Consultation

Energy price cap operating cost and debt allowances consultation: overview

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Contact:	Daniel Newport
Team:	Consumer Protection & Retail Markets
Email:	priceprotectionpolicy@ofgem.gov.uk

We are consulting on our proposals to update the operating cost and debt allowances in the energy price cap ('the default tariff cap' or 'the cap') as part of our operating cost allowances review (operating costs review). This review covers core operating costs, debt-related costs, smart metering costs and industry charges. In this consultation we have detailed our proposed approach across each of these areas covering key strategic themes including benchmarking, stringency and allocation. We have also included discussion on our proposed approach to additional debt-related adjustment allowances, and our decision to not shift operating costs from standing charges to unit rates. This consultation consists of this overview paper which summarises our proposals across each area and provides a high-level rationale for our proposals and a number of appendices which provide further detail for each allowance. We would like views from people with an interest in how we set the operating cost allowances in the cap. We particularly welcome responses from consumer groups and charities. We would also welcome responses from other stakeholders and the public.

Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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Executive Summary

On 1 January 2019 we introduced the default tariff cap ('the cap'), which protects households on standard variable and default tariffs. The cap ensures that default tariff customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy. The cap includes a number of allowances for the costs a supplier faces, such as wholesale costs, network costs, policy costs and operating costs.

In May 2023 we signalled our intention to holistically review the allowances for operating costs for the first time since the introduction of the cap in 2019. Operating costs refer to the costs of running a supply business, such as the call centres, metering and IT systems required to serve customers. They also include the costs incurred by suppliers of customers who fall behind on their bills, known as debt-related costs. In total these costs currently account for around £300 of an annual household bill.

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

Core operating costs

The energy crisis has also resulted in increased challenges for suppliers. Many customers, especially vulnerable customers, require greater and better support. Our recent publication Consumer Confidence outlined our goal that all customers receive not just a good service but one that sets the highest standard for all service sectors.[1] To be clear, we do not believe that good customer service necessarily means higher costs. However, we do think that it is in customers' interest that efficient suppliers are able to recover their costs and attract necessary investment. This is all the more critical as we transition towards a net zero future.

When we first established the cap, we did so in the context of a Competition and Markets Authority (CMA) report suggesting widespread inefficiency and as a result, we set a very stringent benchmark for suppliers to meet on operating costs. Our data suggests that despite the increased challenges, suppliers have become more efficient since the cap was introduced, in part due to re-platforming and invest-to-save measures.

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

However, the cap is no longer a temporary measure, and we consider the most significant efficiencies have already been captured. There are also likely to be some upside pressures associated with the energy transition which offset future efficiency gains. For these reasons we do not consider a permanent approach to setting allowances at a level where the majority of the market does not recover their costs would be sustainable. This document therefore sets out our intention to set allowances based on market average costs in 2023 which we estimate could result in a modest reduction in core operating cost allowances.

Debt-related costs

The energy crisis has also resulted in rising levels of energy debt. Energy is one of many critical bills a consumer must pay and faced with multiple financial pressures, many households are getting into deeper debt with their energy suppliers. Energy is an essential service, and going without energy, even for a short time, can have serious consequences for people.

This is why we have consistently intervened to increase customer protections and support – introducing new rules around involuntary prepayment meters, making prepayment the cheapest form of payment and ensuring additional support credit is available as a last resort for customers at risk of going off-supply. Alongside this document we have also published our Debt Strategy, which outlines the challenges around consumer debt and looks at how these might be tackled.[2] This includes resetting customer debt through a potential debt relief scheme, raising supplier standards in supporting customers in debt and commitment to take action to help prevent the build-up of debt in future.[3,4]

Nevertheless, the costs of providing energy are borne by suppliers and so the costs of unpaid bills need to be met, and as in other sectors these costs are ultimately recovered from paying customers. The alternative would likely see even higher costs to customers in the long-run through supplier failures, and an erosion of choice and competition. The key questions considered in the document are therefore around establishing a) the extent to which suppliers’ costs to date have been recovered b) the likely level of debt costs looking forward and c) how those costs are best shared across customers.

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[2] Ofgem (2024), Debt strategy reset and reform customers debt. www.ofgem.gov.uk/publications/debt-strategy-reset-and-reform-customers-debt
[3] Ofgem (2024), Resetting the energy debt landscape: the case for a debt relief scheme. www.ofgem.gov.uk/consultation/resetting-energy-debt-landscape-case-debt-relief-scheme
[4] Ofgem (2024), Improving debt standars domestic retail market. www.ofgem.gov.uk/consultation/improving-debt-standards-domestic-retail-market

These are difficult judgements. The data on debt-related costs continues to be volatile as the market reacts to the initial energy price shock and a 'new normal' of higher and more volatile prices. Debt-related costs vary considerably across the market, in part likely as a result of different customer bases with different suppliers.

Debt-related costs are driven by a small minority of customers, often facing severe affordability challenges. Typically, these customers either already pay by, or are moved to, Standard Credit and as a result most debt-related costs sit with Standard Credit customers. There is also therefore a significant degree of correlation between suppliers' debt-related costs and the proportion of Standard Credit customers they serve. Standard Credit customers have always paid a premium under the cap (currently £96 per dual fuel customer[5]) to account for the higher working capital and debt risks serving them entails. However, this premium is significantly smaller than the difference in average debt-related costs suppliers report across different payment methods.

Our primary duty in setting the cap is to act in consumers' interests. It is our view that it is in consumers' interests that both the cost of debt is met, and that prices broadly reflect where customers' choice of payment method makes them inherently more costly to serve. However, where costs of non-paying customers are being socialised across paying customers, we consider they should be socialised as broadly as possible rather than concentrated on the unlucky few.

This document therefore outlines our intention to set forward-looking allowances for debt-related costs based on market average costs, keeping payment method premiums in line with today's levels. We estimate this will result in debt allowances at roughly the level customers are paying today.

However, given the uncertainty in the level of debt costs going forward we intend to keep these closely under review as new data becomes available. We also propose to extend the existing temporary debt allowance until the implementation of this review (or September 2025, whichever is sooner) to help smooth the profile of likely costs for both consumers and suppliers.

Standing charges

A significant proportion of operating costs are paid through standing charges. This is because, unlike the cost of fuel, the costs incurred to provide many operating services (for example, metering) do not vary with the amount of energy a customer uses.

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[5] This is the difference between Standard Credit and Direct Debit payment methods in cap 13a for a dual fuel customer at benchmark consumption level (3,100kWh for electricity and 12,000 kWh for gas).

In our August 2024 options paper, we sought views on the potential for moving more of these costs to the unit rate, noting that we cannot eliminate them.[6] We set out that this would mean that such a change would result in bill decreases for some households but increases for others.

We received considerable feedback from customers and other stakeholders. Many were in favour of reducing the standing charges and increasing customers' control over their bills. However, some leading consumer groups and charities highlighted the risk that such a change would increase the bills of vulnerable customers with high energy needs – such as people living with medical conditions and disabilities. They urged us not to proceed with this change unless protection is in place for such customers to mitigate these impacts.

Our position is that we should not, at this stage, move £20 to £100 of costs to the unit rate. It risks vulnerable households facing significant losses. We will continue to work with government to explore what protection for these households could enable us to revisit this option in the future.

Alongside this document we have also published an update on our plans for increasing customer choice and control over standing charges.[7] We also propose to pass on any reduction in core operating costs that result from this consultation as a reduction to the standing charge – however this will be a modest reduction in scale.

Our proposals

As a result of these considerations we are proposing the following:

- To extend the existing temporary debt allowances to cover ongoing, unfunded debt costs, until the implementation of the operating cost allowances review (or September, whichever is soonest). We intend to carry out a 'true-up' review of this allowance, along with wider debt interventions, with actual data at a later date;
- To establish new operating cost allowances using the latest data on average costs across a representative range of suppliers. This will result in some changes to the relative balance of allowances but a similar level of overall allowances as today;
- The net result of these changes, based on current data, would be a £7 reduction in average bills versus current allowances – reflecting an £11 reduction in core

[6] Ofgem (2024), Standing charges: domestic retail options. https://www.ofgem.gov.uk/call-for-input/standing-charges-domestic-retail-options
[7] Ofgem (2024), Standing charges update: our review https://www.ofgem.gov.uk/publications/standing-charges-update-our-review

operating costs and a £5 increase in debt costs. Table 4 in Chapter 2 outlines how this number breaks down across different payment methods and allowances.

- To make modest changes to the premium paid by customers on different payment methods as a result of new data on core operating costs baseline but not to increase premiums paid by Standard Credit customers for the cost of debt;
- To keep debt costs under close review going forwards, including interaction with broader interventions on debt such as the potential debt relief scheme.
- This document also outlines a number of more technical proposals around how we implement allowances and approach pass-through costs associated with funding broader industry bodies.

Next steps

We are seeking written comments on our proposals:

- For our proposal to **extend the current debt-related costs adjustment allowance** by **11:59pm on 23 January 2025.**
- For the rest of the proposals set out in this consultation by **11:59 pm on 6 February 2025**.

Please tell us your views using our webform or send us your views and extra information such as diagrams or charts by emailing priceprotectionpolicy@ofgem.gov.uk.

Structure of the overview document

This overview document outlines our key proposals, rationale and trade-offs. It is organised into four chapters:

- **Chapter 1 – Approach to decision making:** This chapter outlines the approach to setting the cap, with the legal framework we need to follow for decision making.
- **Chapter 2 – Operating costs review**: This chapter provides the background of our previous cap methodology, introduces our new cap allowances for operating costs and presents our proposals for setting these allowances. We also explain the rationale for our proposals, highlighting how the allowances fit together.
- **Chapter 3 – Broader debt-related allowances**: In this chapter we set out our considerations and proposals for the true-up of the additional debt-related costs review. We have also outlined some additional considerations for debt.
- **Chapter 4- Standing charges review**: In this chapter we set out our position on not shifting operating costs from standing charges to unit rates.

Structure of this consultation

This consultation for the operating cost allowances review (operating costs review) comprises several documents which provide further detail and analysis for each allowance. In addition, we have published a detailed appendix setting out our proposals on the debt-related costs true-up and float extension. We also included an impact assessment of our proposals. Table 1 below provides a map of the documents published as part of the operating costs review.[8]

Table 1. The operating cost allowances review document map, along with this document.

Supplementary appendices	**Associated licence condition documents**
Appendix 1 - Core operating costs	Appendix 7 – Notice of proposed licence modifications to the standard licence condition 28AD of all Gas and Electricity Supply Licences
Appendix 2 – Debt-related costs	Appendix 8 - Model guidance for draft Default tariff cap level model (pre-levelised rates), draft Annex 5 and draft Annex 9
Appendix 3 - Smarting metering costs	Draft Default tariff cap level model (pre-levelised rates)
Appendix 4 - Industry charges	Draft Annex 5 – Smart meter net cost change and industry charge allowance methodology
Appendix 5 – Impact assessment	Draft Annex 9 – Levelisation allowance methodology and levelised cap levels
Appendix 6 – Review of additional debt adjustments	

[8] We have also published a draft version of the Default tariff cap level model (pre-levelised rates), Annex 5 and Annex 9 reflecting our proposals. See "Appendix 8: Model guidance for draft default tariff cap level model, draft Annex 5 and draft Annex 9" for further details.

1. Approach to decision making

1.1 The default tariff cap ('the cap') was introduced on 1 January 2019 and protects 26 million customers on standard variable and default tariffs.[9] The cap ensures that default tariff customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy.

1.2 The price cap legislation sets out the objective and five matters we must have regard to in setting the cap.[10] In setting the cap, our primary consideration is the protection of existing and future consumers who pay standard variable and default rates and in doing so we must have regard to the following matters (see section 1(6) of the Act):

(a) the need to create incentives for holders of supply licences to improve their efficiency;

(b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;

(c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts;

(d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence; and

(e) the need to set the cap at a level that takes account of the impact of the cap on public spending.

1.3 The requirement to have regard to these five matters does not mean that we must achieve them all. When setting the cap, our primary consideration is the protection of existing and future consumers who pay standard variable and default rates. In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often, a balance must be struck between competing considerations. We have summarised our balanced consideration of these matters in this paper.

1.4 The legislation underpinning the cap requires us to set one cap for all suppliers (rather than enabling us to set cap levels bespoke to each supplier).[11] We do this by setting a cap level that reflects the notional supplier. We define a notional supplier as a theoretical and efficient supplier that has no direct

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[9] Domestic Gas and Electricity (Tariff Cap) Act 2018. https://www.legislation.gov.uk/ukpga/2018/21/enacted
[10] Domestic Gas and Electricity (Tariff Cap) Act 2018. https://www.legislation.gov.uk/ukpga/2018/21/enacted
[11] For example, see section 1(1) of the Domestic Gas and Electricity (Tariff Cap) Act 2018.

comparison with existing suppliers but draws from the properties across efficient suppliers in the market. We consider protecting consumers means that prices reflect underlying efficient costs of a notional supplier. We can set different cap levels for different areas or cases, such as different payment methods, but each cap level still cannot vary by supplier.[12]

1.5 We have also used Ofgem's Consumer Interests Framework to help support our consideration of how to best protect existing and future consumers throughout this review. Ofgem's consumer outcomes, as set out in the Consumer Interest Framework, include: (1) fair prices, (2) quality and standards, (3) low-cost transition, and (4) resilience. We see all of these outcomes as relevant to the setting of the cap.

1.6 Furthermore, we have had regard to the Growth Duty. Section 108 of the Deregulation Act 2015 establishes that a person exercising a specified regulatory function must have regard to the desirability of promoting economic growth. In performing this duty, Ofgem must consider the importance of the promotion of economic growth and ensure any regulatory action we take is necessary and proportionate.[13] We have considered the statutory guidance provided.[14]

1.7 We do not expect our review to have a significant impact on sustainable economic growth. This reflects that we are considering how to update allowances within an existing price protection measure (which is required by legislation), rather than introducing a new measure. Nevertheless, we have considered throughout the impacts our proposals may have on the following growth drivers listed in the guidance: innovation, competition, efficiency and productivity, and environmental sustainability. We cover these impacts through the discussion in this chapter.

1.8 The level of operating cost allowances materially and directly impacts the prices paid by customers on default tariffs and revenues received by suppliers. Consequently, it is important to consider the trade-offs between the level of the cap relative to existing industry costs (referred to as stringency), standards and

[12] See section 2(1)(f) of the Domestic Gas and Electricity (Tariff Cap) Act 2018.
[13] Deregulation Act 2015, Section 108. https://www.legislation.gov.uk/ukpga/2015/20/section/108
[14] Department for Business & Trade (2024), Growth Duty: Statutory Guidance- Refresh. https://www.gov.uk/government/publications/growth-duty

resilience, while also meeting the requirements set out in the regulatory frameworks.

1.9 The Impact Assessment to this document outlines our analysis of the customer and supplier impacts of our minded-to position relative to key alternative options for setting allowances. It also details our consideration of our Public Sector Equalities Duty.

1.10 However, the operating cost allowances are only part of the cap. The purpose of this review is to update these specific allowances, rather than to reset the overall level of the cap. The considerations below are therefore considering the trade-offs between different options for reflecting notionally efficient operating costs, rather than considering options which would fundamentally change the relationship between notionally efficient costs and the cap level.

2. Operating costs review

2.1 Suppliers' operating costs account for around 15% of the overall customer bill. They reflect a broad range of costs of running a supply business such as central overheads, customer contact, billing, IT, depreciation and amortisation, metering and marketing. They also include the costs associated with customer debt, which has risen significantly in recent years.

Previous approach to setting operating cost allowances

2.2 When we established the cap these operating costs were spread across three cost components in the cap:

2.3 **Operating costs allowance**: which was set at a level reflecting the operational costs associated with serving a typical Direct Debit customer. It includes costs such as metering, billing and payments, central overheads and amortised costs.

2.4 **Payment method uplift**: this allowance accounted for the additional costs of serving Standard Credit and Prepayment Meter (PPM) customers respectively. Broadly, Standard Credit uplift has reflected higher debt costs associated with the payment method and PPM uplift has reflected higher metering costs

2.5 **Smart Meter Net Cost Change (SMNCC):** this allowance is set annually and is intended to capture the change in overall operating costs that have resulted from the rollout of smart meters. Generally smart meters reduce suppliers' operating costs and so over time the SMNCC allowance has tended to reduce overall operating cost allowances.

2.6 In our 2018 decision, we deliberately set a stringent operating cost benchmark for suppliers to meet – setting allowances based on the lower quartile supplier's costs minus £5. This was a conscious choice which required the market as a whole to make considerable efficiency improvements in how they ran their businesses, following a CMA report which highlighted considerable market inefficiencies and customer detriment.

2.7 In 2018, we set the payment method uplift for Standard Credit customers to deliver a differential against Direct Debit which was in line with historical market prices. When PPM customers moved into the default tariff cap, we set the payment method uplift for these customers in line with the uplift from the CMA's previous PPM cap.

2.8 We generally decided to index the operating cost allowances with inflation. However, we updated the majority of the Standard Credit payment method uplift in line with changes in other cap components, given that bad debt and working capital costs scale with bill size. We also included an SMNCC allowance to reflect that the continued rollout of smart meters would change suppliers' operating costs in real terms over time.

Structure of new operating cost allowances

2.9 Our May 2024 policy consultation sets out a detailed case for review, highlighting the need to update operating cost allowances as the cap has now been in place longer than originally envisaged.[15] Outdated costs data, significant sector changes, such as market consolidations (eg acquisitions and exits), introduction of regulatory changes (eg changes in debt-related rules[16]) and external events (eg the gas price crisis) are the key reasons for undertaking this review.

2.10 The existing allowance structure is complex, making it difficult to precisely map how allowances are changing as a result of our proposals. We have therefore sought to create a like-for-like comparison of allowances based around the new proposed structure. This has required mapping existing allowances to the new structure. Table 2 sets out how the existing three operating cost allowances map onto the new four allowances in the cap.

Table 2. Mapping the new allowances against existing allowances

New allowances under the operating costs review	Elements of existing allowances used to create like-for-like comparison
Core operating costs (CO)	**Operating costs for a Direct Debit customer (OC)** • Direct Debit operating costs paid by Direct Debit customers (deducting the elements moved to industry charges and debt-related costs) **Change in smart metering costs from the 2017 baseline (SMNCC)** • New baseline will include non-pass-through smart metering costs in that year – so will reflect changes in smart metering costs between 2017 and 2023 • For PPM, we currently offset uncertainty over traditional PPM costs against part of the modelled reduction in smart metering costs. This step will not be required with a revised (2023) baseline

[15] Ofgem (2024), Energy Price Cap operating cost allowances review, paragraphs 2.18 - 2.31. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review
[16] Ofgem (2023), Consumer standards – Decision, chapter 3. https://www.ofgem.gov.uk/decision/consumer-standards-decision

New allowances under the operating costs review	Elements of existing allowances used to create like-for-like comparison
	Fixed element of payment method uplift (PAAC) • For Standard Credit, additional non-debt operating costs compared to Direct Debit (eg additional customer contact costs) • For PPM, additional operating costs compared to Direct Debit, based on a portfolio of largely traditional meters. (Note – in 2023 suppliers' actual PPM costs would be based on a mix of traditional and smart PPMs)
Debt- related costs allowance (DRC)	**Operating costs for a Direct Debit customer (OC)** • Bad debt and debt-related administrative costs for serving a Direct Debit customer **Change in smart metering costs since the 2017 baseline (SMNCC)** • Very small modelled impact from smart meter rollout on debt would be reflected in debt RFI data **Fixed element of payment method uplift (PAAC)** • For Standard Credit, additional debt-related administrative costs compared to Direct Debit • For PPM, incremental bad debt costs relative to Direct Debit (negative) **Variable element of payment method uplift (PAP)** • Additional bad debt costs of serving Standard Credit customers (currently partly allocated to Direct Debit) • Reallocation of working capital costs (from EBIT) between Direct Debit and Standard Credit. (Note – we may include a working capital reallocation in future for PPM as well).
Smart metering net cost change (SMNCC)	**Change in operating costs resulting from smart meter rollout from the 2017 baseline (Non-pass-through NPT SMNCC)** • Additional rollout since 2023 will affect NPT SMNCC
Industry charges (IC) (also includes other new industry schemes which are not explicitly included in the current allowance, ie costs for the Retail Energy Code Company and the	**Operating costs for a Direct Debit customer (OC)** • Elexon and Xoserve charges (explicitly included in current operating cost baseline) • Other non-smart industry charges (implicitly included in current operating costs baseline)

New allowances under the operating costs review	Elements of existing allowances used to create like-for-like comparison
Distribution Connection and Use of System Agreement)	**Pass-through SMNCC** (including costs for Data Communications Company, Smart Energy GB, Smart Meter Installation Code of Practice) in 2017 **SMNCC- Change in smart metering pass-through costs from the 2017 baseline** • Change in smart metering pass-through costs from the 2017 baseline

Proposals

2.11 In setting new allowances for core operating costs and debt related costs,[17] we have two broad challenges. Firstly, establishing the right level of overall stringency to set the allowance at, which is influenced by what baseline period we use to assess costs and the benchmarking methodology chosen. Secondly, deciding how the overall costs should be allocated across different payment methods, and in particular the premium that standard credit customers (where most debt-related costs are recognised) should pay.

2.12 As set out above we need to consider a range of trade-offs in reaching decisions on the cap. Given the focus on operating costs, there is a particular focus on the trade-off between prices facing consumers and achieving high standards and sector resilience. In the context of Net Zero, these trade-offs are crucial for ensuring that our regulatory framework also supports the transition to a low-carbon economy. By carefully balancing these factors, we aim to maintain fair prices for consumers, uphold high standards of service, enable a low carbon transition and enhance the resilience of our energy system.

2.13 We consider that our proposed combination of benchmark approach, selection of baseline periods and our proposed allocations across payment methods should ensure customers only pay for efficient and fair costs, while enabling good customer service. On the whole, this should allow efficient notional suppliers to recover their costs (noting that ensuring this is always the case in all periods is not within Ofgem's powers or duties). It should also enable suppliers to invest in key innovations (such as Market-wide Half Hourly Settlement [MHHS] and associated services) to enable a low carbon transition.

[17] We focus on core operating costs and debt-related costs because these are the largest of the allowances in scope of our review and because there is a greater role for judgement in setting these allowances than for the other allowances (SMNCC and industry charges).

2.14 It is important to note however, that the cap can only have a direct impact on the revenues that suppliers receive – it does not directly control the service that suppliers provide or the amount they invest. Our proposals are intended to enable improvements to customer service or increased innovation but cannot guarantee these outcomes. Some improvements to these outcomes may be driven by other regulatory action – especially our work on consumer standards. Beyond this, we consider it plausible, at the margin, that improvements to these outcomes may be achieved through some combination of competitive pressure and voluntary action by suppliers.

Approach to benchmarking

2.15 Our goal is to establish an efficient benchmark, such that an efficient notional supplier with 'typical' characteristics could recover their costs, comply with their obligations, and deliver a good standard of service. When the cap was introduced, we set the operating costs allowance at a stringent level, at the lower quartile minus £5. This was in view of the considerable scope for efficiencies improvement highlighted by the CMA's in-depth investigation into the sector, particularly around IT systems, and the emergence of new suppliers with lower costs than legacy suppliers.

Core Operating Cost Benchmark

2.16 We do not have similarly compelling evidence of significant future efficiency savings today. Most suppliers have now upgraded IT systems, and while Artificial Intelligence (AI) and automation may offer scope for future efficiencies, at market level they may be limited by the requirement for sensitive and personal service for vulnerable customers. We also need to be mindful of emerging cost pressures such as MHHS and associated services.[18]

2.17 However, our data does suggest that suppliers have made efficiency improvements in previous years, leading to average costs that are now modestly below existing core operating cost allowances. In this context, **we propose setting the allowance for core operating costs on a weighted average benchmark basis**.[19] This approach would both increase current stringency[20] and move further away from a "frontier efficiency" benchmark. This approach recognises that some higher costs (eg from serving vulnerable customers) may

[18] We expect MHHS to contribute to significant benefits for the energy system and consumers. However, for the purpose of this analysis, we are focussed on the costs incurred by suppliers.
[19] See Appendix 1 - Core operating costs for detailed analysis.
[20] Based on the current difference between allowances and costs.

not be fully in suppliers' control and that the scope for further step-change efficiency savings may be limited.

2.18 We do however consider that such an approach, viewed in the round, sets a level of operating cost recovery that we expect efficient suppliers to be able to operate within on an ongoing basis. As a result of more incremental future efficiency improvements and a normalisation of market conditions, we expect suppliers to be able to improve and innovate service and standards within the proposed allowances.

2.19 We aim to set an allowance that does not require frequent adjustment. We consider our proposed approach will account for foreseen uncertainties in the operating costs, and provide room for suppliers to recover their efficient costs, so we would not need to revisit every time a modest additional cost driver occurred. This should increase regulatory stability, relative to our recent frequency of adjustments.

2.20 We recognise that many customers are facing financial pressures, and that they would value the immediate bill reductions available from a lower quartile benchmark. To set a more stringent lower quartile benchmark we would need compelling evidence that further step-changes in cost savings could be realised for most suppliers while further driving up standards.

2.21 However, while we do not think that high quality service necessarily costs more to deliver, we do see significant risk to the investability of the sector if we were to set a long-term signal that allowances were to be set significantly below average costs, in a context where the largest efficiency gains may already have been realised. We consider that this would not be in the overall interest of customers, given the potential consequences for standards and resilience.

2.22 We also recognise that default tariff customers' preferences may vary about the balance between price and service. We must set a single cap level, so we have a limited ability to take this into account. Customers will retain the option of selecting a fixed tariff that better meets their individual preferences.

Debt-related costs benchmark

2.23 The review of operating cost allowances needs to set on an ex-ante (forward-looking) allowance for debt-related costs, which means first establishing what overall level of debt-related costs we should expect in future. While debt-related costs are likely to be influenced by supplier efficiency, we still consider the primary driver to be customer affordability.

2.24 We therefore **propose to set a weighted average benchmark for debt-related costs**. We consider that a lower quartile benchmark would set the allowance for debt-related costs below the current allowance which would risk significant under-recovery of debt-related costs for the majority of suppliers. This would significantly increase the risks of efficient suppliers failing or exiting the market with associated costs to consumers.

2.25 While weighted average allowances will help stabilise supplier financeability, it does not mean all suppliers fully recover debt costs. This is particularly true given the fact that suppliers have different customer portfolios and that payment method is the only available cap proxy for materially varying debt costs per customer.

Approach to baseline period

2.26 The selection of the baseline period will influence the costs used for benchmarking purposes. We collected suppliers' operating costs for years 2022 and 2023 and we collect ongoing quarterly debt-related cost data going back several years.

Core operating costs baseline

2.27 We consider the 2023 data to be reasonably representative of the ongoing market conditions for core operating costs, which have increased steadily compared to 2022 and in line with inflation. We did consider that 2023 was a year of high operating pressures (delivery of government subsidy, high customer contact), and that future innovation in customer service might reduce costs further. However, 2023 represents the latest available data, and these factors may be offset by pressures to improve customer outcomes, deliver new schemes and interventions, and innovate for Net Zero.

2.28 We do note however, that the high costs in 2023 relative to 2022 inform our view that in aggregate, our benchmark for core operating costs should give room for a normalisation of market conditions (alongside incremental efficiency gains) to offset any upside pressures facing suppliers' operating costs and we expect suppliers to be able to improve and innovate service and standards within the proposed allowances.

Debt-related costs baseline

2.29 Levels of debt and arrears across consumers have increased significantly in recent years, increasing by around £2 billion since summer 2022. Similarly, the data we collect shows an increase in levels of debt-related costs incurred by suppliers, with the costs seemingly peaking across 2023. Relatively lower levels of costs have been seen thus far in 2024, however they remain above the historical average.

2.30 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. 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.[21]
- The **upper end** of the range will use a baseline period made up of the most recent eight quarters of data. Latest data suggests this would be set at £76 per customer per year.

2.31 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 in a similar level of £73 per customer per year. These figures may change based on the latest data prior to decision.

2.32 For the avoidance of doubt, if there is evidence of material changes in the level of debt-related costs (including consideration of leading indicators such as debt and arrears), we intend to take that into account at decision stage. Appendix 2 sets out our approach to this in more detail.

2.33 We will also keep the allowance under close review. If we consider actual costs deviate from allowances in a way that is material and systematic, we may revisit this element of the allowances as well as considering the possibility of ex-post adjustments, which could result in a positive or negative adjustment. We consider adopting this approach balances the need to give suppliers clarity on our approach while enabling flexibility to current volatility in data.

[21] We define "per customer per year" as per dual fuel customer with benchmark consumption level at GB average per year.

2.34 We recognise the importance of certainty to both customers and suppliers. While we consider it necessary, given the real-world uncertainty surrounding ongoing debt costs, to retain the optionality of adjusting to new data, we are giving as much clarity as possible on our approach to that uncertainty.

Approach to allocating costs across payment methods

2.35 When we set the cap we can set different allowances for customers on different payment methods – Direct Debit, Standard Credit and PPM. While some costs vary across different payment methods, it is often difficult to establish whether this is a result of causation (the payment method is inherently more costly to serve) or correlation (the payment method has a disproportionately high number of high cost-to-serve customers on it).

2.36 While certain costs are inherently linked to the specific nature of the payment method, the majority are not and many costs have considerable variation within the payment method. For instance, PPM customers may on average have higher metering costs, but smart PPM meters are generally much less expensive to manage and maintain than traditional PPM meters. Conversely, some traditional PPM customers require minimal customer service. For Direct Debit customers, the cost-to-serve an engaged vulnerable customer differs significantly from that of a disengaged affluent customer.

2.37 Similarly, within Standard Credit customers, customers who pay their bills promptly present a vastly different cost profile compared to customers who fall into arrears or do not pay at all. High costs are frequently driven by atypical cases rather than the "typical" customer within each payment method category.

2.38 When evaluating options for allocating costs across different payment methods, we balance the protection of customers' interests while having regard to the need for cost recovery for an efficient notional supplier. However, our considerations for core operating costs and debt-related costs are different.

Core operating costs

2.39 We propose to allocate core operating costs in a broadly cost-reflective way across payment methods,[22] maintaining consistency with the existing approach. We propose to do this through using cost data from suppliers to look at the difference in costs for customers in each payment method. However, to ensure that we are isolating actual differences in cost-to-serve rather than differences

[22] By 'across payment methods', we mean calculating the weighted average costs for different payment methods, using customer accounts numbers for each payment method at market level.

in supplier efficiency we propose to use only data from suppliers who have at least 100,000 customers on each payment method relevant to a particular differential (this is explained in more detail in "Appendix 1 - Core operating costs"). We consider that our proposed approach is more reliable than using data from all suppliers. This is because the reliability of a supplier's data for a differential will inherently depend on the reliability of the data for both payment methods being compared. Suppliers with a smaller number of customers on a given payment method may have costs which are unrepresentative, leading to an unrepresentative differential. Where suppliers have a small number of customers on a given payment type, their data will be more informative about their overall costs, and less informative about the relative costs of serving two different payment types (this is explained in more detail in Appendix 1 - Core operating costs).

2.40 We consider this approach will continue to incentivise both customers and suppliers to opt for lower cost-to-serve options, reducing overall costs. This will result in a premium of approximately £38 per customer per year for Standard Credit customers. This is notably lower than the £54 per customer per year premium that would have resulted from calculating the cost difference using all suppliers' data. For PPM customers, the premium is about £55 per year compared to Direct Debit customers, which is lower than the £78 per year premium if we used data from all suppliers. Customers will therefore generally be better off paying by Direct Debit.

2.41 Although the data indicates significant variations in core operating costs across payment methods, with PPM customers being the most expensive to serve, we consider that PPM customers are largely protected from higher core operating costs. This is due to our levelisation intervention, which ensures that PPM customers and Direct Debit customers under the cap pay the same standing charge.[23]

Debt-related costs

2.42 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 vice versa. As such, it is generally the case that suppliers with more Standard Credit customers have higher debt-related costs per

[23] Ofgem (2024), Summary of changes to energy price cap 1 April to 30 June 2024 letter. https://www.ofgem.gov.uk/energy-policy-and-regulation/policy-and-regulatory-programmes/energy-price-cap-default-tariff-policy/energy-price-cap-default-tariff-levels

customer and vice versa with Direct Debit customers. However, this is not a steadfast rule across the market.

2.43 Nor does it mean that all Standard Credit customers have high debt-related costs (indeed many pay promptly and the majority of debt costs sit with a minority of non-paying customers). It is also not the case that Direct Debit customers all have low debt risk (customers who stop paying their bills may end up on Standard Credit as a result of not paying their Direct Debit). As a result, we do not consider it to be the case that the average amount of debt-related costs suppliers report on each payment method is "cost reflective" of the cost-to-serve a typical (eg median or mode) customer on that payment method.

2.44 This consideration is further underlined by the fact that any allowance for debt-related costs, at least in part, involves the socialisation of debt-related costs from non-paying customers to paying customers. While paying Standard Credit customers do incur a higher cost-to-serve (cost of 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) of disproportionately low-income customers to bear the burden of non-payers' debt.

2.45 We are also mindful of the negative incentives that high differentials can create. For example, a prompt-paying Standard Credit customer would be significantly more profitable for suppliers if they remain on Standard Credit rather than switching to Direct Debit. With a high differential in place, suppliers would be strongly incentivised to maximise the number of paying Standard Credit customers. This could lead to a focus on retaining Standard Credit customers who pay promptly, rather than encouraging them to switch to potentially more modern, cost-effective payment methods like Direct Debit. Such incentives do not align with the broader goals of efficiency in the market.

2.46 We therefore do not consider it to be in customers' interests to increase the existing premiums paid by Standard Credit customers. In light of this we propose to keep the existing differentials as per cap period 13a. These differentials will change over time, as bad debt costs are indexed to the bill level, but we do not propose to make a further change at this time.

2.47 We do not consider that our proposed approach to allocating debt-related costs across payment methods will disincentivise suppliers from serving Standard Credit customers or customers in vulnerable situations. For paying customers the premium should be adequate incentive to compete for and serve those customers. At the same time, if a customer is unable to pay, then the level of allowance that customer is notionally charged would not be realised by the supplier.

2.48 We acknowledge that this proposal will see different levels of cost recovery across the market. However, as set out in the Impact Assessment to this document, our evidence suggests that correlation between the proportion of Standard Credit customers and debt-related costs is relatively weak, and that our minded-to position enables cost recovery across a broad range of customer bases. Further, we consider that our minded-to position results in less over- and under-recovery across the market than either an equal allocation or an allocation based upon supplier's reported cost data.

2.49 We consider some variation in cost recovery is an inevitable consequence of operating a single cap across suppliers (as required by section 1[1] of the Act) and we do not see further variation of the cap by payment method as a solution for protecting customers. The challenges associated with setting a single cap across suppliers will continue to form part of our considerations as part of our next steps on the Future of Price Protection.

2.50 We also note that, in a market in which suppliers have different existing customer bases with different exposure to underlying risks, it is neither possible, nor appropriate in light of our duty under s1(6) of the Act and the matters we must have regard to and balance there, to ensure that all suppliers recover all costs equally. We consider that in combination, our benchmark, baseline and allocation decisions offer a range of notionally efficient suppliers scope to recover their efficient costs.

2.51 We consider this an important contributing factor to choosing a less stringent level of allowance – under a more stringent benchmark/baseline, the choice of allocation approach could impact cost recovery for suppliers with higher cost-to-serve, or lower-usage, customers. This could even affect efficient suppliers.

Levelisation of debt costs

2.52 Finally, we have considered representations from suppliers over the case for introducing levelisation of debt costs between Standard Credit and Direct Debit payment methods. Such an intervention would seek to move money between suppliers based on their portfolio of customers. We do not propose to proceed with this at this time for a number of reasons.

2.53 Firstly, as above, we would be concerned about the considerable potential for a) perverse incentives resulting from high profitability of paying Standard Credit customers b) the poor proxy of payment method as an indicator of underlying cost to serve per customer and c) the data suggests that a significantly larger differential would not enable more equitable cost recovery across the market.

2.54 Secondly, there are significant feasibility barriers which we are not confident can be completely overcome.

2.55 Thirdly, we have today published our Debt Strategy, which alongside broader action raises the possibility of a debt relief scheme which would allow suppliers to make claims to write off customer debt in line with the need driven by their customer portfolios.[24] While this is still in early development we consider that, if implemented, it would deliver some similar benefits to those intended by suppliers proposing levelisation of debt costs, but without relying on poor proxies such as payment type.

Summary proposals and cap levels

2.56 We use different methodologies to set the cap level for each cost component. In this section, we provide a summary of the main aspects of each methodology. Table 3 below provides a summary of our policy proposals for the operating cost review.

Table 3: Summary of proposals of the operating costs review

Allowance	**Proposals**
Cross cutting proposals	Benchmark at an aggregate level across all fuel and payment methods
Core operating costs	• Weighted average benchmark • Use 2023 data to set the core operating cost baseline • Allocate allowances in a broadly cost-reflective way across payment methods
Debt related costs	• Include bad debt costs, debt-related administrative costs and working capital costs • Use mid-point of recent 2 years data to set the new baseline • Weighted average benchmark • Keep the existing differentials of payment methods as per cap period 13a
Smart meter net change costs (SMNCC)	• Simplify the existing SMNCC model • Adjust SMNCC baseline from 2017 to 2023

[24] Ofgem (2024), Resetting the energy debt landscape: the case for a debt relief scheme. www.ofgem.gov.uk/consultation/resetting-energy-debt-landscape-case-debt-relief-scheme

Industry Charges	Make all industry charges pass-through and update them every 6 months using charging statements.

2.57 Table 4 sets out the values of each cost component for the new baseline compared against the operating cost allowance levels for cap period 13a. Note that these figures are provisional and subject to change (eg following consultation, following any changes to input values such as inflation or following updates to debt-related costs data).

Table 4. Estimated proposed cap levels for per dual fuel customer at benchmark consumption (12,000 kWh gas and 3,100 kWh electricity), for each payment method, in 2024 prices.

	Core operating cost	**Debt-related cost***	**SMNCC**	**Industry Charge**	**Total**
Proposed allowance: Direct Debit	£190	£60	-£2	£31	**£279**
Proposed allowance: Standard Credit	£228	£156	-£2	£31	**£414**
Proposed allowance: PPM	£245	£24	-£18	£31	**£281**
Proposed allowance: weighted average	**£206**	**£73**	**-£4**	**£31**	**£306**
Change vs cap 13a: Direct Debit	-£15	£5	-£3	£3	**-£10**
Change vs cap 13a: Standard Credit	£4	£5	-£3	£3	**£8**
Change vs cap 13a: PPM	-£13	£5	-£2	£3	**-£8**
Change vs cap 13a: weighted average	**-£11**	**£5**	**-£3**	**£3**	**-£7**

*Figures represent latest data. To be updated at decision stage

Updating the cap over time

2.58 For future reviews we have structured the allowances to enable us to consider each allowance separately. As such we have developed a separate update approach for each allowance, considering how allowances are currently updated and the specific features of each allowance. Table 5 below describes how we propose to update each allowance.

Table 5: Summary of update approach by allowance

Allowance	Update Approach Proposals
Core operating costs	Index the core operating cost allowance by CPIH (ie the consumer price index including owner-occupiers' housing costs).
Debt related costs	• Set bad debt costs and debt-related working capital costs as a % of cap allowance and index to cap level (excluding EBIT and headroom allowances). • Update the working capital % in line with EBIT costs of capital. • Index the debt-related administrative costs by CPIH.
Smart meter net change costs (SMNCC)	Maintain the current regular annual review approach to set the allowance for the following October to September.
Industry Charges	Use charging statements and maintain the existing 6 monthly updates to Annex 5.

3. Broader debt-related allowances

Ex-post debt-related cost adjustment allowance

3.1 In addition to our considerations on a separate debt-related costs allowance as part of the operating costs review, in this document we also set out our considerations and proposals related to the existing temporary adjustment allowance for debt-related costs.[25]

3.2 Since April 2024 the cap has included a temporary ex-post allowance for the additional historic debt costs incurred by industry between April 2022 and March 2024. We decided to set this allowance using a 'float and true-up' approach. This meant setting an initial 'float' allowance, due to the use of estimate data for winter 2023/2024. When the actual data became available, we intended to carry review to determine whether a true-up was appropriate. Incorporating the actual data into our analysis, we now consider that the float allowance was broadly appropriate (resulting in suppliers over-recovering relative to our intended benchmark and allocation of costs by around £2.50 per customer) and do not propose to implement a true-up adjustment of the float at this time.

3.3 In our February decision, we set out our analysis of the costs across industry in the period April 2022 to March 2024, using an estimate of costs for winter 2023/24. We decided to set the additional debt allowance within the cap at £28 per customer per year,[26] to be recovered over a period of 12 months. Replacing estimates with actual costs means this allowance would have been £25.50 per customer per year. We consider that this is an indication the float was broadly appropriate, and the materiality of the difference is such that a downward true-up is not necessary at this stage. However, we will continue to consider this in the round as part of any future wider true-up of debt-related costs in the market.

3.4 The approach we took for the float was to allocate the additional allowance to Standard Credit customers only, with zero allocation to PPM customers. We considered that this approach was appropriate as it would help to minimise the impact on payment methods with a higher proportion of vulnerable customers and it would also lead to a lower increase in debt and affordability pressures

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

[26] This is based on the lastest typical domestic consumption value (TDCV) of 2,700 kWh for electricity and 11,500 kWh for gas. At price cap benchmark consumption this translates as £31 per customer per year.

overall when compared to other allocation options (which might have allocated more costs to customers already struggling to pay).

3.5 Given we are not intending to carry out a true-up at this stage, we do not intend to make any adjustments to the methodology of the float. We consider this is consistent with our rationale for setting new forward-looking debt allowances through the operating cost review and is explained further in Appendix 6.

Potential gap in allowances

3.6 The temporary float allowance is due to fall away in April 2025. We recognise the possibility of an 'allowance gap' in 2024/2025, where industry could incur costs above that which is allowed for through the existing debt allowances in the cap. We do not have all the appropriate data available yet with which to fully assess this issue, however we intend to monitor industry costs over time and review where appropriate.

3.7 With the implementation of the new forward-looking debt allowance not occurring until after April 2025, there is also a risk of a temporary step down in debt allowances in the cap with a subsequent step up when the operating cost review is implemented. To help mitigate potential risks to supplier resilience during this period of time, and start to address the potential allowance gap outlined above, we propose to extend the float allowance until the implementation of the operating cost review is complete.

3.8 Appendix 6 sets out our rationale for this in more detail, alongside our latest data which suggests that such an approach is unlikely to result in an overall over-recovery by suppliers but would help to smooth allowances for both customers and suppliers and reduce any requirement for a further ex-post allowance later.

A potential debt relief scheme

3.9 In a separate consultation process, we are consulting on whether we should introduce a potential debt relief scheme.[27] This scheme would be part of a new approach to address the historic debt and arrears accrued during the gas crisis, and the ongoing trends in the market.

3.10 Such a scheme would target funds at alleviating the energy debt accumulated during the gas price crisis by customers with the most severe affordability

[27] Ofgem (2024), Resetting the energy debt landscape: the case for a debt relief scheme. www.ofgem.gov.uk/consultation/resetting-energy-debt-landscape-case-debt-relief-scheme

challenges. Suppliers would be allowed to recover efficient incurred costs that exceed debt related costs already recovered under the existing allowances.

3.11 The interactions between this scheme and debt funded through the cap are likely to be considerable. The consultation of this scheme outlines our thinking on how we would ensure that debt costs were only funded once. We would however expect to take this into account in any broader true-up of debt-related costs.

Additional support credit bad debt allowance

3.12 Since October 2023 the cap has included a temporary allowance for the costs associated with additional support credit (ASC) bad debt. We initially set this allowance for the period of one year, until the operating costs review would consider the appropriate recovery of ASC cost allowances. Due to the delay to the operating costs review, in August 2024 we published our decision to extend this allowance until the outcome of the review of operating cost allowances is implemented in 2025.[28]

3.13 In our ASC allowance consultation process we carried out a review of the first 6 months of the allowance, to assess its performance against the latest industry data. Our analysis then suggested that suppliers continued to incur additional costs associated with supporting customers through ASC, and that the current allowance was set at an appropriate level to recover the costs for a notional efficient supplier.

3.14 We have since received the latest data from industry that covers the first full year of this allowance. We consider that suppliers are still incurring material and systematic costs associated with ASC bad debt, and that the current allowance for these costs is appropriate at present. In future, the costs associated with ASC bad debt will be reflected as part of our proposed ex-ante debt-related allowances. This means that a separate allowance for ASC bad debt will not be required on an enduring basis.

Approach to true-up

3.15 Given these multiple interactions and the uncertainty of ongoing debt costs, we propose to delay and extend the true-up exercise until we have more clarity on

[28] Ofgem (2024), Decision on extension to additional support credit bad debt cost allowance. https://www.ofgem.gov.uk/decision/decision-extension-additional-support-credit-bad-debt-cost-allowance

the size of the allowance gap, and the interaction between the potential debt relief scheme, if implemented, and the cap.

3.16 As set out above, we consider that our methodological approach for the float remains reasonable. However, within any future true-up exercise, we would consider all relevant factors in the round when assessing the appropriate methodology at that point.

4. Standing charge review

Background

4.1 In November 2023 we opened a conversation between Ofgem and our stakeholders to look at the elements which affect energy standing charges.[29] This allowed for the opportunity to understand stakeholder views which could potentially be used in developing options for change.

4.2 Our August 2024 options paper considered the significant response we received to our November 2023 call for input and as a result sought views on ways in which we could reform standing charges.[30] We focussed predominantly on two near-term options:

- Changing the cap allocation methodology to move some supplier operating costs from standing charges to unit rates.
- Increasing consumer choice by increasing tariff diversity.

4.3 We outlined the impacts of moving £20 to £100 of supplier operating costs from standing charges to unit rates and sought views on what mitigants might be required to enable this. We explained that a shift of operating costs would derive a net income-weighted consumer benefit, but that it would result in winners and losers. We also flagged the impacts this shift may have on vulnerable households, especially those on low income with inflexible high demand, for example due to medical needs.

4.4 Additionally, our May 2024 consultation on the operating cost allowances review outlined how we currently allow cost recovery through both standing charges and unit rates. This highlighted options we could take in how costs are allocated, ranging from increasing the allocation of costs to standing charges to moving all costs to unit rates.[31]

4.5 As set out in Appendix 1 to this document, we intend to pass any reduction in core operating costs resulting from the review of operating costs to the standing unit charge. Doing so is expected to result in a roughly £10 reduction in standing charges for most customers.

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[29] Ofgem (2023), Standing charges – call for input. https://www.ofgem.gov.uk/call-for-input/standing-charges-call-input
[30] Ofgem (2024), Standing charges: domestic retail options. https://www.ofgem.gov.uk/call-for-input/standing-charges-domestic-retail-options
[31] Ofgem (2024), Energy Price Cap operating cost allowances review, paragraphs 3.109 - 3.115. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

4.6 In this chapter we set out our decision not to shift a further £20 to £100 of operating costs from standing charges to unit rates. In parallel to this paper, we have also published an update on our broader standing charges work and a summary of responses to our options paper.[32,33]

Responses

4.7 The response to our options paper was significant, with over 5,000 individual consumers contacting us, either independently or as part of email campaigns. Consistent with the responses received to our November 2023 call for input, responses highlighted the perceived unfairness of standing charges and called predominantly for standing charges to be abolished entirely or reallocated to unit rates. We also received 41 responses from stakeholder organisations including suppliers, consumer groups, and charities.

4.8 On shifting supplier operating costs, the majority of the individual consumer responses we received called for 100% of operating costs to be shifted to unit rates. However, responses from stakeholder organisations had mixed views. Some supported the shift to reduce standing charges, while others urged caution, in particular voicing concern for low-income vulnerable consumers who would lose out as a result of this reallocation of costs.

4.9 Energy suppliers offered varied responses. A number of suppliers stated it was not possible to give an assessment of the operating costs shift proposal before the broader operating costs allowances review had concluded. Some responses highlighted the risks we would need to consider in progressing this change, most notably the risk that a shift may lead to under recovery of costs for suppliers, and the risk of harm to vulnerable consumers who could face higher energy bills due to fixed high energy needs. Other suppliers welcomed the proposed shift from standing charges to unit rates, however they supported a shift in the lower half of the proposed £20 - £100 scale.

4.10 Consumer bodies and charities had differing views on shifting operating costs. Eight responses were in favour of shifting operating costs in some way, and four did not support it. A further nine responses agreed with the principle of shifting costs, but that this was conditional on mitigations being put in place to counteract the main downside impacts. This included the impact on low-income

[32] Ofgem (2024), Standing charges domestic retail options: summary of responses. https://www.ofgem.gov.uk/call-for-input/standing-charges-domestic-retail-options
[33] Ofgem (2024), Standing charges: update on our review. https://www.ofgem.gov.uk/publications/standing-charges-update-our-review

households that would significantly lose out. Some respondents referenced a social tariff as an appropriate mitigation for their concerns.

Decision

4.11 We have decided not to implement any immediate shift in operating costs from standing charges to unit rates. Our position is that whilst a shift of operating costs as proposed would deliver a net consumer benefit, some vulnerable households could face significant loss, and these consumers must be adequately protected before we would proceed with this change.

4.12 Instead, we will continue to work with government as it considers how to support a reliable and affordable energy system. Following any development in this area, we will assess the suitability of this change in conjunction with other ongoing work, including longer-term considerations through our broader review of how electricity and gas system costs are recovered from users.

Considerations

4.13 When assessing the impacts of shifting operating costs to unit rates we considered how this may improve consumer control, the potential distributional impacts on consumers, the impact on suppliers and their different average levels of consumption, and the impact on supplier efficiency and ability to finance their operations.

4.14 There are potential benefits and costs to both consumers and suppliers as a result of shifting operating costs as described. These are consumption-dependent, meaning the benefit or costs would be different for each consumer and supplier, relative to their consumption or that of their customers. Suppliers that supported the shift in costs only referenced support for the lower end of the scale (£20), with one response also noting that this would be insufficient for consumers who are facing affordability challenges. Additionally, one supplier argued that reform of standing charges alone wouldn’t address the wider affordability and debt challenges consumers are facing. They voiced concerns that the potential benefits of shifting costs would be insufficient in addressing the challenges we outlined in our case for change.

4.15 We noted that any shift in costs does not lead to a total bill reduction, and as a result presents a zero-sum change. Thus, meaning that in financial terms, some consumers will benefit, other consumers will see little change, and some will lose out. Our analysis estimates that more low-income households would financially benefit, than would lose out, from moving £20 to £100 from standing charges to unit rates. However, the benefits of the winners and costs of the losers are broadly similar in terms of scale. We found that there are approximately 3.7 to 3.8 million low-income households that would gain, with an average bill reduction of -£4 to -£19 per household per year. There are approximately 2.3 to 2.4 million low-income households that would lose, with an average bill increase of +£4 to +£18 per household per year. We expect that some vulnerable consumers would be a part of those households where we expect to see an increase in their annual energy bills. We anticipate these vulnerable consumers to be unable to adjust their usage to manage these additional costs and must consider this in potentially shifting cost allocation. Our Impact Assessment remains unchanged from August 2024.[34]

4.16 Our key concern, as expressed by some consumer bodies and charities, is the impact this shift would have on low income, high usage consumers. We estimate that there would also be a group of low-income households that have consumption at least 50% higher than average. Although the size of this group is hard to measure without better data matching, we estimate that if we were to abolish standing charges and shift all costs to unit rates roughly half a million low-income households/customers would see a bill increase of about 10%. There will be several reasons these households have high energy use, but some of them will relate to personal health or housing circumstances that necessitate higher consumption.

4.17 The potential distributional impact on consumers could exacerbate affordability challenges for those who are already struggling to pay their energy bills. We saw an upward trend in consumer debt and arrears between April 2023 and April 2024, with the increase being across both consumers with arrangements to pay their debt, and consumers without such arrangements. This indicates the growth in debt and arrears is driven by households already behind on their bills.

4.18 Therefore, while we consider that shifting costs from standing charges to unit rates could be a positive move, our position is that vulnerable households must be protected from the downsides of such a change. We will continue to work with government to explore what protection for these households could enable us to revisit this option in the future

[34] Ofgem (2024), Standing charges: domestic retail options. https://www.ofgem.gov.uk/call-for-input/standing-charges-domestic-retail-options

4.19 Some respondents raised questions on how our impact assessment identifies some consumer characteristics, including people with disabilities. For our distributional analysis we currently use Ofgem energy consumer archetypes (2024 update) which models information on income, if a household has disability benefits, energy consumption, and age ranges of members of the household.[35]

4.20 In households where an individual has a disability, the impact assessment uses the Living Cost and Food Survey to generate archetypes that have a proportion of households that have self-reported as an individual having a disability. For example, 99% of households are on disability benefits under archetype B5, therefore the analysis will show the benefits or determinant of a policy change on a consumer that is under archetype B5.

4.21 Outside of this information, we are not aware of a suitable alternative data source that combines information on income, energy expenditure, and household composition. We welcome any input from stakeholders that may hold access to this information.

4.22 Alongside the impacts on consumers, we also considered the effect that moving operating costs from standing charges to unit rates would have on suppliers. Suppliers with lower-than-average consumption across their customer base could see an under-recovery of costs as these customers may not be able to contribute the same level of fixed costs as they do under the current allocation of costs between standing charges and unit rates. This could potentially reduce the revenue of these suppliers. The impact of the reallocation could also vary between suppliers depending on the payment method mix in their customer bases. In particular, PPM customers have lower consumption on average, so a reallocation could lead to under-recovery for suppliers with a higher proportion of these customers. This could reduce the ability of suppliers to specialise in serving PPM customers and therefore reduce consumer choice.

4.23 The risk of suppliers not being able to suitably recover fixed costs was identified among supplier respondents, particularly calling for an additional 'risk premium' to be included in the cap in order to mitigate this risk. Another consideration highlighted was that if weather conditions are warmer than anticipated, there is a chance that the likelihood of under-recovery would be greater across the industry, ie suppliers, network operators, transmission providers etc.

[35] Centre for sustainable energy (2024), Ofgem energy consumer archetypes update 2024. https://www.ofgem.gov.uk/sites/default/files/2024-02/Ofgem_archetypes_update_2024_FinalReport_v4.1.3.pdf

4.24 As noted in our options paper, our view is that shifting all of the operating costs to unit rates is not feasible due to the magnitude of the detriment to low-income customers with inflexible high demand and we are mindful of the potential risk to supplier resilience. We acknowledge that smaller shifts could still have an impact, and should we proceed with operating cost shifts in the future, we would assess any potential changes against the latest information and data we have on the supplier market.

4.25 Affordability has been a persistent challenge in the energy industry even before the cost-of-living crisis. To meet the affordability challenge and achieve our net zero goals in the long term, we need to rebuild our energy system around cleaner, affordable, and secure sources of low carbon and renewable energy, which will require significant investment.

Next Steps

4.26 As set out above, we intend to pass any reduction in core operating cost allowances to standing charges, which we expect to result in a modest decrease of roughly £10 for most customers.

4.27 Alongside this document, we have published a full summary of responses to our standing charges: domestic retail options paper. This gives a summary of views of consumers, charities, and various stakeholders in relation to the options outlined in August 2024, highlighting both common themes and more specific areas of interest among the responses received.

4.28 We have also published an update on our standing charges review which summarises our current position and way forward on standing charges.

Annex 1. Consultation stages

In May 2023 we published our initial call for input in which we outlined the key areas we intended to cover as part of this review. We followed this up with a request for information (RFI) in July 2023 to collect supplier operating cost data for calendar years 2019 and 2022 (with forecast data for 2023).

In October 2023 we published a working paper on benchmarking costs. This paper set out how we could link the benchmark approach with the outcomes we are looking to achieve in the market.

In May 2024 we issued our policy consultation in which we sought stakeholder feedback on our initial set of options. This review covered the four operating allowances under review and helped inform our proposed positions for this consultation. Alongside this consultation we also issued an RFI to collect operating cost data for the calendar year 2023.

Over this summer we carried out further stakeholder engagement on key areas with more complex options (eg debt related costs). This included bilateral calls and conversations with regulatory directors.

As part of our work on debt, we have also been collecting data through the debt-related costs RFI, with the first submission in January 2023, followed up by two subsequent submissions that year in July and October. Since April 2024 we have been collecting regular quarterly RFI submissions from industry.

This is the final consultation for this review in which we have set out our proposed position for each of the four areas covered. In addition, we have also included discussion on two related policy areas, namely our decision on standing charges and our considerations and proposals for the true-up of the additional debt costs review.

We intend to issue a decision in May 2025 which should allow us to implement any updates to the operating cost allowance in July 2025. However our ability to make a decision will be contingent on the feedback we receive from this consultation.

At implementation stage, we propose to publish by way of a statement in writing the Baseline Values and the Initial Values of the CPIH Index for the core operating cost allowance and the debt-related cost allowance, and the Initial Value of the Cost of Capital for the debt-related cost allowance, calculated in the format specified in Annex 1 of the Notice of Modification of the Electricity and Gas Supply Licence.

Table 6: Consultation stages

Stage 1	**Stage 2**	**Stage 3**	**Stage 4**
Policy consultation	Final consultation	Decision	Implementation
May 2024	December 2024	May 2025	July 2025

How to respond

We are seeking written comments on our proposals:

- For our proposal to **extend the current debt-related costs adjustment allowance by 11:59pm on 23 January 2025**.
- For the rest of the proposals set out in this consultation by **11:59 pm on 6 February 2025**.

Please tell us your views using our webform or send us your views and extra information such as diagrams or charts by emailing priceprotectionpolicy@ofgem.gov.uk .

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

Your response, your data and confidentiality

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

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

If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Annex 2.

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

General feedback

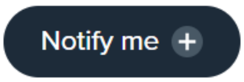
We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

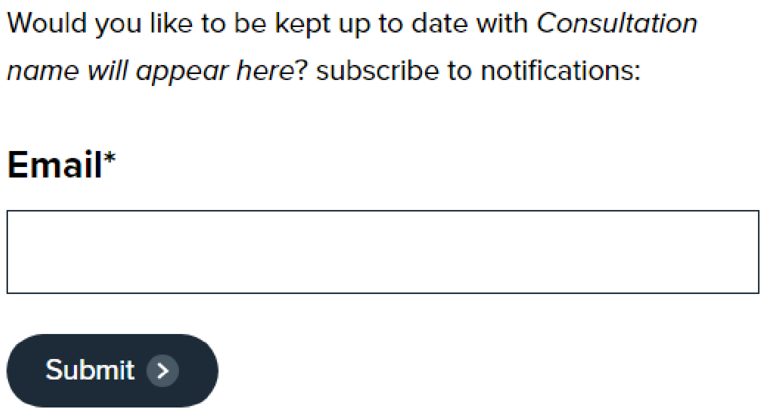
1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6.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

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

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. Choose the notify me button and enter your email address into the pop-up window and submit. ofgem.gov.uk/consultations





Would you like to be kept up to date with *Consultation name will appear here*? subscribe to notifications:

Email*

Submit

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

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

Annex 2 – Privacy notice on consultations

Personal data

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

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

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

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

2. **Why we are collecting your personal data**

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

3. **Our legal basis for processing your personal data**

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

4. **With whom we will be sharing your personal data**

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

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

Your personal data will be held for (be as clear as possible but allow room for changes to programmes or policy. It is acceptable to give a relative time eg 'six months after the project is closed')

6. **Your rights**

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

- know how we use your personal data
- access your personal data

- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 0303 123 1113.

7. **Your personal data will not be sent overseas** (Note that this cannot be claimed if using Survey Monkey for the consultation as their servers are in the US). In that case use "the Data you provide directly will be stored by Survey Monkey on their servers in the United States. We have taken all necessary precautions to ensure that your rights in term of data protection will not be compromised by this".

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

9. **Your personal data will be stored in a secure government IT system**. (If using a third party system such as Survey Monkey to gather the data, you will need to state clearly at which point the data will be moved from there to our internal systems.)

10. More information For more information on how Ofgem processes your data, click on the link to our "Ofgem privacy promise".