

# Decision Appendix

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## Default Tariff Cap: Decision

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### Appendix 8 - Payment method uplift

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In accordance with the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act), we are implementing the default tariff cap to come into effect from 1<sup>st</sup> January 2019. This supplementary appendix sets out our decision and the detailed methodology in relation to payment method uplift.

Please see the default tariff cap – decision overview document for an accessible summary of the complete methodology.

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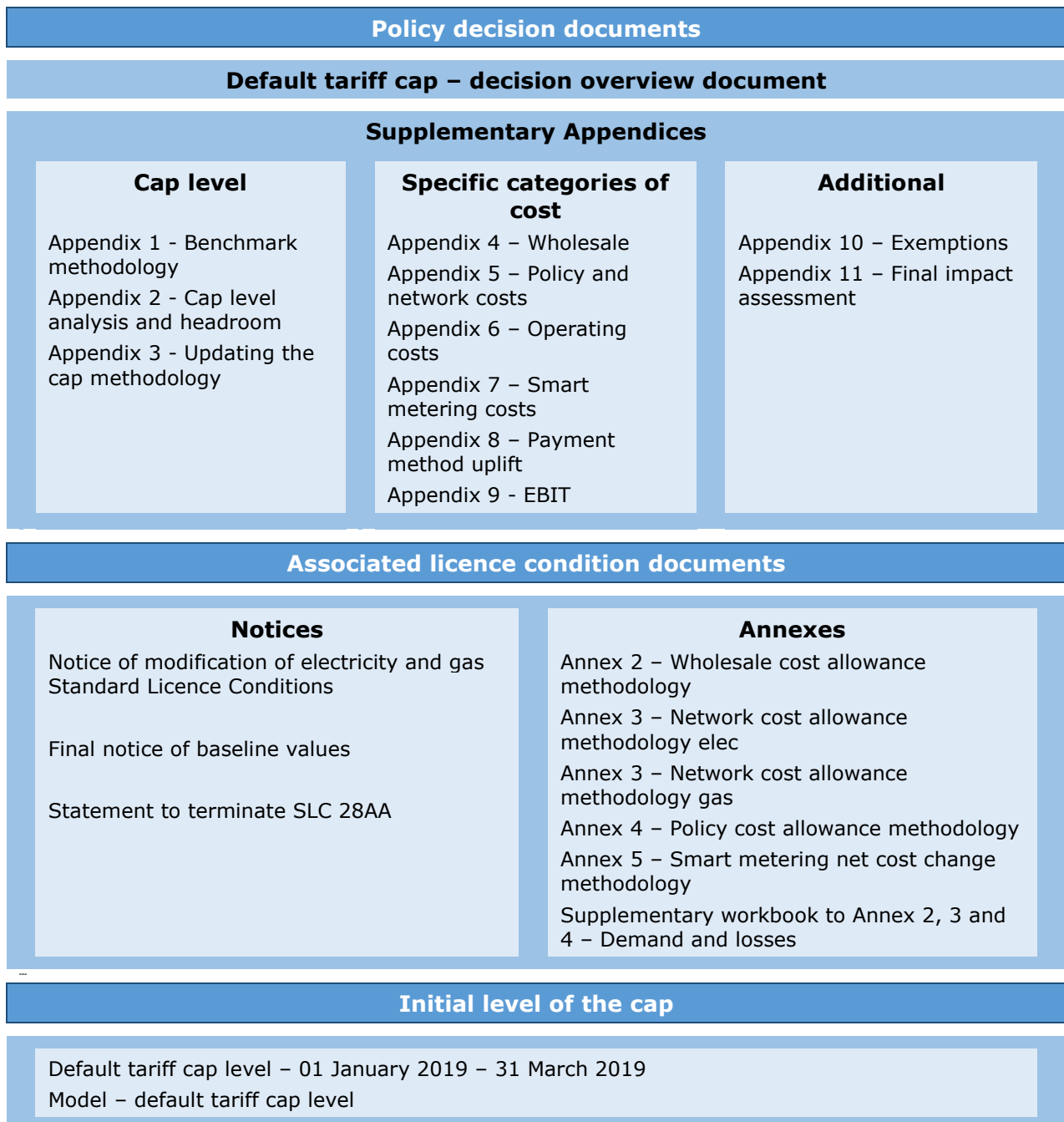
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## Document map

Figure 1 below provides a map of the documents published as part of the decision on the implementation of the default tariff cap.

**Figure 1: Default tariff cap – decision document map**



## Contents

<b>1. Introduction</b> .....	<b>5</b>
Overview .....	5
Methodology .....	5
Considering stakeholders’ responses .....	6
Context and related publications .....	6
<b>2. Methodology</b> .....	<b>7</b>
Overview .....	7
Our methodology .....	9
<b>3. Considering consultation responses</b> .....	<b>20</b>
Relating to additional costs to serve.....	20
How we set the payment method differential and allocate costs .....	25

## 1. Introduction

### Overview

- 1.1. We will set different cap levels for customers with different payment methods. We do this by applying different 'payment method uplifts' to our efficient benchmark.
- 1.2. In this appendix, we provide a detailed explanation of our methodology for calculating, applying, and updating the uplifts. We also explain how we considered responses to our statutory consultation.

### Methodology

- 1.3. In Chapter 2, we set out the different payment method uplifts that will apply to each payment method.
- 1.4. We also explain each part of our methodology for calculating the uplifts. These include:
  - calculating the additional costs of working capital
  - calculating the additional bad debt costs
  - calculating the additional administrative costs
  - benchmarking the efficient level of total additional costs across suppliers
  - considering potential differences in costs between fuels
  - 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<sup>1</sup> customers
  - applying an uplift for non-recovered costs and
  - updating the cap over time

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<sup>1</sup> We refer to direct debit through this appendix. Direct debit payment is used to set the values for payment method defined as "Other Payment Method" in the standard licence conditions (SLC 28AD).

## Considering stakeholders' responses

- 1.5. We received responses from 15 respondents relating to various aspects of the payment level uplift.
- 1.6. In relation to calculating additional costs, the main issues raised were:
  - how we define 'efficient costs'
  - how we apply the payment method uplifts
  - our treatment of prepayment meters.
- 1.7. In relation to how we set the uplifts, the main issues raised were:
  - how we uplift working capital and bad debt for application to benchmark
  - how we set the payment method differential
  - the impact of our approach on customers
  - the impact of our approach on suppliers.

## Context and related publications

- 1.8. 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](https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix_12_-_payment_method_uplift.pdf)
- 1.9. Ofgem (2018), Default Tariff Cap: Statutory Consultation. Appendix 8 – Payment method uplift. [https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix\\_8\\_-\\_payment\\_method\\_uplift.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_8_-_payment_method_uplift.pdf)

## 2. Methodology

In this chapter, we explain that we will set different cap levels for different payment methods, and explain how we calculate the payment method uplifts to set each cap.

### Overview

- 2.1. **We set different caps for customers with different payment methods.**
- 2.2. We set the payment method uplift methodology on the basis of 2017 values as these belong to the same timeframe as the cost data we use, which are also the basis for the baseline cap level. Therefore, numbers quoted in this appendix are in 2017 terms rather than referring to the first cap period, unless stated otherwise.

### Standard credit customers

- 2.3. **We set the default tariff cap level for standard credit customers at a higher level than the cap level for direct debit customers.** We do this by applying a “payment method uplift” to our benchmark. The uplift for standard credit customers is larger than the one for direct debit customers, reflecting the higher costs of supplying these customers. Together, the uplifts for direct debit customers and standard credit customers will:
  - recover the additional efficient cost of serving an average proportion of standard credit customers and
  - set a higher cap for standard credit customers than for direct debit customers (around £75 in our 2017-18 baseline, and £83 in the first cap period, after Earnings before interest tax (EBIT), VAT and headroom<sup>2</sup>)
- 2.4. On average, suppliers incur additional costs when serving standard credit customers compared to customers who pay by direct debit, for example from standard credit customers paying in arrears. The three main sources of costs are:
  - additional working capital costs
  - additional bad debt costs
  - additional administrative costs.
- 2.5. The uplift values are shown in Table A8.1 below. The working capital and bad debt components of the uplifts are calculated as a percentage of our benchmark. These percentages are fixed over time. The administrative costs component of the uplift is calculated as a fixed amount in pounds per customer account. We will index this amount by inflation; we show the 2017 baseline value below. These values are

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<sup>2</sup> For a dual fuel customer with a single rate electricity meter at Typical Domestic Consumption Value (TDCV). TDCV consumption is currently 3,100 kWh for electricity and 12,000 kWh for gas. All payment method uplift and differential values in this appendix are stated with the same parameters unless stated otherwise.

contained in Annex 1 of the standard licence conditions (SLC 28AD of the gas and electricity licence).

**Table A8.1: Payment method uplift values**

Description	Licence condition term	Multi-rate Electricity	Single rate Electricity	Gas
Payment method adjustment percentage for standard credit	PAP <sub>SC</sub>	5.79%	5.83%	5.75%
Payment method adjustment additional cost for standard credit (2017 baseline)	PAAC <sub>SC</sub>	£13.75	£13.75	£13.44
Payment method adjustment percentage for direct debit	PAP <sub>DD</sub>	0.48%	0.49%	0.41%
Payment method adjustment additional cost for direct debit (2017 baseline)	PAAC <sub>DD</sub>	£3.42	£3.42	£3.19

Source: Ofgem analysis of supplier data

### Prepayment customers

**2.6. The Act excludes most prepayment customers from the default tariff cap.**

Customers paying for energy with traditional PPM meters, or smart meters in prepayment mode that are not fully interoperable, are not subject to the default tariff cap as stated in section 3(1)(a) of the Act, so we do not discuss them here.

**2.7. Initially, we set the cap for default tariff customers with fully interoperable smart meters in prepayment mode at the same level as the default tariff cap for direct debit customers.** Customers with fully interoperable smart meters in prepayment mode (SMETS2 PPM<sup>3</sup>) on default tariffs are within the scope of the default tariff cap. The SMETS2 meter rollout has only recently begun, and therefore there are an insufficient number of customers with SMETS2 meters operating in prepayment mode for us to establish reliably any additional efficient costs suppliers incur to serve them, relative to direct debit customers.

2.8. In the near term, the level of the PPM cap and direct debit default tariff cap will be broadly similar for a dual fuel customer with a single rate meter (the majority of customers)<sup>4</sup> – the PPM cap is below the default tariff cap at some levels of consumption and above it at others. During the period covered by the default tariff cap suppliers will roll out SMETS2 meters to a much greater extent. Suppliers have told us that, initially, they will be unable to and need to adjust their systems to distinguish these customers from those with SMETS1 meters.

2.9. To strike a better balance between protecting consumers and ensuring a smooth transition for PPM customers to move to SMETS2 meters, we will monitor any instances where a customer was marginally above the default tariff cap but remained below the level of the PPM cap; in effect receiving the level of protection afforded to other PPM

<sup>3</sup> Where we refer to SMETS2 PPM through this document, we mean a fully interoperable smart meter in PPM mode. This could also be a SMETS1 meter that is fully interoperable.

<sup>4</sup> To note, the default tariff cap is significantly higher than the PPM cap for multi-register customers. In addition, the default tariff cap is higher for electricity but lower for gas than the PPM cap.



customers while suppliers adjust. In Chapter 3, we discuss responses from stakeholders and our considerations in detail.

- 2.10. **Following consultation, the licence includes a power to set a different cap level for SMETS2 PPM customers in the future.** We would consider using this power when more customers have moved onto these meters and there is greater data available.

## Our methodology

- 2.11. We ensure that the payment method uplifts recover the efficient additional costs incurred by a supplier serving an average proportion of standard credit customers by:

- calculating the additional costs of working capital
- calculating the additional bad debt costs
- calculating the additional administrative costs
- benchmarking the efficient level of total additional costs across suppliers
- considering potential differences in costs between fuels
- 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 credit costs
- allocating cost components to standard credit customers and direct debit customers (discussed in Chapter 3)
- applying an adjustment for non-recovered costs.

- 2.12. Our sample of six suppliers, used to benchmark costs, consists of five large suppliers and one medium supplier. These suppliers provided a full set of cost data, which allowed us to include them in our benchmarking exercise.

### Changes from our statutory consultation methodology

- 2.13. In response to the consultation, we have updated the methodology we published in our statutory consultation. We correct for errors and inaccuracies in three places:

1. We benchmark the efficient additional costs components to the costs of the lower quartile supplier, considering additional costs across all components and fuels combined, not separately (paragraphs 2.26 to 2.33).
2. We correct for inconsistencies in allocations over fuels in our sample of suppliers (paragraphs 2.34 to 2.37).
3. We make an adjustment to account for where we have overstated the additional cost of working capital (paragraphs 2.50 to 2.54).

## Calculating additional cost of working capital

- 2.14. 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.
- 2.15. 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 2018 consultation). We express the additional costs of working capital as a percentage of revenue, because the required working capital will vary with consumption.
- 2.16. When serving direct debit customers, customers can pay money in advance. This means that direct debit customers can generate a working capital benefit. We account for this benefit and value the reduction in working capital at 10% (same as the cost of capital).
- 2.17. To calculate the difference in working capital costs between standard credit customers and direct debit customers we:
1. Annualised our quarterly data on working capital requirements per payment method and supplier.
  2. Calculated the cost of that requirement as 10% of the working capital requirement for direct debit and standard credit in 2017. We discuss the cost of capital in Appendix 9 - EBIT
  3. Calculated the ratio of cost of working capital to revenue for each payment method and supplier for 2017.
  4. Calculated the difference per supplier of the measure between standard credit and direct debit.
- 2.18. In algebraic form it would be calculated as below

$$\text{Cost of working capital difference} = \frac{\left( \frac{\text{Working capital requirement}_{SC}}{\text{Revenue}_{SC}} \times 0.1 \right)}{\text{Revenue}_{SC}} - \frac{\left( \frac{\text{Working capital requirement}_{DD}}{\text{Revenue}_{DD}} \times 0.1 \right)}{\text{Revenue}_{DD}}$$

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

- 2.19. The additional cost of working capital for a standard credit customer is 1.9%<sup>5</sup> of standard credit revenue for our benchmark supplier. We explain how we benchmark costs to a supplier in paragraph 2.26 to 2.33

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<sup>5</sup> This is not the EBIT margin; it is the same percentage to one decimal place out of coincidence.

### Calculating additional bad debt costs

- 2.20. On average, standard credit customers incur additional bad debt costs compared to direct debit customers. One reason for this is that direct debit payments are taken automatically by the supplier and therefore minimise the chance of non-payment for a number of reasons.
- 2.21. We calculate this using the bad debt charge as our measure of bad debt. We do not use the bad debt write off as it could vary depending on suppliers' decisions (as outlined in Appendix 12 of our May 2018 consultation). We express the additional cost of bad debt as a percentage of revenue, because the amount of bad debt will vary with consumption.
- 2.22. We calculated the bad debt cost difference using the following approach:
1. we calculated the bad debt charge to revenue ratio for direct debit and standard credit in 2017 per supplier<sup>6</sup>
  2. we then took the difference for each supplier to calculate the bad debt cost difference between payment methods.

We have outlined the calculation in algebraic form below

$$\text{Bad debt cost difference} = \frac{\text{Bad debt charge}_{SC}}{\text{Revenue}_{SC}} - \frac{\text{Bad debt charge}_{DD}}{\text{Revenue}_{DD}}$$

Where DD is direct debit, SC is standard credit.

- 2.23. The additional bad debt cost for our benchmark supplier is 5.1% of standard credit revenue. We explain how we benchmark costs to a supplier in paragraph 2.26 to 2.33.

### Calculating additional administrative costs

- 2.24. 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 and posting
  - customer service costs from a higher propensity to call, for example to pay their bill.
- 2.25. We estimate the additional costs for our benchmark supplier at £19.09 per customer account. We express the additional administrative costs as a flat per customer account

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<sup>6</sup> The bad debt data charge data was already annualised when provided by suppliers.

figure 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 more detail in Chapter 3.

### **Benchmarking to establish the efficient level of additional costs**

- 2.26. In our statutory consultation, we proposed to benchmark the additional costs of serving standard credit customers by taking the lower quartile of the additional cost of bad debt, working capital and administrative costs across suppliers in our sample, looking at each cost component separately. This is in contrast to our approach to benchmarking suppliers' operating costs (see Appendix 6 – Operating costs), which we considered in total, rather than breaking down between different categories of expenditure (eg metering, billing, sales and marketing).
- 2.27. In both analyses, we have considered whether there is a relationship between the separate cost components such that low costs in one category of expenditure may be a result of higher costs in another. We have also considered whether there are circumstances that make the frontier supplier unrepresentative of the market and their costs unachievable for a typical supplier.
- 2.28. Unlike operating costs, the frontier supplier for additional standard credit cost components are large suppliers with many default and standard credit customers. At face value, there is little risk they are unrepresentative. However, there is some uncertainty affecting our estimates and a possibility that factors other than efficiency could be driving some of the variation that we see. For prudence, we therefore proposed to use the lower quartile instead.
- 2.29. In response to the consultation, a supplier suggested that we should benchmark standard credit costs by comparing the total additional costs of standard credit combined across different categories of expenditure, similar to our approach to operating costs. They suggested that suppliers make strategic decisions about spending on different cost components. For example, a supplier could spend more on administrative costs to reduce bad debt costs.
- 2.30. We accept the respondent's reasoning that comparing individual categories of costs separately could distort our estimates, and have adapted our approach to choosing our benchmark as a result, bringing this in line with the approach taken for operating costs. We explain our methodology for benchmarking below. We found our original proposal was likely distorted by interactions between components and allocation decisions by suppliers. Both lower quartile and frontier costs when looking at suppliers' total costs, are lower than the combined total of lower quartiles for each component and fuel separately, showing that we overstated the efficient additional costs.
- 2.31. Although we do not consider there is a risk that the frontier supplier is unrepresentative of the market more widely (which is the case for operating costs and we deal with appropriately) we maintain the use of lower quartile, as there may be unobserved cost drivers affecting the frontier, which are not related to efficiency. Please see Chapter 3 where we discuss this issue in full.
- 2.32. To benchmark suppliers we took the following steps:
1. We calculated the additional cost to serve for the three cost components per supplier as outlined in paragraphs 2.14 – 2.25. Note we use the combined

additional costs for each cost element across fuels. We do this to account for any differing allocation policies and make the costs more comparable across suppliers.

2. We then calculated the full additional cost to serve a dual fuel customer per supplier, by adding together the costs calculated in the previous step.<sup>7</sup>
3. We ranked the suppliers in ascending order of total additional costs, and calculated the lower quartile. As there are six suppliers in our sample, the lower quartile sits between the frontier and second supplier. However, we opted for the second supplier.

2.33. The additional costs for the lower quartile supplier and the range of additional costs across the suppliers in our sample are provided below in Table A8.2.

**Table A8.2 – Additional cost to serve by cost element**

Cost element	Lower quartile supplier (%)	Range <sup>8</sup> (percentage points)
Additional bad debt	5.1%	14.8%
Additional working capital	1.9%	5.3%
Additional administrative costs	£19.09	£99.87

### Differences in costs between fuels

- 2.34. There is significant variation in the additional bad debt, working capital and administrative costs reported for different fuels by the suppliers in our sample, with some suppliers reporting higher costs for electricity customers, others higher costs for gas.
- 2.35. We cannot reliably say that these differences reflect differences in the efficient costs of supplying gas and electricity customers:
1. We cannot infer whether a difference in costs exists from market prices. Direct debit discounts are usually applied uniformly across the fuels. However, we know that suppliers' pricing strategies incorporate factors other than underlying costs.

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<sup>7</sup> We converted the percentage terms to pound figures by applying them to the benchmark, as outlined through our methodology.

<sup>8</sup> The range states the difference between the maximum cost and the minimum cost.

2. There is evidence to suggest that different suppliers may have taken different accounting approaches to allocating these additional costs, which could be driving the variation we see.

2.36. In response to our consultation, one supplier argued that we should compare suppliers' total additional costs, looking at the cost components and fuels together, and use that comparison to set our benchmark. This approach, looking at total costs across fuels, is the one we use to analyse operating costs when faced with similar risks of bias (see Appendix 6 – Operating costs). We are persuaded that we should analyse additional standard credit costs using the approach we consulted on for operating costs.

2.37. Given the above, we use the cost information we have collected to calculate a combined additional cost to serve for each cost component, across fuels ie a single percentage for additional bad debt, working capital and administrative costs for gas and electricity.<sup>9</sup> For example, in calculating bad debt costs, we take the sum of the reported bad debt costs for both gas and electricity standard credit customers, and divide this by the sum of gas and electricity revenues to calculate.

### **Applying adjustments for application to a direct debit benchmark**

2.38. Our measures of the additional working capital and bad debt costs, calculated using the methodology set out above, are expressed as a percentage of standard credit revenue. However, the payment method uplift is expressed as an increment to the direct debit efficient cost benchmark. To ensure consistency, we must therefore uplift the bad debt and working capital ratios to reflect a proportion of total direct debit costs, rather than total standard credit costs.

### **Allocating cost components between the direct debit and standard credit caps**

2.39. We do not allocate all additional costs to standard credit customers. This would result in a differential between the level of the direct debit and standard credit caps that exceed those in the market. Furthermore, there is not a strong case that only standard credit customers should be required to carry all of the additional costs.

2.40. We have set the baseline payment method differential – the difference between the standard credit and direct debit level of the cap in 2017/18 prices – to match the large supplier price differential between standard credit and direct debit for the period April 2017 – April 2018. To do this we:

1. Allocate all additional working capital costs to standard credit customers (about £10 for gas, £11 for single rate electricity and £21 for dual fuel customers in 2017 at TDCV)
2. Allocate 52% of additional bad debt and administrative costs to standard credit customers (about £46 for gas, £50 for single rate electricity, and £96 for dual fuel)

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<sup>9</sup> Final values of Payment method Adjustment Percentage (PAP) and Payment method Adjustment Additional Cost (PAAC) differ slightly for gas and electricity. This is because these values are also affected by the assumption we make about the average proportion of default tariff customers using standard credit and direct debit, which is estimated separately for gas and electricity (see Chapter 3).

customers in 2017 at TDCV). We spread the remaining additional cost to serve over all customers.

- 2.41. We spread the costs between the direct debit and standard credit caps using an assumed percentage of customers using each payment method. We refer to this as the assumed customer base. For the assumed customer base, we use the average proportion of non-prepayment default tariff customers paying by standard credit in 2017: 33.7% for gas and 35.9% for electricity.
- 2.42. In order to calculate the final percentage uplift and additional cost values, we calculated a weighted uplift for each cost element for each fuel and payment method.
- 2.43. In equation form this gives

$$\text{Weighted cost element}_{sc,f} = (\text{cost element} \times a) + [\text{cost element} \times (1 - a) \times CB_f]$$

$$\text{Weighted cost element}_{dd,f} = [\text{cost element} \times (1 - a) \times CB_f]$$

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.

- 2.44. For example, the 5.8% additional cost of bad debt for gas would be allocated 52% to standard credit and the remaining 48% spread over direct debit and standard credit. Based on the assumed customer base of 33.7%, this would result in a bad debt percentage uplift for a gas standard credit customer of 3.95%. We explain our rationale in Chapter 3.
- 2.45. This ensures that the level of the cap for standard credit, as it would have been calculated in the 2017/18 baseline period, is around £75 higher than the direct debit cap (after EBIT, VAT and headroom). Table A8.3 shows the payment method uplifts for standard credit and direct debit cap in the baseline period.

### **Recovery of non-payment**

- 2.46. By allocating the additional efficient costs, the cap should ensure that suppliers are able to recover an efficient level of additional costs, based on our assumed customer base. However, suppliers might under recover due to non-payment among their customers.
- 2.47. We 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 is to account for the under recovery and ensure suppliers are not disadvantaged due to non-payment.
- 2.48. We 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 bad debt cost data for all suppliers from whom we collected the data. 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.

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

### **Adjustment for direct debit working capital benefits**

- 2.50. When calculating the additional working capital for a standard credit customer, we take the difference between the working capital requirement for a standard credit customer and the working capital requirement for a direct debit customer as outlined in paragraphs 2.14 to 2.19.
- 2.51. If the benchmark represented the cost of the direct debit working capital requirement, then by combining it with the additional costs of standard credit working capital (compared to direct debit), we should be left with the full working capital costs of standard credit.
- 2.52. However, as highlighted in paragraph 3.33 of Appendix 9 to the statutory consultation, the benchmark does not only include the pure working capital cost for direct debit customers; it contains a working capital requirement across all payment types (ie a weighted average).<sup>10</sup> Based on our analysis of working capital costs, that means the benchmark is overstated for direct debit customers, because the weighted average cost is higher than the direct debit cost. It also means that the combination of the benchmark and the additional working capital cost of standard credit (as compared to direct debit) overstates the standard credit costs. This is because we double count the difference between the direct debit cost and the weighted average cost, which is included in the benchmark and in the uplift.
- 2.53. In our statutory consultation, we acknowledged that including the weighted average working capital impact in our benchmark would overstate the caps. We estimate the overstatement is approximately £5 per dual fuel customer. On that basis, we make a correction to remove the working capital cost that is double counted in the standard credit cap, and wrongly included in the direct debit cap.
- 2.54. We adjust for this by calculating the weighted average cost of working capital for our payment method uplift benchmark supplier. We then calculate the difference between their weighted average and their cost of working capital for direct debit customers. We subtract the difference from both the direct debit and standard credit cap levels. By doing so we do not change the calculated difference between direct debit and standard credit costs; we just make an adjustment to account for the benchmark to which it is applied.

### **Applying payment method uplifts**

2.55. Following the steps set out above, we calculate our final payment method uplifts for standard credit and dual fuel, for gas and electricity. These are included in the cap via

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<sup>10</sup> “We note that the CMA’s estimate of the amount of capital required was calculated based on supply businesses as a whole (ie including working capital for standard credit customers). As we are making specific allowance for the working capital costs of standard credit through the payment method adjustment, using the CMA’s figure may slightly overstate the amount of capital required for direct debit customers.”



two terms specified in the licence. The Payment Method Adjustment Additional Cost (PAAC), expresses the additional administrative costs (the fixed element), in £ per customer account. The Payment Method Adjustment Percentage (PAP) expresses the percentage uplift applied to the 'core benchmark'.<sup>11</sup> The PAP combines the bad debt percentage and the working capital percentage, giving the total percentage uplift for each payment method and fuel.

- 2.56. Table A8.3 shows a breakdown of the payment method uplift in the 2017/18 benchmark for a dual fuel customer.

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<sup>11</sup> The core benchmark consists of wholesale costs, operating costs, policy costs and network costs.

**Table A8.3: Breakdown of uplift figures for a dual fuel customer**

Cost Element	Additional Cost	Approach	Uplift to SC	Uplift to DD	Difference
Working capital	£21	Fully allocate to standard credit	£21	£0	£21
Bad debt	£56	Allocate 52% to standard credit and spread the remaining 48% over both payment methods	£37	£9	£28
Admin costs	£40	Allocate 52% to standard credit and spread the remaining 48% over both payment methods	£27	£7	£21
Working capital adjustment			-£5	-£5	£0
<b>Total</b>	<b>£117</b>		<b>£80</b>	<b>£11</b>	<b>£69</b>
<b>Total (including EBIT and VAT)</b>	<b>£125</b>		<b>£86</b>	<b>£12</b>	<b>£74</b>

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 dual fuel, typical domestic consumption values. Additional cost is not affected by the working capital requirement as the same amount would be taken off both the standard credit uplift and direct debit uplift if we allocated all costs.

2.57. We expect the difference between the standard credit and direct debit caps to be around £83 for the first cap period for a dual fuel customer, with typical consumption and a single rate electricity meter. The increase compared to 2017/18 reflects the impact of rising costs on bad debt and working capital costs. We explain below how we will update the default tariff cap over time and how this relates to payment method uplift.

### Updating the cap levels

2.58. We will update the default tariff cap so that it changes over time as underlying efficient costs change.

2.59. As described above, we set the uplift relating to bad debt and working capital costs as percentages, applied to the core benchmark consisting of operating, wholesale, policy and network costs. As such, 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 costs as the benchmark is updated.

- 2.60. The uplift relating to administrative costs is an amount in pounds per customer account. We will index these costs using CPIH.<sup>12</sup> This is the part of the cost to serve difference that is a lump sum and does not vary with consumption.
- 2.61. 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.
- 2.62. For further information on the updating the cap methodology, please refer to Appendix 3 – Updating the cap methodology.

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<sup>12</sup> Consumer price inflation including measure of owner occupiers' housing costs (OOH).

### 3. Considering consultation responses

In this chapter, we summarise and consider the main points stakeholders raised in response to our statutory consultation.

- 3.1. We received responses from 15 respondents relating to various aspects of the payment method uplift.
- 3.2. In relation to calculating additional costs, the main issues raised were:
  - how we define 'efficient costs'
  - how we apply the payment method uplifts
  - our treatment of prepayment meters.
- 3.3. In relation to how we set the uplifts, the main issues raised were:
  - how we uplift working capital and bad debt for application to benchmark
  - how we set the payment method differential
  - the impact of our approach on customers
  - the impact of our approach on suppliers.
  - implementation issues.

## Relating to additional costs to serve

### How we define 'efficient costs'

#### *Stakeholder responses*

- 3.4. In our statutory consultation, we proposed to use lower quartile costs to set our efficient benchmark for additional working capital, additional bad debt, and additional administrative costs, benchmarking costs separately for each cost category and fuel.
- 3.5. Two suppliers submitted that we should use an approach that is consistent with the benchmarking process for operating costs. They suggested we should consider benchmarking the additional standard credit costs using the same supplier as we use to benchmark operating costs. They said suppliers with low direct debit costs could have high standard credit costs (and vice versa), as a result of differences between suppliers in the way that costs had been allocated between payment methods.
- 3.6. Furthermore, one supplier suggested that benchmarking each cost element separately could cause distortions in the uplift as there could be strategic interactions between

cost elements, eg a higher administration of managing bad debt cost to keep bad debt charge lower.

- 3.7. One supplier also highlighted that by benchmarking the fuels separately we may be cherry picking costs that are not achievable by an efficient supplier, due to the difference in how costs might be allocated between gas and electricity. They also highlighted that in operating costs we pick the benchmark supplier based on their dual fuel costs.
- 3.8. One supplier implied that suppliers with lower proportions of customers on standard credit would face higher additional costs to serve than those with higher proportions. They argued that suppliers who are good at moving customers onto direct debit would be left with a stock of high cost standard credit customers.
- 3.9. We have decided to make some changes to our approach to benchmarking, following supplier comments. We outline the changes below.

#### *Our considerations*

##### *Benchmarking to the same supplier as operating costs*

- 3.10. We do not think it is appropriate to take the payment differential reported by the supplier used to set the operating cost benchmark, rather than separately benchmarking additional standard credit costs.
- 3.11. First, we note that working capital costs are not captured under our operating costs benchmark, and we therefore did not expect a supplier's direct debit operating costs to be correlated with the working capital costs reported by a supplier for standard credit.
- 3.12. In principle, a relationship could exist between bad debt and administrative costs for direct debit and standard credit. For example, this might be the case if the way that suppliers allocate these costs between payment method causes them to have unusually low standard credit and unusually high direct debit costs. This could cause suppliers to have lower payment method differentials than we might otherwise expect – potentially causing us to understate the efficient benchmark for standard credit, and overstating the direct debit benchmark.
- 3.13. However, in practice, we have not seen any evidence to suggest that such a relationship exists, or the way suppliers have allocated costs between payment methods is driving their position in the cost distribution. We note that direct debit customers have inherently low bad debt costs. We have in any event set both the operating cost and payment method adjustment benchmarks above the frontier, to reflect the uncertainty affecting our estimates.
- 3.14. We also note that an efficient supplier with low direct debit costs is not necessarily efficient at dealing with the additional costs associated with serving a standard credit customer. This possibility would be ignored where a separate benchmarking exercise is not carried out for the payment method adjustment.
- 3.15. Given this, we do not consider that a change is required to our approach.

*Benchmarking additional standard credit costs over cost elements and fuels*

- 3.16. We agree that there could be some interaction between the different components of standard credit costs, and that the approach proposed in the statutory consultation for payment method uplift was less consistent with the operating cost methodology. The risks of interaction across the cost components outweigh the benefits from a larger sample size for costs.
- 3.17. We have therefore updated our approach to benchmarking additional costs to serve standard credit customers in payment method uplift to address these issues (see paragraph 2.26 to 2.37). As described in Chapter 2, we make the following changes:
1. we now use the same benchmark supplier for calculating the total efficient level of bad debt, working capital and administrative costs
  2. we now benchmark costs combined across gas and electricity.
- 3.18. As we now benchmark costs to the same supplier over cost elements and fuels, our sample of suppliers is reduced to six,<sup>13</sup> for whom we have a full set of data. The sample consists of five large suppliers and one medium supplier. We consider this mix of suppliers to be representative of the market as they supply over three quarters of standard credit default customers.
- 3.19. We calculated the additional cost to serve a standard credit customer for each supplier in the sample, combined across fuels. We then picked the supplier closest to the lower quartile additional cost to serve a standard credit customer. To note, as there are six suppliers in our sample, the lower quartile sits between the frontier and second supplier. However, we opted for the second supplier.
- 3.20. We used that supplier's reported costs for each component to set our efficient payment method uplift.
- 3.21. We continue to set our efficient benchmark at the level of the lower quartile supplier, for the reasons mentioned in our statutory consultation. If variation between suppliers' costs was driven only by difference in efficiency, then we would benchmark the additional costs to the supplier with the lowest (frontier) costs.
- 3.22. We do not think it is likely that between the suppliers in our sample that the differences in costs per customer are explained by differences in the customer base. The frontier supplier has a significant proportion of standard credit customers, and a similar proportion to suppliers with substantially higher costs. There is a range of suppliers with very different costs per customer but many of the suppliers have high and similar proportions of default tariff customers paying by standard credit.

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<sup>13</sup> This is in comparison to our methodology at statutory consultation where we treated each cost element separately.

- 3.23. However, we consider that there is some uncertainty affecting our estimates, and it is possible that some of the differences we observe are driven by factors other than efficiency. Therefore, we maintain the lower quartile as our benchmark.

### **Applying payment method uplift**

- 3.24. In our statutory consultation, we proposed to calculate the uplift values separately for gas and electricity. The electricity uplift was higher than the gas uplift. This was the result of a combination of the reported additional costs to serve a standard credit customer being higher for electricity than for gas, and our benchmark being higher for electricity than for gas.
- 3.25. One supplier argued that there was no reason for there to be a difference in uplift values for the two fuels. They also claimed that current market practice is to have the same differential for gas and electricity.
- 3.26. They suggested we calculate the additional cost to serve a dual fuel customer then spread the differential equally over gas and electricity. This would involve re-scaling PAP and PAAC so that the numbers applied to each fuel benchmark individually would give the same differential between gas and electricity.
- 3.27. We do not think it would be appropriate to equalise the pound differential between the fuels. This is because doing so would ignore that bad debt and working capital costs – as described above – are a function of revenues. Because revenues under the cap for a typical level of consumption will differ for gas and electricity, the appropriate level of uplift in pounds will also differ. Ignoring this would lead to gas customers subsidising electricity customers, and create a risk that suppliers with larger numbers of electricity customers would be unable to cover the additional costs of their standard credit customers through their direct debit revenue.

### **Treatment of prepayment meters**

- 3.28. In our statutory consultation, we proposed to set the cap for relevant prepayment customers in line with the cap for direct debit customers.
- 3.29. We proposed that SMETS2 PPM customers on default tariffs would be protected using the direct debit default tariff cap, as we did not believe there to be enough data currently to estimate a market cost to serve estimate. We also proposed to have a clause in the licence conditions that allowed us to revisit a payment method uplift for customers with a fully interoperable smart meter in prepayment mode when we considered there to be sufficient data available.
- 3.30. Responses can be broken down into those regarding implementation and those regarding customers.
- 3.31. Many suppliers argued that the interaction of the default tariff cap and the PPM cap would cause confusion for customers. They mentioned three points in particular:
1. Customers would need to know their meter type to get an accurate quote as the default tariff cap has a different standing charge and unit rate to the PPM cap.

2. A customer could face an increase in price when taking up a smart meter once SMETS2 meters become the standard. This could deter customers from taking up a smart meter and impact smart meter rollout numbers.
  3. The divergence of the two caps in future, due to differing methodologies will likely exacerbate any confusion and consequences.
- 3.32. A few suppliers mentioned there might be operational and implementation difficulties implementing a different tariff for SMETS2 PPM customers, as it would require changes to their IT and billing systems.
- 3.33. One supplier outlined that the direct debit level of the default tariff cap was inappropriate for SMETS2 PPM customers. They highlighted that:
1. PPM customers can have debt if they have carried it across from a different supplier under the Debt Assignment Protocol.
  2. PPM customers have a higher propensity to call than standard credit customers, and there are extensive administrative costs applicable to PPM customers.

*Our considerations*

- 3.34. Our approach remains largely the same. We remain of the view that there is not enough data to calculate a specific uplift for SMETS2 PPM customers and we do not believe it to be an issue currently given the small number of SMETS2 meters operating in prepayment mode.
- 3.35. We maintain that SMETS2 PPM customers are likely to be closer in cost to direct debit customers than standard credit customers due to their lower working capital requirements and lower levels of bad debt.
- 3.36. We recognise that until suppliers have critical mass of customers with interoperable smart meters, then they may have difficulties identifying these customers or managing their communication in a clear way and this could lead to customer confusion. To that end, and to protect consumers, we will monitor any deviations from the default tariff cap and would urge suppliers to ensure that any deviations do not exceed the PPM cap.
- 3.37. This will allow suppliers to align the treatment of SMETS2 PPM customers with those on the PPM cap and ensure a smooth transition on the smart meter rollout.
- 3.38. We will keep this position under review as the factual position changes regarding the level of the two caps and the rollout of fully interoperable meters operating in prepayment mode.
- 3.39. We plan to work with the Competition and Markets Authority (CMA) when they conduct the mid-term review of the prepayment meter cap in 2019 to ensure our approach and thinking is aligned.



## How we set the payment method differential and allocate costs

- 3.40. In our statutory consultation we proposed to set the difference between the level of the standard credit and direct debit caps in our 2017/18 baseline at £75, reflecting the average payment differential between direct debit and standard credit offered by the six largest suppliers in that period. To do this, we would allocate all of the additional working capital cost to standard credit customers, plus 60% of the additional bad debt and administrative costs. We would spread the remaining costs across all customers, using the average proportion of standard credit customers.
- 3.41. One supplier proposed we benchmark the price differential in cap period summer 2018 to the large supplier differential in the same period (£90). They claimed that we benchmarked the price differential at implementation to the simple market average differential of £82.
- 3.42. Another supplier suggested we had moved too far away from our policy consultation position of spreading all additional bad debt and administrative costs over both payment methods, resulting in a lower differential. They also suggested that only a small proportion of standard credit customers incur the majority of additional costs of standard credit customers, and therefore more of the cost should be borne by both payment methods.
- 3.43. We have not changed our approach. Our intention was to benchmark the payment method differential to the large supplier average in the 2017/18 baseline period (approximately £75). We chose to benchmark it in 2017/18, as that is the period for which we have carried out our efficient cost analysis.
- 3.44. Due to changes in the benchmarking of payment method uplift costs, as outlined in Chapter 2, we have adjusted the allocation percentages to get back to the £75 differential. Note that our stated intention in the statutory consultation was to set the differential at the specified level for a dual fuel customer with typical consumption, in cash terms. The percentages we select are set to achieve that differential. We therefore now allocate 52% of additional bad debt and administrative costs to ensure a differential of £75 in 2017/18.
- 3.45. We explain our approach to allocating the different types of costs below.

### Allocating working capital

- 3.46. Working capital is a feature and cost of standard credit, as opposed to a cost associated with the characteristics of the customers who happen to pay by standard credit.
- 3.47. 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

- 3.48. The approach we take to allocating bad debt and administrative costs 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 additional cost. 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 choose to have a paperless account and pay online, thereby not incurring the additional administrative costs that could be attributed to standard credit customers as a group.

- 3.49. We allocate 52% 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 A8.4: Average large supplier differential**

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

Source: Ofgem analysis of Energy Helpline data

Note: Prices at medium TDCVs, GB average for a dual fuel customer. 2017 differential averaged over the period April 2017 to March 2018. 2018 differential as of 28<sup>th</sup> July 2018.

### **Current price trends**

- 3.50. Over 2017, no suppliers had a standard credit to direct debit price differential above what we estimate to be the full additional cost to serve difference in 2017 (£125). As of summer 2018, only one supplier has a differential above the full additional cost to serve (which is likely to be higher in 2018 terms). This means that most suppliers, to some degree, are already spreading costs over the payment methods. From engagement with suppliers there appears to be various reasons for this.

### **The impact of our approach on customers**

- 3.51. One consumer group said that the payment method uplift is a poverty premium. They state, "While we accept that there are more fuel [poor] households on Direct Debit, using this as a rationale for keeping payment differentials is not supported. If these additional costs were spread across all consumers, fuel poor households affected would each incur a smaller burden of additional cost than if left concentrated to one payment method. It is not right for a greater burden to fall on a minority of consumers who are disproportionately less likely to be able to contend with additional costs."
- 3.52. Two suppliers asked for clarification on whether the payment method differential would apply to all tariffs and whether Ofgem would take enforcement action if a supplier were to use a different methodology to calculate their additional costs to serve for fixed tariffs.
- 3.53. We outline below why we have not changed our approach.

### *Our considerations*

#### *Vulnerable customers*

- 3.54. 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.
- 3.55. We note the respondent's arguments that spreading costs over a greater number of people spreads those costs more thinly, however, relatively few of either payment method are in fact fuel poor. We retain the view that payment method is a weak proxy; using this aspect of the price cap as a tool to address fuel poverty would be a relatively ineffective one and distorting in other ways.
- 3.56. There are clear additional costs that standard credit customers incur and we think it would be disproportionate to spread all of these additional costs over both payment methods.

#### *Interaction with SLC 27.2A*

- 3.57. We do not consider that the default tariff cap conflicts with licence condition SLC 27.2A. The underlying costs of standard credit scale with consumption so we have set the cap along those lines.
- 3.58. We do not consider SLC 27.2A to require that the payment differential used to set the default tariff cap maximum charge must be replicated by suppliers' pricing for fixed tariffs. We interpret SLC 27.2A to mean that price differences cannot be more than is justified by cost reflectivity.
- 3.59. It is not always clear what is most cost reflective. Cost reflectivity may look different when considering group effects compared to when we consider individual effects. We have set a differential at the maximum charge that we think is appropriate on average for default tariff customers.
- 3.60. 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 segment – suppliers have discretion to decide how to allocate costs incurred in the fixed term segment. The differential in the fixed term segment is likely to have a different effect than in the default segment, as customers are likely to respond differently to incentives.
- 3.61. Furthermore, to clarify, we are setting the price differential at the maximum charge (ie the cap level) and it is up to suppliers to decide their pricing strategies within this limit. This means that, under the default tariff cap, a supplier may have a lower or higher differential than that set at the maximum charge, for example if a supplier decides to price under the maximum charge for one payment method and at the maximum charge for the other. In setting prices and payment method differentials, suppliers must ensure they are:
1. compliant with the maximum charges set out in the default tariff cap

2. compliant with any existing licence conditions including SLC 27.2A regarding cost reflectivity.

### **The impact of our approach on suppliers**

- 3.62. In our statutory consultation, we proposed to spread the additional costs to serve a standard credit customer over the average proportion of non-PPM default customers paying by standard credit.
- 3.63. One supplier stated that by not allowing for the maximum proportion of non-PPM default customers paying by standard credit, customers with higher proportions will be unable to finance their efficient costs effectively. They, along with another supplier, also mentioned that suppliers with lower proportions than average would have a competitive advantage.
- 3.64. We have not changed our approach as explained below.
- 3.65. 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 are able, within the limits of the cap, to make up the difference by charging direct debit customers more. Whether a supplier pricing to the maximum allowed under the cap under-recovers or over-recovers the costs of standard credit customers depends on the proportion of direct debit and standard credit customers they have.
- 3.66. We 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 could under-recover those costs through the payment method uplift. It is also the case that suppliers with fewer standard credit customers 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 consumers with lower prices.
- 3.67. The greater the price differential, the less prominent either risk is. We have analysed the impact for suppliers with different proportions of standard credit customers compared to the average. At our proposed differential level, the effects are small.
- 3.68. We acknowledge that suppliers with greater than average exposure to standard credit customers will incur higher costs. We also acknowledge setting a higher allowance, provides a greater potential windfall to those with few standard credit customers. We also bear in mind that there can be variation in efficient costs that work in the opposite direction in other components of the cap. For example, suppliers with higher average consumption levels will have higher profitability, given the cap's relationship with underlying costs at different levels of consumption. When considering the cap level, we keep in mind that allowing the maximum allowance for each issue, could significantly over compensate each supplier, as no single supplier is exposed to the maximum cost for all variations. Furthermore, in principle, we would not consider it appropriate to set an allowance for one supplier with the maximum possible efficient costs, where that means substantially increasing the cap above the typical cost of supplying the majority of Standard Variable Tariff (SVT) customers. We consider these factors when setting an appropriate level of headroom (see Appendix 2 – Cap level analysis and headroom).

## **Implementation and operation**

- 3.69. Throughout our consultation process, we have maintained that the payment method uplift will be in part a variable uplift and in part a fixed uplift. The variable element reflects additional bad debt and working capital costs, as they are likely to scale with consumption. The fixed element captures the additional administrative costs - these are unlikely to vary with consumption. Through the explanation in our consultations and the proposed licence conditions, we proposed that the standard credit cap would have a different unit rate and standing charge.
- 3.70. In our statutory consultation, we made it clear by publishing the default tariff cap model and the associated cap levels that this would be the case.
- 3.71. Many stakeholders commented on our proposal to have a different unit rate and standing charge for the standard credit level of the default tariff cap. Most suppliers highlighted that this was a step away from the current industry practice of applying the entire difference to the standing charge and labelling it a direct debit discount.
- 3.72. Some suppliers and a trade association argued that adding a variable element to the payment method differential would cause customer confusion. Customers would find it harder to compare tariffs and understand the differences between payment methods.
- 3.73. Some suppliers raised concerns that a movement towards a variable element to the payment method differential would require system changes and come with an operational cost. One supplier mentioned this might not be achievable in the given timeframe.
- 3.74. Suppliers also flagged required changes to customer messaging. Two suppliers specifically mentioned changes in messaging around current direct debit discounts could be particularly difficult.
- 3.75. One supplier asked for more clarity around how we expect the process to work operationally. They included questions such as, "when to move a customer to standard credit"; and, "If a customer reinstates their direct debit, how quickly will the supplier be expected to return customers to the DD cap level".
- 3.76. One supplier suggested that quarterly direct debit customers should be captured under the standard credit cap, as they pay in arrears so their working capital requirements are similar to standard credit customers. Another supplier suggested that variable direct debit customers also be included under the direct debit cap, as they have lower cash flow and cost to serve benefits than fixed direct debit customers.

### *Our considerations*

#### *Format of the uplift*

- 3.77. As stated in the statutory consultation, there are many factors (beyond cost) that a supplier takes into account when setting their payment method differential; for instance political pressure and customer satisfaction. We believe the uplift format we are suggesting is more reflective of the costs faced by suppliers, as bad debt and working capital costs are influenced by consumption.

- 3.78. We do not believe that changing the structure of the differential will lead to significant customer confusion. Suppliers already bill their customers with a unit rate and a standing charge. This reflects the underlying costs of supply. Some of the costs associated with payment methods scale with consumption so we reflect that in the cap.
- 3.79. Suppliers have experience in explaining the impact of variable rates, so should be in a position to limit confusion. When switching, customers are likely to compare tariffs across suppliers as well as within their current suppliers, which means they already have to compare differing unit rates and standing charges. Furthermore, many customers chose to switch online using online quote tools and price comparison websites that calculate an estimated annual bill based on the standing charge and unit rate of a tariff. Those switching by calling a supplier should have the costs between tariffs explained to them by the call handler. We therefore do not believe that having a different unit rate between payment methods is likely to cause additional complexity to customers looking to switch.
- 3.80. We discuss our approach to the implementation issues raised as part of this consultation in the Overview document.

#### *Operation guidance*

- 3.81. Regarding operational specifics, it is to the supplier's discretion how they operate their supply business. The questions highlighted such as when to move a direct debit customer to standard credit already exist in the market, and suppliers will have their own policies, we do not expect the payment method uplift to change this. We expect suppliers to comply with existing licence conditions and pay close attention to the standards of conduct when dealing with customers to ensure a fair outcome for them.

#### *Quarterly and variable direct debit*

- 3.82. We treat both quarterly direct debit and variable direct debit under the direct debit level of the default tariff cap. They are likely to have higher working capital requirements compared to fixed direct debit, as they pay in arrears. They are likely to have lower bad debt and administrative costs, in comparison to a standard credit customer as the payment is taken automatically, making them less likely to miss payments.
- 3.83. Furthermore, there are currently variations between how suppliers treat variable direct debit in the market. Of the six largest suppliers, while two of them charge variable direct debit at the standard credit rate, the other four charge them at the direct debit rate.