

Consultation

Energy Price Cap: Operating cost allowances review

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We are consulting on our review of the operating cost allowances in the cap, which includes core operating costs, debt-related costs, smart metering costs and pass-through industry charges. In this consultation, we set out options across these four areas, covering key strategic themes such as how we benchmark costs across suppliers and allocate costs across groups of customers. We would like views from stakeholders with an interest in how we set the operating cost allowances in the cap. We particularly welcome responses from consumer groups and charities, energy suppliers and industry bodies. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We expect to implement any decisions from this review for the April 2025 cap period. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response. If you are responding using our online form, please tell us at the end of the form if some or all of your responses are confidential.

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Executive Summary

We introduced the default tariff cap ('the cap') on 1 January 2019, which currently protects 29 million customers on standard variable and default tariffs. The cap ensures that default tariff customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy.

One component of the cap is operating costs. We have previously defined operating costs as a supplier's own costs of retailing energy (eg the cost of running call centres, the cost of IT systems etc), excluding the costs of purchasing energy; the cost of meeting environmental and social obligations; and network charges. The operating cost allowance plays an important role across a number of strategic areas in the cap, such as providing suppliers with incentives to improve efficiency and covers areas such as smart metering and debt-related costs.

They are a key area of the cap because these are the costs suppliers have most control over. Additionally, the operating costs can vary by customer type, so can influence variation in bills between customers.

Context of this review alongside other strategic workstreams

This review is being undertaken within the context of a number of wider interrelated reviews of pricing reforms, which we outline below. When carrying out this review alongside the wider suite of strategic packages, we recognise that there may be competing objectives and demands, for example to facilitate an investable and resilient retail market and to ensure the cap maintains an appropriate level of protection for default customers. There may also be trade-offs across all workstreams around the allocation of costs and benefits between different groups of customers. For example, in considering the allocation between the standing charge and unit rate, which may deliver different outcomes for consumers based on how much energy they use. Across all of these inter-related workstreams, where possible and appropriate, we will seek to align positions with those wider reviews to facilitate a consistent and co-ordinated package of policy reforms, and ensuring they deliver positive benefits for consumers as a whole.

We are exploring pricing reform through a number of reviews, these include:

Standing charges – We published a call for input to explore what interventions may be required to mitigate recent increases in standing charges and whether we need to reform

the role of standing charges in the retail market.¹ Currently the costs associated with supplier operating costs fall on the standing charge. Operating costs are the second largest single contributor to the standing charge (after network costs). As part of this operating cost review, we want to ensure we are scrutinising the component parts of operating costs. In addition, we want to explore whether these costs continue to be appropriately allocated to the standing charge, or whether a unit-rate based approach could be more appropriate and the trade-offs involved.

Debt and affordability – We published a call for evidence on debt and affordability across energy customers.² The call for input sets out the challenges debt and affordability pose to the current and future market and that debt must be managed in a compassionate and sustainable way. We recognise the impact debt has on consumers and the debt and affordability review is a pathway for consumer focused solutions. The operating cost allowance is the primary route through which we assess and capture the costs suppliers incur to manage debt efficiently. We have provided a number of separate uplifts for debt-related costs over time. We want to ensure that this operating cost review takes a holistic look at the costs of debt that suppliers face. This will allow us to provide an allowance that represents efficient costs and ensures appropriate incentives on suppliers, alongside potential other interventions on debt.

Future price protection – In March, we published a discussion paper to set out how the cap may need to evolve to respond to the future energy market and enable greater flexibility in pricing (eg in light of Market wide Half Hourly Settlement).³ The paper outlines how it may become increasingly challenging for Ofgem to maintain a flat, stringent and universal price cap as the costs faced by suppliers become increasingly differentiated. This followed a related publication from DESNZ on “Future Default Tariff Arrangements”.⁴ An updated understanding of operating costs would contribute to the design of some of the options for future price protection.

This document sets out our proposal to conduct a review of the operating cost methodology within the price cap and outlines our considered options regarding the various allowances for suppliers' operational costs.

¹ Ofgem (2024), Standing charges – call for input.

<https://www.ofgem.gov.uk/publications/standing-charges-call-input>

² Ofgem (2024), Affordability and debt in the domestic retail market – a call for input.

<https://www.ofgem.gov.uk/publications/affordability-and-debt-domestic-retail-market-call-input>

³ Ofgem (2024), Future Price Protection Discussion Paper.

<https://www.ofgem.gov.uk/publications/future-price-protection-discussion-paper>

⁴ Department for Energy Security and Net Zero, Default energy tariffs for households: call for evidence.

<https://www.gov.uk/government/calls-for-evidence/default-energy-tariffs-for-households-call-for-evidence>

Price cap background

The operating costs account for up to 21% of the overall bill in a given cap period and are currently spread across three cost components in the cap:

- **Operating cost allowance:** This allowance reflects the operational costs associated with serving a Direct Debit customer. It includes costs such as metering, billing and payments, central overheads and amortised costs.
- **Payment method uplift:** This allowance accounts for the additional costs of serving Standard Credit and prepayment meter (PPM) customers respectively.
- **Smart Meter Net Cost Change (SMNCC):** The SMNCC provides an allowance for the smart meter rollout. The benchmark operating cost based on 2017 data includes some costs for smart metering, but these costs change differently to others as the rollout progresses. We calculate the allowance as a change between 2017 and later periods to capture this difference.

Case for review

Since the cap was introduced and these allowances were set (based on 2017 or older data), the market has gone through several changes, such as market consolidations (eg acquisitions and exits), introduction of regulatory changes (eg quarterly cap updates) and external events (eg the Covid-19 pandemic and the gas crisis). Additionally, the cap has now been in place longer than originally envisaged. In our 2018 decision, we deliberately set a stringent operating cost benchmark for suppliers to meet, thus requiring the market as a whole to make considerable efficiency improvements in how they run their businesses. With consideration given to the efficiency improvements made by suppliers since then, the operating costs suppliers now face may be very different.

Additionally, as set out in our March 2023 programme of work update, the operating cost review forms part of a package of work including the debt-related cost true-up and the next phase of levelisation.⁵ We will need to be mindful of the interactions between these workstreams when conducting this review.

For these reasons, we think it is an ideal time to review the operating cost allowances and if appropriate consider updating the methodology underpinning the allowances, using more recent cost information.

⁵ Ofgem (2024) Energy price cap programme of work for 2024 and 2025.
<https://www.ofgem.gov.uk/publications/energy-price-cap-programme-work-2024-and-2025>

Areas of review

We have split the review into four component areas: core operating costs, debt-related costs, smart metering costs and pass-through industry charges. The four areas have different factors and requirements that may determine the best approach for setting the methodology. Splitting them allows us to consider different sets of options and approaches, enabling us to set a more flexible cap:

Core operating costs – the review covers all operational costs except for debt-related costs and industry charges. We set out options covering benchmarking costs across suppliers (ie the stringency at which we set the allowance), allocating costs across different customer groups (eg payment methods). As part of this, we also consider how we allocate costs across the standing charge and unit rate, acknowledging the interaction with the wider standing charge review. Finally, we explore options for updating the allowance over time.

Debt-related costs – the review covers bad debt, debt administration and working capital costs. We set out options for how we measure the three costs, benchmarking costs across suppliers (covering both stringency and how we account for interactions between the three debt-related costs) and allocating the costs across payment methods given some customers may have a higher propensity to build up debt. We also consider how we could update the allowance over time, particularly given the current uncertainty of debt costs.

Smart metering costs – the review covers the transitional costs for suppliers installing and operating smart meters. We set out options for reviewing and setting the transitional smart meter allowance. We also propose to use the current model to set the allowance between October 2024 and March 2025 without carrying out an update.

Pass-through industry charges – covers costs of industry bodies such as Elexon, Xoserve and RECCo. We discuss an option to set pass-through industry charges as a separate allowance based on industry body charging statements rather than incorporating these costs into the core operating cost element of the allowance.

We are inviting views and evidence from all interested parties to help us shape this operating cost review. We particularly welcome responses from consumer groups and charities, energy suppliers and industry bodies. We also welcome views from other stakeholders and public.

We are seeking written comments to the questions and detail set out in this consultation by 11:59 pm on 14 June 2024. Please tell us your views and answer the questions using

our online survey⁶ or send us your views, answers to the questions and extra information such as diagrams or charts by emailing priceprotectionpolicy@ofgem.gov.uk.

⁶ <https://consult.ofgem.gov.uk/energy-supply/energy-price-cap-operating-cost-allowances-review>

1. Introduction

Section summary

In this chapter, we set out the steps of our operating cost review, including an overview of this consultation, related publications and consultation steps.

What are we consulting on?

- 1.1 This consultation sets out the options under consideration for four key areas of our operating cost review: core operating costs, debt-related costs, smart metering costs and industry charges. At this stage, we are not setting out preferred position or decisions on these policy areas, but rather discussing a range of options and key considerations. We are seeking stakeholder feedback on these options and invite views to help us inform our positions.
- 1.2 The structure of this consultation is set out as below.

Chapter 1: Introduction

- 1.3 In this chapter, we set out a high-level overview of what we are consulting on in respect of the operating cost review and an outline of our consultation process.

Chapter 2: Context

- 1.4 In Chapter 2, we provide background to the legislative framework that underpins the default tariff cap (the “cap”), setting out the objectives and matters we must have regard to. We also set out the wider market context in which we are carrying out this review and the other relevant work Ofgem is doing over the retail market that may interact with this review.

Chapter 3: Core operating costs

- 1.5 In Chapter 3, we set out the first of the four areas we are reviewing – core operating costs. We provide context on how the operating cost allowance is set in the cap, which closely aligns with the cost lines we are considering under core operating costs.
- 1.6 We set out options in a number of areas, such as how we benchmark costs over the market, how we allocate costs across groups of customers (eg those who pay by different payment methods and recovering costs across the standing charge and unit rate) and how we update the allowance over time. We also set out key

considerations for topics that relate to the options we discuss. For example, we discuss the role of non-efficiency factors in setting the benchmark.

Chapter 4: Debt-related costs

- 1.7 In this chapter, we discuss setting an enduring allowance for debt-related costs (including bad debt, debt administration and working capital). We describe how the current allowances for these costs are set in the cap and note the several adjustments we have made for debt-related costs since the cap was introduced (eg to cover the additional costs for COVID-19). We define enduring as the base allowances in the cap for this cost area, excluding ad-hoc adjustments we have made for debt-related costs.
- 1.8 Similar to Chapter 3, we discuss options for benchmarking costs across the market and allocating costs across groups of customers. In addition, we also discuss options for defining how we calculate these costs and a varied option set for how we update the costs over time. Our discussion of these options includes key considerations such as uncertainty in debt-related costs when benchmarking, cost reflectivity when allocating costs, as well as the accuracy with which we can update allowance over time.

Chapter 5: Smart metering costs

- 1.9 In Chapter 5, we set out how we model costs associated with the smart meter rollout in the Smart Metering Net Cost Change (SMNCC) allowance. We also set out broad options for modelling the costs of the rollout.
- 1.10 We also propose to use the current model to set the allowance between October 2024 and March 2025 without carrying out an update.

Chapter 6: Pass-through industry charges

- 1.11 In Chapter 6, we describe how the operating cost allowance captures two key industry charges – Elexon and Xoserve charges. We also set out the pass-through industry charges set by the SMNCC.
- 1.12 We mainly discuss whether to retain the current approach – ie whether we include industry charges in the core operating cost allowance or whether we set a separate pass-through industry charges component.

Related publications

- 1.13 The main general documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018:

<https://www.legislation.gov.uk/ukpga/2018/21>

- 2018 decision on the cap methodology ('2018 decision'):

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

- Energy Prices Act 2022: <https://www.legislation.gov.uk/ukpga/2022/44>

1.14 The main documents relating to this consultation are:

- November 2018 – Decision tariff cap: decision – overview, Appendix 1 –

Benchmark methodology <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

- November 2018 – Decision tariff cap: decision – overview, Appendix 6 –

Operating costs <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

- November 2018 – Decision tariff cap: decision – overview, Appendix 8 –

Payment method uplift <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

- November 2018 – Decision tariff cap: decision – overview, Appendix 7 – Smart

metering costs <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

- February 2023 – Price cap – Decision on the true-up process for COVID-19

costs <https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs>

- February 2023 – Price cap – February 2023 decision on approach to reviewing

the SMNCC allowances <https://www.ofgem.gov.uk/publications/price-cap-february-2023-decision-approach-reviewing-smncc-allowances>

- April 2023 - Levelisation of payment method cost differentials: a call for

evidence <https://www.ofgem.gov.uk/publications/levelisation-payment-method-cost-differentials-call-evidence>

- May 2023 - Call for Input on the Operating Cost Allowances Review

<https://www.ofgem.gov.uk/publications/price-cap-call-input-operating-cost-allowances-review>

- December 2023 – Energy price cap: additional debt costs review consultation

<https://www.ofgem.gov.uk/publications/energy-price-cap-additional-debt-costs-review-consultation>

Consultation stages

- 1.15 In May 2023, we published a call for input in which we outlined the key areas we intended to consider as part of this operating cost review. The document was high level and we did not set out a detailed set of options for each area. However, stakeholder responses have helped us refine options for each area in this consultation.
- 1.16 In July 2023, we issued a request for information to collect supplier operating cost data for the calendar years 2019 and 2022. This covered a breakdown of key activities suppliers carry out, split by fuel, payment method and meter type (ie smart or traditional). We asked suppliers to reconcile costs to their statutory accounts.
- 1.17 We also published a working paper on benchmarking costs in October 2023. The working paper set out how we could link the benchmark approach (and consequential view on stringency of the allowance) with outcomes we seek to achieve in the market.
- 1.18 This policy consultation continues this process and is the first stage of seeking stakeholder feedback on our option set. We set out four areas of the review and ask accompanying questions to help inform our proposed positions for our next consultation.
- 1.19 We intend to carry out further stakeholder engagement over the summer, which will focus on key areas where the options are more complex (eg smart metering costs and debt-related costs). This may be in the form of working papers or stakeholder workshops. Alongside this engagement, we have also issued another RFI to collect operating cost data for the calendar year 2023.
- 1.20 We intend to publish our next and final consultation for this review in Autumn of this year. Our aim is for that consultation to set out our proposed position in each of the areas covered by this review. We also intend to carry out a disclosure exercise alongside that consultation.
- 1.21 We intend to issue a decision in February 2025, which should allow us to implement any updates to the operating cost allowance in April 2025. However, our ability to make a decision at this stage will be contingent on the feedback we receive from the Autumn consultation.

Figure 1.1: Consultation stages

Stage 1	Stage 2	Stage 3	Stage 4
Policy consultation	Working papers/stakeholder engagement	Final consultation	Decision
May 2024	Summer 2024	Autumn 2024	February 2025

How to respond

1.22 We want to hear from anyone interested in this consultation. You can respond in one of two ways:

- tell us your views and answer the questions using our online survey.⁷
- send us your views, answers to the questions and extra information such as diagrams or charts by emailing priceprotectionpolicy@ofgem.gov.uk.

Your response, data and confidentiality

1.23 You can ask us to keep your response, or parts of your response, confidential. We will respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.24 If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we will get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.25 If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its

⁷ <https://consult.ofgem.gov.uk/energy-supply/energy-price-cap-operating-cost-allowances-review>

statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

- 1.26 If you wish to respond confidentially, we will keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We will not link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

1.16. We believe that consultation is at the heart of good policy development. We welcome any comments about how we have run this consultation. We would also like to get your answers to these questions:


1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

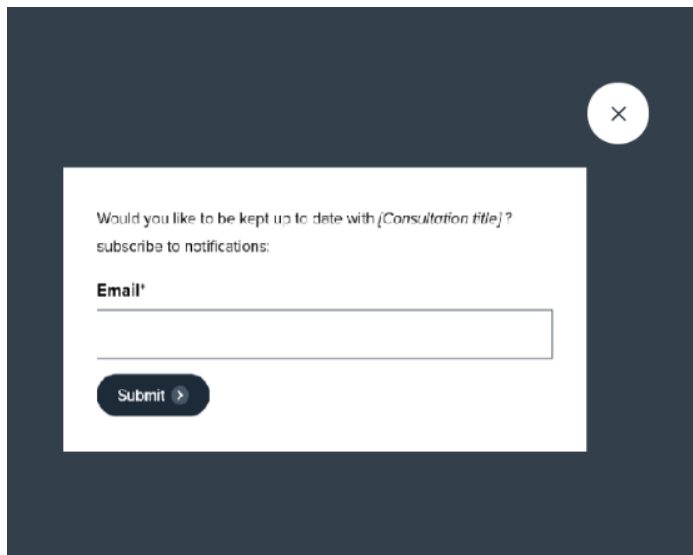
Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website.

[Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations)

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Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

Upcoming > **Open** > **Closed** (awaiting decision) > **Closed** (with decision)

2. Context

Section summary

In this chapter, we set out the background to the cap and the legislative framework under which we set it. We outline the case for change and scope of the operating cost review. We also set out our views on overarching themes such as data collection, disclosure and implementation.

Background

Default tariff cap

- 2.1 The cap was introduced on 1 January 2019 and protects existing and future domestic customers on standard variable and default tariffs (which we refer to collectively as 'default tariffs'), ensuring that customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy. The cap is provided for in legislation through the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the 'Act').
- 2.2 We are required to exercise our functions under the Act with a view to protecting existing and future domestic customers who pay standard variable tariffs and default tariff rates (together we refer to these as default tariffs). We must have regard to five matters when setting the cap:
- The need to create incentives for holders of supply licences to improve their efficiency.
 - The need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts.
 - The need to maintain incentives for domestic customers to switch to different domestic supply contracts.
 - The need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.
 - The need to set the cap at a level that takes account of the impact of the cap on public spending.
- 2.3 The requirement to have regard to the five matters identified in section 1(6) of the Act does not mean that we must achieve all of these. In reaching decisions on particular aspects of the cap, the weight to be given to each of these

considerations is a matter of judgement. Often, a balance must be struck between competing considerations.

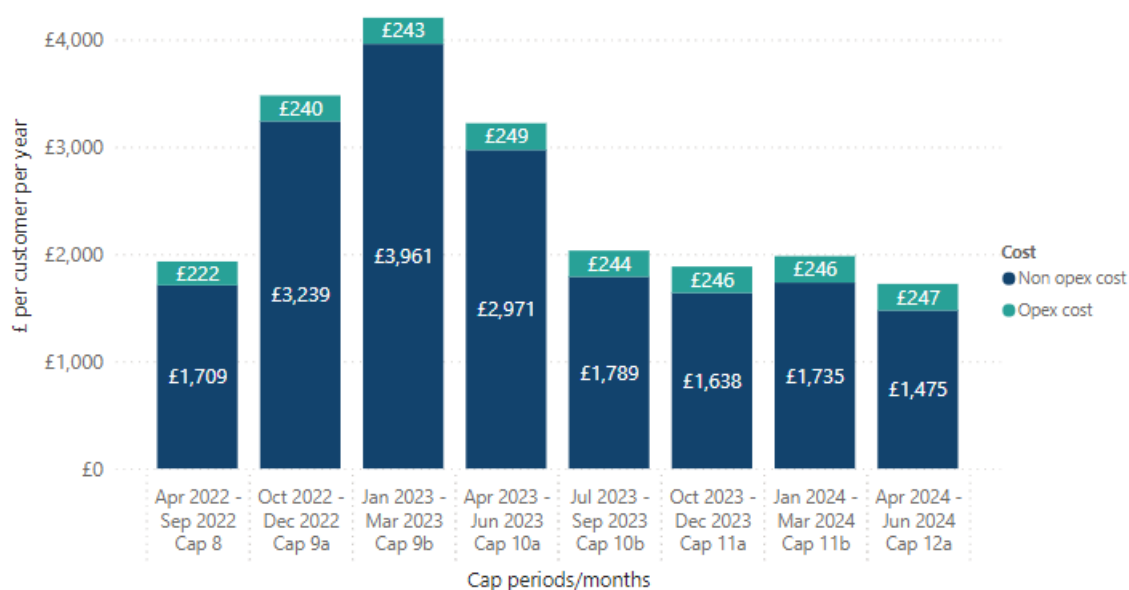
- 2.4 The cap sets the maximum amount a supplier can charge default tariff customers for energy. It varies based on several different parameters, including fuel type, benchmark consumption, electricity meter type, regional differences and payment method.
- 2.5 We calculate the cap using a bottom-up assessment of a notionally efficient supplier's costs (ie we calculate each cost component individually and then add them together) and set it to reflect the notionally efficient energy supply costs. In the aggregate, this approach ensures our benchmark (and cap) reflects the underlying efficient costs of supplying customers with energy.

Operating cost related allowances

- 2.6 The operating cost related allowances are currently made up of three distinct components in the cap: the operating cost allowance, payment method uplift and SMNCC. Together, these components allow for the operational costs of a notionally efficient supplier. Typically, these are costs we deem suppliers to have greater control over based on the commercial decisions they make.
- 2.7 The operating cost allowance reflects the operational costs of serving a Direct Debit customer and is set using 2017 supplier cost data. We use a stringent approach to benchmarking costs (taking the lower quartile minus £5) to set the allowance to incentivise efficiency improvement. We update the allowance by indexing it against the Consumer Prices Index including owner occupiers' housing costs (CPIH). This means that the allowance remains the same in real terms but allows for inflationary pressures. We explain how the operating cost allowance is calculated in Chapter 3.
- 2.8 The payment method uplift reflects the additional costs of serving Standard Credit and Prepayment Meter (PPM) customers relative to Direct Debit customers. The additional costs of PPM customers are set as a flat allowance and indexed by CPIH over time to update. The allowance for Standard Credit customers is mostly set as a percentage of the other cap allowances and therefore varies over time relative to the overall bill size. A smaller proportion of the costs are set as a flat allowance and indexed by CPIH over time. We describe the payment method uplift allowance in more detail in Chapter 3 for PPM and the element of Standard Credit that relates to customer contact. In Chapter 4 we describe the Standard Credit payment method uplift that relates to debt-related costs.

- 2.9 The SMNCC allowance captures the transitional costs of the smart meter rollout. We take a modelled approach to set this allowance, rather than solely relying on supplier cost data. The allowance changes over time as more smart meters are rolled out. The allowance is set at different levels for PPM relative to Direct Debit and Standard Credit. This reflects the differences in metering costs between traditional PPM meters and traditional credit (capturing Direct Debit and Standard Credit) meters. In Chapter 5, we set out in more detail the approach to modelling smart metering costs.
- 2.10 Together, these allowances typically make up around 15-20% of the overall cap level for a dual fuel Direct Debit customer. Figure 2.1 below shows that the allowance is stable over time (constant in real terms given we update it for inflation). However, the allowance as a proportion of the overall cap dropped when the cap level sharply rose in line with commodity costs during the gas crisis.

Figure 2.1 – Operating cost allowance per cap period⁸



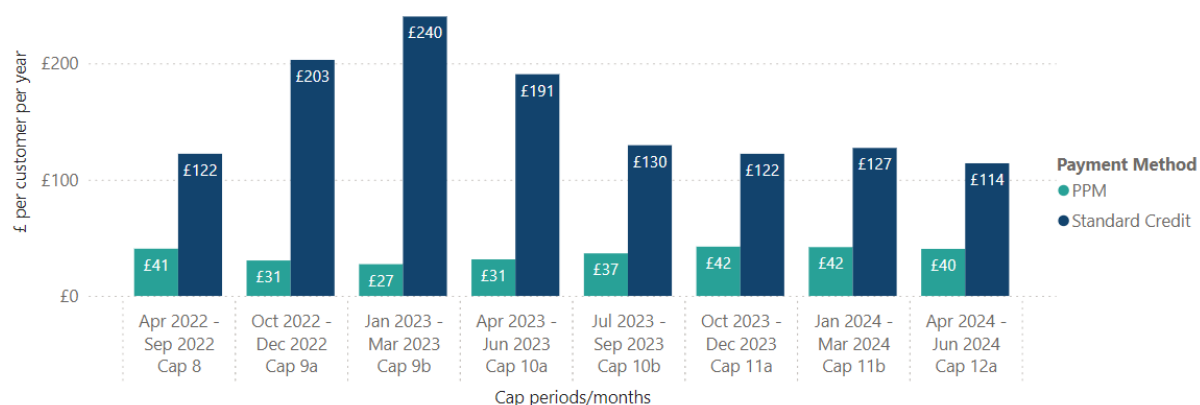
- 2.11 Typically, Standard Credit is the most expensive payment method due to the increased cost of paying in arrears and the increased risk of bad debt that brings. The additional costs of Standard Credit are indexed against the other cap

⁸ £ per typical dual fuel Direct Debit customer, pre levelisation. These values are at benchmark consumption (electricity 3,100 kWh, gas 12,000 kWh) – this is different to the TDCV (Typical Domestic Consumption Value) at which we announce the cap as part of our press material. All figures where we present cap allowances in this document are at benchmark consumption level.

components (ie set as a percentage of other costs such as the wholesale allowance) so changes in scale relative to the overall cap level. This means the differential also increases at times where bills are high. Figure 2.2 shows this trend over time. Notably the differential is at its highest in cap period 9b when the wholesale allowance in the cap was at its highest.

2.12 By comparison, the additional costs of PPM customers driven by operating costs are relatively flat given the additional costs are indexed by inflation and do not differ by consumption.

Figure 2.2 – Operating cost allowance differential relative to Direct Debit by payment method⁹



2.13 To note, Figure 2.2 only reflects the differential driven by the payment method uplift and SMNCC. There are other components outside of operating costs that also impact the PPM cap level, in particular. For example, we applied ad-hoc wholesale adjustments to Direct Debit and Standard Credit customers but not to PPM customers as we deemed the additional wholesale costs were not incurred by PPM customers. Also, the allocation of Unidentified Gas costs as part of the wholesale allowance was weighted more heavily to PPM customers over a certain period as set out by the Allocation of Unidentified Gas Expert (AUGE) statement.

Economic situation

2.14 Energy prices are falling following two years of extraordinary price rises. However, prices remain materially higher than before the crisis and even when

⁹ £ per typical dual fuel customer, pre levelisation.

accounting for wage growth over the period, energy accounts for a much higher share of household income than before the crisis.

2.15 We have seen an increase in cost of living pressures driven by more than just energy costs, which have contributed to financial difficulties for customers, particularly those in vulnerable situations. Government support helped to mitigate affordability issues while the gas crisis was at its height, but we have nevertheless seen debt levels rise as people struggle to meet the costs of higher bills. Our latest data shows there is £3.1 billion of debt and arrears across the energy market (as of December 2023), an increase of over £1 billion since the start of 2023.

2.16 In light of these challenges, we have made substantial changes to the market in the last year to support customers, which include:

- New customer services standards for energy suppliers aimed at making it easier for customers to contact their energy supplier and help support those who may be struggling with their bills last winter;¹⁰
- A voluntary pause on forced prepayment meter installations and a market compliance review focused on forced installation and remote mode switches;
- Introducing new rules for suppliers in relation to involuntary prepayment meter installations.¹¹ We have also set out our expectations to energy suppliers meeting restart conditions for involuntary installations;¹²
- Levelising standing charges between Direct Debit and PPM customers to reduce the impact of otherwise higher standing charges on prepayment meter customers and the impact this can have on debt during low or no consumption periods. This will help ensure there remains support for prepayment meter customers, following the end of the Energy Price Guarantee (EPG) at the end of March 2024; and
- Introducing an initial adjustment for additional debt-related costs.¹³ While this increased the cap, it also enables suppliers to offer better support to customers in payment difficulties.

¹⁰ Ofgem (2023), Consumer standards decision.

<https://www.ofgem.gov.uk/publications/consumer-standards-decision>

¹¹ Ofgem (2023), Involuntary prepayment meter decision.

<https://www.ofgem.gov.uk/publications/involuntary-prepayment-meter-decision>

¹² Ofgem (2024), Expectations to energy suppliers on prepayment meter restart conditions.

<https://www.ofgem.gov.uk/publications/ofgem-sets-out-prepayment-meter-expectations-energy-bosses-edf-octopus-and-scottish-power-meet-regulators-restart-conditions>

¹³ Ofgem (2024), Energy price cap: Additional debt-related cost review decision.

<https://www.ofgem.gov.uk/publications/energy-price-cap-additional-debt-costs-review-decision>

2.17 Our work in the retail market continues, and we are carrying out reviews in a number of areas to continue supporting customers. These areas include, standing charges, debt and affordability, future price protection and wider price cap work. We describe these areas and their interaction with this review later in the chapter.

Case for change

2.18 As our work over the last year highlights, there have been a number of changes in the market since the cap was introduced. This ranges from the support measures we have introduced to the wider industry changes occurring such as the ongoing smart meter rollout and the planned introduction of Market Wide Half-Hourly Settlement (MHHS). The case for change and carrying out this review is informed by two areas: changes in the market/regulatory space and interaction with other work areas.

2.19 For added context, the current allowances were set using data from 2017 (or older in the case of the PPM uplift). Given this and the other factors mentioned above, we consider it is appropriate to carry out this review.

2.20 We do not propose to true-up any differences between the current allowance and the outcome of this review (in either direction). We balance various factors and look over time to make judgements in the round. In particular for this review, we balance passing through any cost savings to customers and allowing suppliers to keep any return on investing in efficiency improvements, but also to ensure the cap does not drift from efficient costs to the detriment of customers. In principle, we anticipate any changes resulting from this review to apply on a forward looking basis.

Changes in the market and regulatory space

Market structure

2.21 Over the last few years, there has been significant consolidation in the market. There have been several large scale mergers and acquisitions such as E.ON's acquisition of Npower, OVO Energy's acquisition of SSE and Octopus Energy's acquisition of Bulb. In addition to this, there have also been a number of suppliers exits leading to further consolidation through the Supplier of Last Resort process. In December 2017, there were 68 active domestic suppliers offering gas and/or electricity in the market, but this number has dropped to 20 as of December 2023.

2.22 Given the number of suppliers entering and exiting the market since the allowance was set means that if we were to benchmark costs again today, the make-up of the data and suppliers in the sample would likely be different to our process in 2018. This supports the view that it is an appropriate time to carry out a review of the operating cost allowance.

External events

2.23 There have been a number of economic events that have impacted the market and may have impacted suppliers' efficient costs. For example, the COVID-19 pandemic is likely to have impacted suppliers both operationally (eg central overheads from staffing costs) as well as from serving customers (eg customer contact frequency). The gas crisis and rising bills, followed by the current cost of living pressures are likely to have also had an effect.

2.24 We have already made a number of adjustments to the cap to reflect these events, for example our decision on the COVID-19 float and more recently the additional debt-related costs float.¹⁴ Some of these impacts may have an enduring effect on suppliers' costs, making it an appropriate time to review the allowances. However, in assessing the options, we will be mindful of where cost impacts could be temporary and captured in our data.

Regulatory and cap changes

2.25 As outlined in the previous section, we have made a number of recent regulatory changes. We expect some of these changes may have a knock-on effect on a notionally efficient supplier's costs. For example, the enhanced customer service standards rules might incur additional costs.

2.26 We have also changed how the cap functions over the last couple of years. For example, from October 2022, we changed from six-monthly cap updates to quarterly cap updates. We introduced this change to the cap to reduce the lag between observing prices and factoring them into the wholesale allowance so the cap reflects changes in wholesale prices quicker. This change could have an impact on suppliers' operating costs as it increases the frequency at which suppliers send out communications on price changes to their customers.

¹⁴ Ofgem (2024), Energy price cap: additional debt costs review decision. <https://www.ofgem.gov.uk/publications/energy-price-cap-additional-debt-costs-review-decision>
Ofgem (2023), Price Cap – Decision on the true-up process for COVID-19 costs. <https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs>

2.27 On the horizon, there will continue to be change in the market. We are carrying out reviews in key parts of the retail market, which may lead to consequential changes in regulation and could impact suppliers' costs. Additionally, as we continue to move towards the future retail market and enabling net-zero through changes such as MHHS, operating costs may also continue to change. For example, new technologies may become available which help suppliers reduce their operating costs. Whilst we may not be able to capture all future changes in costs through this review, we will consider how we best update the allowance to better ensure it remains appropriate over time.

Interaction with other work areas

2.28 The operating cost review is a core part of our price cap work. In March 2024 we published our updated price cap programme of work.¹⁵ In this document, we set out key updates since our last published programme, our package of workstreams intended for an April 2025 delivery (debt-related cost true-up, operating cost review and our next phase of levelisation), our work on future price protection and our wholesale allowance review. In addition to these areas, we are also carrying out reviews of standing charges and debt and affordability.

2.29 All of these areas interact with the operating cost review. Across these areas we seek to develop an approach to retail pricing that enables fair pricing and price signals, whilst setting appropriate incentives for suppliers (eg to improve efficiency and support customers).

2.30 Therefore, this review is being undertaken within the context of a number of wider interrelated review of pricing reforms. Many of the choices across these interrelated areas weigh up often competing objectives and demands, so we may not always reach the same conclusions in consistent circumstances. When carrying out this review, where possible and appropriate, we will seek to align positions with those wider reviews to manage any interactions and seek to achieve a coordinated policy outcome. However, given that timelines across those reviews may change as the workstreams evolve, the options in this consultation, will also be assessed on their own merits. Our decision making in this area does not – and is not intended to – fetter our future decision making in other reviews or reforms.

¹⁵ Ofgem (2024), Energy price cap programme of work for 2024 and 2025. <https://www.ofgem.gov.uk/publications/energy-price-cap-programme-work-2024-and-2025>

2.31 The table below outlines each workstream and describes the interaction with this review.

Table 2.1 – Interactions between workstreams and the operating cost review

Workstream	Description	Interaction
Debt-related cost true-up	We will carry out a review for the need of a 'true-up' of the temporary debt-related cost adjustment 'Float', that was implemented in April 2024. ¹⁶ We will also monitor if any interim adjustments may be appropriate for the period up to April 2025 and whether to extend the float provided for Additional Support Credit.	In the operating cost review, we intend to set an enduring allowance (ie the base allowance excluding any additional adjustments) for debt-related costs and consider how we allocate those costs across payment methods (including the amount PPM customers should bear for additional support credit). We will need to be mindful of considering similar issues and options (eg how we account for differences in suppliers costs or provisioning approaches), though we may take separate approaches where appropriate.
Levelisation of bad debt between Direct Debit and Standard Credit	In the next phase of levelisation, we will consider whether we should proceed with levelising bad debt costs between Direct Debit and Standard Credit. This difference makes up a significant part of the payment method differential. We will also be undertaking a review of the impact and operation of Phase 1 of levelisation. ¹⁷	The operating cost review will consider the enduring allowance for bad debt and set the allowances that are used for levelisation. We may consider different options for allocating debt over payment methods depending on whether we proceed with levelisation. The operating cost review will consider how to allocate costs, which will feed into the outcome of the Phase 1 review as well as allowances going forward for levelising standing charges between PPM and Direct Debit.
Future price protection	This workstream will evaluate the impact of the current cap in context of the current and future market and explore options for evolving price protection. ¹⁸	Our approach to future price protection may influence key strategic themes within reviewing the operating cost allowance such as the stringency at which we benchmark costs.

¹⁶ Ofgem (2024), Energy price cap: additional debt costs review decision.

<https://www.ofgem.gov.uk/publications/energy-price-cap-additional-debt-costs-review-decision>

¹⁷ Ofgem (2024), Decision on adjusting standing charges for prepayment customers.

<https://www.ofgem.gov.uk/publications/decision-adjusting-standing-charges-prepayment-customers>

¹⁸ Ofgem (2024), Standing charges – call for input.

<https://www.ofgem.gov.uk/publications/standing-charges-call-input>

Standing charges review	The review will consider whether we need to reform our approach to standing charges in the retail market. ¹⁹	Within the operating cost review, we intend to consider how we allocate costs between the standing charge and unit rate. We intend the operating cost review to be one tool for implementing any outcomes or recommendations from the standing charge review.
Debt and affordability review	The review will set out the challenges affordability and debt pose to the current and future market. We intend to develop options which will ensure a sustainable, investible market that protects and supports those in debt and struggling with bills. ²⁰	We will consider any recommendations from the review that impact how we set the operating cost allowance. In particular, there may be an interaction with the stringency of the allowance or how we update based on whether we expect suppliers to take on additional responsibilities to support customers.

Scope of the review

2.32 The intention of this review is to update the operating cost allowances in the cap to reflect the efficient costs of a notional supplier in serving customers. When considering changes, we will also consider structural changes to how the operating costs allowances are set in the cap. We consider that this would enable us to select the most appropriate benchmark level and/or how costs are updated over time across cost components that are treated separately.

2.33 In order to achieve our objective, and taking into consideration the stakeholder feedback to our May 2023 Call for input on the scope of the review, our scope of the operating cost review includes:

- **Core-operating costs:** We are considering updating the core operating costs baseline based on re-benchmarking the core operating costs and exploring options for updating the allowance over time. We also consider how we allocate costs across customers (eg across payment methods and across the standing charge/unit rate).
- **Debt-related costs:** We are considering setting a separate allowance in the cap for debt-related costs due to the inherent uncertainty in these costs, which we have observed over the past few years. Our considerations include how we define and benchmark debt-related costs, as well as allocating costs

¹⁹ Ofgem (2023), Standing charges – call for input.

<https://www.ofgem.gov.uk/publications/standing-charges-call-input>

²⁰ Ofgem (2024), Affordability and debt in the domestic retail market – a call for input.

<https://www.ofgem.gov.uk/publications/affordability-and-debt-domestic-retail-market-call-input>

over groups of customers. We also explore options on how we could set this allowance and update it over time.

- **Smart metering costs:** We are exploring options for reviewing and setting the transitional smart meter allowance. We also propose to use the current model to set the allowance between October 2024 and March 2025 without carrying out an update.
- **Industry charges:** We are considering setting a separate allowance in the cap for pass through industry charges. We discuss what industry charges we would include in this allowance and the options on how we could update the allowance over time.

2.34 We set out this review across these four components as they all require different considerations and approaches. For example, the approach to setting industry charges using charging statements does not require benchmarking costs across suppliers like core operating costs or debt-related costs. Setting out the review in this way provides us flexibility in the options we consider.

Overarching themes

2.35 There are a number of areas that cut across all elements of this review, these include: operating cost data collection, disclosure and implementing a change in allowance.

Data collection

2.36 To assess suppliers' operating costs, we carried out a Request for Information (RFI) to collect supplier cost data for calendar years 2019 and 2022, as well as forecast data for calendar year 2023. This provided the latest view of audited costs (linked either to the supplier's consolidated segmental statements or statutory accounts). Collecting 2019 data provided us with a comparison point prior to the gas crisis and COVID-19, which allows us to compare against the 2022 data and consider trends over time.

2.37 In our May 2023 call for input, we said that we considered it appropriate to use the most recent data where possible. However, we noted that we would need to be mindful of the impact recent external events could have on the data. We highlighted the trade-off between using a single year's data to reflect the cost levels against using an average of multiple years' data which would not reflect the latest costs but may smooth out any shocks. In response to our call for input, three stakeholders suggested we should collect 2023 data to use for any updates

to the allowance. They considered that 2023 data would be less impacted by some of the external events such as the numerous supplier failures.

- 2.38 We have analysed 2023 forecast data against the 2022 data we collected. We found there are some significant differences in reported costs between the two years which could partly be explained by the external events. We intend to collect actual 2023 cost data and use this to assess the options we set out in this consultation.
- 2.39 In our RFI to collect 2023 data, we request largely similar information to our previous request, with potential supplementary questions. However, we will look to make changes based on clarification questions to suppliers and experience of the previous RFI process.
- 2.40 In this consultation, we use our analysis of 2022 costs in places as an illustrative example of the difference between options. We note that these numbers are likely to change as we use 2023 data. We expect to use the updated numbers in our final consultation later this year. We do not consider this affects our ability to assess the options put forward from a principle's perspective and expect positions to be informed by more than just a pure numbers perspective.

Disclosure

- 2.41 We understand the importance of transparency in our analysis and calculations to enable good policy making and facilitate a useful consultation process. Whilst we always aim to explain our methodology and analysis in our consultation documents in a way that is transparent and meaningful, we acknowledge there may be circumstances where it may be helpful to disclose additional information eg if the subject matter is complex / highly technical or is commercially sensitive information.
- 2.42 A disclosure process can be a useful tool to provide stakeholders with further detail. In the case of this operating cost review, we intend to carry out a disclosure process alongside the final consultation given the potential complexity of our methodology and volume of commercially sensitive information used in setting the allowance. We consider this should help stakeholders to better understand the matters being consulted on in this review.
- 2.43 Whilst the disclosure process should facilitate a deeper understanding of our approach and assumptions, the purpose of it is to understand and engage with the matters being consulted on rather than the process being used to check our calculations.

- 2.44 We consider whether to carry out a disclosure exercise on a case by case basis given the benefits of carrying out such an exercise differ depending on the matter for consideration.

Implementing updated allowances

- 2.45 The cap is set out in Standard Licence Condition (SLC) 28AD of the gas and electricity supply licences. SLC 28AD sets out how the cap is calculated and how it functions. In addition, several models annexed to the SLCs calculate the different components of the cap (eg Annex 5 is the SMNCC allowance model). We may make changes to the cap models and licence conditions from time to time. For example, in August 2022, we updated SLC 28AD and Annex 2 of the licence conditions to reflect the change from six-monthly cap updates to quarterly cap updates.
- 2.46 Some of the options we consider through this consultation may require structural changes to the cap (through the annex models) and changes to the licence conditions. For example, the option of setting a separate allowance for pass-through industry charges would involve moving some costs to a different annex model and updating the definition of this component in the licence conditions.
- 2.47 As we refine our options and form proposed positions in the next consultation, we will provide further information on these structural changes. Where appropriate, we will publish a draft modification notice for the licence conditions and draft models for changes to annex models.

3. Core operating costs

Section summary

In this chapter, we discuss options for setting the core operating cost benchmark and allocating costs across different groups of customers (eg those on different payment methods). We also cover approaches for updating the core operating cost allowance.

Context

Current approach

- 3.1 The operating cost allowances are currently split between three components in the cap: (i) the operating cost allowance, (ii) the payment method uplift and (iii) the SMNCC. The operating cost allowance reflects the operational cost of serving a Direct Debit customer. In designing the original price cap methodology, we calculated the incremental cost of serving customers paying by Standard Credit or PPM above a Direct Debit customer – this is captured in the payment method uplift.²¹
- 3.2 The third component, the SMNCC, captures the transitional costs of rolling out smart meters. We treat these costs separately as they are more variable over time, with greater change driven by the rollout of smart meters. Therefore, to set these costs, we model the allowance over time, relying on a combination of supplier costs and industry data rather than a purely top-down approach based on a snapshot of supplier costs. The SMNCC differs by payment method with a separate level for PPM and the same level for Direct Debit and Standard Credit. It contributes to the differential between payment methods.
- 3.3 As specified in the previous chapter, we are breaking down this review into four parts: (i) core operating costs, (ii) debt-related costs, (iii) smart metering costs and (iv) pass-through industry charges. This chapter focuses on the core operating costs element of the review.
- 3.4 The core operating costs relate most closely to the operating cost allowance and some elements of the payment method uplift. We explain the similarities and differences below.

²¹ There is also a payment method uplift for Direct Debit, reflecting our decision on how to allocate costs between Direct Debit and Standard Credit customers.

Current operating cost allowance

- 3.5 To set the current operating cost allowance we collected 2017 cost data from suppliers.²² The data was broken down across several cost areas including: metering, billing, contact, central overheads, depreciation, and amortisation. We did not collect the data broken down by payment method, so to isolate the Direct Debit costs, we used information on the additional costs to serve PPM and Standard Credit customers.²³ Additionally, we made a number of adjustments to the data to improve comparability between suppliers (for example, standardising the cost estimate of Xoserve and Elexon charges using the published charging statement).²⁴
- 3.6 We benchmarked the operating cost allowance at lower quartile as we considered that setting the benchmark at the frontier would be unlikely to sufficiently cover the costs of an efficient supplier with a typical customer base.²⁵ We found that – compared to frontier suppliers – those suppliers closest to the lower quartile had proportions of PSR and single fuel customers that were much closer to the market average.²⁶ We considered the lower quartile supplier could still achieve efficiency savings, so we reduced the benchmark by £5 to reflect an efficiency saving incentive.
- 3.7 For the core operating cost element of this operating cost review, we are using a similar breakdown of cost lines to our 2018 decision. Table A1.1 in Appendix 1 shows the cost lines for which we collected breakdowns of in our RFI. While we collect a granular breakdown of costs, we will consider whether it is appropriate to benchmark costs at an aggregate level rather than at a cost line level, and we provide further detail in the next subsection.
- 3.8 A key change compared to our 2018 approach is that we are considering setting a separate pass-through industry charge allowance in this review as opposed to building these costs into core operating costs. We discuss this in Chapter 6.

²² Ofgem (2018), Default tariff cap: Appendix 6 - operating costs, paragraph 2.9. <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

²³ Ofgem (2018), Default tariff cap: Appendix 6 – operating costs, paragraph 2.6. <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

²⁴ Ofgem (2018), Default tariff cap: Appendix 6 – operating costs, paragraph 2.3. <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

²⁵ Frontier would use the supplier with the lowest costs.

²⁶ Ofgem (2018), Default tariff cap: Appendix 6 – operating costs, paragraph 2.23. <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

Payment method uplift

- 3.9 The payment method uplift reflects the additional costs for Standard Credit and PPM customers compared against Direct Debit customers. For Standard Credit customers, this is largely driven by bad debt, debt administrative costs and working capital costs.²⁷ However, there were some other reasons why Standard Credit costs were higher than Direct Debit costs (eg customer contact costs). We discuss debt-related costs in Chapter 4.
- 3.10 To set the payment method uplift for the additional PPM costs, we relied on data from the Competition and Markets Authority (CMA). We adopted the CMA's PPM uplift designed for its cap. The uplift was set using 2014 supplier data and supplemented with further information. The CMA used a combination of top-down and bottom-up cost assessment to set a central estimate of the additional PPM costs split by gas and electricity.²⁸ The additional costs to serve PPM customers largely consisted of higher metering costs (driven by more expensive meters and maintenance costs), payment infrastructure (costs of Prepayment Meter Infrastructure Providers [PPMIPs]) and a higher propensity to call the supplier (leading to greater contact costs).
- 3.11 In our 2020 decision on protecting energy consumers with PPMs, we noted that the CMA had used a stringent benchmarking and calculation approach for the PPM uplift. While we consider this approach to be in line with the rest of the cap methodology, there was uncertainty in these costs so we considered that a range from the CMA value to the weighted average could reasonably reflect these costs. Using the 2014 supplier data, we assessed that an upper bound estimate of the additional costs may have been up to £17 higher than the PPM uplift value, based on a weighted average approach.²⁹
- 3.12 To allow for the £17 uncertainty in cost, we incorporated it into the SMNCC allowance. Given the smart meter rollout is a net benefit to suppliers for PPM customers (driven by smart meters being cheaper than traditional PPM meters)³⁰,

²⁷ Ofgem (2018), Default tariff cap: Appendix 8 – payment method uplift, paragraph 2.4.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

²⁸ Ofgem (2020), Protecting energy consumers with prepayment meters – August 2020 decision, paragraph 4.7.

<https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumers-prepayment-meters>

²⁹ Ofgem (2020), Protecting energy consumers with prepayment meters – August 2020 decision, paragraph 4.2.

<https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumers-prepayment-meters>

³⁰ Ofgem (2020), Protecting energy consumers with prepayment customers – August 2020 decision, paragraph 4.84.

<https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumers-prepayment-meters>

we said that any reduction in the SMNCC allowance for PPM customers would be offset against the £17 additional PPM cost under the upper bound estimate.³¹ This helped to reduce the impact of the tariff differential approach on specialist PPM suppliers over the medium term.

Recovering costs through the standing charge and unit rate

- 3.13 When setting the cap in 2018, our analysis suggested that using a bottom-up approach to set the nil consumption level of the cap would yield an increase in standing charges for default tariff customers above market prices. While most operating costs are fixed (with the notable exception of bad debt), we noted supplier practice was to split these costs between the unit rate and standing charge.
- 3.14 We set the initial level of the cap benchmark at nil consumption in line with market prices in 2017, to avoid significantly increasing charges for low consumption default tariff customers.³²
- 3.15 To achieve this, we took a top-down approach to calculate the implied core operating costs allowance and scaled-down a version of the SMNCC at nil consumption. This resulted in the level of standing charge at nil consumption in the 2018 decision being lower than would be required to collect all fixed charges.
- 3.16 This decision did not affect operating costs at typical consumption. We therefore included some operating costs in the standing charge (those included in the cap at nil consumption) and the remainder in the unit rate (the additional amount included in the cap at typical consumption). This means that if we took a cost reflective approach to allocating operating costs across consumption levels, the standing charge would be higher than they are under the current methodology.
- 3.17 Overall, operating costs make up a significant proportion of the gas standing charge and a smaller proportion of the electricity standing charge. Figure 3.1 and 3.2 show the April 2024 cap level for nil consumption split by operating costs, network costs and other costs.

³¹ Ofgem (2020), Protecting energy consumers with prepayment customers – August 2020 decision, paragraph 4.85.

<https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumers-prepayment-meters>

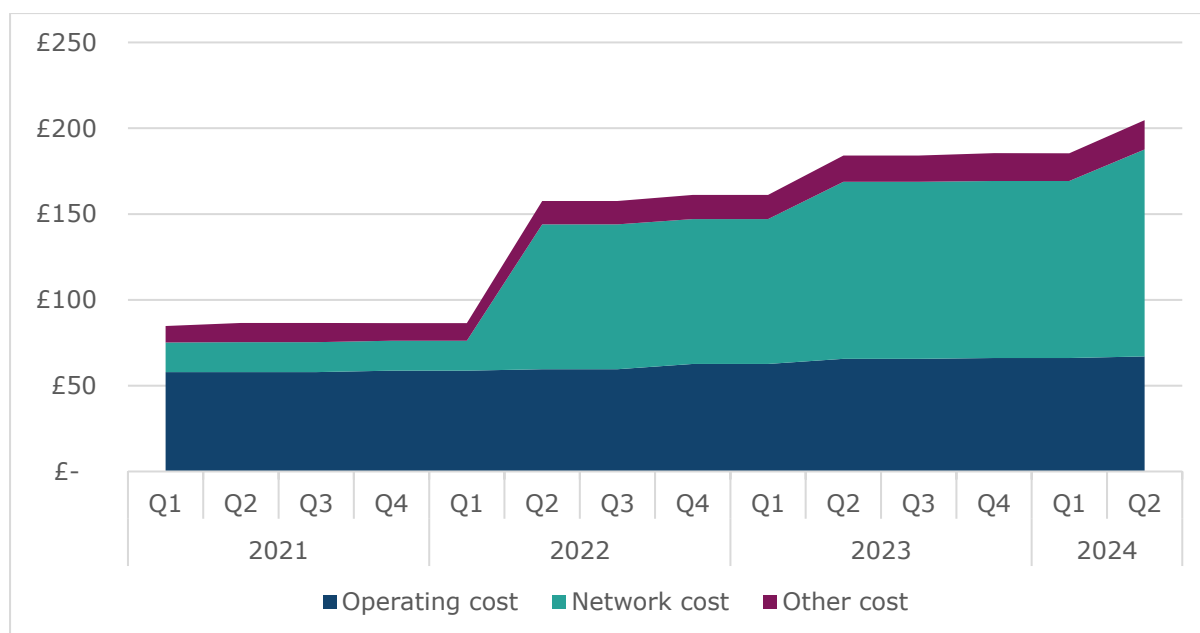
³² Ofgem (2018), Default tariff cap: Appendix 1 – benchmarking methodology, paragraph 1.3.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

3.18 For electricity, the level of operating costs within the nil consumption cap level has stayed relatively stable over time. The overall nil consumption level has increased due to higher network costs over time.

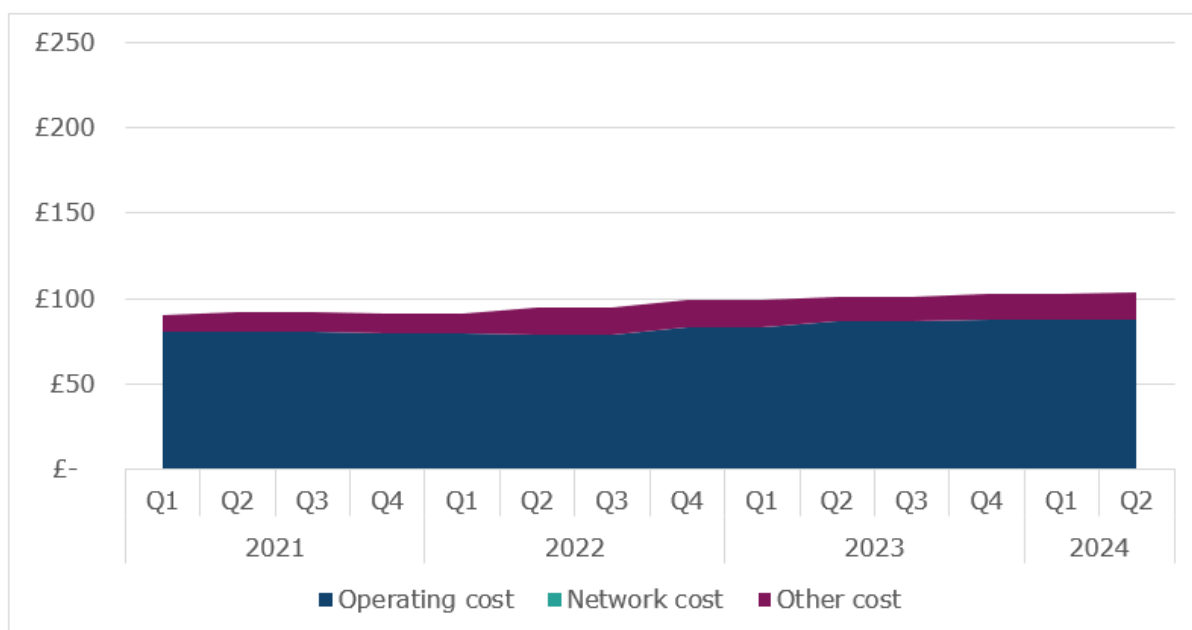
3.19 For gas, the nil consumption level of the cap has remained relatively flat as has the operating cost element of this. Network charges for gas are recovered across the unit rate and therefore do not have the same impact on the standing charge as for electricity.

Figure 3.1 – Electricity nil consumption cap level (£/customer per year)



Note: £ per typical dual fuel Direct Debit customer, pre levelisation.

Figure 3.2 – Gas nil consumption cap level (£/customer per year)



Note: £ per typical dual fuel Direct Debit customer, pre levelisation.

Key considerations for this review

- 3.20 There are two key elements for setting the core operating cost element of the allowance – how we benchmark costs across suppliers and how we allocate costs across different groups of customers (eg payment methods or consumption).
- 3.21 These two areas are more widely key elements on how we set the cap and the approach to pricing in the retail market. Where possible and appropriate, we intend to consider views and findings from the standing charge review, debt and affordability review and future price protection work to ensure we take a consistent approach to retail pricing. However, we recognise that there may be competing objectives and demands, trade-offs across workstreams around the allocation of costs and benefits over different groups of customers, and potential differences in timing between these workstreams as they evolve. Therefore, we will also consider the options in this review on their own merits.
- 3.22 We are also aware that choices on how costs are benchmarked across suppliers and allocated across groups of customers for the purpose of setting price cap allowances could have implications for our financial resilience policy and will continue to ensure these areas of work remain linked and that our policies are robust, fair and in the consumer interest.
- 3.23 The key areas for this chapter can be broken down into several options and considerations, including:

- Level of benchmark we set (ie how stringent we make the benchmark), including the role of non-efficiency factors.
 - How we benchmark costs across the different cap parameters, such as payment method and fuel.
 - How we set the allocation of costs across different groups of customers, where not addressed through the benchmarking.
 - How we update the allowance over time (ie our approach to indexing the allowance).
 - Whether we make any further adjustments to the reported costs.
- 3.24 There is an element of interaction between these options and considerations. For example, if we consider a looser benchmark, we may then consider a different approach to updating the allowance compared with the approach we would take if we chose a more stringent benchmark.
- 3.25 For this review, we propose to use a top-down approach. This means we will use suppliers' reported operating costs to set the allowance, by benchmarking across the market.
- 3.26 The two alternative options to using a top-down approach would be to either carry out a bottom-up cost assessment approach or benchmark costs at a much more granular level. There are many individual activities that make up suppliers' operations, so using a bottom-up approach to try and model a supplier in this way would be overly complex and potentially subject to estimation error.
- 3.27 Benchmarking at a granular cost line level would be much more sensitive to suppliers' individual allocation decisions. This approach may not capture interactions between individual cost lines and could create risks where suppliers do not allocate costs consistently.
- 3.28 The top-down approach we are proceeding with for this review is consistent with how we set the current allowance based on our 2018 decision. We consider this approach to be the most proportionate in the circumstances.

Benchmark approach

Options

Benchmark metric

- 3.29 Under the legislative framework, we can only set one cap level across the market. This means we must take a single cost across suppliers to represent the efficient costs of a notional supplier. We refer to this as benchmarking.
- 3.30 One key consideration of how we benchmark supplier costs is the stringency at which we set the benchmark. In this review, we are considering two options:
- Option 1: A lower quartile benchmark - the cost of the supplier that is at the 25th percentile in the sample.
 - Option 2: A weighted average benchmark - the average cost across suppliers weighted by the number of customers in their portfolio.
- 3.31 There are three key considerations when assessing the options for benchmark metric: (i) the level of price protection, (ii) the role of efficiency and non-efficiency factors, and (iii) the resilience to future developments.
- 3.32 To note, there is a spectrum of options covering how we benchmark costs, ranging from the lowest cost (frontier) to the highest cost. It is our considered view that the two options presented above strike a balance between the key considerations and are consistent with how we have considered cost benchmarking in the cap to date. We discussed these approaches and how they could contribute to various outcomes in our October 2023 benchmarking working paper.³³ We discuss this further in the key considerations section.

Level of price protection

- 3.33 A weighted average approach would be highly likely to lead to a higher core operating cost benchmark and a lower degree of price protection. It could be argued that our objective in setting the cap (to protect existing and future default tariff customers) would be best fulfilled by setting a relatively low benchmark. In our 2018 decision when introducing the cap, we highlighted that we have designed a cap that will provide a high level of protection – preventing unjustified

³³ Ofgem (2023), Energy price cap operating cost review benchmarking working paper. <https://www.ofgem.gov.uk/publications/energy-price-cap-operating-cost-review-benchmarking-working-paper>

price increases and ensuring default tariffs reflect more closely the underlying costs of supplying energy.

- 3.34 It is however worth noting that a stringent benchmark, such as lower quartile, provides less flexibility to account for material and systematic changes in efficient costs. This may increase the likelihood, where appropriate, of adjustments to the cap if efficient costs materially and systematically depart from allowances (eg the adjustments we made for additional COVID-19 costs). Once accounting for these adjustments, the additional price protection provided by a lower quartile approach relative to a weighted average approach is likely to be less. A weighted average approach may provide greater flexibility to absorb unexpected material and systematic costs without requiring an adjustment to the cap, which may also give greater price stability to customers. However, any impact on price stability is likely to be outweighed by fluctuations in wholesale prices.
- 3.35 The discussion above has been from a purely price related viewpoint. However, another element of protecting customers is ensuring suppliers provide appropriate support and treat customers fairly. We expect either approach to allow a notionally efficient supplier to carry out its required activities under the supply licence.³⁴ However, a weighted average benchmark may enable suppliers to carry out a wider range of activities that goes beyond their licence requirements. In setting a weighted average approach, we would expect suppliers to use any additional room in the allowance effectively to support customers. We might consider the outcomes we would expect to see when assessing this option, alongside other considerations.

The role of efficiency and non-efficiency factors

- 3.36 Under section 1(6) of the Act, when setting the cap, we must have regard to a number of matters including incentivising efficiency improvements and enabling notionally efficient suppliers to finance activities authorised by the licence.³⁵ These two matters are important when considering how we benchmark costs.
- 3.37 The cap plays a key role in providing efficiency improvement incentives. As we have previously noted (eg in our 2021 COVID-19 decision³⁶), suppliers have some incentives to become more efficient regardless of the benchmark used as this

³⁴ We would need to consider the balance between efficiency and non-efficiency factors, and it is plausible that either approach could achieve this.

³⁵ Domestic Gas and Electricity (Tariff Cap) Act 2018.

<https://www.legislation.gov.uk/ukpga/2018/21/enacted>

³⁶ Ofgem (2023), Price Cap – Decision on the true-up process for COVID-19 costs.

<https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs>

allows them to achieve a greater return relative to the allowance in the cap, which is fixed for a period. However, we consider these incentives are stronger when the benchmark requires suppliers to make efficiency improvements to achieve a normal rate of return. For example, when setting the operating cost allowance in 2018, there was an approximate £18 difference between the benchmark (lower quartile minus £5) and the weighted average level.

- 3.38 While suppliers can take actions to improve efficiency, there may be some factors that are less within their control – we refer to these as non-efficiency factors. Non-efficiency factors can cover several different types of variation in costs. Customer base characteristics is one example, but others could include variation in timing of supplier costs, variation in commercial strategy that is unrelated to efficiency and random noise.
- 3.39 Our analysis of the 2022 operating cost data shows differences in core operating costs between suppliers. These differences could be driven by either differences in relative efficiency or differences in non-efficiency factors (eg customer base).
- 3.40 If using a lower quartile to set the benchmark, we would seek to set the allowance reflecting a benchmark supplier that is broadly representative of the market. This is particularly important if non-efficiency factors were key determinants of the difference in cost between suppliers. Otherwise, we could risk setting a benchmark that is based on a supplier with a cheaper customer base and is unachievable for a notionally efficient supplier with a typical customer base. We also discuss the impact of customer base characteristics in our Future Price Protection discussion paper, but with a greater emphasis on debt and wholesale costs rather than core operating costs.³⁷
- 3.41 To account for differences in non-efficiency factors, we could either set a weighted average which would be more reflective of the suppliers in the sample. However, this would be at the risk of capturing differences in efficiency and may provide weaker incentives to become more efficient. Alternatively, we could restrict the sample of suppliers to ensure the lower quartile supplier is deemed to be representative (eg with a more typical mix of customers across payment methods).³⁸

³⁷ Ofgem (2024), Future Price Protection Discussion Paper, paragraph 2.35.

<https://www.ofgem.gov.uk/publications/future-price-protection-discussion-paper>

³⁸ Restricting the sample to exclude suppliers with a non-representative customer mix would be applicable if we were seeking to set an allowance for a typical customer across payment methods. If we were setting a payment method specific allowance, then there may be greater scope to include suppliers with non-typical customer bases (eg higher than average proportion of customers of the given payment method to benchmark).

- 3.42 In considering a lower quartile approach and restricting the sample, one supplier has previously suggested that all suppliers in our sample need to be representative of the market. We do not consider this to be the case and using a lower quartile benchmark is already a mitigation against the impact of non-efficiency factors. If all suppliers in the sample were representative of the market, then we are more likely to consider setting a frontier benchmark instead.
- 3.43 If the core operating costs are more related to relative efficiency rather than customer base, then we would be more confident in setting a lower quartile benchmark.
- 3.44 Our current hypothesis is that the majority of core operating costs are less related to differences in customer base and more relative to efficiency. We do not consider the per customer cost for components such as metering costs, and central overheads would vary relative to a supplier's customer base characteristics. There may be some exceptions such as customer contact costs which may be more related to customer base. We consider that by treating debt-related costs separately, we have significantly reduced the variation that's caused by non-efficiency factors.
- 3.45 We discuss drivers of non-efficiency factors in the key considerations section.

Resilience to future developments

- 3.46 As seen over the past years, operating costs can change over time. This could be due to changes in the costs of carrying out specific activities or changes in what suppliers must deliver (eg changes in regulatory requirements). The changes in costs could be in either direction, an increase or decrease.
- 3.47 For an adjustment to the cap, regardless of direction, we assess whether a cost is systematic (whether it nets out in the medium-term) and material. We only consider an adjustment where both criteria are met.
- 3.48 Upward cost changes could affect the ability of a notionally efficient supplier to finance its activities. We could address this through a review of the allowance where an upward cost change was systematic and material (eg the adjustments we have made for debt-related costs). Alternatively, we could mitigate the need for additional adjustments by setting a looser benchmark or providing a more generous uncertainty allowance, which would provide more room within the allowance to absorb upward cost changes. This approach would trade-off a reduction in price protection against certainty in the allowance level.

- 3.49 If we used a weighted average benchmark, we would expect there to be less circumstances that required us to make ad-hoc adjustments to the cap (ie we would expect there to be a higher bar to meet our material and systematic deviations test). We expect this would provide more price stability to customers from less frequent adjustments relative to the status quo. However, we might still need to be mindful of how much room the weighted average benchmark provides to absorb cost shocks relative to the lower quartile approach.
- 3.50 Downward cost changes, where the criteria are met, would support customer protection. We noted in our 2024 additional wholesale cost review decision that we acknowledge the potential for asymmetry in considerations between downward and upward adjustments. In line with the Act, we will have regard to the impact that adjustments may have on supplier incentives to improve efficiency and compete for customers and customer incentives to switch suppliers. Downward adjustments may have different impacts on these factors compared to upward adjustments.³⁹
- 3.51 Some potential examples of future regulatory developments that may impact costs could be system changes required for MHHS, any recommendations resulting from our work on debt and affordability, potential outcomes on future price protection and wider work on the future of the retail market.
- 3.52 The benchmark metric we use also interacts with other key areas for consideration. For example, we could incentivise efficiency or account for uncertainty in the profile of costs through the approach we use to update the core operating cost allowance. We discuss the update approach later in the chapter.

Benchmarking across parameters

- 3.53 Once we determine which benchmark metric to use, we have to consider how we allocate costs across different groups of customers. The first step to this is to consider whether we calculate that benchmark across the different parameters in the cap or benchmark at an aggregate cost level.
- 3.54 The cap varies by several different parameters such as region, payment method, fuel and electricity meter type. For benchmarking across parameters, we focus on fuel and payment method as we consider these best captures the variation in operating costs between groups of customers.

³⁹ Ofgem (2024), Energy price cap additional wholesale costs decision, paragraph 2.4.
<https://www.ofgem.gov.uk/publications/energy-price-cap-additional-wholesale-costs-decision>

- 3.55 We do not focus on region and electricity meter type as we do not consider that core operating costs will substantially vary by these parameters. It is our considered opinion that focusing on payment method and fuel type is a proportional approach in the circumstances, to both carrying out analysis of the operating cost information and not requiring suppliers to provide a further breakdown of their cost data.
- 3.56 There are broadly four combinations of options for benchmarking across payment methods and fuels. These are detailed below and also visually represented in figure 3.3.
- Option A: Aggregate costs for fuel and payment method – for this option we would benchmark at total core operating cost level without any reliance on suppliers’ allocation methodology to split costs between the parameters when benchmarking.
 - Option B: Split by fuel but aggregate payment methods – for this option, we would rely on suppliers’ allocation of costs between fuels but not across payment methods. We would benchmark total gas core operating costs and total electricity core operating costs separately.
 - Option C: Aggregate fuel but split by payment method – for this option, we would take the aggregate costs over gas and electricity but benchmark costs at the payment method level (ie split Standard Credit, PPM, and Direct Debit). We would rely on suppliers’ allocation of costs by payment method.
 - Option D: Split by fuel and payment method – for this option, we would benchmark costs at the fuel and payment method level. We would fully rely on supplier allocation across the two parameters. This option would result in six direct benchmarks covering the combinations of two fuels and three payment methods.

Figure 3.3 - Visual representation of the four benchmarking across parameters options (options A-D)

Option	Fuel type	Payment method	Parameter level benchmark(s)
A	Combined	Combined	Opex Cost
B	Fuel type split	Combined	Opex Cost branching into Elec and Gas, each leading to Combined (SC+DD+PPM)
C	Combined	Payment method split	Opex Cost leading to Combined (Elec+Gas), which then branches into SC, DD, and PPM
D	Fuel type split	Payment method split	Opex Cost branching into Elec and Gas, each leading to SC, DD, and PPM

3.57 The key consideration to determine which approach we take is how confident we are in suppliers’ cost allocations across parameters and how comparable the approach is across suppliers.

3.58 The choice of how we benchmark over parameters is more sensitive if we use a lower quartile approach rather than a weighted average. A lower quartile approach references a particular benchmark supplier’s costs and therefore would build in any allocation choices they make if we benchmarked at a parameter level.⁴⁰ Additionally, if we were to benchmark all three payment methods individually this could risk understating total costs. This would be a risk if the costs of the three payments were negatively correlated such that lower costs in one payment method systematically led to higher costs in the other payment methods.

⁴⁰ Though we note that technically the lower quartile could fall between two suppliers, in which case we could it would reflect the allocation of the two suppliers.

- 3.59 Taking a weighted average approach at parameter level would average out differences in cost allocation across suppliers. It would be less sensitive to an individual supplier's allocation approach.
- 3.60 In relation to the options, option A is likely to be the most resilient to differences in allocation methodologies as we can set a standardised allocation approach across parameters after benchmarking costs at an aggregate level. We discuss this in the next subsection.
- 3.61 By comparison, option D is most influenced by different allocation approaches and could entail setting a different benchmark supplier for each parameter combination. For example, let's take three hypothetical suppliers (x, y and z) that have the same aggregated efficient costs but different allocation approaches. Supplier x allocates relatively less of its costs to Direct Debit, supplier y to Standard Credit and supplier z to PPM. If we were to take the lower quartile of each payment method independently, there is a risk that we would implicitly capture the suppliers' relatively low allocations to the respective payment methods. This means the average allowance across the payment methods may be lower than the aggregate costs of the three suppliers, resulting in an overall allowance that is challenging for any one supplier to achieve.
- 3.62 It is worth noting suppliers could have different allocations to payment methods reflecting a greater efficiency in serving one particular payment method. In this case, it may be advantageous to benchmark at a parameter level to set an allowance that reflects best practice and drives efficiency improvements.
- 3.63 One other consideration is the impact on our ability to use particular suppliers in our sample. Setting three separate benchmarks for the payment methods rather than benchmarking at an aggregate level would allow us to use a greater sample of suppliers where we would otherwise think that a supplier may be unrepresentative. For example, we could use suppliers that specialise in a specific payment method for benchmarking that given payment method and exclude them from other payment methods where they may have very few customers.
- 3.64 We issued an RFI to collect suppliers' costs broken down by cost lines for 2019, 2022 and forecast 2023. For each cost line, we requested a breakdown of costs split into three parameters (fuel type, payment method and smart/traditional). Since then, we have carried out analysis of supplier data and the methodologies suppliers use to understand drivers of costs across parameters.

- 3.65 We observed variation in core operating costs⁴¹ (ie excluding industry charges and debt-related costs) across payment methods between suppliers. The variations in costs were predominantly present within metering and customer contact cost lines. We consider that this generally aligns with our expectations, given that traditional PPM meters are typically more expensive than credit meters and previous evidence has shown PPM and Standard Credit customers have a higher propensity to contact their suppliers than Direct Debit customers. However, we note that differences in the payment method differentials observed across suppliers may, to an extent, also be driven by suppliers' cost allocation methodology and therefore it is important that we are confident in suppliers' cost allocations across parameters.
- 3.66 Overall, we consider there is less variation in core operating costs in contrast to debt-related costs, where we expect most of the impact of variation in customer base characteristics to be at play. We intend to explore the allocation approaches further and have provided more guidance where appropriate for our second data collection exercise.

Stakeholder response summary

- 3.67 In May and October 2023, we published our Call for Input and Benchmarking working paper, respectively. For both publications, we received ten responses made up of suppliers, an industry group, and a charity/consumer group. A summary of stakeholders' responses across key themes can be found below.

Benchmarking

Choice of benchmarking metric

- 3.68 One stakeholder supported using a lower quartile benchmark arguing that the reasons for adopting a stringent benchmark in our 2018 decision remain valid. It suggested using the median as a benchmark to prevent outlying companies from driving the benchmark if there were clear evidence to move away from the lower quartile benchmark. To further improve efficiency, another stakeholder suggested the use of a stringent benchmark.
- 3.69 Five stakeholders did not agree with taking a frontier/lower quartile benchmark and suggested that there is a risk costs would be understated, especially for

⁴¹ We refer to core operating costs as core operating costs excluding industry charges and bad debt, as we are considering to treat them as a separate allowance as discussed in Chapters 4 and 6.

suppliers with a higher proportion of vulnerable and embedded Standard Variable Tariff customers. It also poses a challenge for suppliers to deliver the expectation of customer service standards.

- 3.70 Three stakeholders supported using a weighted average and suggested that it would better account for the diversity of business models and allows the notional supplier to recoup efficiently incurred costs to deliver net zero.
- 3.71 Three stakeholders suggested that an upper quartile benchmark is desirable and would incentivise good customer service.
- 3.72 One stakeholder suggested using a frontier benchmark for customer contact costs to account for expected efficiencies driven by technological advances.

Non-efficiency factors

- 3.73 Five stakeholders reported various non-efficiency factors (linked to customer bases) to drive cost variation among suppliers. In addition to customer characteristics/demographics, stakeholders suggested other non-efficiency factors such as (but not limited to): non-financial vulnerability, smart meter rollout profile and geographical presence.
- 3.74 Two stakeholders suggested that the impact of non-efficiency factors could be mitigated using a weighted average. Another stakeholder suggested reflecting non-efficiency factors within the benchmarking metric is more appropriate than managing through periodic adjustments.
- 3.75 One stakeholder suggested that their customer mix is not “non-efficient”, and by deeming it so will perpetuate under investment for customers who need it most and may also discourage suppliers from competing for such customers.

Considerations

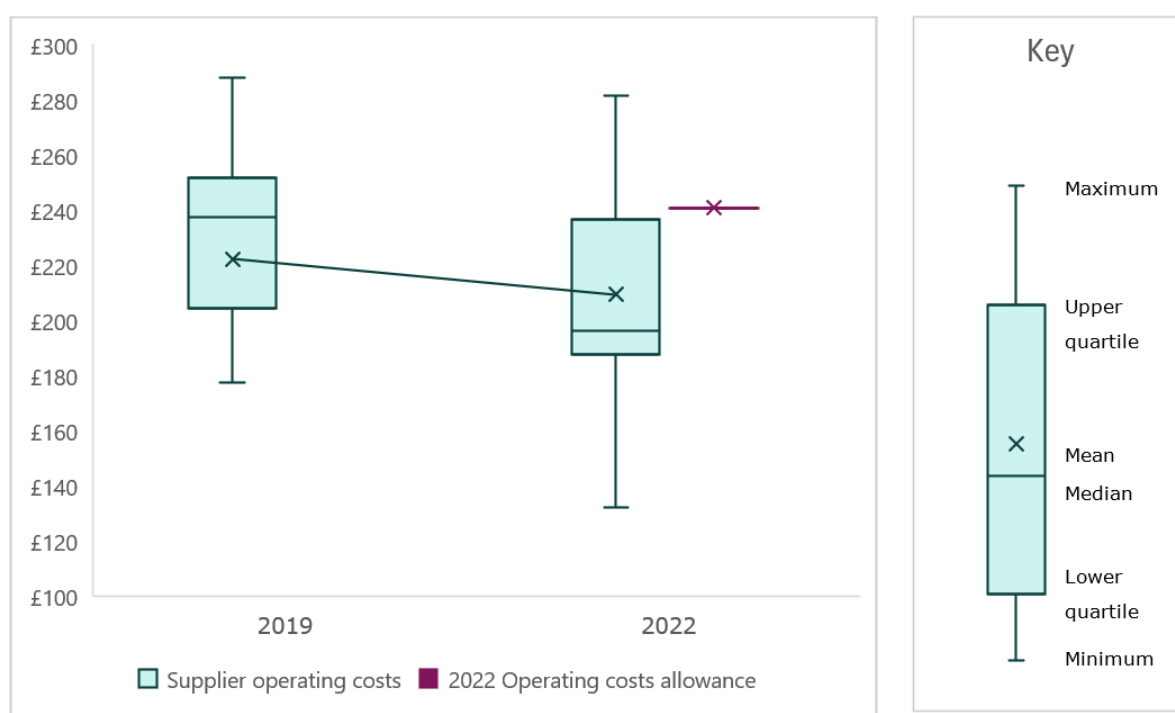
Changes in efficiency

- 3.76 As part of the Energy Market Investigation, the CMA identified there were gaps in efficiency across retail suppliers, which contributed to customer detriment. In 2018, we set a stringent operating cost benchmark at lower quartile minus £5 to focus on customer protection and incentivise suppliers to make efficiency improvements.
- 3.77 Our analysis suggests that the cap has been successful in encouraging suppliers to make efficiency improvements. Figure 3.4 shows the spread of operating costs (excluding debt) for dual fuel customers over 2019 and 2022. The distribution of operating costs has fallen to a lower cost level between the two years. Notably

there has been a significant reduction in the average and median core operating costs.

3.78 While the maximum and minimum costs, denoted by the tails in the graph, have decreased, the range has increased. This could imply that suppliers have made efficiency savings at varying rates. The interquartile range remains fairly similar so these differences may be driven by suppliers towards the ends (tails) of the distribution. To note, this is initial data so some variation may reflect differences in how suppliers have completed the RFI, and it is possible there is additional noise in the 2022 data given it was at the height of the gas crisis.

Figure 3.4 – Box and whisker plots of supplier core operating costs (in 2023 prices)



Notes: Within the box plot, the whiskers (vertical lines) denote the maximum and minimum supplier cost, the ends of the box denote the upper and lower quartile, the horizontal line within the box is the median and the 'x' is the mean. We have also calculated the weighted average for both years (in 2023 prices): £230 for 2019 and £204 for 2022. Figures are for a dual fuel customer.

3.79 Comparing the 2022 core operating cost allowance (calculated as an average across payment methods using the operating cost allowance, SMNCC and Payment method Adjustment Additional Cost (PAAC) term of payment method uplift for Standard Credit and PPM) to the distribution of operating costs in 2022 shows that suppliers may on average be outperforming (achieving a lower cost) the allowance. However, to note, this does not include debt-related costs, which

our recent work on the additional debt-related cost adjustment suggests have been increasing over 2022 and 2023.

- 3.80 Overall, for this review, we intend to consider to what extent we should focus on further efficiency improvements, whether that is changes in the frontier efficiency or allowing the market to catch-up to a notional level of efficiency. We consider there are still efficiency savings to be sought, particularly with further developments in technology, such as artificial intelligence.
- 3.81 So far, suppliers have achieved efficiency savings through actions such as restructuring and re-platforming IT systems. However, over this time we have observed a decrease in customer service satisfaction, with the overall satisfaction reaching its lowest point in 2022 at 66% compared to the 2020 high of 78% (though this may be impacted by the gas crisis and cost of living pressures).⁴² This could suggest that even if suppliers made gains against the allowance or we set a less stringent allowance, the money would not necessarily be invested in achieving a better service.

Non-efficiency factors

- 3.82 As described in the options section, we consider customer base characteristics could be a key non-efficiency factor when assessing variation in costs between suppliers. In our RFI, we asked suppliers to provide customer account number information on three customer base characteristics: (i) Priority Service Register (PSR), (ii) Online account management and (iii) Default tariff customers. We also asked suppliers to comment on how the type of customer with respect to these three categories is likely to impact operating costs.
- 3.83 While we consider these three customer groups, it should be noted that they are an imperfect proxy for customer characteristics that may drive variation in costs.
- 3.84 PSR includes a range of customer circumstances, some of which may be associated with more costs than others. Additionally, a supplier's proportion of customers on PSR may partly depend on how effective they are at identifying PSR customers, rather than only differences in their customer base.
- 3.85 Measuring whether a customer has an online account is more straightforward than understanding the relative use they make of online and offline services - but the latter is what is likely to drive costs.

⁴² Ofgem (2024), Energy consumer satisfaction survey.
<https://www.ofgem.gov.uk/publications/energy-consumer-satisfaction-survey-august-september-2023>

- 3.86 Default tariff customers are likely to correlate to other characteristics (for example, customers on PPM are much more likely to be on default tariffs) so it is difficult to isolate the exact effect of default tariff customers. Additionally, under the current market conditions, most customers are on default tariffs.
- 3.87 Suppliers generally said that all three characteristics were likely to impact operating costs. Eight suppliers said that PSR customers are more expensive to serve given the additional service requirements for this group of customers. Additional support can include services such as assistance with meter readings and accessible information (eg bills in large print or braille).
- 3.88 Seven suppliers suggested that offline customers incur higher costs due to lower engagement through digital channels. Though one supplier said the relationship was not completely clear given many online customers continue to contact through phonelines despite having the app.
- 3.89 Six suppliers responded that default tariff customers are generally more costly to serve due to higher contact costs and more frequent bill changes (ie quarterly cap updates). However, as mentioned above, the cost difference would be currently harder to disentangle given 77% of customers were on default tariffs in 2022 (and 88% in 2023).⁴³ Default tariff customers may also have lower costs in some instances. For example, suppliers may not incur sales and marketing costs for customers who remain on a default tariff for several years.
- 3.90 We consider there may be interactions between the three characteristics and payment methods. A few responses directly supported this view. One supplier said that there was variation across PSR customers who pay by different payment methods in relation to the propensity to call. Another supplier also mentioned that default tariff customers are typically likely to be less engaged and therefore implied they are more likely to be on more expensive payment methods such as Standard Credit.
- 3.91 The most common response to cost lines that differ for these characteristics were customer contact (ie call centre costs) and billing and payment (eg debt-related costs). The billing and payment collection elements will be captured by how we set an allowance for debt-related costs – covered in Chapter 4. This means that in terms of the core operating costs, it is mainly the customer contact costs that differ by customer base characteristics. Our analysis of 2022 operating cost data

⁴³ The proportion of default tariff customer are based on operating cost RFI data and is based on a customer numbers at 1 July 2022.

suggests that customer contact as a proportion of core operating costs ranges from 1% to 19%, with an average of 12%. We expect some of the variation between suppliers could be driven by customer base characteristics.

- 3.92 Overall, we consider that for the purpose of setting an allowance for core operating costs, capturing payment methods as a key parameter mitigates the impact of the other customer base characteristics due to the relationship across them. While we are unlikely to make a direct adjustment for the other characteristics, we may consider them when assessing benchmarking options and an appropriate sample.

Outcomes based approach

- 3.93 Our objective under the Act is to protect existing and future customers who pay by default tariffs. In accordance with this objective, the decision we made in 2018 was to introduce a cap that provides "a high level of protection".⁴⁴ This included an efficiency challenge, by setting operating cost allowances below suppliers' historical operating costs (at just below the lower quartile).
- 3.94 In October 2023, we published a working paper on our benchmarking approach. The paper discussed whether a cap with a "high efficiency expectation and maximising customer price protection" should be maintained when benchmarking supplier costs for the operating costs review or whether we should seek alternative primary outcomes (which will continue to protect customers but at varying levels), given how the market has changed since 2018. We also noted that because the operating cost allowances are a small component of the overall cap level, the degree to which we may be able to influence these outcomes would be limited.⁴⁵
- 3.95 Since we published the working paper, we have started several reviews that will determine the future of pricing in the retail market (such as the future price protection review, the affordability and debt review, and the standing charge review). The operating cost review is part of this package of reviews, and where possible and appropriate, we will seek to establish a consistent view across the reviews. Though noting potential differences in timings between reviews as they evolve, we will also consider the benchmarking options on their own merits in this review. We consider this to be an alternative way to consider the outcome we

⁴⁴ Ofgem (2018), Default tariff cap: decision - overview, page 6.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

⁴⁵ Ofgem (2023), Energy price cap operating cost review benchmarking working paper, paragraph 3.16.

<https://www.ofgem.gov.uk/publications/energy-price-cap-operating-cost-review-benchmarking-working-paper>

seek to achieve in setting the cap, as discussed in the benchmarking working paper.

Discounted benchmark options

- 3.96 Benchmarking costs across suppliers can be seen as a spectrum ranging from using the lowest cost supplier to using the highest cost supplier to reflect the benchmark.
- 3.97 In the options section above, we discussed consideration of two benchmarking approaches: a lower quartile approach for a more stringent benchmark and a weighted average approach for a looser benchmark. We consider these two options strike a balance between trade-offs such as efficiency improvement incentives and uncertainty.
- 3.98 There are two options we have discounted: a frontier costs approach and an upper quartile approach. Under the frontier approach, we would set a benchmark based on the lowest cost supplier in the sample. This approach would maximise efficiency improvement incentives and yield the lowest possible allowance. However, we consider the approach would likely provide less room for uncertainty and be less resilient to cost shocks in future. Additionally, using the lowest cost supplier as the benchmark may increase the risk of capturing non-efficiency factors and therefore, increasing the risk of setting an allowance that is challenging for a notionally efficient supplier to achieve even with further efficiency improvements in place.
- 3.99 The frontier approach may be less risky if we were to refine the sample such that all suppliers (including the frontier) in the sample had a reflective customer base. However, there would still be risks from measurement error or natural variation. We do not currently view that ensuring the entire sample has a reflective customer base is necessary for setting a lower quartile benchmark, as we will assess whether the benchmark supplier has a representative customer base. Additionally, overly restricting the sample creates a risk of removing suppliers that are more efficient. Additionally, there are only a certain number of suppliers operating at scale within the data we collected so cutting down the sample might materially affect the number of data points.
- 3.100 We have also discounted options to set a benchmark above the weighted average level (eg an upper quartile approach). We recognise that some suppliers may have a more costly customer base to serve compared to the average. However, under the current legislation, as we can only set one cap level across suppliers, we seek to reflect a notionally efficient supplier when setting the allowance and

balance any considerations against the level of price protection provided to customers. We do not consider an upper quartile approach would meet the right balance in the circumstances. We note that an upper quartile approach would mean that the total allowance paid by default tariff customers would be greater than suppliers' aggregate costs.

Questions

- Q1. Please explain your preferred approach to benchmarking (benchmark metric and benchmarking costs across parameters) and how it would align with the statutory framework. Explain your answer by providing evidence where possible.
- Q2. Please explain whether differences in core operating costs (excluding debt-related costs and industry charges) are more related to efficiency than differences in the customer base? If you think these costs are related to the customer base, please explain what these customer base factors are.
- Q3. Please explain if you think that future regulatory changes you know of will have material and systematic impact on core operating costs relative to 2023?
- Q4. Do you think technology developments will help make further efficiencies to core operating costs? Please give evidence to support your views.
- Q5. Please explain what you see the role of the operating cost allowance to be in influencing further efficiency improvements.

Allocating costs across customer groups

Options

Allocating benchmarked costs across parameters

- 3.101 If we benchmark at an aggregate cost level for payment method and/or fuel, we then need to consider how we allocate the aggregate costs between these two parameters. This would only apply to options A-C in the previous section.
- 3.102 Note, these options would not impact the total level of costs in the allowance, as these would be set by the benchmarking approach. They only shift costs across different groups of customers.
- 3.103 We are considering two options:
- Option 1: Using the allocation methodology of the supplier closest to the benchmark.

- Option 2: Calculating a weighted average of the percentage split on each parameter across the sample.

3.104 For option 1, we would benchmark costs at an aggregate level and use the allocation of the supplier closest to the benchmark value. For example, if using a lower quartile, we would take the benchmark supplier's allocations across payment method and apply them to the aggregate levels to calculate the allowances.

3.105 The advantage of this approach is that, to the extent efficiency may be concentrated to one payment method, using the allocation of the benchmark supplier might be closer to reflecting what efficient costs were for individual payment methods. However, it does rely solely on a given supplier's allocation methodology. To the extent that differs from the other suppliers in the market, there may be a risk of under or over recovery across parameters depending on a supplier's customer portfolio.

3.106 For option 2, we would calculate the weighted average cost for each payment method and across payment methods. We would then take the benchmark and divide by the weighted average costs across payment methods to get a scaling factor. The scaling factor would then be applied to the weighted average cost for each payment method giving the operating cost allowance level for each payment method based on the aggregate benchmark. We intend to keep the weighted average across parameters equal to ensure we were moving costs between parameters (eg payment methods) rather than changing the total level of costs in the allowance.

3.107 The main advantage of option 2 is that it averages allocation methodologies across the sample of suppliers. This is particularly preferable if the benchmark supplier's allocation approach is unrepresentative (eg it has split costs by customer accounts rather than identifying different cost drivers).

3.108 While the options here apply for both payment method and fuel type, there may be further considerations for allocating across fuels. We discuss these in the key considerations section.

Allocating costs over consumption levels

3.109 As mentioned in the context section, we do not reflect the allocation of costs between the standing charge and unit rate in a cost reflective manner under the current approach. As part of our 2018 decision, we allocated some costs we would typically consider to be fixed by consumption to the unit rate to avoid

increasing standing charges for customers. We expect most cost lines that make up core operating costs are not likely to vary by a customer's consumption and therefore are likely to be fixed in nature.

- 3.110 As we set out in our November 2023 standing charge call for input, we are aware of the pressures that high standing charges have on some groups of customers.⁴⁶ Actions we take on standing charges may have links to this review, as well as our work on debt and affordability, and future price protection. When carrying out this review, where possible and appropriate, we will seek to align positions with those wider reviews to seek a coordinated policy outcome. However, we note there could be potential timing differences between the workstreams so we will also consider the option space on its own merits within this review.
- 3.111 There are a number of options we could take ranging from increasing the allocation of costs to the standing charge to moving all costs to the unit rate. Under the status quo, we would allocate approximately 69% of the costs to the standing charge and recover the remainder through the unit rate.
- 3.112 Changing the allocation of costs between the standing charge and unit rate has a distributional impact on customers. We will need to carefully consider the impacts on different groups of customers, how impacts may be mitigated and how this may affect market participants.
- 3.113 Our current hypotheses are that moving costs to the unit rate may benefit low consumption users, who are often in financially vulnerable situations (eg those self-rationing or self-disconnecting on PPMs). However, the increase in the unit rate may have a negative impact on customers with high consumption. In some cases, these customers can also be in vulnerable situations (eg customers who rely on medical equipment). There is a risk that customers on average may be worse off because, while the cap is based on an old version of median consumption, the overall impact on customers will be determined by average (mean) consumption. So far, average consumption has typically been higher than median consumption.
- 3.114 The impact on a given supplier will depend on the average consumption of its customer portfolio. If it has a greater average consumption relative to the benchmark consumption values used to calculate the cap then it would benefit from the higher unit rate. Whereas if it has a lower than average consumption, it

⁴⁶ Ofem (2023) Standing charges – call for input.
<https://www.ofgem.gov.uk/publications/standing-charges-call-input>

will be worse off. The reverse of the above applies to suppliers, average consumption is typically higher than median consumption, which means suppliers on the whole would benefit from a greater cost allocation on the unit rate. However, to note where this may be true on average, there may also be periods where consumption is lower or higher than expected, which might result in periods of suppliers under-recovering or over-recovering costs. We do not consider this is an issue as it should net out in the medium term.

3.115 We recently introduced the levelisation of standing charge difference between Direct Debit and PPM payment methods. Given the intention of this policy is to equalise the PPM differential, which is currently captured within the standing charge, we will consider whether it is appropriate to allocate any additional PPM costs solely to the standing charge. This would enable any resulting cost differential determined by this review to be covered by the existing levelisation policy design. However, in doing so we would consider the impacts on Direct Debit customers given they would be impacted by the level of PPM costs we levelise.

Stakeholder responses

Cost allocation across payment methods

3.116 Seven stakeholders described some challenges faced with allocating costs. For example:

- Three stakeholders suggested that the approach to allocating costs should consider the impact on vulnerable customers, and whether it aligns with broader social and regulatory objectives which results in incentives with positive outcomes.
- Two stakeholders suggested there is a risk of under/over recovery due to different customer bases.
- One stakeholder described how historical and/or current data may not give an accurate representation of future payment method cost differentials.

3.117 Three stakeholders referenced the levelisation policy and that this work should address some of the payment method costs differentials.

3.118 Two stakeholders supported using a cost-reflective methodology as conditions for a competitive market improvement.

Recovering costs across standing charge and unit rate

- 3.119 Four stakeholders supported option 1 (maintain the current approach) and considered this to be a better approach to option 2 (cost-reflective approach) for allocating costs between the standing charge and unit rate.
- 3.120 Three stakeholders explicitly stated that they do not agree with option 2 as it would likely lead to an increase in the standing charge, and consequently may have a disproportionate distributional impact on customers (ie low consumption households would pay more). One stakeholder suggested that the distributional impacts could be addressed by direct relief (eg payment method levelisation of standing charges and unit rates coupled with a social discount).
- 3.121 The majority of stakeholders suggested a third option, to reduce or remove the standing charge, should be considered and prioritised as part of the operating costs review. They argued that with low-income customers (including PPM customers) currently being disproportionately and unfairly impacted by the high standing charge, the case for intervention is supported.
- 3.122 Three stakeholders suggested that Ofgem should work more closely with government and energy firms to ensure there are protections in place for higher-consuming vulnerable customers who have greater needs (eg medical reasons). We recently published a call for input on our debt and affordability review. The call for input seeks to improve our understanding of the current and future issues and challenges. This will enable us to consider what more could be done in our capacity as the energy regulator, and where we may need to make recommendations for others such as government.⁴⁷

Considerations

Allocating costs across fuels

- 3.123 In addition to the options set out for allocating costs across parameters, we could take an alternative approach for allocating across fuel types.
- 3.124 We consider that the majority of core operating cost do not significantly differ by fuel type. Differences between fuel types in relation to pass-through industry charges will be captured by the industry charge allowance, meaning core operating costs are less sensitive to fuels.

⁴⁷ Ofgem (2024), Affordability and debt in the domestic retail market – call for input. <https://www.ofgem.gov.uk/publications/affordability-and-debt-domestic-retail-market-call-input>

- 3.125 Metering costs may be an exception to this given different types of meters are required for gas and electricity. Additionally, there may be some costs that may not apply to one fuel (eg it could be argued that any MHHS system costs should be allocated to electricity only).
- 3.126 If the cost differences between fuels are relatively small, then we could consider whether it would be proportionate to allocate costs equally between gas and electricity or alternatively in proportion to the remainder of the cap. This would be a simpler approach that is not dependent on how suppliers have allocated costs between fuels. We welcome any stakeholder views on how costs may vary by fuel.
- 3.127 We have used this approach previously when making adjustments to the cap. For example, we allocated the adjustment for COVID-19 equally between gas and electricity.

Cost data analysis and examples

- 3.128 Using our analysis of the 2022 core operating cost data, we have set out illustrative examples below to demonstrate the possible differences between the options we have set out in this chapter. These numbers should be treated as illustrative only, given we are collecting 2023 data, which is likely to change the numbers on which we plan to set the allowance when we conclude this review.
- 3.129 We set out three illustrative examples:
- Example 1 – Lower quartile benchmark, costs benchmarked at an aggregated level (combined payment method and fuel), costs allocated across payment method and fuel by calculating the weighted average parameter split across suppliers.
 - Example 2 – Lower quartile benchmark, costs benchmarked at a payment method and fuel split basis. This approach relies on supplier’s allocations so there is not a need to set a further allocation methodology. It also means we use different suppliers for each of the payment method benchmarks.
 - Example 3 – Weighted average benchmark, costs benchmarked at a payment method and fuel split basis. As this example uses a weighted average benchmark, it is less sensitive to suppliers’ allocation methodologies.

Table 3.1 – Illustrative examples of core operating cost options

Examples	Direct Debit	Standard Credit	PPM	Payment method average
1	£152	£180	£217	£166
2	£150	£154	£183	£155
3	£165	£196	£236	£181

Note: Table shows values for a dual fuel customer with benchmark consumption (3,100 kWh electricity and 12,000 kWh gas).

3.130 Examples 1 and 2 use a comparable level of stringency for setting the benchmark by taking the lower quartile. The differences between the two examples shows that there are variations in cost allocations between suppliers. These variations could be related to relative efficiency between the payment methods or differences in allocation methodologies. As we have set out in this chapter, we will seek to disentangle these two possible effects to determine which approach is preferable.

3.131 By comparison and as expected, example 3 yields the highest level of allowances, driven by the use of a less stringent benchmark approach. However, this is still lower than our analysis of the cap allowances for 2022, which shows that suppliers have made efficiency improvements on core operating costs since the cap was introduced.⁴⁸

⁴⁸ To calculate the cap allowances, we considered the operating cost allowance, SMNCC allowance and PAAC term of payment method uplift for Standard Credit and PPM to be comparable to the operating cost data excluding debt-related costs. We calculated a demand weighted average across the cap periods covering 2022 to estimate an average allowance.

Questions

- Q6. What is your preferred approach to allocating costs between payment methods and fuel type if we take an aggregate benchmarking approach? Please explain your answer.
- Q7. What approach do you prefer to allocating fixed operating costs between the standing charge and unit rate? What would be the impact on customers and suppliers of moving costs to the unit rate?

Updating the core operating cost allowance

Options

- 3.132 The update approach is an important aspect of designing the core operating cost allowance. Through the update approach we can consider how best to reflect potential future cost changes and better ensure the allowance remains appropriate over time.
- 3.133 There are a number of reasons efficient costs may change over time (eg inflation, changes in activities, changes in efficiency, regulatory changes etc.). While we cannot fully control these in the update approach, we would seek to set an approach that limits the number of ad-hoc adjustments we need to make to the cap in future, as these tend to provide uncertainty and are resource intensive.
- 3.134 As discussed in the earlier section on efficiency improvements between 2019 and 2022, we intend to consider the degree to which we should continue to set incentives for suppliers to make efficiency improvements. A proportionate update approach is important to maintain these incentives. If we updated or re-opened the allowance too frequently then suppliers may not be able to retain benefits from efficiency improvements long enough to make the necessary investment. However, a review process is required to ensure customers eventually see the benefit of any cost reductions.
- 3.135 We are considering three options for the update approach:
- Option 1: Indexed by CPIH – for this approach, we would retain the current status quo of indexing by inflation.
 - Option 2: Indexed by CPIH-x (where 'x' could be positive or negative) – for this approach, we would retain the indexation by inflation, but we may subtract or add an additional amount.
 - Option 3: Indexed by a different external indicator.

- 3.136 Retaining the current approach of indexing by CPIH would be the simplest option to adopt. CPIH is a widely used and is a preferred measure of inflation. However, there is a risk that efficient costs do not change at the same scale or direction as inflation. This may be the case as we expect the retail market to change.
- 3.137 Under option two, we would start with the inflation index and set a further adjustment factor. Two examples of how we could set 'x' are:
- A) x = a glide path to move from the weighted average allowance to the lower quartile allowance over a given period of time (eg 5 years). This would allow suppliers time to make efficiency improvements and slowly move to greater efficiency.
 - B) x = an efficiency improvement of $y\%$. This would build in an expectation that suppliers will improve their efficiency over time by a given amount.
- 3.138 There are two factors that could determine whether an adjustment to inflation is required: changes in costs and changes in efficiency.
- 3.139 For changes in costs, these could be driven by a notional supplier's efficient costs changing at a different rate to inflation or the addition of new requirements/outputs impacting costs.
- In principle, existing efficient costs could change at a faster or slower rate than economy-wide inflation, therefore this is a two-sided risk. Given the risk is two-sided, using an economy-wide inflation would be the default approach.
 - For changes in requirements/outputs, this could also change at a faster or slower rate than inflation. However, it is worth noting the potential impact of retail market changes may lead to new costs for suppliers, but this is still somewhat uncertain (both in terms of future changes and impact).
- 3.140 Therefore, to set an adjustment to an inflation index for cost changes, we would need to believe that either cost changes for existing efficient costs or changes in efficient costs driven by regulatory changes were systematically and materially different to inflation in a particular direction. This could lead to a positive or negative adjustment based on our views on the direction of cost changes.
- 3.141 The other factor affecting whether we make an adjustment is efficiency. Efficiency improvements could come from two areas: (1) a supplier catching up in efficiency to a notionally efficient supplier; (2) movements in the efficiency frontier (ie an overall improvement in the maximum feasible efficiency). These two factors, along with how we benchmark costs, may determine how we set an adjustment.

For example, there could be a greater case for setting 'x' as an adjustment to reflect catch up in efficiency under a weighted average approach.

- 3.142 To make an adjustment to the inflation index for efficiency changes, we would need to believe that efficiency improvements were achievable for an average supplier, provided they were afforded time to achieve them. This has been the case so far shown by the improvements in efficiency and reduction in costs between 2019 and 2022. An example option may be to set a less stringent benchmark but build in a glide path to the lower quartile benchmark. Alternatively, if we considered there to be potential efficiency improvements under the lower quartile benchmark, we could build this into the update approach (ie to option B above).
- 3.143 In setting 'x', we would consider both the cost changes and the efficiency improvement incentives. Therefore, the value of 'x' may reflect the net effect of more than one individual factor.
- 3.144 Overall, the main benefit of adjusting the inflation index would be to achieve a better reflection of how we consider costs may change in future and provide additional efficiency incentives (or time for efficiency improvements to be implemented and benefits realised). However, we acknowledge the challenge in defining the parameters of this approach. We will conduct further analysis to understand what an appropriate value of 'x' is likely to be under different benchmarking conditions and assumptions.
- 3.145 For the third option, there may be other externally available indicators that are more appropriate than CPIH to set an index on. We do not have any particular alternative indicator(s) in mind at this stage and welcome any suggestions from stakeholders.
- 3.146 While the above options set out how we may regularly update the allowance, in a mechanistic manner, we will also consider what the role of regular reviews is. As mentioned earlier, we would not seek to frequently re-open the allowance at the risk of dampening any efficiency improvement incentives. However, it may be pertinent to review the operating cost allowance in the future (eg after another five years) depending on the scale of regulatory change in the retail market and the future design and / or existence of the cap.

Stakeholder summary

- 3.147 Three stakeholders agreed with our outlined considerations (ie balancing uncertainty and proportionality, and whether any costs arising in future are

temporary or enduring). One stakeholder did not agree with our consideration of balancing uncertainty with proportionality and stated that a robust impact assessment for both measures should be prioritised and developed. It added that offsetting benefits should not be conflated with efficiency gains.

3.148 One stakeholder supported the use of CPIH as the metric we use to update the core operating costs baseline.

3.149 Two stakeholders suggested that adjustments should be made by making ad-hoc changes when the costs of regulatory changes are materialised, and that costs should be recovered within a reasonable time frame.

Considerations

Future regulatory changes

3.150 In setting the core operating cost allowance, we are mindful of:

- Known regulatory changes which may not yet be present in the 2022 cost data (eg enhanced customer standards rules),
- known changes that are due to occur but with less certainty on costs (eg MHHS system changes) and;
- changes that are not clear at present (eg changes to the retail market as we move to net zero).

3.151 It is worth noting that the impact of future changes could in principle be in either direction – a cost increase or a cost decrease.

3.152 We are collecting 2023 operating cost data and intend to use it for setting the allowances through this review. The 2023 data will provide an updated view of costs and may capture some of the regulatory changes that were recently introduced. We have also asked direct questions on how suppliers expect costs to change over the coming years (eg forecasted cost changes resulting from MHHS or a view of costs from other changes). This will form part of our consideration when benchmarking and we may consider adjusting the cost information. However, we are mindful of the challenges in setting one approach across suppliers when there are differences in the timings at which those costs are incurred (eg suppliers may have different schedules for IT changes related to MHHS).

3.153 Additionally, alongside collecting updated data, we will also consider uncertainty in future costs as part of the 'benchmarking' and 'update approach' options to

consider whether we can better determine and reflect how costs may change over the coming years.

Questions

- Q8. Please explain any views on how we could determine the adjustment factor under option 2 CPIH-X approach.
- Q9. Please explain any views on whether there are any other external indicators we should consider to index the allowance.

4. Debt-related costs

Section summary

In this chapter, we discuss options for setting a separate debt-related cost allowance in the cap. Specifically, we discuss which cost components could be included in the allowance, how they could be measured and how they could be benchmarked to establish separate allowances for different parameters. We also discuss how the allowance could be updated over time.

Context

4.1 This chapter outlines how we could set a separate debt-related cost allowance in the price cap. As outlined in Chapter 2, this review is part of a package of inter-related workstreams intended to deliver a reformed retail market. When carrying out this review, where possible and appropriate, we will seek to align positions with those wider reviews to manage any interactions and seek to achieve a coordinated policy outcome. However, many of the choices across these interrelated areas weigh up often competing objectives and demands, so we may not always reach the same conclusions in consistent circumstances. The options in this chapter will be assessed on their own merits and our decision making in this area does not – and is not intended to – fetter our future decision making in other reviews or reforms.

Background on debt-related costs

- 4.2 Some energy bills are never paid, and therefore ultimately have to be written off by energy suppliers. This is referred to as bad debt, and all energy suppliers accumulate some bad debt. It is usual for businesses in many industries, not just energy, to make a provision for bad debt and to cover this through the pricing of their goods and services. The cap therefore provides an allowance to account for these efficient costs (henceforth we refer to these costs as debt-related costs). This means all default tariff customers pay for the cost of bad debt incurred by customers who do not pay.
- 4.3 Suppliers incur debt-related costs as part of their operating expenses and we divide these costs into three components:
- **Bad debt costs:** These are costs from customers' energy bills that are never paid.

- **Debt-related administrative costs:** These are costs associated with suppliers' activities when dealing with customers in debt. These activities include (but are not limited to) sending out payment reminders, setting up repayment plans and carrying out warrants.
 - **Working capital cost:** These are costs associated with suppliers raising capital for day-to-day operations and funding both customers making scheduled payments in arrears (eg quarterly payments on receipt of bills) and delayed payments.
- 4.4 The following illustrates how a supplier may typically incur these costs: a customer incurs debt when they stop paying for the energy consumed. When debt starts accumulating, suppliers incur debt-related administrative costs when they try to recover the debt. In parallel, suppliers will also incur short-term working capital costs to finance customer debt. The amount of debt that has not been recovered is bad debt.
- 4.5 The largest debt-related cost is bad debt. This cost is reflected in supplier's accounts through the bad debt charge, which is an entry in the income statement. Suppliers make estimates (known as provisions) for the amount which will never be paid. They then adjust these estimates over time and eventually finalise them through write-offs. Write-offs can take some time to crystallise as suppliers attempt to recover the debt.
- 4.6 Over the past year, we have observed an increase in total energy debt and arrears, as well as the number of customers who are in debt.⁴⁹ We recognise the impact this has on consumers and as mentioned in Chapter 2, we have launched a package of reviews to ensure our efforts to support customers. However, through the cap we also recognise that debt-related costs are a cost to suppliers and under the Act, we must have regard to suppliers' need to recover efficient costs and this is the focus of this review.

Current approach to debt-related costs in the price cap

- 4.7 Debt-related costs are generally accounted for in the price cap through three allowances,⁵⁰ as partly discussed in Chapter 3:

⁴⁹ Ofgem (2024) Affordability and debt in the domestic retail market – a Call for Input, figure 1.3. <https://www.ofgem.gov.uk/publications/affordability-and-debt-domestic-retail-market-call-input>

⁵⁰ We noted that additional temporary adjustments to the debt-related costs allowance such as the recent debt-related costs float adjustment are applied through the Adjustment Allowance in the cap.

The core operating costs allowance:

- 4.8 This captures the debt-related costs (bad debt costs and debt-related administrative costs) associated with the Direct Debit payment method and is applied as the baseline for other payment methods.⁵¹

Earnings before Interest and Tax (EBIT) allowance:

- 4.9 This captures the working capital cost associated with customers paying in arrears. These costs are not differentiated by payment method but instead, are set using a common methodology across all payment methods.⁵²

Payment method uplift:

- 4.10 As noted earlier, this allowance captures the additional costs associated with other payment methods, such as debt-related costs, when compared with the Direct Debit baseline. For bad debt and debt-related administrative costs, the additional costs associated with serving Standard Credit customers are captured here. Furthermore, it adjusts the working capital allowance set in the EBIT allowance to reflect the cost differences between payment methods.
- 4.11 We calculated the bad debt cost using the bad debt charge, and we calculated the working capital cost using the working capital requirement and applying the cost of capital from the EBIT decision.⁵³ To estimate the allowance, we calculated the additional costs to serve a Standard Credit customer compared to a Direct Debit customer for the two cost components. For debt-related administrative costs, we used supplier-reported cost differences between a Standard Credit customer and a Direct Debit customer. We collected this information through our 2018 RFI. We combined these costs across fuels and took a lower quartile benchmark.
- 4.12 To set the allowance across payment methods, we then allocated the additional costs between Standard Credit and Direct Debit payment methods. For example, while we allocated additional working capital fully to Standard Credit customers, 52% of the additional costs of bad debt costs and debt-related administrative

⁵¹ Ofgem (2018), Default tariff cap: Appendix 6 – operating costs, paragraph 2.6.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

⁵² Ofgem (2018), Default tariff cap: Appendix 9 – EBIT.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

⁵³ In 2018, we set the EBIT cost of capital at 10%.

Ofgem (2018), Default tariff cap: Appendix 9 – EBIT, paragraph 2.7.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

costs were allocated to Standard Credit customers and the rest across all customers.⁵⁴

- 4.13 We set the allowances for bad debt costs and working capital costs as a percentage which is applied to the rest of the cap 'core cost' components.⁵⁵ We set the allowance for the debt-related administrative costs as a £/customer value.⁵⁶

How the allowance is updated over time

- 4.14 Generally, the allowances are linearly scaled with the overall cap level, with the exception of debt-related costs, which is included within the core operating costs baseline and the fixed element of the payment method uplift, which is indexed to inflation (CPIH).

Trend in the current allowance over time

- 4.15 Figure 4.1 presents the overall cap allowance related to debt-related costs by payment method. We observed an increase in the debt-related costs allowance over cap periods 9a-10b. This is due to the scaling effect driven by an increase in wholesale costs. As part of our debt-related cost review, we also investigated supplier debt-related costs, and our analysis indicated that these costs have diverged materially and systematically from allowances over the period April 2022-March 2024 (ie cap period 8-11b). Thus, we introduced a temporary adjustment (of £31) to the cap from cap period 12a (April 2024 - June 2024) for 12 months, with the intention of delivering a true-up process in April 2025 (together with this review).

⁵⁴ Ofgem (2018), Default tariff cap: Appendix 8 - payment method uplift, paragraph 2.40.

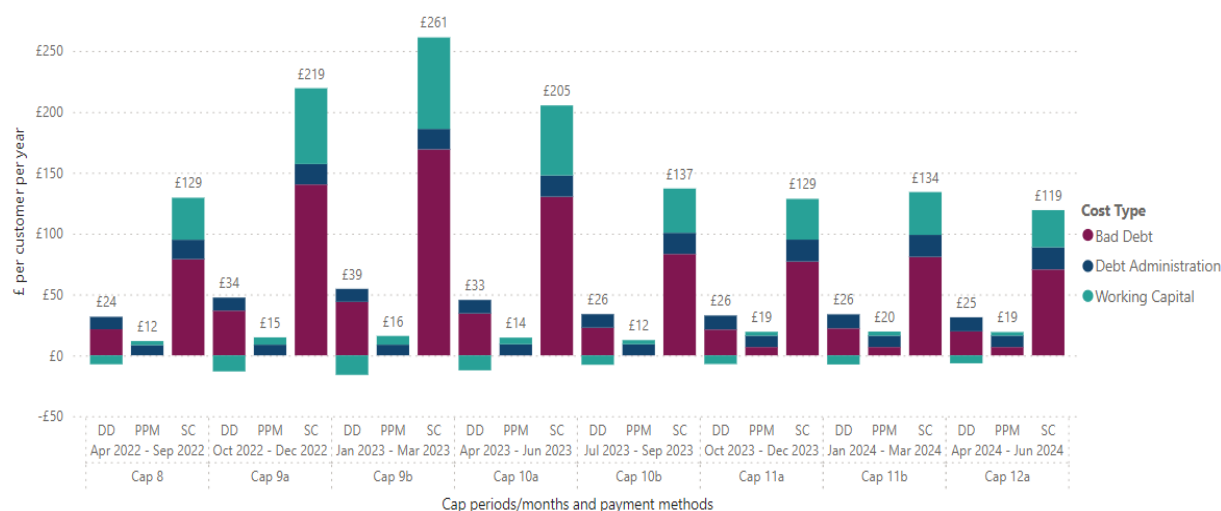
<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

⁵⁵ The core costs consist of wholesale costs, operating costs, policy costs and network costs.

⁵⁶ Ofgem (2018), Default tariff cap: Appendix 8 - payment method uplift, paragraph 2.55.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

Figure 4.1: Debt-related costs cap allowances (annualised, £ per typical dual fuel customer at benchmark consumption)



Notes: The bad debt allowance for PPM in 11a to 12a includes £8.77 for ASC bad debt. The figure excludes adjustments made to the allowance (ie the COVID true-up adjustment (£12 per Direct Debit and Standard Credit customer) implemented over cap periods 10a to 11b and the more recent debt-related cost float adjustment).

Setting a separate allowance for debt-related costs

4.16 Since the introduction of the cap, we have made several adjustments to the debt-related cost allowance in the form of a float and true-up. Firstly, related to additional costs incurred by suppliers due to the COVID-19 pandemic⁵⁷ and, more recently, the increase in debt-related costs following the gas crisis.⁵⁸

4.17 In light of these reviews, we consider it appropriate to isolate these costs from the total operating costs allowance. This is due to several reasons, which are outlined below:

- **Variability in the debt-related costs:** While other operating cost components are likely to be stable over time, we consider these costs to depend on consumer behaviour/economic circumstances and bill size, making them more likely to change. Therefore, we may want to consider a different benchmarking approach and/or update methodology (such as indexing it to other cap cost components) compared to that used for core operating costs.

⁵⁷ Ofgem (2023), Price Cap – Decision on the true-up process for COVID-19 costs. <https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs>

⁵⁸ Ofgem (2024), Energy price cap: additional debt costs review decision. <https://www.ofgem.gov.uk/publications/energy-price-cap-additional-debt-costs-review-decision>

- **Impacted by supplier assumptions:** Suppliers may have various approaches to how they provision for bad debt that may impact reported costs. For instance, two suppliers could have different provisions (estimates) in a given year, even if their outturn costs ended up being the same. In contrast, other operating costs should be known for a given year, and therefore, differences in those operating costs between suppliers should reflect actual cost differences rather than methodology differences. As this may distort the comparability of the total operating costs when benchmarking, we could exclude these debt-related costs to mitigate the impact.
- **Improves transparency:** There would be more transparency in the way debt-related costs are accounted for under the cap. It would be particularly beneficial if we needed to assess whether costs were materially and systematically different from the allowances (as we have previously done when considering if an adjustment is appropriate). Additionally, it would be beneficial if we implement phase two of levelisation, which will consider whether we levelise bad debt costs between Standard Credit and Direct Debit customers.
- **Flexibility to adjust:** If we are required to make any adjustments to the debt-related costs allowance in the future, setting a separate allowance would help us make these adjustments more easily.

Main areas for this review

- 4.18 There are several key elements to setting a separate debt-related cost allowance, and this chapter breaks them into:
- What costs to include and how we measure them;
 - How we benchmark costs across suppliers;
 - How we allocate costs across different groups of customers (eg payment methods or consumption); and
 - How we set the allowance and update it over time.
- 4.19 Some areas (eg how we benchmark and allocate costs) are key elements of how we set the cap more widely and the approach to pricing in the retail market. Therefore, in considering these areas, we intend to incorporate any views and findings, where appropriate, from the standing charge review, debt and affordability review, and future price protection work.

- 4.20 We note that there may be several overlapping options considered for how we benchmark debt-related costs and how we benchmark core operating costs (discussed in Chapter 3). However, we consider that these two areas have different considerations.
- 4.21 We have not previously consulted on the design of a separate debt-related costs allowance. However, we received some feedback from suppliers in response to the October 2023 Benchmarking working paper. We have discussed these where relevant. Further, we consider some of the responses we received in response to our May 2023 CFI (discussed in Chapter 3), which would be relevant when setting this allowance. We also note that there have been several reviews of debt-related costs in the cap, and we have considered these reviews when discussing the options and key considerations in this chapter.

Cost components to include in the allowance

- 4.22 The first element we need to consider when designing this allowance is what cost components we should include.

Options

- 4.23 As stated above, there are three cost components that form debt-related costs (ie bad debt costs, debt-related administrative costs, and working capital costs). When setting the allowance, we have the option of including all cost components or selecting only certain cost components (eg only including bad debt costs) within this separate allowance. A cost component that is not included in this allowance will be included in the core operating costs allowance (ie we are discussing where to capture costs rather than whether to capture them).

Stakeholder responses

- 4.24 In response to the benchmarking working paper, one stakeholder said that if we consider setting a separate allowance for debt-related costs, it should only include bad debt costs, while debt-related administrative costs should be captured in the core operating costs, and working capital costs should be captured in the EBIT allowance.

Considerations

- 4.25 When deciding what cost component to include in this allowance, we would need to consider (i) the correlation between cost components (ii) the definition of costs and (iii) flexibility in updating costs.

Correlation between cost components

- 4.26 We consider costs that are strongly correlated (in particular, inversely correlated) should be treated together. This is to ensure that the benchmarking option we select is not unduly stringent, when considering suppliers' legitimate costs. For example, we consider it plausible that suppliers who invest more in the debt administration process could incur higher debt-related administrative costs but have a lower bad debt cost relative to other suppliers. This means that these cost lines are inversely correlated. If we benchmark these costs separately (ie bad debt costs in the debt-related allowance and debt-related administrative costs in the core operating costs allowance) by selecting a lower quartile benchmark option, it may lead to an unachievable benchmark.
- 4.27 It is worth noting that the risk is greater if we opt for a more stringent benchmarking approach, such as a lower quartile benchmark metric. However, we consider it would not be an issue if we select a weighted average benchmark metric. We discuss benchmark metric options later in this chapter.
- 4.28 The EBIT allowance already includes an allowance for working capital costs at an aggregate level. However, we plan to continue to set an allowance to capture the differences between payment methods.
- 4.29 Since differences in working capital costs between payment methods is currently applied through the payment method uplift, we would use the debt-related cost allowance to apply the payment method differences associated with working capital costs in the future. An alternative approach would be to capture this through the EBIT allowance. However, we recently reviewed this allowance; therefore, we do not intend to review it again through the operating costs review.⁵⁹

Definition of the cost components

- 4.30 We will collect supplier cost data to set the allowance.⁶⁰ We need to ensure that suppliers are able to isolate these costs from core operating costs when submitting the data.

⁵⁹ Ofgem (2023), Amending price cap methodology for Earnings Before Interest and Tax (EBIT) allowance decision.
<https://www.ofgem.gov.uk/publications/amending-price-cap-methodology-earnings-interest-and-tax-ebit-allowance-decision>

⁶⁰ We note that we have collected actual data till 2022 and more recently we issued an RFI to collect actual data for 2023.

- 4.31 Bad debt costs and data requested to estimate working capital costs follow established accounting definitions. Therefore, we can identify and isolate these costs from supplier cost submissions.
- 4.32 There is a risk that some suppliers might not be able to fully isolate debt-related administrative costs from other core operating costs (for example, call centre costs related to debt from other call centre costs).⁶¹ Therefore, we will consider carefully how suppliers have allocated costs between cost lines.

Measuring cost components

- 4.33 Once we have considered what cost components we could include in this allowance, we need to then consider how we could measure these costs. This section discusses potential measures for the three debt-related costs and relevant key considerations.

Options

Bad debt costs

- 4.34 To measure the bad debt costs, we consider the following options:
- Option A.1: Bad debt write-off - The debt written off from supplier balance sheets.
 - Option A.2: Bad debt charge - Profit and Loss charge incurred. Costs include write-off and recoveries, movement in provisions, and credit balance recognition.
 - Option A.3: Bottom-up approach - This approach would collect supplier debt levels by debt characteristics (ie age of debt, payment method and live/final) over a period of time. Using this information, we would estimate the proportion of debt that is unlikely to be recovered. To estimate this, we would use a combination of supplier provisioning approaches and historical data on supplier recoverability rates.

⁶¹ As presented in Appendix 1, we have requested four cost lines that capture debt-related administrative costs (these are (i) external collection, (ii) internal collection, (iii) warrant costs and (iv) active charge) and have carefully defined them to include costs associated with debt collection.

Debt-related administrative costs

4.35 To measure the debt-related administrative costs, we consider the following options:

- Option B.1: Flexible - We would set out a high-level description of debt-related administrative costs and would not provide a specific definition of which costs to include. This would be one line in the operating cost RFI.
- Option B.2: Prescriptive - We would set out a number of defined categories and require suppliers to provide a breakdown of their debt-related administrative costs in line with these categories.
- Option B.3: Hybrid - We would set out a number of defined categories (these are (i) external collection, (ii) internal collection, (iii) warrant costs and (iv) active charge) and ask suppliers to provide a breakdown of their debt-related administrative costs in line with these categories. We would also include the general option to add any cost lines that are not captured by the categories.

4.36 We have currently followed the hybrid approach in the RFI we issued in July 2023. We have also engaged with suppliers through our second draft RFI, which we issued on 18 April 2024, to understand the best approach for data collection.

Working capital costs

4.37 To measure working capital costs, we consider the following options:

- Option C.1: Net account receivables approach - Using supplier net account receivables (ie account receivables minus account payables) and applying the cost of capital (from EBIT decision - 12.26%⁶²) to estimate working capital costs. We note that EBIT cost of working capital assumes working capital requirements are financed fully through equity.⁶³
- Option C.2: Reported working capital costs - We request suppliers provide costs associated with differences in timings of payment.

⁶² Ofgem (2023): Amending price cap methodology for Earnings Before Interest and Tax (EBIT) allowance decision, paragraph 4.5.

<https://www.ofgem.gov.uk/publications/amending-price-cap-methodology-earnings-interest-and-tax-ebit-allowance-decision>

⁶³ Ofgem (2023): Amending price cap methodology for Earnings Before Interest and Tax (EBIT) allowance decision, paragraph 4.6.

<https://www.ofgem.gov.uk/publications/amending-price-cap-methodology-earnings-interest-and-tax-ebit-allowance-decision>

Considerations

Bad debt costs

- 4.38 To assess what is likely to be the appropriate option to measure bad debt costs, we consider the following criteria:
- **Practicality:** Suppliers should be able to readily provide the required data for the relevant option.
 - **Accuracy:** The measure should be able to estimate supplier bad debt costs as closely as possible in order to ensure that we protect future and current customers while still allowing efficient cost recovery.
 - **Comparability:** The comparability of supplier costs is preferable for ensuring that all options are available when selecting a benchmark metric.

Practicality

- 4.39 The two most practical options to measure bad debt costs are (i) bad debt charge and (ii) bad debt write-off. This is because these are standard accounting concepts, and suppliers have previously reported these costs through bad debt and/or operating costs review RFIs.
- 4.40 We consider the bottom-up approach to be less practical. Since suppliers may use different variables to categorise debt, we do not have a clear view of whether they hold the data we require for this approach.
- 4.41 Further, the bottom-up approach would require us to take into account the recoverability of different types of debt, which would be a very complex exercise and may not necessarily be proportionate given that suppliers already carry out their own analysis to set the bad debt charge. It is also worth noting that setting the allowance using this approach might inadvertently change supplier behaviour (eg methodology for provisioning debt) to align with the cap methodology. This may not necessarily impact the level of bad debt in a particular direction.

Accuracy

- 4.42 We consider the bad debt write off to be the most accurate option as this provides suppliers' view of the debt that would not be recovered. However, this information is not timely. This is because the amount written off is only known after the supplier has generally exhausted all efforts to recover the debt (and in some cases, suppliers only write off debt once a customer leaves them). Therefore, the cost would be reported with a significant lag. Despite this, suppliers would typically have a better view of the overall stock of bad debt over

a longer period of time. However, more recent external shocks such as cost of living pressure would likely impact the predictability of debt recovery, which might affect the duration at which suppliers keep a debt before writing it off.

- 4.43 We consider that the bad debt charge option would provide a sufficient level of accuracy as it incorporates the actual level of non-payment through revisions of provisions. This means the cumulative position (original provision, provision movement and write-offs) should reflect the actual level of non-payments over the medium term. However, the measure may be impacted by suppliers' judgement on recoverability (eg whether a supplier was optimistic or pessimistic about recovering costs in a particular period). While we can smooth this out by taking a view of bad debt charge over time, this risks also capturing changes in methodology and other factors that might be less reflective of current conditions.
- 4.44 A benefit of bad debt charge and write off options is that we could validate supplier data against consolidated segmental statements or suppliers' statutory accounts. The bottom-up approach would not relate to terms on a specific supplier's accounts.
- 4.45 We consider the accuracy of the bottom-up approach to depend on the robustness of our modelling approach, given the complexity of modelling bad debt costs and possible data constraints. To consider this approach, we would need to believe that our approach to modelling bad debt costs using granular data was more accurate than benchmarking suppliers' costs. Even with a bottom-up approach, we would be constrained to setting one allowance across suppliers reflecting the efficient cost of a notional supplier.
- 4.46 We also note that the choice of either the bad debt charge or the bad debt write-off options would allow us to easily update the allowance if costs materially and systematically deviate from the allowance. Using the bottom-up approach, we may need to reopen the underlying assumption in order to adjust the allowance. We note, however, that a bottom-up approach would allow us to neatly incorporate an update methodology into the model.

Comparability

- 4.47 We consider the bottom-up approach to be the most comparable option. This is because we would use supplier data to take a standardised approach to model bad debt costs. Further, we would be able to focus on the costs incurred by suppliers at a specific period.
- 4.48 By comparison, bad debt charge and debt write-off are less comparable across suppliers because they are impacted by a supplier's policies and judgement. For

bad debt write-off, there may be differences in the debt collection process and policy on when debt is written off (eg some suppliers may only write off debt when it's 'final').⁶⁴ This may make it the least comparable measure.

4.49 For bad debt charge, suppliers use their own specific methodologies to provision for debt. However, our general understanding is that bad debt charge and provisioning methodologies are independently reviewed by external auditors and consider similar types of factors (eg payment methods). As a result, we could consider bad debt charges to be broadly comparable over the medium term. We intend to explore how suppliers provision for bad debt charges in more detail through our RFIs.

Working level initial views

4.50 As part of our 2018 Decision and COVID-19 adjustments,⁶⁵ as well as more recent decisions involving the bad debt float,⁶⁶ we have used the bad debt charge as the measure for bad debt costs. We, therefore, consider this to be an established measure within the price cap for estimating bad debt costs. In view of this, we consider deviation from this approach would require adequate justification.

4.51 Given the above considerations, we are:

- Inclined to potentially discard bad debt write-off as a suitable option to measure bad debt costs. This is mainly due to the impact of differences in supplier policies and significant lag in receiving the relevant data (ie some suppliers might take time to write off debt). This makes it difficult to compare to the prevailing cap level which is important as we expect debt-related costs to scale with bill size (other costs);⁶⁷
- Inclined to consider bad debt charge as the lead option as it is an established measure, suppliers are able to provide the data, the data is audited and it is reasonably contemporary to the prevailing cap level;
- Seeking views from stakeholders on whether we should consider a bottom-up approach, given the complexity of modelling bad debt costs, including potential data constraints. If stakeholders prefer a modelled approach, we

⁶⁴ 'Final' debt is a term used by suppliers to indicate debt related to customers who are no longer with that supplier.

⁶⁵ Ofgem (2023): Price Cap – Decision on the true-up process for COVID-19 costs.

<https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs>

⁶⁶ Ofgem (2024): Energy price cap: additional debt costs review decision.

<https://www.ofgem.gov.uk/publications/energy-price-cap-additional-debt-costs-review-decision>

⁶⁷ While there is a clear relationship between debt-related costs and overall bill size, broader economic factors may also influence customers' ability to pay their energy bills, thereby affecting debt-related costs.

would appreciate your feedback on our proposed approach (provided under option A.3 above) and how we could improve it. If we were to consider this option, we would need to assess the merits of this approach (compared to alternatives) against the increased complexity it would likely require modelling costs.

Debt-related administrative costs

- 4.52 In developing the options, we considered the degree of flexibility (allowing suppliers to include costs that they consider as important) and the level of prescriptiveness (giving a framework of costs that we consider should be included to facilitate comprehensive and comparable evidence).
- 4.53 While the prescriptive approach may provide greater comparability by being consistent on what costs suppliers should include, it lacks flexibility if there are debt-related administrative costs that do not fit in those definitions. By comparison, the flexible approach helps us to consider a range of costs that we otherwise may not consider but that may reduce comparability across suppliers. We recognise that there is a trade-off between the two options.
- 4.54 We consider that the hybrid option balances the two extremes. Under the hybrid option, we would provide suppliers with a framework to identify the costs that they should consider. This should improve the comparability of data between suppliers compared to the flexible option and reduce the risk of suppliers over or under stating these costs. It also leaves enough flexibility to reduce the risk of excluding buckets of costs compared to the prescriptive approach.
- 4.55 In our recent bad debt float adjustment, while we used a similar hybrid approach, we identified that the cost lines requested between the two RFIs are different. Despite the differences in the cost lines, we would expect the cost information submitted at an aggregate level for the two RFIs to be equal. At a high level, we are concerned that some suppliers may have submitted different data between the two RFIs. This could be due to (i) how we have defined costs, as discussed above, or (ii) the approach we have taken to collect cost data. We have further engaged with suppliers regarding the best approach to collect this data through our second RFI.

Working capital costs

- 4.56 As mentioned earlier, working capital costs are already captured within the EBIT allowance which does not vary by payment method. Working capital costs would generally vary by payment method and we intend to reallocate this cost to

reflect, as accurately as possible, the differences between payment methods. Therefore, as our working capital allowance is provided to rebalance costs between payment methods, the cost of capital chosen in this area is not likely to affect aggregate supplier revenues. However, it would affect the relative amounts paid by customers on different payment methods, and the amounts received by suppliers with different customer bases.

- 4.57 The net account receivable option helps us achieve this objective since it focuses explicitly on customer working capital requirements and costs associated with it by considering amounts owed to and by customers. Conversely, depending on the definition of working capital costs and how suppliers interpret it, there is a possibility that the reported costs option might also include non-customer working capital. Depending on how suppliers allocate these costs between payment methods this could lead to the benchmark deviating from its intended level.
- 4.58 Comparability of supplier costs is desirable for ensuring that all options are available when selecting a benchmark metric. Of the two working capital options (options C.1 and C.2), we consider net accounts receivables to provide a relatively comparable set of data. This is due to the fact that supplier-reported costs could be impacted by supplier-specific financing costs, and/or suppliers could take different approaches to estimate costs. However, for the net account receivable options, we would apply a standardised cost of capital assumption to suppliers' net account receivables (we noted that 'net account receivables' is an established accounting term)
- 4.59 In response to our RFI collecting 2022 costs, some suppliers found breaking down the net accounts receivable by payment method challenging. Assessing the direct additional costs of payment methods (option C.2) provides us with a second estimate and alternative to the first option, facilitating our ability to set the allowance at its intended level.
- 4.60 One key consideration for option C.1 is the cost of capital we assume. We intend to use the EBIT assumed costs of capital based on a notional supplier that fully finances its costs through equity. This is to maintain consistency between the current EBIT allowance and how we reallocate costs between payment methods.

- 4.61 However, assuming full equity finance is a conservative assumption.⁶⁸ In practice, suppliers may have different levels of access to debt finance, including short-term finance. Some working capital needs will be constant (eg some level of payment in arrears by Standard Credit customers). However, other working capital needs will fluctuate over time (eg due to seasonality or variations in customer payment behaviour). There may be a question about whether suppliers would manage such fluctuations through holding equity or by using short-term finance.
- 4.62 We welcome any feedback on whether stakeholders consider it appropriate to maintain the cost of capital (from the EBIT decision) or whether it is appropriate to recognise part of customer working capital costs financed by short-term borrowing. In the latter case, we also welcome any feedback on how we should estimate the costs of short-term borrowing for a notionally efficient supplier.

Questions

Q10. Explain whether you think we should consider a bottom-up approach to estimate costs, and if so, could you please explain how we could improve our proposed approach?

Benchmarking approach

Benchmarking Metric

- 4.63 Thus far, we have discussed options for what cost components to include in this allowance and how to measure them. This section discusses how we could benchmark debt-related costs, particularly what metrics we could employ and whether we would benchmark at the parameter level.

Options

- 4.64 As discussed in Chapter 3, under the legislative framework, we can only set one cap level across the market. This means that when setting this allowance, we must take a single cost across suppliers to represent the efficient costs of a notional supplier.

⁶⁸ Ofgem (2023): Amending price cap methodology for Earnings Before Interest and Tax (EBIT) allowance decision, paragraph 4.6.
<https://www.ofgem.gov.uk/publications/amending-price-cap-methodology-earnings-interest-and-tax-ebit-allowance-decision>

- 4.65 One key consideration of how we would benchmark suppliers is the level of stringency. To this extent, when setting the cap, we have considered the following benchmarking options:
- Option A: lower quartile benchmark - the cost of the supplier that is at the 25th percentile in the sample applied to the three debt-related costs together;
 - Option B: weighted average benchmark - the average cost across suppliers weighted by the number of customers in their portfolio across the three debt-related costs together.
 - Option C: hybrid benchmark - setting different benchmark metrics for different debt-related costs. We could, for instance, set the bad debt component using a weighted average and the working capital and debt-related administrative costs using a lower quartile benchmark.
- 4.66 The choice of benchmark metric would impact how we benchmark cost lines. Choosing lower-quartile benchmarks requires aggregating the cost components to avoid setting an unachievable benchmark because of substitutability in costs (inverse correlation explained in paragraph 4.26).
- 4.67 It is worth noting that benchmarking may be conducted at any level (for example, between the lower quartile and the weighted average). Among our options, we discuss the lower quartile and weighted average, as these options find the balance between key considerations (discussed below) and are typical of those we have used when setting the cap in the past.

Considerations

- 4.68 There are four key considerations when assessing the options for benchmark metrics: (i) the level of price protection, (ii) the role of efficiency and non-efficiency factors, (iii) the level of uncertainty, and (iv) supplier provisioning methodologies. Some of these considerations are similar to those discussed in Chapter 3; however, we discuss them below specifically in relation to debt-related cost allowances.

Level of price protection

- 4.69 We discuss the general consideration of price protection between the lower quartile and weighted average approaches in Chapter 3. In relation to debt-related costs, we expect either approach could allow a notionally efficient supplier

to carry out its required activities under the supply licence.⁶⁹ However, it is likely that a weighted average benchmark could enable suppliers to provide a wider range of support going beyond their licence obligations to customers facing financial difficulties, for example, by setting up additional measures to assist customers who are in debt or at risk of debt. However, it could be difficult to ensure that any additional allowance was spent effectively.

The role of efficiency and non-efficiency factors

- 4.70 Variations in debt-related costs across suppliers is likely to be impacted by efficiency and non-efficiency factors (we introduce these concepts in Chapter 3).
- 4.71 As discussed throughout this consultation, one of the main aims in setting the operating cost allowance was to incentivise efficiency improvements. We discussed in Chapter 3 how this has been successful to date. However, we intend to consider the extent to which we continue to incentivise efficiency through this review. For debt-related costs, while a focus on efficiency would increase customer price protection, the pursuit of efficiency or efficiency incentives could have unintended consequences if it incentivised suppliers to pursue inappropriate debt collection practices. However, under the supply licence obligations, we expect suppliers to treat customers fairly when recovering debt, particularly those in vulnerable situations who may be struggling to pay. Suppliers could mitigate negative consumer outcomes by attempting to engage early to avoid customers accumulating substantial debt. We recently published an Affordability and Debt Call for Input which investigates supplier debt management practices.⁷⁰
- 4.72 We may also consider whether the benchmark reflects the appropriate behaviour of a notionally efficient supplier. On balance, one consideration when benchmarking is that we expect an appropriate benchmark to not reflect poor customer service standards (eg not providing adequate support to customers in debt or non-compliance with licensing requirements). We could potentially consider a supplier's compliance history when considering an appropriate sample on which to benchmark.
- 4.73 In addition to considering efficiency, we acknowledge that variations in supplier debt-related costs, at least to a certain extent, is explained by non-efficiency factors. Some of these factors are:

⁶⁹ We would need to consider the balance between efficiency and non-efficiency factors, and it is plausible that either approach could achieve this.

⁷⁰ Ofgem (2024), Affordability and debt in the domestic retail market – a Call for Input. <https://www.ofgem.gov.uk/publications/affordability-and-debt-domestic-retail-market-call-input>

- **Suppliers' customer base** – For example, having a high proportion of low-income customers is likely to lead to higher debt-related costs.
- **The level of discretionary support** provided to customers (beyond licence requirements) could also affect debt levels.
- **Natural variation** in supplier costs.

4.74 As discussed in Chapter 3, there is a risk associated with selecting the lower quartile benchmark. It is possible that the lower quartile benchmark supplier may not be representative of the market (eg having a high proportion of low-cost Direct Debit customers) and, therefore, set a benchmark that cannot be met by a notionally efficient supplier with a typical customer mix. Hence, when selecting the lower quartile benchmark supplier, we intend to consider the characteristics of the customer base. We could mitigate the impact of customer base characteristics by (i) restricting the sample, or (ii) selecting a less stringent benchmark (eg weighted average).

4.75 To understand what customer base characteristics are likely to drive differences in debt-related costs, we conducted initial analysis to explore the interaction between supplier costs and the customer base characteristics. Our analysis suggests the proportion of Standard Credit customers and the proportion of customers on the Priority Service Register (PSR) are likely drivers of costs.⁷¹ Therefore, when selecting a benchmark supplier, we could take these characteristics into account.

4.76 Overall, in determining the benchmark approach, we intend to balance the impact of both efficiency and non-efficiency factors to determine the most suitable approach.

4.77 It is worth noting that we recently published a discussion paper on Future Price Protection which explores the role of price protection, particularly the challenges posed by establishing a stringent cap level with greater diversity in the retail market.⁷² Where possible and appropriate, we will seek to align positions with Future Price Protection work. As mentioned earlier, many of the choices across

⁷¹ We note that given the sample size, we are unable to carry out robust causal inferences. Consequently, we conducted statistical correlation tests using the observed RFI data. We cannot rule out the possibility that these correlations could be driven by other customer characteristics (such as income levels) that is linked to the observed characteristics. As an example, customers on PSR might have lower income levels, therefore income levels may explain the correlation, rather than the fact that the customer is on PSR.

⁷² Ofgem (2024), Future Price Protection Discussion Paper.
<https://www.ofgem.gov.uk/publications/future-price-protection-discussion-paper>

these interrelated areas weigh up often competing objectives and demands, so we may not always reach the same conclusions in consistent circumstances.

Uncertainty

- 4.78 Given the recent trend in customer debt and subsequent adjustment to the debt allowance in the cap, we expect debt-related costs to change over time. As such, changes are likely to occur due to external factors (eg changes in affordability), changes in what suppliers are required to deliver (changes in regulatory requirements), and/or supplier activities (supplier providing additional support to customers in debt).
- 4.79 These changes could be upwards or downwards. We could mitigate these changes through the updating mechanism (we discuss this later in the chapter). An alternative mitigation would be to set a looser benchmark (ie a weighted average benchmark). It is worth noting that, all things equal, if we select a weighted average benchmark and costs follow a downward trend, we would risk over-recovering costs, which would have a detrimental impact on customers.

Provisioning methodology

- 4.80 We recognise that suppliers have different provisioning methodologies (eg the level of optimism about bad debt recovery a supplier builds into its assumption), and these provisioning methodologies impact suppliers' costs. There is a risk that the lower quartile benchmark is impacted by supplier provisioning methodologies (ie selecting a supplier that has an optimistic view relative to the entire market) potentially leading to an unachievable benchmark. However, we note that this may depend on the time period used to benchmark costs. We consider a weighted average benchmark may mitigate these impacts to a certain extent, though there remains a risk if the market on average took a specific view that did not then materialise.

Comparing the relevance of considerations across cost components

- 4.81 The degree of relevance of the factors discussed above may vary across cost components and this would impact the benchmark metric we would use if we consider option C. We consider:
- bad debt costs to be very relevant across all these factors;
 - debt administrative costs to be very relevant across the level of price protection, the role of efficiency and non-efficiency factors, and are somewhat relevant to uncertainty but not to provisioning methodology;

- working capital to be somewhat relevant to provisioning methodology and very relevant across the other three factors.

Benchmarking across parameters

- 4.82 Similar to the core operating cost allowance, once we determine which benchmark metric to use, we have to consider how we allocate costs across different groups of customers. The first step to this is to consider whether we calculate that benchmark across the different parameters in the cap or benchmark at an aggregate cost level.
- 4.83 In setting this allowance, for benchmarking across parameters, we focus on payment methods. This is because we consider payment method to be a main driver of debt-related cost variation. We have not considered benchmarking across other parameters because:
- Fuel type and electricity meter type: The variation in debt-related costs for these are broadly driven by differences in consumption/bill size. To avoid additional complexity, we are considering allocating them according to consumption (we discuss this in more detail later in the chapter).
 - Region: Regional differences might exist due to differences in economic conditions across regions, but on average we consider these variations are less likely to be significant.

Options

- 4.84 We have two options for benchmarking across payment methods:
- Option A: Aggregate costs across payment method - Similar to the option in Chapter 3, we would benchmark at total core operating cost level without any reliance on suppliers' allocation methodology to split costs between the parameters.
 - Option B: Split by payment methods - For this option, we would benchmark costs at the payment method level (ie split Standard Credit, Direct Debit and PPM). This would mean setting three separate benchmarks. We would rely on suppliers' allocation of costs by payment method.

Considerations

- 4.85 In determining which approach we will take, similar to the core operating cost allowance, a key consideration is how confident we are in suppliers' cost allocation methods and whether they are comparable across suppliers.

- 4.86 Option B is more sensitive to individual suppliers' allocation methodologies. While suppliers generally consider payment method to be a key driver of debt-related costs and incorporate it into their provisioning methodologies (which differ across suppliers), they are not required to break down the information for their accounts. This makes it challenging to collect comparable data without taking a prescriptive approach to the allocation methodology. We are exploring providing further guidance in our RFI and working with suppliers to better align approaches across the market. However, this does risk losing detail on how suppliers consider and incur costs across payment methods, which may include relative efficiencies for particular payment methods.
- 4.87 Customer movements between payment methods makes it difficult to allocate costs between groups. Usually, a Direct Debit customer that defaults on their payment eventually moves to Standard Credit, following this, they may go through a cycle of restarting their Direct Debit and again entering Standard Credit. These movements are hard to capture in cost allocations. Suppliers generally tend to hold data for a customer based on their current payment method rather than their payment method at the time of billing. This creates a risk of overestimating the level of bad debt allocated to Standard Credit and PPM customers because customers often move onto these payment methods when they get into payment difficulties.
- 4.88 Option A is an alternative option if we exhaust the possibility of having a comparable allocation across suppliers and cannot rely on the cost splits provided. In this case, we would benchmark costs at an aggregate level then seek to split costs across payment methods using an alternative approach (discussed in the following section).
- 4.89 It is worth noting that option B might risk understating efficient costs if we were to use a lower quartile benchmark approach. This is because the combination of options (ie option B and a lower quartile benchmark) is sensitive to biases in the allocation decision. Under a weighted average approach, potential differences in approach across the sample would be smoothed out.

Questions

Q11. Please explain your preferred approach to benchmarking (benchmark metric and benchmarking costs across parameters) across debt-related cost components. Explain your answer by providing evidence where possible.

Q12. What customer base characteristics do you think we should consider when selecting an appropriate sample to benchmark on or the benchmark supplier(s)? Please explain your answer, and where applicable, please provide any quantitative evidence.

Cost allocation

4.90 Thus far, we have discussed options for what cost components to include in this allowance and how to measure and benchmark them. As discussed in Chapter 3, if we benchmark costs at the aggregate level, we must then consider how the costs are allocated among various parameters. In this section, we discuss how costs could be allocated between payment methods, fuel types (electricity and gas), electricity meter types (single rate and multi-register electricity meters), and tariff types (fixed tariff and default tariffs).⁷³ We also discuss how we would allocate costs over consumption level (ie standing charge and unit rate).

Allocating costs across payment methods

4.91 There are two perspectives to the question of how to allocate costs between payment methods.

- **Perspective 1:** This focuses on the perspective of a supplier and adopts the general principle of cost reflectivity⁷⁴ to allocate costs to a particular payment method as a group. We consider that this has generally provided benefits to customers, allowing suppliers to recover efficient costs, while providing efficiency incentives for suppliers and improving supplier financeability.
- **Perspective 2:** This focuses on the perspective of individual customers. Debt-related costs are incurred in relation to particular customers in a given payment method, and so the average costs on a particular payment method do not necessarily reflect the costs of most customers on that payment method (in other words in a given payment method there are customers who

⁷³ It is worth noting that we do not set the allowance for fixed term contracts. However, we currently collect data for the entire domestic market. Therefore, we need to consider how we allocate these total costs to default tariff customers.

⁷⁴ We define cost reflectivity as allocating costs to the payment method under which the costs were incurred.

pay their bills on time and do not generate debt-related costs). Therefore, we might consider adjusting the allocation to better reflect the costs from the perspective of individual customers.

4.92 The next stage of levelisation potentially provides a way to bridge these two perspectives by setting the cap at a cost reflective level but obtaining a more equal outcome for customers. In our February 2024 levelisation decision, we said we could potentially consult on the levelisation of Standard Credit and Direct Debit debt-related costs (henceforth referred to as Levelisation phase 2). In the event that Levelisation phase 2 proceeds, it is important for the timely delivery of the policy since it would have a material impact on our decision, particularly regarding how costs may be allocated across different payment methods as discussed later.

Options

4.93 Our approach to allocating costs between payment methods may differ depending on the cost component. This is because while we intend to establish a separate allowance for bad debt costs and debt-related administrative costs, we intend to reallocate the existing allowance for working capital costs to reflect the cost of serving different payment methods (as mentioned in paragraph 4.56).

4.94 The options for allocating bad debt costs and debt-related administrative costs are:

- Option A.1: Equal cost allocation (across Direct Debit, Standard Credit and PPM).
- Option A.2: Reported costs allocation - This option takes the weighted average of all supplier allocations to apportion costs.⁷⁵
- Option A.3: Bespoke approach - Under this option, we begin by assigning all costs to Standard Credit customers and then allocate costs to:
 - (1) PPM customers: Based on the proportion of debt transferred through the Debt Assignment Protocol (DAP) (if material) and debt on Additional Support Credit.
 - (2) Direct Debit customers: We would look at customer movement between Direct Debit and Standard Credit. Specifically, we would look at debt movement from Direct Debit to Standard Credit, where a customer was

⁷⁵ We also have the sub-option of using the allocation of the closest suppliers instead of using the weighted average allocation as discussed in Chapter 3.

not on a repayment plan while on Direct Debit. This would give us the debt incurred under Direct Debit and moved to Standard Credit.

- Option A.4: Hybrid approach - allocate costs to PPM based on option A.3 and allocate the remaining costs based on option A.2.

4.95 The options for allocating working capital costs are:

- Option B.1 (similar to above): Reported costs allocation - This option takes the weighted average of all supplier allocations to apportion costs between payment methods.
- Option B.2: Bespoke approach - Allocate all costs to Standard Credit customers. This means we would reallocate the current allowance that is set through EBIT for Direct Debit and PPM to Standard Credit customers. This method assumes that Direct Debit and PPM customers do not incur working capital costs, on average, over a year.

4.96 We have not considered equal allocation of working capital costs because this would not allow us to reallocate costs to reflect the costs of serving different payment methods.

4.97 Concerning the second perspective, we have the option to smear costs across groups of customers or not, and if we do, whether we would smear some of the costs or all of the costs.

Considerations

Cost reflectivity

4.98 In selecting how to allocate costs, we need to consider the trade-off between customer protection and efficient cost recovery. Whilst equal cost allocation may lead to equitable outcomes for customers, this might impact recovery of efficient costs, which could affect supplier financeability and potentially distort competition, which may not be in the best interests of current and future customers.

4.99 The remaining options seek to achieve cost reflectivity. Though we note that for debt-related costs, it's less clear what cost reflectivity looks like because of movement of customers between payment methods and perspective 2. We consider the remaining options in terms of degree of cost reflectivity (ie reflection of where the cost was incurred), feasibility and complexity.

4.100 **Cost reflectivity** - Under the reported cost approach, as we have mentioned above, there may be limitations to supplier data that lead to over allocation for

Standard Credit and PPM. The bespoke approach, in principle, is the most cost-reflective approach as it intends to tie back the debt to the payment method under which the costs were incurred. The hybrid approach would provide some degree of cost reflectivity as it relies partly on the bespoke approach to allocate costs to PPM customers. However, since a hybrid approach also depends on the reported cost approach, the degree of cost reflectivity would depend on supplier cost allocation between credit customers.

- 4.101 **Feasibility** - Our current view is that at least three of the four options are feasible (ie equal allocation, reported costs allocation and the hybrid allocation). It is necessary to track the movement of debt between Direct Debit and Standard Credit customers for each supplier in order for the bespoke option to be a viable option. Based on responses to previous debt work, some suppliers have suggested it might not be feasible to track these movements.
- 4.102 **Complexity** - Among the alternative approaches, we consider equal allocation and reported allocation to be the least complex, hybrid approaches to be somewhat complex, and bespoke approaches to be the most complex.

Considering a reasonable and proportionate outcome

- 4.103 Not all customers in a given payment method incur debt-related costs. In this regard, there is a question as to whether it is reasonable and proportionate to pass the costs incurred by a subset of customers on to customers who do not incur these costs, within a payment method. Since we have only set one cap, we are unable to differentiate between different groups of customers; thus, we could minimize the impact on customers who do not incur these costs by smearing these costs (ranging from fully to partially) across different payment methods.
- 4.104 Due to the dynamic nature of customer movement between Direct Debit and Standard Credit payment methods, as well as the inherent challenge of tracking costs accurately to the payment method where the cost was incurred (eg linking back debt-related costs under Direct Debit customers in debt repayment plans to the payment method where these costs were incurred), there is a debate about whether costs should be spread between Direct Debit and Standard Credit customers.
- 4.105 We must also consider the interaction with Phase 2 levelisation. Following consultation, if we proceed with Phase 2 levelisation, as set out within the Phase

1 Decision⁷⁶ we might not consider smearing any cost difference and instead we would adopt a cost-reflective allocation approach (though noting the difficulty in defining and calculating a cost-reflective view due to customer movement between payment methods). This is because the levelisation policy would equalise debt-related costs (bad debt costs and debt-related administrative costs) between Direct Debit and Standard Credit payment methods. Ofgem will look to consult further on Phase 2 levelisation in Summer/Autumn 2024.

4.106 In the event that Phase 2 levelisation is not implemented, we could consider adjusting the allocation under the customer perspective to distribute the costs across payment methods which could result in immediate benefits to some customer groups but have wider distributional impacts. There may be an impact on supplier financeability for those with non-average customer bases particularly without a reconciliation mechanism. We would carefully consider these factors if we were to explore moving away from cost reflectivity.

Allocating costs between fuel type, electricity meter type and tariff type.

Options

4.107 We consider the following options when splitting costs between fuel type and electricity meter type:

- Option A.1: Equal allocation;
- Option A.2: Allocate based on bill size.

4.108 In our 2018 decision and later in our debt allowance adjustment (COVID-19 true-up adjustment and bad debt costs float), we allocated costs between fuel types based on the bill size and equally allocated costs between meter types.

4.109 We consider the following options when splitting costs between tariff types:

- Option B.1: Equal allocation;
- Option B.2: Allocate all costs to default tariff customers.

4.110 In our 2018 decision, we allocated costs equally between tariff types. However, in our subsequent debt adjustment, we collected data by tariff type and used supplier allocation to allocate costs.

⁷⁶ Ofgem (2024), Decision on adjusting standing charges for prepayment customers.
<https://www.ofgem.gov.uk/publications/decision-adjusting-standing-charges-prepayment-customers>

Considerations

Fuel and electricity meter type

- 4.111 We consider that there is a correlation between debt-related costs and bill size (quantity consumed and the associated costs), ie, if you consume more, your debt-related costs are likely to be higher. In our view, variation in costs among these parameters is primarily a function of the relative bill size rather than a characteristic of the parameter itself.⁷⁷
- 4.112 In our previous decisions we have taken equal allocation options to allocate costs by meter type. This is due to a lack of data and/or evidence about how costs vary by meter type. Since consumption levels are likely to vary between meter type, we consider it reasonable to allocate based on bill size. However, we recognise that some of the variation in costs might be explained by differences in socio-demographic factors.

Tariff type

- 4.113 We have not collected data by tariff type (ie split by fixed term contracts and default tariff/standard variable tariffs). Therefore, we are unable to estimate how costs may vary. Equal allocation assumes that costs do not vary by tariff type whilst allocating all costs to default tariff customers assumes that only default tariff customers would incur debt-related costs. In response to our RFI, some suppliers have suggested that debt-related costs may vary by tariff type.
- 4.114 We intend to use 2023 data to benchmark costs. Given the recent movement of customers from fixed tariffs to default tariffs, where around 88% of the market is now made up of default tariff customers,⁷⁸ the majority of costs reported in 2023 will relate to default tariff customers. We further recognise that customers may move away from default tariffs as suppliers offer cheaper fixed tariffs, which might impact supplier cost recovery. Although we could expect that much of the movement may be related to engaged Direct Debit customers who are less likely to incur debt-related costs⁷⁹, the wider economic factors over the past few years could have impacted the propensity of these customers to fall into debt (albeit

⁷⁷ Other factors (eg economic circumstances) might account for a small portion of the variability, but on average, we do not expect that these factors would have a significant effect.

⁷⁸ The proportion of default tariff customer are based on operating cost RFI data and is based on customer numbers at 1 July 2023.

⁷⁹ Using a snapshot of the number of customer accounts reported in the Customer Account and Tariff RFI, we conducted preliminary analysis to understand the movement of customers between fixed term contracts and default tariff contracts pre and post the gas crisis. Direct Debit customers account for the majority of the movement. We could expect these customers to move to Fixed Term Contracts when cheaper tariffs become available.

from a lower base than default tariff customers). We seek evidence from stakeholders regarding how recent economic factors (such as the cost of living crisis) may have affected the propensity of engaged Direct Debit customers to incur debt.

Allocating costs over consumption level.

4.115 The current debt-related cap allowances are reflected in the unit rate and standing charge. As an example, the majority of debt-related costs associated with Standard Credit and Direct Debit payment methods are allocated to the unit rate, while those associated with PPM payment methods are allocated to the standing charge. It is pertinent to emphasize that the decision on the latter (ie the allocation of additional support credit for PPM customers) was taken within the context of the Energy Price Guarantee (EPG)⁸⁰ and later these costs were reallocated under levelisation phase 1.⁸¹

Options

4.116 As discussed in Chapter 3, there are a number of options we could take ranging from increasing the allocation of costs to the standing charge to moving the costs to the unit rate.

Considerations

4.117 In contrast to the core operating costs, where the cost lines that make up core operating costs do not vary by a customer's consumption, we consider bad debt costs and working capital costs will vary depending on a customer's consumption, while debt-related administrative costs will vary less. If taking a cost-reflective approach, we would mostly allocate bad debt costs and working capital costs to the unit rate and debt-related administrative costs to the standing charge.

4.118 As discussed in the previous chapter, this allocation choice would have a distributional impact on customers and a supplier impact (depending on the average consumption of its customer portfolio). We will consider these impacts when choosing our preferred options.

4.119 As discussed above, bad debt costs for PPM customers are currently captured within the standing charge to align with the EPG at the time. In our August 2023

⁸⁰ Ofgem (2023), Allowance for additional support credit bad debt costs, paragraph 5.5.

<https://www.ofgem.gov.uk/publications/allowance-additional-support-credit-bad-debt-costs>

⁸¹ Ofgem (2024), Decision on adjusting standing charges for prepayment customers.

<https://www.ofgem.gov.uk/publications/decision-adjusting-standing-charges-prepayment-customers>

consultation on bad debt associated with Additional Support Credit (ASC), we said in principle that, bad debt costs should be captured on the unit rate.⁸² It follows that, in principle we could allocate these costs to the unit rate. However, we would also need to consider our recent levelisation decision which intends to levelise PPM and Direct Debit standing charges. Given the intention of this policy is to equalise the PPM and Direct Debit differential, which is currently captured within the standing charge, allocating PPM debt-related costs to the unit rate would lead to some differential (the magnitude of the differential would depend on how we allocate costs between PPM and Direct Debit). We will consider these interactions when deciding how we could allocate PPM debt-related costs.

4.120 In determining the approach, we are mindful of interacting work areas. We are carrying out a wider review of standing charges, for which we published a call for input in November 2023.⁸³ The operating cost review could act as a vehicle to implement wider changes determined through the review. Where possible and appropriate, we will seek to align positions with the standing charge review to manage any interactions and seek to achieve a coordinated policy outcome. However, many of the choices across the interrelated areas weigh up often competing objectives and demands, so we may not always reach the same conclusions in consistent circumstances, so we intend to align our position with any wider findings.

⁸² Ofgem (2023). Price cap – Statutory consultation on introducing an allowance for bad debt associated with Additional Support Credit, paragraph 5.16.
<https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-introducing-allowance-bad-debt-associated-additional-support-credit>

⁸³ Ofgem (2023) Standing charges – call for input.
<https://www.ofgem.gov.uk/publications/standing-charges-call-input>

Question

Q13. Do you consider a bespoke approach (Option A.3) under cost allocation feasible, in particular tracking customer movement between Direct Debit and Standard Credit customers? Please explain your answer.

Q14. In the absence of levelisation phase 2, please explain whether and, if so, how we should consider spreading debt-related costs across different customer groups.

Setting the allowance and updating mechanism

4.121 Having discussed which costs to include, approaches for benchmarking and allocating costs, in this section, we discuss our options for how we could implement the allowance and update it over time.

Options

4.122 In general, when we implement an allowance in the cap, suppliers will eventually receive the allowance in pounds per customer. Some allowances in the cap are set as pounds per customer values (for example, network costs allowance, core operating cost allowance), while others are indexed to other cap components (for example, payment method uplift, EBIT and headroom). To set this allowance in the cap, we consider the following options:

- Option A.1: Set as a percentage of revenue (ie part of the cap cost stack);
- Option A.2: Set as a pound per customer value;
- Option A.3: Combination of options A.1 and A.2 depending on the cost component.

4.123 In addition to setting the allowance, we need to consider how we update it over time to best reflect how costs change. Even where we set the allowance as a percentage of the bill, which will change over time, we may still want to consider further update approaches. For example, setting bad debt as a percentage allowance means the value will scale with the bill but the assumption on propensity to incur debt (ie the value of the percentage) will not change.

4.124 We consider the following options on how we could update the allowance over time.

- Option B.1: Bill size - Under this option, we would index the allowance to other core cost components in the cap (ie wholesale costs, operating costs,

policy costs and network costs). Where we set the allowance as a percentage already (option A.1) this would incur no further change.

- Option B.2: External indicators - Under this option, we would use one or several indicators to update the allowance. As an example, we could update debt-related administrative costs with CPIH, while updating other debt costs with another indicator. Table 4.1 below lists some external indicators that we could potentially use to update the allowance.
- Option B.3: Regular reviews - Under this option, we would periodically review the allowance to consider whether it remains appropriate by re-collecting supplier data and recalculating the allowance.
- Option B.4: A combination of options B.1 and B.2 - For example, we could scale the appropriate costs by bill size and link it to an external indicator.

Table 4.1: Cost components and external indicators

Cost line	Potential external indicator to update the allowance
Bad debt costs Working capital costs	<ul style="list-style-type: none"> • Customer arrears data collected through Supplier Obligation Reporting (SOR) • Office for National Statistics (ONS) reported average weekly real earnings. • Department for Work and Pensions (DWP) reported Household Below Average Income statistics eg percentage of individuals in relatively low income
Debt-related working capital costs	<ul style="list-style-type: none"> • CPIH

Considerations

How we would set the allowance

4.125 We intend to consider how debt-related costs are incurred and how it may change relative to the bill size. For example, currently, bad debt and working capital scale with the bill level because if a customer who either does not pay or pays in arrears has a higher bill, we expect they would incur a higher debt or a larger payment in arrears. In these cases, we calculate the allowance as a percentage of other costs. By comparison, we do not expect debt administration costs to be linked to the level of bill a customer pays, so we calculate it as a flat £ per customer amount.

4.126 Setting a £ per customer allowance may be a simpler approach and makes the allowance less volatile (for example, during the period of high commodity costs,

we saw the debt allowance increase and in particular increase the differential between Direct Debit and Standard Credit in the cap). However, if rising bills have an impact on bad debt, then setting a flat allowance may risk deviations between efficient costs and allowances. We will consider these factors when assessing these options.

How we would update the allowance

- 4.127 Our current allowance is updated using a combination of approaches. We update the bad debt and working capital allowance in line with bill size (ie by indexing it to other core costs components in the cap) and update the debt-related administrative costs in line with CPIH.
- 4.128 We consider the choice of updating mechanism would depend on the following factors: (i) accuracy (ii) practicality (iii) independence of supplier behaviour (iv) resources.

Accuracy

- 4.129 In updating the allowance, we should consider the most appropriate approach to ensure that it leads to a reasonable approximation of future costs to ensure customer protection while allowing efficient cost recovery.
- 4.130 Using an external indicator (different from CPIH) may provide a better approach to modelling changes in debt-related costs. This could also be applied to a percentage allowance (eg if we set bad debt as a percentage) and as an alternative to a flat allowance such as debt administrative costs. However, the difficulty would be in finding an appropriate indicator that accurately tracked/correlated to the changes in the underlying debt costs. If stakeholders have any specific views regarding what external indicator, we should consider updating the debt-related cost allowance with, we would appreciate hearing from them.
- 4.131 We also consider regular reviews to provide a reasonably accurate allowance, recalculated using the latest supplier costs. However, the level of accuracy would depend on the frequency of reviews and there is a possibility that costs could deviate from the allowance in between review periods.

Practicality

- 4.132 We consider updating the allowance with bill size, and regular reviews to be practicable options.

4.133 We need to consider practicality when considering external indicators (ie under option B.2 and B.4). We should make sure that any indicator we select has readily available and timely data. For example, ONS weekly earning data is readily accessible through the ONS website and available on a monthly basis. On the other hand, SOR data is available on a quarterly basis and DWP reported Household Below Average Income statistics is available annually. The appropriate requirement for the frequency of data available may depend on the choice of option. For example, under option B.4, since the allowance would be updated quarterly with the cap, it might be sufficient to update the allowance with an external indicator annually to account for changes in customers' propensity to pay.

Independent of supplier behaviour

4.134 Our choice of update mechanism should be independent of supplier behaviour in order to prevent the allowance from being deliberately influenced by suppliers.

4.135 We consider bill size is likely to be independent of supplier behaviour as it is determined by the overall cap level. Regular reviews are likely to be based on data provided by suppliers, therefore, suppliers could influence them to some extent. However, we may be able to mitigate this by collecting data that can be validated through audited sources such as Consolidated Segmental Statement (CSS) or statutory accounts. Any external indicator we select to update the allowance must be independent of supplier behaviour.

Resource

4.136 The choice of updating mechanism should also take into account the level of resources required. We consider regular reviews would increase the amount of data submissions, thereby requiring more resources as suppliers would need to submit data more frequently, whereas bill size and external indicators (assuming these are readily available) would require fewer resources.

Questions

Q15. Please explain any views on what external indicators we could use to index the allowance.

5. Smart metering costs

Section Summary

In this chapter, we set out the options for setting an allowance to appropriately reflect the costs of the smart meter rollout.

Context

- 5.1 In this chapter, we cover our review of the current smart meter cost allowance within the cap, which covers the net cost of installing and operating smart meters. It is worth noting that this smart meter cost allowance focuses on the operational costs and benefits to suppliers specifically, rather than taking a wider view of the benefits of the smart meter rollout. For example, where we talk about the net costs of installing smart meters for suppliers, our analysis does not capture wider system benefits, decarbonisation benefits and energy management and bill savings benefits for customers. The cost benefit analysis published by the Department for Energy Security and Net Zero (DESNZ) outlined that the Programme would continue to deliver benefits for households, with a total Net Present Value of £6 billion over the appraisal period and with the rollout having already passed the 'breakeven point' in 2019, each smart meter installation now delivering a net benefit.⁸⁴
- 5.2 In addition, it is important to note that the allowance covers net costs to suppliers of the rollout, which may differ to the ongoing operating costs once the rollout is complete. As with any infrastructure upgrade, the net costs include transitory costs relating to the initial deployment of the technology, which exceed the business-as-usual operating costs. This means that the net costs of the smart meter rollout would likely be much lower once the rollout is complete, and the only remaining costs are ongoing operating costs, just as there are ongoing operating costs for traditional meters.
- 5.3 We consider two areas across this chapter: (1) how we set the allowance going forward, managing the complexity of the allowance; and (2) how we set the allowance between October 2024 and March 2025. Across both of these areas, we

⁸⁴ DESNZ (2023), Smart Meter Targets Framework, paragraph 15.
<https://www.gov.uk/government/consultations/smart-meter-targets-framework-minimum-installation-requirements-for-year-3-2024-and-year-4-2025>

also consider the practicality of options, noting constraints we may face with the cost data we collect.

- 5.4 In our May 2023 call for input, we discussed the concept of setting different cap levels for smart and traditional meters. However, there was a lack of substantial support from stakeholders for this option, with some noting the disproportional impact this option could have on customers who are unable to receive a smart meter. Defining separate cap levels would also be challenging. We do not consider that this would be proportionate, given that we have not seen a strong case why separate caps would better protect customers. In addition, a separate smart metering cap level would only reflect the impacts of smart meters on suppliers' costs, rather than the entirety of the costs and benefits. Consequently, we have decided not to pursue the discussion of separate caps for smart and traditional meters in the ongoing operating cost review.

Smart meter rollout

- 5.5 The smart meter rollout is a key programme for aiding the transformation of the retail energy market, moving to a market that works well for customers and facilitating the move to net-zero. In particular, it enables full use of Market-wide Half-Hourly Settlement (MHHS) and widens access to time-of-use tariffs.
- 5.6 DESNZ sets the smart metering policy framework which underpins the rollout of smart meters, led by energy suppliers. Under the current Target Framework, suppliers are set minimum annual smart meter installation targets on a trajectory to 100% coverage. The targets are subject to annual tolerance levels, which are the difference between 100% coverage at the end of 2025 and DESNZ's calculations on rollout projections. The minimum market-wide smart coverage that is projected in households by DESNZ to be met by 2025 is 74.5%.⁸⁵ This is determined by applying a tolerance level, which is the difference between 100% rollout at the end of 2025 and DESNZ's calculations on rollout projections.
- 5.7 At the end of 2023, there were 32.9 million domestic smart meters installed in Great Britain. This represents a 61% smart meter rollout across the domestic market.⁸⁶ Suppliers are responsible for the rollout and the framework sets out individual targets and tolerance levels for each year of the framework.

⁸⁵ DESNZ (2023), Smart Meter Targets Framework, paragraph 9.
<https://www.gov.uk/government/consultations/smart-meter-targets-framework-minimum-installation-requirements-for-year-3-2024-and-year-4-2025>

⁸⁶ DESNZ (2023), Smart Meter Statistics in Great Britain: Quarterly Report to end December 2023, Page 5.
<https://www.gov.uk/government/statistics/smart-meters-in-great-britain-quarterly-update-december-2023>

5.8 Suppliers incur costs from rolling out smart meters, particularly the costs of smart metering equipment (ie smart meters, communication hubs, In-Home displays) and the costs of installing it. Suppliers also receive benefits from reduced operating costs (eg fewer meter reading and inspection visits, lower switching costs and fewer customer enquires). We currently set a specific smart metering costs allowance in the cap to appropriately reflect the costs of the rollout to suppliers. We describe how we set this allowance below. The cap does not differentiate between a smart meter and traditional meter customer – we set a blended rate between the two groups.

Current approach to setting the smart metering costs allowance

Overarching approach

- 5.9 The cost of installing and operating smart meters, as part of the smart meter rollout, is reflected in the cap through two allowances: the operating cost allowance and the SMNCC.
- 5.10 The core operating cost allowance includes the smart metering costs in the 2017 baseline year (alongside other operating costs). This allowance is uplifted for CPIH when the cap is updated.
- 5.11 The SMNCC allowance reflects the change in smart metering costs since 2017. This approach enabled us, when initially setting up and subsequently updating the cap, to vary the smart metering allowance in a different manner to the other elements of the cap. When the operating cost allowance was set, the smart metering programme was already embedded in supplier operations, and we considered that the baseline costs of smart metering were included in the suppliers' operating cost. However, as it was not possible to isolate smart metering costs from within the total operating costs allowance, the SMNCC allowance was set to reflect the change from the baseline in subsequent cap periods. Therefore, it accounts for the uncertainty around future smart metering costs and rollout profiles over the period of the default tariff cap.
- 5.12 The SMNCC allowance is made up of two parts:
- SMNCC 'pass-through' costs, which reflect the change in industry charges. These costs are not discussed further in this chapter but are the focus of Chapter 6.
 - SMNCC 'non-pass-through' costs, which reflect the change in suppliers' net costs of rolling out smart meters. The non-pass-through costs are the focus of the remainder of this chapter.

Model approach

- 5.13 Under the current cap methodology, we use a forward-looking modelled approach to set the non-pass-through element for future cap periods.
- 5.14 The SMNCC allowance is calculated using the SMNCC model (hereafter referred to as “the model”), which is based on the 2019 DESNZ (formally referred to as BEIS) Cost Benefit Analysis (CBA) model.⁸⁷ We made several modifications to the CBA, including the removal of some cost and benefit categories considered not relevant to suppliers, as well as inputting more recent supplier information.
- 5.15 We assume that the costs and benefits of smart meters are included within the core operating costs baseline, which is set using the lower quartile approach. For smart metering costs, we adopt an average efficiency approach, using a weighted average benchmark to account for any unidentified cost differences between suppliers. As the core operating costs baseline is set differently to the smart metering costs benchmark, we make an adjustment when calculating the non-pass-through SMNCC to ensure the allowance reflects the incremental smart metering cost uplift.
- 5.16 Within the model we consider two scenarios: a ‘no-rollout’ counterfactual scenario (that would have occurred without the smart meter programme) and a ‘policy scenario’ which reflects the costs of rolling out smart meters. We model the additional costs of the rollout by taking the difference between the policy scenario and counterfactual scenario. These operational costs and benefits include the net costs of the rollout, which may differ to the ongoing operating costs once the rollout is complete.
- 5.17 We model the change in the additional costs of smart metering (above the ‘no-rollout’ counterfactual) since 2017, so that we can look at the additional costs of smart metering above the counterfactual cost (rather than the total smart metering cost). As mentioned earlier in this chapter, we focus on the operational costs and benefits to suppliers specifically, rather than taking a wider view of the benefits of the smart meter rollout.

Advance payments adjustments

- 5.18 We can only set one cap across the market, so when setting the SMNCC, we use a central rollout profile. Suppliers will be at different points in their own rollout of

⁸⁷ BEIS (2019), Smart meter roll-out: cost-benefit analysis 2019.
<https://www.gov.uk/government/publications/smart-meter-roll-out-cost-benefit-analysis-2019>

smart meters, which may differ from the rollout profile used to set the allowance. This means, sometimes, suppliers receive payment in advance for smart metering costs they have not yet incurred. The opposite can also occur, where suppliers have incurred costs prior to receipt of payment through the allowance.⁸⁸ Advance payment may occur if there is a difference between the expected rollout profile and the observed rollout profile across the industry.

- 5.19 We do this by calculating SMNCC allowances in a given historical cap period using the latest version of the model, with updated inputs and any changes to methodology applied, and compare it against the actual SMNCC allowances set in that period. The difference between the two forms the basis of an advanced payments adjustment, which is recovered over a 12-month rolling period.

Rollout

- 5.20 We model the profile of smart meter installations over time and refer to this as the rollout profile. The rollout profile is based on two variables: the level of smart meter rollout achieved; and the rate of rollout under DESNZ's 2023 Smart Metering Targets minimum installation requirements ('tolerance' approach).⁸⁹
- 5.21 We use different rollout profiles for credit and PPM smart meters, using the market leader tolerance rollout profile for smart credit meters ('credit') and the market average tolerance rollout profile for smart PPM meters ('PPM').
- 5.22 For smart credit meters, the market leader is the supplier with the largest forecast cumulative SMNCC over the full potential life of the default tariff cap. Using the market leader tolerance profile in the model supports all efficient suppliers to deliver their rollout obligations, including those with above-average rollout, while maintaining the cost-effectiveness of the rollout as far as possible.
- 5.23 For smart PPM meters, we use a single rollout profile to reflect a given level of modelled costs (eg when we use the weighted average rollout profile, we expect to calculate a PPM SMNCC that broadly reflects the average costs of rolling out smart PPM). The single PPM-specific rollout profile is then used as a model input to calculate the PPM SMNCC. We update the rollout profile inputs annually, using

⁸⁸ The opposite case would technically involve lagged payments (rather than advance payments). We use the term advanced payments throughout, regardless of whether we are referring to suppliers receiving payments in advance of in arrears.

⁸⁹ DESNZ (2023), Smart Meter Targets Framework: minimum installation requirements for Year 3 (2024) and Year 4 (2025).
<https://www.gov.uk/government/consultations/smart-meter-targets-framework-minimum-installation-requirements-for-year-3-2024-and-year-4-2025#full-publication-update-history>

the latest Annual Supplier Return (ASR) outturn figures collected by DESNZ, and also reflect any changes or new rollout tolerance values as set by DESNZ.⁹⁰

Costs and benefits under current methodology

- 5.24 The non-pass-through costs and benefits within the model are based on ASR data and are updated annually. We use average costs and benefits to calculate a net cost per installation for credit and PPM meters, and for each fuel type.

⁹⁰ Suppliers submit Annual Supplier Return (ASR) data to DESNZ each year, which provides their smart meter annual information requested by DESNZ. Previous known as Smart Meters Annual Information Request (SMAIR) data.

Table 5.1 - Summary dual-fuel cost and benefits used in the 2023 calculation of the SMNCC allowance.

Cost / Benefit	Description	Credit allowance	PPM allowance
Installation, meter asset and IHD costs	Includes smart meter installation costs, smart meter costs (amortised over the average rental period), communication hubs (amortised as per smart meters), and In-Home Displays (expensed in the installation year).	£10.75	£4.71
Operation and maintenance costs	Includes operation and maintenance costs.	£0.98	-£1.20
Supplier IT (including DCC adaptor services)	Amortised over six years.	-£2.77	-£2.77
Organisational costs	Includes annual industry set-up costs, annual governance costs to industry, data protection and security assurance costs. Frozen at the 2017 level stated in the 2019 CBA.	-£0.07	-£0.07
Advertising costs	Frozen at the 2018 figure in real terms.	-£0.39	-£0.39
Other costs	Includes pavement reading inefficiency and disposal costs.	£1.95	£0.93
Direct operational Benefits	Includes debt handling (credit only), PPM cost to serve benefit (PPM only), customer enquiry, change of tariff benefit, and customer switching. An adjustment factor is applied, reducing the size of the benefits by 12%.	-£2.24	-£10.92
Total		£8.21	-£9.71

Notes: Table reflects a breakdown of the credit and PPM SMNCC values (ie the change in costs and benefits since 2017 rather than gross costs for 2023). The total shown here is different to the value of the allowance in Annex 5. The discrepancy is a consequence of model calculations taken on the net cost (ie not each cost / benefit line), including the GDP adjustment used to calculate change relative to 2017, and the weighted average baseline adjustment). The 2023 values shown are calculated values based on the most recent 2022 data updates / inputs.

Main areas for this review

5.25 In this review, we consider options for how we should set the smart metering costs allowance for the remainder of the rollout. This relates to the non-pass-through smart metering costs. These are the direct operational costs to suppliers driven by the actions they take and to a greater extent within their control.

Stakeholder response summary

- 5.26 In our May 2023 call for input, we asked for stakeholders' view on setting separate caps for smart and traditional meter customers to reflect the underlying costs of the two groups.
- 5.27 The majority of stakeholders (including consumer groups) responding to these questions did not agree with separate caps for smart and traditional meter customers. Six stakeholders said that an approach to separating the cap by smart and traditional meters could impact the incentives for customers to take up a smart meter and/or the incentives for suppliers to roll out smart meters, particularly being an issue if it disincentivises take-up. Separate caps would penalise households that are unable to switch, awaiting installations or do not have smart meters given the technical issues/limitations.
- 5.28 Some suppliers also mentioned potential practical issues when implementing the separate caps. One supplier said separating the cap by smart and traditional meter types would increase the number of tariffs available under the cap, which may increase complexity for customers when considering switching.
- 5.29 One stakeholder supported setting separate allowances for smart meter and traditional meter customers, and said it is fair to pass on some of the cost savings from smart meters to customers who have smart meters. It also suggested customers, who cannot have a smart meter installed for technical reasons, should be offered tariffs same as customers with smart meters.
- 5.30 We have decided not to pursue the discussion of separate caps for smart and traditional meter in the ongoing operating cost review.

Setting the smart metering costs allowance

- 5.31 This section relates to setting the smart meter allowance in the cap. This is an existing allowance that covers the net costs of installing and operating smart meters. Since setting the cap, several stakeholders have commented on the complexity of the SMNCC allowance. This review is an opportunity to consider how we would need to adapt the current approach for the new data or whether it would be preferable to simplify the approach and reduce complexity.

Options for setting the allowance

- 5.32 We are considering two options for setting the smart metering costs allowance in the cap:

- Option 1: Updating the current SMNCC approach (status quo).
- Option 2: A simpler SMNCC type model.

Option 1: Updating the current approach

5.33 Under this option, we would seek to continue using the non-pass-through model we currently use to set the SMNCC (outlined in the context section above). However, we would need to carry out several updates to the model to make it compatible with a new baseline year and carry out data input updates in line with our current approach.

5.34 The allowance is currently set each period as a net cost change between a given year and 2017. This captures the change in costs since the baseline year which we used to set the current operating cost allowance. The fundamental change we would need to make under this approach would be to change the baseline year from 2017 to 2023, which will reflect the data we would use to set the operating cost allowance resulting from this review.

5.35 While this change is conceptually easy to understand, it is complex to implement. We would need to ensure that all calculations reference the correct baseline year. This includes not only the final step of taking differences between years but also changing any uplifts applied through the model such as the adjustment currently calculated to account for the lower quartile operating cost benchmark and weighted average allowance in the SMNCC (should the new operating costs baseline take a different benchmark approach). We would need to ensure that the model consistently calculates the final SMNCC value based on the 2023 baseline.

5.36 Additionally, the approach we take to benchmarking the core operating costs will impact the changes we need to make to the SMNCC model. If we select a lower quartile benchmark, represented by the lower quartile supplier, we may need to carry out sensitivity analysis to understand what costs they would incur once we input their specific costs and rollout data into the model. We then would consider if we needed to make further adjustments.⁹¹

5.37 If we chose a weighted average benchmark for the core operating costs, we would need to amend the calculation steps in the SMNCC model, which currently apply an uplift moving from a lower quartile benchmark in the 2017 operating

⁹¹ Note the data would be based on the Annual Supplier Returns (ASR) data collected by DESNZ, which is used to set and update the SMNCC, not data collected through our operating cost RFI.

cost baseline to a weighted average used to set the SMNCC allowance. This adjustment would be redundant and lead to an over-allowance if not removed.

5.38 While changing the baseline year would be the minimum change required to update the SMNCC model, we would also consider updating the rollout data, cost inputs and benefit inputs in line with our regular update process using the latest ASR data submissions from DESNZ. We consider this would reflect the status quo approach.

5.39 Under this option, we would plan to update the cost lines for smart meters, communication hubs, and In-Home displays (IHDs) and the benefit lines for the number and cost of avoided site visits, change of supplier benefits (credit only), benefits of reduced inbound enquiries (credit only), improved debt management (credit only) and benefits of a remote change of tariff (credit only).⁹² These are outlined in the table below.

Table 5.2 – List of components to update under status quo

Area	Component	Data source
Costs	<ul style="list-style-type: none"> The cost of smart meters The cost of communication hubs The cost of In-Home Displays (IHDs) 	ASR data
Benefits	<ul style="list-style-type: none"> The number and cost of avoided site visits Change of supplier benefits (credit only) Benefits of reduced inbound enquiries (credit only) Improved debt management (credit only) Benefits of a remote change of tariff (credit only) 	ASR data
Rollout	<ul style="list-style-type: none"> Data on actual customer numbers by metering type to update smart meter roll out percentages for upcoming years New or changed rollout target or tolerance values 	ASR data; Smart Meter Policy Framework publications
Other inputs	<ul style="list-style-type: none"> GDP deflator 	ONS and OBR

⁹² Ofgem (2023), Price Cap – February 2023 decision on approach to reviewing the SMNCC allowances. <https://www.ofgem.gov.uk/publications/price-cap-november-2022-consultation-approach-reviewing-smncc-allowances>

- 5.40 Overall, this approach would involve updating at least 8 supplementary models alongside the main overarching model. We would not seek to update all of the costs and benefits in the model as this would require further data collection outside of the ASR data request and would mean updating up to 29 supplementary models. We do not consider such an approach would be proportionate or feasible as this would generate many model changes. As mentioned above, stakeholders have previously commented on the complexity of the allowance, so we would be cautious in taking an approach that adds complexity rather than reduces it, without substantive benefits to robustness or accuracy. Additionally, the costs/benefits in the table above explain most of the overall SMNCC level, updating further models and components would yield increasingly smaller gains in accuracy at the expense of increased complexity.
- 5.41 The main benefit in this approach is that it uses an established model that has been through several consultations and revisions (including disclosure processes) and there is confidence in the overall approach. Stakeholders will also be familiar with the approach from our previous reviews.
- 5.42 The main downside is that this option still requires a lot of additional work to make the SMNCC compatible with a new baseline. From our experience of operating the existing model, it has been resource intensive and complex. We consider it may not be proportionate to continue such an approach given it relates to a relatively small part of the overall cap level (if that is the case) and that resources are better focused on other matters more material to the cap level. Additionally, under a simpler approach it may be easier to make changes to the methodology, if appropriate, should elements of the rollout change.

Option 2: A simpler SMNCC type model

- 5.43 For this option, we intend to consider whether we could take a simpler approach to modelling the transitional costs of the smart meter rollout relative to the current SMNCC model. We would seek to keep the same principle of calculating a net cost change as this remains the most robust approach to ensure we are not double counting costs in absence of having accurate data to split out smart and traditional metering costs in the new operating cost baseline.
- 5.44 One key feature of the current SMNCC model that adds complexity is how it calculates and models a counterfactual to consider the additional costs of smart meters. In practice this means the model calculates a scenario in which there is no smart meter rollout and subtracts it from a policy scenario with the rollout. We consider that this could be an area where an alternative approach could

significantly simplify the modelling approach and reduce the number of calculation steps. For example, rather than modelling a counterfactual we could model only the additional costs for the extra meters that are rolled out after the baseline year. This would mean not modelling total costs at any point, but instead considering a form of simpler counterfactual (in terms of the avoided costs of traditional meters).

- 5.45 The other area of simplification we would consider is the number of granular costs and benefits we include under the simpler approach. Rather than trying to account for a full suite of inputs, we would aim to select a few main variables that capture the majority of cost changes driven by the smart meter rollout. This would help to significantly reduce the reliance on supplementary models and reduce the number of calculation tabs in the model. The key benefit of this approach is that it reduces the complexity, making it easier for stakeholders to understand the approach. We consider this would make any future reviews or changes to the methodology much simpler for our stakeholders to engage with and for us to carry out. Table 5.3 shows some of the key costs and benefits we could consider including from the current SMNCC model.

Table 5.3 - Simpler model inputs - Key costs and benefits of rolling out the remaining smart meters.

Area	Components	Description
Costs	SMETS2 meter asset costs	Amortised procurement costs of SMETS2 meters. As suppliers only install SMETS2 meters now, we only include SMETS2 meter asset costs in the simpler model. (The costs of SMETS2 communication hubs are owned by DCC and costs are covered by DCC charges).
Costs	Installation costs	Costs incurred by suppliers for the installation of SMETS2 meters (not including sunk installation costs). Amortised value.
Benefits	Avoided costs of traditional meter asset costs and installation costs	These savings are largely based on the costs of suppliers' operational processes for traditional meters, which are established.

- 5.46 This is a significant simplification of the model inputs compared to the current SMNCC model. We have not included some costs in the year of an installation, for example, premature replacement charges and costs of IHDs. This is because these costs are less significant compared to smart meter assets and

installations.⁹³ To mitigate the impact of not including these costs, we have not included all the benefits from smart metering, such as cost savings relating to reduced inbound enquiries and meter reading requirements.

- 5.47 When setting the rollout profile, costs and benefits, we would propose to use the Annual Supplier Returns (ASR) data as this is consistent with how we set the current SMNCC allowance and avoids the need for us to replicate data collection. We may also seek to adopt any assumptions that have been established through the various SMNCC reviews we have carried out (eg if setting meter asset costs, we may use the same amortisation period as the current approach).
- 5.48 While a simplification in approach may be perceived as being less robust, we consider option 2 is a proportionate approach in the circumstances. The current SMNCC approach sets an allowance based on a notional rollout profile and mix of benchmarking costs across suppliers and modelling other costs and benefits. We can only set one cap level across the market, so the SMNCC seeks to model a notional supplier's smart metering costs. However, suppliers are at different stages of their individual rollout, with some being ahead of the average profile and others behind it.
- 5.49 Therefore, in setting the SMNCC allowance, we consider the aim is to provide a notional allowance that enables suppliers to rollout smart meters. We consider option 2 would still achieve this aim and is a proportionate approach in terms of reduced complexity compared to the current SMNCC model. As we mentioned earlier in the chapter, the current SMNCC approach is complex with several granular costs and benefits that represent a small part of the SMNCC with little added accuracy. Additionally, there are existing uncertainty mechanisms within the cap that account for differences in payment timing.
- 5.50 A simpler approach would still involve complexity in setting out a new model and ensuring we capture the right balance of costs and benefits, alongside any assumptions we make. While we are not concerned with loss of granularity, we would still intend to understand how the new modelled approach fits with the new 2023 baseline and how it interacts with our benchmarking approach for core operating costs.

⁹³ Ofgem (2021), Price Cap – Decision on credit SMNCC allowance, paragraph 2.16. <https://www.ofgem.gov.uk/publications/price-cap-decision-credit-smncc-allowance>

Options for review and update approach

- 5.51 Regardless of whether we retain the current SMNCC approach or design a simpler approach, we would need to consider whether we regularly review and update the model.
- 5.52 There are broadly two options:
- Option A: Regular reviews and updates (status quo)
 - Option B: Set the profile of allowances with no further update
- 5.53 To decide between these two options, we intend to consider how far along the rollout is and whether it is proportionate to continue a review and update process. If we considered option A was proportionate, we would consider a similar approach to the current annual update using the ASR data – this would ensure that we update the main values, while keeping each review focused.
- 5.54 Under option B, we would set the forward profile of allowances for the coming years when setting the initial operating cost allowance resulting from this review. Under this approach, we would not plan to carry out any further model updates and work on the assumption that the allowance reflects the profile of costs. Suppliers have a mandate to complete the rollout. Variances in costs at this stage are likely to be related to factors within a supplier’s control, such as timing and rollout progress rather than the total cost of the rollout. Given it’s a difference in timing rather than directional difference in cost, there are existing uncertainty allowances within the cap to account for these types of factors.
- 5.55 As discussed in the context section, advance payments are part of the current approach with the aim of aligning differences in forecast modelled costs and outturn modelled costs. They are calculated by assessing the change in allowance for given cap periods between reviews and updates. We may consider retaining advance payments under option A as we would continue to update some inputs influencing the allowance. However, under option B, we would set the forward-looking allowance at one point in time, meaning we would not calculate advance payments through regular reviews.

Questions

- Q16. If we set the allowance using a simpler approach (option 2), what is your view on how we should consider modelling the additional net costs of smart meters?
- Q17. If we set the allowance using a simpler approach (option 2), what in your view are the main costs and benefits associated with the remaining smart meter rollout?
- Q18. Please explain your view on how either approach for setting the smart metering allowance should be reviewed and updated.

Setting the SMNCC between October 2024 and March 2025

- 5.56 In August 2023, we set out our annual update for the SMNCC, which included setting the allowance between October 2023 and September 2024. We are aiming to implement this operating cost review from the April 2025 cap period and therefore need to consider how we set the current allowance between October 2024 and March 2025.
- 5.57 We could either carry out an update of the existing SMNCC allowance to set the allowance for six months, which would involve updating the model using the latest ASR data, or we could use the current inputs in the SMNCC model to set the forward profile of the allowance for the six-month period.
- 5.58 We propose to use the current model to set the allowance between October 2024 and March 2025, without carrying out an update. We consider this is the most proportionate approach given this review will require us to change and update the model in line with the two options we set out above for setting the SMNCC. If we retain advance payments, and dependent on the update approach we take, we could consider taking into account any major discrepancies in future cap periods.

Stakeholder responses

- 5.59 Three suppliers supported using the current SMNCC model to set the allowance. Two others said we could use DESNZ's ASR to formulate an average cost and provide ad hoc additions for future costs.

Considerations

Approach to payment methods

- 5.60 The current SMNCC approach assumes the same allowance for Direct Debit and Standard Credit customers but a different allowance level for PPM customers. The

difference is largely driven by the difference in traditional meter costs between credit and PPM (Direct Debit and Standard Credit use the same type of meter). With traditional PPM meters costing significantly more than traditional credit meters, the move to smart meters yields an operational benefit in terms of metering costs.

- 5.61 For the options presented in this chapter, we would seek to retain the split between credit and PPM for setting the SMNCC regardless of which option we pursue.

Other considered options

- 5.62 We considered two other approaches for setting the smart metering costs allowance but have ruled them out at this stage. Firstly, we considered whether a smart metering costs allowance was still required given the rollout has advanced significantly since setting our 2017 baseline. However, the rollout is now 60% complete, with a significant part of the transition to continue. This could likely change suppliers' costs relative to the baseline highlighting the continued need for a smart metering costs allowance.
- 5.63 We also considered whether we could use a non-modelled approach by providing an allowance in line with a published cost estimate of how much the remainder of the rollout will cost. There are practical challenges with this approach in identifying a suitable figure we could base an allowance on. However, even if there was a clear data source, this would set an allowance to fund the remainder of the rollout, but it would not update the underlying cost differences between smart and traditional meter customers in the cap. This means that once the smart meter rollout is complete, the allowance would drop to zero and the cap would return to reflecting the 2023 blend of smart and traditional meter customers. This could also lead to compressing costs into a shorter time period than a supplier would amortise them over.
- 5.64 In contrast, the SMNCC approach means that once rollout reaches 100% the allowance flatlines at the final allowance number and it becomes an enduring element of the operating cost baseline so the cap reflects 100% smart meters. We consider this is a more robust approach to use on an enduring basis.

Questions

Q19. Do you agree with our proposal to use the current model to set the SMNCC allowance between October 2024 to March 2025 without updating the allowance?

6. Pass-through industry charges

Section summary

In this chapter, we summarise how the cap currently captures pass-through industry charges and we set out options for how we could set the allowance on an enduring basis.

Context

6.1 There have been several changes to the number of schemes administered by industry bodies over the last few years. Given we are reviewing the costs included across the operating cost allowance, we consider it is an appropriate opportunity to review how the allowance compares to the outturn costs and consider how we set the allowance for various industry charges. This includes whether we consider setting a separate approach to the core operating cost allowance and how we index these costs going forward given industry charges may continue to change as the market develops.

Current approach

6.2 In this chapter, we discuss the various industry charges suppliers face in supplying customers with energy. For the purposes of this discussion, we refer to pass-through industry charges. A pass-through industry charge is the cost of an industry body (eg Elexon), that is charged to a supplier through a charging statement or otherwise. Generally, these costs are pass-through as any given supplier does not have control or influence over the level of these costs.⁹⁴

6.3 The cap currently provides allowances for industry charges in two areas; the operating cost allowance and the smart meter cost allowance. The operating cost allowance covers the cost to suppliers of operating Elexon and Xoserve, which we explicitly standardised across suppliers.⁹⁵ The smart meter cost allowance covers the costs of Data Communication Company (DCC), Smart Energy GB (SEGB) and Smart Meter Installation Code of Practise (SMICoP).

Operating cost allowance

6.4 The operating cost allowance was set using 2017 supplier operating cost data. In 2018, to calculate operating costs for each supplier, we used the main categories

⁹⁴ Most charges from industry bodies will be similar on a per customer basis across suppliers. There may still be some variation - eg suppliers may incur ancillary charges for optional services.

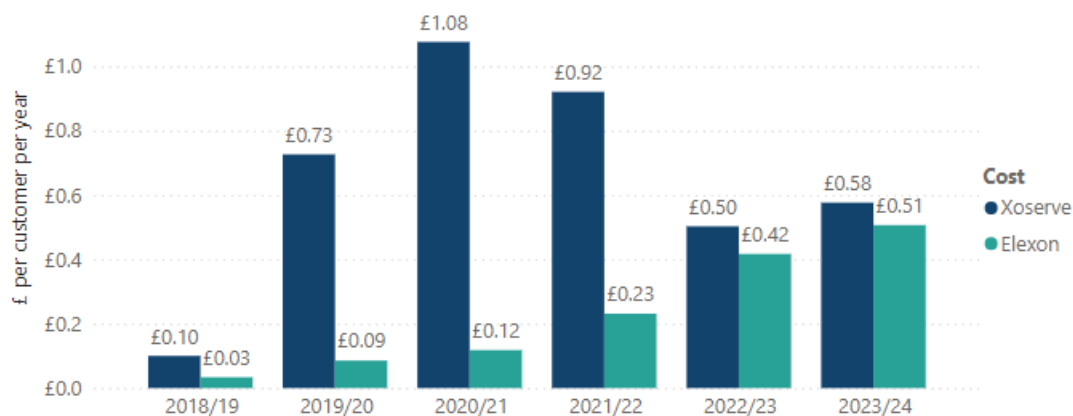
⁹⁵ There may be other industry charges captured in the operating cost allowance implicit in suppliers submitted data used to set the allowance in 2018, which we did not standardise.

of indirect costs as defined by the Consolidated Segmental Statements (CSS) as our starting point. We then made a series of adjustments to increase the comparability between suppliers and increase the likelihood that all relevant costs were captured. This included, among other things, removing the reported Elexon/Xoserve charges and replacing them with a standardised charge.

- 6.5 To calculate the standardised charge for Elexon and Xoserve, we used the relevant charging statements for 2017/18 charges. This gave a clearer indication of the costs each supplier faced based on their market share and standardised the cost per customer across all suppliers in the sample. We noted in our 2018 decision that the estimated charges in the cap were £0.23 per electricity customer for Elexon and £0.69 per gas customer for Xoserve.
- 6.6 After setting the allowance based on 2017 operating cost data, we indexed the allowance at each major cap update (February and August) by CPIH to allow for changes in cost. We do not recalculate any elements of the operating cost baseline. This means that the allowances for Elexon and Xoserve in the cap reflect the 2017/18 charging statement costs then indexed by CPIH for each relevant cap period.
- 6.7 We have assessed whether these allowances align to the levels directly from the charging statements since the introduction of the cap. Our analysis suggests that costs have increased at a greater rate than CPIH.
- 6.8 As figure 5.1 shows, the Elexon costs have continued to diverge from the allowance included in the operating costs. The latest charging statement suggests that the costs of Elexon to suppliers are over double the level included in the cap (£0.79 compared to £0.29 per electricity customer). However, it is worth noting that this is relatively low materiality – the latest difference of £0.51 per electricity customer is approximately 0.41% of the operating cost allowance per electricity customer. This difference may likely be due to the expansion of responsibilities linked to the introduction of MHHS.
- 6.9 By comparison, Xoserve charges have also increased above the rate of inflation. However, rather than the continued divergence observed in Elexon costs, the difference between the indexed allowance and the charging statements peaked in 2020/21 before reducing. Figure 5.1 shows the 2023/24 difference is approximately £0.58 per gas customer (£0.86 compared to £1.43). Similar to Elexon, this difference has low materiality as its approximately 0.47% of the gas operating cost allowance.

6.10 Whilst there are small differences between these two costs and the allowances, they make up a small fraction of the total operating cost allowance. Other cost lines within the operating cost allowance may have seen different trends, therefore these differences could well balance out or be treated as noise overall.

Figure 5.1 – Difference between the indexed allowance and the charging statements



6.11 Alongside these two charges, one other area that is not explicitly captured by the operating cost allowance is the cost of Retail Energy Code Company (RECCo). RECCo was formed in 2019 to implement the new Retail Energy Code (REC) and set up services to meet code requirements. This was after the cap was introduced and therefore the costs are not explicitly captured by the cost lines included in the operating cost allowance. However, part of RECCo’s role was to take on functions from other industry bodies. We expect these industry body costs may be captured in the baseline. Therefore, including RECCo charges now would likely be in part a reallocation of costs between industry bodies rather than a completely new set of costs.

6.12 The most recent REC charging statement sets out the general charges of £0.81 per meter point per year to be recovered from suppliers. Additionally, there is a £0.05 cost per meter point for MHHS project charges.

Smart meter cost allowance

6.13 As explained in Chapter 5, the smart meter cost allowance in the cap is calculated as a net change between the baseline data year (2017) and each cap period we set. This is to account for the fact that there were smart meter costs in the operating cost baseline that we were unable to accurately remove before setting the allowance. The approach of calculating the net cost change also applies to the smart meter related pass-through industry charges (DCC, SEGB and SMICoP).

- 6.14 When setting the allowances for DCC and SEGB, we use the latest charging statements (for DCC) and budget plans (for SEGB). This means for these two costs, we recalculate the allowance based on the latest information, to appropriately reflect the costs suppliers incur.
- 6.15 To set an allowance for Smart Metering Installation Code of Practice (SMICoP) costs, we used an annual budget assumption of £250,000, which was provided to us by SMICoP at the time. We understand since setting the cap, SMICoP has been superseded by the Consolidated Metering Code of Practice (CoMCoP).

Main areas for this review

- 6.16 In this review, we consider three key areas within the options that we set out: (i) which charges do we set an allowance for, (ii) whether the charges should be captured in the operating cost baseline and (iii) how we update the charges over time.
- 6.17 In the options section, we focus on Elexon, Xoserve and RECCo charges as we have an established methodology for DCC and SEBG charges. We consider the existing methodology is appropriate and reasonable, it aligns with the option of setting industry charges based on charging statements. We discuss smart meter industry charges in the key considerations.

Setting the allowance

Options

- 6.18 We consider there are two options for setting the industry charges allowance:
- Option 1: Status Quo - Capture costs in the core operating cost baseline and update by the methodology decided in line with Chapter 3.
 - Option 2: New component - Set a pass-through component using charging statements, which is regularly updated.

Option 1 – Status quo

- 6.19 For this option, we would replicate the approach we took in 2018 when designing the operating cost allowance. This would involve excluding the reported pass-through industry charges from suppliers' operating cost submissions and using the 2023/24 charging statements for the industry charges to add a consistent cost to the benchmarked core operating cost level. Adding the costs to the benchmark using the charging statements would ensure a public and consistent

data source is used to set the element of the allowance relating to pass-through industry charges.

- 6.20 We would select an update approach for the core operating cost allowance in line with the discussion in Chapter 3. This update approach would then apply to the industry charges captured within the benchmark. We would not seek to use a separate update approach for the group of costs and generally consider there are appropriate uncertainty mechanisms in the cap to account for some degree of flexibility.
- 6.21 The main advantage of using this approach is that the update process is proportionate given the materiality of the costs. The three main industry charges (Xoserve, Elexon and RECCO) equate to a cost of approximately £4 per dual fuel customer based on the 2023/24 charging statements. This is a small fraction (less than 2%) of the operating cost allowance (excluding the payment method uplift and SMNCC) and therefore, the approach to updating these allowances is much less sensitive than other cost areas. However, a key downside is the approach is less resilient to future changes in industry costs, particularly if there were new industry change programmes in future that change the costs under the charging statements or if new industry bodies were to be appointed. If we pursued this approach, one option would be to keep its use under review depending on the materiality of any changes to industry charges.

Option 2 – Separate component

- 6.22 Under this approach, we would use the industry charging statements to set the allowance and continue to update it using updated charging statements. The approach would be similar to how we set and update the current DCC allowance within the cap (without the need to calculate a change in costs between years). We set out the data sources and frequency of update in the considerations.
- 6.23 We would set out these allowances in an annex model to the cap, which would allow us to regularly update them from a data source. This is in contrast to the current approach, which does not require a separate annex model because we set one baseline operating cost allowance in the baseline then index it by inflation.
- 6.24 If we pursue this option, then one way of implementing the approach could be to repurpose Annex 5, which currently captures the SMNCC, and expand the scope to include pass-through industry costs.
- 6.25 Setting pass-through industry charges as a separate component and updating it using updated charging statements would address the shortcomings of the

current approach. This approach would account for the changes in Elexon and Xoserve costs, removing any differences between the cost movements and inflation. Unlike option 1, this approach may provide additional resilience to changes in the make-up of the industry bodies' costs as it would be easy to update the allowance without needing to reopen the operating cost benchmark.

- 6.26 This approach would also provide greater transparency of the costs covered in the cap and make it clearer when we may consider changing the methodology to include any new industry body charges should they be introduced in future. Overall, this approach is more future proof compared to the status quo as we move towards net-zero and the future retail market.
- 6.27 One potential risk in this approach relative to option 1 is that it uses publicly published information for setting the allowances on a regular basis. However, this is a risk that already exists across the cap (eg in the network cost allowance) and we have processes for managing it through the standard licence conditions 28AD.⁹⁶ If an input data source was not available for a given update, we would not expect the materiality to be large, but we could seek to update at the next/earliest opportunity. If due to wider industry or administrator changes, an input was not likely to be available going forward, we would then expect to consult on a new data source or alternative calculation methodology.
- 6.28 Additionally, this approach does add an additional layer of complexity by expanding the number of cost lines we set out in the allowance. We are mindful of this when consider the relative merits between the two options.
- 6.29 At this stage, our preference is to pursue option 2, which we think could have merit. However, we particularly welcome any comments on whether stakeholders consider that it would be practical and proportionate in the circumstances.

Stakeholder responses

- 6.30 Most stakeholders who responded to the call for input agreed with the need to review the industry charges in the cap. Five suppliers expressed a preference to set the industry charges on a pass-through basis.
- 6.31 Three suppliers highlighted that Elexon costs had increased over time and this was not captured by the current cap approach. Two of these suppliers also noted that REC costs are currently unaccounted for in the cap.

⁹⁶ Standard Licence Condition (SLC) 28AD.15 and 28AD.14 of the electricity and gas supplier licences respectively set out the process of replacing a data source that is no longer available.

Considerations

Inclusion of industry charges and data sources

6.32 For the purpose of setting a pass-through industry charges component to the cap, we propose to include costs for Elexon, Xoserve, RECCo and smart metering related industry charges. The below table sets out what these charges are, the materiality of them and the data source we use to set and update them. We focus on Elexon, Xoserve and RECCo here as we already have established methodologies for the smart metering pass-through costs.

Table 6.1 – List of industry charges and data sources

Industry body	Charges covered	Cost amount (2023/24)	Data source
Elexon	<ul style="list-style-type: none"> BSC regular activity (including BAU activities) Teleswitch services Demand Led and Digitalisation Helix MHHS 	<p>£0.79 per electricity customer</p> <p>Calculated as (total budget/total volumes)*3.1MWh</p>	<p>Elexon Business Plan (2023/24)</p> <p>Budget summary – Table 1.1</p> <p>Volumes – Table 3.3</p>
Xoserve	<ul style="list-style-type: none"> General services (eg manage Shipper Transfers and Monthly AQ process) Infrastructure (eg UK Link Future Enhancements) Change charges (eg DSC change budget) 	<p>£1.43 per gas customer</p> <p>Calculated as (shipper user budget/number of supply points)</p>	<p>CDSP Annual Charging statement 2023/24</p> <p>Table 4 – grand total</p> <p>AUG statement 2023/24</p> <p>Appendix 3 – Actual Annual Quantities and Supply Meter Points</p>
RECCo	<ul style="list-style-type: none"> REC service charge MHHS project charge Central Switching Service (CSS) charges 	<p>£0.864 per Registerable Measurement Point (ie meter point)</p>	<p>REC charging statement 2023/24</p> <p>(Clause 9)</p>

6.33 In response to our call for input, two stakeholders said we should capture the costs of government support schemes such as the Energy Price Guarantee and Energy Bill Support Scheme. Given these measures were temporary and we intend to set a non-pass-through component on an enduring basis, we do not consider these costs to be material and systematic requiring an adjustment to the cap. We consider they are covered by other uncertainty allowances within the cap.

- 6.34 One supplier suggested we should capture the costs of the Distribution Connection and Use of System Agreement (DCUSA). We intend to explore whether to include DCUSA costs in the pass-through industry charges. We expect these costs to be captured in the operating cost baseline to the extent they constitute an operational cost for suppliers. To consider including them in the pass-through industry charge allowance, we would need to identify a clear data source to quantify these costs for suppliers.
- 6.35 One supplier said we should consider updating the allowance quarterly to minimise the reliance on headroom in the cap for this area. As part of this review, we will consider the appropriate update timings, though note that often these charging statements are published on an annual basis, with charging years starting in April or October.

Smart metering pass-through costs

- 6.36 As mentioned, we consider that the approach we take for setting DCC and SEGB charges continues to be reasonable and appropriate. However, we may need to amend the calculation for these costs as we currently calculate them as a net cost change relative to 2017.
- 6.37 The updated approach could calculate the difference in these costs between the new baseline year data and a given cap period. Alternatively, we could consider using total costs for smart metering industry charges if we are able to exclude them for the core operating cost baseline to avoid double counting.
- 6.38 SMICoP has now been superseded by CoMCoP, which sits under RECCo. The administration of CoMCoP may be covered by the REC charges. Therefore, we will consider removing the existing SMICoP allowance provided it is either (1) covered by the operating cost baseline; or (2) captured within the industry charge allowance we set. It is key we do not double count costs so we will seek to remove any costs from the baseline where we include them in an industry charge allowance.

Non-pass-through costs

- 6.39 Four suppliers have mentioned that they have seen an increase and expect there to be further increases in capital and operational expenditure related to industry change programmes such as MHHS. They have asked that these cost changes be considered within the operating cost allowance as part of this review.
- 6.40 We discuss the update approach and consideration of future regulatory changes in Chapter 3. For the purpose of the approaches set out in this chapter, we are

only considering setting pass-through industry costs, which have a clear public data source that is regularly updated.

Questions

- Q20. Do you agree with our preferred approach of setting a separate allowance for industry charges? Please explain your answer.
- Q21. Please explain whether you agree with the list of industry charges that we intend to include in the industry charge allowance (set out in table 6.1) and their respective data sources.

Appendices

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Appendix 1 – Information request breakdown

Information request

A1.1 As mentioned throughout this document, we issued an information request last year to gather operating cost data from suppliers. We issued the request to suppliers with greater than 100,000 customer accounts, this captured 98% of the market.⁹⁷ We collected annual cost data for 2019 and 2022, as well as forecast data for 2023.

A1.2 The request included granular breakdown of operating cost data (shown in table A1.1 below), customer numbers broken down by parameters and customer numbers broken down by customer base characteristics (priority service register and offline/online).

A1.3 We intend to issue a similar request to collect 2023 cost information.

Table A1.1 – Breakdown of the information request

Category	Sub-category	Sub Sub-category	Description
Environmental and social obligations	Warm Home Discount (WHD), administrative costs only	-	For example, the costs associated with identifying recipients and paying rebates. It excludes the value of the rebates themselves.
Environmental and social obligations	Renewal Obligations (RO) Administrative costs only	-	The administrations costs associated with administering the RO scheme only.
Environmental and social obligations	UK Capacity Market (CM) Administrative costs only	-	The administration costs associated with administering the UK Capacity Market scheme only.
Other direct costs	Industry charges*	-	This includes Elexon charges, Xoserve charges, DCC – Fixed charges, Retail Energy Code (REC) charges, SEGB and SMICoP.

⁹⁷ We count a dual fuel customer as two customer accounts.

Consultation - Energy Price Cap: Operating cost allowances review

Category	Sub-category	Sub Sub-category	Description
Other direct costs	3 rd party commissions	-	Brokers' costs and intermediaries' sales commissions. Note that these costs should ONLY relate to sale and marketing activities.
Indirect costs	Customer contact	Call centre	All costs associated with operation of call/contact centre excluding those of sales & marketing activities and debt collections activities.
Indirect costs	Customer contact	Customer relations	All costs associated with emails, correspondence, web chat and complaints activity (including Ombudsman) excluding the issuing of routine bills/statements to customers, sales & marketing activities and debt collection activities. This includes costs of processing joiners/leavers, and customer retention costs.
Indirect costs	Billing and payment collections	Billing/statements	Costs relating to issuing bills/statements to customers.
Indirect costs	Billing and payment collections	Payment services (PPM)	Cost of PPM payment collection internally and through third parties (Post Office, Payzone, Paypoint).
Indirect costs	Billing and payment collections	Internal collections	Gross internal debt collection costs (excluding those shown under warrants).
Indirect costs	Billing and payment collections	External collections	Gross external debt collection costs (excluding those shown under warrants).
Indirect costs	Billing and payment collections	Bad debt charge*	P&L charge incurred. Costs include write off and recoveries, movement in provisions, and credit balance recognition.

Consultation - Energy Price Cap: Operating cost allowances review

Category	Sub-category	Sub Sub-category	Description
Indirect costs	Billing and payment collections	Warrant costs	Costs associated with execution of warrants.
Indirect costs	Billing and payment collections	Active charge	Debt collection costs recharged to customers who are in debt. (This is a negative cost).
Indirect costs	Billing and payment collections	Bank charges/Transaction costs	Costs paid for a bank's services and/or costs incurred when buying or selling a good or service
Indirect costs	Metering	Rental	Costs of meter asset providers (including meter rental termination costs).
Indirect costs	Metering	Net costs of Installation/removal	Net cost of new meter installation (excluding costs under bad debt eg warrant) and meter removal. This should be net of any installation payments from Meter Asset Providers.
Indirect costs	Metering	Maintenance	Costs of meter operators.
Indirect costs	Metering	Meter reading/Data collection/Data aggregation	Cost of all meter reads, data collection and data aggregation This does not include costs related to customer-provided meter readings (eg online or via a call centre).
Indirect costs	Metering	PPMIP charge	Costs paid (excluding DCC charges) to Prepayment Meter Infrastructure Providers 'PPMIPs' (eg Itron/Siemens).
Indirect costs	Sales and marketing	-	All costs associated with sales and marketing, including contact centre and customer relation costs.

Consultation - Energy Price Cap: Operating cost allowances review

Category	Sub-category	Sub Sub-category	Description
Indirect costs	Central overhead (where not allocated above)	-	Any other central overhead costs, where not allocated to the categories above. This should only include telecom charges, IT costs, Property costs, HR, regulation, corporate recharges, legacy pension costs and Industry code administration costs.
Depreciation	Depreciation	-	-
Depreciation	Amortisation	-	-
Working capital requirements	Net account receivables at the beginning of the period and end of the period	-	The net of total account receivables and total account payables. For net account receivables at the beginning of period is the amount reported as at 1 January of the indicated period and for net account receivables the end of the period is the amount reported as at 31 December of the indicated period.
Working capital requirements	Account receivables at the beginning of the period and end of the period	-	The total value of billed and unbilled consumption minus any amounts paid.
Working capital requirements	Account payables at the beginning of the period and end of the period	-	The total value of credit balances net of unbilled consumption.
Working capital requirements	Debtor days for the period	-	Debtor days for the period. Calculated by taking the average of net account receivables at the beginning of the period and at the end of the period and dividing by revenue and then multiply by 365 days.

Appendix 2 – Summary of areas for feedback

In this Appendix, we provide a summary of the areas for feedback which have been cited throughout this document. We ask for stakeholders to provide evidence to support their views on the areas which have been outlined. These questions are intended to help structure responses, but we welcome views on any other issues discussed in the consultation.

Chapter 3 - Core operating costs

Benchmark approach

1. Please explain your preferred approach to benchmarking (benchmark metric and benchmarking costs across parameters) and how it would align with the statutory framework. Explain your answer by providing evidence where possible.
2. Please explain whether differences in core operating costs (excluding debt-related costs and industry charges) are more related to efficiency than differences in the customer base? If you think these costs are related to the customer base, please explain what these customer base factors are.
3. Please explain if you think that future regulatory changes you know of will have material and systematic impact on core operating costs relative to 2023?
4. Do you think technology developments will help make further efficiencies to core operating costs? Please give evidence to support your views.
5. Please explain what you see the role of the operating cost allowance to be in influencing further efficiency improvements.

Allocation across parameters

6. What is your preferred approach to allocating costs between payment methods and fuel type if we take an aggregate benchmarking approach? Please explain your answer.
7. What approach do you prefer to allocating fixed operating costs between the standing charge and unit rate? What would be the impact on customers and suppliers of moving costs to the unit rate?

Updating the core operating costs allowance

8. Please explain any views on how we could determine the adjustment factor under option 2 CPIH-X approach.

9. Please explain any views on whether there are any other external indicators we should consider to index the allowance.

Chapter 4 - Debt-related costs

Measuring cost components

10. Explain whether you think we should consider a bottom-up approach to estimate costs, and if so, could you please explain how we could improve our proposed approach?

Benchmarking approach

11. Please explain your preferred approach to benchmarking (benchmark metric and benchmarking costs across parameters) across debt-related cost components. Explain your answer by providing evidence where possible.
12. What customer base characteristics do you think we should consider when selecting an appropriate sample to benchmark on or the benchmark supplier(s)? Please explain your answer, and where applicable, please provide any quantitative evidence.

Cost allocation

13. Do you consider a bespoke approach (Option A.3) under cost allocation feasible, in particular tracking customer movement between Direct Debit and Standard Credit customers? Please explain your answer.
14. In the absence of levelisation phase 2, please explain whether and, if so, how we should consider spreading debt-related costs across different customer groups.

Setting the allowance and update mechanism

15. Please explain any views on what external indicators we could use to index the allowance.

Chapter 5 - Smart metering costs

Setting the smart metering costs allowance

16. If we set the allowance using a simpler approach (option 2), what is your view on how we should consider modelling the additional net costs of smart meters?
17. If we set the allowance using a simpler approach (option 2), what in your view are the main costs and benefits associated with the remaining smart meter rollout?

18. Please explain your view on how either approach for setting the smart metering allowance should be reviewed and updated.

Setting the SMNCC between October 2024 and March 2025

19. Do you agree with our proposal to use the current model to set the SMNCC allowance between October 2024 to March 2025 without updating the allowance?

Chapter 6 - Pass-through industry charges

20. Do you agree with our preferred approach of setting a separate allowance for industry charges? Please explain your answer.
21. Please explain whether you agree with the list of industry charges that we intend to include in the industry charge allowance (set out in table 6.1) and their respective data sources.

Appendix 3 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. ie a consultation.

4. With whom we will be sharing your personal data

We may share consultation responses with officials from the Department of Energy Security and Net Zero.

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for 6 months after the project, including subsequent projects or legal proceedings regarding a decision based on this consultation, is closed.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it

- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas

8. Your personal data will not be used for any automated decision making.

9. Your personal data will be stored in a secure government IT system.

10. More information For more information on how Ofgem processes your data, click on the link to our "[ofgem privacy promise](#)".