

# Consultation

## COVID-19 true-up and the default tariff cap: working paper

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This working paper is part of the consultation process on the true-up for COVID-19 costs. We would like views from people with an interest in the level of the default tariff cap. We particularly welcome responses from domestic energy suppliers and consumer groups. 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 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](https://www.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.

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## Executive summary

In our February 2021 decision we introduced an adjustment in the default tariff cap to account for an initial estimate of additional bad debt as a result of COVID-19.<sup>1</sup>

The 'true-up' aims to adjust this initial estimate to reflect the final costs once they are fully known. This working paper is a step towards developing our approach to the true-up.

We began our consideration of the true-up by issuing a call for input in March 2021. We also organised a number of calls with suppliers to further develop our thinking on the policy area.

This working paper focuses on the options for the data source for bad debt that we could use to calculate the true-up. We are seeking comments from stakeholders on three options and our consideration of them:

- Option A: top-down, this approach would look back and focus on a particular period of billed consumption, and look at the combination of provisions for doubtful debts<sup>2</sup> and write-offs that suppliers have made in relation to that cap period of billed consumption up to the point that we gather data.
- Option B: Iterative bad debt charge, we ask suppliers to provide their bad debt charge for a number of accounting periods. The bad debt charge incorporates new provisions, provision movements and write-offs. This option therefore assumes that the total impact of bad debt in relation to a particular cap period of billed consumption will eventually be reflected in suppliers' accounts.
- Option C: bottom-up, we ask each supplier for their level of outstanding debt from a particular period of billed consumption in the past. We then need to make an assessment of the recoverability of the outstanding debt.

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<sup>1</sup> Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap. [https://www.ofgem.gov.uk/system/files/docs/2021/02/decision\\_on\\_the\\_potential\\_impact\\_of\\_covid-19\\_on\\_the\\_default\\_tariff\\_cap.pdf](https://www.ofgem.gov.uk/system/files/docs/2021/02/decision_on_the_potential_impact_of_covid-19_on_the_default_tariff_cap.pdf)

<sup>2</sup> For the remainder of the document, we will refer to a "provision for doubtful debts" as a "provision" for simplicity.

This working paper also provides stakeholders with an update on when we aim to implement the first true-up. This is for information only, rather than for comment.

### **Update on true-up timing**

We have decided that we will aim to implement the first true-up in cap period 9 (October 2022 to March 2023).<sup>3</sup>

A cap period 9 true-up provides us with a more resilient plan, allows us to investigate the data source options further which will improve the accuracy of the true-up. In Chapter 4 we have provided an indicative future timetable.

We are requesting responses by **14 July 2021**. We intend to issue a policy consultation in early Autumn 2021 and a final consultation in Spring 2022. This would be followed by a decision in the Summer of 2022, applying the first true-up from 1 October 2022.

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<sup>3</sup> This remains subject to data availability and further stakeholder consultation.

## 1. Consultation process

### Consultation stages

1.1. We began our consideration of how to calculate the final costs of COVID-19 in the default tariff cap ('cap') through a call for input in March 2021. We arranged a number of calls with stakeholders to discuss the content in our call for input, this provided stakeholders with an opportunity to ask any questions and gave us an opportunity to explore some of the questions further.<sup>4</sup> Following suppliers' responses, we also arranged a number of calls to ask clarification questions on their responses to the call for input and to discuss data source availability further.

1.2. Following this working paper, we expect that the next consultation stage will be a policy consultation in early Autumn 2021. We discuss and seek views on our indicative future timetable further in Chapter 4.

### Related publications

1.3. Key related publications:

- Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation: <https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation>
- Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation: <https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>
- February 2021 decision on the initial allowance for the additional costs of COVID-19 ('February 2021 decision'): <https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap>

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<sup>4</sup> We invited all domestic retail suppliers with above 1% market share across both electricity and gas. We also invited one consumer group.

- March 2021 call for input on the true-up process for COVID-19 costs ('call for input'): <https://www.ofgem.gov.uk/publications-and-updates/price-cap-call-input-true-process-covid-19-costs>
- April 2021 consultation on reviewing the potential impact of COVID-19 on the cap in cap period 7: <https://www.ofgem.gov.uk/publications-and-updates/price-cap-consultation-reviewing-potential-impact-covid-19-default-tariff-cap-cap-period-seven>

## How to respond

1.4. We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

1.5. We do not ask specific questions in this document. Rather, we welcome views on any of the matters discussed in this consultation.

1.6. We will publish non-confidential responses on our website at [www.ofgem.gov.uk/consultations](http://www.ofgem.gov.uk/consultations).

## Your response, data and confidentiality

1.7. You can ask us to keep your response, or parts of your response, confidential. We'll 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.

1.8. 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'll 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.

1.9. If the information you give in your response contains personal data under the UK General Data Protection Regulation (UK GDPR), the Gas and Electricity Markets Authority will

be the data controller for the purposes of UK GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 1.

1.10. 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**

1.11. 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](mailto:stakeholders@ofgem.gov.uk)


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## 2. Introduction

### What are we consulting on?

#### Background

2.1. Our February 2021 decision set out our decision to introduce an adjustment in the default tariff cap to account for the estimated additional bad debt<sup>5</sup> as a result of COVID-19.<sup>6</sup> This was an initial estimate, which we referred to as a float. This decision related to the additional costs incurred in cap periods 4 to 6 (April 2020 to September 2021).

2.2. We said that we would adjust this initial estimate to reflect the final costs once they are fully known (a 'true-up')

2.3. In March 2021 we also consulted on whether a float for cap period 7 to adjust the default tariff cap to account for the impacts of COVID-19 is necessary.

2.4. This working paper is a step towards developing our approach to the true-up. We anticipate the methodology for the true-up would apply to all relevant cap periods.

#### Purpose of this working paper

2.5. In this working paper, we describe options for the data source for bad debt that we could use to calculate the true-up. We are seeking comments from stakeholders on these options and our consideration of them.

2.6. We would like to understand what source constitutes an appropriate measure of the final additional bad debt costs that suppliers will incur due to COVID-19.

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<sup>5</sup> In line with the terms used in our February 2021 decision, bad debt is the unrecoverable debt that suppliers write off. We use the term 'debt-related costs' to include debt-related administrative costs and costs of working capital, as well as bad debt.

<sup>6</sup> Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap. [https://www.ofgem.gov.uk/system/files/docs/2021/02/decision\\_on\\_the\\_potential\\_impact\\_of\\_covid-19\\_on\\_the\\_default\\_tariff\\_cap.pdf](https://www.ofgem.gov.uk/system/files/docs/2021/02/decision_on_the_potential_impact_of_covid-19_on_the_default_tariff_cap.pdf)

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2.7. The data source for bad debt is a key element of the design of the true-up. Other elements of the design are likely to depend on which data source we use. The data source will also affect the data gathering process. This is why we are prioritising this area.

2.8. This working paper also provides stakeholders with an update on when we aim to implement the first true-up. This is for information only, rather than for comment. However, we also provide an indicative future timetable outlining our process to reach the first true-up, and we welcome any feedback on this.

### **Areas outside scope**

2.9. This working paper does not cover all aspects of the true-up for bad debt that we mentioned in the call for input, such as cost allocation. We will discuss these areas in the policy consultation, once we have a proposal for the data source to use.

2.10. We will only consider bad debt in this working paper as we expect it to make up most of the additional debt-related costs due to COVID-19. We have directed our focus on this as our work so far has shown that there is significant uncertainty in determining the final additional bad debt costs. We will consider working capital, debt-related administrative costs and the interaction with bad debt in our policy consultation.

2.11. In response to the call for input, we also received comments on changes to non-debt-related costs that should be considered further, as a result of COVID-19. We intend to respond to these points around the same time as we publish the policy consultation.

- Background on debt

2.12. We understand that debt recovery can normally take around 12 months. However, even after this period, a supplier may still make continued attempts to recover the debt.

### **Accounting process**

2.13. In parallel with the collections process, a supplier also has to reflect in its accounts the risk that not all debt will be recovered from customers.

2.14. A supplier will make a provision, the amount of cash a supplier predicts will not be recovered, at the same time as it recognises the revenue from consumption in a particular period. This will be based, for example, on historical experience of how much revenue is ultimately collected.

2.15. The supplier will then refine this provision over time in light of new information. This could include the progress to date on collecting revenue, and updated expectations for the recoverability of the remaining debt.

2.16. At some point, the supplier will make an accounting judgement that the remaining debt should be written off. The supplier will write off the debt, and reduce the provision accordingly.

## **Sources of uncertainty**

2.17. There are a number of uncertainties around the extent of bad debt for a particular cap period. These uncertainties add complexity to assessing the final additional bad debt cost of COVID-19.

### **Uncertainty for suppliers**

2.18. Even under normal circumstances (absent COVID-19), it takes a considerable amount of time for suppliers to go through their debt collection processes. The lag in billing standard credit customers (who incurred the most debt pre-COVID-19) combined with following the full dunning process means that there may not be clarity on bad debt for at least a year after consumption.

2.19. There will also be a residual amount of uncertainty in normal circumstances, even once the bulk of debt collection is complete. Some customers may be on repayment arrangements which last a number of years. This means there is some uncertainty about whether the customer will ultimately pay off the debt or not. In addition, suppliers may continue to pursue outstanding debts.

2.20. COVID-19 has increased the uncertainty around debt collection:

- COVID-19 has affected suppliers' ability to carry out their usual debt collection processes. The government temporarily paused the recovery of debt for three months. The restrictions put in place on social distancing also restricted suppliers' ability to enter customers premises and led to courts closing which impacted suppliers' ability to get a warrant. To the extent that these processes occur later, this may delay the point at which there is a clear expectation for the amount of debt that is likely to be recovered.

- COVID-19 also has ongoing and hard to forecast impacts on customers' financial situations. This increases the uncertainty about how much debt customers will be able to repay – including for those on repayment arrangements.

### **Accounting uncertainties**

2.21. When viewed from an accounting perspective, there is an additional challenge that suppliers may take different accounting approaches. Although all suppliers are subject to accounting standards, we understand that there is still flexibility for suppliers to take different approaches and judgements. This applies to both how provisions are calculated, and when debt is written off. As time increases after a particular cap period, there will be greater clarity on the amount actually collected, and the role for accounting judgements should reduce. However, this may take a while, especially given the impact of COVID-19.

### 3. Data source for bad debt costs

We describe options for the data source for bad debt that we could use to calculate the true-up. We are seeking comments from stakeholders on these options and our consideration of them.

3.1. This chapter will outline the three options we are considering at present and our considerations.

3.2. We currently prefer the bottom-up approach (option C), but recognise that there is no perfect source of data for determining the final bad debt costs relating to COVID-19. We welcome further comments on all of the options and our considerations.

#### **How we will assess each option**

3.3. There are a number of factors we need to consider when assessing the most appropriate source for bad debt costs. We have outlined a number of key factors below, but this list is not exhaustive.

3.4. First, we want to select the most accurate source for assessing the final bad debt costs. There is going to be uncertainty in any approach we take to assessing final bad debt costs, so it is important that we understand where judgement is required in each option and how we can possibly mitigate the risk of consumers over paying for the cost of bad debt.

3.5. Second, we want to ensure it is feasible for suppliers to practically provide the relevant data required for the data source option.

3.6. Third, we want to make sure that our choice of data source option does not constrain our options for the choice of benchmark. As part of our methodology, we may need breakdowns between customer types. These could potentially be used for some or all of: determining which costs are in scope,<sup>7</sup> controlling for certain factors when benchmarking, and allocating costs between customers. At this stage, we have not reached a firm view on what

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<sup>7</sup> For example whether to include costs from default tariff customers only.

breakdowns we would require. However, our current working assumption is that we would at least seek to gather breakdowns by payment method and tariff type. We therefore want to ensure that our data source can deliver this and the data required can be provided in a consistent format across suppliers.

## Data source options

3.7. The sections below describe each of the three options we are considering at present.

3.8. There may be further options available. We welcome any comments from stakeholders on whether there are additional options that we should be considering.

### Option A: top-down

3.9. This approach would look back and focus on a particular period of billed consumption, and look at the combination of provisions and write-offs that suppliers have made in relation to that cap period of billed consumption up to the point that we gather data.

3.10. This option starts by picking a particular period of billed consumption in the past that we want to assess the level of bad debt for (eg cap period 4). We then select a point in time after this period to gather data from suppliers. We would ask suppliers to provide data on the provisions they have made in relation to this period including any movements. This data would allow us to calculate an estimate of the level of debt that suppliers think will not be recovered. We would also ask suppliers to provide write-offs in case any of the debt is written off up to the point we gather data. When a supplier writes off a debt, it will also reduce the provision accordingly, and so there would be no double counting between provisions and write-offs.

3.11. The time between the period of billed consumption and when we gather data would depend on how long we consider it may take for a suppliers' provisions to stabilise.

3.12. This option therefore uses accounting data from suppliers. It relies on suppliers being able to track any provision movements and write-offs back to the original period of billed consumption. Suppliers need to be able to look at what provision was originally made for a cap period and track any movements up to the point we gather data.

### **Option B: iterative bad debt charge**

3.13. The bad debt charge is an entry in the income statement. It refers to the combination of provision movements plus the cost of write-offs.

3.14. This option uses suppliers' bad debt charge as our source of data. We could gather the bad debt charge for multiple cap periods and cumulatively compare the incremental bad debt charge with the incremental costs used to determine the allowance in the float.

3.15. The supplier who suggested this option said that we could gather data from all cap periods up to the period we do the true-up and then carry out this cumulative comparison. They also suggested that we could then gather the same data again at a later stage to further refine this true-up value.

3.16. The bad debt charge incorporates new provisions, provision movements and write-offs. For a particular accounting period, the bad debt charge will partly reflect new provisions, eg linked to billed consumption during that period. However, the bad debt charge also reflects an updated view of risk attached to the existing debt book and any upwards or downwards adjustment that may be needed to the provisions made in prior periods. There may also be some impact on the bad debt charge when debt is written off, although this should be limited if the debt was already heavily provisioned.<sup>8</sup>

3.17. This means if a supplier was unduly pessimistic or optimistic on their original provision for cap period 4, this will manifest itself in adjustments to provisions in the subsequent periods. The supplier who suggested using this option stated that this is the reason why we must do a cumulative comparison of costs as these adjustments should all even out on a cumulative basis (other things being equal).

3.18. The total impact of bad debt in relation to a particular cap period of billed consumption will eventually be reflected in suppliers' accounts. However, this will be spread over a number of cap periods. For example, the impact of bad debt related to billed consumption in cap period 4 might be reflected in (at least) the bad debt charges for cap periods 4, 5, and 6. The

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<sup>8</sup> When a supplier writes off a debt, it would also remove any provisions in relation to that debt. These steps would have opposite impacts on the bad debt charge, and could largely net off.



bad debt charge for a given cap period is not an estimate of the bad debt incurred due to consumption in that cap period.

3.19. This option relies on suppliers' own accounting data. However, unlike option A, it does not require suppliers to subdivide this data and tie it back to a particular period.

### **Option C: bottom-up**

3.20. This option would look at a particular period of billed consumption in the past (eg cap period 4) and would estimate the bad debt in two stages.

#### *First stage of bottom-up approach*

3.21. In the first stage, we would use data from suppliers to measure what proportion of the billed revenue has been collected by a certain date.

3.22. This step relies on suppliers being able to provide data on how much customers have been billed from a particular period and tie any payments received in the future back to a particular period of billed consumption to calculate the level of remaining debt. Based on our initial discussions with suppliers, we understand that they would be able to use account-level data to build up the amounts that customers have paid to date.

3.23. This means we could gather breakdowns by factors such as the payment method and tariff type on which the debt was incurred. We can also break down this data into further segments that we consider to be relevant (or potentially relevant). Some examples of these breakdowns we may consider gathering include the age of debt, regional breakdowns and whether the customer is still live on supply.

3.24. We could use the breakdowns of data as an indicator of each factor's impact on a supplier's outstanding debt levels. This could be assessed by calculating the difference between the percentage of revenue recovered during a particular COVID-19 period and the baseline whilst controlling for the breakdown. This allows us to assess the impact of each factor and shortlist the factors that we will control for.

#### *Second stage of bottom-up approach*

3.25. In the second stage, we would estimate what proportion of the remaining debt will not be recovered.

3.26. We could consider requesting different types of information from suppliers to make this assessment:

- bespoke forecasts produced by suppliers for the purpose of this analysis;
- suppliers' provisioning approaches;
- historical data on recoverability rates from suppliers.

3.27. We would likely gather information on more than one of these sources to assess what an appropriate set of assumptions should be in any case.

3.28. We will consider whether there are any other data sources that could be used to make this assessment, eg from other sectors of the economy. We recognise that external data sources would not necessarily be specific to energy and be similar to the situations suppliers are facing. We welcome views on what any such data sources could be.

3.29. Based on our initial discussions with suppliers, we understand that the recoverability of debt will vary depending on a number of factors relating to the debt. These factors are similar to the breakdowns that we would look to gather on debt in our first stage.

3.30. We have the option of applying different recoverability rates to different breakdowns of outstanding debt.

3.31. Once we have selected a source for the recoverability rates and have the information in an agreed consistent format, there are two methods we could use to estimate the level of debt that will not be recovered:

- we could apply suppliers' own assumptions (for a given combination of breakdowns) to their own outstanding debt.
- we could form a standardised set of assumptions (for a given combination of breakdowns) that could be applied across suppliers.

3.32. We discuss these choices further in our considerations.

### Discarded option

3.33. We do not intend to consider the option of basing the true-up on write-offs alone. Our initial engagement with suppliers has highlighted that they have different practices for when they write off debt. If we had to wait until nearly all suppliers had completed their write-offs in relation to a particular cap period, this could take a number of years.

3.34. Furthermore, the write-off value in a supplier’s accounts is only an accounting concept. There may be little practical difference between a debt where the provisions have been refined over a significant period of time and a debt which has been written off – we therefore do not consider that write-offs need to have taken place for us to carry out a true-up. As noted above, a write-off also does not represent certainty over the final level of debt, given that suppliers can still carry out collection activities after the debt has been written off.

### Comparison between options

**Table1: Comparisons between options**

	<b>Option A: ‘top-down’</b>	<b>Option B: iterative bad debt charge</b>	<b>Option C: Bottom up</b>
<b>Where is the judgment applied on the recoverability of debt?</b>	Relies on suppliers’ applying judgement through their provisioning and write-off methods	Same as option A	Ofgem sets the standardised format for processing the data or applying a standardised assumption on the recoverability of debt.
<b>Will the numbers provided by suppliers only relate to consumption billed in a given period?</b>	Yes – we ask for suppliers to look at a particular cap period of consumption	No – the bad charge contains provision movements and write-offs which will relate to a number of different periods of consumption. This could include pre-COVID periods. At later stages, it could also include post-	Same as option A

		COVID periods (ie periods for which we are not seeking to carry out a true up).	
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## Considerations

### Option A: top-down

3.35. Option A is simple in theory and involves suppliers’ best estimate from their accounts on how much debt will not be recovered.

3.36. The main concern with option A is the practicality of providing the data. In initial discussions, suppliers were unsure if they could provide the data required for this option. This is because it is difficult to tie provisions and write-offs back to a period of consumption. This is not necessary for suppliers’ business activities. Some provisions may also be inherently difficult to allocate to particular cap periods. We understand that in some cases suppliers may apply overlays – top-down additions to their provisions that reflect an overall accounting judgement on the appropriate provision, rather than being tied to particular consumption or debt.

3.37. Option A would also involve gathering data at one point in time. However, there would always be the potential for the final costs to differ from suppliers’ provisions at that point in time. There is a trade-off between the speed of the true-up and the degree of accuracy. Inaccuracy could lead to overfunding suppliers, in the event that some suppliers made significant upfront provisions for the expected impact of COVID-19 and had not fully adjusted these at the point we gathered data.

3.38. Some stakeholders suggested that provisions and write-offs are very subjective, and indicated that there is room for approaches to vary significantly between suppliers. This means that we would have to consider whether the results were driven by differences in provisioning methodologies rather than actual cost differences between suppliers.

3.39. COVID-19 could have impacted the recoverability of debt that existed prior to COVID-19. When considering the accuracy of any option we must consider if it can take into account debt incurred before COVID-19. Under option A, it would be difficult to consider these impacts as we focus on period of billed consumption.

### **Option B: iterative bad debt charge**

3.40. Option B aligns most closely with suppliers' accounts. This leads to a number of advantages.

- It uses the judgements they make based on their own data and knowledge of their customer bases.
- It would be easy for suppliers to provide data on something they produce for their accounts.
- Suppliers' accounts are audited on an annual basis, which provides some assurance of their provisioning and write-off methodologies.

3.41. Under option B, all impacts of bad debt relating to consumption in a given cap period should eventually be recognised, provided that the methodology includes sufficient cap periods. This is because we would be gathering data at multiple points in time, rather than gathering data only once in relation to a particular cap period of consumption. This means any inaccuracies in the initial provision would be reflected in the data we gather for subsequent accounting period through provision movements.

3.42. Suppliers will produce routine figures on the bad debt charge as part of their own management accounting. This means we could start trueing up more cap periods at an earlier stage in comparison to the other options.

3.43. However, we need to consider the reliability of this data. One way of gaining greater reliability in this data is to acquire audited data. Suppliers figures are audited annually, which means there is a lag between the data being produced for a particular accounting period and it going through the audit process.<sup>9</sup> This suggests that there may be a significant lag between a period finishing and actually acquiring the final audited data across all suppliers. We also may need to ask suppliers to explain or demonstrate how any data they have provided for this option relates to their audited accounts, given that the data we request may be more

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<sup>9</sup> We also understand that for some suppliers there can be a lag between when a suppliers' data has been audited and when it is made available publically available.

granular or the suppliers audited figures may include a greater scope than we are looking for.<sup>10</sup>

3.44. Option B would also make it easier to take into account the potential impact of COVID-19 on debts incurred before this. This is because any provision movements relating to existing debt would be included in the bad debt charge for a given cap period, alongside new provisions related to consumption in that cap period.

3.45. The main disadvantage of option B is that the bad debt charge will include new provisions for cap periods that may not be significantly impacted by the economic effects of COVID-19. For example, to true up cap period 6, we may want to consider data for at least the subsequent year (and potentially longer). This would imply collecting the bad debt charges for cap periods 7 and 8. The bad debt charges in these periods may be affected by other factors beyond COVID-19, and these factors may be more material than the provision movements relating to consumption in cap period 6.<sup>11</sup>

3.46. Furthermore, the new provisions would be based on accounting judgements by suppliers. There is a risk that suppliers could decide to set higher provisions (than in the baseline periods) in order to take a conservative approach given the risks around COVID-19. If these provisions then turned out to be too high, we would only be able to correct for this by continually carrying out true-ups. One supplier said that following an iterative process of trueing up the bad debt charge could take a number of years to realise the final costs.

3.47. Our initial discussions with suppliers suggest it may be difficult to provide a breakdown of the bad debt charge based on the payment method and tariff type on which the debt was incurred. Given option B is tied to the approach taken in suppliers' accounts, we may only be able to use the breakdowns available in their accounts. For example, suppliers may only split their bad debt charge by customers' current payment method and tariff type (rather than the payment method and tariff type on which the debt was incurred). This has a circularity

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<sup>10</sup> We discuss the possibility of acquiring audited data under this option because it more closely aligns with the auditing process suppliers conduct on a regular basis. However, to the extent that other options could require submission of audited data or reconciliation with audited data, this would also increase the time required for submission of data.

<sup>11</sup> In principle, provision movements in relation to consumption in a previous period should become smaller over time, as the amount of debt outstanding becomes smaller and as there is more clarity about the likelihood of recovery.

problem when seeking to understand the impact of these factors – for example, being on standard credit could be either a cause or a consequence of a customer going into debt.

3.48. In addition, we would only be able to use any breakdowns which were common across suppliers. This could limit the number of breakdowns we consider, if suppliers use different breakdowns for their own accounting purposes.

3.49. It is very difficult to isolate costs in relation to consumption in a particular cap period for option B. This makes the option less transparent and makes it harder to build credibility for the true-up value we propose. Customers and their representatives need to have confidence in the outcome of the true-up.

### **Option C: bottom-up**

#### *First stage considerations*

3.50. Option C starts with gathering objective data on the amount that customers have paid to date. This minimises the role of judgement. Unlike the other options we would not be solely reliant on suppliers' accounting methodologies, which could be influenced by different approaches. It also makes the approach very transparent and gives credibility to our outputs.

3.51. Gathering data from a bottom-up approach gives us the opportunity to gather different breakdowns of data. Looking at this data from a bottom-up approach gives us a direct measure of the impact of a given factor, instead of relying on a top-down comparisons between suppliers' customer characteristics and their amount of debt outstanding.

3.52. This allows us to possibly explore the option of identifying and controlling for a number of factors which could affect bad debt. This would be particularly important in the context of benchmarking at an efficient level.

3.53. We recognise that moving away from using suppliers' accounting figures to focus on requesting data from a particular period of billed consumption could have disadvantages. There could be practical issues with suppliers providing consistent data on the level of outstanding debt from a period of billed consumption. We understand that suppliers should be able to use account level data to identify their billed revenue. However, allocating repayments of debt back to the relevant period could be a challenge for suppliers given that we encourage suppliers to allow customers to repay their debt over longer periods of time. One supplier said that they could do this but would allocate any payments they receive to the oldest debt on a

customer's account. Given that we will be comparing a COVID-19 period with a baseline and COVID period, suppliers' approach to allocating payment to particular debts should be less issue of an issue as long as suppliers have kept a consistent approach.

3.54. We welcome any views from suppliers on the practicalities of providing this data.

#### *Second stage considerations*

3.55. Where judgement is required, option C gives us some degree of control in the source we use for estimating recoverability. It would be useful to gather information on all sources to get some sense of comparability. However, the source we select will determine the accuracy of our judgement and our ability to apply different recoverability rates to different groups of debt in a consistent format.

- A bespoke forecast is our preferred source as it allows us to gather information in a standard format and allows us to consider more granular breakdowns. However, these values would likely need to be checked against another source given that they are forecasts.
- Supplier provisions are likely to have variations in their methodologies which makes it difficult to get this information in a standardised format. This source limits the level of granularity that can be achieved.
- Historical data from suppliers would rely on an assumption that COVID-19 has not affected the recoverability of debt of a certain age. This could be useful as a point of comparison, but would not take into account any impacts of COVID-19 on recoverability.

3.56. This option still has a need for judgment and therefore has some of the same disadvantages of option A, that we are making a judgement at one point in time (for a given cap period of billed consumption), and that the final debt may be different from this.

3.57. We also need to consider the most appropriate method for applying the recovery rate to the data we obtain in the first stage.

- Applying suppliers' own information on the recovery rates to their own outstanding debt does ensure that the rate is only determined by their own information. The judgements suppliers will make should be based on their own



data and knowledge of their customer bases. This means it may be more applicable to only apply this to their own outstanding debt rather than influencing the recovery rates of other suppliers' outstanding debt levels.

- A standardised set of assumptions applied across all suppliers could be used to ensure that we are consistently applying recovery rates across suppliers. This could mitigate some of the risks of our bad debt estimates being influenced by individual suppliers' methodology or data. This reduces the impact of any outliers. If we adopted this approach we would need to consider how this interacts with our benchmarking exercise as differences in efficiency could materialise through either better recovery of debt to date, or better recovery of debt in the future.

3.58. There is also a potential distinction between the customer characteristics at the point of billing, which is the data we would gather in the first stage, and the customer characteristics at the point in time we assess its recoverability in the second stage. Our engagement with suppliers informed us that judgments on the recoverability of debt will depend on the characteristics of the debt when they make the assessment and not on the origin of the debt. We could mitigate this by gathering data in stage one split by both original and current customer characteristics. However, we understand that this would add further complexity to the data gathering exercise and we are not sure if suppliers could provide this data.

#### *Other considerations*

3.59. Like option A, it would be difficult to take into account the impact of COVID-19 on existing debt as we are looking at a particular period of billed consumption.

3.60. A minor point we also need to consider is that we might need to use an earlier baseline than 2019. Some revenue relating to consumption in 2019 would still be under collection in the period affected by COVID-19, and so would not be valid as a baseline. Ideally we would have a baseline as close as possible to the start of COVID-19, to increase the likelihood that any differences between the baseline and the COVID-19 period are due to COVID-19 itself, rather than other developments.

#### **Emerging thinking**

3.61. We currently prefer the bottom-up approach (option C), but recognise that there is no perfect source of data for determining the final bad debt costs relating to COVID-19. Below

we outline our thinking and weigh up the pros and cons of each option in terms of accuracy and practicality.

3.62. The bottom-up approach (option C) moves away from relying on suppliers' accounting methodologies and starts with an objective transparent value. It also allows us to gather different breakdowns of data which means we can identify and control for different factors which affect a supplier's bad debt. This will assist us with our benchmarking exercise. This option also limits the judgment required in comparison to other options, as we only apply judgement on the future recovery of each supplier's outstanding debt. We have outlined a number of practical concerns in gathering the data for first stage of this option and possible disadvantages in our considerations.

3.63. We are not confident that option A, 'top-down', is a data source we should use for the purpose of our true-up exercise. There are practical difficulties of gathering appropriate data for this option and it is unclear if we could attain accurate results across suppliers given its reliance on suppliers' various provisioning and write-off methodologies.

3.64. The iterative bad debt charge (option B) is not our preferred option for the data source but we recognise that it has a number of benefits. It has the benefit of ensuring that costs are true-up at some stage if there are sufficient cap periods. It also allows us to true up more periods at once and easily take into account the potential impact of COVID-19 on the recoverability of debt that incurred prior to COVID-19. However, we are concerned with the inaccuracy of including provisions for periods at the end of the iterative process that are not impacted by COVID-19. Not being able to isolate costs that relate to a particular period makes it harder to build credibility for the true-up value we propose and creates problems in communicating this to stakeholders. We also have practical concerns with suppliers providing consistent breakdowns of the bad debt charge and how this will impact the accuracy of our benchmarking exercise.

3.65. We welcome further comments on all of the options and our considerations. We also welcome any other suggestions from stakeholders on what source we should use to determine the additional bad debt cost of COVID-19.

## 4. Update on true-up timing

This chapter provides an update on when we aim to implement the first true-up. We also provide an indicative future timetable outlining our process to reach the first true-up, and we welcome any feedback on this.

### Target implementation date for first true-up

4.1. **We have decided that we will aim to implement the first true-up in cap period 9** (October 2022 to March 2023).<sup>12</sup>

4.2. This decision follows our initial engagement with stakeholders, both through our call for input and bilateral calls, as well as our own work. We consider that targeting a true-up in cap period 9 is the best approach for the following reasons.

4.3. First, initial stakeholder engagement and our own work show that there are advantages and disadvantages to each potential data source for determining the true-up, and that the choice between them is not straightforward. Taking more time will allow us to investigate these options further. This should give us greater confidence over the approach we ultimately propose.

4.4. Second, a cap period 9 true-up could improve the accuracy of the true-up. More time allows suppliers to gather more data to obtain a better understanding of the recoverability of debt during COVID-19. This may improve any estimates they produce on the level of debt they believe will not be recovered. There will also be less outstanding debt to account for as time progresses, given that customers will repay some debt over time. This would reduce the materiality of judgements about how much of the outstanding debt suppliers will ultimately be able to recover and potentially improve suppliers' estimates. These judgements will inevitably be difficult, especially as there are challenges in relying on partial historical data of debt repayment when COVID-19 is an unprecedented shock.

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<sup>12</sup> This remains subject to data availability and further stakeholder consultation.

4.5. Third, the timetable for a cap period 8 true-up would be very tight, especially given the need to gather data in advance of the final consultation. There would be a risk that we would be unable to deliver the true-up as intended. A cap period 9 true-up allows for a more resilient plan.

### **Scope of first true-up**

4.6. The first true-up would at a minimum relate to cap period 4 (April to September 2020). However, adopting a later true-up also means more data will be available and it is possible that we may be able to true up more than one cap period at once– for example, cap periods 4 and 5. This would be subject to bad debt data availability and further stakeholder consultation.

4.7. The scope of the first true-up is likely to depend on (at least) the following factors:

- the data source we intend to use (see Chapter 3);
- the timeframes required to gather data;
- further consideration of when there is sufficient clarity about how much debt will be recovered.

## **Next steps**

### **Working paper**

4.8. We welcome written comments from stakeholders in response to this working paper. Please send any comments to [retailpriceregulation@ofgem.gov.uk](mailto:retailpriceregulation@ofgem.gov.uk). Please include detail and supporting evidence in your comments wherever possible.

4.9. We are also keen to maintain our ongoing bilateral discussions with stakeholders on the true-up. If you would like to arrange a call, please contact us through [retailpriceregulation@ofgem.gov.uk](mailto:retailpriceregulation@ofgem.gov.uk). We are happy to speak either before or after you submit written comments.

### Indicative future timetable

4.10. Table 2 below shows an indicative future timetable for our work on the first true-up. We are publishing this to be transparent about our current best expectations for the progress of this workstream. However, this timetable is subject to change and refinement as we develop our understanding of the tasks required.

4.11. As part of responses to this workstream, we welcome any comments from stakeholders about the intended activities and timeframes in Table 2. We will consider these when updating our plans.

**Table 2 – Indicative future timetable for the first true-up**

Activity	Timeframe
Working paper on data source options (four weeks for comments)	June 2021
Policy consultation on the first true-up (four weeks for comments)	Early Autumn 2021
Draft RFI (one week for comments)	Early Autumn 2021
Final RFI (four weeks for responses)	Two to three weeks after policy consultation published
Final consultation on the first true-up, including possible disclosure process (six weeks for comments)	Spring 2022
Publish decision	Early August 2022

## Appendices

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## Appendix 1 – 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](mailto: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. i.e. a consultation.

### 3. With whom we will be sharing your personal data

We may share consultation responses with BEIS.

Please note that responses not marked as confidential will be published on our website. Please be mindful of this when including personal details.

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

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

### 5. 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 3<sup>rd</sup> 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.

**6. Your personal data will not be sent overseas**

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

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

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