Decision Appendix

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Making a positive difference for energy consumers

Appendix 5: Impact Assessment

Contents

1. Introduction

This chapter sets out the structure of our Impact Assessment and our approach.

Purpose of this paper

1.1 This document sets out the Impact Assessment (IA) of our decisions in setting the allowances across the four key areas of our operating costs review: core operating costs, debt-related costs, smart metering related cost changes, and pass-through industry charges. A summary of our rationale is detailed in Chapter 2 of the overview paper.

1.2 In this IA, we also assess the impact of an alternative benchmark option for core operating costs, and two alternative allocation options for debt-related costs.

Summary of our analysis

1.3 Our analysis focuses on the impact on customers and suppliers, as well as an assessment of how our IA options would affect competition in the market. Moreover, we consider the wider impacts against Ofgem's statutory duties and have assessed matters which we must have regard to in Chapter 1 of the overview paper.

1.4 We have set out the impacts across payment methods: Standard Credit, Direct Debit and Prepayment meters (PPM). Along with the level of allowances, payment method has been used as the variable factor in this IA, as we consider this to be the main driver of differences in impacts for customers and suppliers.

1.5 Our IA options are generally assessed against the status quo - "do nothing". We define this as the operating costs allowance in the current price cap period 14a (1st April to 30th June).[1] We note that this definition includes the following temporary debt allowances:

- The existing additional allowance in the cap for bad debt costs associated with Additional Support Credit (ASC) provided to PPM customers.[2]

[1] At benchmark consumption level, 3,100 kWh for single-rate electricity and 12,000 kWh for gas.
[2] Ofgem (2024), Decision to extend the allowance for Additional Support Credit bad debt costs. https://www.ofgem.gov.uk/decision/decision-extension-additional-support-credit-bad-debt-cost-allowance

- The 12-month float allowance for additional debt-related costs incurred from April 2022 to March 2024.

1.6 This enables us to assess our IA options against a baseline that is reflective of the current operating costs allowance. However, we note that any proposed changes would likely be implemented from July 2025, and therefore the actual impacts would likely vary to some degree from those presented below.

Structure of this Appendix

1.7 Our approach to this IA is based on Ofgem's guidance on impact assessments.[3] The IA is structured as follows:

- IA policy options (Chapter 2)
- Impacts on customers (Chapter 3)
- Impacts on suppliers (Chapter 4)
- Impacts on competition and innovation (Chapter 5)
- Public spend and Public sector equality duty (Chapter 6)

[3] Ofgem (2024), Impact Assessment Guidance. https://www.ofgem.gov.uk/publications/impact-assessment-guidance

2. IA policy options

This chapter sets out the options which we have considered in this IA.

2.1 This section outlines the four policy options which we have considered in this IA

Option 1: decision option

2.2 Decision position across all four operating cost sub-components (core operating costs, debt related costs, SMNCC (Smart Metering Cost Net Cost Change) and pass-through industry charges).

Option 2: lower quartile option for core operating costs

2.3 A Lower Quartile (LQ) benchmark for core operating costs (instead of a Weighted Average (WA) benchmark), combined with our decision for the remaining three operating cost sub-components.

Option 3: equal allocation of debt costs

2.4 Equal allocation across payment methods for debt-related costs (as an alternative to using the current cap differentials), combined with our decision for the remaining three operating cost sub-components.

Option 4: higher Standard Credit allocation of debt cost

2.5 Increase the Standard Credit allocation by £100 and reduce the allocation for other payment methods for debt-related costs (as an alternative to using the current cap differentials), combined with our decision for the remaining three operating cost sub-components.

Rationale for option selection

2.6 Options 2, 3 and 4 allow us to assess the range of approaches we considered to set the key parameters of this review, which ensures that the IA remains proportionate, clear and comprehensive.

2.7 More specifically option 4 is not representing the reported cost allocation of debt cost as was done in the December 2024 statutory consultation, as this option was unrealistic given the burden for the Standard Credit customers. The analysis of this impact assessment will instead use an increased Standard Credit allocation

by £100 which is more realistic of what could be implemented and would still capture the dynamic of moving more cost onto SC.

3. Impact on customers

This chapter sets out the direct impacts and distributional impacts of our IA options on default tariff customers. We also discuss the potential impacts on uncapped customers.

3.1 This chapter outlines the impacts of our IA options on customers. It focuses on the direct impacts on default tariff customers' bills, and presents our analysis of the distributional impacts, to understand how different types of customers are affected. Additionally, we discuss the potential impacts on uncapped customers.

Bill impact on default tariff customers

3.2 The default tariff cap ('the cap') was introduced on 1 January 2019 and protects 22 million customers on standard variable and default tariffs.

3.3 Generally, customers paying for energy via Standard Credit or PPM tend to have a differently priced tariff than customers paying for energy by Direct Debit due to differences in cost-to-serve assumptions. We observed this in the market before the cap was introduced and have continued setting the cap at different levels across these payment types since the cap's introduction[4]. Therefore, the impacts of our benchmarking and allocation decisions may vary between payment methods, resulting in a reduction in bills for most customers and a small increase in bills for others.

3.4 In this section, we have considered the interaction of decisions with levelisation phase 1, which aims to address the higher costs borne by PPM customers by adjusting the standing charges for Direct Debit and PPM customers so that they are equal.[5] This policy has been in place since April 2024 and would automatically apply on top of decisions taken in this review.

3.5 To reflect the impact of levelisation we present below the post-levelised bill impacts on customers as it reflects what customers would actually be paying across our IA options. It is important to note that we are not assessing the impact of levelisation as we consider that this is only a mechanical consequence of the policies which we are proposing and have considered.

[4] Ofgem (2018), Default tariff cap: decision – overview, Appendix 8 - Payment method uplift. https://www.ofgem.gov.uk/consultation/default-tariff-cap-overview-document
[5] Ofgem (2024), Decision on adjusting standing charges for Prepayment Customers. https://www.ofgem.gov.uk/decision/decision-adjusting-standing-charges-prepayment-customers

3.6 We have also included the pre-levelised customer bill impacts for completeness, as this is what suppliers would recover (given the reconciliation mechanism that is part of the levelisation policy).

3.7 For the purpose of this analysis, we have made some key assumptions such as:

- All households currently on default tariffs stay on their current tariff. In most cases, we consider that the bill impacts are sufficiently small to be unlikely to materially affect customers' choices. We discuss exceptions to this below.
- Household energy consumption is fixed at benchmark consumption. We note that customer impacts calculated in this IA would vary based on actual consumption values. We also recognise that there are likely to be small price elasticity impacts (ie changes in consumption in response to changes in prices), but these are likely to be negligible for most customers and we have not included these for simplicity.
- All other allowances in the cap are held constant, except the allowances for: Earnings Before Interest and Tax (EBIT) and Headroom. We consider that these allowances scale with the overall cap level, and therefore with the changes to the operating costs allowance across our options.
- Total bill figures and bill impacts include Value Added Tax (VAT)

3.8 Table 1 below sets out the pre-levelised customer bill impacts of our IA options for each payment method - we compare this to the "Do nothing" scenario.[6] We note that, in the presence of the levelisation phase 1 mechanism, this is not what customers are likely to pay – rather this is what suppliers would recover.

[6] "Do-nothing" refers to the status quo which we have defined as the cap period 14a operating costs allowances.

Table 1: Pre-levelised customer bill impact across payment methods, at benchmark consumption[7], in £ per dual fuel customer per year

	Direct Debit	**Standard Credit**	**Pre payment**
Do-nothing	1989	2123	1979
Option 1	1973 (-16)	2132 (9)	1976 (-4)
Option 2	1959 (-30)	2117 (-5)	1955 (-24)
Option 3	1988 (-1)	2031 (-91)	2033 (54)
Option 4	1951 (-38)	2222 (99)	1954 (-25)

Notes: The values in parentheses represent the difference compared to the Do-nothing option. Values may not sum due to rounding. Values may not match other Appendixes as we also consider EBIT and Headroom Allowance Percentage impact

3.9 Given the objective of our analysis in this section is to understand the impact on bills for default tariff customers and therefore what customers are likely to pay, we present our assessment on the post-levelised bill impacts as illustrated in Table 2.

Table 2: Post-levelised customer bill impact across payment methods, at benchmark consumption, in £ per dual fuel customer per year

	Direct Debit	**Standard Credit**	**Pre payment**
Do-nothing	1996	2123	1936
Option 1	1981 (-15)	2132 (9)	1927 (-10)
Option 2	1969 (-27)	2117 (-5)	1897 (-39)
Option 3	2004 (8)	2031 (-91)	1939 (2)
Option 4	1961 (-35)	2222 (99)	1900 (-36)

Notes: The values in parentheses represent the difference compared to the Do-nothing option. Values may not sum due to rounding. Values may not match other Appendixes as we also consider EBIT and Headroom Allowance Percentage impact

3.10 Option 1 (our decision position) shows that customers paying by Direct Debit or PPM would observe bill savings of approximately £15 and £10, respectively. Customers paying by Standard Credit would see an increase in their bills of £9.

3.11 In comparison, option 2 (which reflects a LQ benchmark for core operating costs) shows that customers across each payment method would observe bill savings, including Standard Credit customers, ranging from £5 to £39. Customers paying

[7] Benchmark consumption values are 3,100 kWh for single-rate electricity, 12,000 kWh for gas and 4,200 kWh for multi-rate electricity.

by Direct Debit or PPM would observe a larger reduction in their bills under option 2 (relative to option 1).

3.12 While option 2 would pass on greater cost savings to customers, we consider that this option is likely unsustainable for suppliers and not in customers' interests overall. We discuss our consideration of cap stringency below, and in the relevant appendices for individual elements.

3.13 Firstly, setting allowances below the level of average market costs, following a period of investment in efficiency gains, may lead suppliers to reduce costs by reducing the quality of their service to the minimum levels required. Another way of reducing costs would be for suppliers to reduce investment in innovative services. For example, these could support delivery of Net Zero by helping customers to shift demand to times when electricity is cheaper. A reduction in such investment could lead to higher bills for future customers (relative to option 1) and negatively affect customers' interests in Net Zero.

3.14 Secondly, a more stringent benchmark may lead to an under-recovery of costs for suppliers. As this is an enduring allowance, the impact would be cumulative over a number of years (until a supplier could reduce its costs to align with the allowance, if this were feasible). This could increase the risk of supplier failures or market exits, which could ultimately increase costs for current and future customers (where customers could be bearing costs through the Supplier of Last Resort process). While we have had regard for the financeability of all suppliers, we do not consider that suppliers who may be inefficient should impact our overarching rationale.

3.15 While it is clearly possible to conceive of a notionally efficient supplier that is able to meet a LQ benchmark, it is also possible to consider a notionally efficient supplier that might not be able to meet that benchmark – for example as a result of its customer base, or lack of scale. We also need to consider this in the context of a cap that is no longer temporary.

3.16 Repeatedly setting LQ benchmarks for all operating costs would send a signal to suppliers and investors that the majority of the market would not be able to recover costs (at least temporarily) even if the whole market continued to make efficiency gains. We do not consider that such a signal would be in the long-term interests of customers, nor would it reflect the right balance across the considerations we need to have regard to under the cap legislation. We also believe that the exposure of the market to the general economic uncertainty could lead to changes in operating costs.

3.17 Option 3 adopts an equal allocation approach across payment methods, creating a zero-payment method differential for debt-related costs. Under this option, Standard Credit customers would be largely protected from a high debt allowance. Table 2 shows that Standard Credit customers would observe a bill reduction of £91, Direct Debit customers would observe a bill increase of £8 and PPM customers would see an increase in their bills of £2.

3.18 While option 3 reduces the financial burden for Standard Credit customers, we consider that the full socialisation of debt-related costs (across all payment methods) would undermine cost-reflectivity. Standard Credit customers would see a reduced incentive to switch from a more expensive payment method to a lower cost payment method. Conversely, there is a risk that some customers on more efficient payment methods (ie Direct Debit and PPM) might switch to Standard Credit to benefit from deferred payments. This would distort market signals, leading to inefficiencies and ultimately higher costs for customers.

3.19 Even without incentive effects, Direct Debit and PPM customers would bear costs related to Standard Credit customers. Indeed, these two payment methods are less costly for suppliers than Standard Credit as discussed in 'Appendix 2: Debt-related costs'. This impact would be negative for PPM customers, who are generally not likely to incur debt. We note that while the impact on PPM customers is lessened due to the levelisation mechanism in place, any negative impact would be more significant (as a proportion of household incomes) for vulnerable customers paying by PPM.

3.20 Given option 3 would not be accompanied by a reconciliation mechanism, we would expect that suppliers with a higher-than-average proportion of Standard Credit customers would cumulatively under-recover costs, impacting supplier financeability and increasing the risk of supplier failures. We therefore consider that option 3 would not be in customers' interest.

3.21 Option 4 aims to reflect an option where we set the allowances closer to the reported cost allocation for debt-related costs. The Standard Credit allowance differential with other payment methods is increased by £100 while Direct Debit and PPM allowances are reduced to maintain a similar industry-wide cost-recovery on debt-related costs. As discussed in 'Appendix 2: Debt-related costs' we do not consider that this increased Standard Credit allocation is cost-reflective in terms of the typical (ie median or mode) cost to serve a customer on that payment type. However, it attempts to reflect more closely the average debt cost incurred by suppliers across different payment types and is a potential indicator

for the costs incurred by suppliers in serving customers in each payment cohort. Whilst there is some correlation between average debt costs and payment type, we do not consider it to be sufficiently strong to justify the sort of differentials that would result from option 4. For example, Standard Credit customers have higher debt costs on average and therefore under option 4, customers paying by Standard Credit would be disproportionately impacted. While Direct Debit and PPM customers do observe significant savings (compared to option 1), Table 2 shows that Standard Credit customers would observe a significant bill increase of approximately £99.[8]

3.22 As discussed in 'Appendix 2: Debt-related costs' and Chapter 6, we do not consider it in customers' interests for the costs of non-paying customers to be spread across a few million paying Standard Credit customers. This consideration would hold across any sub-cohort of paying customers, however it is particularly so given the disproportionate levels of low-income or vulnerable customers who pay by Standard Credit as discussed in Chapter 6.

3.23 We note that option 4 would create payment method differentials that may incentivise customers to switch away from Standard Credit. Customers who do switch to a cheaper payment method would see lower bills. However, there is a risk that this would not lead to a reduction in debt-related costs, especially given the association between low engagement and indebtedness. In Chapter 4, we consider the potential impacts of this on financeability. In theory, a diminishing number of Standard Credit customers in this scenario might then mean we would need to adjust allowances up further, which would increase bills for the remaining Standard Credit customers. It would not be realistic to recover debt-related costs from a decreasing group of Standard Credit customers.

Analysis of the distributional impact on default tariff customers

3.24 We have used Ofgem's domestic energy customer archetypes to understand the impacts of our IA options on different groups of customers.[9] The archetypes were designed to assist with the identification and understanding of different types of energy customers, including those in vulnerable situations, and to model the impacts of future policy changes.

[8] This increase is on top of the existing differential and will not return a £100 increase in the value of the Standard Credit allowance as the Direct Debit allowance will decrease in parallel. The increase also considers EBIT and Headroom Allowance Percentage impact.
[9] Ofgem (2024), Ofgem energy customer archetypes update 2024. https://www.ofgem.gov.uk/publications/impact-assessment-guidance

3.25 The domestic customer archetype framework uses ONS Living Cost and Food survey data to assign each archetype and income distribution. The archetypes vary significantly across a number of characteristics such as age, income, house type and energy consumption levels. From this, we have estimated how our IA options would affect customers at different income levels. The household numbers used in this analysis are not solely a representation of the SVT market but of the entire market, as described in the description of the updated archetypes design[10].

3.26 We presented the bill impact analysis in the previous section based on a single level of consumption (benchmark consumption). This resulted in a single direction of impact for a given payment method. As the customer archetype framework includes different consumption levels for different archetypes, the analysis in this section can generate different directions of impact for customers on the same payment method. The impact of consumption depends on how a particular option affects the standing charge and unit rate.

3.27 While the archetypes help us to better understand the impacts on different groups of customers, they do not provide us with information about the impact on individual customers. Our analysis calculates the impact on the average customer in each archetype. We then summarise the overall impacts across the market by assuming that each customer within a given archetype sees the same impact. All our analysis below should be understood with this caveat in mind.

Distributional impact on all households

3.28 Table 3 below sets out our analysis of the number of households we expect to lose/gain for each option across payment methods. We note that the distributional impacts presented here are post-levelisation, as this represents the bill impact that customers face.

3.29 All options result in the majority of customers being better-off except in option 3 with equal allocation of debt costs across all payment methods. Option 2 benefits all the customers (ie benefits the average customer in each archetype) but is unlikely to protect customers' long-term interests. The bill reduction for the majority of customers is highest in option 2. There is also a high bill reduction in option 4, although it is linked to a high bill increase for those worse-off. In option

[10] [10] Ofgem (2024), Ofgem energy customer archetypes update 2024. https://www.ofgem.gov.uk/publications/impact-assessment-guidance

1, most customers benefit, but the bill increases for those worse-off are under £10 making it a better compromise than option 3 or 4.

Impact

Option 1: decision position

3.30 In more details, Table 3, our modelling indicates that c.21.8m households paying by Direct Debit and c.3.3m households paying by PPM would be better off under our proposed policy changes (option 1). Moreover, a small number of households paying by Standard Credit would also benefit from option 1, due to a reduction in the electricity multi-register unit rate compared to the baseline. This is in contrast with an estimated c.1.4m Standard Credit households potentially worse off due to an increase in Standard Credit standing rate for multi-rate customers and gas unit rate. Under option 1, we expect a small number of PPM households to witness a small bill increase due to a small increase in PPM unit rate for gas.

Table 3: Number of households (HH) worse off or better off across payment methods (post-levelised)

Options	Payment method	No of HH worse off (in m)	Ave. bill increase per losing HH, £ per year	No of HH better off (in m)	Ave. bill reduction per gaining HH, £ per year
Option 1	**Direct Debit**	0m	0	21.8m	-29
Option 1	**Prepayment**	0m	5	3.3m	-33
Option 1	**Standard Credit**	1.4m	9	0.4m	-110
Option 2	**Direct Debit**	0m	0	21.8m	-41
Option 2	**Prepayment**	0m	0	3.3m	-58
Option 2	**Standard Credit**	0m	2	1.8m	-32
Option 3	**Direct Debit**	18.3m	8	3.5m	-92
Option 3	**Prepayment**	2m	3	1.4m	-52
Option 3	**Standard Credit**	0m	0	1.8m	-111
Option 4	**Direct Debit**	0m	0	21.8m	-50
Option 4	**Prepayment**	0m	0	3.3m	-56
Option 4	**Standard Credit**	1.4m	96	0.4m	-48

Note: The values for number of households have been rounded to one decimal place - values shown as '0.0m' are non-zero and are less than five thousand.

3.31 Compared to the December 2024 statutory consultation position the number of worse-off households has reduced due to the change in allocation of debt costs across fuel types discussed in 'Appendix 2: Debt-related costs'.

3.32 Under option 1, the magnitude of bill changes varies depending on the payment method of a household. With the levelisation mechanism in operation, PPM households would benefit the most, with an average bill reduction of roughly £33 under option 1. Direct Debit customers would gain £29 on average. The average bill increases would be small compared to the price cap Baseline standing at £5 for PPM and £9 for Standard Credit. Indeed, based on Table 3, the increase in Standard Credit operating cost allowances would result in an 0.4% increase at benchmark consumption.

3.33 Multi-rate customers would see a higher bill reduction than the average customers as shown with the subgroup of c.0.4m Standard Credit customers with a £111 bill saving due to a reduction in their standing charge.

Option 2: lower quartile option for core operating costs

3.34 Option 1 and option 2 differ by the benchmarking approach adopted for core operating costs. Option 2 with reduced levels of allowances leaves every household better off. The bill reduction stands at £43 on average but varies from £32 for Standard Credit customers to £58 for PPM customers.

Option 3: equal allocation of debt costs

3.35 Option 3, creates a zero-payment method differential by allocating debt-related costs equally across payment methods. Under option 3, our modelling indicates that c.18.3m households paying by Direct Debit and c.2m households paying by PPM would see average bill increases of £8 and £3, respectively. This impact is being driven by Direct Debit and PPM customers bearing a greater proportion of debt-related costs than under option 1 while Standard Credit would bear a smaller proportion of debt-related costs than under option 1. Given Direct Debit and PPM customers are less likely to be in debt, we consider that these customers' interests would not be appropriately protected under this option. Some Direct Debit and PPM customers would still gain from option 4. These would be households with a low consumption level due to a reduction in standing charges compared to the baseline.

3.36 Table 3 shows that under option 3, c.1.8m households paying by Standard Credit would be better off, with an average annual bill reduction of £111. Given

Standard Credit customers are on average, more expensive to serve, we consider that a bill reduction for Standard Credit customers would undermine cost reflectivity and impact suppliers' ability to recover efficient costs.

Option 4: higher Standard Credit allocation of debt cost

3.37 Option 4 creates a high payment method differential and leads to Standard Credit customers being disproportionately impacted, with c.1.4m Standard Credit households facing a premium of £96 on average. This is in contrast to option 1, which holds the current cap differentials for debt-related costs and leads to a more balanced impact across the payment methods. Among Standard Credit customers c.0.4m customers are gaining even after this change. These would be multi-rate customers with a high consumption level.

3.38 In option 4, all Direct Debit and PPM customers would gain from the change with respectively £50 and £56 average bill reductions, saving an additional £20-25 compared to option 1. The 0.4m of electricity multi-register households paying using Standard Credit would still benefit from the change with an average bill reduction of £48.

Conclusion

3.39 We note that while smaller differentials (as in option 1) may lead to more proportionate outcomes for customers relative to option 4, this could impact suppliers' ability to recover efficient costs (if costs are higher than recognised by the current differentials), potentially having an impact on supplier financeability. For example, this could affect suppliers with high proportions of Standard Credit and PPM customers.

Distributional impact on vulnerable customers

3.40 We have also utilised Ofgem's domestic customer archetypes to understand the impact on households with certain vulnerable and protected characteristics. In this section, we have assessed the impact on low-income households and households that are in receipt of disability benefits. We consider that these customer groups are often more susceptible to cost-impacts and policy changes due to financial constraints and additional challenges they may face. Our assessment aims to ensure that our proposed changes do not exacerbate any existing inequalities.

Impact on low-income households

3.41 Table 4 below focuses on the number of lower income households we expect to lose/gain. For the purpose of our analysis here, we have defined low-income as £19,500 (or below).[11]

Table 4: Number of low-income households worse off or better off across payment methods (post-levelised)

Options	Payment method	No of low-income HH worse off (in m)	Ave. bill increase per losing HH, £ per year	No of HH better off low-income (in m)	Ave. bill reduction per gaining HH, £ per year
Option 1	**Direct Debit**	0m	0	4.4m	-34
Option 1	**Prepayment**	0m	0	1.2m	-33
Option 1	**Standard Credit**	0.4m	8	0.1m	-100
Option 2	**Direct Debit**	0m	0	4.4m	-45
Option 2	**Prepayment**	0m	0	1.2m	-56
Option 2	**Standard Credit**	0m	0	0.6m	-29
Option 3	**Direct Debit**	3.4m	7	0.9m	-90
Option 3	**Prepayment**	0.6m	3	0.6m	-42
Option 3	**Standard Credit**	0m	0	0.6m	-100
Option 4	**Direct Debit**	0m	0	4.4m	-52
Option 4	**Prepayment**	0m	0	1.2m	-54
Option 4	**Standard Credit**	0.4m	87	0.1m	-42

Note: The values for number of households have been rounded to one decimal place - values shown as '0.0m' are non-zero but are less than fifty thousand.

3.42 We can see that option 1 would limit the average bill increases for losing low-income households while ensuring a significant average reduction in bill levels for the better-off low-income households. Option 2 would benefit all low household incomes while option 3 and option 4 have negative impacts on low-income households. Option 3 increases bills for more than half of the households in this category by an average of £6 which results in a £79 average reduction for 2.1m households. Option 4 results in a £87 average bill increase for c.0.4m customers with a £52 bill reduction for other low-income households.

[11] We have calculated this based on median household disposable income (£32,300) in the UK for Financial Year Ending (FYE) 2022 as published by the Office for National Statistics. We have taken 60% of median income as our definition of low-income, in line with the ONS definition of the poverty line.

3.43 Option 1 leads to smaller total bill reductions across payment methods compared to option 2. However, as discussed in 'Appendix 1: Core operating costs', we consider that option 1 should provide greater room for suppliers to undertake a range of activities beyond their minimum obligation. This is particularly important for vulnerable customers (ie low-income households) who require a more sensitive and personal service.

3.44 Option 4, which is the second most beneficial option in terms of bill reductions creates an affordability challenge for c.0.4m low-income customers. Option 1 would strike a balance between bill reduction for the majority of vulnerable customers and limited increase for some.

3.45 Contrary to the trend seen in Table 3, the smaller energy usage of low-income households means that the reduction in bill sizes is larger in Table 4. Low-income users would particularly benefit from reduced standing charges.

Option 1: decision position

3.46 As shown in Table 4, we estimate that option 1 would increase bills for c.0.4m low-income Standard Credit households, by approximately £8. At the same time, c.4.4m Direct Debit households and c.1.2m PPM households would be better off and save on average £34 and £33 respectively.

Other options

3.47 Option 3 would mostly benefit Standard Credit low-income households and negatively impact c.4m of Direct Debit and PPM low-income households. Although the magnitude of the impact would be small with an average bill increase of £7 and for Direct Debit and 32 for PPM. Again, the bill increases are smaller due to the low consumption of low-income households.

3.48 While we recognise that any bill increases would be concerning for customers in these situations, the cap is inherently not a targeted measure and it is not possible to avoid bill increases for all low-income customers, especially where the overall direction of cap changes is an increase (as is the case for core operating costs for Standard Credit). Option 1 would limit bill increases to a small share of customers with minimal bill increases, most low-income households would see their bill decrease.

Conclusion

3.49 The other options considered were found to results in significant bill increases (option 3 and 4) for more low-income households or to not be in the customers' long-term interest (option 2).

3.50 While we recognise that any bill increases would be concerning for customers in these situations, the cap is inherently not a targeted measure and it is not possible to avoid bill increases for all low-income customers, especially where the overall direction of cap changes is an increase (as is the case for core operating costs for Standard Credit).

Impact on households in receipt of disability benefits

3.51 Moreover, we have assessed the impact on households that are in receipt of disability benefits using Ofgem's customer archetypes (A3, B5, D10 and E13). While we have not presented the detailed analysis here, we discuss the impacts qualitatively, providing an overview of the key findings and their implications.

Option 1: decision position

3.52 Overall, we find a high number of customers who gain and a small number of customers who lose out for Option 1. No PPM and Direct Debit households are left worse-off in Option 1. The 10% of households in receipt of disability benefits seeing bill increases would be Standard Credit customers with a small bill increase due to a small increase in the unit rate.

3.53 Our analysis suggests that bill increases for households in receipt of disability benefits are small under option 1, with bill increases for those paying by Standard Credit of £9 on average. Households in receipt of disability benefits using other payment methods would see bill reductions of between £10 and £15 on average.

Option 2: lower quartile option for core operating costs

3.54 Option 2 would have all this household group gaining with average bill savings of £39 for PPM and around £5 for Standard Credit. However, we consider that while generally option 1 shows a less positive financial impact on vulnerable customer archetypes than option 2, option 1 will maximise long-term customer protection by supporting better service which may be of particular value to customers with more complex needs (eg issues relating to debt and challenges with online self-service), as well as implementation of innovative technologies to improve customer experience and outcomes (eg in relation to net zero).

Other options

3.55 In option 2, all of these households are better-off but in option 3, although all Standard Credit households would be gaining, all Direct Debit and PPM households would see bill increases. As a result, 63% of those low-income households in receipt of disability benefits would lose out compared to 10% and 7% respectively for option 1 and 4.

3.56 Under option 4, 93% of households in receipt of disability benefits would benefit, but 7% would see their bill increase by more than £100 per household. Those benefiting would see bill reductions of around £36.

Conclusion

3.57 For all options, the bill changes remain small reflecting the low consumption of most of these households. Some households with a higher consumption than average on standard credit would see a bill increase. Under option 1, most of these archetypes are gaining due to the reduction in standing charge levels. Options 3 and 4 lead to larger bill size impacts which could have some strong negative effects on low-income and vulnerable customers.

Impact on customers on uncapped contracts

3.58 In general, we consider that there would continue to be room for Fixed Tariff Contract (FTC) pricing below the cap even with a reduced level of allowances, and therefore we expect the impact on FTC customers would be limited.

3.59 Compared to the original operating cost allowance, the allowance we are setting is less stringent, and it is likely that suppliers could set FTCs at a lower price than the cap. We therefore do not expect a significant reduction in the proportion of customers on FTCs compared to current level.

3.60 Customers would be unlikely to select a FTC priced above the cap. We therefore recognise that allocation decisions might affect the attractiveness of FTC pricing for certain customer types – especially Standard Credit customers. We do not consider that this is an important implication of our proposal, given that the number of FTC Standard Credit customers is limited.

3.61 Any non-price benefits of our proposed approach (in terms of service, innovation, or resilience) could also result in benefits for FTC customers.

Stakeholder responses

3.62 We received 310 individual comments to our consultation although the majority of these supported the views of a stakeholder, many contacts raised concerns around affordability particularly for vulnerable customers (retired age, disabled).

3.63 The majority of the comments supported the views of a stakeholder who requested significant changes to the price cap to increase affordability and reduce the over-recovery of suppliers on operating costs and debt costs over the past years. Allowance increases were deemed unfair to customers.

3.64 Among these comments a proportion criticised the level of the existing standing charge.

3.65 Other individual responses said that the high level of the cap with high debt allowances could further push customers towards debt.

3.66 We not that some stakeholders echoed individual responses' views around affordability. They said that the choice not to levelise the debt cost could create significant affordability issues, particularly for low-income customers on standard credit.

3.67 Another charity highlighted that in spite of the Standard Credit premium few customers were aware of the price differential, reducing their likelihood to act and switch to other payment methods.

Considerations

3.68 The updated operating cost allowances reduce the overall price paid by SVT customers. All customers except from a minority paying by Standard Credit will see their bill reduce. Vulnerable customers with a low level of consumption will see a larger price drop than the average customer as they will benefit from the reduced levels of standing charges.

3.69 There will be a bill increase for 1.4m households (paying by Standard Credit) and a reduction for all other households. As a result, we consider that it is unlikely that the changes made could create material further affordability challenges, though we recognise that there could still be individual customers for whom any price increase is challenging.

3.70 The standing charge will reduce for all payment methods except for Standard Credit customers which will reduce the average standing charge paid by customers.

3.71 In Chapter 6 we highlighted that ensuring Direct Debit and PPM bills drop while having a minimal increase in Standard Credit bills is a good outcome for vulnerable customers. Indeed, the customer engagement survey has shown that the majority of customers that could be vulnerable (disabled, pension age, low income) pay by Direct Debit and PPM.

3.72 We acknowledge that many Standard Credit customers may not be aware of the price differential they face. Nevertheless, Standard Credit customers who are aware of the price differential will be able to make decisions about whether they want to remain on this payment method. Suppliers can also seek to raise awareness of the differential among their Standard Credit customers. Indeed, we found that although most households on Standard Credit are disengaged, the CIM Wave survey showed that 32% of Standard Credit customers surveyed actively chose this payment method and 36% of those surveyed said that it gave them more control on their bills. The survey also found that only 20% of customers on Standard Credit surveyed wanted to change payment method.

3.73 The bill impact analysis highlighted the minimal average bill increase resulting from our decision for Standard Credit households limiting the value of any additional premiums.

4. Impacts on suppliers

In this chapter, we have assessed the impact of our IA options on a range of notional suppliers and have also considered the impact on actual suppliers.

4.1 As we are required by legislation to set a single energy price cap[12], we consider that it is inevitable that suppliers would be exposed to risks differently due to differences in their business models and customer mixes. We therefore note that the impacts on suppliers would vary. We will consider whether the changes made to price cap could have adverse effects like competition distortions.

Our approach to defining Notional Suppliers

4.2 For the purposes of this IA, we have presented three notional suppliers, each with a different ratio of Direct Debit, PPM and Standard Credit customers.

4.3 We consider that our range of Notional Suppliers enable us to assess the impacts of our allocation approach for payment methods, which would not have been possible with a single hypothetical supplier.

4.4 Payment method is the main driver of difference between suppliers under our IA options. We consider that suppliers' costs could be affected by: (a) the extent to which certain payment methods inherently have higher costs, and (b) any impacts resulting from the relationship between certain payment methods and other customer characteristics (eg vulnerability).

4.5 We have made the following assumptions which are relevant to our Notional Suppliers:

- Energy consumption is fixed using benchmark consumption. Financial impacts on Notional Suppliers could differ if payment methods have different consumption levels on average. As mentioned in 'Appendix 1: Core Operating costs' we recognise suppliers' concerns regarding the change in consumption level over time and differences across payment methods. We continue to monitor consumption levels and will review our approach to consumption within the cap in the future.

[12] UK Government (2018), Domestic Gas and Electricity (Tariff Cap) Act 2018. https://www.legislation.gov.uk/ukpga/2018/21/introduction/enacted

- Suppliers' SVT customer numbers used are from January 2025. The customer mix was used to deduce the revenue change that we could expect from the changes we are making.
- We used 2024 FRC stress-test data as a baseline for revenue and EBIT values to gain an insight into the scale of the changes. It represents the baseline for suppliers at Cap 14a.
- All figures are pre-levelisation (because we're looking at supplier impacts rather than customer impacts).

4.6 The Notional Suppliers created have profiles as illustrated in Table 5. Supplier A, B and C respectively represents a large legacy supplier, a supplier with a high proportion of Direct Debit customers and a PPM specialist. The Notional Suppliers' profiles were obtained as follows for the Baseline:

- Notional Suppliers for the Notional Suppliers A and B were based on the average supplier's data (revenue, EBIT, customer numbers) for each type of supplier. The revenue and EBIT were compared at a £ per Dual Fuel customer level.
- On Notional Supplier C averaging suppliers' data was not possible due to the low number of suppliers in this supplier category which could have compromised the confidentiality of their data. The Notional Supplier baseline revenue and EBIT are based on a per customer average for the 10 suppliers available. This Notional Supplier's customer base is informed by data on payment methods across default tariff customers for specialist PPM suppliers while not aggregating or reporting directly their data.

Table 5: Assumed customer accounts base payment method splits of our Notional Suppliers

	Notional Supplier A	**Notional Supplier B**	**Notional Supplier C**
% of customers on DD	59%	76%	5%
% of customers on SC	25%	15%	5%
% of customers on PPM	16%	9%	90%
Number of SVT customers (millions)	5.6	3.7	1.0

4.7 Supplier A represents large legacy suppliers with a higher-than-average proportion of Standard Credit customers – we use an average across the legacy suppliers in the market (25%). While individual suppliers would have different proportions of Standard Credit customers, we consider that Supplier A sufficiently shows the impacts of allocation decisions regarding Standard Credit. We also use the average proportions of PPM and Direct Debit customers among legacy suppliers.

4.8 Supplier B represents a challenger supplier – ie a supplier who acquired their customer base more recently (including that they might also have absorbed other suppliers). This supplier has a customer base with a higher-than-average proportion of Direct Debit customers (76%), and a lower proportion of Standard Credit customers (relative to Supplier A).

4.9 Supplier C has a customer base which is mostly made up of PPM customers (90%) and is intended to reflect the profile of a PPM specialist supplier.

4.10 Our Notional Suppliers have been designed to reflect specialisation for a particular payment method, in a way that it is broadly reflective of actual suppliers' customer bases. Actual suppliers would have different individual customer base payment method splits and total customer numbers.

EBIT assessment

Methodology

4.11 Using our Notional Suppliers, we have carried out an EBIT assessment to understand the impacts of our IA options on suppliers' revenues.

4.12 For the purposes of this analysis, we have made the following assumptions:

- The do-nothing or Baseline represents suppliers' position with the current price cap allowance. In this case we retained the Cap 14a allowance. As a result, we have each Notional Supplier's Revenue and EBIT.
- In each option, there would be no difference in the costs incurred by suppliers or the revenue from Fixed Tariff Customers. The only variable changing would be the revenue from SVT customers.
- For those customers, beyond the operating cost allowances, all other allowances in the cap are held constant, except the allowances for EBIT and Headroom. These allowances scale with the overall cap level, and therefore with the changes to the operating costs allowance across our options. The

total bill figures and bill impacts include Value Added Tax (VAT). The price cap value retained is at benchmark consumption.[13]

- The change in revenue expected for each Notional Supplier and each payment method would therefore be as illustrated below. The total change in revenue would be obtained by summing the revenue change for each payment method:

$$Revenue\ Change\ for\ A\ on\ PPM = SVT\ cust.number\ for\ A\ on\ PPM * Price\ cap\ change\ on\ PPM$$

- The change in Notional Suppliers' EBIT approximated as the revenue change for the Notional Supplier is then compared to their initial position at the Baseline as illustrated below to obtain the likely EBIT change in percentage points:

$$EBIT\ change\ (pp) = \frac{Revenue\ change\ for\ A\ all\ payment\ methods}{Baseline\ EBIT\ for\ A}$$

- We have not considered the interaction post-levelisation - we consider that the levelisation reconciliation mechanism means that levelisation has a neutral impact on suppliers

Results

4.13 Table 6 below shows our estimates of what the change in a notional supplier's EBIT (expressed as a percentage of revenue) would be. Our estimates are presented as a change relative to the Baseline.

Option 1: decision position

4.14 Option 1 (our decision position) sees EBIT as a proportion of total revenue fall by 0.3pp for Supplier A and 0.5pp for Supplier B, relative to the current allowances (Baseline). Supplier C witnesses a lower reduction of its EBIT by 0.2pp. These reductions are due to the reduction in core operating allowances reflecting the efficiency gain suppliers have made, given the benchmark for core operating cost is set at the weighted average (see 'Appendix 1: Core operating costs').

4.15 Our proposed allowances are based on our analysis showing that average costs are lower than the sum of current allowances (when including the temporary adjustment allowances for debt and ASC). A reduction in revenue therefore does

[13] Ofgem (2023), Call for Input: Review of Typical Domestic Consumption Values 2023. https://www.ofgem.gov.uk/call-for-input/call-input-review-typical-domestic-consumption-values-2023

not mean that notionally efficient suppliers would see smaller EBIT margins than the 2.4%[14] cap allowance or vice versa.

Table 6: Change in EBIT as a proportion of revenue at benchmark consumption (percentage points)

	Notional Supplier A	**Notional Supplier B**	**Notional Supplier C**
Baseline	0.0pp	0.0pp	0.0pp
Option 1	-0.3pp	-0.5pp	-0.2pp
Option 2	-0.9pp	-0.9pp	-0.9pp
Option 3	-0.6pp	-0.4pp	1.7pp
Option 4	-0.1pp	-0.6pp	-0.8pp

4.16 This exercise also does not aim at analysing the current efficiency of each Notional Supplier type. Even if actual suppliers of a particular type may have current EBIT levels which differ from the cap allowance, this is not necessarily as a result of the price cap.

Option 2: lower quartile option for core operating costs

4.17 In comparison, option 2 (which reflects a LQ benchmark for core operating costs) shows a further drop in EBIT by 0.4pp to 0.7pp (relative to option 1) across all Notional Suppliers. For example, Supplier C see their overall EBIT decrease by -0.9pp, relative to the Baseline.

4.18 Option 2 would be coherent with a view that a LQ benchmark represented notional efficiency. To that extent, option 2 would also not mean that notionally efficient suppliers would see smaller EBIT margins than the cap allowance. However, a LQ benchmark would require most actual suppliers to make efficiency improvements to earn the cap EBIT allowance. Even if feasible, this could take time. Suppliers could therefore make less than the cap EBIT allowance for a period – ie making less than a normal rate of return on their capital employed. Suppliers in this situation (and their investors) would need to take a judgement on whether this would likely be offset by higher EBIT margins in later years, such that it was attractive to continue participating in the market. They would also have to consider the possibility that over time, Ofgem may set another LQ benchmark which would again mean that most suppliers were unable to recover costs (unless and until they could make further efficiency improvements).

[14] Calculation based on Cap14a EBIT allowance. Annex-9-Levelisation-allowance-methodology-and-levelised-cap-levels-v1.5.xlsx

4.19 Exit is a normal part of a well-functioning market. However, unplanned exit can lead to customers bearing costs through the Supplier of Last Resort process.

4.20 The text above assumes that the LQ correctly reflected notionally efficient costs. However, option 2 creates a potential risk for costs to be understated, given that it would be more heavily influenced by a smaller number of suppliers' data than option 1. This could impact suppliers' ability to recover efficient costs. Any negative impacts on suppliers' EBIT would be cumulative and therefore increase the risk of supplier failures.

4.21 It is important to note that, under option 1, compared to option 2, some suppliers who are operating at above-average efficiency would already be able to achieve a higher EBIT margin than our EBIT allowance. The same would apply to any suppliers who are able to improve their efficiency. Suppliers that are less efficient would struggle to reach the operating cost benchmark of option 2 but could more reasonably achieve option 1. We therefore consider that option 1 would be less susceptible to future market changes and more resilient to future cost shocks, relative to option 2. We consider that this would enable suppliers to improve their services and invest in innovation while having improved regulatory stability. In response to the December 2024 statutory consultation, one supplier disagreed with this statement, on the basis that this would require suppliers with above average costs to make significant efficiency gains. While this statement was in relation to the market in general rather than any specific supplier, as discussed in 'Appendix 1: Core operating costs', we continue to consider that there is the potential for suppliers to make catch-up efficiency gains.

Option 3: equal allocation of debt costs

4.22 Option 3 allocates debt-related costs equally across payment methods to create a zero-payment method differential for debt-related costs. This contrasts with option 1 (which uses current cap differentials), and even more so to option 4 (which assumes a higher Standard Credit allowance).

4.23 A zero-payment method differential would impact the recovery of efficient costs, particularly for suppliers with a more expensive cost-to-serve customer base.[15] Suppliers with a higher-than-average proportion of Standard Credit (Supplier A), would observe decreases in their respective EBIT of 0.6pp while suppliers with a

[15] Standard Credit customers generally have higher debt costs on average. Suppliers with a higher-than-average proportion of Standard Credit customers are therefore considered to have a more expensive cost-to serve customer base.

lower proportion of Standard Credit customers like Supplier B would be less impacted. Supplier B EBIT would only drop by 0.4pp compared to the baseline. While we would in principle expect Supplier B to see an increase in its EBIT (given Direct Debit customers would be paying more under option 3), the revenue decrease per Standard Credit customer is much larger than the revenue increase for Direct Debit customers. Therefore, even the impact on Supplier B's smaller percentage of Standard Credit customers leads to an overall decrease in its EBIT.

4.24 PPM specialist suppliers (ie Supplier C) would significantly benefit from the socialisation of debt-related costs given PPM customers would be paying more (outweighing the impact of Supplier C's Standard Credit customers). This would provide Supplier C with a range of options, including reducing prices for default tariff customers, investing more in customer acquisition, or taking higher profits. The latter strategy would not affect the competitive process, but the other strategies could give the supplier a competitive advantage.

4.25 Moreover, Standard Credit customers would not be paying a cost-reflective amount (on the basis that typical Standard Credit customers do carry some additional capital requirements and debt risk) and debt costs would still be incurred. Supplier A would be disproportionately impacted as they would not be able to cumulatively recover their efficient costs. This risk is exacerbated due to the lack of incentives to choose more efficient payment methods under option 3, where in the long run, more customers might choose to pay by Standard Credit to benefit from making late payments (which would later be socialised). Due to the lack of incentive to pay using a cost-efficient payment method we could suggest that an increasing proportion of customers would use more costly methods.

Option 4: higher Standard Credit allocation of debt cost

4.26 EBIT is disproportionately impacted under option 4 (which uses a higher Standard Credit allowance allocation). We note that Supplier A, which has a higher-than-average proportion of Standard Credit customers, only sees a 0.1pp drop in its EBIT compared to the Baseline, which is a smaller decrease than under option 1.

4.27 In contrast to Supplier A, Suppliers B and C observe higher reduction in their respective EBIT under option 4 compared to option 1. Supplier B, which has a higher-than-average proportion of Direct Debit customers, is impacted the most, with a drop in its EBIT of -0.6pp. Supplier C, which has a particularly low proportion of Standard Credit returns a -0.8pp drop in EBIT. We do not consider that this indicates that suppliers with a high proportion of Direct Debit customers

are currently achieving an EBIT margin significantly above our EBIT allowance. For PPM suppliers the change would have significant negative consequences. This would be likely to negatively impact the financeability of those suppliers.

4.28 Option 4 would rely on setting a high differential for Standard Credit customers. It might therefore incentivise some paying Standard Credit customers to switch to Direct Debit. While this aligns with broader goals to move customers to efficient payment methods, this could lead to a smaller number of Standard Credit customers covering the costs of non-paying customers. We discussed in Chapter 3 that this ultimately would have a negative impact on customers, but we also recognise that this would also make it more difficult for suppliers to recover efficient costs overall and therefore have a negative impact on supplier financeability. In practice, the reduction in EBIT for Supplier A would therefore likely be larger than we have modelled. This effect would be compounded by the fact the number of standard credit customers already in payment difficulty and further increases to the standard credit bill could see an increase in non-payment.

4.29 First, as discussed in Chapter 5 of 'Appendix 2: Debt related costs', we consider that the extent to which supplier-reported costs are 'cost-reflective' is unclear due to factors such as customer movement and supplier provisioning methodologies. Second, our data on actual suppliers shows that suppliers with different customer bases by payment types can have similar debt costs per customer – suggesting that the number of Standard Credit customers and the total level of debt carried by suppliers is only weakly correlated across the market. Thirdly, suppliers remain able to price below the cap, especially where they have a lower cost customer base.

4.30 Further, we recognise that the characteristics of a Standard Credit customer would differ across suppliers. For example, Standard Credit customers of Supplier A may have remained on Standard Credit due to inertia or may have chosen Standard Credit as their preferred payment method for reasons not relating to debt (ie a general preference to pay on receipt of bill). In contrast, for suppliers with a smaller proportion of Standard Credit customers (like Supplier B), a greater fraction of these Standard Credit customers may have moved to Standard Credit for debt reasons. As a result, the cost per Standard Credit customer for Supplier A may therefore be below the market average and the cost per Standard Credit customer for Supplier B may be above the market average. We therefore consider that using a cost allocation with a higher Standard Credit allowance as in option 4 would not be an accurate representation of a payment method's cost-to-serve.

4.31 In 'Appendix 2: Debt-related costs', we discussed the fact that we had not been able to find a strong relationship between the share of Standard Credit customers and the level of debt-related costs of suppliers. Some suppliers with high levels of Standard Credit customers had low debt costs and vice versa, highlighting the importance of other factors (for example suppliers' processes to efficiently deal with debt). In Appendix 2, the net cost-recovery analysis also concluded that using an allocation closer to the reported cost was unlikely to be better for the efficient recovery of debt-related costs.

Conclusion

4.32 We consider that option 1 (our decision position) is likely to have fewer negative consequences for all suppliers compared to either option 3 or option 4.

Stakeholder responses

4.33 One supplier highlighted the need to more accurately reflect the impact on all market players, and their different customer bases which result in different costs, when considering the supplier impact of changes made to the price cap. It also raised concerns around the drafting of the December 2024 statutory consultation IA which justified the current decision instead of analysing its potential effects.

4.34 The same supplier raised concerns around the level of financeability of the industry due to EBIT reductions.

4.35 Three different suppliers and their advisors raised concerns about potential competition distortions due to suppliers under or over-recovering costs through the price cap.

Considerations

4.36 'Appendix 5: Impact assessment' of the December 2024 statutory consultation reported a change in EBIT calculated based on each modelled Notional Supplier's customer payment method mix. We used the price cap as the baseline for the EBIT. In this appendix, we have made two refinements. We used the customer mix in terms of payment method and tariff type to refine Notional Suppliers' definition. We used the financial data of actual suppliers to help generate our Notional Suppliers. Each Notional Supplier's impact is therefore more precise and linked to different business models.

4.37 This IA does not report a forecast EBIT level from our policy options. This reflects that we are seeking to understand the incremental impact of our operating costs

review. We are not seeking to review the adequacy of the cap, as this would go beyond the scope of the operating costs review.

4.38 When considering the potential for competition distortions, we first highlight that the changes we are making to price cap allowances are small. The overall changes in the operating cost allowances would be small compared to the price cap as shown in Table 2, with a reduction in the price cap of 0.75% for Direct Debit, an increase of 0.4% for Standard Credit and a reduction of 0.5% for PPM.

4.39 We do not expect that the reductions in allowances for Direct Debit customers and PPM customers would result in competitive distortions. They predominantly reflect the efficiencies made by suppliers in core operating costs. The choice of a weighted average benchmark for the core operating costs already reflects that we consider the most significant efficiencies have already been captured. As the benchmark is less stringent than in the past, it should be less challenging for suppliers to reach (or outperform) the benchmark. The allocation of cost for each payment method was done cost-reflectively. As a result, the choices we made should deliver an adequate cost-recovery if the supplier is efficient.

4.40 The debt allowance was set at the weighted average benchmark, but the allocation of costs involved judgements, given that bad debt costs inherently must be recovered from customers who did not cause these costs. For suppliers, the benchmark should be easier to reach than our previous debt-related cost allowances, which in part used a lower quartile. The cost allocation decision results in higher allowance levels than the reported costs for Direct Debit and PPM and lower allowances than the reported costs for Standard Credit. The analysis in Chapter 5 of 'Appendix 2: Debt-related costs' discusses the potential competition distortion; it shows that allocating more costs to Standard Credit is unlikely to result in a tighter distribution of over and under-recovery between suppliers. Furthermore, imbalances between suppliers with a high proportion of Direct Debit customers and suppliers with a high proportion of Standard Credit customers were found to be unlikely to persist in the future to the same extent. The Direct Debit customers of the supplier with high proportions of this payment method move more rapidly towards fixed tariffs than other Direct Debit customers in other supplier types reducing the imbalance.

4.41 With a single cap level across the market, there will always be a degree of under-recovery and over-recovery between suppliers with different customer bases, no matter what cost allocation approach is adopted. Given the magnitude of the

change in operating cost values and the choice of a weighted benchmark the changes made are unlikely to result in any additional competition distortions.

5. Impact on competition and innovation

This chapter sets out an assessment on the impact on competition. We have assessed how our proposed changes may affect the underlying features of the market.

5.1 Using Ofgem's Competition Framework,[16] we have conducted a assessment of the impact on competition. We have looked at whether and how our proposed changes may affect the underlying features of the market; namely, (i) customer engagement and empowerment, (ii) market rivalry, and (iii) market entry or exit. In this section, we discuss the options most relevant to these themes.

Customer engagement and empowerment

5.2 Our changes are intended to deliver an operating cost allowance that would continue to enable investment and innovation by retaining a less stringent benchmark as discussed in 'Appendix 1: Core operating costs'. Option 1 supports the possibility for suppliers to attract more investment (relative to a more stringent benchmark for core operating costs under option 2) which can facilitate enhanced customer service, innovative products, innovative services and sustainability initiatives. We consider that such investments by suppliers could strengthen customer engagement linked to net zero.

5.3 We recognise that option 1 could also lead to a potential reduction in the price differential between default tariffs and fixed tariffs. This may dampen customer incentives to switch to potentially lower priced fixed tariffs. However, any reductions in the tariff price differential would be small, so we consider these would have a low impact on incentives to engage. Further, we note that any such impacts would be more significant under option 2.

5.4 Significant savings (at least in the short-term) from moving to fixed tariffs have started to emerge, and switching between suppliers has increased significantly from the low point.[17] Under our proposed changes, we consider that there would continue to be room for suppliers to price fixed tariffs below the cap, and therefore we still expect gains from switching and incentives to switch to remain.

[16] Ofgem (2024), A competition framework for the household retail market. https://www.ofgem.gov.uk/decision/competition-framework-household-retail-market
[17] Ofgem (2025), Number of domestic customers switching supplier by fuel type (GB). https://www.ofgem.gov.uk/retail-market-indicators

Market rivalry

Supplier profitability

5.5 The impact on suppliers' profitability depends on the variation in operating costs, where the benchmarking decisions we make (ie on core operating costs) would be more sensitive for some suppliers than others.

5.6 We consider that notionally efficient suppliers would still be able to serve all customer groups profitably under our proposed changes (option 1). Suppliers who start with (or move to) above average efficiency may achieve profits above the EBIT allowance in the cap. Suppliers with below average efficiency may make profits below the EBIT allowance in the cap – we discuss this further in Chapter 4.

5.7 All options retain higher level of debt allowances compared to a do-nothing scenario where the temporary adjustment allowance fall away. This provisional temporary adjustment allowance was introduced for the efficient additional debt related costs incurred by suppliers between April 2022 and March 2024[18]. In 'Appendix 2: Debt-related costs' we highlight that these higher level of debt allowances reflect the latest debt-related costs of suppliers. The Baseline for this included a period of heightened debt cost (2023). Future debt-related costs could moderate, which would provide additional margin until we reviewed the debt-related costs.

5.8 Option 2 would have a larger impact on suppliers operating at below-average efficiency (compared to option 1). While suppliers can take actions to maximise their efficiency, there may be some factors that are outside the control of suppliers (non-efficiency factors), potentially increasing the risk of failure for some suppliers. Any efficiency improvements that suppliers can make would take time to take effect, which can also increase the risk of failure.

5.9 As set out in Chapter 4, the impact on suppliers' profitability varies across suppliers with different customer base payment method splits and proportions of SVT customers. The impact of the changes we are making could be more significant on suppliers that have a larger proportion of their customers on SVTs. The allocation decisions we make (ie on debt-related costs) could therefore improve the competitive position of some suppliers while weakening others.

[18] Ofgem (2024), Decision to extend the additional debt related costs adjustment allowance. https://www.ofgem.gov.uk/sites/default/files/2025-02/Energy-price-cap-additional-debt-related-costs-extension-decision.pdf

5.10 In Chapter 4 we considered the impact on a range of suppliers, the combined impact of the points discussed above resulted in comparable EBIT reduction across all 3 Notional Suppliers, PPM suppliers would see a lower reduction in their EBIT than others. The reduction in EBIT was higher for the Notional Supplier B which tends to have a lower proportion of SVT customers.

5.11 Crucially though, as set out in the previous section of this IA, we consider that our decision approach achieves a reasonable balance of cost recovery across a range of real and notionally efficient suppliers, and it is not clear that a different allocation would achieve a more balanced outcome as shown in 'Appendix 2: Debt-related costs'.

Product offerings

5.12 As noted in Chapter 2, we expect our proposed changes to have a limited impact on other tariffs offered by suppliers (ie FTC). This is because we expect suppliers would continue to be able to price FTC tariffs below the cap. We also recognise that under option 1, suppliers would have the ability to invest in new innovative products and innovative services. This could lead to cost reductions through improved technologies and efficiencies, passing on cost savings to customers in the long run.

5.13 In contrast, we consider that under option 2, suppliers' would have less flexibility in their pricing of other tariffs. We note that this could weaken suppliers' ability to offer competitive products and attract new customers. However, FTC pricing would remain constrained by suppliers with low operating costs, therefore we would expect any impacts on FTCs to be limited.

5.14 Any reduction of the ability to create a price differential between SVT and FTC could incentivise suppliers to compete on non-price factors. Therefore, this increased incentive could balance out some of the impact of having less money to invest in non-price aspects through the price cap allowances.

Service levels

5.15 Suppliers whose ability to recover costs reduces because of the proposed changes may look to reduce their operating costs. For these suppliers, a reduction in the operating costs allowance could negatively affect the service levels offered to their customers. However, the negative effect on suppliers' incentives would be mitigated by:

(i) the risk of losing customers to suppliers offering better service, and;

(ii) our Customer Standards backed by licence conditions.

5.16 On (i), we consider this point to be more relevant to engaged customers, who are generally more likely to seek better service than disengaged customers. We note that the primary risk for suppliers would therefore be losing engaged customers and therefore those on fixed tariffs.

5.17 We would expect that any impact on service standards would generally affect all of a supplier's customers. For example, some processes should be uniform across a supplier's customer base (eg billing). This could mean that pressure from engaged customers could help to constrain some reductions in service for default tariff customers. However, we consider that a reduction in some costs could affect some customers more than others. For example, a reduction in call centre costs leading to a reduction in service might have a greater impact on default tariff customers than fixed tariff customers, if default tariff customers have a higher propensity to call their supplier.

5.18 Our licence requirements (point ii) would prevent reductions in service below a certain level. However, to the extent that some suppliers provide service levels above the minimum at present, they would have room to reduce service as a way of reducing costs. Licence requirements therefore do not eliminate the risk of a reduction in service.

5.19 The risk of a reduction in service could be greater where there is a greater reduction in suppliers' revenues (eg under option 2, compared to our chosen option 1).

Market entry or exit

5.20 We do not consider that our proposed option 1 would constrain entry to any meaningful extent. A new entrant should be able to use the latest processes and technology, reducing the risk that it would have above average costs in the medium-term.[19] A new entrant may also benefit from acquiring engaged customers who may be less likely to have high cost to serve attributes. We would also expect that new entrants would have fewer default tariff customers than

[19] Entrants may have higher costs on a temporary basis when they first enter, if there are economies of scale that they are unable to realise when building their customer bases.

existing suppliers, as they would need to acquire engaged customers limiting the impact of any changes we make to the price cap. This would reduce the direct impact of the cap on their pricing. Furthermore, to the extent that option 1 provides regulatory stability, this may help entrants obtain finance.

5.21 We noted in Chapter 4 that exit is a normal part of a well-functioning market. However, unplanned exits or supplier failure can lead to customers bearing costs through the Supplier of Last Resort process. We consider that our proposed changes reduce the risks of supplier failures relative to other options (eg option 2), while not eliminating the potential that less efficient suppliers exit over time (as part of normal market functioning).

Stakeholder responses

5.22 A supplier said that the draft IA did not consider the potential impact of the changes we are making to the price cap on non-pricing measure such as service quality. Specifically, it said that we should have considered if there was likely to be detrimental service quality impacts because of a reduction in the operating cost allowances. This supplier also said that, by highlighting the potential for innovation and the development of more advanced technology, the analysis only considered the needs of the most engaged customers.

5.23 This supplier also said that using a weighted average benchmark would be contrary to healthy competition, as it would impose homogeneity between suppliers. It said that we had not considered the impacts on competition sufficiently. The supplier suggested a median benchmark instead.

5.24 As set out in the overview document, we must have regard to the growth duty. In response to our December 2024 consultation, two suppliers referred to our growth duty. One supplier said that we had not provided a "substantive explanation" of how we had considered it.

Considerations

5.25 The supplier said that a focus on price competition could lead to poor service quality outcomes for some customers, particularly disengaged customers who would not benefit as much from innovations and new product development.

5.26 An analysis of customer complaints since the lower quartile operating cost benchmark was set in 2018 tends to show that this is not the case as no clear trend was discernible. A lower quartile benchmark has been in place since 2019. Using Ofgem and Citizens Advice data we were not able to identify a pattern of

degradation in service quality across suppliers, as there had been significant progress on several metrics. The quality of service dropped on wait times and number of complaints during 2022 and 2023 with the energy crisis across all suppliers.

5.27 We do not consider that higher service quality necessarily requires higher costs. Although there were differences between suppliers in terms of service quality metrics (eg call wait times and number of complaints), our analysis was not able to find meaningful correlations between those and the level of operating costs reported by suppliers in our benchmarking sample.

5.28 It is possible that there are different combinations of customer services available to reach a high level of customer satisfaction with a high quality of service. For example, investing in a complete online interface, providing different mediums for customer contacts or ensuring a high level of bill accuracy.

5.29 Even to the extent that some forms of customer service may cost more to adapt to different customers' needs, this does not mean that setting a higher allowance than our decision would be in customers' interests. First, there is no guarantee that suppliers would spend any additional revenue on customer service and adapting to different customers. Second, we cannot set different price cap levels across suppliers, so even if some suppliers used revenue for additional service, others might not. The aggregate impact would therefore mean customers paying more than the costs of the additional service provided.

5.30 Furthermore, even customers who prefer additional services would pay more as a result of any increase to the operating cost allowances. This would affect the net impact on them. The financial impact of setting higher allowances would be most significant (as a proportion of income) for customers who are on lower incomes.

5.31 The move to a weighted average benchmark will be less stringent for suppliers compared to a lower quartile approach (see Chapter 4). This means that fewer suppliers are over the benchmarked values and, for the suppliers remaining above the benchmark, the extent of this is reduced.

5.32 Suppliers have been able to reduce their costs below the 2018 benchmark uplifted by CPIH, as shown by the level of allowance we are setting today at the weighted average level. Some over-recovery on the operating cost has therefore been possible which should have helped mitigate the costs of any necessary investments to balance high service quality and efficient costs.

5.33 We have carefully considered feedback about alternative core operating cost benchmark options in 'Appendix 1: Core operating costs'. In relation to our analysis of our chosen weighted average benchmark in this appendix, we do not consider that there is a widespread problem to recognise. We consider that a weighted average benchmark provides room for a range of suppliers to participate in the market, given the additional revenue provided by a weighted average relative to a lower quartile. We recognise that individual suppliers will have specific circumstances and will make their own business decisions in light of the market situation (including the size of cap allowances). However, we must set a single cap level across suppliers, and we must protect default tariff customers.

5.34 We consider that our considerations throughout our publications cover matters relevant to the growth duty, and therefore do not consider that a standalone assessment is required.

5.35 Furthermore, as this is an update of an existing regulatory measure and not a new regulatory action, we do not believe that it would be proportionate to have a standalone assessment.

5.36 Additionally, we consider that the impact on growth will be limited by our approach to setting the operating cost allowances which allows an efficient Notional Supplier to recover their costs. The supplier impact analysis in this appendix did not highlight any significant risks for suppliers or competition between suppliers.

6. Public spend and public sector equality duty

This chapter sets out the impacts of our proposed changes on public spending. We have also summarised our assessment on customers with protected characteristics as part of the public sector equality duty.

Public spending

6.1 We are required to exercise our functions under the Domestic Gas and Electricity (Tariff Cap) Act 2018 with a primary focus on protecting customers on default tariffs, while having regard to specified considerations (see s. 1(6) of that Act). Following the introduction of the Energy Prices Act 2022, those specified considerations include" the need to set the cap at a level that takes account of the impact of the cap on public spending". We note that this consideration was introduced in a context where the cap was being used as a reference price for determining the support provided under the Energy Price Guarantee and, especially given the small size of overall bill impacts, are not aware of any impact likely to result from our decision position.

Public sector equality duty (Equality Act 2010)

6.2 Ofgem is subject to the Public Sector Equality Duty (PSED) so in exercising our functions we must have regard to the need to:

i) Eliminate discrimination, harassment, victimisation, and any other conduct that is prohibited by or under the Equalities Act 2010;
ii) Advance equality of opportunity between persons who share a relevant protected characteristic and persons who do not share it
iii) Foster good relations between persons who share a relevant protected characteristic and persons who do not share it

6.3 In this section, we have summarised our assessment on customers with protected characteristics. Our assessment overlaps with the PSED for the following protected characteristics: disability, age and pregnancy.

6.4 The impact of the operating costs review would be felt through changes in prices paid for energy. In principle, increases in customers' energy bills can impact them through:

a) Direct financial impacts and,

b) Indirect impacts, such as reducing consumption leading to social, physical detriment, mental detriment, and at worst serious health impacts

6.5 The approach we take to benchmark core operating costs would impact the total amount customers would have to pay, reducing it significantly but not as much as if we had retained a lower quartile benchmark (option 2). In 'Appendix 1: Core operating costs' we discussed why we think that retaining a weighted average benchmark, leading to a higher core operating cost allowance, was more adequate to protect customers' best interest in the long-term, particularly customers in vulnerable circumstances. Moreover, the approach we take to allocate debt-related costs would have different cost impacts on customers depending on the payment method they use. We consider that our proposed changes would reduce energy bills for most customers, and at worst lead to a small increase (less than 0.5%) for Standard Credit customers. We therefore do not consider that the proposals lead to large absolute negative financial impacts for any group of customers.

6.6 We recognise that the significance of an absolute financial impact for a particular customer would depend on their financial situation. While low-income customers would have a range of circumstances, we recognise that customers with certain protected characteristics can be more likely to have low incomes. However, this does not change our assessment that the proposals would not lead to large absolute negative financial impacts for any group.

6.7 Further, we have considered whether any of our options under consideration would have significantly different impacts on different customers, and in particular whether any would have a disproportionate impact on any customers with protected characteristics relative to the wider population. We consider that these impacts (if any) would be driven by the allocation decision we make on debt-related costs.

6.8 As explained in Chapter 3, we consider that our decision position (using current cap differentials to allocate debt-related costs), strikes the right balance (relative to the alternative options we have considered) between setting an allowance that reflects the relative risk associated with a payment method, and ensuring the no particular group of customers is disproportionately impacted by socialised costs.

6.9 The key parameter we consider differing across customers is payment method, and so we have sought to understand the prevalence of protected characteristics in each payment type. We have also aimed at reflecting specific categories' current position regarding energy affordability. We have used the latest available

wave of the Consumer Impacts of Market conditions survey (CIM) to explore this further.[20] Initial insights from the 2025 customer research showed that these findings were still relevant.

6.10 The findings of this section show that although the Standard Credit method has a significant proportion of customers with protected characteristics, the majority of customers with protected characteristics customers pay by Direct Debit or PPM. This reinforces the findings from Chapter 3 that our decision position strikes an adequate balance.

Disability or illness

6.11 Ofgem's latest customer research available shows that 42% of PPM customers, 28% of Standard Credit customers, and 29% of Direct Debit customers self-reported that someone in their household has a long-term disability or illness in their household. The proportion of customers with a long-term disability or illness was highest on the PPM payment method even though the highest number of those customers are paying by Direct Debit. 68% of households which reported a vulnerability were struggling with energy bills at least sometimes compared to 62% among all surveyed households.

Low-income

6.12 Additionally, based on participant responses, the proportion of PPM customers (44%) who reported having an income of less than £20,000[21] is higher than that of Standard Credit customers (24%) and Direct Debit customers (21%). Although the majority of households with an income below this threshold were paying by Direct Debit. When considering the households with an income of less than £16,000 we found that 73% of these households were found to be struggling with bills at least some of the time with 30% constantly struggling. This is compared to 20% among all surveyed households.

[20] Ofgem (2024), Consumer impacts of market conditions survey: wave 5 (January to February 2024), Consumer impacts of market conditions survey: wave 5 (January to February 2024) | Ofgem.
[21] For the purpose of this analysis, we have defined low-income as £20,000 (or below). We note that the CIM survey uses salary increments of £5,000 (up until £35,000) and £10,000.

Pensionable age

6.13 However, compared to Direct Debit and Standard Credit customers, a lower proportion of PPM customers reported having individuals aged 65 or older in their household. Specifically, 27% of Direct Debit households and 14% of Standard Credit households reported this, compared to 9% of PPM households. 87% of those households aged 65 or over surveyed were paying using Direct Debit.

Requiring medical equipment support

6.14 The customer research found that this category of customers was split across all payment methods although most of this category of customers pay by Direct Debit. In this category of customer 14% were behind bills compared to 8% on average for all surveyed customers, 71% of this category of customers mentioned that they were at least sometimes struggling to keep up with energy bills compared to 62% for the other customers.

Receiving benefits

6.15 Although the majority of benefits recipients pay using Direct Debit, there is a higher proportion of benefits recipients in Standard Credit and PPM (38% and 61% of the customers of the payment method). In this category of customer 13% were behind bills compared to 8% on average for all surveyed customers. 75% of this category of customers mentioned that they were at least sometimes struggling to keep up with energy bills compared to 62% for the other customers.

With children under 5 or expecting

6.16 While we found no difference in households with children under 5 or expecting, 12% of those tend to behind bills compared to 8% on average for all surveyed customers, 73% of those households were sometimes struggling keeping up with energy bills compared to 62% for other households.

6.17 We also assessed households on the Priority Services Register (PSR) but found no significant differences across payment methods or difference in affordability.

Our assessment (continued)

6.18 Our proposals have generally limited any increases to the premiums these customers with protected characteristics pay. Most of those customers will see some bill savings as they are paying by Direct Debit and PPM. We highlighted above that Standard Credit among those categories will see a small bill increase. We have adopted a balanced approach to allocating debt costs across payment

method. This helped prevent disproportionately impacting payment method with a higher prevalence of protected characteristics.

6.19 We do recognise that our proposed changes would lead to a very small increase in Standard Credit costs, whereas Direct Debit and PPM would show a small decrease. However, we consider this small difference appropriate given the higher cost-to-serve reflected in the evidence. We are also mindful that customers paying by Standard Credit can generally (although not in all cases) opt to switch to a cheaper payment method. Customers with protected characteristics were found across all payment methods and particularly in Direct Debit.

6.20 As we do not expect large negative financial impacts on any customer group, we also do not expect that there would be significant indirect consequences for any group. We recognise that there would be some individual customers whose financial situations mean that even a small increase in their energy bill would require them to make difficult choices, potentially including reducing the amount of energy they consume. We also recognise that the consequences of reducing energy consumption may be particularly significant for customers with certain protected characteristics (eg older customers). We note that suppliers remain subject to licence requirements to support vulnerable customers, including those at risk of self-disconnection.

6.21 The assessment in this section therefore recognises that any negative impacts may be greater for customers with protected characteristics which are associated with having lower incomes, as well as customers with protected characteristics for whom the consequences of reducing energy consumption may be greater. We consider that there may be other protected characteristics, such as religion or sexual orientation, where we have not identified any potential for adverse impacts.

6.22 In that case given the bill reduction for most customers based on the bill impact analysis and the sub £10 average increases for those worse-off we would not expect our decision to create any additional hardship.