Making a positive difference
for energy consumers

Suppliers, consumer groups and
other interested parties

Email: retailpriceregulation@ofgem.gov.uk
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Dear stakeholder,

Price cap – notice to delay COVID-19 true-up decision and work on debt-related costs

1. The purpose of this letter is to inform stakeholders of changes to the COVID-19 true-up and debt-related costs timeline:
   - **COVID-19 true-up:** we have decided to delay the COVID-19 true-up decision until February 2023. Instead, we will be issuing a consultation in the autumn, to consult with stakeholders on our methodology after we received feedback from stakeholders proposing an alternative methodology to calculate the COVID-19 true-up allowance.
   - **Debt-related costs**: we still intend to come forward with a consultation on this topic but on a longer timeline than previously suggested in our April 2022 letter,[1] and we will initiate a policy consultation only if our supplier monitoring indicates bad debt levels have risen above the price cap allowance in a material and systematic way. We consider that the government package targeting energy affordability will reduce and delay the impact of any bad debt incurred, and delaying our timeline to consult on debt-related costs allows more time to understand the implications of high energy bills. There is also a risk that consulting too soon may mean we under or over-estimate the scale of debt-

[1] Ofgem (2022), Price cap and market stabilisation charge update.
https://www.ofgem.gov.uk/publications/price-cap-and-market-stabilisation-charge-changes

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related costs if they are realised after we have collected responses. Given the uncertainty, we are continuing to monitor bad debt on an ongoing basis.

COVID-19 true-up

Context

2. In February 2021, we concluded that the COVID-19 pandemic had resulted in additional debt-related costs for credit meter customers that were material and not allowed for through the existing cap methodology.[2] We therefore included an additional allowance in the cap for cap period six and seven (April 2021 – March 2022). We set this as a "float" which was based on initial estimates, which would be "trued-up" later using final cost data.

3. We have engaged with stakeholders through consultations and supplier calls to provide an opportunity for stakeholders to inform our planning, process, and proposals for the true-up.

4. We said in our November 2021 consultation that we wanted to focus on the costs of default tariff customers.[3] As such, in our December 2021 request for information (RFI), we requested from suppliers' debt-related cost data broken down by tariff type (fixed/ default tariff), to ensure that we had the correct costs in scope of our review.

5. However, we were unable to gather this data in a proportionate and consistent basis across all suppliers. This meant that we calculated the incremental bad debt charge across all domestic credit customers, and we proposed to not use suppliers' breakdown of bad debt data by tariff type.[4]

6. Using this method, the additional bad debt costs for cap periods four to six was £0.71[5] per typical dual fuel credit customer (net of the float), and in our May 2022 consultation we proposed to make no adjustment in the cap to "true-up" our initial estimate of bad debt costs for credit meter customers.[6]

Stakeholder comments

7. Four stakeholders in response to our May 2022 consultation said that they were concerned with our proposed methodology which spread costs across all credit customers. They believe that our consultation approach did not account for the

[2] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, executive summary. https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap
[3] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, paragraph 4.11 & 5.45. https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs
[4] Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.27. https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs
[5] 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.
[6] Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.60. https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs

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proportion of credit customers paying by standard credit which is higher for default tariff customers than all credit customers.

8. These stakeholders said that the consultation method significantly under-estimated costs as they consider that there is a higher probability of standard credit customers incurring debt.

9. Three stakeholders said that it would be more accurate to calculate the cost for standard credit and direct debit customers separately, before calculating a weighted average for default tariff customers based on the proportions of standard credit and direct debit customers on default tariffs.

Considerations

10. Given the alternative methodology was proposed by three stakeholders and was not included in our May 2022 consultation, we consider that it would be worth considering the method further. This is because of suppliers' concerns regarding the under-recovery of additional COVID-19 costs using our May 2022 consultation method. We consider it appropriate to consult on the alternative method which these suppliers think is more reflective of costs, since other stakeholders have not had a fair opportunity to comment on it.

11. We consider that by issuing another consultation, stakeholders would be able to compare the alternative method to our original consultation methodology and provide their views on it. It will also reduce the risk of providing suppliers with an under or over-allowance.

12. We therefore consider that it would be appropriate to delay the decision and issue a separate consultation where we will set out the positives and negatives of each methodology and the differences in allowances.

13. This will allow us to receive stakeholder feedback on our consultation method compared to the alternative approach, which will feed into our February 2023 decision.

Next steps

14. We intend to consult with stakeholders this autumn to gather feedback which will help inform our decision in February 2023 on the true-up process for COVID-19 costs. This consultation and decision will include data from the second COVID-19 true-up RFI which means that the consultation will be in scope of COVID-19 costs from cap periods four to seven.

15. Alongside the consultation this autumn, we will be carrying out a similar disclosure process as our disclosure arrangements for the May 2022 consultation.[7] This will allow

[7] Ofgem (2022), Disclosure arrangements for Spring 2022 consultations.

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stakeholders' advisers to inspect the true-up model and data. We will publish information about the disclosure process on our website soon.

Debt-related costs

Reasons for delay

16. In our April 2022 letter,[8] we indicated that in August 2022 we would undertake a consultation on debt-related costs triggered by the recent sharp increase in gas prices. However, following the Energy Bills Support Scheme announced on 26 May 2022, we now consider it is prudent to delay the consultation to allow more time to understand the implications of the combination of the government support package and high gas prices on supplier bad debt costs.

17. We are considering a float and true-up approach as we did to adjust debt-related costs due to the COVID-19 pandemic. However, we are also taking into account the interests of customers who have already experienced a significant increase in their energy bills, as well as the other interventions we have made to support supplier finances. We consider that we should consult on this topic only when our supplier monitoring indicates a material and systematic increase in the bad debt level above the bad debt cost allowance in the existing cap methodology.
18. There remains significant uncertainty regarding the scale of the impact of high bills on bad debt, as well as the impact of the government support package. Starting the consultation too early risks an under or over-estimation of the impact. We will continue monitoring suppliers' bad debt through our stress tests and supplier monitoring RFIs.

19. Based on the analysis we undertook of suppliers' bad debt forecasts for cap periods eight, 9a and 9b (submitted through April 2022 stress test RFI), it is likely the allowance for bad debt in the existing cap methodology adequately covers suppliers' bad debt once the government support package is accounted for. We recognise this analysis is based on April 2022 supplier forecasts, and subsequent events may have changed this position. Notwithstanding this, our key considerations are:
    - The bad debt allowance is scaling up with the rising cap level. The bad debt allowance in the cap will increase as the current methodology scales the bad debt allowance up with a rising price cap.

    - The government support package is likely to materially reduce and defer bad debt incurred. The government energy support package provides financial assistance to households to deal with the cost of living crisis via bill rebates and

https://www.ofgem.gov.uk/publications/price-cap-disclosure-arrangements-spring-2022-consultations
[8] Ofgem (2022), Price cap and market stabilisation charge update.
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cash payments (including the £400 energy bill discount to all customers and a £650 one-off cost of living payment for low-income households).

- Our analysis considered the full range of bad debt forecasts from suppliers as well as different estimates of low-income households' use of the government cash payment support. We incorporated conservative estimates, given that households are not obligated to spend all the government's financial support on energy bills.
- We found these government support packages would reduce the bad debt incurred by energy suppliers during cap periods eight, 9a and 9b (and potentially defer the impact to a later cap period) to the point that the existing cap methodology may provide an appropriate level of bad debt allowance during these cap periods.

Next steps

20. Continue monitoring bad debt: there are a lot of uncertainties on future global gas prices and government policies, as well as the wider economic situation. It is important to monitor the development of bad debt as suppliers gain a better view on forecasting approaches after updating their methodologies to consider price cap levels for cap periods eight, 9a and 9b as well as the government support packages.

21. Work with suppliers to ensure our monitoring includes updated bad debt forecasts: we are considering options for collecting the data and taking into consideration the ease of gathering this (i.e. aiming to not add further burdens to suppliers on submitting data, and trying to join with existing Ofgem monitoring mechanisms, including potentially through the Winter stress test RFI which suppliers are due to return in August 2022). Revised forecasts (as well as actual bad debt incurred in cap period eight) should account for any changes in customer payment behaviour following the 1 April 2022 cap increase, and expected levels of bad debt under an increased winter cap from 1 October 2022 (after accounting for the government support package). If our supplier monitoring indicates that bad debt levels are likely to rise materially and systematically above the price cap allowances, then we would consider initiating a policy consultation.

Yours faithfully,

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