ofgem Making a positive difference for energy consumers

Default Tariff Cap: Policy Consultation Appendix 12 - Payment method uplift

Consultation - supplementary appendix

Publication date: 25 May

Response deadline: 25 June 12.30pm

Contact: Anna Rossington

Team: Retail Price Regulation

Tel: 020 7901 7000

Email: retailpriceregulation@ofgem.gov.uk

Overview:

The energy market works well for consumers who shop around. Suppliers compete for these engaged consumers, offering low prices to gain or retain their custom.

But the retail energy market is not working for consumers who remain on their supplier's default tariff. Our work, and the Competition and Markets Authority's investigation, has shown there is little competitive constraint on the prices suppliers charge these consumers. As a result, they are paying more than they should be.

To address this problem, Government has introduced legislation into Parliament which would require Ofgem to design and put in place a temporary cap on all standard variable tariffs and fixed-term default tariffs. We anticipate that Parliament will approve the Domestic Gas and Electricity (Tariff Cap) Bill in the summer, and the default tariff cap will come into force at the end of 2018.

We are now consulting on how we might design and implement the default tariff cap. This supplementary appendix to the main consultation document sets out our proposals in relation to calculating and applying a payment method uplift for standard credit customers. 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 main consultation document.

Associated documents

Policy consultation for Default Tariff Cap – Overview
https://ofgem.gov.uk/system/files/docs/2018/05/default_tariff_cap_-_policy_consultation_-_overview.pdf

Links to supplementary appendices

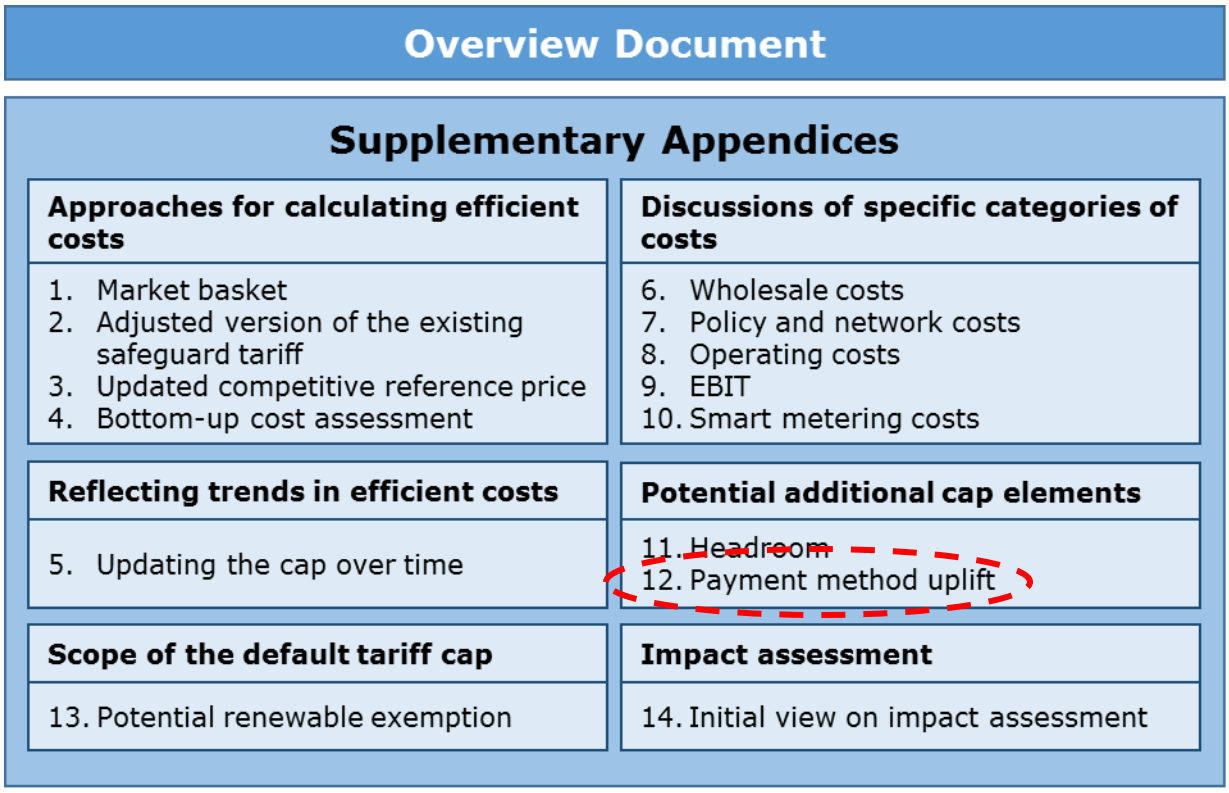
- Appendix 1 - Market basket: https://ofgem.gov.uk/system/files/docs/2018/05/appendix_1_-_market_basket.pdf
- Appendix 2 - Adjusted version of the existing safeguard tariff https://ofgem.gov.uk/system/files/docs/2018/05/appendix_2_-_adjusted_version_of_the_existing_safeguard_tariff.pdf
- Appendix 3 – Updated competitive reference price https://ofgem.gov.uk/system/files/docs/2018/05/appendix_3_-_updated_competitive_reference_price.pdf
- Appendix 4 – Bottom-up cost assessment https://ofgem.gov.uk/system/files/docs/2018/05/appendix_4_-_bottom-up_cost_assessment.pdf
- Appendix 5 – Updating the cap over time https://ofgem.gov.uk/system/files/docs/2018/05/appendix_5_-_updating_the_cap_over_time.pdf
- Appendix 6 – Wholesale costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_6_-_wholesale_costs.pdf
- Appendix 7 – Policy and network costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_7_-_policy_and_network_costs.pdf
- Appendix 8 – Operating costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_8_-_operating_costs.pdf
- Appendix 9 – EBIT https://ofgem.gov.uk/system/files/docs/2018/05/appendix_9_-_EBIT.pdf
- Appendix 10 – Smart metering costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_10_-_smart_metering_costs.pdf
- Appendix 11 – Headroom https://ofgem.gov.uk/system/files/docs/2018/05/appendix_11_-_headroom.pdf
- Appendix 12 – Payment method uplift https://ofgem.gov.uk/system/files/docs/2018/05/appendix_12_-_payment_method_uplift.pdf
- Appendix 13 – Renewable tariff exemption https://ofgem.gov.uk/system/files/docs/2018/05/appendix_13_-_renewable_tariff_exemption.pdf
- Appendix 14 – Initial view on impact assessment https://ofgem.gov.uk/system/files/docs/2018/05/appendix_14_-_initial_view_on_impact_assessment.pdf

Document map

This supplementary appendix to the main overview document set out our proposals for calculating the additional costs to serve a standard credit customer over a direct debit customer. It also presents our proposal and considered options for calculating the uplift.

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

Figure 1: Default tariff cap – policy consultation document map



Links to these documents can be found in the 'Associated documents' section of this document

Contents

1. Overview **5**
Additional costs associated with standard credit customers 5
How we propose to allocate those additional costs 5

2. Framework **7**
Additional cost of standard credit customers 7
Options considered 8
Option 1: Two caps with no socialisation of standard credit costs 8
Option 2: Single cap with full socialisation 9
Option 3: Two caps with partial socialisation of standard credit costs 11
Our proposed option 12
Rationale 13

3. Methodology **16**
Calculating the uplift 16
Comparisons with other estimates 18
Socialisation level 19
Effect on suppliers 20

4. Indexing the payment method uplift **21**

5. Summary of consultation responses **22**

6. Consultation response and questions **23**

1. Overview

Additional costs associated with standard credit customers

1.1. Consumers paying for energy by direct debit tend to pay less than consumers paying for energy by standard credit. Currently, average market prices are around £55 higher for standard credit consumers, and £77 higher when looking at the large suppliers only.[1]

1.2. During its investigation, the Competition and Markets Authority (CMA) estimated that the cost of serving standard credit customers was between £88-158 per dual fuel account (in 2017 prices) higher than for direct debit customers. The main reasons for additional costs are: higher levels of bad debt; greater working capital requirements; and other administrative costs to serve (not captured by bad debt or working capital).

How we propose to allocate those additional costs

1.3. This appendix considers the costs of serving the different payment methods, and how we propose to treat them in the default tariff cap. We refer to this treatment as the "payment method uplift". We have analysed whether we consider it right to have two caps, attributing each or some element of the additional costs to Standard Credit customers; or to have one cap, spreading each category of additional cost across both payment methods.

1.4. All bad debt and working capital figures presented in the appendix are calculated at Typical Domestic Consumption Value (TDCV).[2] We present values as whole numbers for presentational purposes so there may be instances of rounding error where breakdowns across the document are slightly inconsistent by small amounts.

1.5. We consider three options for the uplift, and discuss the merits of each approach. We propose separate caps for direct debit customers and standard credit customers to reflect the genuine additional costs to serve. However, where appropriate we would spread some of the additional cost categories onto direct debit customers.

[1] Prices based on Energyhelpline data for dual fuel at medium TDCV in March 2018. Difference remains fairly stable over 2017.
[2] 3,100 kWh for electricity and 12,000 kWh for gas.

1.6. We propose allocating additional working capital costs to standard credit customers, and spreading the costs of bad debt and other administrative costs between both payment types.

1.7. Stakeholders have raised concerns that standard credit consumers are more likely to be fuel poor or vulnerable, so cost differentials should be reduced on that basis. We do not think payment method is the perfect proxy for vulnerability. Around 50% of all fuel poor customers pay by direct debit, whereas only 20% pay by standard credit.[3] This is an issue we continue to consider, and we welcome stakeholders' view on the merits of fully socialising costs between standard credit and direct debit customers.

1.8. In this appendix, we also present our methodology for deriving the uplift. In order to analyse this issue, we requested cost information from suppliers. We drew on the CMA's experience and collected similar information used to carry out their analysis. For the default tariff cap, payment uplifts would be calculated and applied separately for gas and electricity. For simplicity, we mainly discuss dual fuel figures in this appendix.

[3] Based on electricity households only and estimated based DECC Fuel Poverty Statistics, https://www.gov.uk/government/collections/fuel-poverty-statistics

2. Framework

In this chapter, we present the additional cost to serve for a standard credit customer over a direct debit customer.

We introduce the three options for calculating the uplift: no socialisation, full socialisation, partial socialisation of additional costs.

We also provide our rationale for our proposed option of partial socialisation of the cost difference.

Additional cost of standard credit customers

2.1. The additional costs of serving standard credit customers comprise three different elements. Table A12.1 shows our current estimates for the three cost categories and the additional cost per gas and electricity account compared to direct debit customers. We explain how the value of each category was calculated in the next chapter (paragraphs 3.1 to 3.16).

2.2. All values in this appendix are presented as whole numbers for presentational purposes. As a result, there might be rounding errors, meaning that numbers do not completely sum up.

Table A12.1 – additional costs to serve a standard credit customer by fuel type

cost element	description	potential additional costs to serve - electricity	potential additional costs to serve - gas
bad debt	the impact of customers who do not pay their bills	£30	£25
working capital	to account for the delayed payment, billing frequency and advance payment differences	£12	£10
other administrative costs	covers additional categories such as debt administration, call centre cost differences and bill printing	£16	£19
total		**£59**	**£55**

Source: Ofgem analysis of supplier data

2.3. Our calculation of the additional costs to serve a standard credit customer is £114, within the range calculated by the CMA (£88-158 in 2017 prices).[4] However, it is higher than the difference in market prices (£55 on average for the Standard Variable Tariff, SVT, market), suggesting that at least some of these additional costs are spread across all customers, regardless of payment type. We elaborate on these differences in paragraphs 3.18–3.21.

Options considered

2.4. When considering how to allocate these additional costs, we considered three different options. Each option varies which, if any, of the additional cost categories we choose to allocate to standard credit customers, and which we choose to socialise (ie share) between standard credit customers and direct debit customers.

Option 1 - Two caps, with all additional cost categories allocated to standard credit customers.

Option 2 - A single cap, that socialises all three additional cost categories.

Option 3 - Two caps, that allocate some of the additional cost categories to standard credit customers, but not every category.

Option 1: Two caps with no socialisation of standard credit costs

2.5. If we allocated all additional costs to standard credit customers, the cap for standard credit customers would be £114 higher than for direct debit customers. The uplift would be applied to standard credit customers only. No uplift would be applied to direct debit customers.

2.6. We note that this option creates a bigger difference between direct debit prices and standard credit prices than the market already offers. This suggests to us that suppliers spread at least some of the cost categories shown in Table A12.2 across both groups of customers. This implies full cost allocation (ie no socialisation) could be inappropriate.

[4] CMA range adjusted for inflation using CPIH

Table A12.2 – breakdown of the uplift for a dual fuel customer with no socialisation

cost element	uplift for standard credit customers	uplift for direct debit customers
bad debt	£56	£0
working capital	£22	£0
other administrative costs	£36	£0
total	**£114**	**£0**

Source: Ofgem analysis of supplier data

2.7. From consumers' perspective, the impact on standard credit consumers would be high. If suppliers priced to the level of the default tariff cap, the amounts standard credit customers pay that exceed prices for direct debit customers would increase from around £55 (market average) or £77 (large suppliers) to £114.

2.8. From suppliers' perspective, they would receive no benefit or loss depending on the different proportions of standard credit customers they have. They would be able to recover the additional costs of serving standard credit customers.

2.9. Our additional costs are based on an analysis of the lower quartile costs to serve. Actual unit costs vary between suppliers. Suppliers with lower costs compared to the lower quartile values will benefit whereas those with higher costs may under-recover their additional costs to serve. We believe those suppliers should be able to improve their efficiency.

Option 2: Single cap with full socialisation

2.10. This option spreads all of the additional costs of standard credit between standard credit customers and direct debit customers evenly. We spread the costs using the market average proportion of non-prepayment standard variable tariff customers paying by standard credit (35%).

2.11. The uplift for both payment types is approximately £38, relative to the direct debit benchmark. Table A12.3 shows how we socialise the cost categories.

Table A12.3 – breakdown of uplift for a dual fuel customer with full socialisation

cost element	additional cost to serve	uplift for standard credit customers	uplift for direct debit customers
bad debt	£56	£18	£18
working capital	£22	£8	£8
other administrative costs	£36	£12	£12
total	**£114**	**£38**	**£38**

Source: Ofgem analysis of supplier data

2.12. From a consumers' perspective, this means the price differential between those payment methods is zero. This would mean a reduction in prices for standard credit customers, (£76, relative to full cost allocation) and an increase in prices for direct debit customers (£38, relative to full cost allocation). Currently, according to our data, no suppliers charge standard credit prices that are £114 higher than direct debit prices, so the relative impacts would vary between suppliers.

2.13. From a supplier's perspective, using a socialised uplift, means that they under-recover costs from standard credit customers (by £76, compared to fully allocated costs), and can over-recover on each direct debit account (by £38, compared to fully allocated costs). Suppliers will break-even if the proportion of their customers that pay with standard credit matches the overall market proportion (35%). Suppliers with a greater proportion of standard credit customers will make a loss, because they have too few direct debit customers to make up the difference. Suppliers with fewer than average standard credit customers could make gains, because they do not have as many standard credit costs to offset. This affects incentives, and we consider it a disadvantage of full socialisation. We elaborate further on supplier variations in paragraphs 3.28–3.31.

2.14. However, we believe economies of scale may reduce the impact of variation on suppliers. Suppliers with more standard credit customers than average tend to have lower additional costs of serving a standard credit customer than average. For this option, we propose using the market average proportions and assessing the net financial impact of varying efficient costs in this and other areas. This analysis will inform our decision on headroom (which we discuss in Appendix 11) and how we give regard to the matter that holders of supply licences who operate efficiently are able to finance the activities authorised by the licence (as set out in the Bill).

Option 3: Two caps with partial socialisation of standard credit costs

Version 3a (socialisation of bad debt)

2.15. This option socialises the bad debt costs, but not the working capital or other administrative costs to serve. In this case, we would blend bad debt to the market proportion of non-prepayment standard variable customers paying by standard credit, in the same method as the fully blended uplift.

2.16. This option would mean we set cap for standard credit customers £58 higher than the cap for direct debit consumers. The total uplift for standard credit customers would be £77. The uplift for direct debit customers would be £19, because the bad debt is spread across both direct debit and standard credit customers.

2.17. From a consumers' perspective, the standard credit price would be £37 lower than if costs were fully allocated and direct debit customers would pay £19 more.

2.18. From a supplier's perspective, the allocation is more cost reflective than full socialisation, reducing some of the cross-subsidisation effects for suppliers with higher or lower than average proportions of standard credit consumers.

2.19. Note that the difference between standard credit and direct debit (£58) in this option is similar to the average price difference currently offered in the market (£55).

Table A12.4 – breakdown of the uplift for a dual fuel customer with partial socialisation (socialising bad debt)

cost element	additional cost to serve standard credit	uplift for standard credit customers	uplift for direct debit customers	standard credit - direct debit
bad debt	£56	£19	£19	£0
working capital	£22	£22	£0	£22
other administrative costs	£36	£36	£0	£36
total	**£114**	**£77**	**£19**	**£58**

Source: Ofgem analysis of supplier data

Version 3b (socialisation of bad debt and other administrative costs to serve)

2.20. In this option, we socialise both bad debt and other administrative costs.

2.21. The cap for standard credit customers would be £22 higher than the cap for direct debit customers. Table A12.5 shows the impact of socialising the bad debt and administrative cost categories.

2.22. From a consumers' perspective, the standard credit price would be £61 lower than if costs were fully allocated and direct debit customers would pay £31 more.

2.23. From a supplier's perspective, the allocation is more cost reflective than full socialisation, reducing some of the cross-subsidisation effects for suppliers with higher or lower than average proportions of standard credit consumers.

2.24. Note that the uplift difference (£22) is below the average price differences currently offered in the market (£55).

Table A12.5 – breakdown of the uplift for a dual fuel customer with partial socialisation (socialising bad debt and administrative costs)

cost element	additional cost to serve standard credit	uplift for standard credit customers	uplift for direct debit customers	standard credit - direct debit
bad debt	£56	£19	£19	£0
working capital	£22	£22	£0	£22
other administrative costs	£36	£12	£12	£0
total	**£114**	**£53**	**£31**	**£22**

Source: Ofgem analysis of supplier data

Our proposed option

2.25. Table A12.6 shows the impact of all options considered. Our preferred option is to have two separate caps with partial socialisation (option 3b).

Table A12.6 – the uplift by option and payment method for a dual fuel customer (on the CMA benchmark)

socialisation level	uplift for standard credit customers	uplift for direct debit customers	standard credit - direct debit
1. no socialisation	£114	£0	£114
2. full socialisation	£38	£38	£0
3a. partial socialisation (socialise bad debt)	£77	£19	£58
3b. partial socialisation (socialise bad debt and other administrative costs to serve)	£53	£31	£22

Source: Ofgem analysis of supplier data

Rationale

2.26. We do not believe it is reasonable to allocate the additional cost of bad debt exclusively to standard credit customers. Full allocation would mean that standard credit customers *who have paid their bills* are treated as responsible for covering the cost of standard credit customers who have not paid their bills. We do not believe sharing a payment method makes them any more responsible for that debt, than a direct debit customer is. The propensity to default on debt is a characteristic of the customers and not a necessary feature of the payment method. We do recognise the debt has to be recovered, so we propose spreading its cost across all bill payers. We know some suppliers already do this.

2.27. On a similar principle, we propose socialising the other administrative costs.

- Our initial analysis suggests much of these administrative costs include expenses associated with bad debt. We would socialise these costs on the same principle described above relating to the debt itself.

- Similarly, much of the costs relate to services such as call centres. Whilst we recognise that standard credit customers may be more likely to contact supplies this way, it is not a necessary feature of the payment method.

2.28. We recognise that some of the administrative costs may be better allocated to standard credit customers. However, suppliers' data is not sufficiently granular and comparable for us to either split these costs in a robust way, or assess the materiality of the issue. Therefore, we currently treat these other administrative costs as being a result of customer characteristics as opposed to a feature of the payment method and for the same reason as bad debt, spread the cost over both payment types. We welcome suppliers' views on this treatment. If we were persuaded that a certain proportion of the administrative costs were a direct and necessary feature of standard credit (and not the result of customer characteristics), we would consider allocating a proportion to those customers, for example, 50% of the costs.

2.29. We do not propose socialising working capital. This is because it is an inherent feature of the payment method ie billing in arrears. Suppliers incur a cost for raising the capital to fund the delayed payment. Therefore, we consider that direct debit customers should receive the benefit of paying through a more cost-effective payment method, and should not have to cover the costs that are inherent to standard credit.

Other considerations

2.30. We recognise that there are matters in the Bill that we are required to give regard to, that affect this decision: incentives to improve efficiency, incentives to switch, and protection for current and future consumers.

2.31. We are concerned that fully socialising costs does not provide suppliers with incentives to reduce their costs in the case where they have more than average direct debit customers, they would get a benefit that would not necessarily be passed onto consumers. Efficient suppliers with more standard credit customers than average may not be able to finance their activities.

2.32. It may also affect consumers' incentives to switch to cheaper payment methods, if socialisation makes those methods more expensive, because they subsidise other payment methods.

2.33. Incentives to switch might also be reduced if the difference between fixed standard credit tariffs and default standard credit tariffs reduces as a result of socialisation. This could result in standard credit customers considering default and fixed tariffs for standard credit of equal value and therefore deciding not to switch. The risk of this increases as more of the cost is socialised.

2.34. The Bill requires us to protect existing and future customers who pay standard variable and default rates. Among these customers, it does not distinguish between direct debit and standard credit customers. By socialising the whole cost, we may be providing more protection to standard credit customers at the expense of direct debt customers for costs that are not reflective of the payment method.

2.35. However, we acknowledge (as raised by some of our stakeholders) that a standard credit customer is more likely to be vulnerable than a direct debt customer. Approximately 8% of direct debit households are fuel poor whereas 17% of standard credit are fuel poor.

2.36. We do not believe payment type is a strong proxy for vulnerability. When considering all fuel poor customers, 48% of them pay by direct debit compared to only 20% on standard credit.[5] Therefore, the absolute number of fuel poor customers on direct debit is much higher than those on standard credit.

2.37. We welcome views on whether we should consider full socialisation of the additional costs to serve, if there is a strong vulnerability case, we would consider revising our position to also socialising working capital.

Prepayment meters

2.38. Customers with traditional prepayment meters are exempt from the cap. They will continue to be protected by the prepayment meter cap. Customers with smart prepayment meters will be protected by the default tariff cap (if they have an SVT or default tariff). We propose treating them as direct debit customers, due to their impact on working capital (ie they pay in advance of consuming). There is currently

[5] Based on electricity households only and estimated based DECC Fuel Poverty Statistics, https://www.gov.uk/government/collections/fuel-poverty-statistics

limited information available to consider a separate uplift for these customers, we might revisit this option when more evidence is available.

QA12.1: Do you agree with our proposed methodology for allocating additional costs between standard credit and direct debit customers.

Application to our benchmark

2.39. In this appendix, we have used dual fuel accounts to show how we are considering different payment types. We have not proposed a dual fuel cap. We will apply different caps for gas and electricity.

2.40. The two tables below show how the uplift for our proposed options applies to the electricity cap (Table A12.7a) and the gas cap (Table A12.7b). The tables highlights the cost to serve difference, the proposed uplift amounts and the difference in uplift between standard credit and direct debit.

Table A12.7a – application of the proposed uplift to the electricity cap

cost element	additional cost to serve standard credit	uplift for standard credit customers	uplift for direct debit customers	standard credit - direct debit
bad debt	£30	£10	£10	£0
working capital	£12	£12	£0	£12
other administrative costs	£16	£6	£6	£0
total	**£59**	**£28**	**£16**	**£12**

Source: Ofgem analysis of supplier data

Table A12.7b – application of the proposed uplift to the gas cap

cost element	additional cost to serve standard credit	uplift for standard credit customers	uplift for direct debit customers	standard credit - direct debit
bad debt	£25	£9	£9	£0
working capital	£10	£10	£0	£10
other administrative costs	£19	£7	£7	£0
total	**£55**	**£26**	**£15**	**£10**

Source: Ofgem analysis of supplier data

3. Methodology

We set out our methodology for calculating the different cost elements of the additional costs to serve and the socialisation level.

We provide a comparison of our calculated additional cost to serve to the CMA's cost difference estimate and the market SVT differential.

We also outline variation in suppliers, costs and proportion paying by standard credit, stating the impact this could have on suppliers.

Calculating the uplift

Calculating bad debt

3.1. To calculate the difference in bad debt between direct debit and standard credit, we collected information relating to bad debt charge and bad debt write off from suppliers. We decided to opt for bad debt charge as our measure of bad debt opposed to write off because the bad debt charge is less likely to be affected by suppliers' individual approaches to bad debt. For example, there were big differences in bad debt write off policies between suppliers: one supplier did not write off debt and others only wrote it off after the customer account had been closed for varying numbers of months.

3.2. To find the cost differences for bad debt, we calculated bad debt charge as a proportion of revenue for direct debit and standard credit then took the difference. We found the bad debt cost difference between direct debit and standard credit to be approximately 4.8% for gas and 5.6% for electricity at the lower quartile for 2017. There was a large range of 15.7% between the maximum and the minimum bad debt difference for both fuels.

3.3. We propose to calculate the bad debt element of the uplift as a percentage because bad debt should scale with consumption. Furthermore, at nil consumption it is still possible to incur bad debt, because of the standing charge.

3.4. When applying the uplift, we took into account that the cost of bad debt will only be recovered from consumers who do pay their bills.

3.5. We based our analysis on nine suppliers consisting of five large, three medium and one small. We used these suppliers as they were the ones that provided a full set of bad debt data with both fuel type and payment method splits allowing us to calculate the bad debt cost differences per fuel.

Calculating working capital

3.6. We collected two different measures on the cost to fund customers: debtor days and working capital. We decided to use working capital because there were inconsistencies between suppliers when calculating debtor days. Some suppliers had included advance payments for direct debit whereas other had not meaning there was a lack of comparability across suppliers.

3.7. To calculate the cost differences between standard credit and direct debit, we first took the working capital as a percentage of revenue for each payment method. We then calculated the difference between payment methods and then applied 10% for the cost of capital. We used the CMA's value for cost of capital – see Appendix 9 (EBIT) for our discussion of cost of capital.

3.8. We calculated the difference in the cost of working capital (expressed as a percentage of revenue) to be around 2.1% for gas and 2.4% for electricity using the lower quartile values and 2017 figures. The range was approximately 8.4% for gas and 6.3% for electricity between the maximum and minimum cost of working capital difference. Like bad debt, we believe working capital will also scale with consumption therefore we propose to present it as a percentage.

3.9. We centred our analysis on seven suppliers, five large and two medium. We used these suppliers for the reasons mentioned in paragraph 3.5. Two supplier failed to provide a breakdown of working capital by fuel type and payment method which is why we used seven suppliers opposed to the nine used for bad debt.

Other administrative costs to serve

3.10. The other administrative costs to serve cover cost differences not included in bad debt and working capital. These could include categories such as:

- Debt collection/administration – standard credit bills are not automatically collected so there could be some cost in collecting these bills.
- Bill printing – standard credit customers could be more likely to receive paper bills.
- Call centre costs – standard credit customers might have a higher propensity to call a supplier eg to pay their bill.

3.11. There were large differences in the detail provided by suppliers on these matters. While some suppliers broke down the other administrative costs into categories, others provided a single figure with minimal explanation.

3.12. Our initial estimates indicate that other administrative costs to serve could be approximately £36 at a lower quartile for a dual fuel bill. However, we are continuing to refine this figure and we will be seeking clarifications with suppliers in order to

arrive at a suitably robust figure. We will have to consider our final estimate alongside any other adjustments we decide to make so that we do not double count cost allowances.

3.13. We have analysed current submissions from suppliers and believe the main areas of other administrative costs are in debt administration/credit management, billing and customer service costs. However, there is a lack of comparability across the data submissions as suppliers have their own cost categories.

3.14. We believe some of these other administrative costs to serve should be socialised (those relating to debt administration and customer service costs) for the same reasons as mentioned for bad debt. The debt collection and customer service are features of the payment method based around the behaviour of the customers paying by that payment method. A standard credit customer who does not call their supplier should not be solely responsible for standard credit customers who call the supplier frequently.

3.15. However, it would be difficult to isolate the specific costs that should be socialised, as they are a function of the customer base from the costs that are related to the cost effectiveness of the payment method.

3.16. We have chosen to include the other administrative costs to serve as a lump sum figure as opposed to a percentage as these costs are not likely to scale with consumption.

Selecting efficient unit costs

3.17. When calculating the additional costs to serve for each component we use the lower quartile. This approach acknowledges that there will be some variation in costs that is not related to efficiency. However, our analysis shows that the variation is wide, and more likely to reflect the effectiveness of suppliers' administration.

Comparisons with other estimates

CMA estimate

3.18. During the energy market investigation, the CMA calculated a potential cost difference between direct debit and standard credit. They estimated the cost differential to be approximately £105 however, £49 for electricity and £56 for gas (in 2017 prices). However, they did note a range of between £88 and £158[6] (in 2017

[6] https://assets.publishing.service.gov.uk/media/576bcc08ed915d3cfd0000b9/appendix-9-8-analysis-of-costs-by-payment-method-fr.pdf

prices)[7]. In comparison, the additional costs we calculated were £114 in total. This is very close to the CMA estimate and sits within their range.

Market observations

3.19. The price differential between standard credit and direct debit is around £55 on average when observing the standard variable tariff market. The difference increases to approximately £77 when considering only the six largest suppliers.

3.20. We calculated these differentials by comparing the standard variable tariff prices for each supplier and then taking the average of those differences. A limitation of this is that we are missing data where a supplier's SVT or standard credit tariff are not open for sale.

3.21. The market differential is lower than the CMA's calculated differential as well as our differential with no socialisation. An explanation for this could be that suppliers already spread this risk of bad debt over all payment methods as opposed to the payment method that consumer is on. This could confirm our assumption that suppliers find difficulty in assigning bad debt to specific payment methods.

Socialisation level

3.22. We intend to socialise costs in proportion to the non-prepayment standard variable customers paying by standard credit. We blended the uplift to the market proportion as this would ensure that on average the cost of bad debt incurred by customers on default tariffs is spread over direct debit and standard credit customers.

3.23. In order to calculate the market proportion value we started with the number of direct debit and standard credit standard variable customers for suppliers with over 100,000 customers. We double counted dual fuel customers so they were weighted accordingly in comparison to single fuel customers. Lastly, we took the proportion of standard credit SVT accounts over standard credit and direct debt SVT accounts.

3.24. The Bill applies to all default tariffs, including both standard variable tariffs and default fixed tariffs. We use standard variable tariffs as a proxy for default tariffs. When we collected the customer accounts data (October 2017), fixed default tariffs were not prevalent.

3.25. We calculated a single socialisation level for simplification. We will revisit calculating a socialisation figure for gas and electricity separately if needed.

[7] Adjusted using CPIH to March 2017.

3.26. This gave us an approximate 35% blend to apply for the socialisation.

3.27. For the default tariff cap, we will apply this approach to gas and electricity separately.

QA12.2: Do you agree with our proposed methodology for allocating additional costs between standard credit and direct debit customers?

Effect on suppliers

3.28. Variations between suppliers in additional unit costs and proportion of default customers paying by standard credit (volumes of customers) cause gains and losses for some suppliers.

Variation in additional unit cost to serve

3.29. As shown above, there is variation in the costs across bad debt, working capital and other administrative costs to serve. There will be gains and losses for suppliers depending on their cost position in relation to the lower quartile. However, as mentioned in paragraph 2.9, we expect that some of this difference will reduce through efficiency improvements from suppliers.

Variation in the proportion of SVT customers paying by standard credit

3.29. There is a range in the proportion of SVT customers on standard credit for suppliers. Some smaller suppliers do not have any standard credit customers. The current license requirement only obligates suppliers with over 50,000 customers to offer a range of payment methods (including standard credit). Within the six largest suppliers, the range in the proportion on standard credit is around ten percentage points.

3.30. As a result, some suppliers gain from having fewer customers on standard credit whereas others lose from having a proportion on standard credit above the market average. We found that in some cases the gains and losses from the two variations worked in opposite directions. This could imply some level of economies of scale in cost to serve for suppliers with a higher stock of standard credit customers.

3.31. We will analyse the effect of supplier variations over all aspects of the tariff design methodology and consider this when setting the benchmark for efficiency and whether there is any remaining need for headroom to account for variation in efficient costs.

4. Indexing the payment method uplift

Our proposal on how to index the bad debt, working capital and other administrative costs elements of the uplift.

4.1. As we propose to calculate the working capital and bad debt elements in percentage terms and apply them to the efficient benchmark, we would not need to index them. Instead, we would apply them after the efficient benchmark has been indexed each period.

4.2. The other administrative costs to serve part of the uplift would be applied as a lump sum and therefore we would need to index that portion of the uplift over time. We propose to do this by indexing it to CPIH, in line with our proposal for operating costs in general.

5. Summary of consultation responses

A summary of responses regarding the payment method uplift to our December 2017 consultation on providing financial protection to more vulnerable consumers and our first working paper on setting the default cap.

5.1. In our consultation "Providing financial protection to more vulnerable consumers"[8], published in December 2017, we consulted around a range of adjustments we proposed to make to the CMA methodology. One of those adjustments was the payment method uplift. We also received responses regarding the payment method uplift to our first working paper on setting the default cap.[9]

5.2. While the majority of respondents supported the requirement of a bespoke uplift for standard credit customers, there was a mixed reaction to implementing a blended rate. Responses generally noted this would result in some customers cross subsidising other payment methods.

5.3. One consumer group acknowledged that there are different underlying costs to serving standard credit customers in comparison to direct debt customers. Moreover, blending the uplift could create competitive distortions between suppliers based on their customer base. However, another consumer group support blending the uplift as it will protect vulnerable standard credit customers. They mention that standard credit customers are more likely to be vulnerable.

5.4. One supplier did propose the socialisation of the bad debt element of the uplift across other payment methods. They mentioned that difference in bad debt costs is driven by characteristics of a subset of expensive customers. They suggest if all costs for expensive-to-serve standard credit customers who do not pay their bills were recovered from standard credit customers alone, standard credit customers who do pay their bills could be disproportionately penalised. However, they note that working capital costs are largely a function of the payment method.

5.5. One supplier suggested that the wide range in the CMA's estimates between direct debit and standard credit could be the result of significantly differing customer bases held by the six largest suppliers.

[8] Providing financial protection to more vulnerable consumers. https://www.ofgem.gov.uk/publications-and-updates/providing-financial-protection-more-vulnerable-consumers
[9] Working paper 1 - Setting the price cap. https://www.ofgem.gov.uk/electricity/retail-market/market-review-and-reform/government-s-default-tariff-cap-and-ofgem-s-broader-vulnerable-safeguard-tariff

6. Consultation response and questions

We want to hear from anyone interested in this document. Send your response to the person or team named at the top of the front page.

We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can. The full list of consultation questions is available in Chapter 7 in the main consultation document.

Unless you mark your response confidential, we'll publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

Question A12.1: Do you agree with our proposed methodology for allocating additional costs between standard credit and direct debit customers?

Question A12.2: Do you agree with our proposed methodology for calculating the additional costs to serve and the socialisation level?