Consultation Appendix

Default Tariff Cap: Statutory Consultation

Appendix 8 - Payment method uplift

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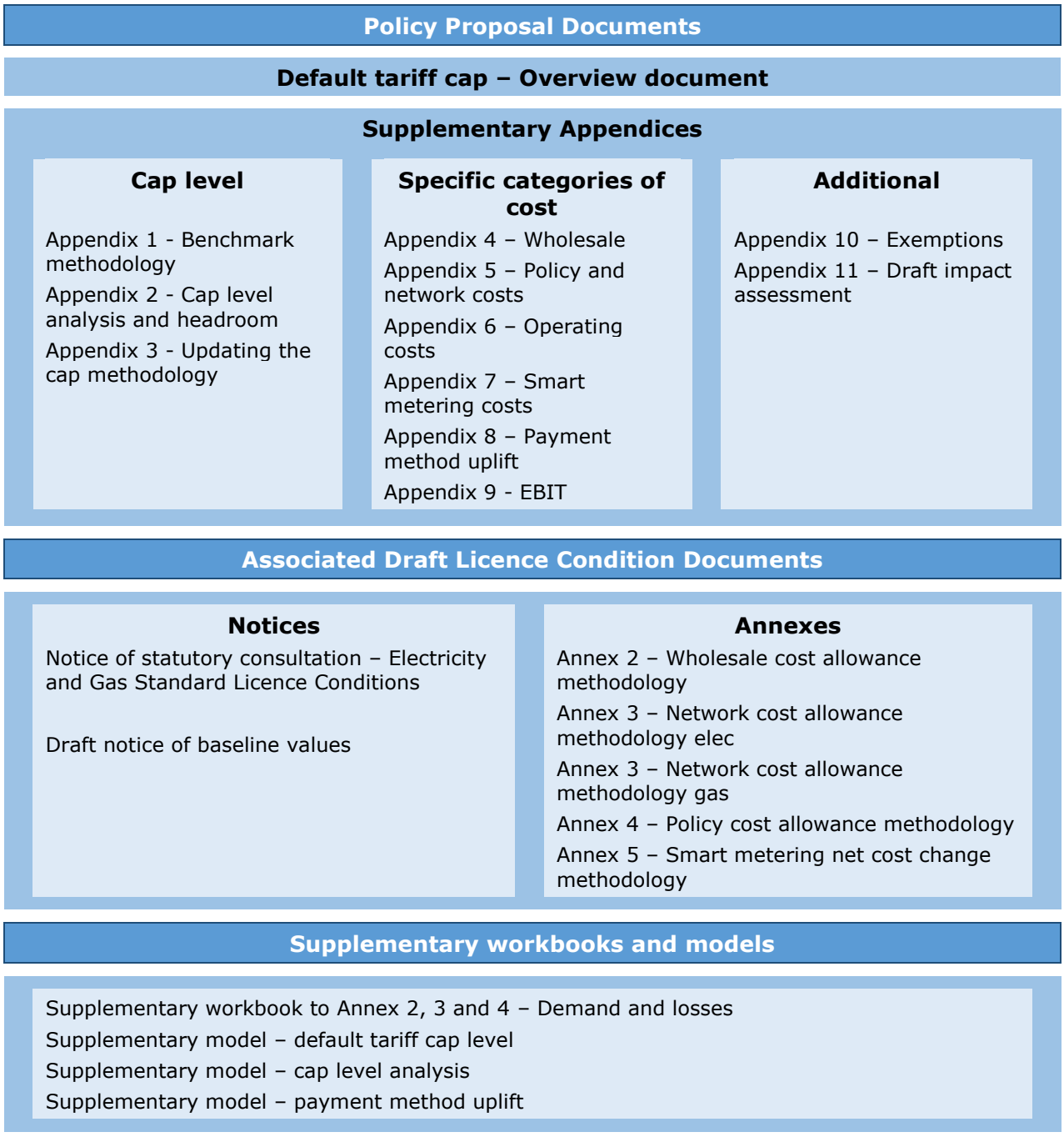
We are consulting on our proposals for setting and updating a default tariff cap in accordance with the Domestic Gas and Electricity (Tariff Cap) Act 2018. This supplementary appendix provides details of the proposals and methodology in relation to a payment method uplift. This document is aimed at those who want an in-depth understanding of our proposals. Stakeholders wanting a more accessible overview should refer to the Default tariff cap – Overview document.

We welcome views from stakeholders on all of our proposals set out within this document. Please see the Default tariff cap – Overview document for instructions on how to respond to the consultation.

Document map

Figure 1 below provides a map of the default tariff cap documents published as part of this statutory consultation.

Figure 1: Default tariff cap – statutory consultation document map



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1. Introduction

Overview

1.1. In this appendix, we provide a detailed explanation behind our payment method uplift proposals. These are:

- to allocate some of the total efficient additional costs incurred when serving standard credit customers to those customers, and spread the remaining costs over direct debit and standard credit customers
- to set our baseline 2017[1] default tariff cap for customers paying by standard credit at approximately £75 higher than the cap for those paying by direct debit – the market average in 2017
- to apply the direct debit cap to customers with SMETS2[2] prepayment (PPM) meters.[3]

1.2. We also provide details on how we plan to update the payment method uplift over time.

1.3. We also published Supplementary model – Payment method uplift alongside this appendix, which can be used with this appendix to understand our methodology on the payment method uplift.

Additional costs of standard credit customers

1.4. On average, suppliers incur more costs when serving standard credit customers, compared to customers that pay by direct debit for example from standard credit customers paying in arrears. These costs include additional working capital, additional bad debt, and associated administrative expenses. We calculate that in 2017, an efficient supplier would have incurred an additional £131 per standard credit customer (before profit and tax, £140 after profit and tax).

1.5. In Chapter 2, we explain how we calculate these additional costs, explain our methodology for calculating the payment method uplifts, and consider stakeholders' responses to our May consultation.

Allocating costs

1.6. SLC 27.2A states "Any difference in terms and conditions as between payment methods for paying Charges for the Supply of Electricity shall reflect the costs to the supplier of the different payment methods". We recognise that the allocation of costs inherent to the respective payment method is not always clear-cut, and allocation

[1] Where we refer to our 2017 baseline, we mean the weighted average of the charge restriction periods covering April 2017 to September 2017 and October 2017 to March 2018 at TDCV.
[2] The second standard of Smart Metering Equipment Technical Specifications.
[3] Referred to as Fully-interoperable smart prepayment in SLC 28AD of the licence conditions.

requires difficult judgement. Additional working capital requirements are an inherent feature of providing standard credit. Additional bad debt and administrative costs are a predictable consequence of serving a large number of standard credit customers, but not an inherent aspect of the payment method of an individual – who pay their bills on time and not increase administrative costs for a supplier.

1.7. In 2017, suppliers set direct debit and standard credit prices that are much closer together than the additional efficient costs would suggest (around £76 on average after EBIT[4] and VAT, as opposed to £131 – or for comparison, £140 after EBIT and VAT).

1.8. We propose to benchmark our 2017 baseline payment method differential – the difference between standard credit and direct debit prices – to approximately the market average in 2017. We intend to allocate all of the additional working capital costs to standard credit customers, and 40% of the additional bad debt and administrative costs. As additional costs relate to working capital and bad debt, which scale with bills, the differential will change over time as bills change. We expect the differential to increase from £75 (after EBIT and tax) in 2017/18, to around £83 for the first cap period ending 31 March.

1.9. In Chapter 3, we explain our approach, and consider stakeholders' responses to our May consultation.

Updating the cap

1.10. Bad debt and working capital costs are calculated as percentages and applied to the benchmark. We therefore do not need to update these values as the values they are applied to will update over time. We intend to index other administrative costs with CPIH[5], which is consistent with of our methodology for other operating costs excluding smart costs) – see Appendix 6.

1.11. In Chapter 5, we explain our rationale.

Context and related publications

1.12. Ofgem (2018), Default Tariff Cap: Policy Consultation. Appendix 12 – Payment method uplift. https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix_12_-_payment_method_uplift.pdf

[4] EBIT is the Earnings Before Interest and Tax
[5] CPIH is the Consumer Price Index including a measure of owner occupier's housing costs

2. Additional costs of standard credit customers

In this chapter, we explain how we calculate the additional costs of serving standard credit customers for an efficient supplier, and consider stakeholders' responses to our May consultation.

2.1. On average, suppliers incur additional costs when serving standard credit customers compared to customers that pay by direct debit, for example from standard credit customers paying in arrears. The three main sources of costs are additional working capital; additional bad debt; and additional administrative costs. In total, we calculate that an efficient supplier would incur an additional £131 per standard credit customer (table A8.1).

Table A8.1: Breakdown of the additional cost to serve a standard credit customer in 2017

Cost element	Description	Additional cost electricity	Additional cost gas	Total
Working Capital	The cost associated with delayed payment, billing frequency and advance payment differences	£21	£11	£31
Bad debt	The cost of customers who do not pay their bills and where the supplier does not expect to recover the debt.	£32	£24	£56
Additional administrative costs to serve	The additional costs not covered by working capital or bad debt. For example debt administration, customer service costs and bill printing.	£21	£23	£44
Total		£74	£57	£131

Note: Figures may not sum due to rounding. We calculate working capital and bad debt as percentages, not absolute amounts. Figures represent 2017 only for a customer with TDCV pre EBIT and VAT. Figures are calculated on a sample of suppliers.[6]

2.2. Customers paying for energy with PPM meters are not subject to the default tariff cap as stated in section 3(1)(a) of the default tariff cap act, so we do not discuss them here.[7] However, customers with SMETS2 PPM meters on default tariffs will be within the scope of the cap.

2.3. The SMETS2 meter rollout has only recently begun, and therefore there are an insufficient number of customers with these meters for us to reliably establish the additional efficient costs suppliers incur to serve them. We therefore propose that SMETS2 PPM are subject to the direct debit default tariff cap, but will review this in the

[6] We sent out a request for cost information to 14 suppliers with customer accounts over or near 250,000. Three suppliers could not provide the information with breakdowns for fuel and payment method and other suppliers provided different levels of detail for different questions. Therefore, our sample varies by cost element.
[7] These customers are already protected by the PPM safeguard tariff. However, the safeguard tariff does not apply to customers with SMETS2 PPM meters. Therefore, SMETS2 PPM customers who are on default tariffs will be protected by the default tariff cap.

future when more customers have moved onto these meters and there is reliable data available.

Our proposed methodology

2.4. We propose to ensure that the cap recovers the efficient additional costs for serving a standard credit customer by:

- calculating the efficient additional costs of working capital
- calculating the efficient additional bad debt costs
- calculating the efficient additional administrative costs
- applying an uplift to the bad debt and working capital costs, so they can be applied to a direct debit benchmark to estimate additional standard costs
- allocating cost components to standard credit customers and direct debit[8] customers (discussed in Chapter 3)
- applying an uplift for non-recovered costs.

Additional cost of working capital

2.5. Standard credit customers cause additional working capital costs because, in general, they pay a higher proportion of their bills in arrears. Suppliers need more capital to purchase and supply energy before standard credit customers reimburse them.

2.6. We calculate additional working capital costs using standard credit customers' additional working capital requirement, rather than standard credit customers' debtor days (as outlined in Appendix 12 of our May consultation).We express the additional costs of working capital as a percentage of revenue as the required working capital will vary with consumption. We estimate the additional working capital cost for an efficient supplier is 2.0% for gas and 3.5% for electricity per customer.

2.7. When serving direct debit customers, suppliers can receive a net benefit, ie customers pay money in advance. This means that direct debit customers can generate a negative working capital requirement. In our May consultation, we did not recognise the benefit, recording the cost as zero. After reviewing our methodology, we now propose to account for this benefit and assume the benefit on capital to be the same as the cost of raising it, 10%.

2.8. To calculate the difference in working capital costs between standard credit customers and direct debit customers we:

[8] Note where we refer to payment method Other in the standard licence conditions (SLC 28AD), the analysis relates to that based on direct debit through this appendix.

1. annualised our quarterly data on working capital requirements per payment method, fuel and supplier.

2. calculated the cost of that requirement at 10% of the working capital requirement for direct debit and standard credit per fuel in 2017. We discuss cost of capital in Appendix 9.

3. calculated the ratio of cost of working capital to revenue per payment method and fuel for 2017.

4. calculated the difference per supplier of the measure between standard credit and direct debit.

5. selected the lower quartile to represent the efficient cost.

2.9. In algebraic form it would be calculated as below

$$Cost\ of\ working\ capital\ difference_f = \frac{\left(Working\ capital\ requirement_{SC,f} \times 0.1\right)}{Revenue_{SC,f}} - \frac{\left(Working\ capital\ requirement_{DD,f} \times 0.1\right)}{Revenue_{DD,f}}$$

Where DD is direct debit, SC is standard credit and f is fuel type. 0.1 represents the 10% cost of capital.

2.10. We based our estimate on an analysis of the difference between standard credit and direct debit cost of working capital requirements for seven suppliers. We deemed these seven suppliers to have provided sufficiently granular data for working capital requirements. The sample comprised five large suppliers and two medium suppliers.

2.11. The calculations yield a lower quartile value of 3.5% for electricity and 2.0% for gas, which we selected to represent the efficient supplier. This is different to the 2.4% and 2.1% for electricity and gas respectively, proposed in our policy consultation. The difference relates to two changes: recognising working capital benefits for direct debit (increase the additional cost of standard credit), and corrections to data after additional quality assurance.

Additional bad debt costs

2.12. On average, standard credit customers incur additional bad debt costs compared to direct debit customers. We estimate the additional bad debt cost for an efficient supplier is 4.6% for gas and 5.4% for electricity.

2.13. We calculate this using bad debt charge as our measure of bad debt. We do not use bad debt write off as it could vary depending on suppliers' decisions (as outlined in Appendix 12 of our May consultation). We express the additional cost of bad debt as a percentage of revenue as the amount of bad debt will vary with consumption.

2.14. We calculated the bad debt cost difference using the following approach:

1. we calculated bad debt charge to revenue ratio for direct debit and standard credit in 2017 per fuel[9]

2. we then took the difference for each supplier to calculate the bad debt cost difference per fuel

3. of those suppliers that provided sufficiently granular data, we took the lower quartile as our payment method cost difference for bad debt per fuel.

2.15. We have outlined the calculation in algebraic form below

$$Bad\ debt\ cost\ difference_f = \frac{Bad\ debt\ charge_{SC,f}}{Revenue_{SC,f}} - \frac{Bad\ debt\ charge_{DD,f}}{Revenue_{DD,f}}$$

Where DD is direct debit, SC is standard credit and f is fuel type.

2.16. We based our estimate on an analysis of the difference between standard credit and direct debit bad debt costs per fuel for ten suppliers that provided bad debt data to sufficient granularity for bad debt costs. The sample for this cost element is comprised of six large suppliers, three medium suppliers and one of small suppliers.

2.17. This calculation gave us lower quartile values of 4.6% for gas and 5.4% for electricity in 2017, which we selected to represent the efficient supplier.

Additional administration costs

2.18. On average, suppliers incur higher administrative costs (excluding working capital and bad debt) when serving standard credit customers. These include categories such as:

- the additional administration and collection costs of bad debt (as opposed to the bad debt itself)
- additional bill printing
- customer service costs from a higher propensity to call, for example to pay their bill

2.19. We estimate the additional costs for an efficient supplier is £21.50 for gas and £20.15 for electricity per customer. We express the additional administration costs as a flat per customer figure. This is because the additional costs should scale by the number of standard credit customers, not customers' consumption. We discuss why costs might be higher for standard credit customers in Chapter 3.

2.20. We based our estimate on an analysis of the difference between standard credit and direct debit administrative costs per customer by fuel type of ten suppliers who

[9] The bad debt data charge data was already annualised when provided by suppliers.

provided data on additional administrative costs. The sample for this cost element is comprised of six large suppliers, three medium suppliers and one small suppliers.

2.21. We adjusted the data for one supplier, who provided other administration costs by dual fuel customer, rather than for gas and electricity accounts separately. We applied a weighting based on their customer accounts to split this data into single gas and electricity accounts. No further calculation of the numbers was required as the other administrative costs do not vary by consumption and are therefore a lump sum.

2.22. As with working capital and bad debt, suppliers' additional administrative costs varied substantially. We selected the lower quartile costs to represent the efficient level of additional cost.

Applying adjustments for application to a direct debit benchmark

2.23. Our measures of the additional working capital and bad debt costs are expressed as a percentage of standard credit revenue. We will use our direct debit efficient cost benchmark to calculate additional standard costs whenever we set and update the cap. Therefore, the additional costs of standard credit would be understated, as they would be based on a lower baseline than is appropriate for standard credit customers. Therefore, we need to apply an uplift to the percentage difference to calculate the correct additional costs in cash terms.

2.24. The uplift increases the working capital cost difference from 2.0% to 2.3% for gas and 3.5% to 4.1% for electricity. It increases the bad debt cost difference from 4.6% to 5.3% for gas and 5.4% to 6.2% for electricity. For further details, please review Supplementary model - payment method uplift published alongside the statutory consultation.

Allocating cost components

2.25. To incorporate these additional efficient costs into the cap, we allocated some of the costs to standard credit and spread the remaining costs over both payment types.

2.26. We propose to allocate 100% of working capital to standard credit customers and 40% of bad debt and additional administrative costs. We propose to allocate the remaining 60% of bad debt and additional administrative costs over standard credit and direct debit customers. In Chapter 3, we explain these allocations further alongside our rationale.

2.27. We propose a percentage of customers to spread the remaining costs over, we refer to this as the assumed customer base. For the assumed customer base, we propose to use the average proportion of non-prepayment default customers paying by standard credit at 33.7% for gas and 35.9% for electricity. We explain our rationale for this in paragraphs 3.34-3.38.

2.28. In order to calculate the final percentage uplift and additional cost values, we calculated a weighted uplift for cost element for each fuel and payment method. For example, the 6.2% additional cost of bad debt for electricity would be allocated 40% to standard credit and the remaining 60% spread over direct debit and standard credit (assuming a customer base of 35.9%). This would result in a bad debt percentage uplift for an electricity standard credit customer of 3.8%.

2.29. In equation form this gives

$$Weighted\ cost\ element_{SC,f} = (cost\ element\ \times a) + [cost\ element\ \times (1 - a)\ \times CB]$$

$$Weighted\ cost\ element_{DD,f} = [cost\ element\ \times (1 - a)\ \times CB]$$

Where cost element is either additional bad debt cost (%), additional working capital cost (%) or additional administrative costs. a is the proportion of the cost element allocated to standard credit and CB is the assumed customer base percentage.

Recovery of non-payment

2.30. By allocating the additional efficient costs, the cap should recover all additional costs. However, suppliers may under recover due to non-payment among their customer base.

2.31. We propose to apply an adjustment to account for non-payment to both the percentage part (bad debt and working capital cost difference) and the fixed part (additional administrative costs) of the uplift. This was to account for the under recovery and ensure suppliers are not disadvantaged due to non-payment.

2.32. We propose to use the proportion of bad debt charge to revenue per payment method and fuel as a proxy for the proportion of customers that do not pay. We calculated this using the same data from our bad debt cost difference methodology. We calculated this to be approximately 5.5% for standard credit electricity and 4.6% for standard credit gas. It was 0% for direct debit.

2.33. We then calculated what the increase in the standard credit uplift would need to be to cover non-payment. We propose to allocate that additional amount of uplift between the payment methods in a consistent method to bad debt.

Payment method uplifts

2.34. To calculate the Payment Method Uplifts that are applied to our benchmark, the licence specifies two terms. The Payment Method Adjustment Additional Cost (PAAC), which expresses the additional administrative costs (the fixed element). The Payment Method Adjustment Percentage (PAP), which expresses the percentage uplift applied to the core benchmark[10]. The PAP combines the weighted bad debt percentage and the weighted working capital percentage giving the weighted percentage uplift for each payment method and fuel.

2.35. The proposed uplift values are shown in table A8.2 below. We propose that the percentages are fixed as long as the cap is in place. We propose to index the additional administrative costs by inflation (see Chapter 5) – we show the 2017 baseline value below. They are contained in Annex 1 of the draft standard licence conditions (SLC 28AD of the gas and electricity licence conditions) that we are consulting on alongside this document.

[10] The core benchmark is made up of wholesale costs, operating costs, policy costs and network costs.

Table A8.2: Proposed payment method adjustment values

Description	Licence condition term	Multi-rate Electricity	Single rate Electricity	Gas
Payment method adjustment percentage for standard credit	PAP_{SC}	8.18%	8.24%	5.71%
Payment method adjustment additional cost for standard credit (2017 baseline)	$PAAC_{0,\ SC}$	£12.84	£12.84	£13.32
Payment method adjustment percentage for direct debit	PAP_{DD}	1.43%	1.44%	1.13%
Payment method adjustment additional cost for direct debit (2017 baseline)	$PAAC_{0,\ DD}$	£4.50	£4.50	£4.47

Source: Ofgem analysis of supplier data

Prepayment meters

2.36. Most customers with prepayment meters are already protected by the prepayment safeguard tariff and are not eligible for additional protection by the default tariff cap as stated in sec. 3(1)(a) of the default tariff cap act. However, customers with a SMETS2 PPM meter are not covered by the PPM safeguard tariff. Where they have default tariffs, we propose that the default tariff cap will protect them.

2.37. We propose that SMETS2 PPM customers on default tariffs will be protected using the direct debit default tariff cap.

2.38. We have collected data on the additional costs of serving smart PPM customers, compared to smart direct debit customers. There are few smart PPM customers (and much fewer SMETS2 PPM customers), so we are unable to make a reliable assessment.

2.39. We propose to include the power of the Authority to reflect any differences in costs related to serving SMETS2 PPM customers at a later date provided we received sufficient data as basis for further analysis and depending on the respective outcome.

What we consulted on

2.40. In our May consultation, we set out our methodology for calculating the additional costs of serving standard credit customers (on average). This was very similar to our current proposed methodology bar the elements we have now updated:

1. updating the benchmark (that the working capital and bad debt percentages apply to) to reflect our proposed methodology for the efficient benchmark

2. recognising the benefit to suppliers of negative working capital requirements when serving direct debit customers

3. updating our analysis with more accurate data from suppliers regarding the additional administrative costs.

Stakeholder feedback

2.41. We received few comments regarding our proposed methodology to calculate the cost to serve difference. Below we summarise supplier feedback to our policy consultation and we address the comments in the rationale section of this chapter.

Transparency of our methodology

2.42. Suppliers measure their own additional costs to serve using a variety of different approaches. For instance, some suppliers weight by customer numbers rather than revenue (as we proposed). There are also differences in how specific costs are allocated. This can make it harder for stakeholders to verify our approach, so some stakeholders requested more transparency about our calculations.

Measuring efficiency

2.43. Two suppliers raised concerns with our use of the lower quartile to establish the efficient cost. One supplier claimed that lower quartile is not a good measure of efficiency as higher costs were sometimes related to the differences in their standard credit customers' needs and characteristics, rather than differences in the suppliers' efficiency.

Working capital

2.44. One supplier suggested that direct debit customers paying quarterly would incur a working capital cost, so they should be treated as standard credit customers or separately. Another supplier questioned whether we took into account the frequency of payments within our definitions of payment methods.

Smart prepayment meters

2.45. One supplier argued that smart prepayment customers were not the same as direct debit customers in terms of cost to serve. They mentioned that prepayment customers face higher payment transaction costs due to their frequency of payment and that they have a higher propensity to call the supplier leading to higher customer service costs.

Rationale for our proposed decision

Transparency of our methodology

2.46. We have set out our methodology in this appendix, so that suppliers can follow how we have calculated and adjusted differences in working capital, bad debt, and additional administration costs. For further details on our calculations, refer to the Supplementary model – payment method uplift published alongside this appendix.

Use of lower quartile to estimate efficient costs

2.47. Suppliers' additional working capital, bad debt, and administration costs vary substantially. If this variation was only driven by difference in efficiency, then we would benchmark the additional costs to the supplier with the lowest (frontier) costs.

2.48. However, we share stakeholders' concerns that variation might (in part) be affected by the differences in suppliers' customer bases rather than their efficiency. Similarly, where we benchmark operating costs per direct debit customer, we do not use the frontier costs, we start with the lower quartile and deduct an efficiency challenge (see Appendix 6). For standard credit costs, we use the lower quartile additional costs, rather than the frontier, but do not deduct any additional amount. In part, this is because we consider there to be greater uncertainty in regards to standard credit costs than we have when benchmarking the operating costs per account. We consider this to be a conservative approach already, and do not regard differences in suppliers' customer bases to imply we should benchmark to the average additional costs, as we would risk substantially overstating the cap and failing to protect customers from overcharging.

2.49. To assess whether the lower quartile is appropriate we compared the ranges for each of the cost categories (see tables A8.3a and A8.3b). While it is possible that suppliers with few standard credit customers may have higher costs per customer because their customers are more likely to incur costs such as bad debt, we do not consider the effect to have large influence on the actual differences between suppliers' costs.

2.50. Differences in customer bases could be relevant for some small suppliers. In these cases, the majority of their standard credit customers are former direct debit customers that have cancelled their direct debit and incurred bad debt. These suppliers tend to have few standard credit customers (for example, under 10% of their overall customer mix). They would be unrepresentative of the costs of serving the typical standard credit customer.

2.51. However, we do not think it likely that between the suppliers in our sample that the differences in costs per customer are fully explained by differences in the customer base. There is a range of suppliers with very different costs per customer but many of the suppliers have high and similar proportions of SVT customers paying by standard credit.

Table A8.3a: Electricity cost difference variations

	Working capital cost difference (%)	Bad debt cost difference (%)	Additional administrative costs (£)
Lower quartile	3.5%	5.4%	£20.15
Range	5.1%	15.9%	£106.48

Table A8.3b: Gas cost difference variations

	Working capital cost difference (%)	Bad debt cost difference (%)	Additional administrative costs (£)
Lower quartile	2.0%	4.6%	£21.50
Range	7.4%	15.6%	£94.00

Source: Ofgem analysis of supplier data
Note: The range shows the difference in percentage points between the minimum value for a supplier in the sample, and the maximum.

Working capital

2.52. We have adjusted the calculation for cost of working capital difference to account for negative working capital requirements. We believe negative working capital requirements associated with direct debit customers paying in advance is a benefit that should be accounted for. Negative working capital reduces the need for borrowing for the supplier and frees up capital for other purposes.

2.53. We recognise that some direct debit customers will incur more working capital costs – for instance if they pay quarterly – than other direct debit customers. However we propose to have one cap for all direct debit customers since:

1. We do not consider it necessary to split direct debit customers into sub sections. It would also add unwarranted complexity. Our analysis has included all types of direct debit customer, so the variation in working capital is taken into account in the aggregated comparison. Even within the different payment frequencies, direct debit customers will incur different working capital requirements, as customers start payments at different times of year and suppliers have different policies on advance payments. All approaches to a manageable price cap require a proportionate level of approximation. We therefore propose to maintain a cap for all direct debit customers, and another for standard credit.

2. It would not be appropriate to treat quarterly direct debit customers as standard credit customers. Standard credit customer will incur additional risk of bad debt and other administrative costs that does not apply to quarterly standard credit.

3. As mentioned above, we have considered all lengths of direct debit payment method in the analysis. The direct debit allowance is therefore appropriate for all suppliers with a typical proportion of quarterly direct debit customers, as a proportion of their total direct debit customers.

Additional costs of SMETS2 prepayment meters

2.54. As SMETS2 PPM metered customers pay upon consuming their energy or just before, we do not expect them to have working capital requirements and in this sense, we consider it reasonable to treat them as direct debit customers.

2.55. Though SMETS2 PPM customers may have debt associated with them, they are unlikely to have accumulated this debt while on a PPM. If they did not pay while on a PPM, they would risk self-disconnection. They are more likely to be paying off some debt they previously incurred and therefore the debt is not a consequence of a customer paying by PPM.

2.56. SMETS2 PPM customers might incur additional administration costs. They may have a higher propensity to contact the supplier. Customer service costs make up the majority of the cost to serve difference between smart direct debit and smart PPM.

2.57. We requested information regarding the cost to serve difference between smart prepayment and smart direct debit customers to suppliers with over 250,000 customer accounts. We asked suppliers to complete the cost to serve differences if they had over 10,000 smart PPM customer accounts for a given fuel.

2.58. Four suppliers met the criteria and we received responses from three of them. One supplier mentioned they did not have enough data to estimate the cost to serve difference for customer contact. We do not believe we can have a reliable market cost to serve estimate difference based on three suppliers.

2.59. We propose to have a clause in the licence conditions that will allow us to revisit a payment method uplift for SMETS2 prepayment customers when we consider that there is sufficient reliable data available to conduct an assessment. The result of the assessment will provide the basis for introducing a different treatment of SMETS2 PPM customers.

3. Allocating costs

In this chapter, we explain our approach to allocating the additional costs of serving standard credit customers, and consider stakeholders' responses to our May consultation.

Proposed decision

3.1. In the previous chapter, we explained that the average efficient additional costs of serving a standard credit customer are about £131. If these costs were allocated to only standard credit customers, then (in 2017) suppliers would have charged standard credit customers £140 more than they charged direct debit customer (after EBIT and VAT). In fact, they charged standard credit customers only approximately £76[11] more.

3.2. SLC 27.2A states "Any difference in terms and conditions as between payment methods for paying Charges for the Supply of Electricity shall reflect the costs to the supplier of the different payment methods". We recognise that the allocation of costs inherent to the respective payment method is not always clear, and allocation requires difficult judgement.

3.3. Additional working capital requirements are an inherent feature of providing standard credit. Additional bad debt and administrative costs are a predictable consequence of serving a large number of standard credit customers, but not an inherent aspect of the payment method of an individual – who may pay their bills on time and not increase administrative costs for a supplier.

3.4. We propose to benchmark our 2017 baseline payment method differential – the difference between standard credit and direct debit prices – to the market average in 2017/18. We do not propose to allocate all the additional costs to standard credit customers. We propose to:

1. allocate all additional working capital costs to standard credit customers (about £11 for gas, £21 for electricity and £31 for dual fuel customers in 2017 at TDCV)

2. allocate 40% of additional bad debt and administrative costs to standard credit customers (about £46 for gas, £53 for electricity, and £100 for dual fuel customers in 2017 at TDCV[12]).

3.5. We propose to spread the remaining additional costs to serve a standard credit customer across all customers. We spread the costs using an average SVT standard credit customer base of 34% for gas and 36% for electricity (this was based on non-prepayment default customer accounts as of October 2017).

3.6. This means that our 2017 baseline for the standard credit cap is around £75 higher than the direct debit cap (after EBIT and VAT). Table A8.4 shows the impact of the payment method uplift on the standard credit and direct debit cap baselines. We

[11] Based on a large supplier average at medium TDCV for period April 2017 to March 2018.
[12] Combination of the additional cost of bad debt and additional administrative costs pre allocation.

expect the differential to be around £83 for the first cap period ending 31 March. The increase reflects the impact of rising prices on bad debt and working capital costs.

Table A8.4: Breakdown of uplift figures for a dual fuel customer

Cost Element	Additional Cost	Approach	Uplift to SC	Uplift to DD	Difference
Working capital	£31	Fully allocate to standard credit	£31	£0	£31
Bad debt	£56	Allocate 40% to standard credit and spread the remaining 60% over both payment methods	£33	£12	£21
Admin costs	£44	Allocate 40% to standard credit and spread the remaining 60% over both payment methods	£26	£9	£17
Total	£131		£91	£21	£70
Total (including EBIT and VAT)	£140		£97	£22	£74

Source: Ofgem analysis of supplier data
Note: Numbers may not sum due to rounding. Numbers above are based on the 2017/18 weighted average cap. Once headroom is applied, the final differential is £75. Values for typical domestic consumption values.

What we consulted on

3.7. In our May consultation, we consulted on different approaches to how we might allocate or spread the additional costs of standard credit customers.

3.8. We proposed allocating working capital costs to standard credit customers only. This was because they are an inherent feature of the payment method. In the policy consultation, we stated a lower additional working capital cost, as we did not include working capital benefits associated with direct debit (see paragraph 2.52).

3.9. We also proposed spreading all of the costs of bad debt and administrative costs across all customers. Our rationale was that we did not believe that standard credit customers who do not exhibit characteristics of other customers in the group should be held solely responsible to bear those costs. For example, we did not consider that a standard credit customer who pays their bills on time should be held solely responsible for covering the cost of standard credit customers who default into bad debt.

Stakeholder feedback

Principles of allocating additional costs

3.10. Most stakeholders felt that the difference between standard credit and direct debit SVTs should be greater than we proposed in May – this included a broad range of issues and views on what constituted a cost reflective allocation.

3.11. Suppliers did not challenge our view that suppliers' current prices did not fully reflect the additional costs of standard credit customers, suggesting supplier already spread some of the additional costs. They gave a range of reasons why they do not attribute all the costs to standard credit customers and that this can be considered cost reflective.

3.12. One supplier suggested that we should have a differential approximately equivalent to the industry average then spread the remaining cost to serve difference over both payment methods.

Allocating working capital

3.13. The majority of stakeholders agreed with our proposed position, agreeing that the difference in working capital requirement between direct debit and standard credit was an inherent consequence of the different payment methods, rather than the difference in the characteristics of the customers that happen to use those payment methods.

Spreading bad debt and administrative costs

3.14. There was a mixed opinion on our proposed approach to allocating the costs of bad debt and administrative costs.

3.15. For instance, a few suppliers (and one consumer groups) agreed with our May proposal to spread all of the additional bad debt and administrative costs. They agreed that an individual standard credit customer might not be any more responsible for additional administrative costs or bad debt, than a direct debit customer.

3.16. However, some suppliers argued it would not be cost reflective to ignore that additional standard credit customers led to predictable increases in suppliers' costs. They argued that though there would be individuals that do not reflect the group behaviour, on average as a group, standard credit customers incur more bad debt and are more costly to serve. For example:

- when considering call centre costs, part of the propensity to call could be due to a standard credit customer calling in to pay their bill, which could be argued to be a feature of standard credit as a payment method. One supplier provided data to suggest there was a clear link of additional administrative costs to payment method.

- when considering debt, standard credit customers are more likely to fall into debt and incur additional administrative costs related to that debt for reasons that are related to their payment method – for instance, because payments are not automatic and make additional contact time more likely.

Impact on customers

3.17. Stakeholders (including consumer groups) agreed that payment methods were not a good proxy for fuel poverty.

3.18. Some suppliers were concerned that reducing the payment method differential (compared to current prices) would reduce incentives for SVT customers to use more cost effective payment methods.

3.19. Some stakeholders were also concerned that reducing the payment method differential (compared to current prices) would affect fixed tariff prices, believing that standard licence condition SLC 27.2A would mean the differential set in the default tariff cap must be adopted in the fixed tariff market. SLC 27.2A states "Any difference in terms and conditions as between payment methods for paying Charges for the Supply of Electricity shall reflect the costs to the supplier of the different payment methods".

Impact on suppliers

3.20. A few stakeholders mentioned that we should allow for the maximum proportion of non-prepayment default customers paying by standard credit to spread the costs over rather than the average. They argued that a supplier should not be penalised for having more standard credit customers than average.

3.21. One supplier mentioned that by not accounting for suppliers with a higher than average mix of standard credit customers, we were not considering the matters we must have regard to in particular as set out in sec.1(6)(d) of the Tariff Cap Act "the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence".

3.22. There were also some concerns that suppliers with fewer standard credit customers would have a competitive advantage, using the direct debit 'uplift' to increase profits.

Rationale for our proposed decision

Allocating working capital

3.23. Working capital is a feature and cost of standard credit, as opposed to a cost associated with the characteristics of the customer who happen to pay by standard credit.

3.24. There is a cost involved in raising the capital to fund all customers who pay by standard credit – therefore these customers should be charged this cost.

Allocating bad debt and administrative costs

3.25. We have changed our position on what percentage of the additional costs of bad debt and administrative costs we allocate to standard credit from what we consulted on in May (to spread all bad debt and additional administrative costs over both payment methods). We now propose to allocate a higher proportion to standard credit customers, and spread the remaining costs across all customers. This approach acknowledges Cost reflectivity can be considered in different and conflicting directions. At a group level, standard credit customers are more expensive and it would be cost reflective to charge them for that. However, on an individual level it would not be cost reflective to charge a standard credit customer, who does not exhibit the characteristics of the group, the full cost to serve difference. For example, a standard credit customer could chose to have a paperless account and pay online, therefore not incurring the costs that could be attributed to standard credit customers as a group.

3.26. We propose to allocate 40% of bad debt and administrative costs directly to standard credit in order to produce a payment method differential that broadly reflects the

payment differential already in the market. Over the period April 2017 to March 2018, the average large supplier payment differential was about £76 (after VAT).

Table A8.5: Average large supplier differential

	Large supplier 2017 average differential	Large supplier 2018 average differential
Standard credit – direct debit differential (£)	£76	£90

Source: Ofgem analysis of EnergyHelpline data
Note: Prices at medium TDCVs, GB average. 2017 differential averaged over the period April 2017 to March 2018. 2018 differential as of 28th July 2018.

Current price trends

3.27. Currently only one supplier charges near to what we consider to be the 2017 full cost allocation differential of approximately £140 (this is likely to be higher if in 2018 terms). This means that they are all, to some degree, already spreading costs over the payment methods. From engagement with suppliers there appear to be various reasons for this. The market simple average dual fuel differential was £82 as of July 2018, which is in line with what the price differential of our proposed option would be in the first cap period.

Impact on customers

3.28. In our policy consultation, we stated that we did not think the decision to spread costs was a vulnerability principle, we maintain that this is not a vulnerability argument. We do not consider there to be a strong argument to reduce the payment method differential in order to protect vulnerable customers. While standard credit customers are twice as likely to be fuel poor, we consider that standard credit is a weak proxy for fuel poverty, especially as there are twice as many fuel poor customers paying by direct debit.

3.29. We do not believe that lowering the differential will have a strong effect on default tariff customer incentives to switch payment methods. These customers are already likely to be disengaged and be less responsive to prompts.

3.30. On the other hand, suppliers would have a stronger incentive to encourage customers to move onto direct debit if the costs were spread between the payment methods to a greater extent.

3.31. We do not consider that SLC 27.2A requires that the payment differential used to set the caps must be replicated by supplier pricing in the fixed tariff market. We interpret SLC 27.2A to mean that price differences cannot be more than is justified by cost reflectivity.

3.32. It is not always clear what is most cost reflective. As mentioned in paragraph 3.25, cost reflectivity may look different when considering group effects compared to when we consider individual effects.

3.33. We use the analysis as set out above to set the default tariff cap direct debit and standard credit levels. This analysis is not intended to be transferred into the fixed term market as it is in the suppliers own discretion to decide how to allocate costs

incurred in the fixed term market. The differential in the fixed term market is likely to have a different effect than in the default market, as customers are likely to respond differently to incentives.

Impact on suppliers

3.34. By spreading some of the additional costs of standard credit customers, suppliers will under-recover the total cost of standard credit customers from standard credit customers, but will make up the difference by charging direct debit customers more. Whether a supplier under-recovers or over-recovers the costs of standard credit customers depends on the proportion of direct debit and standard credit customers they have.

3.35. We propose to spread the additional costs to serve over the market average proportion of non-prepayment default customers paying by standard credit. We acknowledge that suppliers with more standard credit customers than average will under-recovering those costs. It is also the case that suppliers with fewer standard credit customer than average could over recover costs, increasing their profits. We would expect suppliers that over recover due to their customer base to pass some of this benefit through to the consumer with lower prices.

3.36. The greater the price differential, the less prominent either risk is. This is a benefit of making the payment differential more reflective of the current market average. We have analysed the impact for suppliers with more standard credit customers than average, and suppliers with fewer standard credit customers than average – who receive a benefit. At our proposed differential level, the effects are small.

3.37. Although a few suppliers have greater than average exposure to standard credit customers, we do not think increasing the cap by the necessary amount would satisfy the Act. The primary objective of the Act is to protect customers, and we do not think this is achieved by increasing the cap for every SVT customer in the market, when the supplier in question may have a small share of the market.

3.38. For the limited exposure that remains, those suppliers should be able to utilise the headroom allowance.

4. Applying the payment method uplift

In this chapter, we discuss how we plan to apply the cap to the efficient benchmark.

4.1. We propose to apply the payment method uplift to our efficient benchmark (as set out in Appendix 1 – Benchmark methodology).

4.2. Had we chosen a price reference to set the benchmark, we would have had to assess whether costs of standard credit were already reflected in the benchmark, otherwise we would risk double counting additional standard credit costs.

4.3. As we propose to use a bottom up cost assessment, based on direct debit costs per account (see Appendix 6 – Operating costs) we avoid this risk.

5. Updating the cap

In this chapter, we discuss how we plan to update the payment method uplift over time in line with the default tariff cap.

Indexing the payment method uplift

Proposed decision

5.1. As explained in Chapter 2, we propose that bad debt and working capital are set as percentages, whereas other administration costs are a pounds amount.

5.2. As explained in Appendix 3 we propose to update the default tariff cap so that it increases and decreases over time as underlying efficient costs change. As bad debt and working capital are percentages, there is no need to index them and the differential between the direct debit default tariff cap and standard credit default tariff cap will vary with the benchmark as the benchmark is updated.

5.3. We propose to index the other administrative costs to CPIH. This is the part of the cost to serve difference that is a lump sum and does not vary with consumption.

5.4. The impact of this approach means that the payment method differential increases from £75 in our baseline to £83 for the level we would expect when the cap is introduced.

5.5. For a further algebraic description, please see our draft standard licence conditions SLC28AD.12 which we have published for consultation alongside this doc.

What we consulted on

5.6. Our proposed decision is in line with our proposal from our policy consultation.[13]

Stakeholder feedback

5.7. We received no comments on the updating of payment method uplift over time.

[13] https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix_12_-_payment_method_uplift.pdf