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Consultation

Price Cap – Consultation on the true-up process for COVID-19 costs

Publication date:	19 November 2021	**Contact:**	Leonardo Costa, Head of Price Cap Policy
		Team:	Retail Price Regulation
Response deadline:	17 December 2021	**Email:**	retailpriceregulation@ofgem.gov.uk

This paper is part of our consultation process for assessing the true-up of COVID-19 costs in the default tariff cap. 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**. 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

The default tariff cap ('the cap') protects default tariff customers, ensuring that they pay a fair price for their energy, reflecting its underlying costs. In our February 2021 decision,[1] we concluded that the COVID-19 pandemic had resulted in additional debt-related costs for credit meter default tariff customers. We concluded that these costs were material in cap periods four to six (April 2020 to September 2021) and not allowed for through the existing cap methodology. We therefore included an additional allowance in the cap levels for cap period six (which started on 1 April 2021) and cap period seven (which started on 1 October 2021). We set this as a float, which we would "true up" later using final costs.

For cap period six, the COVID-19 adjustment allowance was £23.69 per typical dual fuel customer. The remaining float of £8.86 per typical dual fuel customer was applied in cap period seven.[2]

Overview

This document consults on how we plan to true up the additional float allowances we set for cap periods six and seven. We will determine the final additional debt-related cost incurred by suppliers as a result of COVID-19 and then compare this to the float adjustment. We will not be considering any non-debt-related impacts in the scope of this true-up.

Debt-related costs are bad debt costs, working capital costs and debt-related administrative costs. We outline our proposed approach and considerations for assessing the additional cost of each of these elements.

Bad debt costs

We propose to implement a cumulative bad debt charge approach and use data gathered via a request for information ('RFI') to calculate any additional bad debt costs due to COVID-19. We consider that this is the most proportionate approach, taking account of the exceptional nature of COVID-19 and the current market circumstances.

[1] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap. https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

[2] All values are measured for the typical domestic consumption values (TDCV) used to set the cap (3,100kWh for electricity and 12,000kWh for gas). Cap levels are GB averages, including VAT.

Other debt-related costs

We propose to collect debt-related administrative costs in a way which ensures that we can gather consistent data. We will set out the key cost areas that could have been impacted by COVID-19 but allow suppliers to provide us with additional information on other costs they consider were affected by COVID-19. We will then determine which of these categories to include when defining the relevant additional costs due to COVID-19.

We propose to calculate the additional debt-related working capital costs using a debtor days approach. We consider it is a direct way of understanding how suppliers' costs in relation to late payments have changed since COVID-19.

Benchmarking

We have considered whether to use a weighted average or lower quartile approach for suppliers recovering these costs. Given the exceptional nature of the pandemic (including potential impacts on the importance of non-efficiency factors driving supplier costs) and the limited duration for which the true-up allowance is in place, we believe it is appropriate to use a weighted average, ensuring that an efficient supplier can recover these costs.

Other considerations

We propose not to implement a sharing factor to share the impact of additional COVID-19 costs between suppliers and customers. This reflects the challenges suppliers are facing under the current market circumstances due to the recent increases in wholesale gas prices. However, we will reserve our final judgment on this subject to data from a Request for Information and the future costs customers will face.

Next steps

We are requesting responses by 17 December 2021. We intend to issue a final consultation in spring 2022. This would be followed by a decision in summer 2022. The first true-up would apply from 1 October 2022.

1. Consultation process

Consultation stages

March 2021 call for input

1.1. We published a call for input in March 2021 ('March 2021 call for input') on the true-up process for COVID-19 costs. This was to give stakeholders an opportunity to provide comments to inform our planning and future work.

June 2021 working paper

1.2. We published a working paper in June 2021 ('June 2021 working paper') that set out our initial thinking on the options for the data source for bad debt costs that we could use to calculate the true-up. The June 2021 working paper also provided stakeholders with an update on when we aim to implement the first true-up.

Ongoing engagement with suppliers

1.3. We have hosted three rounds of calls with suppliers. The first two rounds of calls were to engage in discussions around data source options and benchmarking, which we raised within the March 2021 call for input and the June 2021 working paper. The third round of the calls was to further test our thinking on these topics. We plan to continue this ongoing engagement throughout the true-up consultation process.

Next stage of consultation

1.4. We intend to publish our final consultation in spring 2022.

Related publications

1.5. The main documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018: http://www.legislation.gov.uk/ukpga/2018/21/contents/enacted
- Default tariff cap decision: https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

1.6. The main documents relating to reviewing the potential impact of COVID-19 on the default tariff cap are:

- June 2021 working paper on the true-up process for COVID-19 costs ('June 2021 working paper'): https://www.ofgem.gov.uk/publications/price-cap-working-paper-true-process-covid-19-costs
- March 2021 call for input on the true-up process for COVID-19 costs ('March 2021 call for input'): https://www.ofgem.gov.uk/publications/price-cap-call-input-true-process-covid-19-costs
- February 2021 decision on the potential impact of COVID-19 on the default tariff cap ('February 2021 decision'): https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap
- November 2020 consultation on 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
- September 2020 policy consultation on reviewing the potential impact of COVID-19 on the default tariff cap: ('September 2020 consultation'): https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation
- Impact of COVID-19 on retail energy supply companies – regulatory expectations from 1 July 2020: https://www.ofgem.gov.uk/publications-and-updates/impact-covid-19-retail-energy-supply-companies-regulatory-expectations-1-july-2020

How to respond

1.7. 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.

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

1.9. We will publish non-confidential responses on our website at http://www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

1.10. 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.

1.11. 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.

1.12. 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 statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 6.

1.13. 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

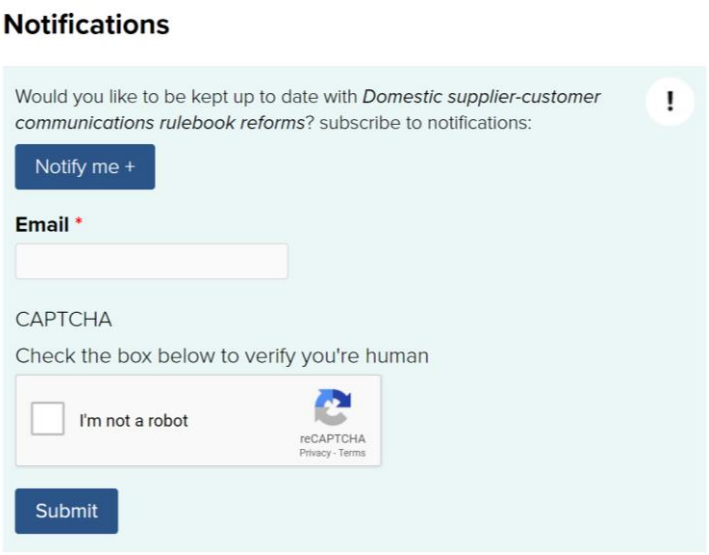
1.14. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We would also like to get your answers to these questions:

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?

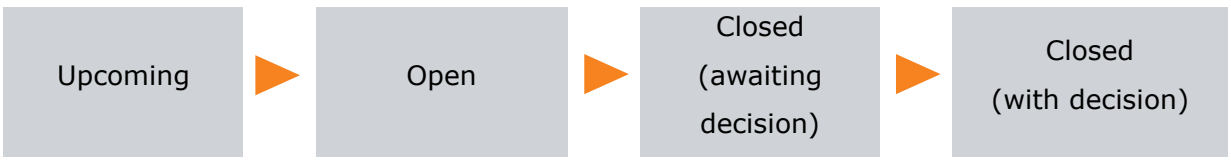
Please send any general feedback comments to stakeholders@ofgem.gov.uk

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.



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:



2. Introduction

What are we consulting on?

2.1. The default tariff cap ('the cap') protects domestic customers on standard variable and default tariffs (which we refer to collectively as 'default tariffs'), ensuring that they pay a fair price for their energy, reflecting its underlying costs. The cap is one of the key activities which fall within the outcome "consumers pay a fair price for energy and benefit from rights and protections" within our Forward Work Programme for 2021-22.[3]

2.2. We decided in February 2021 to introduce an adjustment in the cap to account for the estimated additional bad debt[4] costs as a result of COVID-19.[5,6]

2.3. This was an initial estimate, which we referred to as a float. We said that we would adjust this initial estimate to reflect the final costs once they are fully known (a 'true-up').

2.4. This consultation sets out our proposals and further thinking for how we plan to true up the impact of COVID-19 costs in the cap.

Background

2.5. We have issued two decisions on whether to introduce an initial adjustment to the price cap to account for additional COVID-19 costs:

- in February 2021, we decided to adjust the cap for the potential impacts of COVID-19 on bad debt costs for credit customers incurred in cap periods four to six (April 2020 to September 2021); and

[3] Ofgem (2021), Forward work programme 2021/22. https://www.ofgem.gov.uk/publications-and-updates/forward-work-programme-202122
[4] 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.
[5] 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
[6] We also made a subsequent decision in August 2021 to not include an additional allowance for cap period seven (winter 2021).

- in August 2021, we decided to not adjust the cap to account for the potential impacts of COVID-19 in cap period seven (October 2021 – March 2022) for credit customers, and cap periods four to seven for prepayment meter (PPM) customers' bad debt costs.[7]

2.6. The retail market is currently facing significant challenges as a result of unprecedented rises in gas prices. In light of the continued uncertainty over the impact on the future market, protecting consumers remains our key priority, while also considering the impact on suppliers' ability to finance their activities.

Structure of this consultation document

2.7. This consultation document has the following structure:

- Chapter 1 outlines our consultation process.
- Chapter 2 summarises our proposals and the structure of this document. It also provides a general introduction to the cap.
- Chapter 3 discusses our proposed approach for accounting for bad debt costs. It also explains the design of our calculation based on this proposal.
- Chapter 4 sets out our proposed approach for accounting for debt-related administrative costs and working capital.
- Chapter 5 sets out our proposed approach for benchmarking.
- Chapter 6 sets out our proposed approach for a number of cross-cutting methodological considerations.
- Appendices 1 and 2 provide further information on the options presented for our bad debt source proposal and their considerations. Appendices 3 and 4 contain further details on benchmarking. Appendix 5 presents further details on the options

[7] Ofgem (2021), Price Cap - Decision on the potential impact of COVID-19 on the default tariff cap: cap period seven. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-covid-19-default-tariff-cap-cap-period-seven

considered for the debt-related administrative data sources and appendix 6 outlines the privacy notice.

The default tariff cap

2.8. We set the cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act'). The objective of the Act is to protect current and future default tariff customers. We consider protecting customers to mean that prices reflect underlying efficient costs. In doing so, we must have regard to four matters:[8]

- 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; and
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

2.9. The requirement to have regard to the four matters identified in section 1(6) of the Act does not mean that we must achieve all of these. In setting the cap, protecting existing and future customers who pay standard variable and default rates remains our key priority. In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often a balance must be struck between competing considerations, particularly in light of the challenges presented in the current market crisis.

2.10. In setting the cap, we may not make different provisions for different holders of supply licences.[9] This means that we must set one cap level for all suppliers.

[8] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6). http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[9] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted

3. Bad debt costs

Chapter summary

We set out our proposed approach for calculating any additional bad debt costs due to COVID-19.

Summary

3.1. We are proposing to implement a cumulative bad debt charge approach to calculate any additional bad debt costs due to COVID-19. We propose to use data gathered via a request for information ('RFI') to do this.

3.2. We have also outlined what this approach means for the design and timing of the additional bad debt calculation.

- We propose to calculate the increment relative to the same months before COVID-19. We propose to use data from October 2018 to March 2019 for our winter baseline and from April to September 2019 for our summer baseline. This means each summer or winter cap period included in our calculation will remove an equivalent baseline period in the increment calculation before we sum across periods.

- We propose to gather data on payment type and tariff type when investigating the impact of the additional bad debt costs from COVID-19.

- We are proposing that our first true-up in cap period nine (October 2022-March 2023) would consider the bad debt charge costs for cap periods four, five and six (April 2020 – September 2021).

- We are proposing to treat cap periods four, five and six as the main cap periods that were affected by COVID-19.

- However, we propose to gather bad debt charge data for twelve months after these periods, to account for any provision movements. This means gathering

bad debt charge data on cap periods seven and eight (October 2021-September 2022).

Data source

Context

Factors to consider when assessing data source options

3.3. In our June 2021 working paper,[10] we outlined three key factors we would consider when assessing the most appropriate data source for bad debt costs, noting that this list was not exhaustive. These were: the accuracy of the data source for assessing the final bad debt costs, the feasibility for suppliers to provide the relevant data required, and the ability to control for certain customer base factors.

3.4. We have assessed our data source options against these factors and considered stakeholders' comments in response to our June 2021 working paper. We also recognise that, in the current market circumstances caused by increases in global gas prices, supplies are facing growing risks and uncertainties. We take these into consideration when determining our proposal.

Data source options

3.5. In our June 2021 working paper,[11] we outlined three data source options for determining additional bad debt costs due to COVID-19: the top-down approach, the cumulative bad debt charge approach and the bottom-up approach.

3.6. We have decided to discard the top-down approach. We provide an explanation of this approach, stakeholder views and our considerations in Appendix 1.

3.7. We discuss the remaining options and our considerations below.

[10] Ofgem (2021), Working paper on the true-up process for COVID-19 costs, paragraphs 3.4-3.5. https://www.ofgem.gov.uk/publications/price-cap-working-paper-true-process-covid-19-costs
[11] Ofgem (2021), Working paper on the true-up process for COVID-19 costs, paragraphs 3.4-3.5. https://www.ofgem.gov.uk/publications/price-cap-working-paper-true-process-covid-19-costs

Cumulative bad debt charge approach

3.8. The bad debt charge is an entry in the income statement in suppliers' accounts. It incorporates new provisions, provision movements and write-offs. For a particular accounting period, the bad debt charge would partly reflect new provisions, for example 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 consequent 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.

3.9. This means if a supplier was overly pessimistic or optimistic on its original provision, this would manifest itself in adjustments to provisions in the subsequent periods.

3.10. The total impact of bad debt in relation to a particular cap period of billed consumption would eventually be reflected in suppliers' accounts. However, this will be spread over a number of cap periods. As a result, the bad debt charge for a given cap period is not an estimate of the bad debt incurred due to consumption in that cap period.

3.11. This means that under this cumulative bad debt charge approach, we would need to gather data from all cap periods since the start of COVID-19 which are available at the time we do the true-up. We would then do a cumulative comparison against the baseline to ensure we capture the costs associated with COVID-19. The cumulative comparison is applied so that we capture any adjustments made to provisions over time. For further information, please see the detailed discussion in our 'Considerations- cumulative bad debt charge approach' section of this chapter.

3.12. We would then gather data again at a later stage to further refine this true-up value, as more data became available.

Bottom-up approach

3.13. This approach consists of two stages. The first stage would identify the outstanding debt. The second stage would assess the recoverability of the outstanding debt.

3.14. In the first stage, we would ask suppliers to provide us with their level of outstanding debt from a particular cap period of billed consumption[12] in the past.

3.15. This requires suppliers to use account level data to provide information on how much customers have been billed during a particular cap period. Suppliers would then need to calculate the level of outstanding debt in relation to a particular cap period of billed consumption by tying any payments received back to that cap period. Using account level data means that we could gather breakdowns of outstanding debt by a number of factors that we consider to be potentially relevant for our benchmarking exercise.[13]

3.16. In the second stage, we would assess the recoverability of the outstanding debt using a combination of data sources. Our primary data source would be a bespoke forecast from suppliers. We would also gather information on a supplier's recovery rates from their provisions and historical data.

3.17. Based on our 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 those included in the breakdowns that we would use in our first stage.

3.18. We would estimate the level of debt that will not be recovered by applying a supplier's own forecast (for a given breakdown) to its own outstanding debt for that breakdown.

3.19. Suppliers would be able to use the information available to them when providing forecasts for the second stage. For the baseline periods in particular, suppliers would be able to take into account actual data between the end of the first stage and the time we

[12] By billed consumption, we are referring to consumption that was billed for in a particular cap period.
[13] Throughout this paper we use the term 'factor' to refer to an individual characteristic (ie payment method). We use the term 'breakdown' to refer to a combination of different characteristics.

gather data. They would only need to use judgment for any residual recoverability after the time we gather data.

Proposal

3.20. We propose to use the cumulative bad debt charge approach as our data source for determining the additional bad debt costs due to COVID-19. We consider that this is the most proportionate approach while meeting the test we set out in our June 2021 working paper. It takes into account of the exceptional nature of COVID-19, and the current market circumstances.

Overview of responses

3.21. Four suppliers preferred the cumulative bad debt charge approach. However, one supplier said that the cumulative bad debt charge approach would allow suppliers to use their provision methodologies to manipulate the bad debt provision data.

3.22. Two suppliers agreed with the bottom-up approach. However, some suppliers raised their concerns with the bottom-up approach on the recoverability of debt that existed prior to COVID-19 and the practicality of providing the data required.

Considerations – Cumulative bad debt charge approach

3.23. Under the current market circumstances, we consider that the cumulative bad debt charge approach provides us with the best approach against the framework we have outlined in our June 2021 working paper. We set out our considerations below against each of the criteria we set out in our June 2021 working paper.[14]

Accuracy

3.24. Suppliers who preferred the cumulative bad debt charge approach in response to our June 2021 working paper said that this approach gave a more accurate reflection

[14] Ofgem (2021), Working paper on the true-up process for COVID-19 costs, paragraphs 3.4-3.5. https://www.ofgem.gov.uk/publications/price-cap-working-paper-true-process-covid-19-costs

(than the bottom-up approach) of the bad debt costs accrued due to the impact of COVID-19.

3.25. The cumulative bad debt charge approach provides a sufficient level of accuracy because it incorporates actual levels of non-payment, through revisions to provisions made during COVID-19. The cumulative position (original provisions, provision movements and write-offs) in relation to consumption during COVID-19 should reflect actual levels of non-payment.

3.26. However, under the cumulative bad debt charge approach, we would need to use bad debt charge data for periods beyond the main impact of COVID-19. This is to account for any provision movements beyond the last of the periods of the main COVID-19 impacts to ensure we reflect the final bad debt cost rather than the original estimate from the provisions. We recognise that COVID-19 may have some residual impacts on cap periods beyond those mainly affected. For example, the end of the furlough scheme may affect some customers' financial situations.

3.27. The bad debt charge in a future period will be a combination of provision movements related to consumption in previous cap periods, which are relevant to our work on the additional debt-related costs of COVID-19, and new provisions related to consumption in that cap period, which are not relevant (except to the extent that there are residual impacts of COVID-19).[15]

3.28. Suppliers have different approaches to provisions, but we consider there are generally two elements that can be applied:

- a mechanical element that relies on using data on past recoverability of debt to determine the current recovery rates; and

- a forward-looking element, which will use macro-economic data to inform a judgment about whether future recoverability is likely to be better or worse than in the past.

[15] We are primarily interested in those periods which are mainly affected by COVID-19. However, we recognise that COVID-19 may have some residual impacts on cap periods beyond those mainly affected.

3.29. If a supplier only applies a mechanical approach, then we expect that there is a risk that using periods beyond the main impact of COVID-19 will overstate the allowance. This is because new provisions for future periods will be influenced by the recovery rates experienced during COVID-19.

3.30. Where a supplier applies a forward-looking element as well, this could help to make the provision a more accurate reflection of likely future costs. As the economy returns to normal, a forward-looking element should result in lower provisions, which are closer to the levels in the baseline period. However, this assumes that suppliers are able to reduce their provisions. There may be other reasons which mean that suppliers would have higher provisions in future cap periods compared to the baseline. In any case, the forward-looking element will still be subject to uncertainty.

3.31. Specifically, these new provisions could be affected by factors beyond COVID-19, such as an increased risk of debt due to high energy prices or by any changes to the judgments suppliers make as part of their provisioning methodologies. This means there is a risk that the new provisions are higher than those in the pre-COVID-19 baseline period and would therefore lead to us overstating the additional costs of COVID-19.

3.32. We need to consider how we would separate the effect of COVID-19 from other factors beyond COVID-19. There are two effects we need to consider: the increase in energy prices (ie known events) and any unknown future events.

3.33. We propose to mitigate the impact of the increase in energy prices on the bad debt charge by calculating the increment in percentage point terms (rather than as an absolute value). We cannot however remove the impact of higher energy prices on the propensity of customers to incur debt under this approach.

3.34. For the unknown future events, there is an inherent risk that the bad debt charge will be affected by any future events. We propose to limit the impact that unknown future events could have by limiting the cap periods that we would consider as part of the true-up. We propose to limit this to twelve months after the cap periods that are mainly affected by COVID-19. We cannot fully mitigate against this risk. Limiting the number of periods also means that the residual impact from COVID-19 impacts may not be fully captured. We welcome stakeholders' views on whether there are any potential additional mitigations for unknown events, so we can focus on the impact of COVID-19.

Audited data

3.35. Related to accuracy, we recognise that there is an advantage to the cumulative bad debt charge approach in that some of the bad debt charge data will go through an audit process.

3.36. However, there are also limitations to this benefit, given that any breakdown we request that is not part of preparing the figures in suppliers' accounts (ie tariff type) will not go through this audit process.

- Our discussions with suppliers highlighted that a breakdown by tariff type was not part of their routine accounts. Any assumption that they did apply for the purpose of our request would not have gone through the usual audit scrutiny.

- Some suppliers noted that they applied the forward-looking element of their provision, the overlay, at a domestic group level. This also implies that any breakdown of this overlay would not be subject to audit, which limits the assurance of data accuracy that the audit provides.

3.37. One supplier said that in order to mitigate any issues in the reliability of the data collected, we should engage with suppliers to understand their different methodologies. If we had any major concerns with the credibility of some suppliers' approaches, then these could be discounted when forming a benchmark.

3.38. In our June 2021 working paper, we also flagged that there might be a lag between producing the data for an accounting period and the data being audited. We said that this could hinder our ability to true up more than one period. We discuss this in more detail at the bottom of this chapter in the section 'Design and timing of the additional bad debt cost calculation', where we consider the data to gather for the true-up process.

3.39. We are not proposing to use suppliers' audited data but reserve the right to check our findings against the audited data in future. We consider that this proposal will allow us to carry out the true-up process in a reasonable timeframe whilst also providing a good level of assurance.

Practicality

3.40. The bad debt charge from suppliers' accounts is likely to be the most practical data for suppliers to provide and is easier to provide in comparison with the bottom-up

approach. Suppliers already need to produce a bad debt charge for their own accounts. Requesting suppliers' bad debt charge data should also reduce the volume of data they need to provide (compared with the bottom-up approach), given the bad debt charge is limited in the number of customer base factors it can be broken down into.

3.41. Ideally, we would like to gather a breakdown of the bad debt charge by certain customer base factors and not the high-level figure produced in suppliers' accounts. This would be to assist with our allocation exercise. We consider that suppliers should be able to provide the bad debt charge broken down by payment type and tariff type. However, any further breakdowns are unlikely to be readily available and would likely require additional work for suppliers to make assumptions.

Benchmarking constraint

3.42. We would ideally select a data source that can be broken down by a number of customer base factors. This would provide us with more evidence on the impact of these factors on bad debt across suppliers and enable us to potentially control for certain customer base factors when benchmarking. Controlling for these factors would be particularly relevant the more stringent the benchmark.[16] It is however less relevant given our proposal to use a weighted average benchmark (see Chapter 5).

3.43. The bad debt charge is limited in the number of customer base factors it can be broken down into. Our discussions with suppliers and experience from requesting breakdowns of the bad debt charge previously (for our decision on the cap period seven float[17]) suggest that suppliers' systems do not easily provide a breakdown of the bad debt charge by tariff type. Many suppliers have also noted in our engagement calls that they would need to apply assumptions in order to produce these figures. However, some suppliers mentioned they might be able to provide breakdowns by payment method and tariff type for the bad debt charge if they were given enough time to prepare.

3.44. Suppliers normally produce a bad debt charge for the purpose of their routine internal accounts and also for their external accounts. This is normally a high-level figure,

[16] For the avoidance of doubt, using a more stringent benchmark is not contingent on our ability to control for any relevant customer base factor.
[17] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap: cap period seven. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-covid-19-default-tariff-cap-cap-period-seven

for example, at a supplier group level or across all a supplier's domestic customers. A supplier will only have a more granular breakdown of its bad debt charge if it uses this as part of its calculation of the bad debt charge for its accounts. This means that the granularity of breakdowns will differ between suppliers if they adopt different methodologies. Given we propose to use a weighted average benchmark (see Chapter 5), we therefore do not consider that we need to gather granular data on customer base factors to potentially allow us to control for them. If some suppliers have above-average costs and others have below-average costs, in each case due to their customer bases, the weighted average will still reflect the overall customer base.

Considerations – bottom-up approach

3.45. We consider that the bottom-up approach could provide more accurate data on suppliers' additional bad debt costs due to COVID-19 than the cumulative bad debt charge approach. It would also enable us to gather breakdowns of outstanding debt by a number of customer base factors that could be relevant for benchmarking. However, it is complex and would require a significant amount of data from suppliers. We currently consider that it is not a proportionate approach – we do not consider that the additional complexity is justified given the potential size of the true-up adjustment and our proposal to use a weighted average benchmark.

Accuracy

3.46. The first stage of the bottom-up approach would collect actual data on the amount recovered by suppliers. This stage would therefore be accurate, as it does not require any judgment.

3.47. However, there is uncertainty in how much of the residual amount, the outstanding debt at the end of the first stage, will eventually be collected. The aim of the second stage is to make an assessment of the level of debt that will not be recovered. For a particular supplier, this is achieved by assigning a recovery rate to each breakdown of outstanding debt it has provided in the first stage.

3.48. Determining this recovery rate for the second stage of the bottom-up approach would require a level of judgment. This is because suppliers will generally need to be making forecasts for future recoverability, rather than relying on historical data.

3.49. Please see Appendix 2 for further detail on supplier feedback on the bottom-up approaches and our considerations.

Impacts on the recoverability of debt existing prior to COVID-19

3.50. Three suppliers said that their main concern with the bottom-up approach was that it did not consider the impact on the recoverability of debt that existed prior to COVID-19.

3.51. We acknowledge that COVID-19 has potentially impacted the recoverability of debt that existed prior to COVID-19. If we were using the bottom-up approach, we would amend our methodology so that we could account for this potential impact. We consider that, under the bottom-up approach for bad debt, gathering data for cap periods two and three (April 2019 – March 2020) would be sufficient to account for the impact on pre-COVID-19 debt. This would involve gathering data on billed consumption a year prior to the impact of COVID-19. We consider that gathering data in any periods prior to those proposed would risk capturing changes in the recoverability of debt that were not due to the impact of COVID-19.

Practicality and constraints on benchmarking

3.52. Two of these suppliers also raised concerns about the practicality of the data required for the bottom-up approach.

3.53. If we were using the bottom-up approach, in the first stage of the bottom-up approach, we would ask suppliers to use account-level data to produce figures on the level of outstanding debt broken down into a number of different factors.

3.54. In the second stage of this approach, we would collect information from suppliers on their bespoke forecasts of the outstanding debt's recoverability, provisions, and information on their historical collection data.

3.55. There are a number of benefits of gathering granular data in the bottom-up approach. In the first stage, we would be able to assess and determine whether any factor has had a material impact on suppliers' overall debt levels, and we would be then able to potentially control for these factors for our benchmarking exercise. In principle, COVID-19 could affect both the recovery of debt to date and also future recoverability, so gathering granular information at both stages delivers a higher degree of accuracy.

3.56. Having more granular data could help us to better understand the extent to which variation in costs between suppliers was due to efficiency or other factors. This could help

support our choice of benchmark, including in the event that we were intending to use a more stringent benchmark.

3.57. However, relative to the cumulative bad debt charge approach, this approach requires suppliers to provide significantly more data. This is because it is broken down into more customer base factors, and we require data for the first and second stages. We recognise it would be more challenging for suppliers to extract data for the bottom-up approach than for the cumulative bad debt charge approach. We have taken this into account as part of considering the proportionality of this approach, particularly in the context of current market circumstances.

Design and timing of the additional bad debt cost calculation

Context

3.58. We have proposed to use the cumulative bad debt charge approach as our data source for determining the additional bad debt costs due to COVID-19. We now need to consider what this proposal means for points on the design and timing of the additional bad debt costs calculation. These include:

- the cap periods we gather data for to control for the impact of COVID-19 on the recovery of debt that was incurred pre-COVID-19;
- the periods we intend to use for our baseline;
- the breakdowns of data based on customer base factors we intend to gather data on; and
- the cap periods we intend to true up and what this means in terms of the data we gather for the true-up process.

Proposals

3.59. We intend to gather data from April 2020 onwards to take into account the impact on the recoverability of debt incurred during COVID-19. We consider that this will be

sufficient because it captures the changes in provisions for debt incurred before the COVID-19 period.

3.60. We need to calculate the incremental change in costs in a cap period relative to a baseline before COVID-19. We propose to calculate the increment relative to the same months before COVID-19, to avoid seasonality impacts. We propose to use data from October 2018 to March 2019 for our winter baseline and April to September 2019 for our summer baseline. This means each summer or winter cap period included in our calculation will have an equivalent baseline period. We consider the proposed baseline reaches the correct balance in ensuring that it is free from any COVID-19 impacts but also recent enough to mitigate the risk of factors outside of COVID-19 impacting the results.

3.61. We propose to gather data on the following factors when investigating the impact of the additional bad debt costs from COVID-19:

- payment method (direct debit /standard credit /pre-payment meter (PPM)); and
- tariff type (fixed/default).

3.62. Gathering these breakdowns enables us to ensure that the correct costs are in scope and that we have evidence to support our cost allocation exercise.

3.63. We propose to true up debt that was incurred in cap periods four, five and six (April 2020 – September 2021) in cap period nine. We consider that these are the main periods impacted by COVID-19. We also propose to gather bad debt charge data for twelve months from the end of the main cap periods impacted by COVID-19 costs to account for any provision movements. This is to ensure we reflect the final bad debt cost rather than the original estimate from the provisions. This means gathering data on cap period seven and eight to account for any provision movements from the cap periods mainly impacted by COVID-19.

Overview of responses

3.64. In response to our June 2021 working paper, one supplier said that the cumulative bad debt approach naturally took account of the impact of COVID-19 on the recoverability of pre-existing debt.

3.65. In response to our June 2021 working paper, one supplier said that it was important that our baseline was set using a comparable historical cap period that allowed us to account for the impact on debt that was incurred prior to COVID-19.

3.66. In our discussions with suppliers and in response to our June 2021 working paper, several suppliers said that it was possible to gather data for the cumulative bad debt charge broken down by payment and tariff type. One supplier said that payment method was a particularly important factor to determine the comparability of provisions between suppliers as it was one of the main factors in the provisioning methodology.

3.67. In response to our decision to perform the first true-up in cap period nine,[18] one supplier agreed with our position. It acknowledged the need for time to determine the appropriate data source and for us to gather and assess the necessary data in advance of any final decision. Another supplier disagreed with this decision. As we were starting the true-up later, it said that it was necessary to include more cap periods in the scope of the first true-up under any data source approach.

Considerations – Impact on the recoverability of debt incurred pre-COVID-19

3.68. Suppliers will have a historical level of outstanding debt related to consumption that occurred before COVID-19. The recoverability of this debt could be impacted by COVID-19 in two broad ways.

- Changes in customers' circumstances - COVID-19 has had an impact on customers' income and put some customers in financial difficulty. In particular, there are customers who were already struggling to pay bills who have found themselves in worse financial positions.[19] This impact could reduce the likelihood of recovering debts from customers that were incurred prior to COVID-19 and were still outstanding when COVID-19 began.

- Changes in suppliers' ability to recover debt - COVID-19 and the subsequent social distancing restrictions impacted a supplier's ability to carry out its normal site visits and follow its normal debt collection process. Debt collection

[18] Subject to data availability and further stakeholder consultation.
[19] Citizens Advice (2020), Near the cliff-edge: how to protect households facing debt during COVID-19. https://www.citizensadvice.org.uk/cymraeg/amdanom-ni/our-work/policy/policy-research-topics/debt-and-money-policy-research/near-the-cliff-edge-how-to-protect-households-facing-debt-during-covid-19/

activities were paused for a period, and there were also impacts on a supplier's ability to take legal action.[20] These impacts could reduce the likelihood of recovering debt that was incurred prior to COVID-19. Although suppliers would have been able to resume debt collection activities at a later date, the delay could have reduced the effectiveness of such activities. For example, a supplier might no longer have accurate contact information for a customer if they had moved house.

3.69. We therefore propose to account for the impact on the recoverability of debt incurred prior to COVID-19. We consider that, under our cumulative bad debt charge approach, gathering data from April 2020 onwards will be sufficient to account for the impact of the pandemic on pre-COVID-19 debt. Any impacts on the recoverability of debt pre-COVID-19 will manifest in provision movements in later accounting periods. This means that gathering data from the start of COVID-19 will capture any provision movements from the debt that was originally incurred pre-COVID-19.

3.70. We recognise that restrictions were put in place from late March 2020 and that there is a possibility that some provision movements related to the expected impact of COVID-19 may have been put into this accounting period (ending 31 March 2020). However, we do not consider that this means we should also gather bad debt charge data for March 2020. We do not expect that there would be material COVID-19 impacts from part of one month (given that restrictions were imposed in the latter part of that month). There would also be a risk of including non-COVID-19 impacts that impacted the bad debt charge, particularly given that we would likely need to gather data for the whole of cap period three (October 2019 to March 2020), for consistency with the rest of our analysis.

Considerations – baseline period

Controlling for seasonality

3.71. For each cap period that we are assessing for the true-up, we propose to calculate the increment relative to the same months before COVID-19. The alternative would have been to look at a calendar year for the baseline. We propose to do this by choosing a six-month summer baseline period and a six-month winter baseline period. For each cap

[20] BEIS (2020), Government agrees measures with energy industry to support vulnerable people through COVID-19. https://www.gov.uk/government/news/government-agrees-measures-with-energy-industry-to-support-vulnerable-people-through-covid-19

period we assess as part of the true-up, we would remove an equivalent summer or winter baseline period in our increment calculation. We would then sum the incremental values to ensure we look at a supplier's cumulative additional costs from COVID-19.[21]All our calculations are done as a percentage of revenue in a given period. We discuss this proposal and considerations further in chapter six, section 'Accounting for changes in consumption and energy prices over time'.

3.72. We consider our approach to be appropriate in order to control for seasonal patterns in debt-related costs (reflecting the seasonality of consumption).

Baseline options

3.73. The baseline must be before any of the cap periods that we are truing up. Any cap period that we are truing up is potentially affected by COVID-19. If the baseline was affected by COVID-19, then the difference in costs between the baseline and the cap period we were truing up would understate the impact of COVID-19.

3.74. Table 3.1 below shows which six-month periods are options for the baseline, and which are not, because they are cap periods we are proposing to true up.

[21] For example, assume we were assessing cap periods four, five and six (April 2020 – September 2021). Cap periods four and six are summer periods and cap period five is a winter period. We would use our selected summer baseline period for the increment calculations for cap periods four and six. We would use our selected winter baseline for the increment calculation for cap period five. We would then sum the increments across these periods to ensure to ensure we look at a supplier's cumulative additional costs.

Table 3.1 – Options for the baseline

Six-month period	Is this an option for the baseline?
October 2017 to March 2018	Yes
April 2018 to September 2018	Yes
October 2018 to March 2019	Yes (proposal)
April 2019 to September 2019	Yes (proposal)
October 2019 to February 2020 (scaled up)[22]	Yes
April 2020 to September 2020	No – cap period we are proposing to true up (cap period four)
October 2020 to March 2021	No – cap period we are proposing to true up (cap period five)
April 2021 to September 2021	No – cap period we are proposing to true up (cap period six)

Selecting a baseline that is recent

3.75. We also want the baseline to be recent to reduce the scope of other factors beyond COVID-19 impacting the change in debt-related costs.

3.76. In the context of our proposal to use a weighted average benchmark (see Chapter 5), we do not need to consider changes in individual suppliers' costs, as we are only interested in developments which affect costs across the market.

3.77. The main potential development at market level is a change in efficiency. Suppliers' debt management performance and collection processes may improve or get worse over time. Any change in efficiency from the baseline period could impact their incremental debt-related costs. The Act requires us to have regard to the need to create incentives for holders of supply licences to improve their efficiency. A more recent baseline allows suppliers to retain any improvements in efficiency. Changes in the characteristics of a supplier's customer base (eg due to growth, change in supplier policy or acquisitions) may change its exposure to debt-related costs. For example, if a supplier acquired customers who were more likely to enter into debt which would lead to costs,

[22] Under this option we would not include March 2020 data in the baseline. The data in this month could be impacted by COVID-19, given restrictions were put in place from late March. Instead, to calculate the float, we scaled up the October 2019 to February 2020 period to produce a six-month baseline.

then its change in debt-related costs from the baseline may seem high, due to its relatively low baseline.

3.78. These factors outside of COVID-19 are limitations that we need to accept in any approach we take, given that we are looking at data at different points in time to estimate the impact of COVID-19. However, having a baseline that is recent mitigates the impacts these factors may have on our results.

The trade-off

3.79. There is a trade-off between selecting a baseline that is recent and selecting a baseline that is free from any COVID-19 impacts.

3.80. We have outlined reasons why keeping the baseline close to the period being trued up is important. However, for this exercise, we want the baseline to be a period of time that has not been impacted by COVID-19. We consider this takes priority over ensuring the baseline is current – we want a comparison between a COVID-19 and non-COVID-19 period to improve the accuracy of the additional costs we calculate.

3.81. One option for our winter baseline is to gather the bad debt from October 2019 to February 2020 and then scale this up to a six-month period. We do not consider this to be our preferred option as this requires suppliers to provide bad debt data on a monthly basis to be able to calculate this figure. We consider that this adds unnecessary complexity. We also prefer to use actual data instead of making an assumption by scaling up.

3.82. Our proposal is instead to use the October 2018 to March 2019 period as our winter baseline. We also propose to use the April 2019 to September 2019 period as our summer baseline. We consider that these periods strike the right balance between ensuring that the baseline is not impacted by COVID-19 and gathering data for a recent period.

Considerations – Factors we intend to gather data on

3.83. Throughout this paper, we use the term 'factor' to refer to an individual characteristic (eg payment method). We use the term 'breakdown' to refer to a combination of different characteristics.

3.84. There is a trade-off between gathering data on more factors to improve the accuracy of our assessment and the additional complexity for suppliers from requesting data on each factor.

3.85. In Table 3.2 we have summarised the shortlist of proposed factors that could impact bad debt (or by which bad debt could vary) which we intend to consider as part of our cumulative bad debt charge approach. Table 3.2 also includes a summary of our rationale for gathering this data in each case. Some suppliers informed us in our engagement with them that they should be able to provide their bad debt charge broken down by payment type and tariff type. They also noted that any further breakdowns would be difficult to provide and hard to obtain on a consistent basis across suppliers.

3.86. We expand on our reasoning for gathering each breakdown in our 'Considering customer base factors' section in Chapter 5.

Table 3.2 - Factors we intend to gather data on

Factors	Rationale for gathering data
Payment method (DD/SC/PPM)	Primarily for evidence to allocate between payment methods
Tariff type (Fixed/Default)	To ensure we have the correct costs in the scope (ie to focus on costs for default tariff customers).

Considerations – The data we gather for the true-up process

Using audited data or management accounts

3.87. The cumulative bad debt charge approach uses data on suppliers' bad debt charge. We have the option of using data from suppliers' management accounts or using supplier audited data. Our proposal will impact the number of cap periods we can include in our true-ups (at any point in time) and how many true-ups we will need.

3.88. Data from suppliers' management accounts would be produced on a routine basis and available not long after the end of an accounting period. This means we could include more periods in our first true-up. The disadvantage of this approach is that we would not capture any amendments made to the bad debt charge following the audit process.

3.89. If we were to use audited data then we consider that we should gather data from suppliers after they have all followed their usual audit process. The alternative option would be to request a bespoke audit from suppliers, that changed the scope of data to be audited and/or changed the timeline for when data in their accounts are audited. We consider that a bespoke audit would significantly increase the cost and regulatory burden on suppliers which we consider to be disproportionate for the true-up exercise.

3.90. We recognise that there is a lag between when a bad debt charge is produced for management purposes and when it is audited. We also understand that suppliers in our sample will prepare accounts at different times. To use consistent audited data across suppliers, we would therefore need to wait until the last supplier in our sample audits their data. This would significantly increase the time it takes for us to carry out the full true-up process.

3.91. We propose to use suppliers' management accounts over waiting for audited data. We consider that this ensures we can carry out the true-up process in a reasonable timeframe. We recognise this presents a risk that the bad debt charge figures may not be 'final'. However, suppliers have informed us through our engagement that they produce all bad debt charge figures bearing in mind the prospect of future audits and the methodology they follow to produce figures is heavily scrutinised by auditors. We also intend to engage with suppliers on any audited figures in future and reserve the right to make future amendments to the cap if we consider that the final figures are considerably higher than what was provided. Therefore, it is imperative that suppliers maintain updated management accounts (we can assume these are edited monthly and they would contain recent adjustments to levels of debtors and provisions and write offs of bad debts.

The data we include in our first true-up

3.92. Our proposal to use suppliers' management accounts as our source for bad debt charge means that more periods will be available to true-up (than if we were to use audited data).

3.93. We are proposing to gather bad debt charge data on periods that are available when we issue our RFI for a true-up. This means bad debt charges for cap periods four, five and six (April 2020 -September 2021) will be available in time for our first true-up.

3.94. We recognise that the cap period seven (October 2021 – March 2022) bad debt charge may be available in time for our decision, but we do not think it is feasible to include this in time for our first true-up in cap period nine. We need time for the bad debt data to become available and time to gather and analyse data prior to following an appropriate consultation process on each true-up.

Process for future true-ups

3.95. As we have described above, the bad debt charge includes any upwards or downwards adjustment that may be needed to the provisions made in prior periods. If a supplier was overly pessimistic or optimistic on its original provision, this would manifest itself in adjustments to provisions in the subsequent periods.

3.96. This means we need to gather bad debt charge data for the accounting periods that we consider are mainly impacted by COVID-19, and also for cap periods beyond the cap periods that are mainly impacted by COVID-19. This is to ensure we account for provision movements that materialise in subsequent periods.

3.97. We propose to true up debt that was incurred in cap periods four, five and six (April 2020 – September 2021) in cap period nine. We consider that these are the main periods impacted by COVID-19. We recognise that COVID-19 may have some residual impacts on cap periods beyond those mainly affected. For example, the end of the furlough scheme may affect some customers' financial situations.

3.98. However, we consider that our proposal should still account for some of these residual impacts as a by-product of gathering data for cap periods beyond those which are mainly impacted by COVID-19. This data will include any new provisions for debt related to COVID-19 in the cap periods beyond those which are mainly impacted by COVID-19. However, our proposed methodology will not include all subsequent provision movements in relation to debt incurred in such periods.

3.99. We have considered three options for the appropriate length of time to gather data after the cap periods that are mainly impacted by COVID-19, to capture a sufficient amount of the provision movements:

- six months from the from the end of the last period we are truing up (ie gathering the bad debt charge for cap period seven;

- twelve months from the from the end of the last period we are truing up (ie gathering the bad debt charge for cap periods seven and eight); and

- eighteen months from the from the end of the last period we are truing up (ie gathering the bad debt charge for cap periods seven, eight and nine);

3.100. We are proposing to gather bad debt charge data for cap period seven (October 2021 – March 2022) and cap period eight (April 2022 – September 2022) to account for provision movements from the main cap periods impacted by COVID-19. These will be accounted for in future true-ups, see Table 3.3 for further details.

3.101. As discussed in our considerations of this option, gathering data beyond the end of main impacts of COVID-19 presents a risk that we capture factors beyond COVID-19. These could include an increased risk of debt due to high energy prices or any changes to the judgments suppliers make as part of their provisioning methodologies. We therefore want to limit the amount of this data we use to mitigate the impact these non-COVID-19 factors could have on our allowance.

3.102. We consider that twelve months provides the right balance of limiting the number of periods we use after COVID-19 and ensuring we allow sufficient time for suppliers to go through their debt collection activities and make adjustments to their original provisions. We consider that only allowing six months does not provide sufficient time for suppliers to complete their debt collection activities. We recognise that using 18 months would provide extra time for suppliers to refine their provisions. However, we do not consider that this approach necessarily improves accuracy, given the risk that using extra periods could introduce more non-COVID-19 impacts into our calculation.

3.103. Table 3.3 summarises our proposals for when the bad debt charge for each accounting period is recovered in the true-up process.

Table 3.3 – When each bad debt charge will be trued up

Bad debt charge accounting period	What data is being used for	Adjustment cap period
Cap period four (April 2020 – September 2020)	Cap period being trued-up	Cap period nine (October 2022 – March 2023)
Cap period five (October 2020 – March 2021)	Cap period being trued-up	Cap period nine (October 2022 – March 2023)
Cap period six (April 2021 – September 2021)	Cap period being trued-up	Cap period nine (October 2022 – March 2023)
Cap period seven (October 2021 – March 2022)	Post COVID-19 period used to capture provision movements from periods being trued-up	Cap period ten (April 2023 – September 2023)
Cap period eight (April 2022 – September 2022)	Post COVID-19 period used to capture provision movements from periods being trued-up	Cap period eleven (October 2023 – December 2023)

4. Other debt-related costs

Chapter summary

This chapter sets out our proposal to adjust for debt-related administrative costs and working capital costs in the COVID-19 true-up. We discuss the approach we will use to gather data.

Summary

4.1. We propose to adjust for debt-related administrative costs and working capital costs in the COVID-19 true-up.

4.2. In this chapter, we discuss the options we have considered to collect debt-related administrative cost and working capital cost data. We set out our proposed options.

Debt-related administrative costs

Context

Defining debt-related administrative costs

4.3. We expect that COVID-19 has increased the level of customer debt in the domestic energy market. We consider that the number of customers in debt and the value of their debt are likely to be positively correlated with debt-related administrative costs, whereby any increases in the number and value of customer debts are also likely to increase debt-related administrative costs. For example, a higher number of customers in debt is likely to result in additional printing and postage costs for communicating with customers about their debts.

4.4. In our November 2018 decision to implement the cap, we did not define debt-related administrative costs. Instead, we laid out some costs that should be considered in debt-related administrative costs, such as:

- the additional administration and collection costs of debt (as opposed to the bad debt itself);

- additional bill printing and postage; and

- customer service costs from a higher propensity to call, for example, to pay their bill.[23]

4.5. For the COVID-19 true-up adjustment, we define debt-related administrative costs, at a high level, as administrative costs incurred by suppliers when seeking to recover debt and, in the case of PPM customers, also any administrative costs when customers incur debt. There are different views among suppliers on which costs should be included, therefore a high-level definition would allow us to be flexible to consider the range of costs that suppliers have incurred.

Consideration of debt-related administrative costs for the float

4.6. In our February 2021 decision on the float, we decided not to include an adjustment for debt-related administrative costs. This was because of the poor quality of the data received from our voluntary RFI.[24] In our August 2021 decision on the float for cap period seven, we also decided not to include an adjustment for debt-related administrative costs. This was because the lower quartile benchmark for the incremental debt-related administrative costs for credit and PPM customers for cap period seven was not material.[25] We said that we would consider debt-related administrative costs as part of the COVID-19 true-up.

Options for collecting debt-related administrative costs

4.7. We have considered three options to collect debt-related administrative costs. In each option, we would like to ask suppliers for their total debt-related administrative costs split by tariff type and payment method. We will engage with suppliers through the

[23] Ofgem (2018), Default tariff cap- decision – overview, November 2018, Appendix 8, paragraph 2.24. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[24] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap February 2021, paragraph 4.29. https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/decision_on_the_potential_impact_of_covid-19_on_the_default_tariff_cap.pdf
[25] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap: cap period seven August 2021, paragraph 4.15. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-covid-19-default-tariff-cap-cap-period-seven

draft RFI process to understand whether they are able to provide data split by tariff type and payment method.

4.8. These three options relate to the information we would ask suppliers to provide alongside the total figure we request on debt-related administrative costs:

- Flexible – we would set out a high-level description of debt-related administrative costs, but would not provide specific definitions of which costs to include or request a specific breakdown. Rather, we would ask suppliers to provide supporting information on what costs they have considered and how they have calculated them.

- 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.

- Hybrid - we would set categories and ask for breakdowns. We would also allow suppliers to put forward any additional debt-related administrative costs not covered by the categories, and to explain why we should consider them. We would also ask suppliers to provide supporting information on how they have calculated their cost submissions.

4.9. Please see Appendix 5 for additional information on some options.

Proposals

4.10. We propose to use the hybrid option to gather data. We consider that this option lets us balance the trade-off between giving suppliers the flexibility to define relevant debt-related administrative costs and the increased comparability available when we are more prescriptive. We have included this option in the draft RFI.

4.11. We propose to collect debt-related administrative costs breakdown by payment method and tariff type. We consider these breakdowns would allow us to focus on the costs to default tariff customers and support potential options for allocating costs across payment methods.

4.12. We also propose to gather debt-related administrative cost data from the beginning of the COVID-19 period to twelve months from the end of the last cap period we are truing up. This is because we consider debt-related administrative costs will be

incurred over time beyond a particular cap period of billed consumption, as it will take time to recover debt.

Overview of responses

4.13. In response to our March 2021 call for input, suppliers said that debt-related administrative costs should be considered in the true-up. Two suppliers said that debt-related administrative costs were likely to increase as the COVID-19 restrictions lifted.

Considerations

Flexibility and prescriptiveness

4.14. In response to the March 2021 call for input, one supplier said that we would need to provide a bespoke definition of debt-related administrative costs to ensure we set an appropriate allowance. Two suppliers said that it is important for us to provide clarity around what suppliers should capture within debt-related administrative costs.

4.15. We recognise this, and we have provided a high-level definition (see the 'Context' section in this chapter) for suppliers to use when providing the data for debt-related administrative costs.

4.16. In developing our proposal, 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). We consider that prescriptiveness improves consistency and comparability, and would help provide suppliers with more clarity about what to include. Flexibility, however, helps us to consider a range of costs that we otherwise may not consider. We recognise that there is a trade-off between them.

4.17. 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 with leaving suppliers full flexibility under the flexible option.

4.18. The hybrid option would also give some clarity around what should be considered in calculating these costs. It therefore would reduce the risk of suppliers understating or overstating debt-related administrative costs, which may have implications on the benchmarking exercise.

4.19. We also consider that our proposed option gives suppliers the flexibility to incorporate any additional debt-related administrative costs they consider to be affected by COVID-19.

4.20. Furthermore, the supporting evidence improves our ability to understand and verify suppliers' costs compared to the prescriptive option. We consider that having additional information on what costs suppliers considered in each category would be important in setting an accurate true-up.

Split by tariff type and payment method

4.21. If the relevant data were available, a split by tariff type would allow us to focus on the costs to default tariff customers, who are in the scope of the cap. If default tariff customers have higher risks of incurring additional debt than fixed tariff customers, then suppliers may incur higher debt-related administrative costs in relation to these customers. Collecting information by tariff type would align with our intention elsewhere in the true-up.

4.22. We consider that gathering data split by payment method would be helpful in allocating costs, particularly when allocating costs to a specific payment method. We discuss this in Chapter 6, specifically the section on 'Allocating costs'.

Time periods for debt-related administrative costs

4.23. We understand that debt-related administrative costs will be incurred over time beyond a particular cap period of billed consumption, as it will take time to recover debt. For example, for debt related to billed consumption in cap period four, suppliers may incur debt-related administrative costs at least over the next twelve months – ie cap periods five and six. We also expect that suppliers are unlikely to be able to subdivide debt-related administrative costs based on the period of billed consumption they relate to.

4.24. We intend to follow a similar approach as the bad debt charge approach for collecting data. We collect debt-related administrative cost data from all cap periods from the start of COVID-19 to the time we do the true-up (depending on data availability) and then make a cumulative comparison against the baseline. By following this approach, we consider that we would be able to true up any additional debt-related administrative costs due to COVID-19.

4.25. We consider that debt-related administrative costs incurred pre-COVID-19 are not relevant for our assessment because they would not have been affected by COVID-19.

Debt-related administrative costs for PPM

4.26. We understand that suppliers may have incurred some debt-related administrative costs at the point PPM customers incurred debt. For example, a supplier may incur call centre costs when providing discretionary credit to a PPM customer. This is an upfront cost that the supplier would face regardless of how long it takes the customer to repay the credit. These debt-related administrative costs may have been greater during COVID-19 than historically, for example if more customers were seeking discretionary credit. Our proposed definition takes into account the potential increased costs in this area and we intend to gather this data through the RFI.

4.27. We consider that PPM customers are likely to incur higher debt-related administrative costs relative to customers on other payment methods at the point debt is incurred. This is because a supplier has to take action (with potential associated costs) to allow a PPM customer to build up material levels of debt.[26] We consider that customers with other payment methods are unlikely to incur debt-related administrative costs at the point the debt is incurred. This is because customers with other payment methods can incur debt without a supplier's action. Therefore, we would only consider costs at the point the debt is incurred for PPM customers.

Working capital costs

Context

4.28. The cost of working capital is the cost to suppliers of raising capital for funding customers paying in arrears. Data and discussions with suppliers suggest that there has been an increase in late payments due to COVID-19. We understand that delayed payments will impact suppliers' cash flow and create a financial need for suppliers (one example may be the financial need to raise more capital), which in turn has a cost.

[26] PPM customers can claim small amounts of credit automatically, through emergency and friendly credit arrangements. However, these could only lead to small amounts of debt.

4.29. We did not include an adjustment for the cost of working capital in our February 2021 decision for the float because we were not able to reassure ourselves that suppliers had responded in consistent ways to the working capital questions. We said that we had not ruled out the possibility of including working capital costs in a true-up.[27]

4.30. We need to find an approach that allows us to compare working capital costs across suppliers in a consistent manner, so that our benchmarking is not affected by data inconsistencies. Such data inconsistencies could arise, in particular, from differences in suppliers' provisioning practices.

4.31. We have considered three approaches for determining additional working capital costs due to COVID-19. We intend to consider how best we can mitigate the impacts of differences in suppliers' provisioning practices.

4.32. These three approaches are:

- Option 1 – using the 2018 decision working capital definition
    - this approach is consistent with the approach we used to calculate the payment method uplift in the 2018 cap decision;
    - working capital = current assets - current liabilities, for the supply business[28];
    - we would then apply a cost of capital, to convert the working capital value into a cost.
- Option 2 – request data on half-yearly 'debtor days'[29]

[27] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 4.53.
https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap
[28] This excludes items: additional cash and working capital requirements relating to trading, taxation balances, and derivatives.
[29] Accounts receivable is the balance of money due to a firm for goods or services delivered or used but not yet paid for by customers. Revenue is the money generated from normal business operations. We are asking for accounts receivable (debtors) and revenue for the domestic energy supply business only.

- this is a measurement of the average amount of time it takes customers to pay suppliers;

$$half\ yearly\ debtor\ days = \frac{\begin{array}{c}average\ of\ accounts\ receivable\\ at\ the\ beginning\ of\ the\ half\ year\\ and\ that\ of\ the\ end\ of\ the\ half\ year\end{array}}{half\ yearly\ revenue} \times 365 \div 2$$

- then covert it into a monetary value by combining it with suppliers' revenue and a cost of capital.

- Option 3 – a bespoke approach

  - this requests repayment data by using the same approach as the bottom-up option for measuring bad debt costs;

  - we would calculate how the average time for late payment had changed since COVID-19, then convert it into a monetary value.

4.33. Under each option, for each cap period we are assessing for the true-up, we propose to calculate the increment relative to the baseline period before COVID-19 (ie incremental working capital or incremental debtor days).

Proposal

4.34. We propose to use option 2 (half-yearly debtor days) to request data in order to determine the additional working capital costs due to COVID-19. This is because it is more focused on debt than the 2018 decision working capital approach (option 1). It is also a more proportionate approach for acquiring data compared to the bottom-up approach (option 3), particularly given that we do not propose to use a bottom-up approach to measure bad debt. We have included this option in the draft RFI.

4.35. We also propose to collect suppliers' debtor days breakdown by payment method and tariff type. We consider these breakdowns would allow us to focus on the costs to default tariff customers and support potential options for allocating costs across payment methods.

4.36. We propose to collect suppliers' half-yearly debtor days data for the same time periods (baseline and cap periods) as discussed for bad debt charge data in Chapter 3.

Overview of responses

4.37. In response to our March 2021 call for input, suppliers supported considering working capital costs in the true-up process. Two suppliers suggested we should reconsider our approach to calculating debt-related working capital costs.

Considerations: timing sensitivity of accounting provisions

4.38. The two suppliers who said we should reconsider our approach noted that the '2018 decision definition' of working capital was sensitive to suppliers' accounting practices (ie the timing of making provisions for bad debt). This is because debts are excluded from the calculation of working capital once they are provided for, since they are no longer a current asset. This means, if other things are equal, a supplier with a relatively early bad debt provision policy will therefore have lower working capital under this definition than a supplier which makes relatively late provisions, even though both may ultimately have the same level of debts and debt write-off.

4.39. One supplier said this measure of working capital penalised prudent suppliers who made early provisions since this measure was net of provisions.

4.40. We consider there are two issues that could arise in the context of COVID-19[30] if the working capital approach is sensitive to suppliers' accounting practices:

- one is variation between suppliers in terms of timing of provisions as we discussed above;
- another is variation relative to expectations. Even if suppliers all had the same accounting approach, their provisions could still (legitimately) be different to the ultimate amount of bad debt. For example, if the economy performed better than expected, then provisions could be larger than the final bad debt. This would again affect the working capital calculated.

[30] We do not consider that these factors would have had a material impact on the payment method uplift set through our 2018 decision, as we expect that the level of debt was more stable at that point in time compared to under COVID-19. We therefore consider that our approach to calculating the payment method uplift is still appropriate.

4.41. This means there are limitations to comparability across suppliers under options 1 and 2, due to impacts of differences in provisioning approaches. The scale of the impact depends on the extent to which suppliers' provisions vary. However, both these options have the advantage that they are well-known accounting definitions that suppliers understand and can provide data for.

4.42. We are proposing to use a weighted average benchmark (see Chapter 5). This would reduce the impact of variation in the timing of provisions between suppliers, as the benchmark would be driven by the overall market position rather than individual suppliers' approaches. However, there would still be an impact to the extent that suppliers had collectively set initial provisions that were too low or too high.

4.43. We prefer option 2 to option 1 because it focuses on accounts receivable. The working capital definition in option 1 includes not only the debtors but also a range of other current assets, as well as current liabilities, including the creditors.[31] Option 2 therefore provides a more direct answer to our question on how suppliers' costs in relation to late payments have changed since COVID-19.

4.44. Option 3 is a bespoke approach that tries to tackle the problem of the accounting options being sensitive to suppliers' provisioning methods. However, when moving away from fixed accounting definitions, there is a risk that we would add significant complexity to the RFI. This could risk suppliers completing the RFI in different ways, which could adversely affect the accuracy.

Considerations: proportionality of our options

4.45. We also need to consider the proportionality of our options. We need to consider the trade-off between increased accuracy and increased complexity (to both suppliers and us) in terms of gathering and analysing data.

4.46. Requesting data for option 2 (half-yearly debtor days) would not add significant additional burden to the overall data request. In contrast, option 3 would make the overall true-up data request significantly more complex and is the most resource-intensive option. This is particularly in the context where we are not proposing to use a

[31] A creditor is an entity, company or person that has provided goods, services or a monetary loan to a debtor. A debtor is the opposite of a creditor – it refers to the person or entity who owes money.

bottom-up approach to measure bad debt costs (see the 'Data source' section in Chapter 3), meaning that the incremental work required to use a bottom-up approach for working capital costs would be very significant.

4.47. We expect additional working capital costs due to COVID-19 to be a significantly smaller amount in comparison to the bad debt costs. This is because working capital costs cover the financing costs of late payments but bad debt is a loss of the entire amount owed. We therefore consider that it would be disproportionate to request complex data in relation to working capital costs.

Considerations: breakdown by payment method and tariff type

4.48. We have discussed our considerations on collecting data broken down by payment method and tariff type for debt-related administrative costs in the section above. These considerations remain the same for working capital costs.

Considerations: timing

4.49. We intend to gather data on working capital costs over the same period as for bad debt.

4.50. We do not consider that we need to take specific steps to account for the impact of debt incurred pre-COVID-19. Any impact on delayed payments for this debt will be captured in our proposed approach from April 2020 – any such delayed payments will form part of the average accounts receivable.

5. Benchmarking

Chapter summary

We discuss the type of benchmark we should use for the additional debt-related costs due to COVID-19. We discuss what data we might collect on how costs vary across suppliers' customer bases. We consider which suppliers to include within our benchmarking.

Summary

5.1. We propose to benchmark the additional COVID-19 costs using a weighted average.

5.2. We propose to set a combined benchmark across each cap period we are truing up (rather than individual benchmarks for each cap period). We also propose to set a combined benchmark across all debt-related costs.

5.3. In this chapter, we also discuss the potential impact of suppliers' customer bases, in the context of our proposal to use a weighted average benchmark. The additional debt-related costs that a supplier faces due to COVID-19 could vary in part due to its customer base, not just its level of efficiency.

5.4. We propose to consider suppliers with more than 100,000 default tariff customer accounts for the benchmarking exercise.

Type of benchmark

Context

5.5. The aim of carrying out benchmarking is to assess an efficient level of additional debt-related costs under COVID-19, while taking into account that suppliers' costs may also vary for reasons unrelated to efficiency. The stringency of the benchmark is therefore a key issue. We could set the benchmark at different levels:

- a **frontier** benchmark would use the supplier with the lowest costs;

- we generally use a benchmark at or near the **lower quartile** in the cap.[32] This is the cost of the supplier that is halfway (in number of suppliers) between the suppliers with the lowest and median (ie midpoint) costs; or

- we could select an average benchmark, such as a **weighted average**. Another type of average benchmark would be a median.

5.6. In each case, we could apply the benchmark to the data as provided by suppliers, or after controlling for certain customer base factors. We discuss customer base factors in the next section ('Considering customer base factors').

5.7. We also need to consider the number of benchmarks. One choice is whether we calculate separate benchmarks for each cap period that we are truing up, or whether we calculate a combined benchmark for all cap periods. Another choice is whether we calculate a single benchmark across all debt-related costs, or separate benchmarks for each type of debt-related costs.

Proposals

5.8. We have considered whether to use a weighted average or lower quartile approach for suppliers recovering these costs. Given the exceptional nature of the pandemic (including potential impacts on the importance of non-efficiency factors driving supplier costs) and the limited duration for which the true-up allowance is in place, we believe it is appropriate to use a weighted average, ensuring that an efficient supplier can recover these costs.

5.9. We propose to set a combined benchmark across each cap period we are truing up. This is a consequence of our proposed data source for bad debt costs,[33] which looks at cumulative costs over a number of cap periods.

5.10. We also propose to set a combined benchmark across all debt-related costs. This reflects that a supplier may be able to achieve lower costs in one area by spending more

[32] For example, we used a lower quartile to set the payment method uplift (which largely related to debt). We also set the operating cost benchmark at the lower quartile minus £5.
[33] We expect bad debt to be the most significant debt-related cost.

in another area. Taking separate benchmarks for different debt-related costs could therefore understate efficient overall debt-related costs.

Overview of responses

5.11. Suppliers who commented supported the use of an average benchmark, rather than a lower quartile. This reflected that they considered a suppliers' customer base factors would affect its debt-related costs.

Considerations: stringency of benchmark

5.12. When considering the appropriate stringency of the benchmark, the high-level issue is whether a supplier's debt-related costs are primarily due to its efficiency or factors outside its control.

5.13. This issue would be particularly important if we were proposing to set a benchmark below average cost. We would need to understand whether the benchmark resulted from differences in efficiency between suppliers, or whether the suppliers closest to the benchmark had below-average costs for other reasons. The issue is less important under our proposed weighted average benchmark, because we would be considering costs across suppliers, and therefore incorporating each of their circumstances into the calculation of the average. If some suppliers had higher costs and others had lower costs, in each case due to factors outside their control, the weighted average would reflect the average situation across suppliers.

5.14. In response to the March 2021 call for input, several suppliers said that customer base factors would affect their bad debt costs more than efficiency would. Several suppliers said that we should therefore use an average benchmark. One supplier said that a lower quartile was unlikely to be reasonable unless we could control for factors outside suppliers' control. In response to the June 2021 working paper, one supplier said that we should use an average benchmark, as it considered that debt-related costs were associated with a supplier's customer mix.

Non-efficiency factors

5.15. We recognise that there are a number of factors beyond efficiency that could affect suppliers' additional debt-related costs. In particular, we note that suppliers have raised various **customer base factors** – we discuss these in the next section. Even if we were to consider whether to control for certain customer base factors (if we used a below-

average cost benchmark), we recognise that there may be some factors we would be unable to control for.

5.16. In response to the March 2021 call for input, one supplier said that the degree of **voluntary support** to customers could affect debt levels. We agree that differences in company policy towards providing voluntary support (beyond licence requirements) could lead to variation in suppliers' costs. However, we do not intend to gather data in this area, given our proposal to use a weighted average benchmark, which will account for variation in voluntary support between suppliers.

5.17. Another non-efficiency factor that could affect a supplier's incremental debt-related costs from COVID-19 is its costs in the **baseline period**. For example, if a supplier had abnormally high debt-related costs in the baseline period then this could reduce its incremental costs of COVID-19, making it appear more efficient.

5.18. We also recognise that there may be some **natural variation** in suppliers' costs (ie noise).

5.19. We cover other stakeholder feedback on non-efficiency factors in Appendix 3.

Efficiency

5.20. We consider that suppliers' additional debt-related costs will be affected in part by their level of efficiency. For example, actions that suppliers could control might include: setting direct debits at the right level and reviewing them regularly, effectively prompting customers paying by standard credit to pay their bills, reacting quickly when a customer stops paying, encouraging customers in arrears to agree a repayment plan, and collecting debt effectively. Efficiency in relation to debt could also be influenced by suppliers' general efficiency, including their IT systems and data capabilities. Appendix 4 provides more information about our initial considerations in this area.

5.21. However, in the exceptional circumstances of COVID-19, it may be harder than usual to be confident on the link between a supplier's efficiency and its costs. A supplier might have developed processes which were efficient in normal circumstances, but which did not function well in the unexpected disruption caused by the pandemic. (For example, if a supplier normally made significant use of site visits).

Discussion of options

5.22. We propose not to adopt a frontier benchmark. This is because the variation in costs is unlikely to be solely related to suppliers' efficiency, and we must have regard to the ability of efficient suppliers to finance their licensed activities. If efficiency was the only remaining effect (after controlling for any customer base factors), we would set the allowance at the frontier benchmark.

5.23. In normal circumstances, we consider that setting a lower quartile benchmark would have regard to the need for suppliers to finance their licensed activities, by reducing the risk that we set the benchmark below efficient costs due to customer base or other non-efficiency factors.[34] We set the benchmark at a lower quartile for other areas of the cap which are trying to achieve an efficient level but recognise this risk.

5.24. However, we do not propose to adopt a lower quartile benchmark. Given the exceptional nature of the pandemic (including potential impacts on the importance of non-efficiency factors driving supplier costs) and the limited duration for which the true-up allowance is in place, we believe it is appropriate to use a weighted average, ensuring that an efficient supplier can recover these costs.

5.25. We note that a weighted average benchmark is equivalent to dividing the total additional costs by total customers. Subject to any changes in customer numbers, the amount to be recovered per customer would therefore be the same as the per customer costs incurred. Individual suppliers would under or over-recover, but in aggregate suppliers would recover all of their additional costs.

5.26. A weighted average benchmark would also take into account that our true-up may not be able to take account of all residual COVID-19 costs in later cap periods. Using a less stringent measure of efficiency is one way to counteract this. We do not consider that we can extend the true-ups indefinitely, as this would risk including significant non-COVID-19 impacts.

[34] Normally, we also consider that a lower quartile is beneficial because it has regard to the need to provide incentives for suppliers to improve their efficiency. This is not as relevant in the context of an adjustment which largely relates to historical costs, which suppliers would be unable to influence through their future actions.

5.27. Our proposal to adopt a weighted average benchmark is specific to the current work on the debt-related costs of COVID-19. We are making a judgment in a particular set of market circumstances, in relation to a narrow area of exceptional costs (linked to the COVID-19 pandemic). For the avoidance of doubt, we are not indicating that we would use a weighted average to assess efficiency in other areas of the cap – our normal position remains to use a lower quartile.

Considerations: number of benchmarks

Benchmarking across cap periods

5.28. We propose to use a cumulative bad debt charge as the data source for bad debt. Given this proposal, we propose to benchmark costs over all cap periods that we are truing up (ie on a cumulative basis), rather than calculating benchmarks for individual cap periods. This is a direct consequence of our proposed bad debt data source.

Benchmarking across cost categories

5.29. As discussed earlier, we propose to consider three different debt-related costs (bad debt costs, debt-related administrative costs and working capital costs). We could benchmark these separately. However, this would risk understating efficient costs, if we used a benchmark below average costs. This is because there could be interactions between them. For example, a supplier which increased its debt management capabilities by spending more on debt-related administrative costs could potentially reduce its bad debt or working capital costs.

5.30. In practice, given our proposal to use a weighted average benchmark, this concern does not apply.[35] However, we still propose to benchmark based on the combined cost per customer across the three debt-related costs.

[35] Provided that we use the same sample of suppliers to calculate each debt-related cost.

Considering customer base factors

Context

5.31. COVID-19 has affected customers in different ways. We considered evidence on this previously through our work on assessing whether a float was required for cap period seven.[36]

5.32. Suppliers have different customer bases. The additional debt-related costs that a supplier faces as a result of COVID-19 could therefore vary in part due to its customer base, not just its level of efficiency. In particular, key customer base factors could include tariff type and payment method.

5.33. In this section, we discuss what customer base factors we are considering and the potential impact of them.

Proposals

5.34. Given our proposals to measure bad debt costs using the cumulative bad debt charge and to use a weighted average benchmark, we do not propose to carry out extensive analysis on how costs vary by customer base factors. We propose to gather data on how costs vary by payment method and tariff type where feasible. These breakdowns are to define which costs are in scope for our analysis (tariff type) and to support potential options for how we allocate costs across customers (payment method).

5.35. Where feasible, we propose to carry out our benchmarking using data on default tariff customers only, given that the cap applies to default tariff customers.

[36] Ofgem (2021), Price cap working paper – Reviewing the potential impact of COVID-19 on the default tariff cap: cap period seven, paragraphs 2.30-2.31.
https://www.ofgem.gov.uk/publications/price-cap-working-paper-reviewing-potential-impact-covid-19-default-tariff-cap-cap-period-seven
Ofgem (2021), Price Cap consultation – Reviewing the potential impact of COVID-19 on the default tariff cap: cap period seven, paragraph 4.48.
https://www.ofgem.gov.uk/publications/price-cap-consultation-reviewing-potential-impact-covid-19-default-tariff-cap-cap-period-seven

Overview of responses

5.36. Suppliers said that we should consider customer base factors, particularly tariff type and payment method.

Considerations

5.37. We propose to use a weighted average benchmark. This will ensure that the benchmark reflects the domestic customer base of the suppliers included in our analysis. If some suppliers have above-average costs and others have below-average costs, in each case due to their customer bases, the weighted average will still reflect the overall customer base. We therefore do not need to be concerned about customer base factors affecting our benchmarking (unlike if we were proposing to use a lower quartile benchmark). This means that we do not need to gather data on customer base factors to potentially allow us to control for them.

5.38. We therefore only need customer base data to define which costs are in scope for our analysis and to support potential options for how we allocate costs across customers.

5.39. We discuss below the two customer base factors where we propose to gather data – tariff type and payment method.

5.40. The cap also varies by region, fuel and electricity meter type. Given our proposal to measure bad debt costs using the cumulative bad debt charge, we do not consider that it would be feasible to gather data for these other customer base factors, in order to support potential allocation decisions. We understand that suppliers do not generally break down their bad debt charge by these customer base factors.

Tariff type

5.41. In response to the March 2021 call for input, one supplier said that it was fundamentally important that we took into account only data from default tariff customers. Two other suppliers said that we should take into account tariff type before benchmarking. In response to the June 2021 working paper, one supplier said that tariff type affected debt levels.

5.42. Where feasible, we propose to carry out our benchmarking using data on default tariff customers only. This is because the cap applies to default tariff customers, and so we are most interested in the additional COVID-19 costs related to customers under the

cap. This would address concerns from suppliers about default tariff customers being more likely to incur debt than fixed tariff customers.[37]

5.43. Under our proposal to use a cumulative bad debt charge approach to gather data on bad debt, we understand that some suppliers can provide bad debt charge data split by tariff type. We recognise that other suppliers may need to make assumptions in order to provide this split.

5.44. We will engage with suppliers through the draft RFI process to understand whether they are able to provide data split by tariff type for working capital and debt-related administrative costs.

5.45. This proposal is specific to our calculation of the true-up. For the true-up, we currently consider that it is feasible to focus on the costs relating to default tariff customers (at least for bad debt). It does not mean that we consider it necessary to take this approach in other areas of the cap.

Payment method

5.46. In response to the March 2021 call for input, three suppliers said that we should consider payment method. In response to the June 2021 working paper, one supplier said that payment method affected debt levels.

5.47. We recognise that additional debt-related costs are likely to vary by payment method. In part this reflects that there are intrinsic differences between payment methods in terms of how easy it is to incur debt. It also reflects that there are differences in the characteristics of customers on each payment method.[38]

5.48. Suppliers have told us that debt-related costs are generally higher for standard credit customers than for direct debit customers. We expect that debt-related costs are much lower for PPM customers (than for other payment methods), but suppliers consider that there are some costs.

[37] We still intend to gather data for all domestic customers, so that we retain the option of benchmarking based on suppliers' entire domestic customer bases.
[38] Ofgem (2019), Consumer Survey 2019.
https://www.ofgem.gov.uk/publications/consumer-survey-2019

5.49. We intend to gather data split by payment method to help provide us with options about how to allocate costs by payment method (see Chapter 6). We expect that this should be feasible for bad debt, as we understand that suppliers generally consider the recoverability of debt by payment method when calculating their bad debt charges. We will engage with suppliers in relation to the other debt-related costs.

Suppliers to include within benchmarking

Context

5.50. When considering whether to set a float for cap period seven, we issued a mandatory RFI to suppliers with at least a 1% market share in any fuel in the domestic market segment.[39]

5.51. We recognise that, in the current market circumstances caused by increases in global gas prices, suppliers will be facing multiple additional information requests from other teams within Ofgem. We will engage with suppliers during the draft RFI process so that they have the opportunity to comment on our proposed scope for the RFI.

5.52. The current market circumstances have also led to supplier exits. We recognise that this context will affect the potential scope of suppliers from whom we can gather data from.

Proposals

5.53. We propose to include suppliers with more than 100,000 default tariff customer accounts[40] within our data gathering. This ensures that we are able to consider data from suppliers with a meaningful number of default tariff customers, while avoiding gathering data from suppliers with low numbers of default tariff customers, which would have a limited impact on the weighted average. This would help to keep the RFI proportionate.

[39] Ofgem (2021), Price Cap - Decision on the potential impact of COVID-19 on the default tariff cap: cap period seven, paragraph 4.2. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-covid-19-default-tariff-cap-cap-period-seven

[40] Counting each dual fuel customer as two accounts.

Overview of responses

5.54. Stakeholders have not previously commented on this area.

Considerations

5.55. We first set out the key elements that we consider affect which suppliers to include within our benchmarking exercise. We then consider our overall approach to which suppliers to include. We finally consider circumstances in which we might exclude suppliers from our benchmarking exercise.

Elements to consider

5.56. We consider that the following elements are important when assessing which suppliers to include within our benchmarking exercise and which suppliers to gather data from. These are the elements which we consider are important in the context of our proposal to use a weighted average benchmark – the elements could be different if we were proposing to use a different benchmark.

5.57. Subject to the other elements below, we would prefer to include a larger **number of suppliers** in our benchmarking exercise. Using a larger number of suppliers would mean covering a greater proportion of domestic suppliers, making our results more representative of the market.

5.58. We need to consider the **proportionality** of asking suppliers to provide data. It takes time for suppliers to respond to RFIs and for us to analyse responses. If a supplier's data would be unlikely to have a significant impact on our final benchmarking analysis (due to the size of the supplier), then it could be best to not request this data.

5.59. To assess the additional debt-related costs due to COVID-19, we propose to compare costs under COVID-19 against a historical **baseline period**. Each supplier that we include in our benchmarking exercise must be able to provide usable data for both the baseline and COVID-19 periods. Other suppliers may not be able to do this – for example if they have entered the market since the baseline period, or if they only had a small number of customers in the baseline period.

5.60. We will only be able to gather data from suppliers who are **active** in the market at the point of issuing the RFI. We will not be able to gather data from suppliers who have exited the market through the Supplier of Last Resort process.

5.61. This list is not exhaustive – further factors may also be relevant, particularly when considering suppliers' individual situations.

Overall approach

5.62. As a starting point, we consider that we can largely address the factors mentioned above by using a customer number threshold. We would base this threshold on a supplier's number of default tariff customers specifically, given our proposal to focus on the costs relating to default tariff customers.

5.63. **Number of suppliers:** A customer number threshold helps us to understand the maximum number of suppliers who could be included in our benchmarking analysis.[41] We can therefore reduce (as far as possible) the likelihood of having an insufficient number of suppliers in our sample. However, there would always be some risks that we would need to exclude suppliers.

5.64. **Proportionality:** If data from smaller suppliers would have a limited impact on the weighted average, then a customer number threshold will reduce unnecessary work for these suppliers, and allow us to focus our analysis.

5.65. **Baseline period:** Small suppliers (in the cap periods we are truing up) are more likely than larger suppliers to have been at an early stage of entering the market in the baseline period. A customer number threshold would therefore also tend to address this factor, by excluding small suppliers.

5.66. We then need to consider the level of this customer number threshold.

5.67. We used a 1% market share threshold for the cap period seven float RFI. We received 11 submissions.[42] A 1% share of default tariff customers (approximately 300,000 customer accounts) would, based on historical data, lead to us including a broadly similar number of suppliers. (This is before the impact of recent supplier exits).

[41] The number of suppliers could be lower in practice due to supplier exits.
[42] Ofgem (2021), Price Cap - Decision on the potential impact of COVID-19 on the default tariff cap: cap period seven, Appendix 1, paragraph 1.15. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-covid-19-default-tariff-cap-cap-period-seven

We therefore do not consider that we would set the threshold above this level, as this would reduce the number of suppliers further.

5.68. However, to support the accuracy of the true-up, we consider that it would be better to use a somewhat reduced threshold. On this basis, we consider that 100,000 customer accounts could be an appropriate level.

5.69. We intend to use data from our existing customer account and tariff data RFI to determine which suppliers should be in scope for our data gathering for each cap period that we are truing up. This data is available for April and October each year. We therefore intend to use the data from the start of the cap period in question. For cap period four (April to September 2020), we would therefore use the customer account data from April 2020.[43]

Exclusions

5.70. Even after using a customer number threshold, there may be some suppliers that we decide to exclude from our benchmarking exercise. We set out below our initial thinking on a case where we might consider excluding suppliers. However, this is not intended to be exhaustive, as there may be supplier-specific circumstances that we need to consider. We also welcome any suggestions for additional reasons to consider excluding suppliers.

5.71. Some suppliers may have a **small number of default tariff customers in the baseline period**. We would only apply the customer number threshold to the period we were trying to true up – we would not rigidly apply the same threshold to the baseline period as well, as this could unnecessarily reduce the number of suppliers considered (for example by excluding cases where a supplier had grown slightly over time). Instead, we would make a judgment about whether a supplier's baseline data was usable. However, in cases where a supplier had very few default tariff customers in the baseline period, we would be likely to exclude them, and therefore we would be willing to consider

[43] Ofgem (2021), Price Cap - Decision on the potential impact of COVID-19 on the default tariff cap: cap period seven, paragraph 4.3. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-covid-19-default-tariff-cap-cap-period-seven

representations from the supplier that we should not require them to complete the RFI. Suppliers will be able to provide these representations in response to the draft RFI.

6. Other considerations

Chapter summary

In this chapter, we set out our proposals on: how we adjust the cap, how we allocate costs (between payment methods, fuels, electricity meter types, and the unit rate and standing charge), how we account for changes in the number of default tariff customers and how we account for changes in consumption over time.

Summary

6.1. We are currently proposing not to include a sharing factor for the COVID-19 true-up but reserve our judgment on this subject to RFI data and the situation that customers are facing at the time of the true-up.

6.2. We propose to use the adjustment allowance to set a COVID-19 adjustment in the cap.

6.3. We have presented options for how we can allocate costs across different caps and cap components.

6.4. We propose not to account for costs due to timing differences between when a cost was incurred and when the allowance is received.

6.5. We propose to account for inflation when comparing costs incurred in different periods.

6.6. We propose to make adjustments for the changes in the number of default tariff customers between the period when costs were incurred, the period the initial float adjustment was made and the final period in which costs are trued up.

6.7. We propose to account for any changes in consumption over time by taking an approach that calculates the incremental costs as a percentage of revenue.

Sharing factor

Context

6.8. In our May 2021 consultation on the float,[44] we proposed to introduce a sharing factor to equally share the impact of the additional COVID-19 costs between suppliers and customers for the cap period seven float. This was to ensure that our cap period seven float was conservative and protected customers' interests.

6.9. We decided that a further float in cap period seven was not necessary. Therefore we did not need to decide whether to introduce a sharing factor in our August 2021 decision.[45]

6.10. In our March 2021 call for input, we said we would need to consider whether we should apply a sharing factor before calculating the amount to recover in the true-up.[46]

6.11. The recent increases in global wholesale gas prices are having a significant impact on the cost of supplying energy. Suppliers are therefore likely to be more financially stretched than previously. We consider this situation as part of the context when assessing whether or not to introduce a sharing factor, given that a sharing factor affects the amount of additional COVID-19 costs that suppliers would be able to recover from customers.

Proposals

6.12. We are proposing not to apply a sharing factor when calculating the amount to recover in the true-up. This reflects the context of current market circumstances due to the recent increases in wholesale gas prices. However, we will reserve the final judgment subject to the size of incremental debt-related costs due to COVID-19 for the cap

[44] Ofgem (2021), Reviewing the potential impact of COVID-19 on the default tariff cap: cap period seven, paragraphs 3.49-3.52. https://www.ofgem.gov.uk/publications/price-cap-consultation-reviewing-potential-impact-covid-19-default-tariff-cap-cap-period-seven
[45] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap: cap period seven August 2021, paragraph 2.4. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-covid-19-default-tariff-cap-cap-period-seven
[46] Ofgem (2021), Call for input on the true-up process for COVID-19 costs. https://www.ofgem.gov.uk/publications/price-cap-call-input-true-process-covid-19-costs

period(s) we are truing-up.[47] We will also need to consider the situation that customers will be facing at the time of the true-up.

Overview of responses

6.13. In response to our March 2021 call for input, five suppliers disagreed with including a sharing factor in the true-up adjustment. Suppliers said a sharing factor would limit the recoverability of efficient costs incurred and would add a further financial burden on suppliers.

6.14. One supplier supported the inclusion of a sharing factor. It said that suppliers should not expect to be remunerated for the full value of the estimated cost.

Considerations

6.15. In response to our March 2021 call for input, one supplier said that retail supply sector finances continued to be constrained and it would not be in the interest of customers to see further supplier insolvencies. Another supplier said that a sharing factor would be arbitrary and required further justification for it.

6.16. Under the current circumstances of the recent increases in wholesale gas prices, we are proposing not to introduce a sharing factor. A sharing factor would prevent suppliers from recovering the efficient additional costs linked to COVID-19 under the cap. In the current context, we are conscious that suppliers' ability to bear a shortfall in relation to these costs is likely to be lower than when we previously raised the possibility of a sharing factor. We must have regard to the ability of an efficient supplier to finance its licensed activities.

6.17. However, our final judgment on this proposal is subject to the size of incremental debt-related costs due to COVID-19 for the cap period(s) we are truing-up. Knowing the size of the costs would allow us to understand the impact on customers, including the impact of including a sharing factor or not. This aligns with the Act's objective to protect current and future default tariff customers.

[47] We would be likely to take the same approach for all cap periods, while reserving the right to review this.

6.18. Under normal circumstances, we consider that there is an argument for introducing a sharing factor to protect customers in the true-up of additional COVID-19 costs. COVID-19 is a one-off external shock. It could be fairer to split the impact of one-off shocks between suppliers and customers. This is because, at an individual level, no supplier or customer is fully responsible for the disruption. Sharing the costs between customers and suppliers' owners (ie shareholders) would reduce the impact on any one group. This balance could help protect customers and have regard to the ability of an efficient supplier to finance its licensed activities.

6.19. One supplier also said that if we considered implementing a sharing factor, we should ensure that it would be implemented as fairly and equitably as possible across the industry.

6.20. In the event that we were proposing to introduce a sharing factor, we would consult on sharing factor options.

How the cap is adjusted

Context

6.21. In our February 2021 decision, we decided to use the existing cap adjustment allowance to set the COVID-19 adjustment for our initial float in the default tariff cap. We also indicated that we were strongly minded to use the same approach for future floats and true-ups.[48]

Proposals

6.22. We propose to use the existing cap adjustment allowance to set the COVID-19-related adjustment for the true-up in the default tariff cap.

[48] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 3.13. https://www.ofgem.gov.uk/system/files/docs/2021/02/decision_on_the_potential_impact_of_covid-19_on_the_default_tariff_cap.pdf

6.23. The adjustment allowance is defined in the methodology for adjustment allowance workbook referenced in Annex 8 of standard licence condition 28AD of the electricity and gas supply licences (SLC28AD).

Overview of responses

6.24. One supplier supported our use of the existing adjustment allowance for the true-up in response to our March 2021 call for input.

Considerations

6.25. We consider that using the adjustment allowance is the simplest and most flexible method for adjusting the cap for the true-up.

6.26. We are also not aware of any compelling reason to use any other component of the cap to implement the true-up.

Timing of recovery

Context

6.27. In our March 2021 call for input,[49] we said that we need to consider how many periods to recover the true-up adjustment over. We have considered three options.

- Recovery over six months (ie one cap period) - this would involve applying an uplift to the costs to set the allowance (which we present in annualised terms). We would uplift the standing charge element on a time-weighted basis and the unit rate element on a demand-weighted basis.

- Recovery over a year (ie two cap periods) - no uplifts would be required as the cap would be calculated on an annual basis.

- Recovery over the remainder of the cap - the first true-up would be recovered over the remaining 15 months of the last three cap periods. Subsequent true-ups would still be recovered over the remainder of the cap, but the number of months

[49] Ofgem (2021), Call for input on the true-up process for COVID-19 costs. https://www.ofgem.gov.uk/publications/price-cap-call-input-true-process-covid-19-costs

they would be recovered over would reduce. This option would involve re-weighting the costs to set the allowance. We would need to re-weight the standing charge element on a time-weighted basis and the unit rate element on a demand-weighted basis.

Proposals

6.28. We propose to spread the costs over a period that is at least one year, with our preference being that we should spread costs over the remaining cap periods. In the first true-up, we are considering additional debt-related costs from several cap periods. Therefore, we consider that introducing the true-up gradually would strike a balance between causing any sudden changes in customers' bills and allowing suppliers to quickly recover any additional debt-related costs.

Overview of responses

6.29. We did not receive any responses on this point in our March 2021 call for input.

Considerations

6.30. We recognise that there is a trade-off between recovering the true-up at the earliest opportunity and the impact on customers' bills. For example, if the true-up value is positive and is recovered over one cap period, this may lead to a sudden increase in customers' bills.[50]

6.31. We also recognise that in our first true-up, we will be considering costs related to several cap periods. It is likely that the first true-up allowance may be greater than future true-ups, as it will be taking into account costs from a larger number of cap periods for the first time.

6.32. Therefore, we consider that smoothing costs for the true-up would mitigate the potential risk of sudden changes in customers' bills, and would protect customers'

[50] The cap level will change over time in any event (eg due to changes in wholesale prices). In this section, we are focussed on changes caused by the true-up.

interests. This approach could also benefit suppliers if the true-up value is negative (ie costs were lower than the amount provided in the float).

6.33. We also recognise that there may be some risks from recovering the true-up over an extended period of time (recovering costs over several cap periods as opposed to one cap period). In particular, whichever group (customers or suppliers) is owed money through the true-up would need to wait longer to receive this. It could also present a risk to accuracy as there are more likely to be changes in suppliers' customer bases over a longer period of time. This means that an adjustment determined before the start of the recovery period could end up leading to over-or under-recovery.

6.34. As outlined in the 'Accounting for the timing difference between costs and the allowance' section below, we do not consider there is a need to provide an allowance for the timing difference between the costs being incurred and the allowance being fully recovered. Recovering over a longer period will therefore not increase the amount to be recovered.

6.35. Under an approach where we recover over more than one cap period, we recognise that, as we include more cap periods within our true-up calculation, the total size of the costs taken into account when calculating adjustment allowance is likely to increase.[51] (For example, the true-up in cap period nine would include some of the costs from cap periods four, five and six. The subsequent true-up in cap period ten would therefore include further costs from cap periods four, five and six, as well as some of the costs from cap period seven). We will take this into account when considering whether it is appropriate to extend the recovery period over a year.

6.36. When we publish our final consultation on the first true-up, we will have data to help us understand the direction and the materiality of this true-up. This may inform our considerations on the appropriate recovery period. However, we intend to have a single recovery period across all true-ups, and we would not have data on the size of future true-ups at the point of our first true-up decision. We may therefore need to rely more on our consideration of the principles rather than our consideration of the data.

[51] This assumes that the adjustment is in the same direction in each cap period.

Allocating costs

Context

6.37. In calculating the adjustment, we need to consider how we should apportion additional debt-related costs between the different caps and the cap components. This includes allocation across:

- different payment types (ie direct debit, standard credit, and PPM);
- different fuel types (electricity and gas); and
- single-rate and multi-register electricity meters.

6.38. We also need to consider whether to allocate costs equally across all customers through the standing charge or allocate it proportionally to consumption through the unit rate.

6.39. In our February 2021 decision[52] for the float we decided to adopt an equal allocation approach across credit payment types (standard credit and direct debit customers), fuel type, and single-rate and multi-register electricity meters. One reason for this decision was because the data we gathered was not broken down by these allocation factors. We also decided to recover costs between the standing charge and unit rate in the same proportions as total costs are currently recovered under the cap. We noted that these decisions did not prejudge our approach for the true-up.

6.40. As discussed in Chapter 3, we are proposing to use a cumulative bad debt charge to gather data on bad debt costs for the true-up. This means we will gather evidence on the bad debt charge for a number of cap periods broken down by payment method and tariff type. For debt-related administrative costs and working capital costs, we are also proposing to gather data broken down by payment method and tariff type for a number of cap periods.

[52] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraphs 3.109-3.127.
https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap

6.41. For the allocation across payment types, we have considered three options.

- allocate costs based on the customer mix impact on bad debt costs. This means we would allocate costs based on the cost per customer from the breakdown of data we receive.

- equal allocation. This means we recover the same absolute amount across each area in question (on a pounds per customer account at benchmark consumption basis).

- hybrid approach. A hybrid approach would work out the pounds per customer difference between the above allocation options and then consider how to allocate this difference.

6.42. For the allocation across fuel type and electricity meter type, we do not have the bad debt charge data broken down by these cap components. We have therefore considered two options.

- Equally allocate across each cap component. This means we would use the same weighted average figure we calculate through our benchmarking exercise for each fuel and/or electricity meter type cap component allowance.

- Allocate costs across cap components based on the estimated revenue per customer in the cap periods we are truing-up.[53]

6.43. If stakeholders think there are any other approaches we should consider for how to allocate costs across these cap components, they should raise them in response to this consultation. Stakeholders should explain in detail what any additional approach is and the reasons for it. When explaining the reasons for any additional approach, stakeholders should explain why this would be proportionate and likely to significantly increase the accuracy of the allocation of COVID-19 costs in the true-up.

[53] The number we calculate in our benchmarking exercise will be a cost per customer that is a weighted average across both fuel and electricity meter type. For making an estimate of the costs on different fuels, for example, we would need to take into account the revenue per customer on each fuel and the number of customers on each fuel.

Proposals

6.44. We propose to separate PPM customers and credit meter customers (standard credit and direct debit) when allocating costs. This means that we will only allocate PPM COVID-19 debt-related costs to PPM customers. We propose to adopt a hybrid approach in allocating costs across credit meter customers by payment type (standard credit and direct debit). This means that additional COVID-19 debt-related costs for credit customers will be spread across standard credit and direct debit customers.

6.45. For allocating the incremental debt-related costs due to COVID-19 across fuel and electricity meter types, we propose to adopt equal allocation across each component. We consider this will avoid the risk of making inaccurate assumptions and we consider this is the simplest approach.

6.46. We propose to allocate the incremental debt-related costs due to COVID-19 between the standing charge and unit rate in the same proportions as total costs are currently recovered under the cap[54] (in the cap period we are truing-up). This approach is unchanged from our February 2021 float decision.[55]

Overview of responses

6.47. In response to our March 2021 call for input, one supplier said costs should be fully socialised across all domestic customers. Another supplier said that cost recovery should be aligned with debt cost drivers.

Considerations: general considerations

6.48. It is not possible to allocate additional debt-related costs to the individual customers who drive these costs. Inherently, suppliers recover the costs of bad debt from customers who pay their bills.

6.49. We recognise that debt-related costs are likely to vary across customer groups. Some customer groups are likely to have higher debt-related costs than others (on an

[54] This means recovering costs in the unit rate and standing charge based on the proportions of the cap at nil and the medium Typical Domestic Consumption Value (TDCV) in the cap period we are truing-up.
[55] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 3.114.
https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap

average cost per customer basis). However, at an individual level, it would not be cost-reflective to charge the entirety of the costs to customers belonging to these groups.

6.50. Allocating costs equally across customer groups avoid the risk of one group of customers potentially facing a larger true-up. However, it reduces the degree to which the adjustment allowance through the true-up would reflect the efficient costs of a supplier serving its own customer base. Suppliers with a low proportion of customers who are more likely to build up debt could be overfunded, and other suppliers with a high proportion of customers who are more likely to build up debt could be underfunded.

6.51. When allocating across customer groups, we must protect customers on default tariffs and, among other things, have regard to an efficient supplier's ability to finance its licensed activities.

Considerations: Recovery over payment methods

Allocating PPM costs separately

6.52. We intend to separate PPM customers and credit meter customers when allocating the costs. We intend to only allocate PPM costs to PPM customers. We consider three main reasons for our proposal: vulnerability, ability to accumulate debt and feasibility of separating the debt fairly.

Vulnerability

6.53. We consider it is not appropriate to spread costs from credit customers to PPM customers. This is because PPM customers are more likely on average to be in vulnerable situations than credit customers as a whole. [56] Including PPM customers in the cost-sharing exercise would potentially have the opposite effect, reducing protection for PPM customers.

Ability to accumulate debt

6.54. We consider that it is much harder for a PPM customer to build up similar levels of debt to that of a standard credit or direct debit customer. If a PPM customer does incur

[56] BEIS (2019), Fuel Poverty Factsheet, Slide 3. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966517/Fuel_Poverty_Factsheet_2019_data.pdf

debt, it is unlikely to be as much (on average) as the amount a credit customer can accrue over time. This is because a supplier has to take action to allow a PPM customer to build up material levels of debt.[57]

6.55. We recognise that a customer may have incurred debt on a credit meter, been moved to a PPM, and then switched supplier. In this situation, the debt would transfer with the customer through the Debt Assignment Protocol (DAP).[58] We discuss the implications of this below.

Feasibility to separate debt fairly

6.56. Under the cumulative bad debt charge approach, the costs can only be split based on a customer's current payment method, not the customer's payment method at the point of billing. This is because the cumulative bad debt approach measures the bad debt charge for the current payment method. For example, for a customer who is currently on a PPM, and has moved to this meter after accumulating debt on a credit meter, the bad debt charge would be categorised as PPM and not as credit meter. As a result, the bad debt charge figure for PPM customers is higher than the actual debt incurred by customers who are on PPM at the point of billing.

6.57. We consider the above as a limitation of the proposed cumulative bad debt charge approach when allocating costs. This is because the cost allocations would be based on an overstated PPM cost. Therefore, we consider it is important that we separate the PPM costs without adding further burden to PPM customers by sharing some costs of credit customers.

Hybrid approach for credit customers

6.58. As outlined in Chapter 5, we expect that many of the additional debt-related costs due to COVID-19 will result from customers paying by standard credit.

[57] PPM customers can claim small amounts of credit automatically, through emergency and friendly credit arrangements. However, these could only lead to small amounts of debt.
[58] An energy supplier can stop a customer who owes them money from switching to a new supplier, where a debt has not been repaid for 28 days or more. This is known as a debt objection. Prepayment customers can, however, still switch supplier in the event of a debt objection by using a process known as the Debt Assignment Protocol (DAP). The DAP is a process by which prepayment customers can transfer their debt to a new supplier to overcome a debt objection and complete their switch.

6.59. Two suppliers who responded to our November 2020 consultation[59] on the float told us that, when allocating costs equally between credit meter customers, there was a risk of penalising some suppliers with higher proportions of standard credit customers and overcompensating others which could create further market distortions.

6.60. We consider that we would need to strike a balance when applying cost-sharing across credit customers. We do not consider that most of the additional debt-related costs associated with standard credit customers should solely be allocated to standard credit customers because:

- at an individual level, a standard credit customer who pays their bill is not more responsible for those costs than a direct debit customer who pays their bill;
- it would lead to a potential increase in the standard credit cap level when compared to other groups of customers, as a significant proportion of costs could be recovered from a minority of customers; and
- under the cumulative bad debt charge approach, the bad debt costs would be the costs from the customers currently on standard credit, not those related to consumption from customers originally on standard credit. Therefore, some bad debt costs for standard credit customers might relate to debt incurred when they were on the direct debit payment method. This is particularly if a customer moves from direct debit to standard credit due to cancellation of their direct debit after incurring debt.

6.61. Moving away from allocating all additional standard credit costs to standard credit customers could lead to a shortfall for those suppliers with above-average proportions of standard credit customers. This risk is mitigated in that there is less variation in suppliers' proportions of standard credit and direct debit customers compared to the variation in the proportion of PPM customers.

6.62. We also consider that our 2018 approach regarding the impacts on suppliers of their customer mix are still valid. We have provided details of this approach in our

[59] We discuss previous comments from stakeholders on allocation in relation to the float, given that we have not previously sought views from stakeholders in detail on allocation in relation to the true-up.

discussion of separating PPM costs from the allocation between credit payment methods above.

6.63. We consider that adopting a hybrid approach in allocating costs across credit meter customers by payment type (standard credit and direct debit) reaches a good balance between these trade-offs.

6.64. We have not reached a position on the precise allocation split across credit customers in the hybrid approach. We invite comments from stakeholders on what a suitable split could be under this approach.

Considerations: recovery over fuel type

6.65. Debt-related costs could differ between fuels. We expect that when a customer stops paying, the debt they build up is proportional to their bill (ie how much they should have paid). The level of the cap at typical consumption was higher for electricity than for gas in the periods we are truing-up. Therefore, electricity bad debt costs could be higher than gas bad debt costs. However, we could not control for any differences in the propensity to incur debt across fuels, as we do not have evidence on this.

6.66. Given that most customers are dual fuel, cost allocation between fuels should have a relatively limited impact on customers. However, we recognise that suppliers can have variations in their customer bases between fuels.

6.67. We consider our proposal of equal allocation to be the simplest approach that avoids introducing potentially uncertain assumptions.

6.68. The alternative is to use an estimate to allocate costs based on the revenue in the cap period being trued up for each fuel. This would lead to a higher COVID-19 adjustment allowance for electricity than for gas. We consider that this allocation could have a fairly immaterial impact on each allowance, given that the difference between each fuel's cap level is not large.

6.69. However, it still presents a risk that any inaccuracies in the alternative approach may lead to overfunding for suppliers with more electricity customers or underfunding for those suppliers with more gas customers. Although, this risk is mitigated in that there is less variation in suppliers' proportions of customers by fuel type. This means most

suppliers have an average mix of customers, and therefore each supplier should recover its costs, given that this is a matter of allocation between fuels.

6.70. When we publish our final consultation on the first true-up, we will have data to help us understand the materiality of this allocation decision. This will better inform our decision on the impact this could potentially have on customer bills and supplier finances.

Considerations: recovery over single-rate and multi-register electricity meters

6.71. The cap has two levels for electricity, one for single-rate meters and another for multi-register meters. Multi-register meter customers tend to use more energy on average, so the typical consumption benchmark for the multi-register meter cap level is set at a higher level of consumption.

6.72. Bad debt costs are likely to be proportional to customers' bills. This means multi-register meter customers could incur a higher bad debt cost per customer than single-rate meter customers (driven by the amount of their bill rather than their propensity to incur debt). We reflect this in the current payment method uplift by applying a percentage allowance to the single-rate and multi-register meter benchmarks separately. This gives a higher allowance for the multi-register meter typical consumption benchmark than for the single-rate meter typical consumption benchmark.

6.73. If we selected an approach that attempts to estimate the allocation across the single rate and multi-register meter cap allowances based on revenue in the cap period being trued up, then we would set a higher adjustment for multi-register meter customers than for single-rate meter customers. This presents benefits in that:

- suppliers who serve these higher-cost groups (ie serve a large number of multi-register meter customers) would be more able to recover the efficient costs associated with their customer bases; and

- low cost (single-rate electricity meter) customers would not pay more than the costs of serving their group.

6.74. The downside to this approach is that multi-register meter customers are likely to have a larger true-up adjustment due to COVID-19 than single-rate meter customers. Multi-register meter customers are more likely to use electricity for heating than single-rate meter customers. We need to consider whether these customers require additional

protection compared to single-rate meter customers. However, as we discussed in Chapter 3, suppliers are not able to provide this breakdown for their bad debt charges.

6.75. We propose to equally allocate costs across single-rate and multi-register electricity meter types, given we do not have the broken-down data. This means we intend to use the weighted average figure we calculate through our benchmarking exercise for each cap component allowance. We consider that this is a simple approach that best protects electricity customers on multi-register meters from potentially facing a sharp increase in their bills. The considerations for equal allocation are the opposite of those for allocation back to customers based on their group's costs.

6.76. When we publish our final consultation on the first true-up, we will have data to help us understand the materiality of this allocation decision. This will better inform our decision on the impact this could potentially have on customer bills and supplier finances.

Considerations: recovery over the unit rate and standing charge

6.77. We consider that recovering the costs over a mixture of the standing charge and unit rate remains appropriate for the reasons we set out in our November 2020 consultation on the float.[60]

6.78. We consider this better reflects how customers might build up debt and is in line with how we treat the payment method uplift for bad debt and working capital costs (applied as a percentage to the cap at nil and TDCV). We consider that looking at how consumption might affect debt build-up gives us a fair way of allocating the costs across all customers.

[60] Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraphs 3.121-3.127. https://www.ofgem.gov.uk/publications/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation

Accounting for the timing difference between costs and the allowance

Context

6.79. In our March 2021 call for input, we asked whether it was appropriate to consider any costs incurred from timing differences between when a cost was incurred and when the allowance was received.[61] We noted that for this issue, we could consider both the time between the original costs and the float, and also the time between the float and the true-up.

6.80. In our February 2021 decision for the float, we decided to not take into account the cost of timing difference in the adjustment or to adjust for inflation. We noted that we would consider this further in our true-up exercise.

Proposals

6.81. We propose to not account for costs resulting from timing differences between when a cost was incurred and when the allowance is received. We consider that suppliers will have the tools to manage temporary cashflow issues in the normal course of business and so we do not see a need to provide a specific allowance for this in relation to the additional debt-related costs of COVID-19. We recognise that suppliers will have additional cashflow pressures in the current market conditions, but this is separate from the impacts of COVID-19.

6.82. We propose to account for inflation when determining the amount to recover through the adjustment allowance. We consider this is appropriate in order to improve the accuracy of comparing costs across different time periods.

Overview of responses

6.83. One supplier responded to our November 2020 consultation and stated that there was a working capital cost associated with the timing difference between suppliers making provisions for bad debt and when the cap provided funding. It said that we should

[61] Ofgem (2021), Call for input on the true-up process for COVID-19 costs. https://www.ofgem.gov.uk/publications/price-cap-call-input-true-process-covid-19-costs

make an allowance for this cost, or amend our current definition of our working capital costs to incorporate this cost.

Considerations

Timing differences between costs and allowances

6.84. In principle, we do not consider that default tariff customers need to provide an additional allowance due to temporary cash flow differences. We consider that suppliers have the tools to manage temporary cash flow issues in the normal course of business (eg credit lines), so we do not see a need to provide a specific allowance for this in relation to the additional debt-related costs due to COVID-19.

6.85. This approach is consistent with other similar adjustments, such as the approach taken in reassessing the wholesale allowance in the first cap period.[62] It is also consistent with other cap allowances suppliers receive on a lagged basis.

6.86. We consider that our float and true-up approach has mitigated some of the impact from timing differences. The materiality of the impact on suppliers' cash flow would have been limited to some extent given that they were able to recover a float allowance not long after they incurred costs.

Inflation

6.87. We consider that accounting for inflation allows us to accurately compare costs that have been incurred in different periods of time. One method of doing this is by uprating using the consumer price index, including owner occupiers' housing costs (the 'CPIH Index'), given that this is the inflation measure used elsewhere in the cap, eg for the operating cost allowance.

6.88. We welcome comments from stakeholders on the most appropriate inflation measure to use. We also welcome comments on whether there are any temporary factors

[62]Ofgem 2020, Decision on reassessing the wholesale allowance in the first default tariff cap period. https://www.ofgem.gov.uk/publications/decision-reassessing-wholesale-allowance-first-default-tariff-cap-period

since the pandemic which would affect the degree to which any particular inflation measure was appropriate.

Accounting for changes in the number of default tariff customers

Context

6.89. In our March 2021 call for input, we asked for comments on whether we should adjust for changes in the aggregate number of default tariff customers between the period when costs were incurred and the period when the allowance was provided.[63]

6.90. The number of default tariff customers in aggregate will change across time as customers move between default and fixed tariffs. This means that it is unlikely that suppliers will have the same number of customers across: the cap periods in which the costs were incurred, the cap periods in which suppliers were able to collect a float, and the cap periods when the final costs are recovered for the true-up.

6.91. In our February 2021 decision on the float, we decided not to make an adjustment for the change in the number of default tariff customers. We said that we intended to consider this further when carrying out the true-up exercise.[64]

Proposals

6.92. We propose to make adjustments for the change in the aggregate number of default tariff customers between the cap periods when costs were incurred, the cap periods in which the initial float adjustment was made and the cap periods in which costs are trued-up. This is to improve the accuracy of the true-up.

Overview of responses

6.93. One supplier who responded to our November 2020 consultation on the float told us that despite the pandemic, switching was still prevalent, and so there was a risk that

[63] Ofgem (2021), Call for input on the true-up process for COVID-19 costs. https://www.ofgem.gov.uk/publications/price-cap-call-input-true-process-covid-19-costs
[64] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 3.1. https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap

shifts in customer bases could result in a mismatch in cost recovery. It wanted us to consider these changes in the true-up, believing the increase in accuracy justified the additional complexity.

Considerations

6.94. We cannot account for the change in each supplier's number of default tariff customers, given that Act requires that the cap is a single level for all suppliers.[65] This means that we can only look at the aggregate (average) change in default tariff customer numbers.

6.95. If we trued up on a pounds per customer basis, this approach would not account for changes in default tariff customer numbers.

6.96. If we trued up on a collective basis, accounting for the aggregate change in suppliers' default tariff customer numbers over time, then we would offset the total amount of costs in full.

6.97. When carrying out a retrospective adjustment, there is no way of recovering the correct amount for both customers and suppliers.

6.98. We have discussed the concept and our considerations on adjusting for changes in the number of default tariff customers in a retrospective adjustment previously in our August 2020 decision on reassessing the wholesale allowance in the first default tariff cap period.[66]

6.99. That decision discussed the case where the number of default tariff customers is falling (and where the adjustment is a transfer from customers to suppliers). In this circumstance, either individual customers would pay more than the average cost incurred per customer, or suppliers would recover only part of their costs. In the opposite case where the number of default tariff customers was increasing, either individual customers

[65] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[66] Ofgem (2020), Decision on reassessing the wholesale allowance in the first default tariff cap period, paragraphs 4.17-4.34. https://www.ofgem.gov.uk/publications/decision-reassessing-wholesale-allowance-first-default-tariff-cap-period

would pay less than the average cost incurred per customer, or suppliers would over-recover their costs.

6.100. In either case, accounting for the changes in default tariff customers would ensure that suppliers as a whole recover a better approximation of the costs that they incurred.

6.101. This proposal does not pre-judge our position on changes in default tariff customer numbers for any future retrospective adjustments in the cap.

Accounting for changes in consumption and energy prices over time

Context

6.102. When calculating the additional debt-related costs due to COVID-19, we need to consider whether we will account for any changes in consumption or energy prices. These could occur between the baseline and the COVID-19 cap period we are assessing and/or between the COVID-19 cap period we are assessing and the cap period we set the allowance for.

6.103. To calculate the incremental debt-related costs, we compare costs during COVID-19 to a relevant baseline. We want as best as possible to isolate the impact of COVID-19.

6.104. We are considering two different approaches for calculating incremental costs.

- Cost per customer increment - calculate the debt-related costs per customer during COVID-19 and compare this to the cost per customer in a relevant baseline period. This approach assumes all changes in the cost per customer between periods are a result of COVID-19.

- Incremental costs as a percentage of revenue - calculate the debt-related costs as a percentage of revenue for the COVID-19 period and compare this to a relevant baseline. This approach accounts for changes in consumption and energy prices between the baseline and the COVID-19 period.

6.105. If we choose to calculate the incremental costs as a percentage of revenue, then we also need to consider the best approach to convert this back into a figure in pounds per customer for each supplier. We have considered two methods.

- We could apply the percentage increment figure to the market average revenue per customer account for the period being trued up.

- We could also apply the percentage increment figure to the cap level at TDCV per customer account for the COVID-19 cap period we are assessing.

6.106. We discuss our considerations on these options below.

6.107. Under any approach, we also need to consider whether to try and control for any changes in consumption between the COVID-19 cap period and the cap period we set the allowance for.

Proposals

6.108. We propose to account for any changes in consumption and energy prices between the baseline and the COVID-19 cap period by taking an approach that calculates the incremental costs as a percentage of revenue.

6.109. We consider this approach is the most accurate given that, as far as practicable, we want to focus solely on the impact of COVID-19 and remove any impacts of changes in consumption levels or energy prices.

6.110. We also propose to control for changes in consumption (but not energy prices) between the COVID-19 cap period and the cap period we set the allowance.

Overview of responses

6.111. We have not consulted on this area before and therefore have not received any stakeholder comments.

Considerations

Approach for calculating the incremental costs between baseline and COVID-19 period

6.112. Domestic consumption levels have been impacted by COVID-19. For example, lockdown restrictions kept more people at home, and this resulted in an increase in domestic consumption.

6.113. The debt-related cost[67] per customer could therefore increase between the baseline and the cap period we are truing-up due to changes in consumption levels. Similarly, to the extent that retail energy prices had changed between the baseline and the cap period we are truing-up, this could also affect the debt-related cost per customer. Both consumption and energy prices affect the amount of revenue that suppliers bill, and we would therefore expect them to affect the amount of debt (all else being equal).

6.114. However, consumption and energy price impacts do not themselves require an adjustment. Increased consumption will have allowed suppliers to collect additional allowances from default tariff customers which relate to debt-related costs (especially through the payment method uplift). In addition, as the payment method uplift is largely defined as a percentage of other allowances, it will have reflected changes in energy prices over time.

6.115. We want to ensure that we are isolating the impact of COVID-19 and that our results are not impacted by changes in consumption levels or energy prices. Calculating the debt-related costs as a percentage of revenue ensures that we account for any changes in consumption or energy prices between the baseline and the COVID-19 period.

6.116. This approach is also consistent with the approach taken in the original cap decision in November 2018 on our payment method uplift calculation for debt-related costs.[68]

Approach for converting the percentage increment to a pound per customer figure

6.117. We consider that converting the increment percentage to a pounds per customer figure is best achieved by applying the increment to different cap levels at TDCV in the cap period, which we are truing-up.

6.118. Using the cap levels will simplify our analysis, and we consider that this is reasonable because the majority of default tariff customers were on tariffs priced at the cap level. The cap is clearly split by a number of relevant breakdowns for our

[67] In this context, we are only referring to bad debt and working capital costs. We would expect debt-related administrative costs to be affected more by the number of customers in debt, rather than the value of that debt.
[68] Ofgem 2018, Default tariff cap: Decision Appendix 8 - Payment method uplift. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview

calculations. We propose to use the cap levels at TDCV for consistency with the rest of the cap design.

Accounting for changes in consumption between COVID-19 and the cap period we set the allowance

6.119. We consider that it is also appropriate to control for changes in general levels of consumption between the COVID-19 cap period and the cap period we set an allowance for, given its impact on cost recovery. For example, if consumption were higher during the COVID-19 period for temporary reasons related to restrictions than it is likely to be in future, then suppliers would under-recover.

6.120. However, we do not need to control for any future changes in retail energy prices. This is because we would be defining the adjustment as an absolute figure (in pounds per customer) rather than as a percentage of other future allowances. The amount to recover would therefore depend on the costs incurred historically but would not be affected by future energy prices.

6.121. We will not know upfront what consumption will be in the cap period we are setting the allowance for. The best available approach may be to assume that future consumption will be the same as the most recent data available. We could control for changes in consumption levels between the COVID-19 cap period and the cap period we set the allowance for by using statistics on consumption (eg from BEIS) to apply a percentage adjustment to our calculation. This would at least provide a proxy for some of the changes in consumption between these cap periods, and would attempt to mitigate any impact on recovery.

6.122. Under any approach, outturn consumption in the cap period which we are setting the adjustment for may be higher or lower than expected (eg due to weather effects). This would have some impact on the revenue that suppliers receive through the adjustment. We do not intend to correct for this through an additional adjustment in future cap periods. We do not consider that any resulting increase in precision would be material.

6.123. We welcome comments from stakeholders if there are any alternative methods we should consider to control for differences in consumption levels in the COVID-19 period and the period we set the allowance.

Appendices

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Appendix 1. Bad debt data source option: Top-down approach

Summary

1.1. We have decided not to adopt a top-down approach to the bad debt data source due to practicality issues. This appendix includes the explanation of this approach, stakeholder responses and our considerations.

Explanation of the top-down approach

1.2. The top-down approach looks back and focuses on a particular cap period of billed consumption. It investigates 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.

1.3. This option would start by picking a particular cap period of billed consumption in the past that we want to assess the level of bad debt for (eg cap period four). We would then select a point in time after this cap period to gather data from suppliers. We would ask suppliers to provide data on the provisions they have made in relation to this cap period, including any provision movements. This data would allow us to understand the level of debt that suppliers expect will not be recovered. We would also ask suppliers to provide write-offs, in case any of the debt has been 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.

1.4. 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 cap period of billed consumption. Suppliers would need to be able to look at what provision was originally made for a cap period and track any provision movements up to the point we gather data.

Stakeholder responses and considerations

1.5. In responses to our June 2021 working paper, suppliers did not support this option.

1.6. We consider this option against our main criteria (as set out in Chapter 3): practicality, accuracy and assurance, and benchmarking.

Practicality

1.7. We have to consider the practicality of providing the data for this option. In response to our June 2021 working paper, four suppliers had concerns about the practicality of providing the data for this approach. They said that it would be not possible to tie both billed consumption and any associated provisions back to specific cap periods of consumption. We recognise this difficulty.

1.8. We also noted that if a supplier has applied any 'overlays' (top-down additions to their provisions that reflect an overall accounting judgment on the appropriate provision), it would be especially difficult to match any bad debt charges to a particular period of billed consumption.

1.9. One supplier said that it applied overlays at a granular level. It said that if any supplier applied overlays at a less granular level, it would be able to apply assumptions to allocate the overlays at a more granular level. While we acknowledge that any overlays could be broken down to a more granular level by applying certain assumptions, we consider this does not eliminate the issue of being unable to tie a provision to a particular period of billed consumption.

Accuracy and assurance

1.10. With regards to the accuracy element, one supplier said that the need for suppliers to link debt to billed consumption might require certain assumptions that might vary between suppliers, which could affect the comparability and accuracy of the data. We agree that this could be a risk with the top-down approach.

1.11. In addition, three suppliers said that the top-down approach did not consider the impact of COVID-19 on the debt incurred before the start of COVID-19, and that it was critical to assess this.

1.12. COVID-19 could have impacted the recoverability of debt that existed prior to this period. Under the top-down approach, it would be difficult to consider these impacts, as this option focuses on the period of billed consumption. We therefore agree that excluding pre-COVID debt would have some impact on the accuracy of the top-down approach.

Benchmarking

1.13. We propose to use a weighted average benchmark (see Chapter 5). We consider that the top-down approach would not constrain our ability to implement a weighted average benchmark.

Appendix 2. Bad debt data source option: Bottom-up approach

Summary

1.1. In this appendix, we discuss specific comments from suppliers on the bottom-up approach and give our considerations on these comments.

Detailed stakeholder comments and considerations

Practicality

1.2. One supplier said that it did not have the ability to link debt back to a specific consumption period, and that there could be inconsistencies in suppliers' approaches when providing this data for the first stage. Another supplier highlighted that the data requested under the bottom-up approach would be significantly more difficult to provide than the data required under the cumulative bad debt charge approach. It said that the bottom-up approach might require suppliers to develop entirely new data extraction and analysis procedures, and it might take all suppliers time to get this accurate and consistent.

1.3. In the first stage of this approach, we would be asking suppliers to provide data on how much customers have been billed during a particular cap period. We would then ask them to tie any payments received in the future back to a particular period of billed consumption to calculate the level of remaining debt. Our engagement with suppliers has suggested that they would be able to use account-level data to build up these values. However, we also recognise that extracting the data would require more work from suppliers. We consider that, given the current market circumstances, suppliers may already be experiencing resource constraints. We therefore consider that the cumulative bad debt approach would be more proportionate relative to the bottom-up approach.

Accuracy and assurance of approach – the second stage

1.4. Under the bottom-up approach, one supplier said that, given the uncertainty over future recoverability, we should use historical industry recovery rates based on the age of debts rather than creating an overly complex bespoke model. We consider that historical recovery rates may explain part of the future recovery rates. However, the future recovery of debt may have changed due to the impact of COVID-19. We

therefore consider that supplier forecasts could be more accurate than using historical recovery rates alone.

1.5. However, in this approach, we would like to also gather information and use the recovery rates from suppliers' historical data and provisions as a sense check of the forecasts provided. This would also provide some level of assurance by comparing the forecasts with historical data on the recovery rate.

1.6. One supplier said that they would need to make a judgment in the second stage given the need to produce bespoke forecasts. We recognise that both the bad debt charge approach and the second stage of the bottom-up approach require a level of judgment to be applied to make an assessment on the additional level of bad debt.

1.7. We consider that the bottom-up approach would provide some transparency over the materiality of any judgment compared to the cumulative bad debt charge approach. However, many of the judgments under the cumulative bad debt charge approach will be refined through subsequent provision movements, whereas the judgments under the second stage of the bottom-up approach would be permanent (not subject to future revisions).

1.8. One supplier said it was concerned about creating a single provision rate that would be applied across all suppliers. It also discussed how difficult it would be to compare suppliers' provisions given the different segments used when applying recovery rates in their provisions.

1.9. In this approach we would estimate the level of debt that will not be recovered by applying a supplier's own forecast (for a given breakdown) to its own outstanding debt. This means one supplier's forecasts or provisions would not impact another supplier's calculations. We are not considering creating a single provision rate across suppliers.

1.10. The supplier also said that it would be difficult to compare suppliers' provisions given the different segments used when applying recovery rates in their provisions. We recognise that suppliers may have different factors and breakdowns that they include when they carry out their provisioning. We would gather information on a supplier's provisioning to use as a sense check for suppliers' bespoke forecasts if we chose to use the bottom-up approach.

Accuracy and assurance of approach – interactions

1.11. There is a minor limitation in the link between the first stage and the second stage of this approach.

1.12. The data we gather in the first stage is based on the customer's status (eg payment type and whether they are live on supply) when they are billed. In contrast, the recovery rates in suppliers' provisions are based on the current status of the customer at the point when they make the assessment. We expect that the same would be true for any bespoke forecasts that suppliers develop – the expected recoverability of the outstanding debt would depend on the customer's current status rather than their status at the point of billing. Therefore, there is a discrepancy between the data at each stage, in the event that a customer has changed status.

1.13. We do not consider that this is a significant limitation. This is mainly because the issue only relates to the recovery rate we would apply at the second stage (under a bottom-up approach). We consider that the amount of debt outstanding at the end of the first stage should be small, given the length of time between the period of billed consumption and the point (at least a year later) when we would gather data. The latter would consequently reduce the importance of which recovery rate we apply.

Further refinements to the true-up for a specific cap period

1.14. Under this approach, we would not gather data at a later stage to further refine our true-up for a specific cap period (ie there would be no true-up of the initial true-up). The only possible justification in this case for a further true-up (in relation to a specific cap period) would be if there was significant uncertainty in our initial true-up.

1.15. In contrast, we would need to further refine our true-up under the cumulative bad debt approach. This is because a supplier's bad debt charge for a specific cap period contains initial estimates and any provision movements flow through to bad debt charges in future cap periods.

Appendix 3. Other feedback on non-efficiency factors

1.1. In this appendix, we summarise stakeholders' comments on non-efficiency factors in response to our March 2021 call for input and our June 2021 working paper.

1.2. In response to our March 2021 call for input, five suppliers said that it was important to consider non-efficiency factors. Two suppliers also commented on this matter in response to our June 2021 working paper.

1.3. Most suppliers who commented stated that differences in debt-related costs due to COVID-19 were most likely to be driven by non-efficiency factors and not by differences in operational efficiency.

1.4. One supplier said that we should gather data on factors that drive significant differences in costs between suppliers. It said that we should control for these factors before we undertook any benchmarking. Another supplier stated that controlling for non-efficiency factors was important if we implemented a lower quartile benchmark.

1.5. Suppliers suggested several non-efficiency factors that we should potentially consider. These non-efficiency factors included: tariff type, payment method, location, socioeconomic groups and levels of engagement, voluntary support provided to customers in hardship, fuel type, meter type and whether a customer was on the PSR.

1.6. In addition to the factors above, two suppliers said that we should also consider customer selection in the true-up. They said that some suppliers were able to proactively choose their customer bases according to their credit characteristics. Therefore, these suppliers were likely to see lower customer debt relative to a supplier which did not select its customer base.

1.7. Chapter 5 explains our views on the potential impact of a supplier's customer base on their additional debt-related costs due to COVID-19. In the section on 'Considering customer base factors', we outline the customer base factors that we intend to gather data on.

Appendix 4. Efficiency in relation to bad debt

1.1. We consider that suppliers' additional debt-related costs due to COVID-19 are likely to be affected by their level of efficiency. Some suppliers are likely to be more efficient than others in their debt management.

1.2. In this appendix, we summarise some ways in which suppliers could achieve higher efficiency in relation to debt management. This is not an exhaustive list.

1.3. It is important to note that, as stated in our letter on regulatory expectations from 1 July 2020, we "expect suppliers to continue to provide strong support for those customers struggling to manage their energy costs", which "includes ensuring that any debt management processes are fair and that repayment plans take account of ability to pay".[69] Our autumn 2021 consumer protection report has also set out how Ofgem and industry are working together to help to protect consumers this winter.[70] Efficiency is about how suppliers deliver their operations, while remaining compliant with all obligations and expectations.

1.4. Suppliers could take steps to **reduce the risk of customers going into debt**. For example, suppliers could encourage customers (where possible) to pay by direct debit, which reduces the risk of missed payments compared to standard credit. For direct debit customers, suppliers could also reduce the risk of debt by ensuring that direct debits are set at an appropriate level and reviewed regularly. Where customers pay by standard credit, suppliers could consider how frequently to bill customers. We expect suppliers to proactively prompt their customers to provide meter reads regularly.[71] This could minimise the risk of bill shock and therefore the amount of debt that customers could incur.

1.5. Suppliers could **proactively engage with their customers** particularly in relation to their queries around billing and debt. Energy suppliers need to ensure that

[69] Ofgem (2020), Impact of COVID-19 on retail energy supply companies – regulatory expectations from 1 July 2020, p2.
https://www.ofgem.gov.uk/publications/impact-covid-19-retail-energy-supply-companies-regulatory-expectations-1-july-2020
[70] Ofgem (2021), Consumer protection report: Autumn 2021, Chapter 1.
https://www.ofgem.gov.uk/publications/consumer-protection-report-autumn-2021
[71] Ofgem (2021), Consumer protection report: Autumn 2021, paragraph 2.2.
https://www.ofgem.gov.uk/publications/consumer-protection-report-autumn-2021

they have the resources in place to respond to the level of consumer need, which is likely to increase given the rise in energy prices. Suppliers should also ensure that consumers are signposted to relevant support, including external debt advice.[72]

1.6. When a customer goes into debt, suppliers could **provide more support to customers who are struggling to pay.** This could mitigate the amount of debt that a customer incurs. For example, we expect all suppliers to make arrange appropriate and manageable repayment plans with their customers in debt.[73] Suppliers can set tailored payment levels and repayment time periods. They can also provide signposting to help and advice from third parties. We would like to see average arrears decreasing, in line with an increase in the number of customers in debt being put on to repayment plans. We expect suppliers to be investigating failed payments and engaging with customers to understand their circumstances and set up appropriate support.[74]

1.7. Suppliers could also display different levels of efficiency when **collecting outstanding debt**. This will depend on how a supplier delivers activities such as written communications, telephone contacts and field visits. With any operational activity, there is likely to be room for suppliers to make improvements to deliver it with more efficiency. Suppliers may also be able to improve efficiency by selecting an appropriate mix of debt collection activities. This includes considering how to target debt collection activities to improve effectiveness (eg using different approaches for different customer groups). However, we expect suppliers to treat customers fairly and offer support accordingly. In the first instance, we expect suppliers to communicate the matter clearly to the customer and attempt to resolve it before escalating the debt recovery process.[75]

1.8. As mentioned in Chapter 5, we consider that efficiency in relation to debt could also be influenced by suppliers' **general efficiency**, including their IT systems and data capabilities. For example, a supplier which has accurate contact information for

[72] Ofgem (2021), Consumer protection report: Autumn 2021, paragraph 2.8. https://www.ofgem.gov.uk/publications/consumer-protection-report-autumn-2021
[73] Ofgem (2021), Consumer protection report: Autumn 2021, paragraph 2.22. https://www.ofgem.gov.uk/publications/consumer-protection-report-autumn-2021
[74] Ofgem (2021), Consumer protection report: Autumn 2021, paragraph 2.28. https://www.ofgem.gov.uk/publications/consumer-protection-report-autumn-2021
[75] Ofgem (2021), Consumer protection report: Autumn 2021, paragraph 2.32. https://www.ofgem.gov.uk/publications/consumer-protection-report-autumn-2021

its customers may be better able to communicate with customers to resolve debt issues.

Appendix 5. Options considered for debt-related administrative costs data source

1.1. This appendix provides additional information about two options (the prescriptive option and the hybrid option) we considered to gather data for debt-related administrative costs for the COVID-19 true-up. As noted in Chapter 4, in each option, we would ask suppliers to provide the breakdown by tariff type and payment method.

1.2. In all options, we would ask suppliers to provide debt-related administrative costs net of any amount charged back to customers. This is to avoid double counting.

Prescriptive option

1.3. We provide a description of this option in Chapter 4, in the section 'Debt-related administrative costs'.

1.4. The defined categories are:

- 'Internal collections' - Internal debt collection costs
- 'External collections' - External debt collection costs (excluding those shown under warrants)
- 'Warrant costs' - Costs associated with execution of warrants (eg legal costs).

1.5. We would expect suppliers to allocate costs that they consider fall within the scope of debt-related administrative costs into our defined categories.

Hybrid option

1.6. We provide a brief description of this option in Chapter 4, in the section "Debt-related administrative costs".

1.7. Table A5.1 provides an overview of the proposed costs that suppliers should consider when calculating their debt-related administrative costs. We would like to seek comments from suppliers, and following the comments, we would consider amending the list for the final RFI.

Table A5.1: Proposed cost categories

Cost type	Main cost categories
Cost related to collecting debt	Legal/warrant costs – the cost of any legal fees associated with debt
	Cost of field visits (excluding any legal/warrant costs)
	Additional account management costs due to debt such as: • communication costs (written communications and inbound enquiry costs) • setting up payment plans for debt • cost of engaging debt collection agencies (ie the cost of outsourcing debt collection)
Cost related to incurring debt (PPM only)	Administrative costs of providing discretionary credit to PPM customers, including: • communication costs • costs of providing additional keys/cards to deliver credit

Appendix 6. 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 BEIS.
Please note that responses not marked as confidential will be published on our website. Please be mindful of this when including personal details.

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 six 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".