mean all Direct Debit customers have a low debt risk. Indeed, some customers in debt begin their debt journey as a Direct Debit customer.

5.9 One supplier said that a subset of paying customers within Standard Credit should not be paying lower costs similar to Direct Debit Costs, stating that in a competitive market, a group of customers who are more costly to serve will face higher prices on average. We agree that a typical Standard Credit customer is somewhat more expensive to serve and hence should pay a reasonable premium. We do not agree that it is reasonable for that premium to cover all the costs of non-paying customers. Nor do we consider that a competitive market would necessarily be able to sustain such pricing strategies as the financial reward for paying Standard Credit customers to switch payment type (or supplier) would be significant.

5.10 While paying Standard Credit customers do incur a modestly higher cost to serve (working capital costs related to paying on credit) and greater risk (likelihood of non-payment), we need to consider whether it is in the overall interest of customers for this relatively small group (around 4 million households) to bear the burden of non-payers' debt.

5.11 As discussed in Appendix 5, we consider that our proposed approach strikes the right balance between, setting a payment method differential, and ensuring that

[28] Ofgem (2024), Consumer impacts of market conditions survey: wave 5 (January to February 2024) https://www.ofgem.gov.uk/publications/consumer-impacts-market-conditions-survey-wave-5-january-february-2024

no particular customer group is disproportionately impacted. It leads to a more balanced impact across different payment methods.

Cost reflectivity

5.12 Theoretically, we consider a higher value per customer of debt-related costs could be associated with Standard Credit customers compared to other payment methods. This is due to:

- **Paying in arrears**: Unlike other payment methods, Standard Credit customers pay in arrears. This increases the risk of a customer not paying, leading to debt-related costs. Payment in arrears also generates higher working capital costs, even for customers who are not in debt.
- **Financial vulnerability**: Evidence from a recent consumer survey suggests that, on average, Standard Credit customers face greater than average financial pressures, increasing the likelihood of falling into debt and incurring associated debt-related costs compared to other payment methods[29].

5.13 Therefore, suppliers with more Standard Credit customers are likely to incur higher debt-related costs and vice versa.

5.14 One supplier said that reported costs (specifically bad debt charge, which makes up a significant proportion of costs) are calculated in line with accounting standards considering the recoverability based on payment methods and, therefore, is "cost reflective". On the contrary, another supplier said bad debt charge does not appropriately reflect the debt risk suppliers face concerning each payment method.

5.15 To that extent, we consider that supplier-reported costs are not "cost reflective" of a typical customer for the following reasons.

- **Customer movement**: Customers in debt generally move between payment methods and typically end up in PPM on their debt journey. As suppliers generally cannot reallocate their bad debt charge back to the payment method at the point of consumption, it results in relatively higher debt-related costs reported under PPM compared to Direct Debit (see Figure 5.1, which presents supplier-reported costs per dual fuel customer for legacy suppliers). We consider that a typical PPM customer cannot accrue large debt costs as

[29] Ofgem (2024), Consumer impacts of market conditions survey: wave 5 (January to February 2024), pages 15 - 18. https://www.ofgem.gov.uk/publications/consumer-impacts-market-conditions-survey-wave-5-january-february-2024

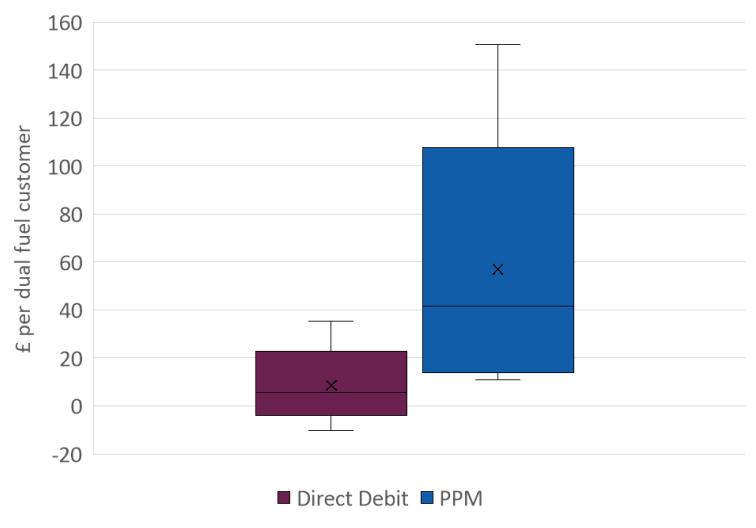
they pay in advance for their energy use; therefore, supplier-reported costs do not reflect costs incurred by a typical PPM customer.

- **Provisioning impacts**: Suppliers' debt provisions vary based on payment method. One supplier said that the same debt incurred on a payment method gets provisioned differently, holding everything constant as the debt moves between payment methods. It noted that, as a result, bad debt costs are typically undervalued under Direct Debit, while costs are typically overvalued under Standard Credit. This suggests that the same debt accrued by a customer would have varying provisioning rates depending on the customer's payment method in a given period, whilst the customer's characteristics remain the same. We consider that a customer moving between Direct Debit and Standard Credit conveys some relevant information about their likelihood of repaying. It is therefore unreasonable to expect that provisions would remain constant. However, the provisioning reflects the average situation for debt of a particular payment method. This general approach may create discontinuities in the provisioning rate (eg likelihood of non-payment doesn't jump between the day before the customer moves to Standard Credit and the day after). However, it is hard to see this having a significant impact on the overall balance of provisions between Direct Debit and Standard Credit.

5.16 As a result, one supplier said that we should move away from cost reflective allocation (which we understand as referring to the costs reported by suppliers) to reallocate some costs to Direct Debit payment methods to account for this.

5.17 As discussed in Chapter 4, there is some positive correlation between the proportion of Standard Credit customers and average debt costs, however the relationship is a relatively weak one. This is likely to be a result of the dilution effect of prompt paying Standard Credit customers which is high amongst legacy suppliers and low amongst challenger suppliers. The remaining correlation suggests a modest premium as is being proposed for Standard Credit customers, should actually result in relatively steady cost-recovery across the market.

Figure 5.1: Spread in the supplier reported total debt-related costs per dual fuel customer for Direct Debit and PPM payment method for the period October 2023-September 2024 for a sub-sample of legacy suppliers



5.18 Further, in our latest customer account and tariff RFI data, we do not observe suppliers with a predominant Standard Credit customer base in the default tariff market.[30] This mitigates the impact of allocation choices regarding Standard Credit. We consider that in combination, our benchmark, baseline and allocation proposals offer a range of notionally efficient suppliers to recover their efficient costs while protecting the interest of current and future customers.

5.19 One supplier said we should consider equal allocation if the bespoke approach is not feasible. In contrast, several stakeholders said equal allocation without a reconciliation mechanism would disproportionately impact suppliers, particularly those with a relatively large proportion of high cost to serve customer base. We consider equal allocation without a reconciliation mechanism would impact supplier financeability, including for some efficient suppliers, which is not in the best interest of the customer (see detail discussion in Appendix 5). Further it could also lead to higher costs in the future if more customers select the Standard Credit payments method to benefit from payment in arrears.

5.20 We discuss the impact of our allocation options on suppliers in detail in Appendix 5.

Incentives

5.21 One supplier said it is important to have a price differential between Direct Debit and Standard Credit as it is useful to send signals to customers (which we

[30] Currently the proportion of Standard Credit customers across suppliers ranges from 6% - 27%.

understand as referring to a signal that would move customers to a more efficient payment method). We are mindful of the incentives a relative differential between payment methods would create among suppliers and customers.

5.22 A relatively high differential, such as under the reported cost allocation option, would provide a significant incentive for customers to move to another payment method. However, it would also create a market in which prompt paying Standard Credit customers would be significantly more profitable for suppliers. This may impact the incentives in place for suppliers to encourage customers to switch to more efficient payment methods. With a high differential, there is an incentive for suppliers to maximise the number of paying Standard Credit customers, potentially reducing incentives for suppliers to encourage customers to move from Standard Credit to Direct Debit, holding everything constant. Such incentives do not align with the broader goals of efficiency in the market.

5.23 We also consider a relatively high differential might incentivise some paying standard credit customers to switch to Direct Debit payment methods, holding everything else constant. While this aligns with broader goals to move customers to efficient payment methods, it would leave the costs of non-paying customers to be recovered from a smaller number of Standard Credit customers. This would increase bills for paying customers on Standard Credit, making it harder to achieve a reasonable and proportionate outcome for these customers. It could also make it harder for suppliers to recover efficient costs, impacting supplier financeability, which is not in the best interest of current and future customers.

5.24 On the contrary to a high differential, one supplier said that low differentials would create an incentive for suppliers to limit the payment method options available to customers. Suppliers are required to offer a wide choice of payment method options.[31] Therefore, suppliers should not limit the choice presented to customers.

5.25 Therefore, we consider a reasonable differential between payment methods is desirable to provide an incentive for both customers and suppliers to adopt efficient payment methods, reducing total costs to serve.

[31] Ofgem (2024), Standard Conditions of electricity supply license, paragraph 27.1. https://www.ofgem.gov.uk/energy-policy-and-regulation/industry-licensing/licences-and-licence-conditions

Ofgem (2024), Standard Conditions of gas supply license, paragraph 27.1. https://www.ofgem.gov.uk/energy-policy-and-regulation/industry-licensing/licences-and-licence-conditions

Consideration to other options presented in the policy consultation

5.26 In our policy consultation, we presented the following option. For the reasons set out below, we are not proposing to take this forward.

- Bespoke approach - Under this option, we begin by assigning all costs to Standard Credit customers and then allocate costs to:

  (1) PPM customers: Based on the proportion of debt transferred through the Debt Assignment Protocol (DAP) (if material) and Debt on Additional Support Credit.

  (2) Direct Debit customers: We would look at customer movement between Direct Debit and Standard Credit. Specifically, we would look at debt movement from Direct Debit to Standard Credit, where a customer was not on a repayment plan while on Direct Debit. This would give us the debt incurred under Direct Debit and moved to Standard Credit.

5.27 In the policy consultation, we asked suppliers about the feasibility of the bespoke approach. Three suppliers said that the bespoke approach is not feasible. Some said this is due to difficulty in tracking customer movement between Direct Debit and Standard Credit. One supplier said that even though it is feasible, this method would lead to a greater administrative burden. As a result, we are proposing to discard this option.

Allocating costs between fuel type, electricity meter type, and tariff type.

5.28 In our 2024 policy consultation, we discussed the following options to allocate costs between fuel types and electricity meter types:

- Option A.1: equal allocation;
- Option A.2: allocate based on bill size.

5.29 In our 2018 decision and in subsequent debt-related cost adjustments, we allocated costs between fuel types based on the bill size (revenue) and equally allocated costs between electricity meter types.

5.30 To allocate costs between tariff type, we discussed the following options in our 2023 policy consultation.

- Option B.1: equal allocation;
- Option B.2: allocate all costs to default tariff customers.

5.31 In our 2018 decision, we allocated costs equally between tariff types. However, in our most recent additional debt adjustment, we collected data by tariff type and used supplier allocation to allocate costs.[32]

Proposals

5.32 We propose to allocate costs between fuel types proportionately to supplier-reported revenue for the most recent four quarters. This is because debt-related costs are likely to be proportionate to the split between gas and electricity.

5.33 We propose to allocate costs equally between electricity meter types. This is because there is no evidence suggesting that debt-related costs per unit vary by meter type. We propose to account for the difference in bill size across electricity meter types through our updating approach – see Chapter 6.

5.34 We propose to allocate costs equally between tariff types. This is due to incomplete data.

Summary of Stakeholder Responses

5.35 We received limited feedback on this topic. One supplier favoured equal allocation across all these parameters to ensure simplicity and fairness and avoid undue burdens on any group.

5.36 One supplier favoured equal allocation between tariff types. Two suppliers proposed to allocate costs differently between tariff types because SVT debt-related costs are greater than those for FTC, and as customers move away to FTC, the equal allocation would impact supplier cost recovery.

Consideration

Fuel type allocation

5.37 Debt-related costs (and in particular bad debt and working capital costs) 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 a customer's bill.

[32] It should be noted that we only use tariff-type breakdown data to benchmark bad debt costs since suppliers were unable to consistently separate other cost components by tariff type.

Ofgem (2024), Energy price cap additional debt costs review decision, paragraph A2.10 - A2.16. https://www.ofgem.gov.uk/decision/energy-price-cap-additional-debt-costs-review-decision

5.38 To split the allowance into fuel types, we propose to use supplier-reported revenue as it better reflects the most recent customer bill split. We used data from the last four quarters. This results in allocating 67% of the costs to electricity and the remainder to gas.

5.39 The balance between electricity and gas bill sizes varies over time. This is partly driven by the rates charged, but even more so by consumption fluctuations. In particular, gas consumption is sensitive to weather. We therefore recognise that there could be questions about whether an allocation based on data from a single period would be representative. While our proposed update approach would scale allowances with consumption, this does not eliminate the impact of the starting value of the allowance for a given fuel.

5.40 We consider that our proposed source of bill size data is reasonable, but in principle there could be other alternatives, such as using the cap levels at benchmark consumption. This would be less sensitive to actual consumption in historical periods, if this was considered important.

5.41 A more equal allocation between fuels would lead to lower costs to electricity-only customers than our proposal. Allocating similar costs to gas and electricity could also be seen as aligned with supporting net zero. However, more equal allocation could reduce the alignment with the costs suppliers incur, with potential impacts on financeability.

Electricity meter type allocation

5.42 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.

5.43 In our 2023, Operating Costs Review RFI, we asked suppliers what costs are likely to vary between electricity meter types. Suppliers did not indicate that debt-related costs vary by this parameter. Therefore, we do not have evidence that suggests debt-related costs would vary between meter types, beyond the variation in consumption.

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

5.45 Therefore, we consider it appropriate to take a simple approach of setting the allowance in percentage terms equal across electricity meter types. Since we are proposing to set the bad debt and working capital allowances as a percentage and

are indexing it to other cap components (see discussion in Chapter 6), the per customer allowance for each meter type would scale with consumption.

5.46 The same rationale applies to regions.

Tariff type allocation

5.47 We requested debt-related cost data to be split by tariff type. Two suppliers did not provide the tariff type splits and their market share makes up 38% of the entire SVT market.[33] Those who provided the splits mostly split the data by revenue. Therefore, we do not have the confidence to use the data to set the allowance.

5.48 One supplier said that, in its experience, SVT customers are more likely to incur debt-related costs than FTC. However, we do not have evidence to show to what extent the costs would differ. In our COVID-19 decision, we controlled for SVT customers using revenue[34] - reflecting that SVT customers pay higher prices than FTC customers and therefore would be expected to incur higher levels of debt-related costs. We considered this approach. It had a low material impact on the benchmark level and, therefore, was not applied in our calculations.[35] The low materiality is due to most customers in the market being on SVTs.

5.49 We further recognise that customers may move away from default tariffs as suppliers offer cheaper fixed tariffs, which might impact supplier cost recovery. While we could expect that much of the movement may be related to engaged Direct Debit customers who are less likely to incur debt-related costs, this would reduce the number of customers over which they can recover this revenue.[36] We consider that supplier costs are partly driven by efficiency. Therefore, under our proposed benchmark metric, a supplier could mitigate potential under recovery by improving its efficiency.

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[33] Figures are based on the July 2024 tariff and customer account RFI.

[34] Ofgem (2023), Price Cap – Decision on the true-up process for COVID-19 costs, paragraph A3.5. https://www.ofgem.gov.uk/decision/price-cap-decision-true-process-covid-19-costs

[35] Steps for adjustment: We take the aggregate benchmark value per customer account and multiply it by the total number of customer accounts (SVT and fixed). We then multiply this by the proportion of SVT revenue of total revenue to estimate the total debt costs relevant to SVT customers. We divide this by the total number of SVT customer accounts.

[36] Using a snapshot of the number of customer accounts reported in the Customer Account and Tariff RFI, we conducted preliminary analysis to understand the movement of customers between fixed term contracts and default tariff contracts pre and post the gas crisis. Direct Debit customers account for the majority of the movement. We could expect these customers to move to Fixed Term Contracts when cheaper tariffs become available.

6. Update mechanism

In this section, we discuss our proposals, summarise stakeholder responses and provide considerations on our approach to updating the allowance over time.

Context

6.1 The mechanism used to update the debt-related cost allowance is an important aspect of the policy design. It would intend to capture the potential future changes in costs, to ensure the cap allowance remains appropriate over time.

6.2 We consider that, in general, debt-related costs are driven by various factors, such as bill size, inflation, changes in the regulatory landscape, and wider macroeconomic conditions. Notably, we've observed that over the past few years, debt-related costs have been susceptible to unexpected external shocks such as the COVID-19 pandemic and the more recent gas crisis. As a result, we adjusted the cap to allow suppliers to recover additional debt-related costs due to these events.

6.3 Setting an ex ante allowance to accurately capture the change in efficient costs over time is inherently challenging, particularly when external factors influence costs. Whilst the update mechanism may not be able to account for all the possible external factors, we aim to develop a mechanism that would allow the debt-related allowance to change over time, broadly reflecting the efficient costs of a notional supplier over time. Doing so would help limit the need for ad hoc adjustments in the future.

6.4 In our May 2024 policy consultation, we set options around how we would implement the allowance and how we would update it. We consider the method by which the allowance is updated would dictate how we would implement the allowance in the cap. For example, to update the allowance in line with bill size, we need to set the allowance as a percentage of revenue. Therefore, we combine the two and present the following options:

- Option 1: Bill size - Under this option, we would index the allowance to other core cost components in the cap (ie wholesale costs, operating costs, policy costs and network costs). This means we would set the allowance as a percentage of revenue.
- Option 2: External indicators - Under this option, we would use one or several indicators to update the allowance. As an example, we could update debt-

related administrative costs with CPIH, while updating other debt-related costs with another indicator. Table 6.1 below lists the external indicators we considered. Under this option, we could set the allowance as a percentage with respect to the indicator or as a £ per customer.

- Option 3: Regular reviews - Under this option, we would periodically review the allowance to consider whether it remains appropriate by re-collecting supplier data and recalculating the ex ante allowance. For avoidance of doubt, this option does not include ex post adjustment for under or over allowance in between periods. Under this option, we could set the allowance as a percentage of revenue or as a £ per customer.
- Option 4: A combination of options 1 and 2 - For example, we could scale the appropriate costs by bill size and link it to an external indicator. Under this option, we could set the allowance as a percentage of revenue or as a £ per customer.

Table 6.1: Description of potential external indicators

External indicator[37]	Description
Consumer Price Index including owner occupiers' housing costs[38]	The CPIH index is produced by the ONS and reflects the evolution of consumer prices from a base 100 in 2015 (June 2015). Figures are available by month/year/quarter and are updated monthly.
Office for National Statistics (ONS) Direct Debit Failures[39]	Direct Debit data from ONS, average Direct Debit for main utilities and rate of Direct Debit failures. The data is available from 2019 to 2024, published on a monthly basis. It holds the £ per month and percentage of failures for key utilities (electricity, gas, mortgage etc.).
ONS Average wage-PAYE[40]	ONS and HMRC jointly produce an output from the PAYE system updated every week. Among the indicators we find the aggregate pay, the number of employees and the median pay. It is a macro-economic indicator. It is updated monthly.

Proposal

6.5 We propose updating bad debt and working capital costs using option 1, bill size. This is similar to the status quo, where a majority of these costs are updated using bill size. We consider this option is independent of supplier behaviour, feasible and provides a reasonably accurate allowance in the steady state. It is worth noting that allowances are likely to change at the time of decision due to new data submissions (see discussion in Chapter 4). Thus, we have not provided percentage values, but we describe how we estimate the values in Chapter 7.

6.6 We also propose updating the working capital cost allowance to align with the EBIT cost of capital to maintain consistency with the EBIT allowance. This is

[37] We also considered other external indicators such as 1) Department for Work and Pension (DWP) data – Effect of taxes and benefits on household income 2) DWP data – Household income. We have discarded these options due to lack of recent data.

[38] ONS (2024), Inflation and price indices. https://www.ons.gov.uk/economy/inflationandpriceindices

[39] ONS (2024), Monthly Direct Debit failure rate and average transaction amount. https://www.ons.gov.uk/economy/economicoutputandproductivity/output/datasets/monthlydirectdebitfailurerateandaveragetransactionamount

[40] ONS (2024), Earnings and employment from Pay As You Earn Real Time Information, non-seasonally adjusted. https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/realtimeinformationstatisticsreferencetablenonseasonallyadjusted

because we intend to reallocate the working capital costs allowance already provided in the EBIT allowance across payment methods.

6.7 We propose to update debt-related administrative costs in line with CPIH, similar to the status quo. This is because our analysis suggests that operational costs tend to align with inflation.

6.8 Given the uncertainty in future debt costs (as discussed in Chapter 4), if we consider debt-related costs to materially and systematically deviate from the allowance, we may consider the possibility of an ex post adjustment, which could result in a positive or negative adjustment.

Summary of Stakeholder Responses

6.9 Three suppliers favoured updating the allowance with bill size, with two suppliers said that, along with bill size, we should carry out regular reviews to ensure any changes in supplier costs are reflected in the allowance.

6.10 Two suppliers favoured regular reviews, with one favouring this option if there is no appropriate external indicator to update the allowance.

6.11 One supplier favoured a combination of options where some cost components are updated in line with bill size and also linked to supplier costs for any additional adjustments.

6.12 One supplier said that each element should be updated differently and proposed to index bad debt costs to a profit and loss metric provided by suppliers, debt-related administrative costs by CPIH, and working capital costs to a cost of capital measure.

Considerations

6.13 In determining the most appropriate update mechanism, we evaluated each option using three criteria: 1) accuracy, 2) feasibility, and 3) independence from supplier behaviour.

Evaluation under the criteria

Accuracy

6.14 In our policy consultation, we said the current updating mechanism does not consider changes in customers' propensity to pay. For example, both the COVIDovid-19 pandemic and the cost-of-living crisis have had an impact on

customers' ability to pay. As a result, we decided to make additional adjustments to the debt allowance due to these external shocks.

6.15 In updating the allowance, we should consider the most appropriate approach to ensure that it leads to a reasonable approximation of future costs to ensure customer protection while allowing efficient cost recovery. A transparent mechanism that better predicts future costs would benefit the market by providing a level of certainty of future costs and revenue.

6.16 We assessed the evolution of debt-related cost components against bill size and external indicators. We provide a summary of the assessment in Table 6.2. For bad debt cost and working capital costs, bill size performed well compared to external indicators. CPIH and Direct Debit failure performed well for debt-related administrative costs compared to other indicators.

6.17 One supplier that favoured the status quo approach said that debt-related costs do not move in the direction of energy costs and therefore, we need to consider a non-linear indexation.

6.18 We have assessed the correlation between bill size and debt-related costs. Our analysis suggests that bad debt costs and working capital costs moved roughly in line with bill size over the period 2019-2021, which we consider represents a pre-crisis steady state. Other factors, such as the energy crisis, have recently impacted this relationship. It is challenging to design an update mechanism that accounts for external shocks and, as we move away from the current energy crisis (prices returning to almost the pre-crisis level), it is our expectation that the market will return to a steady state in the future, all else remaining constant. Therefore, we consider a linear relationship to be appropriate for a forward looking allowance. In the meantime, if costs materially and systematically deviate from the allowance, we may consider the possibility of ex post adjustment, which could result in a positive or negative adjustment.

6.19 We consider the option of regular reviews to provide a reasonably accurate allowance, recalculated using the latest supplier costs. However, the level of accuracy would depend on the frequency of reviews, and there is a possibility that costs could deviate from the allowance in between review periods. An ex post adjustment could mitigate the latter but it could lead to a delay in costs recovery.

6.20 Therefore, from an accuracy point of view, we consider bill size, regular review, CPIH (for debt-related administrative costs only), and Direct Debit failures (for debt-related administrative costs only) as leading options.

Feasibility

6.21 Table 6.2 also provides a summary of the feasibility of options. We consider bill size, regular review, and CPIH to be the most feasible options.

6.22 Of the other external indicators, Average Wage PAYE is the only data that is available frequently. Direct Debit failure data is available monthly, but it is currently a test data set. Therefore, there is a risk that ONS will discontinue publishing this data. DWP data is updated annually but observed delays in updating could delay allowance updates.

Independent of supplier behaviour

6.23 Our choice of update mechanism should be independent of supplier behaviour to prevent the allowance from being deliberately influenced by suppliers and to help drive efficiency improvement. We consider bill size and external indicators to be independent of supplier behaviour.

6.24 Linking the allowance to supplier costs may dampen incentives for a less efficient supplier to improve their efficiency in a given period, if they expect that the future allowance will cover their costs. For example, a less efficient supplier in one period could expect the allowance to increase and cover their costs in the following period, if they consider average market costs will rise.

6.25 Further linking the allowance to supplier costs would enable suppliers to influence any snapshot of figures through their provisioning approach. However, over time, suppliers couldn't use accounting to suggest that provisions would keep growing, as revisions to previous provisions would reduce the bad debt charge.

Other consideration

Future changes in costs

6.26 In the 2024 operating costs RFI, we asked suppliers about their expected future trends in costs for 2024 and 2025. We analysed these responses, and it predicts that debt-related costs are likely to change in the future (some predicted upwards and some predicted downward, albeit remaining high compared to pre-crisis level). Most recent debt-related cost data from 2024 shows that costs have fallen since 2023.

6.27 Further, as discussed in the overview paper of this consultation, there could be changes in the regulatory environment, for example, implementing a potential debt relief scheme which could significantly impact supplier debt-related costs

assuming all other factors remain constant.[41] If we consider debt-related costs to materially and systematically deviate from the allowance, we may consider the possibility of ex post adjustment, which could result in a positive or negative adjustment.

Consistency across other cost components

6.28 As discussed in Chapter 3, we use the EBIT cost of capital assumption to estimate working capital costs. This is to maintain the consistency with the EBIT allowance for working capital costs. In our 2023 EBIT decision, we decided to update the cost of capital percentage annually due to an update in the risk-free rate parameters.[42] Therefore, we consider it appropriate to update the working capital costs in line with the EBIT cost of capital changes. This will affect the allocation of debt-related costs between payment methods, but will not affect the total amount recovered, which is determined by the EBIT allowance.

[41] Ofgem (2024), Resetting the energy debt landscape: the case for a debt relief scheme www.ofgem.gov.uk/publications/debt-strategy-reset-and-reform-customers-debt

[42] Ofgem (2024), Price Cap – Decision on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance, paragraph 4.5. https://www.ofgem.gov.uk/decision/amending-price-cap-methodology-earnings-interest-and-tax-ebit-allowance-decision

Table 6.2: Assessment of indicators against the evaluation criteria.

Indicator[43]	**Accuracy-Bad debt costs**	**Accuracy-Working capital cost**	**Accuracy-Debt-related admin cost**	**Feasibility**	**Independent of supplier behaviour**
Bill Size	Strong correlation except during price spikes	Strong correlation except during price spikes	No correlation	High – updated quarterly	Yes
CPIH	Some correlation with anomalies	Some correlation with anomalies	Strong correlation with some temporary over or under-estimations	High - updated monthly	Yes
Direct Debit failures – ONS	No correlation	No correlation	Strong correlation with some temporary over or under-estimations	Moderate - updated monthly but statistic in development	Yes
Energy as % of earnings[44]	Some correlation with spikes	Some correlation with spikes in those 2 metrics.	No correlations	Moderate – updated monthly	Yes
Supplier cost per customer	Yes	Yes		Low - requires maintaining debt RFI	No

[43] We also explored variation of these indicators such as DD value/Median pay and Suppliers' Revenue/Median pay; the findings were similar to those presented in the total bill size/aggregated pay metric.

[44] Estimated by total bill size divided by PAYE aggregate pay.

7. Methodology for estimating the allowance

In this section, we explain the method used to calculate the debt-related costs allowances. This includes estimating the cost per customer, applying the benchmark metric, allocating costs across different parameters and cost components and converting these allowances to the appropriate format to facilitate the proposed update mechanism.

Estimating cost per customer

7.1 As discussed in Chapter 3, the debt-related costs RFI gathers the following data split by payment method, fuel type and tariff type.

- Bad debt charge (including bad debt write off) – reported in monthly intervals;[45]
- Debt-related administrative costs – reported in quarterly intervals;
- Account receivable and payable - reported in quarterly intervals, with the amounts at the beginning and end of the quarterly period.

7.2 Since our baseline considers multiple periods, we converted all costs to reflect June 2024 prices, as this is the latest price index used in the current cap period (cap 13a) to uplift the relevant operating cost allowances.

7.3 As discussed in Chapter 4, we propose to benchmark costs at the total cost level. This means that we would aggregate costs across all parameters when estimating the annual costs per customer account.

7.4 We estimate the annual bad debt charge and debt-related administrative costs per customer account per supplier following the below steps:

- We aggregated the respective costs across parameters over the relevant baseline period;
- We then divided these costs by the average number of customer accounts over that period.

7.5 We take the following steps to calculate the annual net working capital costs per customer account per supplier across parameters over the relevant baseline period.

[45] Henceforth where we refer to bad debt charge, it also includes bad debt write-offs.

- We began by calculating the average of accounts receivables. We did this by taking the average of accounts receivables at the beginning of the respective period and accounts receivables at the end of the respective period. We repeated this step for accounts payables as well.
- We then multiplied the average of accounts receivables by the cost of capital assumption used for working capital of 12.8%. We also multiplied it by the fraction of the year covered by the periods considered in our baseline. We repeated this step for the average of accounts payables as well.
- We then calculated the net working capital cost by subtracting the accounts payables from the accounts receivables from the step above.
- Finally, we divided the net working capital cost by the respective average number of customer accounts.

7.6 We note that where the baseline period is 8 quarters, we divide the total costs by 2 to represent costs per year before dividing it by the average customer accounts. This is applicable to all cost components.

7.7 After the above steps, we arrive at the annual cost per customer account for each cost component for the sample of supplier over the relevant baseline period. We discuss our sample in Chapter 3.

Estimating the proposed benchmark

7.8 In Chapter 4, we proposed to use a weighted average benchmark approach. We apply this by taking the weighted average of each debt-related cost component estimated separately for the sample of suppliers during the relevant baseline period. The average number of customer accounts determines the weights. Since we are taking a weighted average, benchmarking costs at the total or cost component levels does not impact the overall benchmark level.

7.9 As discussed in Chapter 4, our current benchmark proposal is the midpoint of two baseline periods. This is calculated by taking the simple average between the weighted average costs of the last 4 quarters and 8 quarters.

7.10 The above two steps provide an annual pounds per customer account benchmark value for each cost component.

Estimating the proposed cost allocation across parameters

Payment method allocation under the proposed option

7.11 In Chapter 5, we propose to use a current differential allocation methodology.

7.12 The current differential approach uses the debt allowance in cap 13a to estimate the payment method allocation, which includes the recent debt-related adjustment for the credit payment method.[46] Please refer to Appendix 1 of the recent debt-related cost float decision for details on estimating cap allowances.[47]

7.13 To estimate the allowance for each payment method, we followed the steps below:

- We first estimate the allowance differentials in cap 13a between Standard Credit and PPM with respect to Direct Debit.
- We then estimate the total costs to be recovered by the market by multiplying the benchmarked total debt costs per customer account by the total number of SVT customers.[48]
- We estimate the annual Direct Debit allowance per customer account, we applied the following formula:

$$Direct\ Debit\ allowance\ per\ customer\ account = \frac{Total\ costs - [(SC - DD) \times SC\ SVT\ customers\ accounts)] - [(PPM - DD) \times PPM\ SVT\ customer\ accounts)]}{Total\ number\ of\ customer\ accounts}$$

Where $SC - DD$ denote the differential in the cap allowance between Standard Credit and Direct Debit, $PPM - DD$ the differential in the cap allowance between PPM and Direct Debit.

- We estimate the Standard Credit and PPM allowances by adding respective estimated differential to the estimated Direct Debit allowance. For example, we add the Standard Credit and Direct Debit differential estimated in the first step to the Direct Debit allowance to obtain the Standard Credit allowance.

[46] Ofgem (2024), Energy price cap: additional debt costs review decision. https://www.ofgem.gov.uk/decision/energy-price-cap-additional-debt-costs-review-decision#:~:text=We%20have%20decided%20to%20apply,up%20process%20by%20April%202025.

[47] Ofgem (2024), Energy price cap additional debt costs review decision, paragraph A1.1 – A1.19. https://www.ofgem.gov.uk/decision/energy-price-cap-additional-debt-costs-review-decision

[48] The annual benchmark total debt costs per customer account is the summation of the weighted average benchmark of each costs component.

- We then deduct the estimated weighted average working capital costs from each allowance. By taking this step, we will avoid double counting working capital costs included in the EBIT allowance.

7.14 The above steps will provide an annual pounds per customer account allowance for each payment method. We multiply this by 2 to convert the allowances to £ per dual fuel customer.

Allocating the allowance into cost components

7.15 Using the payment method allowance, we need to break it down into different cost components to facilitate the appropriate updating mechanism discussed in Chapter 6.

7.16 We take a top-down approach as set out below to split the payment method allowances into cost components:

- We first estimate the allowance in cap 13a (including the February 2024 float adjustment) for the three cost components for each payment method.
- We estimate the proportion that each cost component represents of the total allowance for each payment method.
- We multiply the payment method allowance by the above step.

7.17 The steps provide an annual pounds per dual fuel customer allowance for each payment method broken down by bad debt costs, debt-related administrative costs, and working capital costs.

Allocating allowance across fuel types

7.18 As discussed in Chapter 5, we need to allocate these allowances across fuel types. We do this using supplier-reported SVT revenue for the last four quarters (October 2023-September 2024).

7.19 Below, we illustrate the steps taken:

- We first estimate the total supplier SVT revenue for the last four quarters for electricity and gas using the debt-related costs RFI.
- We then take the proportion split of the two revenues.
- We apply this proportion to the pounds per dual fuel customer allowance for each cost component across payment methods.

7.20 The steps provide an annual pounds per customer allowance for each payment method broken down by cost component and fuel type.

Converting the allowances to a percentage

7.21 As discussed in Chapter 6, we intend to set the bad debt costs and working capital allowances as a percentage of revenue.

7.22 To convert the allowance, we use the cap allowances excluding EBIT, headroom, PAP, PAAC and adjustment allowance to maintain consistency with how these allowances are indexed in the cap for the updating mechanism.[49]

7.23 We estimate the percentage values using the following steps:

- We estimate the annual cap level, excluding the EBIT, headroom, Payment Adjustment Percentage (PAP), Payment Method Adjustment Additional Cost (PAAC) and adjustment allowance for the most recent cap period (cap 11b-13a) for each payment method, fuel type and electricity meter type.
- Using the most recent gas and electricity demand shares (cap 13a), we then estimate the demand-weighted average annual cap level over this period for each payment method, fuel type and electricity meter type.
- We estimate the weighted average between single-register and multi-register electricity meter average annual cap levels for each payment method to get the average electricity annual cap levels. The weights are based on the proportion of single-register and multi-register customer accounts in the SVT market.
- We then divide the annual £ per customer account allowance per payment method and fuel type for bad debt and working capital costs component by the respective demand-weighted average annual cap level.

[49] When converting allowances to percentages, we intend to ensure that they are closely aligned with indexation. Since the current additional adjustment relates to debt costs and is expected to fall away at the time the operating costs review is implemented, we consider it appropriate not to use the additional adjustment in the conversion of the allowance to percentages. However, it is worth noting that when indexing the allowance, we would index it against the additional adjustment allowance to ensure it captures any future cap adjustments.

Allocating the allowance between consumption level

7.24 As discussed in Chapter 3 in the overview document, we are proposing to not change the allocation of the debt cost allowances between the unit rate and standing charge.

7.25 The current debt allowances are smeared across different operating costs allowances (ie operating costs allowance and payment method uplift) with different allocations across unit rate and standing charge. Given the structural change we are proposing to make to the operating costs allowances, it would be complex to strictly follow the status quo allocation for debt allowances. For example, while the bad debt costs are largely captured in the payment method uplift, they are also captured in the operating costs allowance. To maintain the status quo, we need to estimate the proportion of bad debt costs captured within the operating costs allowance and the payment method uplift then apply these to the bad debt allowance to apply the allocations differently.

7.26 We consider it is reasonable to simplify the allocation whilst maintaining the status quo as closely as possible. We therefore propose to allocate costs using the allocation of the current allowance where a majority of each cost component sits for a given payment method.

7.27 To this extent, we allocated the following allowances, as explained below.

- Credit bad debt cost allowances and all payment method debt-related working capital cost allowances would be allocated using the current Payment Adjustment Percentage (PAP) allocation. This means the percentage allowance would not vary at the typical and nil consumption level.
- The PPM bad debt cost allowance is fully allocated to the standing charge, similar to the current ASC allowance. It would align with the policy intention of levelisation phase 1. This means that the allowance will be calculated using the typical consumption level by applying the percentage allowance and then allocating it to the allowance at the nil consumption.
- All payment method debt-related administrative costs allowances are allocated using the current allocation of the operating costs allowance. These allocations vary by gas and electricity fuel types.