Consultation

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Price cap – consultation on the true-up process for COVID-19 costs

Subject	Details
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This is our final consultation on the process for assessing the true-up of COVID-19 costs in the default tariff cap before our decision. We would like views from people with an interest in 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.

Contents

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 suppliers were unable to recover these additional costs 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] The adjustment we made in our February 2021 decision 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').

Overview

This document sets out our proposals for how we intend to true up the additional float allowances we set for cap periods six and seven.[3] We have determined the final additional debt-related cost incurred by suppliers as a result of COVID-19 and then compared this to the float adjustment. We have not considered, and do not intend to consider, 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. In our November 2021 consultation,[4] we outlined our proposed approach and considerations for assessing the additional cost of each of these elements.

[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.
[3] We set an initial float in February 2021
[4] Ofgem (2021), Consultation on the true-up process for COVID-19 costs. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

Proposed true-up adjustment

We propose to make no adjustment in cap period nine (October 2022 – March 2023) to true up the initial float provided for additional debt-related costs. The data we gathered on debt-related costs in cap periods four to six (April 2020 – September 2021) to assess the final impact of COVID-19 suggests that there has not been a material change in incremental costs from what we have already allowed suppliers to recover in the float. Whilst we do consider that cap periods four – six (April 2020 – September 2021) are the main cap periods impacted by COVID-19, we recognise that some debt-related costs may flow through to the following cap periods. We therefore propose to gather bad debt and debt-related admin cost data for cap period seven (October 2021 – March 2022) as our final assessment of these costs on a cumulative basis.

Our proposal to make no adjustment in the cap period nine to true up the initial float provided for additional debt-related costs is based on our proposed methodology:

- Calculate our benchmark on a cumulative basis across cap periods;
- Calculate a benchmark for each individual debt-related cost;
- Adopt a weighted average benchmark; and
- Carry out our benchmarking exercise using data on suppliers' entire domestic customer bases costs.

Next steps

We are requesting responses by 1 June 2022. We intend to take a decision ahead of the next cap update in early August 2022. This would take effect from cap period nine, which begins on 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.

November 2021 consultation

1.3. We published a consultation in November 2021 ('November 2021 consultation') that set out our initial proposals for the process of the true-up of additional debt-related costs. This provided stakeholders an opportunity to comment on a more detailed outline of our process and proposal for the true-up.

Ongoing engagement with suppliers

1.4. We hosted four 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 calls was to further test our thinking on these topics. The fourth round of calls was to discuss debt on prepayment meters (PPM).

Next stage of consultation

1.5. We intend to publish a decision in early August 2022, ahead of announcing the default tariff cap ('the cap') level for cap period nine. Any changes would take effect from 1 October 2022.

Disclosure

1.6. Alongside this consultation, we are carrying out a disclosure process. This allows stakeholders' advisers to inspect the True-up model and data, subject to confidentiality restrictions. We have published information about this disclosure process on our website.[5]

1.7. If you would like to participate in the disclosure process and have not yet registered your interest, please contact us as soon as possible at: RetailPriceRegulation@ofgem.gov.uk.

Related publications

1.8. 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

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

- November 2021 consultation on the true-up process for COVID-19 costs ('November 2021 consultation'): https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
- 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

[5] Ofgem (2022), Price Cap - Disclosure arrangements for Spring 2022 consultations. https://www.ofgem.gov.uk/publications/price-cap-disclosure-arrangements-spring-2022-consultations

- 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

- August 2021 decision on the potential impact of COVID-19 on the default tariff cap: cap period seven ('August 2021 decision'): https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-covid-19-default-tariff-cap-cap-period-seven

- 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

The default tariff cap

1.10. We set the cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('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:

- 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.

1.11. 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, our primary consideration is the protection of existing and future consumers who pay standard variable and default rates. 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.

1.12. In setting the cap, we may not make different provisions for different holders of supply licences.[6] This means that we must set one cap level for all suppliers.

How to respond

1.13. We want to hear from anyone interested in this consultation. Please send your response to RetailPriceRegulation@ofgem.gov.uk.

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

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

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

Your response, data and confidentiality

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

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

1.18. 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 4.

1.19. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't 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

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

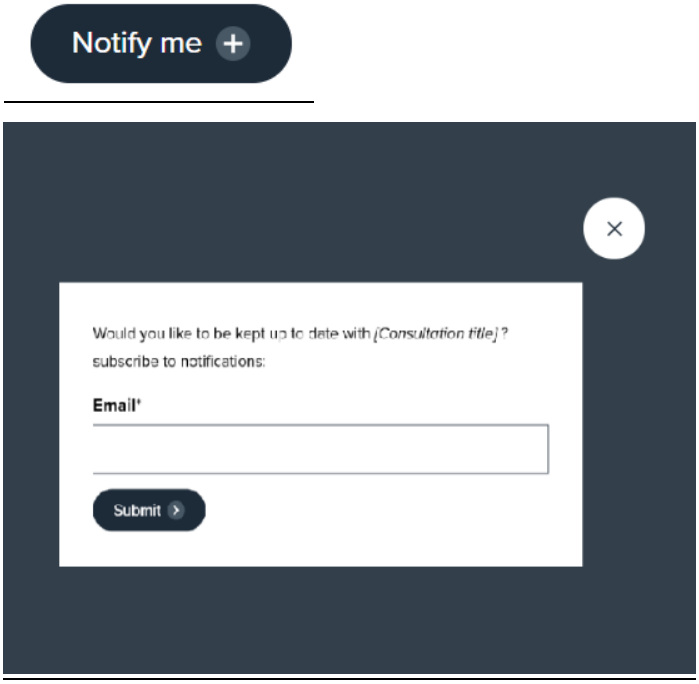
1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?

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:

Upcoming	▶	Open	▶	Closed (awaiting decision)	▶	Closed (with decision)

2. Introduction

Background

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 "Deliver fair prices for consumers" within our Forward Work Programme for 2022-23.[7]

2.2. We have issued two decisions on whether to introduce an initial adjustment to the price cap to account for any 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);[8] and
- 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 PPM customers' bad debt costs.[9]

2.3. The adjustment we made in our February 2021 decision 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').

Objective

2.4. This document has two main objectives:

[7] Ofgem (2022), Forward work programme 2023/23. https://www.ofgem.gov.uk/publications/forward-work-programme-202122
[8] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap. https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap
[9] 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

- Outline and consult on our proposed approach used to determine the final impact of COVID-19 costs on domestic energy suppliers.

- Consult on the result of our proposed approach and whether we should introduce a true-up adjustment in the default tariff cap.

Overview of key proposals

Debt-related costs summary

2.5. We propose to make no adjustment in cap period nine (October 2022 – March 2023) to true up the initial float provided for additional debt-related costs.

2.6. The data we gathered on debt-related costs in cap periods four to six (April 2020 – September 2021) to assess the final impact of COVID-19 suggests that there has not been a material change in incremental costs from what we have already allowed suppliers to recover in the float.

2.7. Whilst we do consider that cap periods four – six (April 2020 – September 2021) are the main cap periods impacted by COVID-19, we recognise that some debt-related costs may flow through to the following cap periods. We therefore propose to gather bad debt and debt-related administrative cost data for cap period seven (October 2021 – March 2022) in order to conduct our final assessment of these costs on a cumulative basis.

Table 1: Final Debt-related costs compared with our initial float[10]

	Final incremental cost per Dual Fuel (DF) customer determined from December 2021 RFI	Incremental cost per Dual Fuel (DF) customer determined in the float	Difference
Bad debt costs	14.49	13.78	0.71
Debt-related administrative costs	-1.27	0.00	-1.27
Working capital costs	0.00	0.00	0.00

Bad debt costs - credit

2.8. We propose to make no adjustment in the cap to true up our initial estimate of bad debt costs for credit meter customers. Our bad debt data from the December 2021 Request For Information (RFI) on cap period four to six (April 2020 – September 2021) showed that the additional bad debt charge for credit customers was only £0.71 per customer higher than our original estimate in the float.[11]

2.9. We consider that this change in cost, between the final cost and what was already provided for in the float, is not material or systematic in isolation and when considered alongside other debt-related costs and does not justify introducing an adjustment in the cap. Please see Chapter 3 for further details.

Bad debt costs - PPM

2.10. We propose to make no adjustment in the cap to true up additional PPM bad debt costs in the cap due to COVID-19. We did not provide a float for debt-related PPM costs in our February 2021 decision. Our bad debt data suggests there is not a significant amount of additional PPM bad debt costs due to COVID-19. Our discussions with suppliers also evidence

[10] Our calculation output flows into the Annex 8 model, where an adjustment allowance would be calculated if we proposed to make an adjustment. For more detailed model modifications of Annex 8, please see Appendix 3 in this consultation.
[11] This figure takes Total bad debt charge spread over all credit customers and subtracts the additional cost calculated in the float.

that the majority of bad debt costs on PPM are related to debt that was incurred on a credit meter and then moved over to PPM, this supports our view that PPM customers are unlikely to build up significant amounts of debt. Please see Chapter 6 for further details.

Debt-related administrative costs

2.11. We propose to make no adjustment in the cap to true up additional debt-related administrative costs in the cap due to COVID-19. We did not provide a float for debt-related administrative costs in our February 2021 decision. Our debt-related administrative cost data from the December 2021 RFI for cap period four to six (April 2020 – September 2021) showed that the final incremental debt administrative cost was -£1.27 per dual fuel customer.

2.12. We could recover this benefit from suppliers. However, when viewed in the round with all debt-related costs we consider that there are no additional material and systematic costs above what was already allowed for in the cap. Please see Chapter 4 for further details.

Working capital

2.13. We propose to make no adjustment in the cap to true up additional debt-related working capital costs in the cap due to COVID-19. We did not provide a float for working capital costs in our February 2021 decision.

2.14. We consider that suppliers should already have had short-term financing facilities in place and should not need an additional allowance for the impact of COVID-19 on an increase in delayed payments. Suppliers are expected to have robust financial governance frameworks in place to meet their financial obligations. Please see Chapter 4 for further details.

Benchmarking

2.15. We propose to benchmark the additional COVID-19 costs using a weighted average benchmark. This position is unchanged from our November 2021 proposal.

2.16. We propose to benchmark debt-related costs separately. This proposal has changed since our November 2021 consultation. We consider that our proposal will result in a more robust benchmark as it maximises the sample used in the calculation. Please see Chapter 5 for further details.

Payment method allocation

2.17. We propose to allocate any additional debt-related costs equally across all credit customers. We consider that this strikes the right balance between customer protection and ensuring suppliers are able finance their licenced activities.

2.18. We propose to allocate no debt-related costs to PPM customers. We consider that PPM bad debt primarily originates from debt built up on a credit meter. Please see Chapter 6 for further details.

Other considerations

2.19. In Chapter 7, we have summarised our other proposals for remaining points we considered for calculating a true-up adjustment and identified whether this position had changed from our November 2021 consultation.

Methodology summary

The data gathered

2.20. We issued the COVID-19 true-up RFI in December 2021 to gather information on suppliers' debt-related costs (bad debt charge, debt-related administrative costs and working capital costs). We also gathered information on suppliers' revenue and customer accounts, to ensure we could control for different sizes of suppliers in our benchmarking exercise.

2.21. We also requested this information broken down by tariff type (fixed/default) and by payment method (direct debit /standard credit /PPM). The intention of gathering these breakdowns was to try to ensure that the correct costs are in scope and have evidence to support our cost allocation exercise.

2.22. Once we had suppliers' RFI submissions, we conducted several checks and supplier engagements to ensure we understood the data, so that we would be confident in the data's comparability across suppliers. We have provided an explanation of our inclusion criteria and reasons for exclusions in Appendix 4.

Methodology summary

2.23. The role of our methodology is to isolate the COVID-19 effect on debt-related costs by comparing the costs incurred during COVID-19 with a pre-COVID-19 benchmark.

2.24. We have provided a detailed explanation of our methodology in Appendix 2.

2.25. Below, we summarise some key steps in our methodology:

2.26. For each debt-related cost we calculate a £ per customer account across suppliers:

- we use cost data relating to a suppliers' total domestic customer base;
- we then subtract the relevant baseline from each COVID-19 cap period (ie calculate the incremental change); and
- we calculate a cumulative weighted average £ per customer account across all COVID-19 cap period increments.

2.27. The weighted average £ per customer account increment for each debt-related cost is inputted into the 'Annex 8 – methodology for adjustment allowance' of standard licence condition 28AD of the electricity and gas supply licences (SLC28AD). Annex 8 would be used to determine the adjustment allowance if we had proposed to make an adjustment. See Appendix 3 for a detailed explanation of the possible Annex 8 modifications.[12]

[12] We have published a revised 'Annex 8 – methodology for adjustment allowance' model alongside this consultation.

3. Bad Debt

Chapter summary

We set out our proposed approach for calculating the final additional bad debt costs due to COVID-19. We also outline our proposal and considerations on whether we should make a true-up adjustment in the default tariff cap for additional bad debt costs.

Summary

3.1. We propose to use a cumulative bad debt charge approach to calculate if there are any additional bad debt costs due to COVID-19. We propose to use the data gathered via our December 2021 true-up RFI to do this.

3.2. We propose to not use the breakdown of the bad debt charge by tariff type as we were unable to gather this data in a proportionate and consistent basis across suppliers.

3.3. We propose that any additional bad debt costs in our true-up adjustment will be recovered through credit meter customers.

3.4. We propose to make no adjustment in cap period nine (October 2022 – March 2023) to true up the initial float provided for bad debt costs. The data we gathered on debt-related costs in cap periods four to six (April 2020 – September 2021) to assess the final impact of COVID-19 suggests that there has not been a material and systematic change in incremental costs from what we have already allowed suppliers to recover in the float.

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

3.6. However, we propose to gather bad debt cost data for six months after these cap periods to account for any provision movements. This means gathering bad debt charge data on cap period seven (October 2021- March 2022). This proposal has changed since our November 2021 consultation. We consider that if we gather data beyond this six-month period there is a risk that we capture impacts on customers that are out of the scope of this work.

Data source for bad debt costs

Context

3.7. In our November 2021 consultation, we outlined two options for determining the additional bad debt costs due to COVID-19: the cumulative bad debt charge approach and the bottom-up approach.[13]

3.8. We proposed to adopt the cumulative bad debt charge and have since gathered data on suppliers' bad debt charge data though our December 2021 RFI.

Proposal

3.9. We propose to use a cumulative bad debt charge approach to calculate if there are any additional bad debt costs due to COVID-19. This proposal is unchanged from our November 2021 consultation. We propose to use the data gathered via our true-up RFI to do this.

Stakeholder responses

3.10. Six suppliers commented on our proposed cumulative bad debt charge approach and on the data source for bad debt costs.

3.11. Five suppliers agree with our proposed approach.

3.12. Furthermore, we received just under 40,000 responses related to our November 2021 consultation from a petition website. Respondents commented on 'whether the COVID-19 pandemic has or has not affected my ability to pay my energy bills'. Of the individuals that responded, almost 18,000 (46.5%) respondents indicated that the COVID-19 pandemic had not affected their ability to pay their energy bills, while 17,000 (42.6%) indicated that the COVID-19 pandemic had affected their ability to pay their energy bills.

[13] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 3.8 – 3.19. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

Considerations

3.13. Our considerations are outlined in detail and remain unchanged from our November 2021 consultation.[14] We have summarised some of these considerations below to outline the benefits and limitations to this approach. This provides some context for when we discuss the quality/analysis of the December 2021 RFI.

3.14. As noted in our November 2021 consultation, we consider that the cumulative bad debt charge approach benefits from being a more practical data source, as suppliers already need to produce a bad debt charge for their own accounts. We also noted that it 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.

3.15. However, we also made it clear that despite these benefits there are limitations to this approach. 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[15]) 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.

3.16. We also noted that there is a potential limitation in the accuracy of this approach as we would need to use bad debt charge data for cap 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. 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

[14] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 3.23 – 3.57. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
[15] 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-defaulttariff-cap-cap-period-seven

is a risk that the new provisions could lead to us overstating or understating the additional costs of COVID-19.

3.17. We do not consider that these limitations justify changing approach. We are outlining these limitations to give further context to our proposals produced from our data analysis.

3.18. One supplier said that it had concerns regarding the ability of suppliers to inflate their COVID-19 bad debt costs given that they have flexibility in their method of provisioning.

3.19. We consider that taking a cumulative bad debt charge means that we look at the bad debt charge over a longer period of time and can capture and mitigate the impact of any differences in provisioning methods. All suppliers provisioning methodologies also go through an audit process to check they are fit for purpose. Bad debt charge provision is a forward-looking provision, the methodology can be reviewed by auditors. Our proposal to collect data for six months (one cap period) after cap period six, will account for provision movements from the main cap periods impacted by COVID-19. We also engaged in calls and emails with suppliers when we were concerned by their bad debt charge data.

RFI data analysis

3.20. We requested bad debt charge data from suppliers that included total bad debt charge and the total bad debt charge broken down by tariff type (Fixed/Default) and payment method (direct debit /standard credit /PPM).

3.21. We received eleven submissions to the bad debt charge cost question from our December 2021 RFI.

3.22. We excluded two suppliers from our sample. Please see Appendix 2 for a detailed explanation of our methodology and Appendix 4 for more information on our inclusion criteria for the calculation of our sample data.

3.23. Nine suppliers were included in our sample for calculating the total weighted average benchmark for the incremental bad debt costs. We are satisfied with the size and quality of the data sample.

3.24. In the sub-sections below, we discuss the issues we faced in using the breakdown of bad debt costs by tariff type and payment method, what this means for our proposals of how

we calculate our bad debt allowance, and what our overall position is on the true-up adjustment for bad debt costs.

Breakdown by tariff type

Context

3.25. In our December RFI, we requested the bad debt charge broken down by tariff type (Fixed/Default) to ensure we have the correct costs in our scope. Our proposal was to focus on the costs for default tariff customers when carrying out our calculations, given that the cap applies to default tariff customers.

3.26. Please see Chapter 5 Benchmarking, 'Considering customer base factors' for further details on our rationale for gathering tariff type breakdown and how this interacts with our benchmarking exercise.

Proposal

3.27. We propose to **not** use suppliers' breakdown of bad debt data by tariff type as we were unable to gather this data in a proportionate and consistent basis across suppliers. This is a change in proposal from our November 2021 proposal.

Stakeholder responses

3.28. In response to our December 2021 RFI, suppliers shared its capability to provide tariff type breakdowns for bad debt charge.

3.29. Six suppliers were unable to provide bad debt charge broken by tariff type. Two large suppliers noted that providing a breakdown of the bad debt charge by tariff type would take significant time to produce and would likely rely on allocations which wouldn't necessarily be accurate or comparable across suppliers.

3.30. In response to the March 2021 call for input, one supplier said that it was fundamentally important that we considered only data from default tariff customers. In response to the June 2021 working paper, one supplier said that tariff type affected debt levels.

Considerations

3.31. We noted in our November 2021 consultation that the bad debt charge data was limited in the number of customer base factors it could be broken down into. We flagged that assumptions may be required and that we would engage with suppliers throughout the RFI process on whether they would be able to provide debt-related costs broken down by tariff type.

3.32. Our engagement with suppliers highlighted that no supplier uses tariff type as a factor in their regular provisioning methodology. This means that suppliers' systems do not easily provide a breakdown of the bad debt charge by tariff type and assumptions would be required.

3.33. We were unable to make ourselves comfortable that the limited number of suppliers who had provided tariff type breakdowns had done this in an accurate and consistent manner.

3.34. Our engagement with suppliers who did not provide this breakdown provided enough evidence and reasoning to suggest that trying to focus solely on default tariff customers costs may actually have a detrimental impact on the accuracy of this approach.

3.35. We consider that not being able to control for tariff type in our calculations is an inherent limitation of the cumulative bad debt data approach.

Breakdown by payment method

Context

3.36. 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.[16]

3.37. Suppliers have told us that debt-related costs are generally higher for standard credit customers than for direct debit customers. We also expect that debt-related costs are much lower for PPM customers (than for other payment methods).

[16] Ofgem (2019), Consumer Survey 2019.
https://www.ofgem.gov.uk/publications/consumer-survey-2019

3.38. In our December RFI, we requested the bad debt charge broken down by payment method (direct debit /standard credit /PPM) to assist us in our allocation exercise.

3.39. Please see Chapter 6 on 'Allocating across payment methods' for further details on our rationale for gathering payment method breakdown and our considerations for our allocation proposals.

Proposal

3.40. We propose to allocate all additional bad debt costs equally to credit customers (standard credit and direct debit) only. We consider that this best reflects that the vast majority of all bad debt costs are inherited from debt that is built up whilst on a credit meter.

3.41. We propose to allocate no bad debt costs to PPM customers. We consider that there is a limited amount of bad debt that comes from debt that is built up whilst on a PPM.

3.42. This is a change in proposal from our November 2021 consultation. We discuss how our data has driven some of the rationale for this proposal below and we discuss our overall considerations for our allocation proposal in Chapter 6.

Stakeholder responses

3.43. In response to the December 2021 RFI, the majority of suppliers noted that the bad debt data provided in the payment type breakdown does not reflect where the debt was accrued (ie where the costs were incurred) and raised concerns about using this data as it was provided to set an allowance across the different caps for each payment method.

Considerations – General

3.44. We provide our considerations of how our data impacts our calculations below and what it means for the allowances set. Please see Chapter 6 for a more detailed discussion of allocating costs.

Considerations – the approach

3.45. We requested the bad debt charge 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. This means 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.

3.46. Using the breakdown of PPM customers bad debt as requested would result in overfunding the PPM allowance, given that 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. We consider that this would not protect PPM customers and would not reflect where costs are actually incurred from COVID-19.

3.47. One supplier requested that we ask all suppliers to apply assumptions to reallocate costs back to where the debt was incurred or to apply this assumption ourselves across suppliers.

3.48. In our engagement with suppliers on the bad debt data source we discussed the concept of trying to tie bad debt back to its original source. The overall consensus among suppliers was that this was extremely difficult and trying to perform this exercise would take significant time and resource from suppliers and they could not guarantee that outputs would improve the accuracy.

3.49. We therefore consider that it is not proportionate to ask suppliers to produce these assumptions, given that it may not result in increased accuracy.

3.50. We also consider that if we put a significant weight on needing our data source to tie back costs to their origin, then the alternative bottom-up approach would be more appropriate to achieve this.

Considerations – the source of bad debt costs

3.51. In our final round of engagement with suppliers in our RFI sample, we asked questions that related specifically to bad debt categorised as PPM in their submission and where this debt originated from. All suppliers agreed that the scale of bad debt allocated to PPM was predominately accrued from debt that was built up on credit meters and was subsequently moved to PPM.

3.52. Two suppliers said that they consider discretionary credit provided to PPM customers as a form of COVID-19 related additional bad debt cost, as they've offered the credit repeatedly for PPM customers facing financial difficulty. Suppliers did flag that there may have

been an increase in the levels of debt built up on PPM meters due to COVID-19, as they increased their levels of emergency or discretionary credit. However, they flagged that the scale of this impact on bad debt is insignificant in comparison to the amount transferred over from credit meters.

3.53. One supplier said that PPM customers may acquire debt directly, and that the debt can be transferred to a supplier via the Debt Assignment Protocol (DAP), resulting in that supplier facing unfunded costs.

3.54. Suppliers also flagged that the PPM bad debt that originates from debt that is inherited through a switch from another supplier, through the DAP, has likely reduced since the baseline period due to the lack of competitive PPM offers available on the market since the wholesale price rises.

3.55. The evidence suggests that the majority of bad debt costs are inherited from customers on credit meters, and we therefore intend to reflect this in our allowance by allocating any additional costs to credit customers.

Output from RFI

3.56. In Table 2 below, we show the difference between the final weighted average incremental cost per dual fuel (DF) customer at typical benchmark consumption.

3.57. This was calculated using a sample of nine suppliers. We excluded two suppliers.

3.58. Our final incremental bad debt cost per DF customer (£14.49) is calculated based on the methodology outlined in Appendix 2, which incorporates the following proposals:

- using total bad debt charge in our calculation as opposed to focusing on default tariff costs;
- spreading total bad debt costs over credit customers only; and
- taking a weighted average benchmark across suppliers.

3.59. As outlined in Table 2, our bad debt data from the December 2021 RFI on cap period four to six (April 2020 – September 2021) showed that the additional bad debt charge for credit customers was £0.71 per customer higher than our original estimate in the float.

3.60. We therefore propose to make no adjustment in the cap to true up our initial estimate of bad debt costs for credit meter customers. We consider that this change in cost between the final cost and what was already provided for in the float is not material when considered in isolation or alongside other debt-related costs and does not justify introducing an adjustment in the cap.

Table 2: Final weighted average bad debt costs compared with our initial float

	Final incremental cost (£ per DF customer) from December 2021 RFI	Incremental cost (£ per DF customer) determined in the float	Difference
Bad debt credit costs	14.49	13.78	0.71
Bad debt PPM costs	0.00	0.00	0.00

The process for future true-ups

Context

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

3.62. This means we need to gather bad debt charge data for the accounting cap 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 cap periods.

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

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

Proposal

3.64. We propose to consider a true-up of 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 cap periods impacted by COVID-19. This position is unchanged from our November 2021 consultation.

3.65. We also propose to gather data for six months from the end of the last period we are truing up. This means gathering the bad debt charge for cap period seven (October 2021 – March 2022). This is a change in proposal form our November 2021 consultation.

November 2021 consultation proposal

3.66. Our November 2021 consultation proposal was 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.

3.67. We have changed our proposal because we consider there is a significant risk that bad debt data for cap period eight (April 2022 – September 2022) could reflect an increased risk of non-payment due to the increase in the cap, as opposed to the residual impact of COVID-19.

Stakeholder responses

3.68. From our November 2021 consultation, we had responses from four suppliers, with respect to the process for future 'true-ups' of bad debt. The responses relate to which cap period we should look at for costs, and when we should consider these costs.

3.69. Two suppliers agreed that we should consider cap periods four to six (April 2020 – September 2021) in cap period nine. One of the suppliers also commented that they had an uplift in debt and subsequent bad debt due to COVID-19 but over the course of the restrictions.

3.70. One supplier disagreed and suggested that we should consider gathering data earlier, in either February or March of 2020.

3.71. One supplier agreed with our November 2021 consultation approach, they noted that higher debt-related costs due to COVID-19 will persist into 2022, given the backlog in courts.

Considerations

3.72. We recognise that COVID-19 may have some residual impacts on the cap periods beyond those mainly affected. For example, the end of the Coronavirus Job Retention Scheme (furlough scheme)[17] is likely to affect some customers' financial situations. We consider that our approach 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.

3.73. As discussed in our considerations of this option, gathering data beyond the end of the 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 that these non-COVID-19 factors could have on our allowance.

3.74. We consider that recent price increases, and the resulting impacts on the cap and suppliers provisions, should not be in scope of this work and we should try to not capture any of the impacts within our assessment of the final impact of COVID-19 on debt-related costs.

3.75. We therefore consider that we should only gather data on cap period seven (October 2021 – March 2022) to capture the residual impact from the bad debt provided for in cap periods four to six.

3.76. We consider that six months provides the right balance of limiting the number of cap 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

[17] HM Revenue & Customs (2021), Changes to the Coronavirus Job Retention Scheme. https://www.gov.uk/government/publications/changes-to-the-coronavirus-job-retention-scheme

recognise that using 12 or 18 months would provide extra time for suppliers to refine their provisions.

3.77. We propose to gather debt-related cost data on cap period seven (October 2021 – March 2022). We will engage with suppliers when collecting this data to limit as much as possible, any non-COVID-19 impacts on suppliers' bad debt.

Table 3: When each bad debt charge will be trued up

Bad debt charge accounting cap 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 cap period used to capture provision movements from cap periods being trued-up	Cap period ten (April 2023 – September 2023)[18]

[18] An adjustment would only be made in cap period ten if we were comfortable that the cap period seven data reflected the residual impact of COVID-19 and not the impact of increased price rises.

4. Other debt-related costs

Chapter summary

We set out our proposed approach for calculating the final additional debt-related administrative costs and working capital costs due to COVID-19. We also outline our results from our proposed approach and what this means for the true up of additional debt-related administrative costs and working capital costs in the cap.

Summary

4.1. We propose to not make an adjustment in cap period nine to true up debt-related administrative costs or working capital costs.

4.2. We propose to gather debt-related administrative costs data for six months from the end of the last cap period we are truing up. This means gathering the debt-related administrative costs for cap period seven (October 2021 – March 2022).

4.3. We also propose to not gather any further working capital data beyond cap period six. Unlike bad debt and debt-related administrative costs, we consider that the majority of working capital costs from repaid delayed payments should materialise within the cap periods impacted by COVID-19, cap periods four to six. We also consider that unpaid delayed payments should have limited residual impact on working capital that would flow through to future cap periods given that this debt should be provisioned for.

Debt-related administrative costs

Defining and collecting debt-related administrative costs

Context

4.4. In our November 2021 consultation, we outlined that we expected that COVID-19 had increased the level of customer debt in the domestic energy market. We also considered that

the number of customers in debt and the value of their debt are likely to be positively correlated with debt-related administrative costs.[19]

4.5. We also noted, that in our November 2018 decision to implement the cap we set out some costs that should be considered in debt-related administrative costs. For example: additional administration and collection costs of debt, additional bill printing and postage, and customer service costs.[20]

4.6. In our November 2021 consultation, we outlined three options to collect debt-related administrative costs data:[21]

- Flexible – a high-level description of debt-related administrative costs, without specific definitions of which costs to include or request a specific breakdown.
- Prescriptive - a number of defined categories which would require suppliers to provide a breakdown of their debt-related administrative costs in line with these categories.
- Hybrid - set categories and breakdowns. Suppliers would be able 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.

Proposal

4.7. For the COVID-19 true-up adjustment, we propose to 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

[19] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.3. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
[20] 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
[21] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.8. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

when customers incur debt. This proposal is unchanged from our November 2021 consultation.[22]

4.8. We propose to use a hybrid approach for collecting debt-related administrative cost data. We set out categories in our December RFI and asked for breakdowns, while allowing suppliers to put forward any additional debt-related administrative costs not covered by these categories. This proposal is unchanged from our November 2021 consultation and was included in our December 2021 RFI.[23]

Overview of stakeholder responses

4.9. Only one supplier responded to our November 2021 consultation specifically on our debt-related administrative costs approach. This supplier agreed with our proposed hybrid option for collecting debt-related administrative cost data.

Considerations

4.10. Our considerations remain unchanged from our November 2021 consultation.[24]

4.11. As noted in our November 2021 consultation, we consider that the hybrid option to gather data 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. This option was favoured by the one supplier who commented on our three data collection options, noting that many of the categories are similar to suppliers' management accounts, while allowing for differences in suppliers approach.

4.12. We requested debt-related administrative costs using the hybrid option in our December 2021 RFI alongside the total figure. We consider that this option, allowed suppliers to incorporate any additional debt-related administrative costs which they consider to be affected by COVID-19.

[22] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.5. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
[23] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.10. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
[24] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.14-4.16. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

RFI data on Debt-related administrative cost

Background on data quality

4.13. 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.[25] 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.[26] We said that we would consider debt-related administrative costs as part of the COVID-19 true-up.

4.14. In our December 2021 RFI, we requested the debt-related administrative costs broken down by tariff type and payment method, to ensure that we have the correct costs in scope of our consultation. Our proposal was that these breakdowns would allow us to focus on the costs to default tariff customers and support potential options for allocating costs across payment methods.

Proposal

4.15. We propose to use a cumulative debt-related administrative cost approach to calculate if there are any additional debt-related administrative costs due to COVID-19. This proposal is unchanged from our November 2021 consultation. We propose to use the data gathered via our true-up December 2021 RFI to do this.

4.16. We propose to not use the breakdown of the debt-related administrative costs by either payment method or tariff type as we were unable to gather this data in a proportionate and consistent basis across suppliers.

[25] 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

[26] 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

4.17. We propose to use the total debt-related administrative costs to calculate if there are any additional debt-related administrative costs due to COVID-19, as opposed to focusing only on default tariff costs. This is a change in proposal from our November 2021 proposal.[27]

4.18. We propose to allocate all additional debt-related administrative costs equally across credit customers (standard credit and direct debit) only.

4.19. We propose to allocate no debt-related admin costs to PPM customers. The limited available evidence we have on PPM debt-related administrative costs suggests that there has not been a material increase due to COVID-19.

4.20. We propose to make no adjustment in cap period nine to true up additional debt-related administrative costs. The data we gathered on debt-related costs in cap periods four to six to assess the final impact of COVID-19 suggests that there has not been a material and systematic change in incremental costs from what we have already allowed suppliers to recover in the float.

Stakeholder responses

4.21. In response to our November 2021 consultation, two suppliers provided general comments relating to debt-related administrative costs.

4.22. One supplier urged us to balance out any uplift in debt-related administration costs with savings that suppliers had made during the COVID-19 pandemic. It said that suppliers had benefitted from cost savings, for example from furloughing customer service and field employees.

4.23. One supplier noted our previous recognition that PPM customer can incur higher debt-related administrative costs, particularly on contact centres. This supplier said that we may, as previously in the float, dismiss PPM debt-related administrative costs as immaterial if the data is not-consistent. It said that if the extra costs are small and dismissed, a supplier cannot recover efficient costs and would be penalised by an unfair cross subsidy.

[27] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.11. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

Considerations – RFI data submissions

4.24. We received eleven submissions to the debt-related administrative costs question in response to our December 2021 RFI.

4.25. Some suppliers could not breakdown debt-related administrative costs by the individual cost categories we requested. These suppliers were not automatically excluded from our analysis because we calculated the weighted average increment using the total figure. For suppliers who were able to provide the split, we used this as a sense check for how debt-related administrative costs changed over time and across suppliers.

4.26. We excluded three suppliers from our sample. Please see Appendix 2 for a detailed explanation of our methodology and Appendix 4 for more information on our inclusion criteria for the calculation of our sample data.

4.27. Eight suppliers were included in our sample for calculating the total weighted average benchmark for the incremental debt-related administrative costs. We are satisfied with the size and quality of the data sample.

Considerations – RFI data breakdowns

4.28. We wanted to assess if the incremental debt-related administrative costs were different among payment methods as we highlighted in our November 2021 consultation that PPM customers could incur higher debt-related administrative costs relative to customers on other payment methods at the point the debt is incurred.[28]

4.29. However, the majority of suppliers who submitted data could not split debt-related administrative costs by payment method or tariff type. Some suppliers said that they do not report debt-related administrative costs by payment method and/ or tariff type and were unable to accurately apportion these costs in a comparable or reliable format.

4.30. Only four suppliers were able to provide data for PPM debt-related costs. One supplier said that its reporting of debt-related administrative costs is not broken down by payment

[28] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.27. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

method and tariff type, so this level of granularity would require assumptions which may not be consistent with other suppliers. We consider it appropriate to include as many suppliers as possible in our analysis of debt-related administrative costs, so that we can be confident on the accuracy of our result.

4.31. On an aggregate level, we did not see an increase in total debt-admin costs. We also looked at PPM specific costs, albeit with a smaller sample, and we saw no evidence of a material or systematic increase in debt-related administrative costs for PPM customers due to COVID-19. We consider that we had enough confidence with our smaller PPM only sample to sense-check our results, given that this sample still covered a sufficient proportion of all PPM customers.

4.32. Only three suppliers (out of eleven) were able to break down the data by tariff type.

4.33. Given the data breakdown issues, we consider that it would be appropriate to look at total debt-related administrative costs only.

Considerations – materiality

4.34. Our final incremental cost per DF customer is calculated based on the methodology outlined in Appendix 2, which incorporates the following proposals:

- using total debt-related administrative costs in our calculation as opposed to focusing on default tariff costs;
- spreading total debt-related administrative costs over credit customers; and
- taking a weighted average benchmark across suppliers.

4.35. Our debt-related administrative cost data from the December 2021 RFI on cap period four to six, showed that the additional debt-related administrative cost for all customers was −£1.27 per typical DF customer.

4.36. We propose to make no adjustment in the cap for additional debt-related administrative costs. The incremental debt-related administrative benefit could be recovered from suppliers. However, when viewed in the round with all debt-related costs, we consider that there are no additional material or systematic cost above that already allowed for in the default tariff cap. This approach is consistent with our August 2021 float decision.

4.37. We previously recognised that suppliers may experience a decrease in their debt-related administrative costs due to the suspension of certain debt collection activities and the furlough scheme at the beginning of the COVID-19 pandemic, and that suppliers may experience increased debt-related administrative costs after this. We also recognise that COVID-19 may have some residual impacts on the debt-related administrative costs in cap periods beyond those mainly affected. We will reconsider debt-related administrative costs when we gather cap period seven data.

The process for future true-ups

Context

4.38. In our November 2021 consultation, we proposed that cap periods four to six (April 2020 – September 2021) were the main cap periods impacted by COVID-19 and we also proposed to gather data beyond this period to capture any provision movements in bad debt.

4.39. We did not specify in that consultation whether we would gather data beyond cap period six for the other debt-related costs, but the expectation was that this would be required in the event we were calculating a combined benchmark.[29]

4.40. In Chapter 5, we note our proposal to calculate individual benchmarks for debt-related costs, this means we must consider whether we need to gather data for debt-related administrative costs beyond cap periods six.

Proposal

4.41. We propose to consider a true-up of debt-related administrative costs 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 cap periods impacted by COVID-19. This position is unchanged from our November 2021 consultation.

[29] A combined benchmark would have required us to gather data on all three debt-related costs to ensure we could calculate a combined benchmark across.

4.42. We also propose to gather data for six months from the end of the last cap period we are truing up. This means gathering the debt-related administrative costs for cap period seven (October 2021 – March 2022).

Stakeholder responses

4.43. From our November 2021 consultation, we had responses from four suppliers, with respect to the process for future 'true-ups' of other debt-related costs. The responses relate to which cap period we should look at for costs, and when we should consider these costs.

4.44. Two suppliers agreed that we should consider cap periods four to six (April 2020 – September 2021) in cap period nine. One of the suppliers also commented that they had an uplift in debt and subsequent bad debt due to COVID-19 but over the course of the restrictions.

4.45. One supplier disagreed and suggested that we should consider gathering data earlier, in either February or March of 2020.

4.46. One supplier agreed with our November 2021 consultation approach, they noted that higher debt-related costs due to COVID-19 will persist into 2022, given the backlog in courts.

Considerations

4.47. As discussed in Chapter 3, we recognise that COVID-19 may have some residual impacts on the cap periods beyond those mainly affected.

4.48. We consider that debt-related costs could be incurred over time beyond a particular period of billed consumption, as it may take time to recover debt. This means that additional debt-related administrative costs could flow beyond cap period six and materialise.

4.49. We therefore consider that we should only gather data on cap period seven to capture the residual impact from the bad debt provided for in cap periods four to six. This is consistent with our approach for bad debt.

Working capital costs

Defining working capital costs

Context

4.50. In our November 2021 consultation, we noted that an increase in delayed payments will impact suppliers' cash flow and may create a financial need for suppliers, which in turn may have a cost.[30]

4.51. In our November 2021 consultation, we considered three options on the approaches for determining additional working capital costs due to COVID-19:[31]

- 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;[32]
    - 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'[33]
    - this is a measurement of the average amount of time it takes customers to pay suppliers;

[30] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.28. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
[31] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.32. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
[32] This excludes items: additional cash and working capital requirements relating to trading, taxation balances, and derivatives
[33] 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.

- $Debtor\ days_{half-yearly} = \frac{Average\ accounts\ recievables_{half-yearly}}{Revenue_{half-yearly}} * \frac{365}{2}$

- 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.

Proposal

4.52. We propose to use option 2 (half yearly debtor-days) to determine the additional working capital costs due to COVID-19. This is a measurement of the average amount of time it takes customers to pay suppliers. This proposal is unchanged from our November 2021 consultation.[34]

Overview of stakeholder responses

4.53. From our November 2021 consultation, we received four responses from stakeholders relating to defining working capital costs. Suppliers commented on our debtor days proposal.

4.54. Three suppliers who responded to our November 2021 consultation supported the debtor days approach.

4.55. One supplier did not agree that the debtor days option was the best approach to recover working capital costs.

[34] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.34. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

Considerations

4.56. Our considerations remain unchanged from our November 2021 consultation, and we consider that option 2 (half yearly debtor days) is more focused on debt than the 2018 decision working capital approach (option 1).

4.57. The one supplier who did not agree with our debtor days option, said that the calculation does not consider seasonal fluctuations which impact direct debit payments.

4.58. Our calculation to determine the additional working capital costs calculates the incremental debtor days for cap period four, five and six. We calculate the increment relative to the same months before COVID-19. We 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 remove an equivalent baseline period in the increment calculation, and net off any seasonal effects. This means that our calculation of additional working capital costs should capture the seasonal variability of direct debit payments.

The difference between working capital and short-term financing

Context

4.59. We have previously consulted on working capital costs but have not included a discussion on what additional costs suppliers are facing due to additional delayed payments.

4.60. As part of the true-up exercise we need to determine what we consider to be the final costs to suppliers from additional delayed payments. We have now done some further thinking on this topic and the actual impact it has on suppliers' costs.

Proposal

4.61. We propose to make no adjustment in the cap to true up additional working capital costs due to COVID-19. We consider that the cost suppliers are facing due to COVID-19 are related to suppliers' need to cover the additional risk of short-term delays in payments, as opposed to the cost associated with capitalising a full business for providing standard credit.

Stakeholder responses

4.62. This is a new proposal, so stakeholders have not yet had the opportunity to comment on this particular point.

Considerations

4.63. Suppliers' incur additional working capital costs because standard credit customers generally pay a higher proportion of their bills in arrears. Additional working capital costs are an inherent feature of providing standard credit. The cap includes an allowance, through the payment method uplift (PMU), for the additional cost of working capital.[35]

4.64. We recognise that an increase in delayed payments due to COVID-19 will have an impact on suppliers' cashflow and will result in temporary additional costs.

4.65. However, we consider that the resulting cost from this impact are more akin to suppliers needing to cover the additional risk of short-term delays in payments, as opposed to the cost associated with capitalising a full business for providing standard credit.

4.66. Suppliers should already have short-term financing facilities in place as part of their normal business functions. We expect suppliers to have robust financial governance frameworks in place to meet their financial obligations.

4.67. We consider that the cap includes various provisions to help suppliers with the costs of managing uncertainty and risks, including through allowances such as the PMU, the Earnings Before Interest and Tax (EBIT) allowance, and the headroom allowance. We recognise that there will be uncertainty in all cost allowances, but we do not consider this justifies unduly increasing the cap in a way which does not reflect how suppliers manage their risks in practice.

4.68. We therefore do not consider an additional allowance is required in principle.

[35] Ofgem (2018) Default tariff cap: decision – overview – Appendix 8 – Payment method uplift. https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf

4.69. When initially investigating the impact of COVID-19, as part of setting a float, we were not aware, at the time, of how long the impacts of COVID-19 would last and the impact additional delayed payments would have on suppliers' cash flow. We considered it necessary to try and gather data on this area on the basis that that there could have been widespread increase in delays and failures to pay. An impact on this scale could have required suppliers to acquire additional capital, to meet standard credit needs.

4.70. We consider that it was still appropriate to consult on and gather data on this potential cost as part of our true-up exercise. The true-up exercise involves understanding the best approach to determine the final additional cost and comparing this with what is already provided for in the cap and what is expected from suppliers as part of their routine obligations.

4.71. We also used the data from our December 2021 RFI to understand the materiality of this potential cost alongside all other debt-related costs. We consider that our view of this potential cost has evolved since our initial float and earlier consultations and we now have a better understanding of the impact of COVID-19, the length of time these impacts lasted and what this actually means for the additional delays in payments experienced from suppliers. As discussed below, we do not consider there is an additional material and systematic cost.

RFI data on working capital costs

Background on data quality

4.72. In our February 2021 decision, we did not include an adjustment for the cost of working capital. One reason for this was because we were not able to reassure ourselves that suppliers had responded in consistent ways to the working capital questions.[36] We also decided in our August 2021 decision to not introduce a float for additional working capital costs as we did not have confidence in the robustness of suppliers' forecasts.[37] We previously said that we had not ruled out the possibility of including working capital costs in the true-up.

[36] 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
[37] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap: cap period seven, paragraph 4.11.

4.73. In our December 2021 RFI, we requested the debtor days inputs[38] broken down by tariff type and payment method, to ensure that we have the correct costs in scope of our consultation. Our proposal was that these breakdowns would allow us to focus on the costs to default tariff customers and support potential options for allocating costs across payment methods.

Proposal

4.74. As noted above, we propose to make no adjustment in the cap to true up additional working capital costs due to COVID-19.

4.75. In the event that we considered it appropriate to provide an allowance, we would propose to:

- allocate all additional working capital costs equally across credit customers (standard credit and direct debit) only;
- allocate no working capital costs to PPM customers. We consider that this best reflects that PPM customers pay in advance of consuming their energy; and
- not use the debtor days payment method or tariff type breakdowns and only consider total debtor days.

Considerations – RFI data quality

4.76. We received eleven submissions to the debtor days question in response to our December 2021 RFI.

4.77. Suppliers were generally able to provide more complete responses to this question, in comparison to the debt-related administrative costs question. One large supplier was not able

https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-covid-19-default-tariff-cap-cap-period-seven

[38] Suppliers were asked to submit accounts receivables at the beginning of the cap period, accounts receivables at the end of the cap period, and total actual revenue over the cap period.

to breakdown the debtor days inputs by tariff type. Another supplier was not able to breakdown the debtor days inputs by tariff type for the baseline period only.

4.78. We excluded four suppliers from our sample. Please see Appendix 2 for a detailed explanation of our methodology and Appendix 4 for more information on our inclusion criteria for the calculation of our sample data.

Considerations – breakdown by tariff type and payment method

4.79. As noted in the RFI data quality section above, one large supplier was not able to provide a breakdown of the debtor days inputs by tariff type. We consider that maximising the sample size used is important in ensuring that our weighted average benchmark is representative of market costs. To assess the materiality of using total costs in our calculations, as opposed to focusing on default tariff costs, we assessed data from the reduced sample who did provide the tariff type breakdown. We found that there was not a material difference (£0.06 difference per DF customer account) between focusing on default tariff customers, as opposed to looking at total costs across the same sample. We therefore choose to include all data points to ensure that our weighted average benchmark better represents market costs and to not overcomplicate our modelling.

Considerations - materiality

4.80. Our final incremental cost per DF customer is calculated based on the methodology outlined in Appendix 2, which incorporates the following proposals:

- using total debtor days in our calculation as opposed to focusing on default tariff costs;
- spreading total debtor days over all domestic credit customers; and
- taking a weighted average benchmark across suppliers.

4.81. To translate the debtor days into a monetary format, we must apply a cost of financing assumption (%), which would calculate an allowance for working capital.

4.82. We have not previously made a decision on what the appropriate cost of financing assumption is. In the consultations relating to our February and August 2021 decision we made a simplification by applying a 10% cost of capital to convert the amount of working

capital into a cost. This was to be consistent with the cost of capital used in our 2018 cap decision and to try and give us a sense of scale of the materiality.[39] We include a 10% weighted average cost of capital (WACC) in our cap methodology to fund suppliers the cost of capitalising their full business and the long-term cost of permanent capital.

4.83. However, as noted above, we consider that the cost suppliers are facing due to increased delayed payments because of COVID-19, are fundamentally different costs.

4.84. If we applied a cost of financing rate of 10%, in line with our previous cap calculations, then using our working capital cost data from our December 2021 RFI on cap period four to six would show that the additional working capital cost for all customers would be £4.42 per typical DF customer.

4.85. We provide this figure to illustrate the sensitivity of the assumption. We consider that if there is any cost of short-term financing then it will be significantly lower than 10%. We note that most suppliers in our sample have backing from larger parent companies and will have access to a lower cost of financing through lower rates or credit facilities. We also note that suppliers have historically been able to use credit balances as a low-cost source of working capital. Although Ofgem is preparing to consult on 'Customer Credit Balances and Renewables Obligation protection' in line with the latest policy position[40], we consider that suppliers were still able to benefit from this during the cap periods we are assessing.

4.86. We are not aware of any research which looks specifically at this area and the associated costs for domestic energy suppliers. However, our research on publicly available data that closely relates to what the cost of financing could be for energy suppliers indicates that any assumption should be considerably lower than the WACC assumption:

Cost of financing	Description
1.71%	SONIA rate[41] plus 1%: Proxy for short term financing

[39] Ofgem (2018), Default tariff cap: decision – overview – Appendix 8 – Payment method uplift. https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf
[40] Ofgem (2022), Update to December Action Plan: Customer Credit Balances and Renewables Obligation protection. Update to December Action Plan: Customer Credit Balances and Renewables Obligation protection (ofgem.gov.uk)
[41] We have taken the maximum SONIA rate from the 2020 calendar year (15-Jan-2020) at 0.7125%. Bank of England (2022), Daily Sterling overnight index average (SONIA) rate. https://www.bankofengland.co.uk/boeapps/database/fromshowcolumns.asp?Travel=NIxAZxSUx&FromS

1.11-4.71%	Monthly average of UK bank's sterling weighted average interest rate (2019-present)[42]

4.87. Interest rates also give us an indication of the price of borrowing. If this was the type of mechanism suppliers' used to cover this further delay in payments, then it could be a useful assumption.

4.88. We have illustrated the UK bank sterling interest rates which give us an indication of the scale of interest applied to loans. The SONIA (Sterling Overnight Index Average) is also an important interest rate benchmark, it reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions and other institutional investors, the risk-free rate of transition. We consider that this rate plus a small mark-up could possibly be used to give an indication of scale of this cost.

4.89. The Evidence suggests that the rate of short-term financing could be somewhere in the range of 0-5%, which would result in a £0-£2.21 cost per DF customer.

4.90. We consider that if there were any costs relating to short term financing needs, then these costs would not be material or systematic in isolation or when considered alongside other debt-related costs.

The process for future true-ups

Context

4.91. In our November 2021 consultation, we proposed that cap periods four to six (April 2020 – September 2021) were the main cap periods impacted by COVID-19 and we also proposed to gather data beyond this period to capture any provision movements in bad debt.

eries=1&ToSeries=50&DAT=RNG&FD=1&FM=Jan&FY=2019&TD=31&TM=Dec&TY=2025&FNY=Y&CSVF=TT&html.x=66&html.y=26&SeriesCodes=CFMZJ3U&UsingCodes=Y&Filter=N&title=CFMZJ3U&VPD=Y

[42] Bank of England (2022), CFMZJ3U. https://www.bankofengland.co.uk/boeapps/database/fromshowcolumns.asp?Travel=NIxSUx&FromSeries=1&ToSeries=50&DAT=RNG&FD=1&FM=Jan&FY=2020&TD=1&TM=Jan&TY=2021&FNY=&CSVF=TT&html.x=44&html.y=23&C=5JK&Filter=N

4.92. We did not specify in that consultation whether we would gather data beyond cap period six for the other debt-related costs, but the expectation was that this would be required in the event that we were calculating a combined benchmark. [43]

4.93. In Chapter 5, we note our proposal to calculate individual benchmarks for debt-related costs, this means we must consider whether we need to gather data for working capital beyond cap period six.

Proposal

4.94. We propose to not gather any further working capital data beyond cap period six. We consider that cap periods four to six (April 2020 – September 2021) are the main cap periods impacted by COVID-19. Unlike bad debt and debt-related administrative costs, we consider that there should be limited residual impact on working capital that would flow through to future cap periods.

Stakeholder responses

4.95. This is a new proposal, so stakeholders have not had the opportunity to comment yet.

Considerations

4.96. The reason we have proposed to gather data beyond cap period six for bad debt and debt-related administrative costs is because we consider that some of the costs related to debt incurred in cap period four to six (April 2020 – September 2021) take time to materialise and these residual impacts will flow through to future cap periods.

4.97. We consider that working capital cost do not have a lag in fully materialising and it would be more appropriate to focus on data from the cap periods we consider to be mainly impacted by COVID-19.

4.98. The working capital cost associated with delayed payments which are repaid will materialise in the accounting cap period they are incurred. This means it is more appropriate

[43] A combined benchmark would have required us to gather data on all three debt-related costs to ensure we could calculate a combined benchmark across debt-related costs.

to only consider the main cap periods we consider to be impacted by COVID-19. There will be minimal residual impact that flow through to the cap periods that follow which means the benefits of using this data do not outweigh the risk of capturing costs related to other factors that are not related to COVID-19.

4.99. We also consider that late payments which are not paid back should already be provisioned for and accounted for by suppliers and will be captured in the bad debt charge.

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 collected on how costs vary across suppliers' customer bases.

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).

5.3. We also propose to benchmark debt-related costs separately. This is a change in proposal from our November 2021 consultation.

5.4. 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.

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. In our November 2021 consultation, we described how we could set the benchmark at different levels:

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

- a benchmark at or near the lower quartile in the cap (commonly used in our methodology).[44] 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

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

5.6. We have also discussed the 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.

5.7. In our November 2021 consultation, we noted that 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').

Proposal

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 consider it 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 primarily a consequence of our proposed data source for bad debt costs,[45] which looks at cumulative costs over a number of cap periods. Also, a cumulative benchmark across cap periods for other debt-related costs ensures that our results are not impacted by the timing of when costs materialise and different accounting approaches across suppliers.

[44] 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.
[45] We expect bad debt to be the most significant debt-related cost.

5.10. The above proposals are unchanged from our November 2021 consultation.

5.11. We also propose to benchmark debt-related costs separately. This is a change in proposal from our November 2021 consultation.

November 2021 Proposal

5.12. In our November 2021 consultation, we proposed to take a combined benchmark across debt-related costs. This was to minimise the risk that that we understate efficient costs because a supplier may be able to achieve lower costs in one area by spending more in another area.

5.13. We now consider that this risk is small because we are considering total costs across our sample in our proposal to adopt a weighted average benchmark. Also, taking a combined benchmark across debt-related costs reduces the size of the sample we can use, which means that our benchmark calculation is less robust given that it is not representative of the market.

Stakeholder responses

5.14. From our November 2021 consultation, we received seven responses from stakeholders relating to our benchmarking approach. Stakeholders expressed their stance on our proposal to adopt a weighted average benchmark.

5.15. Six suppliers supported our proposal to adopt a weighted average benchmark, rather than a lower quartile. This reflected that they considered a suppliers' customer base factors would affect its debt-related costs.

5.16. One supplier disagreed with our proposal to use a weighted average benchmark, noting that it could worsen customer detriment.

Considerations: general

5.17. Our considerations remain unchanged from our November 2021 consultation. We have outlined a summary of these considerations below, but please refer to the November 2021 consultation for full details.[46]

Considerations: stringency of benchmark

5.18. 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.

5.19. 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.

Non-efficiency factors

5.20. We consider that there are a number of non-efficiency factors that could affect suppliers' additional debt-related costs. These include:

- customer base factors – we discuss these in the next section.
- voluntary support from suppliers. 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

[46] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 5.12 – 5.49. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

area, given our proposal to use a weighted average benchmark, which will account for variation in voluntary support between suppliers.

- 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.

- natural variations (ie noise).

Efficiency

5.21. 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.

5.22. 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

5.23. We propose not to adopt a frontier benchmark. This is because the variation in the costs we calculate 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.

5.24. We do not propose to adopt a lower quartile benchmark in our true-up benchmarking. 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 consider it appropriate to use a weighted average, ensuring that an efficient supplier can recover these costs.

5.25. 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.

5.26. We can only set one cap level across suppliers. As noted above, we consider that suppliers costs' will not be solely related to efficiency and therefore consider that a weighted average approach will ensure that we are reflecting the costs of the overall customer base of our sample.

Considerations: number of benchmarks

Benchmarking across cap periods

5.27. 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).

5.28. We also propose to use a cumulative benchmark across cap periods for other debt-related costs. This ensures that our results are not impacted by the timing of when costs materialise and different accounting approaches across suppliers.

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 have the option between benchmarking these separately or a combined benchmark across all debt-related costs.

5.30. We consider there is a trade-off between two key risks from the options:

- benchmarking separately presents a possible risk of understating efficient costs if a benchmark below average costs was adopted. This is because there could be interactions between the det-related costs. 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.

- for a supplier to be included in a combined benchmark calculation, they would need to have submitted good quality data that passed our inclusion tests for all three debt-related cost data sets. This can result in more suppliers being excluded from the sample used in the combined benchmark calculation. A reduced sample size may not be fully representative of the market, and this presents a risk of inaccuracy in the determined efficient cost level.

5.31. We do not consider that taking separate benchmarks will create a risk of understating efficient costs due to our proposed design of the true-up. We are proposing a weighted average benchmark, and this means that this risk is unlikely to materialise because we are considering total costs across our sample.[47] We therefore have not given this risk significant weight when making our proposal.

5.32. Taking a combined benchmark would result in excluding five supplier's debt-related cost data sets from a total sample of eleven. We consider that this reduces the robustness of our benchmark by presenting a significant risk of misrepresenting the efficient level of costs.

5.33. On balance we consider the benefits of having a more robust benchmark calculation, by maximising the sample size used, significantly outweighs the risk that we understate efficient costs from our proposal. We therefore propose to benchmark debt-related costs separately as we consider it will produce the most robust benchmark.

Considering customer base factors

Context

5.34. 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.[48]

[47] If our sample of suppliers to calculate each debt-related cost was the same as the sample used in the combined benchmark, then it would result in the same outcome under a weighted average approach.
[48] 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

5.35. 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.

5.36. Given our proposals to measure bad debt costs using the cumulative bad debt charge and to use a weighted average benchmark, there is less of a need to consider the impact of different customer groups impact on debt-related costs because we are considering total costs across our sample. We have therefore proposed to not carry out extensive analysis on how costs vary by customer base factors.

5.37. In our December 2021 RFI, we requested data to understand how debt-related costs varied by payment method and tariff type. We outlined that the intention of gathering these breakdowns was 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).

Proposal

5.38. We propose to carry out our benchmarking exercise using cost data on suppliers' entire domestic customer bases, as opposed to only using cost data on default tariff customers.

November 2021 Proposal

5.39. We proposed to carry out our benchmarking using data on default tariff customers only.

5.40. As noted above in Chapter 3 and Chapter 4, we were unable to gather all debt-related costs data broken down by tariff type in a proportionate and consistent basis across suppliers.

Stakeholder responses

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

5.42. From our 2021 November consultation, one supplier responded, in relation to the appropriate level of granularity for customer base factors.

5.43. The supplier said that it agreed that payment and tariff types are the lowest factors for comparisons and that any more detailed factors could make comparisons more complex and historical data harder to extract.

Considerations

5.44. 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 consider that we do not need to further try to control for customer base factors (unlike if we were proposing to use a lower quartile benchmark) as they will be reflected in our calculation of the weighted average. Moreover, we can only set one cap across suppliers, and we consider it appropriate to set it so that it reflects the total customer base rather than any individual supplier's customer base.

5.45. We therefore intend to consider customer base data instead to define which costs are in scope for our analysis and to support potential options for how we allocate costs across customers.

5.46. We discuss below the two customer base factors that we have gathered data on – tariff type and payment method.

5.47. 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

5.48. 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.

5.49. In our November 2021 consultation, we said that we intended 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 have addressed concerns from suppliers about default tariff customers being more likely to incur debt than fixed tariff customers. However, we did flag that we would gather data for all domestic customers, so that we retain the option of benchmarking based on suppliers' entire domestic customer bases.

5.50. We have attempted to gather data to evidence how the additional debt-related costs that a supplier faces as a result of COVID-19 could vary in part due to the customers they have with different tariff types. As outlined in Chapter 3 and Chapter 4, we were unable to gather tariff type breakdown data all debt-related costs in an accurate and consistent manner across suppliers. We therefore consider that our next best option is to benchmark based on suppliers' entire domestic customer bases.

5.51. In our November 2021 consultation, we noted that our proposed bad debt data source was limited in how many customer base factors it could be broken down into and that suppliers may not able to easily provide the tariff type breakdown and it may require assumptions to produce.

5.52. We recognise that if default tariff customers are in fact more likely to incur debt than fixed tariff customers, on a pound per customer basis, then our new proposal could potentially result in a lower allowance. We considered this potential limitation when defining our proposed data source for bad debt, which was supported by stakeholders (see Chapter 3).

5.53. We do not consider that controlling for tariff type customers is essential for our benchmarking exercise under a weighted average approach. However, if suppliers are still concerned, then we would need to re-consider our choice of data source given these clear limitations.

5.54. We consider that applying further assumptions to try and only account for default tariff debt-related costs would not necessarily improve the accuracy of this approach. In order to provide such a breakdown, suppliers would have to use other data sources to estimate it, given the provisions suppliers produce are not broken down by tariff type. We expect that suppliers would have to do this at a top-down level given comments on the time-consuming nature and difficulty of doing a bottom-up approach. As a result, we expect that suppliers are likely to take different approaches to estimate it. This means that our results may be driven

to an unknown extent by the top-down assumptions and estimates from suppliers than underlying costs. This is supported by our engagement with one supplier who unsuccessfully attempted to bake tariff type as a factor in their provisioning and noted these risks. We therefore consider that there is significant risk that this exercise will not improve accuracy.

Payment method

5.55. Our proposal to take a weighted average benchmark means that we do not need to control for the difference in impact that each payment method has on additional debt-related costs (unlike if we were proposing to use a lower quartile benchmark).

5.56. We requested debt-related costs broken down by payment methods to help inform our policy proposals for allocating costs across payment methods (see discussion on this below in Chapter 6).

6. Allocating across payment methods

Chapter summary

In this chapter we outline our proposed approach for allocating debt-related costs across the different caps for each payment method.

Summary

6.1. We are proposing to allocate each individual additional debt-related costs equally across credit meter customers.

6.2. We also propose to allocate none of the individual additional debt-related costs to PPM customers.

Context

6.3. We recognise that additional debt-related costs are likely to vary by payment method. 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).

6.4. In calculating the adjustment, we need to consider how we should apportion additional debt-related costs between the different caps for payment types (ie direct debit, standard credit and PPM).

6.5. In our February 2021 decision for the float, we decided to adopt an equal allocation approach across credit payment types (standard credit and direct debit customers). One reason for this decision was because the data we gathered was not broken down by payment methods.

6.6. In our November 2021 consultation, we discussed that we would gather debt-related costs broken down by payment and we would consider three options for allocation across payment methods:

- 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.

Proposal

6.7. We are proposing to allocate each individual additional debt-related cost equally across credit meter customers.

6.8. We also propose to allocate none of the individual additional debt-related cost to PPM customers.

6.9. This is a change in proposal from our November 2021 consultation. We consider our new proposals strike the right balance between protecting customers and ensuring that efficient suppliers are adequately financed for the additional cost due to COVID-19.

November 2021 Proposal

6.10. In our November 2021 consultation, we proposed to separate PPM customers and credit meter customers (standard credit and direct debit) when allocating costs. This meant that we would only allocate PPM COVID-19 debt-related costs to PPM customers. We proposed 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.

6.11. After gathering data from suppliers and having further rounds of engagements with suppliers on PPM specific bad debt, we consider that our previous proposal risks not protecting PPM customers and not reflecting where costs were actually incurred.

Stakeholder responses

6.12. In response to our November 2021 consultation, one supplier responded, relating to the materiality of PPM debt costs.

6.13. In response to our March 2021 call for inputs, one supplier said that there should be a fair sharing of burden across all domestic customers and that costs should be fully socialised across all customers.

6.14. As outlined in Chapter 3, the majority of suppliers noted that the bad debt data provided in the payment type breakdown did not reflect where the debt was accrued (ie where the costs were incurred) and raised concerns about using this data as it was provided to set an allowance across the different caps for each payment method.

Considerations: General considerations on allocation

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

6.16. 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 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.

6.17. Allocating costs equally across customer groups avoids the risk of one group of customers potentially facing a larger true-up, which would not be cost reflective of how suppliers recover their costs.[49] 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

[49] This assumes that we have a significant positive true-up adjustment, ie the float provided was significantly below the final determined costs.

debt could be overfunded, and other suppliers with a high proportion of customers who are more likely to build up debt could be underfunded.

6.18. 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: PPM – bad debt

Allocating no additional bad debt costs to PPM

6.19. We intend to allocate none of the additional bad debt costs to PPM customers when allocating costs. We consider three main reasons for our proposal: feasibility of separating bad debt fairly to its source, ability to accumulate debt and customer protection and recoverability.

Feasibility to separate bad debt fairly to its source

6.20. In Chapter 3, in the 'Considerations - breakdown by payment method' section, we flagged that our data for bad debt, the bad debt charge, can only be split based on a customer's current payment method, not the customer's payment method at the point of billing. We noted that 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.

6.21. We also presented evidence that suggests there are not significant levels of PPM bad debt that comes from debt that was built up on whilst on a PPM meter (ie through credit facilities from suppliers). From our data and discussion with suppliers we understand that the majority of PPM bad debt costs (approximately a range of 90-99% from our engagement with suppliers) originate from customers who built this debt up whilst on a credit meter and were then moved onto a PPM.

6.22. In our November 2021 consultation proposal, we said that this was a limitation of the approach and that isolating PPM costs from credit costs would provide protection. However, we now consider that our previous proposal would not provide sufficient protection for PPM customers and consider that allocating no bad debt costs to PPM customers would provide better levels of customer protection for PPM and would better reflect the fact that there is a minimal level of bad debt that originates from PPM customers.

6.23. One supplier commented that Ofgem cites difficulties with data but uses the same data to determine that PPM costs are not material, resulting in PPM costs not being included in the allowance.

6.24. We acknowledge the stakeholder's concerns regarding the use of imperfect data to make decisions on the materiality of PPM costs. We consider the arguments above to demonstrate our engagements to understand the data and the materiality of PPM bad debt costs. Therefore, even without being able to separate PPM bad debt at the source we do understand the general scale, and we consider it low materiality.

Ability to accumulate debt on a PPM

6.25. 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 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.[50]

Customer protection and recoverability

6.26. The main objective of the cap is to protect default domestic default tariff customers. We do not consider that spreading costs from credit customers to PPM customers would protect default tariff customers.

6.27. Suppliers have told us that between 90-99% of the bad debt on a PPMs was built up whilst the customer was on a credit meter.[51] They said that this debt was transferred across to PPM when the customer transferred payment methods. This further emphasises that including PPM customers in the cost sharing exercise would potentially have the opposite effect, reducing protection for PPM customers. It also highlights that allocating no costs to PPM customers ensures that we allocate the majority of costs to where they were incurred.

6.28. The remaining PPM bad debt costs that can be attributed to debt that was built up whilst on a PPM meter (ie through credit facilities from suppliers) accounts for 0-10% of PPM

[50] 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.
[51] 90-99% presents the range of estimates provided by suppliers.

debt. We do not consider that the actual level of additional bad debt that would result from the percentage of debt accrued by PPM customers would be material or systematic. We have considered these assumptions alongside suppliers data and this supports our considerations. We also do not consider that trying to allocate some of the total bad debt charge to the PPM allowance would necessarily improve the accuracy of the true-up. Through our engagement, suppliers have told us that they cannot allocate provisions or bad debt charge back to its original source. This again means suppliers would need to apply top-down assumptions based on total debt levels, not bad debt, to trying and allocate a proportion to PPM customers which may not be reflective of reality. We therefore propose to not allocate any of the total bad debt costs to PPM customers.

Considerations: PPM - other debt-related costs

Allocating no additional debt admin costs to PPM

6.29. As outlined in section 'RFI data on debt-related administrative costs' in Chapter 4, we propose to allocate none of the debt-related administrative costs to PPM customers and instead to spread it equally across credit customers only.

6.30. Our data suggests that aggregate debt-related administrative costs have actually decreased since our baseline. We also looked at PPM specific costs, albeit with a small sample, and we saw no evidence of a material or systematic increase in debt-related administrative costs for PPM customers due to COVID-19.

6.31. We consider that allocating all debt-related administrative costs across credit customers reflects that the vast majority of debt-related administrative costs were incurred seeking to recover debt which was incurred on credit meters.

Allocating no additional working capital costs

6.32. As outlined in section 'RFI data on Working capital costs' in Chapter 4, we propose to allocate no additional working capital costs to PPM customers and instead to spread any additional cost equally across credit customers only.

6.33. We consider that this best reflects that PPM customers pay in advance of consuming their energy and should not result in significant working capital costs for their suppliers.

Stakeholder comments

6.34. From our November 2021 consultation we received one supplier response relating to considering other costs into the 'true-up'.

6.35. The supplier said that all exogenous costs since the introduction of the PPM cap in April 2017 should be reconciled in the 'true-up'.

6.36. We consider that the purpose of the COVID-19 true-up is to 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. Since this consultation is for the true-up of debt-related costs only, other exogenous costs sit out with the scope of this consultation.

Considerations: Equal allocation across credit customers

6.37. Suppliers have flagged that many of the additional debt-related costs due to COVID-19 will result from customers paying by standard credit.

6.38. Two suppliers who responded to our November 2020 consultation[52] 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.

6.39. 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;

[52] We discuss previous comments from stakeholders on allocation in relation to the float, given that we have not received any further comments from suppliers in relation to our November 2021 consultation.

- 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 the case if a customer moves from direct debit to standard credit due to cancellation of their direct debit after incurring debt;

- therefore, bad debt costs breakdowns by tariff and payment types may not be necessarily reflective of where the costs originate;

- a positive true-up 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.

6.40. 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. However, 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.

6.41. We also consider that our 2018 approach regarding the impacts on suppliers of their customer mix are still valid. That is, it would not be appropriate to set an allowance which covers the costs of one supplier with the maximum possible efficient costs, where that means substantially increasing the cap above the typical cost of supplying the majority of default tariff customers. If we did this, suppliers would on aggregate recover more than their efficient costs from default tariff customers, and this would not protect customers.

6.42. We consider that equal allocation provides protection for standard credit customers and does not further exacerbate the problem. We also consider that this approach does allow a supplier with an average customer mix to recover their costs.

7. Other considerations

Section summary

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

Proposals

7.1. In Table 4 below, we outline all our remaining proposals and highlight whether this position has changed from the November 2021 consultation. Please see Appendix 1 for any stakeholder comments and our considerations of these proposals.

7.2. Given our proposal is to have no true up adjustment allowance in cap period nine, there is no impact from the proposals summarised below and discussed in Appendix 1. However, we still consider it is important indicate what our proposed position would be in the event a true-up adjustment was introduced to allow stakeholders to provide their views.

Table 4: Other proposals

We propose to:	Has this position changed from November 2021 consultation?
not include a sharing factor	Unchanged
use the adjustment allowance to set the COVID-19 adjustment in the cap	Unchanged
recover the true-up adjustment over a year (two cap periods)	New proposal
allocate the incremental debt-related costs equally over fuel and meter types	Unchanged
allocate the incremental debt-related costs between the standing charge and unit rate in the same proportions as total costs are currently recovered under the cap (in the cap period we are truing-up)	Unchanged

not account for costs resulting from timing differences between when a cost was incurred and when the allowance is received.	Unchanged
to account for inflation when determining the amount to recover through the adjustment allowance	Unchanged
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.	Unchanged
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.	Unchanged
not control for changes in consumption between the COVID-19 cap period and the cap period we set the allowance.	New proposal

Appendices

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Appendix 1 - Other considerations

Sharing Factor

Context

1.1. A sharing factor is a mechanism that we have previously considered using to share the impact of COVID-19 between suppliers and customers. If introduced suppliers would bear some of the additional costs due to COVID-19, they would not recover all additional efficient costs and customers would only defined portion of this cost.

Proposal

1.2. We propose to not include a sharing factor when calculating the amount to recover in the true-up. This position is unchanged from our November 2021 consultation.

1.3. We consider that this appropriate given 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.

Stakeholder responses

1.4. From our November 2021 consultation, four suppliers responded to our proposal to not include a sharing factor.

1.5. Three suppliers supported our proposal to not include a sharing factor. One supplier disagreed with our proposal and said that this position does not support our primary function of protecting customers.

1.6. From our March 2021 call for input, two suppliers responded, with general comments on the retail supply sector finances and sharing factor.

1.7. 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.

Considerations

1.8. Our considerations remain unchanged from our November 2021 consultation. We have outlined a summary of these considerations below, but please refer to November 2021 consultation for full details.[53]

1.9. 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.

1.10. 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.

1.11. However, our assessment shows that suppliers did incur additional debt-related costs due to COVID-19. We consider that suppliers should be able to recover the efficient additional costs linked to COVID-19 under the cap. We consider that this finds the right balance between protecting customers have regard to the ability of an efficient supplier to finance its licensed activities in the current market conditions.

[53] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 6.15 – 6.20. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

How the cap is adjusted

Context

1.12. 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.[54]

Proposal

1.13. We propose to use the existing cap adjustment allowance to set any COVID-19 related adjustment for the true-up in the default tariff cap. This proposal is unchanged from our November 2021 consultation.

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

Stakeholder responses

1.15. We did not receive any comments from stakeholders on this proposal in response to our November 2021 consultation.

Considerations

1.16. Our considerations remain unchanged from the November 2021 consultation.[55]

1.17. We consider that using the adjustment allowance is the simplest and most flexible method for adjusting the cap for the true-up and we are not aware of any compelling reason to use any other component of the cap to implement the true-up.

[54] 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
[55] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 6.25-6.26. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

Timing of recovery

Context

1.18. In our November 2021 consultation, we discussed three options for how many cap periods we could recover the true-up adjustment over:

- 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 they would be recovered over would reduce. This option would involve reweighting 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

1.19. Our proposal was 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.

Proposal

1.20. We propose to recover the first true-up adjustment over a year (two cap periods). This means the first true-up adjustment will be spread over cap periods nine (October 2022-March 2023) and ten (April 2021 – September 2022).

1.21. We consider that this proposal strikes the right balance between smoothing out customer cost increases and allowing suppliers to recover additional debt-related costs accurately and in a timely manner.

1.22. In the event that we do make a true-up adjustment in cap period ten we will need to revisit the question of how long we recover over, as we would only have nine months' worth of cap periods to recover any true-up adjustment over.

Stakeholder responses

1.23. In response to our November 2021 consultation, we received responses from two stakeholders, relating our proposal on timing of recovery. Comments related to fairness concerns.

1.24. Two stakeholders commented that allowing new suppliers to recover COVID-19 costs, which they did not face, through the cap may pose as an unfair source competitive advantage over incumbents.

1.25. In setting the cap, we cannot make different provisions for different holders of supply licences.[56] This means that we must set one cap level for all suppliers and cannot differentiate between suppliers.

Considerations

1.26. In our November 2021 consultation, we have outlined in detail the trade-offs between recovering costs as soon as possible or spreading costs over a number of cap periods.[57] These considerations are summarised below.

1.27. If the true-up value was positive and is recovered over one cap period, this may lead to a sudden increase in customers' bills.

1.28. Smoothing costs over a longer timeframe has the opposite effect in that it protects customers' bills from any potential sharp rise. However, 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

[56] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[57] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 6.30 – 6.36. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

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.

1.29. Our proposal to recover any additional costs over a 12-month period aligns with how the cap is calculated, on an annual basis. This means we do not need to introduce possibly unnecessary assumptions into our calculations to scale our allowance to account for the recovery period being more or less than 12 months.

1.30. We decided against our preferred position in our November 2021 consultation, recovering over a 15-month period, because our data showed that the additional benefit of spreading the costs over an extra three months was only marginal. We consider that this marginal benefit does not outweigh the negatives of introducing additional complexity and possible inaccuracy, in the event that an adjustment was made for the true-up.

1.31. In the event that we do make a true-up adjustment in cap period ten we will need to revisit this proposal as we would only have nine months' worth of cap periods to recover any true-up adjustment over.

Allocating costs over the other cap levels

Context

1.32. 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:

1.33. 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.

1.34. allocate costs across cap components based on the estimated revenue per customer in the cap periods we are truing-up.

1.35. We also considered whether to allocate equally across all customers through the standing charge or allocate it proportionally to consumption through the unit rate.

1.36. In our February 2021 decision[58] for the float, we decided to adopt an equal allocation approach across 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.

1.37. 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.

Proposal

1.38. 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.

1.39. 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 (in the cap period we are truing-up).[59]

1.40. Both proposals are unchanged from our November 2021 consultation.

Stakeholder responses

1.41. We did not receive any comments from stakeholders on this proposal in response to our November 2021 consultation.

[58] 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
[59] 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.

General Considerations

1.42. Our considerations remain unchanged from our November 2021 consultation. We have outlined a summary of these considerations below, but please refer to November 2021 consultation for full details.[60]

Considerations: Recovery over fuel type

1.43. 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.

1.44. 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.

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

1.46. We prefer this option over the alternative of assuming that debt is proportional to bill size and reflecting this in our allocation. We consider that this assumption still presents a risk of inaccuracy and could potentially 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.

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

1.47. 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

[60] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 6.65 – 6.76. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

typical consumption benchmark for the multi-register meter cap level is set at a higher level of consumption.

1.48. 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.

1.49. 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.

1.50. 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.

1.51. 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.

Considerations: Recovery over the unit rate and standing charge

1.52. 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.

Accounting for the timing difference between costs and the allowance

Context

1.53. There is a possible cost associated with the timing difference between when suppliers incur costs and when they receive an allowance through the original float and subsequently through the true-up adjustment.

1.54. 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.

Proposal

1.55. 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.

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

1.57. These proposals are unchanged from our November 2021 consultation

Stakeholder responses

1.58. From our November 2021 consultation, we received one comment from stakeholders, relating to our proposal on accounting for inflation.

1.59. One supplier agreed with our approach to account for inflation.

Considerations

1.60. Our considerations remain unchanged from our November 2021 consultation.[61]

1.61. We consider that accounting for inflation allows us to accurately compare costs that have been incurred in different periods of time. We consider the most appropriate way of doing this is by uprating using the CPIH Index, given that this is the inflation measure used elsewhere in the cap, eg for the operating cost allowance.

Accounting for changes in the number of default tariff customers

Context

1.62. 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.

1.63. 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.[62]

[61] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 6.84 – 6.88. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
[62] 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

Proposal

1.64. 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.

Stakeholder responses

1.65. From our November 2021, one supplier responded, in relation to concerns with accounting for changes in customer numbers.

1.66. One supplier said that accounting for changes in default tariff customers may impact the fairness of suppliers' cost recoveries especially if vulnerable customers' switch. This would lead to customers' new supplier recovering costs the previous supplier incurred.

Considerations

1.67. Our considerations remain unchanged from our November 2021 consultation. We have outlined a summary of these considerations below, but please refer to November 2021 consultation for full details.[63]

1.68. 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.[64] This means that we can only look at the aggregate (average) change in default tariff customer numbers.

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

1.70. We consider that 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.

[63] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 6.94 – 6.101. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
[64] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted

1.71. 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

1.72. 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.

1.73. 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

Proposal

1.74. 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. This remains unchanged from the November 2021 consultation.

1.75. 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.

1.76. We propose to not account for changes in consumption between the COVID-19 cap period and the cap period we set the allowance. This has changed from our November 2021 consultation.

November 2021 proposal

1.77. From the November 2021 consultation, we considered it to be 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.

Stakeholder responses

1.78. We did not receive any comments from stakeholders regarding this topic from our policy consultation.

Considerations

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

1.79. Our considerations remain unchanged from our November 2021 consultation. We have outlined a summary of these considerations below, but please refer to November 2021 consultation for full details.[65]

1.80. 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.

1.81. The debt-related cost 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).

1.82. 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.

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

[65] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 6.112 – 6.116. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

1.83. 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[66] in the cap period, which we are truing-up. This position is unchanged from our November 2021 consultation.

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

1.84. We noted in our November 2021 consultation that we should 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.

1.85. We also flagged that to control for general levels in consumption we would need to assume that future consumption will be the same as the most recent data available. We said we could use energy consumption data published by BEIS.

1.86. We have now considered this further, BEIS publish their energy consumption statistics annually in December. This means, for our August 2021 Decision, we would only have data up to the start of 2021 (For Electricity the latest data will be February 2020 to January 2021 and for Gas mid-May 2020 to mid-May 2021). If we make a further decision in February 2023, we would also not have time to incorporate any new data before issuing a consultation.

1.87. Therefore, we do not have data on the changes in domestic consumption patterns after the COVID-19. This means we would only be able to compare the change in consumption between the COVID-19 periods and previous years. We consider that this data alone is not sufficient to make an assessment on how the general levels of consumption will change between the COVID-19 periods we are assessing and the cap period we are truing up.

1.88. The data we have available from BEIS, suggests that there has not been a significant increase in energy consumption between the baseline and the COVID-19 period (approx. ~3%). We consider that energy consumption will not return to pre-COVID-19 levels, for example there has been a general shift to a more hybrid way of working since COVID-19, and

[66] Where we discuss the Typical Domestic Consumption Value (TDCV), we are referring to the TDCV values used to set the cap rather than the latest values set by Ofgem. The cap values are 3,100kWh for electricity and 12,000 kWh for gas.

therefore we consider that the difference between the consumption levels in the COVID-19 period and cap period we set the allowance will be even less.

1.89. We therefore propose to not control for general changes in domestic energy consumption between the COVID-19 period and the cap period we set the allowance due to accuracy concerns and low materiality.

Appendix 2 - Detailed explanation of Methodology

Introduction

1.1. In this Appendix we explain our methodology for calculating the additional COVID-19 costs in cap period four to six using data from our December 2021 RFI.

1.2. We issued the COVID-19 true-up RFI in December 2021 to gather information on suppliers' debt-related costs (bad debt charge, working capital, and debt-related administrative costs). We also gathered information on suppliers' revenue and customer accounts, to ensure we could control for different sizes of suppliers in our benchmarking exercise. We requested this information broken down by tariff type (fixed/default) and by payment method (direct debit /standard credit /PPM).

1.3. Table A2 below outlines the cap periods we gathered data, for each debt-related cost. It indicates the cap periods we consider to be impacted by COVID-19, "COVID-19 impacted cap periods", and the relevant baseline periods we gathered data on to ensure we could calculate the incremental change in costs.

Table A2: Cap periods we gathered data for, and the baseline period used for increment calculations

	Cap period four increment	Cap period five increment	Cap period six increment
COVID-19 impacted cap periods	April 2020 – September 2020	October 2020 -March 2021	April 2021 – September 2021
Relevant baseline periods	April 2019 – September 2019	October 2018 – March 2019	April 2019 – September 2019

Bad debt charge

Relevant proposals

1.4. We proposed in Chapter 3 to not use the breakdown of the bad debt charge by tariff type as we were unable to gather this data in a proportionate and consistent basis across suppliers. (See paragraph 3 in the main body).

1.5. From our RFI we have collected each suppliers' revenues broken down by payment types for the cap periods we're analysing. For our analysis on bad debt charge, we will only use

credit revenues. Motivated by our proposals to recover costs only through credit meter customers. We consider it appropriate to use suppliers' credit revenue. Credit revenue refers to the combined revenue associated with standard credit and direct debit customers. (See paragraph 3 in the main body).

Calculations methodology

1.6. To calculate the weighted average bad debt charge (£) per customer account, we aggregate for suppliers in our sample, the total bad debt charge and credit revenues, for the main COVID-19 cap periods and baseline cap periods.

1.7. We divide the total bad debt charge by credit revenues. This provides a figure for the total bad debt charge (£) per unit of credit revenue. We repeat this calculation for all baseline and COVID-19 cap periods.

1.8. We have proposed to take a cumulative bad debt approach. Therefore, we consider the differences of the bad debt charge (£) per unit of credit revenue between the main COVID-19 cap periods and their respective seasonally matched baselines as the COVID-19 impact. This will provide an incremental bad debt charge (£) per unit of credit revenue for the main COVID-19 cap periods.

1.9. To monetise the incremental bad debt per unit of credit revenue, we apply a capped credit revenue per customer account assumption for each COVID-19 cap period (see 'Cap level workings' below for an explanation of the calculation). This is multiplied with the incremental bad debt charge per unit of credit revenue, to provide a bad debt charge (£) per customer account for each COVID-19 cap period.

Debt-related administrative costs

Relevant proposals

1.10. We proposed in Chapter 4 to not use the breakdown of the debt-related administrative costs by either payment method or tariff type as we were unable to gather this data on a proportionate and consistent basis across suppliers. (See paragraph 4 in the main body).

1.11. We propose to use the total debt-related administrative costs to calculate if there are any additional debt-related administrative costs due to COVID-19. This is a change in proposal from our November 2021 proposal.[67] (See paragraph 4 in the main body).

Calculations methodology

1.12. To calculate the weighted average debt-related administrative costs (£) per customer account, we aggregate for suppliers in our sample, the total debt-related administrative costs and credit revenues for the main COVID-19 and baseline cap periods.

1.13. We then divide the aggregate debt-related administrative costs with the aggregate credit revenues for each of the main COVID-19 cap periods and baseline cap periods. This provides a measure for debt-related administrative costs (£) per unit of credit revenue for each COVID-19 and baseline cap period.

1.14. We then calculate the difference between the debt-related administrative costs (£) per unit of credit revenue for each of the main COVID-19 cap periods and their respective seasonally matched baseline cap periods. The difference is defined as the incremental change and informs the impact of COVID-19 in terms of debt-related administrative costs per unit of credit revenue.

1.15. To monetise the incremental debt-related administrative cost per unit of credit revenue, we apply a capped credit revenue per customer account assumption for each COVID-19 cap period (see 'Cap level workings' below for an explanation of the calculation). This is multiplied with the incremental debt-related administrative cost per unit of credit revenue, to provide a debt-related administrative cost (£) per customer account for each COVID-19 cap period.

Working capital costs

Relevant proposals

1.16. We proposed in Chapter 4 to use half yearly debtor-days to determine the additional working capital costs due to COVID-19. This is a measurement of the average amount of time

[67] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.11. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

it takes customers to pay suppliers. This proposal is unchanged from our November 2021 consultation.[68] (See paragraph 4)

Calculations methodology

1.17. From our RFI, we have gathered accounts receivables at the beginning and end of cap periods, and revenue across payment and tariff types, for the main COVID-19 cap periods and baseline cap periods.

1.18. For each supplier, we sum accounts receivables and revenues across all payment and tariff types due to data quality and comparability concerns (see paragraph 4).

1.19. The working capital measure we proposed, were half-yearly debtor days matched with the time duration of cap periods. We input each included supplier's data into the formula below for each main COVID-19 and baseline cap periods. Please note that average accounts receivables refer to the simple average of accounts receivables at the beginning and end of cap periods.

$$Debtor\ days_{half-yearly} = \frac{Average\ accounts\ recievables_{half-yearly}}{Revenue_{half-yearly}} * \frac{365}{2}$$

1.20. To calculate the COVID-19 impact on working capital, we subtract half-yearly debtor days between the main COVID-19 cap periods and their respective seasonal baseline cap periods for each supplier in our sample. This results in incremental half-yearly debtor days for each included supplier across COVID-19 cap periods.

1.21. To monetise the cost of financing working capital, we apply a capped credit revenue per customer account assumption per day for each COVID-19 cap period (see 'Cap level workings' below for an explanation of the calculation). This is multiplied with the incremental half-yearly debtor days and a cost of financing assumption for each supplier in our sample.

1.22. To calculate the weighted average working capital costs per customer account we first calculate the aggregate working capital costs for included suppliers. This is achieved by multiplying included suppliers' incremental working capital costs per customer with their

[68] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.34. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs

respective customer accounts across the main COVID-19 cap periods. We can now sum the aggregate working capital costs for each COVID-19 cap period to calculate the total aggregate working capital costs for the entirety of the COVID-19 cap periods.

1.23. The weighted average working capital cost per customer account is calculated by dividing the total aggregate working capital costs with the simple average of total customer accounts across the COVID-19 cap periods for suppliers in the sample.

Cap levels workings

1.24. The weighted average credit capped revenue per customer account is an assumption based on cap level workings and data input from below. The weighted average has been used in the calculations for the debt-related costs above in the process of monetising the costs.

1.25. Please note for the purposes of this consultation that credit revenues/ customer accounts are defined as the sum of standard credit and direct debit revenues/ customer accounts.

Data input

1.26. The weighted average credit capped revenue per customer assumption is calculated from the default tariff cap levels breakdowns, customer accounts from the domestic customer & tariff RFI, and seasonal demand shares broken down by fuel and meter type. The data covers the cap periods we are focussing on.

Calculations

1.27. To calculate the weighted average credit capped revenue, we first calculate the direct debit and standard credit expected revenues per customer. This is achieved by multiplying the direct debit and standard credit cap level breakdowns by their respective seasonal demand shares matched by payment, fuel and meter type, for each COVID-19 cap period.

1.28. Finally, we take the sum of expected direct debit and standard credit revenues per customer multiplied with their respective credit customer proportions, matched by meter and fuel types, for the COVID-19 cap periods. This provides the weighted average credit capped revenue assumption.

Annex 8 – Adjustment allowance methodology

1.29. We propose to not amend 'Annex 8 – Adjustment allowance methodology'. We consider an amendment is not required if we reach a decision to make no adjustment in cap period nine (October 2022 – March 2023) to true up the initial float provided for additional debt-related costs.

1.30. However, we have published a revised Annex 8 model alongside this consultation to provide stakeholders the opportunity to comment on the changes that would be made to annex 8 in the event we did decide to introduce an adjustment to true up the initial float provided for additional debt-related costs.

1.31. In Appendix 3 below, we have outlined what the detailed model modifications of Annex 8 would be if we decided to introduce an adjustment for the true-up.

Appendix 3 - Detailed model modification of Annex 8

Model Modifications

1.1. In this appendix we summarise the modifications to 'Annex 8 – methodology for adjustment allowance' of standard licence condition 28AD of the electricity and gas supply licences (SLC28AD). The modifications are based upon our considerations set in Appendix 1 from this consultation to account for the timing difference between costs and the allowance, and changes in the number of default tariff cap customers.

1.2. As noted above, we propose to not amend 'Annex 8 – Adjustment allowance methodology' if we reach a decision to make no adjustment in cap period nine (October 2022 – March 2023) to true up the initial float provided for additional debt-related costs.

1.3. The revised Annex 8 model published alongside this consultation provides stakeholders the opportunity to comment on the changes that would be made to annex 8 in the event we did decide to introduce an adjustment to true up the initial float provided for additional debt-related costs. We invite stakeholder's views on these possible amendments. A summary of the modifications we have made can be found below.

1.4. In the published revised Annex 8 model, updated cells are highlighted in yellow.

1.5. If further changes are needed to accommodate other proposals, then we may make consequential amendments before our decision.

Tab '1a Adjustment Allowance'

1.6. Cells AA13:AB264: We have updated the cells such that it draws the adjustment allowance values for each fuel, charge restriction region, benchmark metering arrangement, payment method and 28AD charge restriction period from cells F429:G440 in tab '2c COVID true-up'.

Tab '2c COVID true-up'

1.7. New tab '2c COVID true-up' created for the COVID-19 true-up adjustment. This tab sets out the input value and our calculations to convert the weighted average increment into an allowance figure.

1.8. Cells F10:G33 in section 1.a: added to input the true-up increment from our analysis of supplier data in the true-up model.[69, 70]

1.9. Cells F39:F62 in section 1.b: added to input the cap period four to six float increments from sheet '2b COVID Adjustment'.

1.10. Cells F68:F70 in section 2: input from the tab '3g CPIH & Attrition' for the multipliers to convert additional COVID-19 costs incurred in cap periods four to six to a comparable cap period. We have chosen to convert all costs to cap period four costs based on customer attrition and CPIH relative to the float cap period and the costs period of origin. Please see the subsection for tab '3g CPIH & Attrition' below for an explanation of how the multipliers were calculated.

1.11. Cells F76:G99 in section 2: calculates the allowance net the float (difference between section 1.a and section 1.b) and multiplies the net allowance with the factors from cells F68:F70 to convert into cap period four prices and customer numbers.

1.12. Cell F106: inputs a multiplier from tab '3g CPIH & Attrition' to convert the net allowances at cap period four prices and customer numbers into cap period current prices and customer numbers.

1.13. Cells F112:G135: multiplies the net allowances at cap period four prices and customer numbers with the multiplier in cell F106 to convert into cap period current prices and customer numbers.

1.14. Cells F141:F144: inclusion table for additional COVID-19 costs increments for each cap period. Costs are included in the cap if the relevant cell is set to 1.

[69] Our analysis of supplier data is from a separate model, we explained our methodology of this separate model in Appendix 2

[70] Alongside this consultation, we are carrying out a disclosure process. This allows stakeholders' advisers to inspect the True-up model and data, subject to confidentiality restrictions. We have published information about this disclosure process on our website.
Ofgem (2022), Price Cap - Disclosure arrangements for Spring 2022 consultations.
https://www.ofgem.gov.uk/publications/price-cap-disclosure-arrangements-spring-2022-consultations

1.15. Cells C151:D152 and C155:D156: inputs the cap period seven and eight cap level, Nil and TDCV consumption tab '3f Cap Levels'.

1.16. Cell C167: calculates the average Nil level of the cap as a proportion of TDCV[71] for cap period seven and eight.

1.17. Cells F173:G196 and F199:G222: calculates the Nil and TDCV consumption for the COVID-19 true-up allowance.

1.18. Cells F255:G278: calculates the net TDCV of the allowance. This is the amount of costs only in the unit rate and is calculated by subtracting the Nil consumption value from TDCV value.

1.19. Cells F305:G309: input for which cap periods of costs (if any) are to be recovered over one cap period only.

1.20. Cells F315:G338 and F343:G366: calculates the weighted Nil and TDCV value levels of the adjustment for a given cap period of cost. These values will only be different to F229:G252 and F255:G278 if we were to recover a cost over one cap period only. In that case the cost would be scaled up using the relevant fuel demand weights.

1.21. Cells F429:G440: sums the adjustment values across the cap periods of cost. This gives us the total allowance per cap parameter for each cap period where we are setting an allowance split by fuel, payment method and benchmark annual consumption.

Tab '3e CPIH'

1.22. Cells B286:C306: we have updated the Consumer price index including owner occupiers' housing costs (CPIH) inputs using the 13th of April 2022 CPIH time series dataset release from the Office for National Statistics (ONS).

[71] We are referring to the TDCV values used to set the cap rather than the latest values set by Ofgem. The cap values are 3,100kWh for electricity and 12,000 kWh for gas.

1.23. Cell T16: hard coded cell to use the latest available CPIH value for June 2022 (currently March 2022). We will update this cell, to lookup the June 2022 CPIH value using the same formula in cells C16:S16 when it is available before our decision.

Tab '3f Cap levels'

1.24. Cells A18:D22 and A24:D28: inputted cap period seven and eight cap levels for direct debit electricity and gas respectively. The cap levels are broken down by Nil and TDCV for a given consumption level and this is used to apportion the COVID-19 adjustment into Nil and TDCV values.

Tab '3g CPIH & Attrition'

1.25. New tab '3g CPIH & Attrition' created for calculating the multipliers needed to adjust the incremental costs such that they factor in inflation and customer attrition between when the float was set, when the costs were incurred, and when the costs would be recovered.

1.26. Cells B11:H11: inputs CPIH values from '3e CPIH' for cap periods four to ten.

1.27. Cells B13:H13: calculates the ratio between cap nine/ ten prices and the cap period prices for each column.

1.28. Cells B14:H14: calculates the ratio between cap four prices and the cap period prices for each cap period.

1.29. Cells B23:B25: Hard coded input of customer attrition of cap periods four to six relative to float cap periods six and seven. This was calculated from Ofgem analysis of the Domestic Customer Account & Tariff RFI.

1.30. Cells B27:B29: calculates the implied factor to adjust cap period four to six customer numbers to cap period four.

1.31. Cells B34:B36: calculates the factor to adjust cap period four to six prices and customer numbers to cap period four by multiplying cells B27:B29 and B14:H14 respectively. This converts cap period four to six prices and customer numbers into cap period four prices and customers.

1.32. Cell B43: hard coded input of customer attrition for cap period four relative to cap period nine/ ten. This was calculated from Ofgem analysis of the Domestic Customer Account & Tariff RFI.

1.33. Cell B45: calculates the implied factor to adjust cap period four customer numbers to cap period nine/ ten.

1.34. Cell B50: calculates the factor to adjust cap period four prices and customer numbers to cap period nine/ ten by multiplying cell B45 and B13. This converts cap four prices and customer numbers into cap period nine/ ten prices and customers.

Appendix 4 - Inclusion and exclusion criteria in our sample

Inclusion and exclusion

1.1. We proposed to check data consistency and remove any suppliers' data if they were not representing reasonable estimates or not comparable between the baseline and the cap period assessed or with other suppliers in the sample that we used to benchmark costs.

1.2. We issued a mandatory RFI to supplies with at least 1% market share in any fuel in the domestic market segment to gather data on debt-related costs. We collected data from eleven suppliers.

1.3. We break down our filters for inclusion and the individual reasons why suppliers have been excluded for certain debt-related costs below.

Table A4: Percentage of domestic credit energy market represented in the included sample for each debt-related costs.[72]

	Bad debt charge	Debt-related administrative costs	Working capital costs
Percentage of domestic credit energy market represented in the included sample	91%	85%	75%
Number of suppliers included	9	8	7

Exclusion criteria

1.4. We consider the additional filters below to scrutinise whether the assumptions underpinning suppliers' forecast costs are updated and reasonable as well as checks on data consistency.

[72] We have used the latest credit customer accounts from Ofgem's analysis on Domestic customer accounts and Tariff RFI.

- completeness and comparability between the baseline period and the relevant cap period;
- appropriateness of suppliers' provisioning methodologies;
- appropriate justification for any inconsistency on suppliers' submitted data; and
- comparability of suppliers' submitted debt-related costs with other suppliers.

1.5. Consistent with our August 2021 decision we have decided to introduce an additional filter to exclude PPM specialists from our calculation of additional costs relating to credit customers. This is because while they may have some credit customers, but their specialism means that, their costs are less relevant for the credit-only cost assessment.

1.6. We have highlighted suppliers' general data quality, consistency, and comparability concerns in each of the debt-related costs sections below.

1.7. Where we have been unsure on the consistency of supplier data, we have engaged with them. This includes asking suppliers specific questions about their data, assumptions over email and calls.

Bad debt charge

1.8. We have included nine suppliers out of a possible eleven. This reflects 91% of the domestic credit energy market in terms of customers.

1.9. We excluded one supplier due to the lack of comparability between the suppliers' bad debt charge with other suppliers' due to the composition of their customer base being PPM heavy.

1.10. We also excluded one supplier as it did not provide a complete response to our RFI.

Debt-related administrative costs

1.11. We have included eight suppliers out of a possible eleven. This reflects 85% of the domestic credit energy market in terms of customers.

1.12. We have excluded one supplier due to the lack of comparability between the suppliers' debt-related administrative costs with other suppliers' due to the composition of their customer base being PPM heavy.

1.13. We have excluded one supplier as it did not provide a complete response to our RFI.

1.14. We have excluded one supplier due to their inability to provide data for the baseline cap periods which severely impacts the comparability and completeness of the data.

Working capital costs

1.15. We have included seven suppliers out of a possible eleven. This reflects 75% of the domestic credit energy market in terms of customers.

1.16. We have excluded one supplier due to the lack of comparability between the suppliers' working capital costs, with other suppliers' due to the composition of their customer base being PPM heavy.

1.17. We have excluded one supplier as it did not provide a complete response to our RFI.

1.18. We have excluded one supplier as it was not able to separate credit balances against unbilled balances which inflates the debtor days calculations. This makes their data less comparable to other suppliers in the sample. This supplier's debtor days increment was therefore high due to an acquisition, and we removed them as we were not able to isolate change in debtor days due to COVID-19.

1.19. We have excluded one supplier as we are not confident in their submitted data. We have tried to engage with this supplier and have still not received clarity. If we do receive clarity before our decision which enables us to be confident that their data is comparable and consistent with other suppliers, then we will include them in our calculation at a later stage. We, therefore, exclude them based on comparability concerns.

Supplier comments

One supplier said that it would be important for us to include companies which had gone through supplier of last resort (SoLR) or special administrative regime (SAR) processes in our baseline. It said that adding data from the largest supplier failures will improve our

understanding of the true-up process. A different supplier said that customers who went through the SoLR process should be excluded from all reporting for the purpose of the true-up, as the debt has been negotiated separately or is an asset held by administrators.

We issued a mandatory RFI to supply license holders with at least 1% market share in any fuel in the default tariff domestic market segment to gather data on debt-related costs. More suppliers than usual exited the energy market from the end of cap period six. We consider that after being appointed a SoLR, it would take time for the transferred customers to be reflected in the acquiring suppliers' accounts, and we consider that this would not have impacted our analysis of additional COVID-19 debt-related costs in cap period four to six. We will engage with suppliers on this issue in preparation for gathering data for cap period seven to see if there is anything they can do to separate out the impacts of SOLRs from the general impact due to COVID-19 on debt-related costs.

Appendix 5 - 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.

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".