Decision

Energy price cap operating cost and debt allowances decision: overview

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This decision concludes our review of operating cost and debt allowances. In this document, we summarise our decisions on how we have restructured the allowances, benchmarked costs across suppliers, allocated costs across different groups of customers and set out an update approach for each cost component. This decision overview is accompanied by several appendix documents that set out our decisions in greater detail, alongside our considerations to stakeholder feedback.

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Executive Summary

On 1 January 2019 we introduced the default tariff cap ('the cap'), pursuant to the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act'), which protects households on standard variable and default tariffs. The cap ensures that default tariff and standard variable tariff customers (jointly referred to as 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 for a typical dual fuel customer.

We followed up by publishing our December 2024 statutory consultation, supported by an extensive disclosure exercise. We set out proposals to set the operating cost allowances as four distinct components: core operating costs, debt-related costs, industry charges and a component to capture the ongoing change in operating costs resulting from the smart meter rollout.

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 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. In acting in customers' interests, we have considered a number of different factors that promote customers' interests including:

- direct price protection through limiting the price that can be charged to different customer cohorts;
- quality of service and support customers receive from suppliers; and
- supplier financial resilience which reduces the risk of supplier failure, the costs of which are mutualised and recovered across customers.

Following our consideration of stakeholder responses, we have reached a set of decisions which, based on our regulatory judgement, balance the various considerations set out in the Act (including having regard to the need to ensure suppliers who operate efficiently are able to finance their licensed activities and that there are incentives to improve efficiency). We set out an overview of our decisions in this document and further detail

of our decisions, rationale and consideration of stakeholder responses in the accompanying appendices.

Decision impact

The impact of this review is an average reduction of £8 per customer in the cap. The table below provides a breakdown by payment method – in Chapter 2 we also provide further splits by cost component. For comparability, we display the allowances as they would have been in the April 2025 cap period.

Total allowance by payment method (£ per customer, April 2025 cap prices)

Payment method	Decision values	Change on current approach
Direct debit	280	-15
Standard Credit	427	9
Prepayment	288	-3
Weighted Average	312	-8

Notes: Dual fuel, benchmark consumption (3,100 kWh electricity 12,000 kWh gas). Pre-levelised levels. Weighted average calculated using January 2025 SVT customer numbers.

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 publication 'Consumer confidence: a step up in standards' outlined our goal that all customers receive not just a good service but one that sets the highest standard for all service sectors.[1] In January 2025 satisfaction with customer service was at its highest since 2020, increasing from 71% in July 2024 to 74%.[2] To be clear, we do not believe that good customer service necessarily means higher costs. However, we do think that it is in customers' interests 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

[1] Ofgem (2024), Consumer confidence: a step up in standards. https://www.ofgem.gov.uk/publications/consumer-confidence-step-standards
[2] Ofgem (2025), Energy Consumer Satisfaction Survey: January 2025 interim findings. https://www.ofgem.gov.uk/publications/energy-consumer-satisfaction-survey-january-2025-interim-findings

stringent benchmark for suppliers to meet on operating costs. Our data suggests that despite increased challenges, suppliers have generally become more efficient since the cap was introduced, in part due to significant investment in new IT systems and invest-to-save measures.

However, the cap is no longer a temporary measure, and we consider the most significant efficiency savings have now been captured and future savings may be offset by new costs as the energy sector transitions to a more flexible market.

We have therefore decided to set the core operating cost allowance on the following basis:

- Set the allowance at a weighted average level using 2023 supplier cost data;
- Allocate costs across payment methods in a cost reflective manner (pre-levelisation);[3]
- Continue to spread costs between the unit rate and standing charge, whilst also passing on savings from this review to the standing charge

We have made two key changes following consultation. Firstly, we have included more suppliers in our sample when allocating costs between payment methods. This reduces the risk of under-recovery for a notional efficient PPM supplier. For customers, while the cost of this will be recovered broadly from across PPM and DD customers, it reduces the risk of supplier failure, the costs of which are borne by customers, and enables suppliers to continue providing a high level of support to PPM customers.

Secondly, we have included a small upwards adjustment for the increase in employer National Insurance Contributions (NICs). In this case, we consider it appropriate to allow recovery of employer NICs costs as it results from changes in economic policy, which is passed through to suppliers.

Debt-related costs

The energy crisis has also resulted in rising levels of energy debt. 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, levelising certain PPM and direct debit costs and ensuring additional support credit is available as a last resort for customers at risk of going off-supply. In December 2024 we published our

[3] Levelisation allocates some PPM costs across direct debit customers to reduce the level of additional costs PPM customers face.

debt strategy which outlined proposals to reset household debt and raise debt standards. This includes proposals for a debt relief scheme, a 'Debt Guarantee' and standardising the approach suppliers take to assessing a customer's ability to pay.[4]

Nevertheless, the costs of providing energy are borne by suppliers and so the costs of unpaid bills need to be met. 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.

To set the debt-related cost allowance, we have decided to:

- Set the allowance using a weighted average benchmark across the market, based on observed debt costs over 2023 and 2024. After considering the latest data, we have decided to set the allowance at the bottom of the range consulted on, at £71 per customer per year, on average. While this is a change in the structure and permanence of debt costs in the cap it reflects a similar level to costs already paid by customers (representing a £2 increase versus current allowances). This will vary over time with overall bill size as we set the debt allowance as a percentage of the cap level.
- Retain the current differences between direct debit and standard credit customers. While standard credit customers are more likely to incur higher debt-related costs on average, we consider that we would not be protecting the interests of default tariff customers taken as a whole, if one group of customers was to disproportionately bear the costs of the minority who are in debt. Nor do we consider that there is compelling evidence that recovering a greater proportion of costs from standard credit customers would materially improve the distribution of under- and over-recovery of debt costs across actual suppliers.

Debt costs are inherently uncertain and may change in future as a result of changing economic circumstances or broader policy interventions. We will keep these costs under close review going forwards and consider the case for further ex-ante changes if costs depart from allowances in a systematic and material way. We also remain committed to reviewing the temporary backwards-looking debt allowances against actual data once full data is available.

Smart metering costs and Industry Charges

We have retained the current approach to setting the Smart Meter Net Cost Change (SMNCC) allowance, until we have greater clarity on the post-2025 rollout framework.

[4] Ofgem (2024), Debt Strategy: a 'reset' and 'reform' for customers in debt. https://www.ofgem.gov.uk/publications/debt-strategy-reset-and-reform-customers-debt

While we have made several consequential changes to reflect the new core operating cost baseline, these updates are procedural and do not change the underlying policy intent when calculating the allowance. Following stakeholder responses, we have updated the calculation of the PPM cost to serve benefit using latest available data to address uncertainties in PPM costs.

We have decided to implement our proposed pass-through allowance for industry charges using business plans and charging statements.

Next steps

In conclusion to this operating cost review, the new set of allowances will be implemented in the July 2025 cap (cap period 14b). However, there are remaining related policy areas where we intend to carry out further work.

Consumption review

Average energy consumption per customer is an important assumption used in setting the price cap. Average energy consumption per household has been declining in recent years, and its position relative to benchmark consumption (the consumption level we use to set the cap) remains uncertain in the long run. Furthermore, we observe differences in average consumption between payment methods (eg lower average usage for PPM customers) that are not currently reflected in how we set the cap.

While we do not update this figure regularly, some stakeholders raised the risk that continuing to rely on historical estimates may lead to systemic issues where the resulting cap is set at a level where some efficient suppliers may be unable to recover their fixed costs (costs that do not vary by usage).

While we have decided to not make an adjustment to the consumption level used to set the cap at this stage, we will continue to monitor consumption trends and intend to review the consumption level used to set the cap in the coming year.

Debt True-up

As previously signalled it is our intention to carry out a review of debt costs in relation to the "float" allowance that will be ending in July 2025. We intend to carry out this review when we have full available evidence on the materiality of debt-related costs up to the implementation of the operating costs review (July 2025), and of any interactions with wider debt strategy work.

1. Introduction

In this chapter, we set out the process we have undertaken across this review. We also outline the various frameworks we have considered to reach our final decisions.

Context and related publications

1.1 This publication sets out our decisions on the review of the operating cost allowances in the price cap.

1.2 The key general documents relating to the price cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018
- 2018 decision on the cap methodology

1.3 The key documents relating to this publication are:

- May 2023 call for input on the operating cost allowances review
- October 2023 operating cost review benchmarking working paper
- May 2024 operating cost allowances review consultation
- August 2024 smart metering costs working paper
- December 2024 operating cost and debt allowances consultation
- February 2025 decision to extend the additional debt related costs adjustment allowance

Our decision-making process

1.4 We sought stakeholders' feedback through an initial call for input in May 2023, two working papers in October 2023 and August 2024 (on our approach to benchmarking and on the smart metering cost allowance respectively), and two consultations in May 2024 and December 2024. Stakeholders' responses to these publications have informed our final decision.

1.5 In February 2025, we published a decision on the extension to the additional debt-related costs adjustment allowance.

1.6 The table below summarises these key stages of our decision-making process. Any non-confidential responses received to our publications have been published on the relevant consultation page.

Decision-making stages

Date	Stage description
May 2023	Initial call for input on the operating cost allowances review, setting out the case for change and our early thinking and considerations.
October 2023	Working paper on benchmarking for the operating cost allowances review, setting out our initial ideas on developing a framework for choosing between a range of potential benchmarking options.
May 2024	Policy consultation on the review of the operating cost allowances, setting out options for restructuring the allowance in four new areas: core operating costs, debt-related costs, smart metering costs and pass-through industry charges.
August 2024	Working paper on options for the simplification of the smart metering cost allowance.
December 2024	Statutory consultation and extensive disclosure exercise on the review of the operating cost allowances, setting out our minded-to position across the four new allowances. This included a proposal to extend the current additional debt cost allowance until the implementation of the operating cost review or the end of September 2025, whichever is sooner.
February 2025	Decision to extend the additional debt related costs adjustment allowance.
May 2025	Decision on the operating cost allowances review.

General feedback

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

1. Do you have any comments about the overall quality of this document?
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. Are its conclusions balanced?
5. Did it make reasoned recommendations?

6. Any further comments

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

Decision-making framework

Price Cap and legislation

1.7 The default tariff cap ('the cap') was introduced on 1 January 2019 and protects 22 million default tariff and standard variable tariff customers (referred to collectively as default tariff customers).[5] The cap ensures that default tariff customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy.

1.8 The price cap legislation sets out the objective and five matters we must have regard to in setting the cap.[6] 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.

1.9 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.

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

1.10 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).[7] We do this by setting a cap level that reflects a notional supplier. We define a notional supplier as a theoretical and efficient supplier that has no direct comparison with existing suppliers but draws from the properties across efficient suppliers in the market. We consider protecting customers means that prices reflect the underlying efficient costs of a notional supplier. We can set different cap levels for different regions or cases, such as different payment methods, but each cap level still cannot vary by supplier.[8]

1.11 In reaching the decisions put forward in this review, we have sought to achieve the objective set out in the Act to protect existing and future default tariff customers. Through our regulatory judgement, we have balanced the various considerations set out in the Act (including the need to ensure suppliers who operate efficiently are able to finance their licensed activities and the need to create incentives to improve efficiency).

1.12 We have considered the legislative framework across our decisions on each of the components that make up the operating cost allowances. We detail our rationale and considerations across the appendices to this decision.

Consumer interest overview

1.13 We have also used Ofgem's Consumer Interests Framework to help support our consideration of how to best protect existing and future customers 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.[9]

1.14 We consider these outcomes are relevant to the setting of the cap and align with the legislative framework outlined above.

Growth duty

1.15 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

[7] For example, see section 1(1) of the Domestic Gas and Electricity (Tariff Cap) Act 2018.
[8] See section 2(1)(f) of the Domestic Gas and Electricity (Tariff Cap) Act 2018.
[9] Ofgem (2024), Ofgem's Multiyear Strategy. https://www.ofgem.gov.uk/our-strategy-and-priorities

economic growth and ensure any regulatory action we take is necessary and proportionate.[10] We have considered the statutory guidance provided.[11]

1.16 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 (and more generally through the considerations in this decision).

Overarching considerations and trade-offs

1.17 As set out in the previous section, there are several decision-making frameworks we consider when making price cap decisions. We have exercised our functions under the Act with a view to protecting existing and future domestic customers who pay standard variable and default rates and sought to achieve this through a number of considerations and trade-offs.

1.18 The level of operating cost allowances materially and directly impacts the prices paid by customers on default tariffs and the revenues received by suppliers. Consequently, it is important to consider cost recovery in the context of our legislative objective to protect default tariff customers, having regard to the relevant statutory criteria such as ensuring an efficient supplier is able to recover its costs. Throughout our decision making, our balancing of the legislative criteria can be seen in various different ways, including in how we consider the level of the cap relative to existing market costs (referred to as stringency), as well as in relation to standards and resilience.

1.19 Two key areas we've considered alongside direct price protection are quality of service and supplier financial resilience. Both are key outcomes in the Consumer Interest Framework and valuable factors in protecting customers.

1.20 Quality of service is an important element of protecting customers by ensuring they are supported and treated fairly. While we consider good quality customer service does not necessarily cost more, we are able to take decisions that enable

[10] Section 108, Deregulation Act 2015. https://www.legislation.gov.uk/ukpga/2015/20/section/108
[11] Department for Business & Trade (2024), Growth Duty: Statutory Guidance - Refresh. https://assets.publishing.service.gov.uk/media/66476caebd01f5ed32793e09/final_growth_duty_statutory_guidance_2024.pdf

suppliers to recover efficient costs associated with undertaking a range of activities beyond their minimum obligations.

1.21 Financial resilience is key to having an investible energy market that promotes innovation and allows suppliers to support customers under a greater diversity of business models. Setting an allowance in the cap too low could create a risk of failure for some suppliers. The cost of supplier failure is mutualised and recovered across customers, so it is in customers' interests to have a resilient market. Resilience is also relevant to our consideration of whether efficient suppliers are able to recover their costs.[12] There is a greater degree of risk where cost differences between suppliers aren't solely explained by differences in efficiency. For example, differences in suppliers' customer bases could impact the costs they face.

1.22 One area of the decisions where we have balanced various customer interests, such as price protection, quality of service and resilience, is our choice of benchmark metric. We have decided to move away from a lower quartile benchmark and move to a weighted average benchmark. In 2018, we set the operating cost benchmark using a lower quartile approach to specifically drive efficiencies across suppliers. Since then, there has been significant investment and re-platforming to address these inefficiencies. Given driving further efficiency savings is no longer our primary consideration, a weighted average approach is more appropriate. This approach enables suppliers to recover efficient costs related to the support provided to customers (relative to a more stringent benchmark metric), whilst also providing greater mitigation for uncertainties and potential future cost changes.

1.23 In other areas, we have prioritised customer protection for certain groups. For example, our debt allowance retains the current price difference between payment methods. While debt costs must be met, we consider they should be shared as widely as possible across paying consumers, rather than shouldered disproportionately by a group which may include a minority who are in debt. We have also decided to maintain our approach of recovering core operating costs between the standing charge and unit rate. This protects customers against a rise in standing charges that a cost reflective allocation would bring.

1.24 We discuss our decisions across the allowance in greater detail over the following chapters and in the appendices to this decision. Additionally, the impact

[12] Section 1(6)(d) of the Domestic Gas and Electricity (Tariff Cap) Act 2018.

assessment to our decision outlines our analysis of the customer and supplier impacts of our decided positions relative to key considered alternative options for setting the allowances. It also details our consideration of our Public Sector Equalities Duty.

Wider consumer protection

1.25 Overall, we are confident that we have found the right balance across customer outcomes for this review. However, we note this allowance is just one small element of the wider regulatory landscape.

1.26 Protecting the interests of energy consumers is our principal objective. We continue to develop and deliver policies to enhance protection outside of the cap. On customer service quality, we have introduced greater requirements to ensure suppliers are able to best support customers without power or a gas supply due to a meter fault.[13] We are working on further protections through the debt relief support scheme. We discuss the interaction between this and our decision on the debt related cost allowance in the price cap in Chapter 3.

1.27 To support financial resilience in the market and reduce the risk of supplier failure, the costs of which are recovered from customers, we have introduced several measures.[14] These include, amongst other things, the Financial Responsibility Principle and a Minimum Capital Requirement. The aim of such measures is to ensure suppliers put their own capital at risk and ensure they are not relying on their customers' money to fund their business.

1.28 We consider that the outcome of this review complements our wider work. The operating cost review is an incremental update to the current cap methodology. 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.

[13] Ofgem (2025), Consumer Standards: Supplier 24-7 Metering Support. https://www.ofgem.gov.uk/decision/consumer-standards-supplier-24-7-metering-support

[14] Ofgem (2024), Financial resilience in the energy retail market. https://www.ofgem.gov.uk/energy-policy-and-regulation/policy-and-regulatory-programmes/financial-resilience-energy-retail-market

2. Overview of Decisions

In this chapter, we provide a summary of our decisions based on what we have and have not changed since our December 2024 statutory consultation. We follow this with a more detailed summary of our decisions by cost component.

Structure of the allowances

2.1 When we established the cap, operating costs were spread across three cost components in the cap:

- **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.
- **Payment method uplift:** this allowance accounted for the additional costs of serving Standard Credit and Prepayment Meter (PPM) customers respectively. Broadly, the Standard Credit uplift has reflected higher debt and administrative costs associated with the payment method and the PPM uplift has reflected higher metering costs.
- **Smart Meter Net Cost Change (SMNCC):** this allowance is set annually and is intended to capture the change in overall operating costs that has resulted from the roll-out of smart meters.

2.2 We have decided to restructure the operating cost allowances to provide greater transparency of where various types of costs are captured. The new structure also allows us to apply different calculation and update approaches where appropriate.

2.3 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 1 sets out how the existing three operating cost allowances map onto the new four allowances in the cap. It is worth noting since April 2024 the price cap has included an adjustment allowance for additional debt-related costs.[15]

[15] Ofgem (2024), Energy price cap additional debt costs review decision. https://www.ofgem.gov.uk/sites/default/files/2024-02/Energy-price-cap-additional-debt-costs-review-decision.pdf

Table 1 – Mapping of the new allowances against the 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 **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 **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 have decided to include a

New allowances under the operating costs review	Elements of existing allowances used to create like-for-like comparison
	working capital reallocation in future for PPM as well). **Change in smart metering costs since the 2017 baseline (SMNCC)** • Very small modelled impact from smart meter roll-out on debt would be reflected in debt RFI data
Smart metering net cost change (SMNCC)	**Change in operating costs resulting from smart meter roll-out from the 2017 baseline (Non-pass-through NPT SMNCC)** • Additional roll-out 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 Distribution Connection and Use of System Agreement)	**Operating costs for a Direct Debit customer (OC)** 1. Elexon and Xoserve charges (explicitly included in current operating cost baseline) 2. Other non-smart industry charges (implicitly included in current operating costs baseline) **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

Summary of decisions

2.4 In reaching our decision on this operating cost review, we have sought to balance several outcomes. As highlighted in the previous chapter, these include the legislative requirements for us to carry out our functions with a view to protecting default tariff customers (including by enabling suppliers to continue supporting customers) and having regard to supplier financial resilience.

2.5 Overall, our decisions have led to an £8 decrease in the operating cost allowances compared to the current approach (on average across the payment methods). This largely reflects that suppliers have become more efficient since the current approach was designed using 2017 data.

Decisions that have not changed following consultation

2.6 We have balanced this decrease by setting a weighted average benchmark across the allowances. This is a departure from the more stringent lower quartile approach used for the current allowances which reflected the greater need and

priority for efficiency improvement in 2018 when the cap was designed. We consider under the weighted average approach suppliers will be able to continue providing customers with the right support and that this choice of benchmark will mitigate against changes in costs.

2.7 We have exercised our regulatory judgement when considering how we set costs between groups of customers. The costs are more easily attributable to specific groups of customers for core operating costs (eg PPM and direct debit have distinctly different traditional meter costs). Therefore, we have adopted what we consider is a cost reflective approach of assigning relevant costs to the given payment methods.

2.8 Debt-related costs differ in this respect. For example, bad debt costs reflect the costs incurred by a minority who do not pay their energy bills and are recovered from those who do. As such we do not think a "cost reflective" approach at the customer level is a very informative principle here. While standard credit does imply some modestly higher level of direct debt-related cost (ie higher working capital) and likely some indirect propensity towards debt, this is limited. We consider the current cap payment method differentials for debt costs maintain an appropriate balance between allowing a differential due to higher costs to serve on average and protecting customer interests. While we acknowledge this will see some suppliers under-recover their debt costs and others over-recover, we do not consider that a higher differential would materially improve this distribution of supplier impacts.

2.9 We have decided to set an allowance based on our analysis of supplier debt data – we have set the debt allowance as 3.6% of bills on average (this equates to approximately £71 in the April 2025 cap). However, we're mindful this data may change over time and so we will continue to monitor the situation and may consider the possibility of an ex-post adjustment if appropriate.

Decisions that have changed following consultation

2.10 Following stakeholder feedback to our December 2024 statutory consultation, we have made modest changes to our position reflecting concerns raised. These changes are summarised below and detailed further in the following section.

2.11 Firstly, we have made an adjustment for the increase in National Insurance Contributions that was implemented from April 2025. This adjustment increases the allowance by £1.24 per customer. We have decided not to adjust for other costs suppliers said may increase in future. We explain our rationale for this in the following section.

2.12 Secondly, we have made two adjustments to reduce uncertainties in PPM costs, which could lead to under-recovery for a notional efficient supplier with an above average PPM customer base. The adjustments increase the PPM level of the allowances by £10 relative to our statutory consultation positions, though the impact of this on customers will be significantly offset by levelisation of standing charges between PPM and direct debit customers. Despite these increases, PPM customers continue to see a reduction in bills resulting from this operating cost review.

- We have reduced the PPM cost to serve benefit in the smart allowance. We have scaled down the benefit to reflect observed reductions over time in smart meter data collected by the Department of Energy Security and Net Zero.
- We have adjusted the supplier sample for payment method allocations for core operating costs. We have decreased the threshold for supplier inclusion (from 100k to 50k customers) when allocating costs between payment methods. This means we include an extra supplier in our sample.

2.13 For the debt allowance we have made two changes to our proposed position. Firstly, we have weighed up the evidence from the latest data submission, along with stakeholder feedback that our proposed approach risked too much emphasis on the most recent periods. Taking these factors into consideration has led us to a debt allowance of £71. This corresponds with the bottom of the range originally consulted on. However, it is above the number that would have resulted from simply updating our consulted-on position with the latest data.

2.14 Secondly, we have changed our approach to allocating costs to fuel types. We have decided to base this on bill size rather than supplier reported revenue. Stakeholder feedback highlighted issues with using reported revenue to set the fuel type allocation. This change has limited impact on the overall debt allowance per dual fuel customer, however will change what suppliers can recover based on their customer fuel type profile and will avoid placing too much of the debt burden on electricity only customers.

2.15 While we have addressed several areas raised in responses, we are aware of the remaining need to consider the impacts of energy consumption on the cap. Average consumption across the market has been declining and its position relative to benchmark consumption (the consumption level we use to set the cap) remains uncertain in the long run. Furthermore, there are differences in average consumption between payment methods (eg lower average usage for PPM

customers) that are not currently reflected in how we set the cap. Where we have allocated fixed costs across the unit rate, both factors could lead to under-recovery of efficient costs.

2.16 We have decided not to make an adjustment at this stage given the uncertainty in long-term consumption trends. Furthermore, splitting consumption in the cap by payment method would require further consideration and consultation.

2.17 We continue to monitor consumption trends and intend to review the consumption level used to set the cap in the coming year.

Table 2: Allowances by component and payment method

Payment method	Component	Decision	Vs Statutory consultation	Vs Current approach
Direct Debit	Core operating costs	194	0	-14
Direct Debit	Debt	58	-2	1
Direct Debit	SMNCC	-4	1	-5
Direct Debit	Industry Charges	32	0	3
Direct Debit	**Total**	**280**	**-1**	**-15**
Standard Credit	Core operating costs	233	0	4
Standard Credit	Debt	166	-2	6
Standard Credit	SMNCC	-4	1	-5
Standard Credit	Industry Charges	32	0	3
Standard Credit	**Total**	**427**	**0**	**9**
PPM	Core operating costs	254	6	-8
PPM	Debt	20	-3	0
PPM	SMNCC	-18	5	1
PPM	Industry Charges	32	0	3
PPM	**Total**	**288**	**8**	**-3**
Weighted average	Core operating costs	212	1	-9
Weighted average	Debt	74	-2	2
Weighted average	SMNCC	-6	2	-4
Weighted average	Industry Charges	32	0	3
Weighted average	**Total**	**312**	**1**	**-8**

Note: Table shows the allowances for a dual fuel customer with benchmark consumption (3,100 kWh electricity and 12,000 kWh gas). Weighted average calculated using January 2025 SVT customer numbers. The £74 debt allowance noted above is the equivalent of

the £71 value from Appendix 2 applied as a combination of percentage scalar and flat allowance to the cap 14a cost stack.

2.18 To create a like-for-like comparison against the current approach within Table 2, the existing allowances have been translated to match the structure of the decision allowances. For example, there is a material reduction in the SMNCC allowance between the April 25 and July 25 caps due to our decisions being implemented. This reflects that we have updated the baseline year for core operating costs from 2017 to 2023. Changes to smart metering costs between these years are therefore now factored into the new baseline, rather than being part of the SMNCC. This change therefore represents a mechanical consequence of updating the baseline, rather than an overarching change in approach. Given this, the difference between 2017 and 2023 smart costs is captured within the £8 reduction stated for core operating costs. Without capturing these differences the reduction would appear much larger but be offset by a corresponding decrease in the SMNCC.

2.19 As a result, changes between the decision and current approach for individual allowances within Table 2 will not reconcile with the same components within the cap update. Given the changes to the structure of the operating cost allowances, a like-for-like comparison should only be made when comparing all components of the cap impacted by the operating cost review.[16]

2.20 The allowance values have changed relative to the statutory consultation position, reflecting the changes in our positions above. To provide a meaningful comparison to the December 2024 statutory consultation, we have recalculated the allowance based on our statutory consultation positions for cap period 14a (April 2025 – June 2025). If we compared the decision to the numbers in our December 2024 publication, which were based on cap period 13a (October-December 2024), this would capture both the ongoing cap updates and changes in our position. For example, for the SMNCC, this would capture the difference in allowance between cap periods 13a and 14a, as well as the reduction in the PPM cost to serve benefit.

[16] This would be a comparison between PAP, PAAC, operating costs, Adjustment Allowance and SMNCC under the current approach, to core operating costs, debt-related costs, SMNCC and industry charges under the new approach.

Decisions by cost component

2.21 We provide a summary of our decision across the cost components below. For the core operating cost and debt-related cost allowances, we break this down into several areas, including:

- Benchmark metric
- Baseline period and costs
- Allocating costs
- Update approach

2.22 For further detail and explanation of our decisions, please refer to the appendices published as part of this decision:

- 'Appendix 1 Decision – Core operating costs' and
- 'Appendix 2 Decision – Debt-related costs'
- 'Appendix 3 Decision – Smart metering cost'
- 'Appendix 4 Decision – Industry charges'

2.23 All the summaries in this chapter should be read in conjunction with the relevant appendices, as the summaries are not intended to be exhaustive.

Core operating costs

Benchmark metric

2.24 We have decided to set the core operating cost allowance using a weighted average benchmark. This is a departure from the current approach where we set the allowance based on the lower quartile supplier minus £5 for further efficiency factors.

2.25 We recognise that some higher costs (eg from serving vulnerable customers) may not be fully in suppliers' control and could be a function of non-efficiency characteristics relating to the supplier's customer base. Setting a weighted average reduces the risk that a notional supplier with a non-typical customer base might under-recover its efficient costs. This enables a wider range of suppliers to continue supporting their customers' diverse needs. Under the Act we cannot set different cap levels for different suppliers and must protect default tariff customers, so we cannot eliminate the risk of any individual supplier under-recovering its costs (even where these were incurred efficiently).

2.26 Suppliers have made efficiency improvements since the cap was introduced. As suppliers have carried out extensive investment and re-platforming to improve

efficiency and reduce costs, the scope for further overall step-changes in efficiency may be limited. However, we do think there is still scope for technological advancements leading to greater efficiency (eg the role AI may play in furthering digital and operational efficiencies).

2.27 Our decision seeks to protect default tariff customers, the objective set out in the Act. We achieve this by balancing overall customer interests through price protection, quality of service and supporting supplier financial resilience to reduce the cost of unplanned exits to customers, all important elements of customer protection. We consider a weighted average benchmark better enables continued improvement to customer service standards and reduces the risk of costly supplier failure compared to a benchmark which could risk being overly stringent in the circumstances.

2.28 We seek to reduce regulatory uncertainty and the burden of needing to frequently adjust the allowance. We consider our approach will account for foreseen uncertainties in operating costs reducing the need to revisit the allowance every time a modest additional cost driver occurs.

Baseline period and costs

2.29 We have decided to use 2023 data to set the core operating cost allowance. We consider 2023 cost data to reflect the latest market conditions and be less likely to have been impacted by any external events in comparison to 2022 cost data. We also have confidence in the data after scrutinising it and requesting further clarifications on specific cost lines from suppliers.

2.30 Several stakeholders highlighted a few future cost increases that are unlikely to be captured in the 2023 cost data (eg Market-wide Half-Hourly Settlement or MHHS costs, sales and marketing as switching returns). We acknowledge costs might have increased since the 2023 RFI data, though noting uncertainties around future costs. However, some costs lines may have also decreased (eg the administrative costs for the Energy Bill Support Scheme). We have seen evidence of some supplier operating costs falling in 2024, so adjusting for upward cost pressures in isolation risks setting a benchmark above efficient costs.

2.31 We have decided to make a small adjustment for the increase in employer's National Insurance Contributions (NICs). This cost differs from other areas such as MHHS as it's an economic policy change that is a pass-through cost to suppliers. We set an upward adjustment of £1.24 based on our modelling using supplier staff costs and OBR economic data.

2.32 We have decided not to make an adjustment for National Living Wage (NLW) increases. While the NLW is also an economic policy, we expect that these cost changes will vary more between suppliers than the employer's NIC changes. This reflects that the impact of NLW changes will depend on the proportion of a supplier's staff paid the NLW, whereas the change to employer's NICs will affect a supplier's entire UK-based workforce.

2.33 In setting an adjustment for NICs, we assume none of the increase is covered by inflation. In reality, we expect that inflation indexing of the overall allowance will offset some of the additional costs from the NLW increase. We have considered in the round our approach to measuring the increase in NICs and whether to make an adjustment for NLW increases, so our decisions should be viewed in this context.

Allocating costs

Payment method

2.34 We have decided to use a cost reflective approach to allocating core operating costs between payment methods. To achieve this, we have decided to benchmark the cost differential between payment methods across suppliers with more than 50,000 customers on each of the relevant payment methods. For example, to set the allowance for PPM, we calculate the differential between PPM and direct debit for each supplier with above 50,000 PPM and direct debit customers. We then take the weighted average of these cost differentials. Finally, we allocate costs between direct debit and PPM to maintain this differential and a weighted average over payment methods equivalent to the aggregate benchmark.

2.35 We consider benchmarking the cost differentials as opposed to the individual payment method costs is appropriate, as the differentials between payment methods are less susceptible to being amplified by low or high-cost suppliers. Furthermore, the allocation better reflects the differences in cost to serve seen within suppliers' RFI data.

2.36 Restricting the sample ensures that the suppliers captured in the sample have costs reflective of serving that given payment method. In our December 2024 statutory consultation, we proposed a 100,000 customer threshold. In response, a few suppliers disagreed with the threshold we set.

2.37 We are mindful that the 100,000 customer threshold was particularly sensitive for the PPM level of the core operating cost allowance. We have decided to lower the threshold to address some of the cost uncertainties that a notional supplier with

an above average proportion of PPM customers may face. This change increases the core operating cost allowance for PPM by approximately £5. We consider this approach provides an appropriate balance of protecting PPM customers through a decrease to the overall allowance, whilst reducing the risk of cost under-recovery for PPM suppliers. The impact on PPM customers will be mitigated by levelisation.

Unit rate and standing charge

2.38 We have decided to apply the reduction in the core operating cost allowance to the standing charge to benefit direct debit and PPM customers with low usage. In doing so, we have calculated new standing charge and unit rate allocation percentages for the three payment methods and two fuels. To note, this differs to the SMNCC and Industry Charges allowances, where we maintain the current split of costs between the standing charge and unit rate, given neither of these areas has seen a reduction from our review.

2.39 We received comments from stakeholders suggesting that average consumption has fallen below benchmark consumption. This means an increased risk of a notional supplier under-recovering its efficient costs. This impact would be exacerbated for PPM suppliers as PPM customers typically consume less than average.

2.40 While average consumption fell over the COVID-19 period, we observed an increase between 2022 and 2023 in electricity and gas consumption. Average electricity consumption remains approximately in line with benchmark consumption while gas is slightly below. Given the recent increase, we consider the longer-term trend of energy consumption to be uncertain.

2.41 We recognise that on average PPM customers consume less energy than the average across payment methods. On the other hand, direct debit customers consume more than average. A notional supplier with an average mix of customers across payment methods will recover its efficient costs in aggregate over the payment methods. However, a notional supplier with a greater than average proportion of PPM customers may under-recover its efficient costs, all else being equal. It is important that PPM customers continue to be financially viable for suppliers to serve to ensure they continue to receive the appropriate level of service and support.

2.42 While our decisions in the round reduce the risks of cost under-recovery for PPM suppliers (as outlined above), we are mindful of the ongoing uncertainty regarding PPM-specific consumption. Implementing consumption profiles for each

payment method at this stage would be a significant change to the cap and would therefore require further consideration and consultation.

2.43 We intend to monitor trends in energy consumption and formally review our approach to consumption in the cap in the coming year.

Fuel allocation

2.44 To allocate costs across the two fuels, we have decided to use a weighted average fuel type allocation. To achieve this, we use suppliers' allocation between fuel types to calculate the weighted average core operating costs for electricity and gas customers.

2.45 This approach retains a cost reflective cost allocation whilst minimising the risk associated with relying on any single supplier's cost allocation, which can vary due to inconsistent allocation approaches among suppliers.

Update approach

2.46 We have decided to update the core operating cost allowance by indexing it to CPIH for future cap periods. This approach is consistent with how we currently update operating costs.

2.47 We consider this approach is the most appropriate to carry out a mechanistic update of the allowance. The CPIH inflation index will reflect the changes in efficient operating costs that we expect to take place over time. We did not receive views on alternative indices we could use instead of CPIH to index the allowance.

2.48 We received suggestions to carry out regular reviews of the operating cost allowance. We do not consider frequent reviews of the core operating cost allowance would be beneficial. This would create regulatory uncertainty and reduce incentives to improve efficiency, as suppliers would have less time to benefit from efficiency improvements.

2.49 Costs could change over time in both directions and it's possible that where the net of these changes is an increase, this could outpace CPIH. We will continue to consider whether an adjustment to the cap is appropriate where the costs materially and systematically diverge from the allowance. However, as part of any assessment, we will account for the looser stringency at which we have set the benchmark by opting for a weighted average approach.

Debt-related costs

Benchmark approach

2.50 We have decided to set the debt allowance using a weighted average benchmark of total costs, set at an aggregate level across all components of debt-related costs. We consider this will help to mitigate the risk of setting an unachievable benchmark, enabling suppliers to recover their notionally efficient costs, which is in the interests of current and future customers. It would also enable suppliers to provide a wider range of support, relative to a more stringent benchmark.

Baseline Period

2.51 When benchmarking industry costs to set the allowance, it is important to observe the cost data across a period of time which is representative of expected future costs. Debt-related costs were at their highest levels across 2023, and we've seen a decreasing trend in costs across 2024. However, it's still too early to conclude if costs have peaked. 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. We consider the primary driver of debt-related costs to be customer affordability, and we acknowledged that many customers are still facing financial challenges with likely high debt costs. For this reason, we have decided to set the baseline on a combination of the data from 2023 and 2024 to allow an approach that we consider is representative of expected future costs while also recognising the uncertainty about how costs might progress over time.

2.52 In December we consulted on a range that the allowance could fall within after we updated our analysis with Q4 2024 data. The lower end of this range uses a baseline made up of the most recent four quarters (2024), and the upper end of the range uses a baseline period made up of the most recent eight quarters of data (2023 & 2024). The position proposed in the December 2024 statutory consultation was to set the allowance in the mid-point of this range, which, based on the latest data at the time, was £73 per customer per year.

2.53 While the latest data for Q4 2024 has shown an increase on Q3 2024, it is still in keeping with the lower level seen across 2024 relative to 2023. Updating this range with Q4 2024 has shifted the limits of the range, resulting in a mid-point of £68, which is a decrease of £5 per customer per year compared to the consultation proposal.

2.54 We have however taken on board stakeholder feedback relating to the relative weighting between periods used within our range. We agree there is a risk in

weighting the most recent quarters too highly, not taking into account downward corrections in 2024 for pessimistic provisioning during the peak of the crisis and changes to provisioning methodologies in the most recent data. This position is also informed by the rate of continued increases in customer debt and arrears, a leading indicator which continues to rise.

2.55 Weighing up stakeholder feedback and the evidence from the latest data submissions has led us to set the allowance at the bottom of the range consulted on, which means a debt allowance of £71 per customer per year[17], a £2 decrease in the debt allowance figure compared to the December 2024 consultation position. This is however an increase of £3 per customer per year compared to simply carrying out a mechanical update of our proposed position with the latest data. In doing so, we consider this allows for a more balanced weighting between the periods.

Allocating costs

Payment method allocation

2.56 We have decided to allocate debt-related costs across payment methods using the current differential approach. We consider this appropriately balances the case for reflecting relative direct debt related costs and indirect debt risks associated with a payment method, with overall customer interests of socialising debt costs evenly across the broader customer base.

2.57 The cap has broadly followed principles of cost reflectivity when setting the allocation of allowances. This approach tends to have benefits for both consumers and industry. However, it is not always clear what constitutes a cost reflective approach. This is particularly true of debt costs which by definition are incurred by one set of customers and paid for another set of customers. As such we do not consider that cost reflectivity as a principal can be neatly applied to debt-related costs in the way it can for other allowances. The current differentials in the cap were developed based on the differentials observed in the market. It was observed at the time that no supplier priced in the average additional cost to serve the standard credit payment method, that was reported through supplier cost data.

[17] This is an estimation based on the 14a cap levels, in benchmark consumption (3100 kWh for electricity & 12,000 kWh for gas). This figure will change once it is converted into a percentage and then reflected in 14b cap levels.

2.58 Our evidence indicates that, on average, standard credit customers are more likely to be in debt compared to other payment methods. However, this does not mean that all standard credit customers are higher cost to serve, nor that suppliers with more standard credit customers will necessarily have higher debt costs (we see some correlation which to an extent justifies the existing differentials, but it is weak). This is in part because standard credit is often the payment type non-paying customers end up on as a result of non-payment, rather than necessarily being the cause of non-payment. It would not be cost reflective to charge those customers at the average reported cost level for that payment type. We also do not observe any reliable corelation between a supplier debt-related costs and other metrics like PSR and WHD.

2.59 Our analysis suggests that increasing the differential between direct debit and standard credit allowances would not fundamentally change the cost recovery variance, or materially improve the distribution of cost recovery across the market as a whole. 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.

2.60 We consider that the current differential approach does not seek to levelise costs or create competitive distortions against some suppliers, therefore we consider that a reconciliation mechanism is not required.

Fuel type allocation

2.61 We have decided to allocate the allowance across fuel types based on bill size, specifically those set by cap. Taking on board stakeholder feedback, we consider that using cap levels instead of reported revenue better reflects the underlying ratio of debt-related costs. If we use reported revenue, it is likely that electricity customers would pay a disproportionate amount of debt costs. Using cap levels would also be less sensitive to fluctuations in actual consumption across historical periods (eg due to weather affecting gas consumption).

2.62 This is a change in how we allocate the debt allowances between fuels, so would not affect the overall amount paid by a dual fuel customer. While it is a change in metric used, it is in keeping with the policy intent consulted on – to ensure that debt costs are recovered through fuels relative to how much customers in aggregate spend on those bills. Using cap levels achieves this as it results in the level of debt related costs being a very similar percentage of each bill.

Other allocation

2.63 We have decided to allocate costs equally between electricity meter types and also between tariff types. We have no evidence that suggests debt-related costs differ between meter types, beyond the variation in consumption. We also have a no evidence to suggest anything other than an equal allocation across tariff types.

Update mechanism

2.64 We have decided to update both bad debt and working capital costs based on bill size. This means indexing these components of the allowance to other core cost components in the cap (ie wholesale costs, operating costs, policy costs and network costs). This is similar to how these cost components are updated in the old allowances for debt. We consider this approach is independent of supplier behaviour, feasible and provides a reasonably accurate allowance in the steady state.

2.65 We have decided to update the debt-administrative costs in line with CPIH, similar to the status quo, as operational costs tend to move with inflation.

2.66 Given the uncertainty in future debt costs, we may consider the possibility of an ex-post adjustment if we consider debt-related costs to have materially and systematically deviated from the allowance. This could result in a positive or negative adjustment. We may also consider changing debt-related cost allowances on a forward-looking basis if there was a material and systematic change.

Wider debt & monitoring

2.67 Consumers are continuing to see high level of debt and arrears. A separate area of work is looking at how the issue of historical debt and arrears accrued during the gas crisis can be addressed, aiming to alleviate affordability challenges of some of the hardest hit customers.

2.68 In terms of costs faced by industry, there has been a material and systematic increase in costs since 2022. This led to us introducing a temporary 'float' allowance, for the efficient additional costs incurred during a specific period, for which we said we would carry out a true-up review. We are aware however that suppliers may have continued to incur additional costs, so we extended the temporary float allowance to help bridge the gap until the operating cost review is implemented.

2.69 We have previously signalled a delay and extension of the true-up review, until we have more clarity on various factors such as the 'allowance gap' that suppliers may have experienced and the impact of interactions with any wider debt strategy interventions such as the debt relief scheme. We would also aim to take into account true-up of the temporary float allowance along with the impact of its extension. All factors would have to be considered in the round, and any true-up review could indicate either an upward or downward adjustment to allowances, which would have to be deemed material and systematic in nature, in order for us to consider implementing a true-up adjustment.

2.70 Given the uncertainty over how debt-related costs will progress, we intend to continue to monitor this data over time, along with wider debt and arrears indicators. The timing of any true-up would depend on the availability of the appropriate data and when the interactions of any debt relief scheme are more fully understood.

Smart metering costs

2.71 The smart metering allowance is closely aligned with the core operating cost allowance as it provides an allowance for the change in cost compared to the core operating cost baseline. It tracks the difference in net costs between a given year and the baseline year for the operating cost allowance.

2.72 Overall, we have decided to retain the status quo approach to setting the SMNCC. As noted above, we have decided to use 2023 RFI data to set an updated operating cost allowance. Therefore, we have made several consequential technical changes to the SMNCC model to account for this. These changes include:

- Updating the SMNCC baseline from 2017 to 2023, in line with the new core operating cost allowance.
- Removing the calculation steps to calculate the difference between the lower quartile and weighted average costs, as our core operating cost allowance is now also based on a weighted average.
- Updating the roll-out profiles to reflect the weighted average roll-out split by credit (covering direct debit and standard credit) and PPM, for the new baseline year and all previous years.
- Removing the PPM cost offset, which relates to an uplift accounting for uncertainty in additional PPM costs based on our current operating cost

allowance using historical data. This is no longer relevant as we have recalculated the PPM core operating cost allowance based on the 2023 data.

2.73 When considering the cost and benefit components captured by the SMNCC, in our December 2024 statutory consultation we proposed to set an SMNCC with a reduced number of costs and benefits (referred to as option 3). We considered these costs and benefits were immaterial and so excluding them would reduce the complexity of the approach. A less complex model would reduce the time taken to update each year and would be able to deliver a sufficient level of robustness in the context of a revised core operating costs baseline.

2.74 Following stakeholder responses suggesting that certain excluded costs (eg Operation and Maintenance costs) were material over time, we analysed the materiality of these costs over the period covering cap period 14 (April 2025 – September 2025) to cap period 17 (October 2026 – March 2027) by projecting forward rollout. We found that while the costs and benefits we proposed to exclude were immaterial in the most recent cap period, the materiality increased over time. By cap period 17 the difference between the proposed option 3 and the status quo was approximately £5 for a dual fuel credit customer.

2.75 We have therefore decided to retain the status quo (referred to as option 4) mix of costs and benefits. On balance, we consider that retaining the status quo is preferable as it provides a more reliable allowance, and maintaining a wider range of costs and benefits will be more robust than making a single change to option 3 (retaining operation and maintenance costs). We are placing a greater weight on having a robust allowance over the simplicity of update. This enables a notional supplier to recover its efficient costs, while also ensuring that customers continue to see the benefits of the smart meter rollout.

2.76 We have made one change to reflect a greater cost uncertainty for the PPM level of the operating cost allowance. Our analysis of supplier Annual Supplier Return (ASR) data suggests that the PPM cost to serve benefit in the SMNCC, set using 2019 RFI data, may overstate the benefit to an efficient notional supplier. We found that according to the ASR data, the cost to serve benefit has been falling over time.

2.77 We have decided to reflect the reduction by scaling down the benefit in line with the change observed in the ASR data between 2019 and 2023. We use the ASR as a proxy to calculate the change, rather than using it as the input for the benefit, to reduce the risk of double counting costs and benefits captured elsewhere in the SMNCC. The ASR data does not include a granular breakdown of

activities, so it is difficult to cross-check this against other cost and benefit components in the SMNCC. This was our original rationale for using RFI data to set this component in our 2021 decision to set a PPM specific SMNCC allowance.[18]

2.78 The reduction in benefit increases the allowance by approximately £5 in cap period 14 (April to September 2025) and results in smaller reductions over time. This reduces the risk of a notional supplier with a greater than average PPM customer base not recovering its efficient costs.

2.79 The smart meter rollout framework is due to expire this year. The Department of Energy Security and Net-Zero (DESNZ) is in the process of designing its post 2025 framework, which will, amongst other things, set the appropriate rollout incentives for suppliers. The allowance we are setting as part of this decision is in place until October 2025, after which the allowance will be updated using the latest ASR data. Without this update, the model currently assumes no further smart meters will be installed past September 2025.

2.80 As part of our annual update to account for the latest ASR data in the SMNCC model this year, we will also set a temporary rollout profile for 2026 and 2027. We expect to announce this temporary roll-out profile at the same time as informing suppliers what the SMNCC allowances will be for cap period 15 (October 2025 – March 2026), following our annual ASR update. Following a DESNZ decision on the rollout framework, we will set a final roll-out profile (following consultation) that reflects the decided approach. The temporary roll-out profile will be in place until we are able to take a decision. To note, any allowance differences between the temporary approach and actual roll-out will be accounted for by our advanced payment adjustment, which allows for the difference between modelled and outturn roll-out.

Industry Charges

2.81 Industry charges were previously split between the operating cost allowance and the smart metering allowance. The operating cost allowance included an allowance for Xoserve and Elexon charges, which were set using 2017/18 charging statements then indexed by inflation alongside the rest of the operating cost allowance. The smart metering allowance included an allowance for charges relating to the Data Communications Company (DCC), Smart Energy GB (SEGB) and the Smart Metering Code of Practice (SMICoP). These costs were mostly

[18] Ofgem (2021), Price Cap – decision on PPM SMNCC allowance, paragraphs 3.35 – 3.71.
https://www.ofgem.gov.uk/decision/price-cap-decision-ppm-smncc-allowance

treated as pass-through costs and updated regularly based on charging statements.

2.82 Following our restructure of the allowances, we have decided to set a separate pass-through industry charges allowance. The allowance will be updated every six months reflecting the latest final or interim charging statements for each cost.

2.83 In addition to now setting Xoserve and Elexon charges on a pass-through basis, we have decided to include an allowance for Retail Energy Code Company (RECCo) and Distribution Connection and Use of System Agreement (DCUSA) costs. We have removed the allowance for SMICoP costs as this has been replaced by the Consolidated Metering Code of Practice (CoMCoP), which is covered under RECCo charges.

2.84 We have retained allowances for DCC and SEGB, though have moved away from calculating these costs as a change on the core operating cost baseline to using the full cost from the charging statements. We've made this change as we no longer include costs relating to DCC and SEGB in the core operating cost baseline so there is no risk of double counting.

2.85 We have decided to implement the pass-through industry charges component through the newly renamed 'Annex 5 – Smart metering net cost change and industry charge allowance methodology'. This annex previously covered pass-through and non-pass-through smart metering costs. We have expanded the scope to avoid creating further components through additional annexes to the Standard Licence Conditions.