

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

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This is a supplementary consultation on the process for assessing the true-up of COVID-19 costs in the default tariff cap. We are running this supplementary consultation to gather stakeholder views on the methodology options after stakeholders suggested an alternative methodology to what we consulted on in May 2022. We would like views from people with an interest in the level of the default tariff cap. We particularly welcome responses from domestic energy suppliers and consumer groups. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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Executive summary

On 19 July 2018, the Domestic Gas and Electricity (Tariff Cap) Act came into force after the government introduced this legislation.¹ This legislation required us to design and implement the default tariff cap. We then introduced the default tariff cap (the 'cap') on 1 January 2019, which protects households on standard variable and default tariffs (which we refer to collectively as 'default tariffs'). The cap ensures that default tariff customers pay a fair price for their energy that reflects the efficient underlying costs to supply that energy.

The government recently announced the Energy Price Guarantee, which will mean that from 1 October 2022 a typical UK household will pay up to an average of £2,500 a year on their energy bill for the next two years.² This means that the costs in scope of this consultation will not directly affect customers. We still need to review the true-up process for COVID-19 costs, to ensure we have a benchmark cap figure to measure how much suppliers are able to recover from the government as part of the Energy Price Guarantee.

In our February 2021 decision,³ 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.⁴ The adjustment we made in our February 2021 decision was an initial

¹ Domestic Gas and Electricity (Tariff Cap) Act 2018.

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

² Department for Business, Energy & Industrial Strategy (2022), Energy bills support factsheet: 8 September 2022.

<https://www.gov.uk/government/publications/energy-bills-support/energy-bills-support-factsheet-8-september-2022>

³ 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-tariffcap>

⁴ 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.

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

We then proposed in our May 2022 consultation to make no adjustment in cap period nine (October 2022 – March 2023) to true-up the initial float provided for additional debt-related costs. This was on the basis that the data we gathered on debt-related costs in cap periods four to six to assess the final impact of COVID-19 suggested that there had not been a material change in incremental costs from what we had already allowed suppliers to recover in the float. Whilst we did consider that cap periods four – six were the main cap periods impacted by COVID-19, we recognised that some debt-related costs may flow through to the following cap periods. We therefore proposed to gather bad debt and debt-related admin cost data for cap period seven as our final assessment of these costs on a cumulative basis.

Our proposal to make no adjustment in cap period nine to true up the initial float provided for additional debt-related costs was 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.

However, in August 2022 we decided to delay the COVID-19 true-up decision until February 2023. We decided that instead, we would issue a further 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.

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.⁵ We have determined the final additional debt-related costs incurred by suppliers as a result of COVID-19 and then compared this to

⁵ We set an initial float in February 2021.

the float adjustment. We have not considered, and do not intend to consider, non-debt-related impacts in the scope of this true-up.

In this supplementary consultation, we outline three possible methodologies for determining the additional COVID-19 debt-related costs for cap periods six and seven and consider the merits of each methodology. We invite stakeholders to comment on each method and inform us which is their preferred method. We have not revisited every area which was discussed in our May 2022 consultation, although we do still welcome comments on any part of both this consultation and the May 2022 consultation to help inform our decision. Please note, we have not considered, and do not intend to consider, non-debt-related impacts in the scope of this true-up.

Proposed true-up adjustment

We still maintain our position set out in the May 2022 consultation: to make no adjustment in cap period 10a (April 2023 – June 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 seven (April 2020 – March 2022) 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.

Next steps

We are requesting responses by 20 October 2022. We intend to make a decision ahead of the announcement of the cap period 10a update in February 2023. This would mean that our decision would take effect from cap period 10a, which begins 1 April 2023.

1. Consultation process

Consultation stages

March 2021 call for input

1.2. We published a call for input in March 2021 ('March 2021 call for input') on the true-up process for COVID-19 costs.⁶ This was to give stakeholders an opportunity to provide comments to inform our planning and future work.

June 2021 working paper

1.3. 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.⁷ The June 2021 working paper also provided stakeholders with an update on when we aim to implement the first true-up.

November 2021 consultation

1.4. 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.⁸ This provided stakeholders an opportunity to comment on a more detailed outline of our process and proposal for the true-up.

May 2022 consultation

1.5. We published a consultation in May 2022 ('May 2022 consultation'), that set out proposals for the process of truing up bad debt and debt admin costs.⁹ This provided stakeholders an opportunity to comment on the process and proposal for the true-up. We intended for this consultation to be used to decide on the COVID-19 true-up decision for early August 2022.

⁶ Ofgem (2021), Call for input on the true-up process for COVID-19 costs.

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

⁷ Ofgem (2021), Working paper on the true-up process for COVID-19 costs.

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

⁸ 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>

⁹ Ofgem (2022), Consultation on the true-up process for COVID-19 costs.

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

August 2022 Letter

1.6. We published a letter in August 2022 ('August 2022 letter') in which we set out that we had decided to delay the COVID-19 true-up decision until February 2023 and that would be issuing a further consultation in the autumn, to consult on our methodology after we received feedback from stakeholders proposing an alternative methodology to calculate the COVID-19 true-up allowance.¹⁰

1.7. Given an alternative methodology was proposed by three stakeholders, and had not been included in our May 2022 consultation, we considered that it was appropriate to examine this alternative methodology further. We also considered that by issuing a supplementary consultation, stakeholders would have the opportunity to compare the methodology with our original May 2022 consultation approach and provide their views.

Ongoing engagement with suppliers

1.8. We hosted four rounds of calls with suppliers. The first two rounds of calls were in Spring and Summer of 2021 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 in December 2021 and was to further test our thinking on these topics. The fourth round of calls was in April 2022 and was to discuss debt on prepayment meters (PPM).

Next stage of consultation

1.9. We intend to publish a decision in February 2023, ahead of announcing the cap level for cap period 10a. Any changes would take effect from 1 April 2023.

Disclosure

1.10. Alongside this consultation, we are carrying out a disclosure process. This allows stakeholders' advisers to inspect the disclosed COVID-19 true-up model and data, subject to

¹⁰ Ofgem (2022), Notice to delay COVID-19 true-up decision and work on debt-related costs. <https://www.ofgem.gov.uk/publications/price-cap-notice-delay-covid-19-true-decision-and-work-debt-related-costs>

confidentiality restrictions. We have published information about this disclosure process on our website.¹¹

1.11. 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

1.12. 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>

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

- August 2022 letter informing stakeholders of delay to COVID-19 true-up decision ('August 2022 letter'): <https://www.ofgem.gov.uk/publications/price-cap-notice-delay-covid-19-true-decision-and-work-debt-related-costs>
- May 2022 consultation on the true-up process for COVID-19 costs ('May 2022 consultation'): <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>
- 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>

¹¹ Ofgem (2022), Disclosure arrangements for Autumn 2022 COVID-19 true-up consultation. <https://www.ofgem.gov.uk/publications/price-cap-disclosure-arrangements-autumn-2022-covid-19-true-consultation>

- June 2021 working paper on the true-up process for COVID-19 costs ('June 2021 working paper'): <https://www.ofgem.gov.uk/publications/price-cap-working-paper-true-process-covid-19-costs>
- March 2021 call for input on the true-up process for COVID-19 costs ('March 2021 call for input'): <https://www.ofgem.gov.uk/publications/price-cap-call-input-true-process-covid-19-costs>
- 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

1.14. 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 are fair and reflect the underlying efficient costs to supply that energy. 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.

1.15. 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.

1.16. In setting the cap, we may not make different provisions for different holders of supply licences.¹² This means that we must set one cap level for all suppliers.

How to respond

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

1.18. We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

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

¹² 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

1.20. 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.

1.21. 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.

1.22. If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 6.

1.23. 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

1.24. 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:

- Do you have any comments about the overall process of this consultation?
- Do you have any comments about its tone and content?
- Was it easy to read and understand? Or could it have been better written?

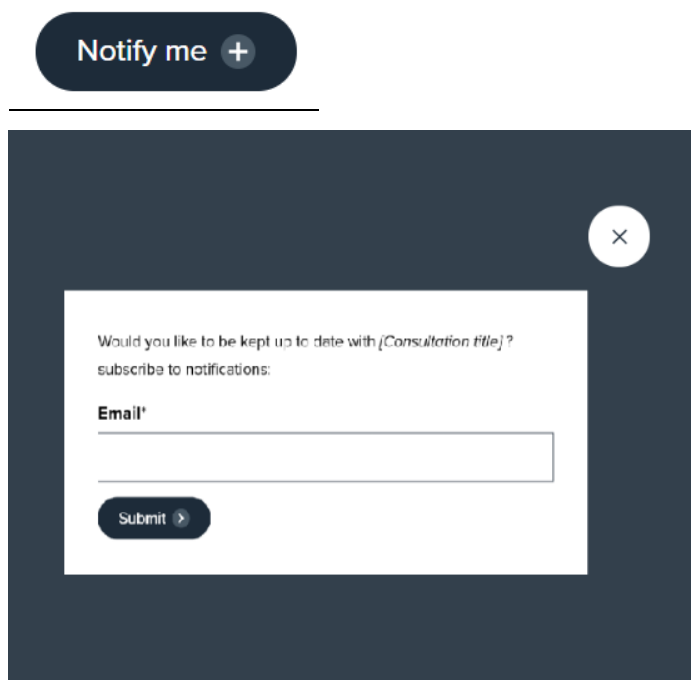
- Were its conclusions balanced?
- Did it make reasoned recommendations for improvement?
- Any further comments?

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

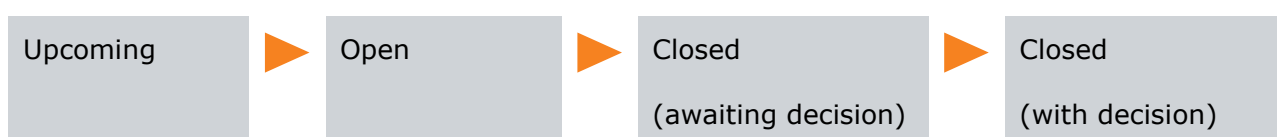
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You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website.

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



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



2. Introduction

Background

2.1. The default tariff cap ('the cap') protects approximately 24 million¹³ 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 the underlying costs to supply that energy. The cap is one of the key activities which fall within the outcome "Deliver fair prices for consumers" within our Forward Work Programme for 2022-23.¹⁴ We set the cap by considering the different costs suppliers face. The cap is made up of a number of allowances which reflect these different costs.

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);¹⁵ 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.¹⁶

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').

¹³ This number is as of July 2022.

¹⁴ Ofgem (2022), Forward work programme 2022/23.

<https://www.ofgem.gov.uk/publications/202223-ofgem-forward-work-programme>

¹⁵ 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>

¹⁶ 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>

Objective of this consultation

2.4. This supplementary consultation has three main objectives:

- Outline the methodological options for calculating the additional COVID-19 debt-related costs and gather feedback on these options.
- Outline and consult on our proposed methodology which was explained in the May 2022 consultation 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

2.5. We propose to continue using the method outlined in the May 2022 consultation to determine the additional COVID-19 debt-related costs in cap period four to seven.

2.6. We 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 the difference in cost between the final cost and the initial allowance we had already provided for in the float is not material when considered alongside other debt-related costs, and therefore it does not justify introducing an adjustment in the cap.

Methodology summary

May 2022 consultation methodology

2.7. We issued two COVID-19 true-up requests for information ('RFI'), one in December 2021 and one in June 2022,¹⁷ to gather information on suppliers' debt-related costs (bad debt charge, debt-related administrative costs and working capital costs¹⁸). We also gathered

¹⁷ We collected COVID-19 impacted cap period data related to cap periods four to six (April 2020 – September 2021) in the December 2021 RFI, and cap periods four to seven (April 2020 – March 2022) in the June 2022 RFI. In both RFIs, we collected data a winter and summer baseline period (October 2018 – March 2019 and April 2019 – September 2019 respectively).

¹⁸ We did not gather information on suppliers' working capital costs in the June 2022 RFI.

information on suppliers' revenue and customer accounts, to ensure we could control for different sizes of suppliers in our benchmarking exercise.

2.8. We also requested this information broken down by tariff type¹⁹ (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.

2.9. We ideally, if possible with the data, would seek to allocate debt-related costs by payment method. It is not possible to allocate additional debt-related costs to individual customers who drive these costs, and 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 inherently, suppliers recover debt-related costs from customers who pay their bills.

2.10. When comparing credit and PPM customers; as PPM customers pay off their debt, it is difficult for them to accrue new debt on that meter and if they do incur additional debt, then it is unlikely to be as much as the amount a credit customer can accrue over time due to the payment structure and ability to access credit. It is also more difficult for a PPM customer in debt to switch between payment methods. Installing PPMs during the initial phases of COVID-19 was restricted, new COVID-19 related PPM debt would likely not be material either. Suppliers are invited to comment and provide evidence on whether new COVID-19 related debt is material for PPMs, and to what extent it should be considered.

2.11. Within the credit payment method (direct debit and standard credit), customer movement is more fluid as customers who cancel their direct debits which can be part of the process of falling into debt will become standard credit customers. However, we are also interested in the propensity of standard credit and direct debit customers to fall into debt. We therefore would invite stakeholders to submit evidence that may indicate that customers at the beginning of the COVID-19 pandemic paying by standard credit accrued more debt per customer than customers who were on a direct debit arrangement, and subsequently accrued debt as a standard credit customer.

2.12. Direct debit customers that had debit balances and ceased paying by this method would realise their debit balances as debt. Since there are sustainably more direct debit

¹⁹ We did not gather data broken down by tariff type in the June 2022 RFI.

customer than paying standard credit customers, it would suggest that more COVID-19 related debt could have arisen from customers who were on direct debits at the start of COVID-19 than paying standard credit customers.

2.13. Lastly for standard credit customers that had debt at the beginning of the COVID-19 pandemic, how much did those debt levels rise by. To assign COVID-19 related debt to one particular payment without specific evidence would risk assigning debt to a particular payment method where it may not have been incurred on that specific payment method.

2.14. If debt is to be apportioned differently between direct debit customers and standard credit customers for COVID-19 related debt, then suppliers are invited to provide evidence to demonstrate that there should be different apportionment by payment type and what that quantum per customer by payment type should be.

2.15. Due to the reasons listed above, there is an intrinsic uncertainty in debt accrual between different types of credit customers, which combined with the methodological uncertainty of allocating debt between these groups means that we are not convinced that cost reflectively will be accurate in using the granular data.

May 2022 consultation methodology summary

2.16. 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 seasonal pre-COVID-19 baseline.

2.17. We provide an explanation of our May 2022 consultation methodology in Appendix 2.

2.18. We summarise some key steps in this methodology. For each debt-related cost, we calculated 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.

Overview of stakeholder feedback

2.19. 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 considered that our consultation approach did not account for the proportion of customers paying by standard credit which is higher for customers on default tariffs than all credit customers across the domestic market (where the percentage of standard credit customers is lower).

2.20. 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.

2.21. As a result of these comments, in August 2022 we issued a letter informing stakeholders that we had decided to delay the COVID-19 true-up decision until February 2023.²⁰ We informed stakeholders that we would instead be issuing a consultation in Autumn 2022, to consult with stakeholders on our methodology after we received feedback proposing an alternative methodology to calculate the COVID-19 true-up allowance.

Alternative method summary

2.22. The alternative methodology was proposed in response to our May 2022 consultation. We issued the COVID-19 true-up RFI in June 2022 to collect information of supplier's debt-related costs during cap periods four to seven. 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. In this section we provide details of the alternative methodologies and provide an illustrative simplified example.

2.23. As we said in the section above, three stakeholders said that we should calculate the bad debt cost for standard credit and direct debit customers separately, before calculating a weighted average for default tariff customers. We have used this explanation to form

²⁰ We had previously said that we intended to publish a decision on the first COVID-19 true-up ahead of announcing the cap level for cap period nine, in August 2022. Our August 2022 letter therefore superseded this prior intention.

Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 1.5.
<https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

alternative method 1, which attempts to control for the payment method mix for default tariff customers.

2.24. Alternative method 2 attempts to control for the payment method mix for credit customers. No stakeholders proposed this alternative method, however, we considered that in the round of allowing stakeholders to provide their views on our May 2022 consultation methodology and alternative method 1, it would be appropriate to further consider accounting for the payment method mix for credit customers as well. This will allow stakeholders an opportunity to provide their views on a range of methodology options, before our decision.

2.25. Below, we summarise some key steps to calculate both alternative methodologies.

2.26. Our final incremental bad debt cost per dual fuel (DF) customer is calculated based on the methodology outlined above and in Appendix 3 of this consultation:

- Taking a weighted average benchmark across suppliers in our sample to calculate the incremental bad debt charge per customer account for direct debit and standard credit.²¹
- We then multiply and sum the product of the total standard credit and direct debit incremental bad debt charge (£) per customer account with its respective payment method proportions.
 - For Alternative method 1: (controlling for the payment method mix of default tariff customers) we use the proportional split of revenue between default tariff customers on a standard credit and direct debit payment method.
 - For Alternative method 2: (controlling for the payment method mix of credit customers) we use the proportional split of revenue between credit customers on a standard credit and direct debit payment method.²²

²¹ We apportion all bad debt which suppliers assigned to PPM to standard credit.

²² Alternative method 2 was not suggested by any stakeholders, however, we considered that it was appropriate to consider in the round with the May 2022 consultation methodology and alternative method 2 since the approach combines elements of the two other methodologies.

2.27. We have provided a simplified illustrative example below to help explain our approach for calculating both the alternative method 1 and 2 to stakeholders.

2.28. Table 2.1 explains the inputs used to calculate the weighted average bad debt cost for both alternative methods 1 and 2:

- We calculate the weighted average bad debt separately for both standard credit customers and direct debit customers. These inputs are used in the calculations for both Alternative method 1 and 2. This is shown by 'BD' with respect to the subscript for the individual payment method.
- We calculate the percentage split of revenue between default tariff customers on a standard credit and direct debit payment method.²³ These inputs are only used in the calculation for alternative method 1. This is shown by ' RS_{SC}^{A1} ' and ' RS_{DD}^{A1} ' with respect to the superscript for alternative method 1.
- We calculate the percentage split of revenue between credit customers on a standard credit and direct debit payment method. These inputs are only used in the calculation for alternative method 2. This is shown by ' RS_{SC}^{A2} ' and ' RS_{DD}^{A2} ' with respect to the superscript for alternative method 2.

2.29. Equations 2.1 and 2.2 display a simplified version of how we have calculated the weighted average bad debt cost for both alternative method 1 and 2. For example, alternative method 1 in Equation 2.1 is attempting to control for payment method mix for default tariff customers. We therefore multiply bad debt with respect to payment method by the percentage breakdown of revenue on that particular payment method.

2.30. Similarly, alternative method 2 in Equation 2.2 is attempting to control for payment method mix for credit customers. We therefore cross multiply bad debt with respect to payment method by the percentage breakdown of revenue on that particular payment method.

²³ To calculate the percentage split for direct debit, we divide direct debit revenue by total revenue. Likewise, to calculate the percentage split for standard credit, we divide standard credit revenue by total revenue.

Table 2.1: Inputs used to calculate the weighted average bad debt cost

Payment method	Bad Debt	% Revenue Split	
		% revenue split for default tariff customers	% revenue split for credit customers
		Alternative method 1	Alternative method 2
Standard Credit	BD_{SC}	RS_{SC}^{A1}	RS_{SC}^{A2}
Direct Debit	BD_{DD}	RS_{DD}^{A1}	RS_{DD}^{A2}

Equation 2.1: Weighted average bad debt cost: alternative method 1

$$BD^{A1} = (BD_{SC} \times RS_{SC}^{A1}) + (BD_{DD} \times RS_{DD}^{A1})$$

Equation 2.2: Weighted average bad debt cost: alternative method 2

$$BD^{A2} = (BD_{SC} \times RS_{SC}^{A2}) + (BD_{DD} \times RS_{DD}^{A2})$$

2.31. Key for the equations 2.1 and 2.2:

- BD = Bad debt, this is the total bad debt for all suppliers in our sample.
- SC = Standard credit.
- DD = Direct debt.
- RS = revenue split²⁴
- A1 and A2 are both the terms for alternative method 1 and 2.

²⁴ NB, $RS_{SC} + RS_{DD} = 1$

3. Bad debt methodology options

Section summary

We explain three different methodological options 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 continue using the methodology set out in the May 2022 consultation to determine the additional COVID-19 debt-related costs in cap periods four to seven.

3.2. As a result, we propose to make no adjustment to the cap for additional costs related to cap periods four to six in our true-up of the initial estimate of bad debt costs for credit meter customers. We consider that the difference between the final cost figure and the initial allowance figure that was already provided for in the float is not material when considered alongside other debt-related costs, and therefore it does not justify introducing an adjustment to the cap.

Context

Proposed approach from November 2021 consultation

3.3. In our November 2021 consultation, we intended to focus on costs of default tariff customers (DTC) only and requested debt-related cost data from suppliers to be broken down by payment method and tariff type. However, the breakdowns provided were not sufficiently accurate/reliable across suppliers and so we did not have meaningful data on the differences in bad debt by tariff types.²⁵

3.4. If the tariff type data is not available, then we have to resort to using proxies based on the payment method (as explained in this section), however, we have concerns on the validity of splitting that debt by payment method and there is methodological uncertainty of

²⁵ Ofgem (2021), Consultation on the true-up process for COVID-19 costs, paragraph 3.20. <https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs>

allocating debt between these groups which means that we have doubts about using an unreliable proxy as a way of allocating costs between tariffs. To assign COVID-19 related debt to one particular payment without specific evidence would risk assigning debt to a particular payment method where it may not have been incurred on that specific payment method.

Proposed approach from May 2022 consultation

3.5. In our May 2022 consultation, we proposed not to use suppliers' breakdown of bad debt by tariff type as we were unable to gather this data in a proportionate and consistent basis across suppliers.²⁶

3.6. As we did not control for the differences in tariff type or payment method, it meant that we proposed to allocate all additional bad debt costs equally across credit customers (standard credit and direct debit) only. We considered that this was the best way to reflect that most of the bad debt costs are inherited from debt which is built up whilst on a credit meter.²⁷

3.7. We proposed to make no adjustment in the cap to true-up our initial estimate of bad debt costs for credit meter customers. We considered that the difference in cost between the final cost and what was already provided for in the float was not material when considered either in isolation or alongside other debt-related costs.²⁸ This was based on the data collected from the December 2021 RFI on cap periods four to six, which showed the additional bad debt charge for credit customers was £0.71 per customer higher than our original float estimate.²⁹

RFI data

3.8. In our December 2021 RFI, 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).

²⁶ 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>

²⁷ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.40.

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

²⁸ 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>

²⁹ This figure took total bad debt charge spread over all credit customers and subtracted the additional cost calculated in the float.

3.9. We received eleven submissions to the bad debt charge cost question³⁰ from our December 2021 RFI.

3.10. Nine suppliers were included in our sample for calculating the total weighted average benchmark for the incremental bad debt costs in our May 2022 consultation.

3.11. In June 2022, we requested suppliers submit responses to a second COVID-19 true-up RFI. The main purpose of this RFI, was to extend the COVID-19 period to gather data for cap period seven.³¹ We received eleven submissions to the bad debt charge cost question from this RFI.³²

Breakdown by tariff type

3.12. In our December 2021 RFI, we requested that suppliers broke down the bad debt charge by tariff type (Fixed/Default) to ensure we had the correct costs in scope of our review. This was to reflect our proposal in our November 2021 consultation where we said that we wanted to focus on the costs of default tariff customers.³³

3.13. In response to this RFI, six suppliers were unable to provide the bad debt charge by tariff type and two large suppliers noted that providing a breakdown of the bad debt charge by tariff type would rely on allocations which would not necessarily be accurate or comparable across suppliers.

3.14. Therefore, in our May 2022 consultation, we were not reasonably satisfied that the limited number of suppliers who had provided tariff type breakdowns had done this in an accurate and consistent manner. Consequently, we considered that being unable to control for tariff type in our calculations was an inherent limitation of the cumulative bad debt approach.³⁴

³⁰ We asked suppliers to provide the bad debt charge data from their management accounts for October 2018 – September 2019 and April 2020 – September 2021 broken down by payment method and tariff type.

³¹ We decided to remove the tariff type breakdown, working capital questions in this RFI request. Further we asked suppliers to exclude debt-related costs data relating to SoLRs.

³² We asked suppliers to provide the bad debt charge data from their management accounts for October 2018 – September 2019 and April 2020– March 2022 broken down by payment method.

³³ 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>

³⁴ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.33 & 3.35. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

3.15. Subsequently in our June 2022 RFI, we did not request bad debt charge data to be broken down by tariff type. This was because the majority of suppliers were unable to provide the data split by tariff type in response to the first COVID-19 RFI, however, suppliers were voluntarily able to submit a breakdown of bad debt if they wished. This means that we only have bad debt charge data broken down by tariff type for cap periods four to six for three suppliers³⁵ (out of eleven suppliers who responded to our December 2021 RFI). Eleven suppliers also responded to our June 2022 RFI and none of them submitted cap bad debt charge data that was broken down to a more granular level than was requested for cap period seven.

Breakdown by payment method

3.16. In our May 2022 consultation, we said that suppliers had told us that debt-related costs are generally higher for standard credit customers than for direct debit customers in part reflecting on the differences in the characteristics of customers.³⁶

3.17. We recognised that any additional debt-related costs were likely to vary by payment method to reflect that there are intrinsic differences between payment methods in terms of how easy it is to incur debt, and the characteristics of customers on each payment method.

3.18. Within the credit payment method (direct debit and standard credit), customer movement is more fluid as customers who cancel their direct debits which can be part of the process of falling into debt will become standard credit customers.

3.19. Direct debit customers that had debit balances and ceased paying by this method would realise their debit balances as debt. Since there are sustainably more direct debit customer than paying standard credit customers, it would suggest that more COVID-19 related debt could have arisen from customers who were on direct debits at the start of COVID-19 than paying standard credit customers.

³⁵ We said in our May 2022 consultation that suppliers had highlighted that they do not use tariff type as a factor in their regular provisioning method, which means that they cannot easily provide a breakdown of the bad debt charge by tariff type, many assumptions would be required to do so. Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.32. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

³⁶ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.36 & 3.39. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

3.20. There is an intrinsic uncertainty in debt accrual between different types of credit customers, which combined with the methodological uncertainty of allocating debt between these groups means that we are not convinced that cost reflectively will be accurate in using the granular data. To assign COVID-19 related debt to one particular payment without specific evidence would risk assigning debt to a particular payment method where it may not have been incurred on that specific payment method.

3.21. In both our December 2021 and June 2022 RFI, we requested the bad debt charge broken down by payment method (direct debit/ standard credit/ PPM).

3.22. We requested the bad debt charge be split based on a customers' current payment method, and not the payment method at the point the debt was incurred. This is because the cumulative bad debt approach measures the bad debt charge for the current payment method. This means that 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. We would not expect this to be as significant due to the restriction in granting warrants in the early stages of the COVID-19 pandemic.

Proposal

3.23. Having considered the options set out in this consultation, we propose to continue using the methodology set out in the May 2022 consultation to determine the additional COVID-19 debt-related costs in cap periods four to seven.

3.24. We propose to continue using 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 the May 2022 consultation and November 2021 consultation. We propose to use the data gathered via our true-up RFI to do this.

3.25. We 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 the difference in cost between the final cost and the initial allowance we had already provided for in the float is not material when considered alongside other debt-related costs, and therefore it does not justify introducing an adjustment in the cap.

Stakeholder responses

Stakeholder feedback on our proposed May 2022 consultation method

3.26. 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 proportion of customers paying by standard credit which is higher for customers on default tariffs than all credit customers across the domestic market (where the percentage of standard credit customers is lower).

Alternative methodology

3.27. 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: alternative methodologies

Methodology assumptions

3.28. We explain in more detail the assumptions and approach behind the alternative methodology in Appendix 3, however we summarise that approach below. We also provide an illustrative example in Chapter 2 and Appendix 3 to help stakeholders understand our approach.

3.29. To calculate the weighted average bad debt charge (£) per customer account, we aggregate for suppliers in our sample, the bad debt charge and credit revenues for both the standard credit and direct debit payment methods. This is for the main COVID-19 cap periods, we define the main COVID-19 cap periods as being cap periods four to seven (April 2020 – March 2022).

3.30. We assign 100% of the bad debt which suppliers allocated to the PPM payment method to standard credit.

3.31. We divide the bad debt charge by credit revenues for standard credit and direct debit separately. This provides a figure for the total bad debt charge (£) per unit of credit revenue, and this is repeated for all baseline and COVID-19 cap periods for both payment methods.

3.32. We proposed in our May 2022 consultation that our methodology would take a cumulative bad debt approach to calculate if there are any additional bad debt costs due to COVID-19.³⁷ Therefore, the calculation considered the difference of 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 for both payment methods.³⁸ This provides an incremental bad debt charge (£) per unit of credit revenue for the main COVID-19 cap periods.

3.33. Subsequently, we then monetise the incremental bad debt per unit of revenue by applying a capped direct debit and standard credit revenue per customer account for each COVID-19 cap period (please see 'Cap level workings' in Appendix 2 for an explanation of the calculation, and changes to the cap level calculation from our May 2022 consultation).

3.34. We then multiply and sum the product of the total standard credit and direct debit incremental bad debt charge (£) per customer account with its respective payment method proportions.

- For alternative method 1 (controlling for the payment method mix of default tariff customers) we use the proportional split of revenue between default tariff customers on a standard credit and direct debit payment method.
- For alternative method 2 (controlling for the payment method mix of credit customers) we use the proportional split of revenue between credit customers on a standard credit and direct debit payment method.³⁹

Allowance

3.35. In Table 3.1 below, we show the difference between the final weighted average incremental cost per DF customer at typical benchmark consumption for the alternative methodologies.

³⁷ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.9.

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

³⁸ We use a baseline period of October 2018 – March 2019 for the winter COVID-19 impacted cap periods, and a baseline period of April 2019 – September 2019 for the summer COVID-19 impacted cap periods.

³⁹ Alternative method 2 was not suggested by any stakeholders, however, we considered that it was appropriate to consider in the round with the May 2022 consultation methodology and alternative method 2 since the approach is between the two other methodologies.

3.36. This was calculated using a sample of nine suppliers. We excluded two suppliers from our sample, which is consistent with our approach in our May 2022 consultation.⁴⁰

3.37. Our final incremental bad debt cost per DF customer is calculated based on the methodology outlined above and in Appendix 3 of this consultation:

- Taking a weighted average benchmark across suppliers in our sample to calculate the incremental bad debt charge per customer account for direct debit and standard credit.⁴¹
- We multiply and sum the product of the total standard credit and direct debit incremental bad debt charge (£) per customer account with its respective payment method proportions.
 - For alternative method 1 (controlling for the payment method mix of default tariff customers) we use the proportional split of revenue between default tariff customers on a standard credit and direct debit payment method.
 - For alternative method 2 (controlling for the payment method mix of credit customers) we use the proportional split of revenue between credit customers on a standard credit and direct debit payment method.⁴²

3.38. Our bad debt data from the June 2022 RFI on cap periods four to seven (April 2020 – March 2022) showed that when we attempt to control for the payment method mix for default tariff customers, the additional bad debt charge for credit customers was £12.15 per DF customer⁴³ higher than our original estimate in the float.

3.39. Our bad debt data from the June 2022 RFI on cap periods four to seven (April 2020 – March 2022) showed that when we attempt to control for payment method mix for credit

⁴⁰ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.23.

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

⁴¹ We apportion all bad debt which suppliers assigned to PPM to standard credit.

⁴² Alternative method 2 was not proposed by any stakeholders, however, we considered that it was appropriate to consider in the round with the May 2022 consultation methodology and alternative method 2 since the approach is between the two other methodologies.

⁴³ 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 4 in this consultation.

customers, the additional bad debt charge for credit customers was £6.88 per DF customer higher than our original estimate in the float.

Table 3.1: Final weighted average bad debt costs compared with our initial float using the alternative methodology⁴⁴

	Final incremental cost (£ per DF credit customer)	Incremental cost (£ per DF credit customer) determined in the float	Difference (Final increment - float)
Alternative method 1	+25.93	+13.78	+£12.15
Alternative method 2	+20.66	+13.78	+£6.88

Pros of the alternative methodologies

Alternative method 1: controlling for payment method mix for default tariff customers

3.40. Alternative method 1 attempts to focus on costs which are in scope of default tariff customers only which is what we had previously said we wanted to focus on.⁴⁵ This is achieved by creating a proxy using revenue data. This means that it would only attempt to look at the costs that are relevant to customers who during the COVID-19 pandemic were protected under the cap and on a default tariff. The objective of the cap legislation is to protect existing and future default tariff customers, and we consider this means that prices should reflect the efficient costs of a supplier to supply that energy. Therefore, if we can be confident on its accuracy ourselves, then a calculation which focuses on the costs of just default tariff customers would be preferable and would allow cost recovery over a targeted segment of the domestic customer base.

3.41. Theoretically this makes sense, and we attempted to sense check how well the proposed alternative method predicted bad debt by tariff type through comparing the proposed method’s output of bad debt using the proxy calculation with the bad debt charge broken down by tariff type for suppliers who have provided them. The difference between these two methods was approximately 6%. This could act as an estimator for how much debt

⁴⁴ The output is using data from our June 2022 RFI which covers the COVID-19 periods of cap periods four to seven.

⁴⁵ 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>

moves between standard credit and direct debit and suggests a small difference between the alternative method and controlling for tariff type through only looking at default tariff costs. Please note that for this calculation, we only included suppliers who were able to break down tariff type and compared the aggregate output for the alternative method 1 and using tariff type breakdowns. This sample only included three suppliers, which is much lower than our sample for both of the alternative methods and the May 2022 consultation methodology.

Alternative method 2: controlling for payment method mix for credit customers

3.42. We have previously noted that whilst additional debt-related costs are likely to vary by payment method which would reflect the intrinsic differences between them in terms of how easy it is to incur debt, it will also reflect the differences in characteristics of customers on each payment method.^{46, 47} Suppliers have previously told us that it is more costly to serve standard credit customers and that they build up debt easier than direct debit customers.

3.43. This intuitively makes sense since a customer on a standard credit meter must actively pay their bill to avoid getting accruing debt. Whereas for a direct debit customer there is an automatic transfer of money on an agreed date for the customer to pay their energy bill. Therefore, if a direct debit customer has the funds in their bank account, they would need to actively cancel their direct debit in order to accrue debt notwithstanding an appropriate direct debit level.

3.44. In this method we calculate the incremental weighted average bad debt cost per customer account for both standard credit and direct debit customers before using the proportionate breakdown of credit customers on a direct debit and standard credit to weight our calculation based on the makeup of the credit market.

Cons of both the alternative methodology 1 and 2

3.45. When requesting data split by payment method in our RFIs, we asked suppliers to split the bad debt charge based on the current payment method, and not the customer's payment method at the point of billing or the point the debt was necessarily incurred. This was because the cumulative bad debt approach measures the bad debt charge for the current

⁴⁶ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.36. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

⁴⁷ Ofgem (2019), Consumer Survey 2019. <https://www.ofgem.gov.uk/publications/consumer-survey-2019>

payment method. It means that for a customer who moved to a different payment method after accumulating debt, the bad debt charge would be categorised as a payment method where the debt was not incurred.

3.46. This inherently means that any method which involves breaking down the bad debt charge by payment method would not accurately control for payment method as we do not know the payment method to which the debt was incurred on. Both the alternative method 1 and 2, control for payment method using data broken down by payment method, but this does not necessarily show where the debt was incurred, thus reducing the accuracy of the data.

3.47. Following feedback from stakeholders, we proposed the cumulative bad debt charge approach in our May 2022 consultation, and we considered that the approach benefits from being a more practical data source, as suppliers need to produce a bad debt charge for their own accounts. We noted that 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.⁴⁸

3.48. However, we did note that despite this benefit there are limitations to this approach. The bad debt charge is limited in the number of customer characteristics and base factors it can be broken down into. Our experience from requesting data is that suppliers' systems do not easily provide a breakdown by tariff type or payment method, and if they are able to, suppliers' need to apply assumptions to produce these figures. This means that the more granular the data is, the more likely assumptions are made behind data which both suppliers and we ourselves would need to accept as being reasonable and appropriate in the circumstances. Given suppliers made their own assumptions in breaking down payment method to respond to our RFI, their data at the granular level is unlikely to be consistent with each other. This becomes more problematic, when basing a calculation from the bad debt charge broken down by payment method and there would be a risk that the output is not reflective of additional debt-related costs because of these assumptions. The more granular

⁴⁸ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.14. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

the data is, then the more likely it is that assumptions will be made that underpin it, which could lead to inaccuracies.

3.49. To assign COVID-19 related debt to one particular payment without specific evidence would risk assigning debt to a particular payment method where it may not have been incurred on that specific payment method. If debt is to be apportioned differently between direct debit customers and standard credit customers for COVID-19 related debt, then suppliers are invited to provide evidence to demonstrate that there should be different apportionment by payment type and what that quantum per customer by payment type should be.

Limitations of the alternative methodologies

3.50. Both the alternative methodology 1 and 2 have a higher additional cost impact on customers than the methodology outlined in the May 2022 consultation method, therefore on average, there is a greater risk of over-recovering from suppliers, but a lower risk of under-recovery. If an allowance is set too high, then it could reduce the incentives for suppliers to price additional bad debt due to COVID-19 into their fixed tariff contracts as they would be able to recover that sum of money from their default tariff customers. It could also allow suppliers to earn a higher margin from default tariff customer than we would expect an efficient supplier to achieve.

Considerations: May 2022 consultation methodology

Methodology assumptions

3.51. 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. We define the main COVID-19 cap periods as being cap periods four to seven (April 2020 – March 2022).

3.52. We use the total (credit + PPM) bad debt charge in our calculation. This means that 100% of the bad debt which suppliers allocated to the PPM payment method we assign to credit customers in our calculation.

3.53. 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, and this is repeated for all baseline and COVID-19 cap periods.

3.54. We proposed in our May 2022 consultation that our methodology would take a cumulative bad debt approach to calculate if there are any additional bad debt costs due to COVID-19.⁴⁹ Therefore, the calculation considered the difference of 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.⁵⁰ This provides an incremental bad debt charge (£) per unit of credit revenue for the main COVID-19 cap periods.

3.55. Subsequently, we then monetise the incremental bad debt per unit of credit revenue by applying a capped credit revenue per customer account for each COVID-19 cap period (please see 'Cap level workings' in Appendix 2 for an explanation of the calculation, and changes to the cap level calculation from our May 2022 consultation).

Allowance

3.56. In Table 3.2 below, we show the difference between the final weighted average incremental cost per DF customer at typical benchmark consumption.

3.57. This was calculated using a sample of nine suppliers. We excluded two suppliers from our sample consistent with our approach in our May 2022 consultation.⁵¹

3.58. Our final incremental bad debt per DF customer is calculated based on the methodology outlined above and in Appendix 2 of this consultation and our May 2022 consultation which incorporates the following proposals:

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

⁴⁹ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.9.

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

⁵⁰ We use a baseline period of October 2018 – March 2019 for the winter COVID-19 impacted cap periods, and a baseline period of April 2019 – September 2019 for the summer COVID-19 impacted cap periods.

⁵¹ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.23.

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

3.59. Our bad debt data from the June 2022 RFI on cap period four to seven (April 2020 – March 2022) showed that the additional bad debt charge for credit customers was £3.09 per DF customer⁵² higher than our original estimate in the float.

Table 3.2: Final weighted average bad debt costs compared with our initial float using the May 2022 consultation methodology

	Final incremental cost (£ per DF customer) from June 2022 RFI	Incremental cost (£ per DF customer) determined in the float	Difference
May 2022 consultation methodology	+16.87	+13.78	+£3.09

Pros of the May 2022 consultation methodology

3.60. This method uses the total bad debt charge, which is at the lowest level of granularity of the data we collected and therefore is underpinned by fewer assumptions than if we had used data broken down by payment method or tariff type. The greater the level of granularity in our calculation, then the more assumptions both we and suppliers would have to make, which then reduces the accuracy of the data. For suppliers to apportion the bad debt charge into specific breakdowns, assumptions would need to be made, and we would have to ensure they were consistent between suppliers to ensure that data submitted allowed us to be convinced that cost reflectivity would be accurate. By using more granular data, it would require specific assumptions which may not be consistent between other suppliers' own assumptions.

3.61. We therefore consider that the May 2022 consultation methodology approach is the least susceptible to data quality issues as we are using less granular data and so the calculation is based on the fewest assumptions. This lowers the risk of data accuracy or consistency issues.

⁵² 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 4 in this consultation.

3.62. Based on the design of the cap, we can only set one cap level for all licenced energy suppliers, as we may not make different provisions for different holders of supply licences.⁵³ This means that by default, customers who did not accrue debt during COVID-19 will pay for any debt-related cost allowance. It could be considered appropriate to spread total bad debt costs over all credit customers (rather than trying to control for tariff type), to protect default tariff customers as the individual who pays for any additional debt on a default tariff should not be more liable than an individual customer on a fixed tariff. This would ensure that customers on both default and fixed tariffs pay for their fair share in additional debt-related costs.

3.63. Adopting this method would not therefore penalise debt-free customers and it would increase the incentive for suppliers to evenly spread additional costs between all tariffs, rather than placing it on default tariffs.

Cons of the May 2022 consultation methodology

3.64. In our November 2021 consultation, we said that we wanted to focus on the costs of default tariff customers only.⁵⁴ The May 2022 consultation method calculation spreads the total bad debt charge over all credit customers and therefore does not isolate the impact on default tariff customers. This means that the method does not control for tariff type, so its accuracy would depend on how similar additional debt-related costs are for both default tariff and fixed tariff customers.

3.65. If default tariff customers have a higher propensity to accumulate debt, then this method could underestimate the additional bad debt charge due to COVID-19; theoretically this method would be most likely to be accurate if all domestic energy customers had a similar propensity to accumulate debt.

3.66. Therefore, if customers have a different propensity to accumulate debt in respect of their tariff type, this method would not be cost reflective of additional debt-related costs. Similarly, the method does not control for the payment method to which the debt was accumulated. One supplier commented in our May 2022 consultation that credit customers

⁵³ Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 2(2).

<http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted>

⁵⁴ 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>

incur larger bad debt costs per customer than direct debit customers. We have recognised previously that debt-related costs are likely to vary by payment method.

Limitations of the May 2022 consultation methodologies

3.67. The May 2022 consultation methodology has a lower additional cost impact on customers than the alternative methodologies, therefore on average, there is a lower risk of over-recovery by suppliers, but a higher risk of under-recovery. If there is an under-recovery, then it could be considered unfair to fixed tariff customers, who may pick up the bill.

Further considerations

Methodological options

3.68. In the section above we have discussed the following methods options:

- Alternative method 1: control for the payment method mix for default tariff customers⁵⁵
- Alternative method 2: control for the payment method mix for credit customers⁵⁶
- May 2022 consultation method: spread total bad debt costs over credit customers only.

3.69. We consider that there is intrinsic uncertainty in debt accrual between different types of credit customers, which combined with the methodological uncertainty of allocating debt between these groups means that we are not convinced that cost reflectivity will be accurate using the granular data.

3.70. However, there are significant data quality issues with both alternative methodologies. Given that they both use granular data broken down to the payment method level, we are concerned that the breakdown does not accurately depict which tariff the customer was on

⁵⁵ This is calculated by controlling for payment method and then creating a proxy using revenue data to weight the calculation for default tariff customers only.

⁵⁶ This is calculated by controlling for payment method and then creating a proxy using revenue data to weight the calculation for credit customers only.

when the COVID-19 related debt was incurred which is an inherent problem with using the cumulative bad debt approach.

3.71. Over the past year, there has been a convergence of customers moving on to default tariffs, and now the majority of domestic energy customers are on default tariffs. This would mean that the customer base we would be recovering any additional allowance over is very different to the customer base during the COVID-19 pandemic. It could be considered less representative which could mean this method overstates the cost being recovered and for the customer base that cost is being recovered over, spreading total bad debt over all customers would be more representative due to the base.

3.72. In evidence of debt by tariff type during the COVID-19 debt-related period we propose to use the method detailed in our May 2022 consultation, and allocate all additional bad debt costs equally to credit customers.

3.73. We propose to make no adjustment in the cap to true-up our initial estimate of bad debt costs for credit customers. We consider that this difference in cost between the final cost and what was already provided for in the float is not material when considered alongside other debt-related costs.

Prepayment meter customers

3.74. One supplier explained that no allowance for PPM customers would not allow suppliers to manage their debt-related to prepay customers. Another supplier commented that it had incurred a significant level of incremental debt from PPM customers during the pandemic. This was due to an increase in emergency and discretionary credit being offered to those customers.

3.75. We requested the bad debt charge split 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.

3.76. 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 PPMs 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.

3.77. Suppliers previously told us that between 90-99% of the bad debt on a PPM was built up whilst they were on a credit meter.^{57, 58} We consider that there is a limited amount of evidence that shows bad debt comes from debt that is built up whilst a customer is on a PPM, as suppliers have previously said to us that the majority of the PPM bad debt is inherited from a credit meter when a customer is moved from a credit meter to a PPM.

3.78. We propose to allocate no bad debt costs to PPM customers. However, we do welcome evidence from suppliers of additional debt-related costs incurred on PPMs due to COVID-19.

Additional information

3.79. In this chapter we have discussed the origin of debt and how the data we have collected broken down by payment type displays where the debt ended up and not the point at which the debt was incurred. We are therefore interested in whether suppliers are able to provide further data on the debt origin than what was provided in their previous RFI submissions.

3.80. We would be interested to know if suppliers are able to provide us with data on the payment method to which the debt was incurred on based on when a debt letter was sent to a customer.

⁵⁷ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 6.26 – 6.28. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

⁵⁸ 90-99% presents the range of estimates provided by suppliers.

4. Other debt-related costs

Section 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.

Debt-related administration cost

Context

4.1. In our May 2022 consultation, we had outlined our proposed definition of debt-related administrative costs for the COVID-19 true-up, which is administrative costs incurred by suppliers when seeking to recover to recover debt and, in the case of PPM customers also any administrative costs when customers incur debt.⁵⁹

4.2. We also proposed a hybrid approach for collecting debt-related administrative cost data. We had set out categories in our December 2021 and June 2022 RFIs and had asked for breakdowns of individual cost categories⁶⁰, also while allowing suppliers to put forward any additional debt-related administrative costs not covered by these categories.

4.3. In our May 2022 consultation, we proposed to not use the breakdown of 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.⁶¹ We also proposed to make no adjustment, as the data gathered suggested that there had not been a material and systematic change in incremental costs from what had already been allowed for suppliers to recover in the float.

⁵⁹ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 4.7.

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

⁶⁰ These categories were legal/warrant costs, costs of non-warrant field visits, other communication costs, setting up payment plans, debt collection agencies, credit delivery costs (only PPM) and other.

⁶¹ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 4.16.

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

Proposal

4.4. For the COVID-19 true-up adjustment, we propose to define debt-related administrative costs, at a high level, as administrative cost incurred by suppliers when seeking to recover debt and, in the case of PPM customers, also any administrative costs when customers incur debt. This proposal is unchanged from our November 2021 and May 2022 consultations.⁶²

4.5. 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 of individual cost categories, 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.⁶³

4.6. We propose to not use the breakdown of 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.

Stakeholder responses

4.7. One supplier's economic adviser said that as there was an increase in supplier bad debt cost due to COVID-19, it would have been highly unlikely that there would have been a benefit from reductions in debt-related administrative costs. It said that we should assume COVID-19 had no impact on administrative costs. It said that the reduction in debt-related administration costs likely indicates a deferral in costs.

4.8. It said that restrictions during COVID-19 led to some suppliers deferring their debt-related administrative cost activities and it welcomed our proposal to collect data for cap period seven. It did however say that its client thought debt-related administrative costs would likely remain high due to COVID-19 for the remainder of 2022 due to a backlog in courts and prepayment meter fittings.

⁶² Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.5 – 4.6. <https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs>

⁶³ Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.10, 4.14 – 4.16. <https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs>

Considerations

4.9. Our considerations remain unchanged from our November 2021 consultation.⁶⁴

4.10. We did not provide a float for debt-related administrative costs in our February 2021 decision. The data we have from the June 2022 RFI for cap periods four to six had shown that the final incremental debt administrative cost may have fallen.

4.11. We consider that there is likely a positive correlation between bad debt charge and debt-admin costs. Therefore, we acknowledge that theoretically during COVID-19 we would have expected higher debt-admin costs due to the higher bad debt levels. However, we acknowledge the physical restrictions which were in place during the COVID-19 pandemic which limited the ability for suppliers to recover debt, which may have kept certain debt-related administrative costs low.

4.12. The recoverability of the debt would also determine the incentive and reward for a company in chasing up the debt. If the debt built up in COVID-19 was unrecoverable due to certain customer characteristics, then suppliers would see little value in chasing this bad debt. Therefore, we may have a situation where bad debt rises and debt-admin does not.

4.13. Suppliers' debt-related admin activities were reduced by the COVID-19 restrictions, therefore it's reasonable to think that backlogs of warrants may have materialised later than in cap periods four to seven.

Considerations – RFI data submissions

4.14. We received eleven submissions to the debt-related administrative costs question in both our December 2021 and June 2022 RFI.

4.15. As before in our December 2021 RFI, some suppliers could not breakdown debt-related administrative costs by the individual cost categories we requested. Although as we

⁶⁴ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, Paragraph 4.10-4.12. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

explained before,⁶⁵ these suppliers were not automatically excluded from our sample because in our calculation, we use the total debt-related cost figure.

4.16. Eight suppliers were included in our sample for calculating the total weighted average benchmark for incremental debt-related administrative costs.

Considerations – RFI data breakdowns

4.17. In our May 2022 consultation, we said that the majority of suppliers who submitted data could not split debt-related administrative costs by payment method or tariff type, and some suppliers said that they do not report debt-related administrative costs at such a granular level.⁶⁶ In the June 2022 RFI, we only requested that debt-related administrative costs be broken down by payment method and not tariff type. However, similar to the response to the June 2021 RFI, only four suppliers were able to provide data for PPM debt-related costs. We consider that it would not be appropriate to base a calculation on a sample so small and still be confident in the accuracy and robustness of our result.

4.18. This also means that in the event of a change of proposal in Chapter 3, we would not be confident in taking a weighted average for default tariff customers based on the proportions of standard credit and direct debit customers on default tariffs as the sample would be very small. Therefore, we are considering any additional debt-related administrative costs using the May 2022 consultation methodology and neither alternative methodology 1 or 2 as they both require breakdowns of data by payment method.

4.19. As a result, we consider that it would be appropriate to look at total debt-related administrative costs on an aggregate level, and we did not see an increase in total debt-related administrative costs in our calculation.

Considerations - Materiality

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

⁶⁵ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 4.25. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

⁶⁶ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 4.28-4.33. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

- using total debt-related administrative costs in our calculation;
- spreading total debt-related administrative costs over credit customers; and
- taking a weighted average benchmark across suppliers.

4.21. Our debt-related administrative cost data from the June 2022 RFI on cap periods four to seven, showed that the additional debt-related administrative costs for credit customers was –£1.76 per DF customer.

4.22. We propose to make no adjustment in the cap for additional debt-related administrative costs. When viewed in the round with the bad debt charge, we consider that there has not been an additional material or systematic increase in debt-related costs above those already allowed for in the cap.

4.23. One supplier said that beyond the COVID-19 pandemic, it would be likely that suppliers will have higher levels of debt in conjunction with affordability challenges and increasing administrative costs and that we should consider performing future analysis to ensure price cap benchmarks reflect the costs of an efficient supplier.

4.24. This comment is out of scope of the review into the true-up process for additional COVID-19 costs, however, as previously explained in our August 2022 letter, we do intend to issue a consultation on debt-related costs but only if we find evidence which suggests there are material and systematic increase in these costs.⁶⁷ We are continuing to monitor the debt-related costs on an ongoing basis.

4.25. One supplier's economic adviser said that we should consider making an allowance for additional debt-administration in cap period eight, while giving particular attention to this as we analyse debt-related administrative cost data for cap period seven.

4.26. Since the previous May 2022 consultation, we have collected debt-related administrative cost data for cap period seven and have given this attention in our analysis. There was still a reduction in debt-related administrative costs compared to a pre-COVID-19

⁶⁷ Ofgem (2022), Notice to delay COVID-19 true-up decision and work on debt-related costs, paragraph 1. <https://www.ofgem.gov.uk/publications/price-cap-notice-delay-covid-19-true-decision-and-work-debt-related-costs>

baseline period for cap period seven, and therefore, we have not found evidence in our analysis to suggest that there would be an uptick in this cost in the latter stages of the COVID-19 pandemic. Although as we have said above, we are continuing to monitor debt-related costs on an ongoing basis given recent uncertainty and if we find evidence which suggests that there are material and systematic increases in debt-related costs, we intend to consult on it.

Working capital

Context

4.27. In our May 2022 consultation, we had proposed 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 it takes for customers to pay suppliers.⁶⁸

4.28. We also proposed to make no adjustment in the cap to true-up additional working capital costs due to COVID-19. We considered that the costs suppliers faced due to COVID-19 were 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.

Proposal

4.29. We propose to continue half yearly debtor-days to determine the additional working capital costs due to COVID-19.

4.30. We propose to make no adjustment in the cap to true-up additional working capital costs due to COVID-19. We consider that any working capital cost is based on a need for suppliers to cover the additional risk of a short-term delay in payments. Suppliers should have had these short-term financing facilities in place as part of their day-to-day business before the COVID-19 pandemic.

⁶⁸ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph, 4.51 – 4.52. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

Stakeholder responses

4.31. Four suppliers did not agree with our proposal not to include an adjustment for the additional cost of working capital due to COVID-19.

4.32. One supplier disagreed that this is short term financing and can be covered by low financing rates, given the scale of the debt. They also disagree that this is covered through the uncertainty allowances.

4.33. Another supplier had noted that scale and time period meant it is not plausible 'business-as-usual' variation in working capital requirements. They disagreed that it could be covered by Earnings Before Interest and Tax (EBIT) or Payment Method Uplift (PMU). The supplier then commented that it considers our range of 0-5% doesn't consider indirect impacts, which increases suppliers' debt-to-capital ratios, which in turn increases the marginal cost of raising future capital. In corporate finance, when cash is raised by a business to finance certain activities, the cost of financing does not depend on the form of financing. Any extra financing attracts a marginal cost exactly equal to the WACC, assuming the activity being financed carries a similar risk profile to that of the rest of the business. If raising extra cash from short-term financing only incurs a short-term financing cost and nothing beyond, then companies would never use any other forms of financing that are more expensive such as long term debt or equity.

4.34. One supplier said that there would be no justification to use the Sterling Overnight Index Average (SONIA) interest rate, as no retail business would have been able to borrow at a rate close to the SONIA due to the risks involved in the retail energy supply business. This supplier suggested that we should use the average weighted average cost of capital (WACC) faced by suppliers to better reflect risks and the cost of borrowing.

Considerations

4.35. We are currently consulting on amending the methodology for setting the earnings before interest and tax (EBIT) allowance which was determined in 2018 using a similar methodology that adopted by the Competition and Markets Authority (CMA) during its Energy Market Investigation (EMI) in 2016.⁶⁹

⁶⁹ CMA (2016), Energy market investigation
<https://www.gov.uk/cma-cases/energy-market-investigation>

4.36. One area which the EBIT consultation is exploring is the cost of capital and we proposed to recalculate the components of the Capital Asset Pricing Model (CAPM) method and are currently inviting stakeholder views on that approach.⁷⁰ The current cost of capital used in the cap is 10%, and this was determined using a methodology by the CMA in its EMI analysis which determined an appropriate level of capital employed per customer. This EBIT consultation is a forward-looking consultation, and it does not seek to assess whether the previous or existing EBIT cap allowance were sufficient.

4.37. We consider that the current EBIT allowance is still appropriate for the cap periods which are in scope of this review into the true-up process for COVID-19 costs. As such we will consider the cost of capital which defined through the EBIT consultation process, and consider how it may impact our assessment of any additional working capital costs due to COVID-19.

Considerations RFI data submission

4.38. We removed the working capital costs question from our June 2022 RFI. This was because we proposed to not gather any further working capital data beyond cap period six in our May 2022 consultation.⁷¹ Therefore, we have not received additional working capital data since our previous December 2021 RFI. This means that our considerations of the RFI remain unchanged from our May 2022 consultation.⁷²

Considerations – RFI data quality

4.39. Our considerations on RFI data quality have not changed since our May 2022 consultation.⁷³

⁷⁰ Ofgem (2022), Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance, page 6.
<https://www.ofgem.gov.uk/publications/consultation-amending-methodology-setting-earnings-interest-and-tax-ebit-allowance>

⁷¹ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph, 4.94, 4.96 & 4.99.

⁷² Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph, 4.72-4.73.
<https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

⁷³ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph, 4.77-4.79.
<https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

Considerations - Materiality

4.40. As mentioned above we did not collect any additional data on working capital costs in our June 2022 RFI and we will reconsider our position once cost of capital analysis has been completed for the EBIT consultation process. However, below we summarise our position on materiality.

4.41. 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.

4.42. 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.

4.43. We have not previously made a decision on what the appropriate cost of financing assumption is. In the consultations relating to our February 2021 and August 2021 decisions 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.⁷⁴ 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.

4.44. 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.

4.45. 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

⁷⁴ 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

typical DF customer. If the rate of short-term financing is in the range of 0-5% as we previously suggested in our May 2022 consultation that it could be, then the additional working capital cost would be between £0-£2.21 cost per DF customer.

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 define 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 May 2022 consultation.

Stakeholder responses

1.3. No stakeholders commented on this aspect of our May 2022 consultation.

Considerations

1.4. Our considerations remain unchanged from our November 2021 consultation. We have outlined a summary of these considerations below. Please refer to the November 2021 consultation for full details.⁷⁵

1.5. 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.

1.6. We consider that this finds the right balance between protecting customers and having regard to the ability of an efficient supplier to finance its licensed activities in the current market conditions.

⁷⁵ 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

1.7. 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.

Proposal

1.8. 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.⁷⁶ 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). This proposal is unchanged from our May 2022 consultation.

Stakeholder responses

1.9. No stakeholders commented on this aspect of our May 2022 consultation.

Considerations

1.10. Our considerations remain unchanged from the November 2021 consultation.⁷⁷

1.11. 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.

Timing of recovery

Context

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

⁷⁶ We have provided details of our proposed changes to 'Annex 8 – methodology for adjustment allowance' in Appendix 4 of this consultation.

⁷⁷ 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>

- 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-ups⁷⁸ 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.

1.13. Our proposal in our May 2022 consultation was to spread the costs for the first true-up adjustment over one year, with the adjustment being spread over cap periods nine and ten.

1.14. The Domestic Gas and Electricity (Tariff Cap) Act 2018 is currently due to expire at the end of 2023,⁷⁹ however the Department for Business, Energy & Industrial Strategy (BEIS) has previously set out guidance that it is legislating to enable the cap to be extended beyond 2023 if specific conditions for an extension are met.⁸⁰

Proposal

1.15. We propose to recover the any true-up adjustment over the remainder of the cap (cap periods 10, 10b and 11a). Since the cap is currently due to expire at the end of 2023, this

⁷⁸ We discussed 'subsequent true-ups' before we decided in our August 2022 letter to delay the COVID-19 true-up decision until February 2023, which was due in August 2022.

By delaying the 'first true-up' decision until February 2023, it means that we are now considering additional COVID-19 debt-related costs in scope of cap periods four to seven.

Ofgem (2022), Notice to delay COVID-19 true-up decision and work on debt-related costs.

<https://www.ofgem.gov.uk/publications/price-cap-notice-delay-covid-19-true-decision-and-work-debt-related-costs>

⁷⁹ Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 8().

<http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted>

⁸⁰ BEIS (2022), Energy Security Bill factsheet: Default tariff (price cap)

<https://www.gov.uk/government/publications/energy-security-bill-factsheets/energy-security-bill-factsheet-default-tariff-price-cap>

means that the true-up adjustment will be spread over cap periods 10a and 10b (April 2023 – October 2023) and 11a (October 2023 – December 2023). This is a change in proposal from our May 2022 consultation.

1.16. If by our February 2023 decision, there is progress in the legislation that for the cap to be extended beyond 2023, then we would instead favour recovering any true-up allowance over 12 months rather than 9 months. This is because a 12-month period aligns with how the cap is calculated, on an annual basis, and would require less assumptions.

1.17. 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.

Stakeholder responses

1.18. No stakeholders commented on this aspect of our May 2022 consultation.

Considerations

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

1.20. 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 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.

1.21. We consider that our proposal to recover any additional costs over a 9-month period is more favourable than 6 months as it would smooth costs over a longer timeframe. However, as previously noted in our May 2022 consultation, recovering any additional costs over a 12-month period would in fact be more closely aligned to how the cap is calculated, on an annual basis and it would reduce the assumptions which would be needed in our Annex 8 model

calculates to scale the allowance to account for the recovery period being less than 12 months.⁸¹

1.22. Therefore, our preference would be to recover any additional allowance over a 12-month period, so long as the relevant cap legislation was in place to allow so. We will revisit this proposal at the time we make our decision and consider whether there have been any developments in the progress of legislation which could extend the cap beyond the end of 2023 and allow recovery of any true-up allowance over a 12-month period.

Allocating costs over the other cap levels

Context

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

- equally allocate across each cap component. This means we would use the same weighted average figure we calculate through our benchmarking exercise for each fuel and/or electricity meter type cap component allowance.
- allocate costs across cap components based on the estimated revenue per customer in the cap periods we are trueing-up.

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

1.25. In our February 2021 decision⁸² 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.

⁸¹ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, Appendix 1, paragraph 1.29. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

⁸² Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 3.110-3.114. <https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap>

1.26. 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 prejudice our approach for the true-up.

Proposal

1.27. 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.

1.28. 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 trueing-up).⁸³

Stakeholder responses

1.29. No stakeholders commented on this aspect of our May 2022 consultation.

General Considerations

1.30. 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.⁸⁴

Considerations: Recovery over fuel type

1.31. 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 trueing-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.

⁸³ 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 trueing-up.

⁸⁴ 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>

1.32. 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.

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

1.34. 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

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

1.36. 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.

1.37. 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.

1.38. 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.

1.39. 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

1.40. 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

1.41. 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.

1.42. 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

1.43. 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.

1.44. 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.

1.45. These proposals are unchanged from our May 2022 and November 2021 consultation.

Stakeholder responses

1.46. No stakeholders commented on this aspect of our May 2022 consultation.

Considerations

1.47. Our considerations remain unchanged from our November 2021 consultation.⁸⁵

1.48. 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.

⁸⁵ 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>

Accounting for changes in the number of default tariff customers

Context

1.49. 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.

Proposal

1.50. 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 true-up. This is to improve the accuracy of the true-up.

Stakeholder responses

1.51. One supplier who responded to our May 2022 consultation, said that they supported our proposal to account for changes in the number of default tariff customers.

Considerations

1.52. 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.⁸⁶

1.53. 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.⁸⁷ This means that we can only look at the aggregate (average) change in default tariff customer numbers.

⁸⁶ 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>

⁸⁷ Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2). <http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted>

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

1.55. 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.

1.56. 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

1.57. 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.

1.58. 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

1.59. 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.

1.60. 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.

1.61. 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.

1.62. These proposals are unchanged from our May 2022 consultation.

Stakeholder responses

1.63. No stakeholders commented on this aspect of our May 2022 consultation.

Considerations

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

1.64. 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.⁸⁸

1.65. 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.

1.66. 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).

1.67. 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

1.68. 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 TDCV⁸⁹ in the cap period, which we are truing-up. This position is unchanged from our November 2021 consultation.

⁸⁸ 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>

⁸⁹ 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.

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

1.69. 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.

1.70. 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.

1.71. 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.

1.72. 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.

1.73. 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 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. There has not been an update of data from when we last performed this calculated ahead of our May 2022 consultation.

1.74. 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 the May 2022 consultation methodology

Methodology

1.1. We have not made substantial changes to our May 2022 consultation methodology. Details of our methodology for calculating the additional COVID-19 costs can be viewed in Appendix 2 of our May 2022 consultation.⁹⁰

1.2. A summary of the changes we have made to our May 2022 consultation methodology are as follows:

- We have extended our model to include data for cap period seven (October 2021 – March 2022) from the June 2022 RFI. This means that our calculation is in scope of cap period four to seven, whereas in May, our calculation was only in scope of cap period four to six as the cap period seven data was not available.
- We have amended the cap level workings calculation, for more details on the specific changes, please see the section below.

1.3. We also provide a summary of the May 2022 consultation methodology at the end of this appendix.

Cap levels workings

1.4. 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.

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

⁹⁰ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, Appendix 2. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

Data input

1.6. The weighted average credit capped revenue per customer account assumption is calculated from the:

- default tariff cap level breakdowns for cap periods four to seven (not including VAT);⁹¹
- customer accounts from the domestic customer & tariff RFI;
- seasonal demand shares, split by fuel type.⁹²

1.7. Before we get to the calculation stage of this tab, we calculate the net TDCV value of the cap for cap periods four to seven. This is done by subtracting the nil consumption value of the cap from the TDCV. This results in a figure which is only the variable component of the cap.

1.8. We also calculate the average customer accounts for cap periods four to seven for each respective payment method, fuel type and meter type.

Calculations

1.9. To calculate the weighted average capped revenue per credit customer account, we first calculate the estimated unit rate revenue for each cap period. This is achieved by multiplying the direct debit and standard credit net TDCV cap level by their respective seasonal demand shares matched by payment, fuel and meter type for each COVID-19 cap period.

1.10. We the calculate the estimated standing charge revenue for each cap period. This is achieved by multiplying the direct debt and standard credit nil rate by 50%. This is because regardless of payment, fuel and meter type, half of the respective standing charge is applied in the winter cap period and half in the summer cap period. This step is an addition to our methodology from the May 2022 consultation following stakeholder feedback, and it has been

⁹¹ Ofgem (2022), Default tariff cap level: 1 April 2022 to 30 September 2022, tab 1b.

https://www.ofgem.gov.uk/sites/default/files/2022-02/Default_tarif_cap_level_v1.10.xlsx

⁹² Ofgem (2022), Annex 2 – Wholesale cost allowance methodology v1.13, tab 3b.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-level-1-october-2022-31-december-2022>

included to account for the standing charge being constant throughout the year and not varying by seasonal demand.⁹³

1.11. We then take the sum of expected direct debt and standard credit unit rate and standing charge revenues per customer account multiplied with their respective credit customer proportions, matched my meter and fuel types for the COVID-19 cap periods. This provides the weighted average credit capped revenue assumption.

May 2022 consultation methodology

1.12. We issued the COVID-19 true-up RFI in June 2022 to collect suppliers’ debt-related costs (bad debt charge and debt-related administrative costs) for cap periods four to seven. We requested cost information broken down by payment method (direct debit, standard credit, and prepayment). We also gathered information on suppliers’ revenues and customer accounts broken down by payment and tariff types (fixed and default tariff).

1.13. Table A2.1 below outlines the cap periods we have gathered debt-related costs data. It indicates the cap periods we consider to be impacted by COVID-19, “COVID-19 impacted cap periods”, and the relevant baseline periods to ensure that we could calculate the incremental change in costs.

Table A3.1: COVID-19 impacted cap periods and associated baseline periods

Cap period	Four	Five	Six	Seven
COVID-19 impacted cap periods	April 2020 – September 2020	October 2020 – March 2021	April 2021 – September 2021	October 2021 – March 2022
Associated baseline periods	April 2019 – September 2019	October 2018 – March 2019	April 2019 – September 2019	October 2018 – March 2019

⁹³ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, Appendix 2, Cap levels workings.

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

1.14. 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.

1.15. 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.

1.16. 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.

1.17. 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' above 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.

1.18. We follow the same process for our calculation of additional debt-related administrative costs.

Appendix 3 – Detailed explanation of the alternative methodologies

1.1. In this appendix we will explain the alternative methodology proposed by stakeholders to control for the payment method mix for default tariff customers and another method to control for payment method mix for credit customers (alternative method 2), to calculate the additional incremental COVID-19 costs in cap period four to seven using data from our June 2022 RFI. The output from the alternative methodologies can be inputted into Annex 8 – ‘methodology for adjustment allowance’ in the same way as Ofgem’s May request for information (RFI) analysis model.

1.2. We issued the COVID-19 true-up RFI in June 2022 to collect suppliers’ debt-related costs (bad debt charge and debt-related administrative costs) for cap periods four to seven. We requested cost information broken down by payment method (direct debit, standard credit, and prepayment). We also gathered information on suppliers’ revenues and customer accounts broken down by payment and tariff types (fixed and default tariff).

1.3. Table A3.1 below outlines the cap periods we have gathered debt-related costs data. It indicates the cap periods we consider to be impacted by COVID-19, “COVID-19 impacted cap periods”, and the relevant baseline periods to ensure that we could calculate the incremental change in costs.

Table A3.1: COVID-19 impacted cap periods and associated baseline periods

Cap period	Four	Five	Six	Seven
COVID-19 impacted cap periods	April 2020 – September 2020	October 2020 – March 2021	April 2021 – September 2021	October 2021 – March 2022
Associated baseline periods	April 2019 – September 2019	October 2018 – March 2019	April 2019 – September 2019	October 2018 – March 2019

Alternative method 1 – to control for payment method mix for default tariff customers

Default tariff customers split proxy

1.4. To estimate the percentage of default tariff customers on SC and DD:

- We aggregate the sample's total revenue from default tariff customers, for both SC and DD respectively, for each COVID-19 impacted cap period.
- We then calculate the percentage of SC and DD customers on default tariffs across all COVID-19 impacted cap period (cap periods four to seven), by dividing the SC and DD revenues associated with default tariffs by the total credit (SC+DD) revenue associated with default tariffs.

Bad debt charge

1.5. Firstly, to calculate the weighted average incremental bad debt cost (£) per customer account for default tariff customers, we will need to calculate the SC and DD incremental costs separately.

1.6. To calculate the incremental SC and DD bad debt cost (£) per customer account for our sample, we have followed the steps below for SC and DD separately:

- We aggregate bad debt charge for the given payment method, for each baseline and COVID-19 impacted cap period, which includes a proportion of PPM bad debt (see paragraph 3.30).
- We aggregate the associated revenue across included suppliers (matched by payment method), for each baseline and COVID-19 impacted cap period.
- We calculate a bad debt charge (£) per unit revenue by dividing each cap period's bad debt charge by revenue, for each baseline and COVID-19 impacted cap period.
- To calculate the additional cost of COVID-19, we calculate the incremental change in bad debt charge (£) per unit revenue by subtracting the appropriate baseline from each COVID-19 impacted cap periods (see table 3.1).

- Then for each COVID-19 impacted cap period, we multiply the incremental bad debt charge (£) per unit revenue by a capped revenue per customer account assumption (matched by cap period and payment method, see Appendix 2 for more details on cap levels). This results in a bad debt charge (£) per customer account for each COVID-19 impacted cap period.
- We aggregate the incremental bad debt charge (£) per customer account across all COVID-19 cap periods to calculate the total incremental bad debt charge (£) per customer account for the given payment method.

1.7. We multiply and sum the product of the total SC and DD incremental bad debt charge (£) per customer account multiplied with its respective payment method default tariff split (as calculated in default tariff customer split proxy).

1.8. The step above results in the weighted average total incremental bad debt charge (£) per customer account. This value can be inputted into "Annex 8 – Adjustment Allowance Methodology", to calculate the impact on the retail price cap. (See Appendix 4 for more details on Annex 8).

Alternative method 2 – to control for the payment method for credit customers

Credit tariff customers split proxy

1.9. To estimate the percentage of credit (SC+DD) customers on SC and DD:

- We aggregate the sample's total revenue from credit (SC+DD) customers, for both SC and DD respectively, for each COVID-19 impacted cap period.
- We then calculate the percentage of SC and DD customers on credit (SC+DD) across all COVID-19 impacted cap period (cap periods four to seven), by dividing the total SC and DD revenues by the total credit (SC+DD) revenue.

Bad debt charge

1.10. We follow steps outlined in paragraphs 1.6 and 1.7 from alternative method 1 in this appendix. This will provide a £ per DD customer and £ per SC customer, across our COVID-19 impacted cap periods.

1.11. We multiply and sum the product of the total SC and DD incremental bad debt charge (£) per customer account multiplied with its respective payment method credit split (as

calculated in *credit customer split proxy*). This provides the final additional incremental cost (£) per customer account.

Illustrative example

1.12. Equations A3.1 and A3.2 display a simplified version of how we have calculated the weighted average bad debt cost for both alternative method 1 and 2. For example, alternative method 1 in Equation 3.1 is attempting to control for payment method mix for default tariff customers. We therefore multiply bad debt with respect to payment method by the percentage breakdown of revenue on that particular payment method.

1.13. Similarly, alternative method 2 in Equation A3.2 is attempting to control for payment method mix for credit customers. We therefore multiply bad debt with respect to payment method by the percentage breakdown of revenue on that particular payment method.

Table A3.2: Inputs used to calculate the weighted average bad debt cost

Payment method	Bad Debt	% Revenue Split	
		% revenue split for default tariff customers	% revenue split for credit customers
		Alternative method 1	Alternative method 2
Standard Credit	BD_{SC}	RS_{SC}^{A1}	RS_{SC}^{A2}
Direct Debit	BD_{DD}	RS_{DD}^{A1}	RS_{DD}^{A2}

Equation A3.1: Weighted average bad debt cost: alternative method 1

$$BD^{A1} = (BD_{SC} \times RS_{SC}^{A1}) + (BD_{DD} \times RS_{DD}^{A1})$$

Equation A3.2: Weighted average bad debt cost: alternative method 2

$$BD^{A2} = (BD_{SC} \times RS_{SC}^{A2}) + (BD_{DD} \times RS_{DD}^{A2})$$

1.14. Key for the equations A3.1 and A3.2:

- BD = Bad debt, this is the total bad debt for all suppliers in our sample.

- SC = Standard credit.
- DD = Direct debt.
- RS = revenue split⁹⁴
- A1 and A2 are both the terms for alternative method 1 and 2.

⁹⁴ NB, $RS_{SC} + RS_{DD} = 1$

Appendix 4 – Annex 8: detailed model modifications

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).

1.2. In the published revised Annex 8 model, updated cells compared to our May 2022 consultation⁹⁵ are highlighted in yellow.

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. Please note we have modified several formulas and have added new inputs to correctly control for changes in customer accounts between when the float was recovered and when the costs originated. We achieve this by adjusting the £ per customer account increment inputs for the float to reflect that the proportions of customers were different. For example, if customer accounts were greater in the period where the float was recovered, compared to the period of cost origin, we would adjust the increment upward to account for the over recovery. These adjusted float inputs are used to net off the cost increments for cap period four to seven calculated from our RFI analysis model. This provides the amount of COVID-19 costs still needed to be recovered by suppliers, controlled for float recovery.

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 AB13:AC264: We have updated the cells such that it draws the adjustment allowance values for each fuel, charge restriction region, benchmark metering arrangement,

⁹⁵ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, Appendix 3. <https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs>

payment method and 28AD charge restriction period from cells F445:G456 in tab '2e COVID-19 true-up'.

Tab '2e 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 1a: added to input the true-up increment from our analysis of supplier data in the true-up model.^{96, 97}

1.9. Cells F38:F41 in section 1b: New table which draws the relative proportion of customers in cap periods 4, 5, 6, and 7 compared to the cap period the float was recovered in (cap periods 6 and 7), from tab '3j CPIH & attrition'. This is used to account for the under/ over recoveries caused by the change in customers between when the cost of was calculated and when the float was recovered.

1.10. Cells F45:F68 in section 1b: We have updated the formula in these cells such that the costs that were recovered under the float are multiplied by their relative customer account proportions (matched by the cap period of cost origin) from cells F38:F41.

1.11. Cells F74:F77 in section 2: We have Updated the cell references for the table so they draw the proportion of customers in cap periods 4, 5, 6 and 7 compared to cap period 4, from tab '3j CPIH & attrition'. These values are used to convert all cost increments net of the float into cap period 4 prices and customer accounts, so that we can convert them into cap period 10a and 10b prices and customers later.

⁹⁶ Our analysis of supplier data is from a separate model, we explained our methodology of this separate model in Appendix 2.

⁹⁷ 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), Disclosure arrangements for Autumn 2022 COVID-19 true-up consultation. <https://www.ofgem.gov.uk/publications/price-cap-disclosure-arrangements-autumn-2022-covid-19-true-consultation>

1.12. Cells F83:G106 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 F74:F77 to convert into cap period four prices and customer numbers.

1.13. Cell F113 in section 3: 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.

1.14. Cells F119:G142 in section 3: multiplies the net allowances at cap period four prices and customer numbers with the multiplier in cell F113 to convert into cap period current prices and customer numbers.

1.15. Cells F148:F151 in section 4: 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.

1.16. Cells C158:D159 and C162:D163 in section 5: inputs the cap period eight and nine cap level, Nil and TDCV consumption from tab '3f Cap Levels'.

1.17. Cell C174 in section 5: calculates the average Nil level of the cap as a proportion of TDCV798 for cap period eight and nine.

1.18. Cells F180:G203 and F206:G229 in section 5: calculates the Nil and TDCV consumption for the COVID-19 true-up allowance.

1.19. Cells F262:G285 in section 6: 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.

1.20. Cells C291:C292 in section 7: new table to calculate the factor to account for the reduction in time to recover costs over, since cap period 11a is only 3 months long. Cells C291:C292 are an input for the length of cap periods. Cell C294 calculates the factor to account for reduction in time to recover costs over.

⁹⁸ 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.

1.21. Cells C301:D304 and C307:D308 in section 7: new tables have been added to display the quarterly and seasonal electricity demand.

1.22. Cells C312:D315 and C319:D320 in section 7: new tables have been added to display the quarterly and seasonal gas demand.

1.23. Cells C324:C325 in section 7: new table added to calculate how we weight by fuel type, to scale up costs included in cap period 10a, 10b and 11a to account for a reduced recovery period, of nine months.

1.24. Cells F333:G256 and F360:G383 calculates the weighted Nil and TDCV value levels of the adjustment for a given cap period of cost. This table re-scales the values up to account for cap period 11a not being 6 months long.⁹⁹

1.25. Cells F445:G456 in section 10: 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'

1.26. Cells C306:C310 - we have updated the Consumer price index including owner occupiers' housing costs (CPIH) inputs using the August 2022 CPIH time series dataset release from the Office for National Statistics (ONS).

1.27. Cell U16: hard coded cell to use the latest available CPIH value for December 2022 (currently August 2022). We will update this cell, to lookup the December 2022 CPIH value using the same formula in cells C16:U16 when it is available before our decision.

Tab '3f Cap levels'

1.28. Cells C13:D13 – New row input for electricity DD cap period 9 TDCV100 and Nil rate of consumption cost from the default tariff cap.

⁹⁹ We have explained our reasoning for this in the 'Timing of recovery' section in Appendix 1 of this consultation.

¹⁰⁰ 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.

1.29. Cells C22:D22 - New row input for Gas DD cap period 9 TDCV and Nil rate of consumption cost from the default tariff cap.

1.30. These 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 '3j CPIH & Attrition'

1.31. 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.

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

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

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

1.35. Cells B23:B26: We have added a new table which contains the proportions of customers in cap periods 4, 5, 6, and 7 relative to cap period 4.

1.36. Cells B38:B41: We have changed the formula to calculate the multiplier needed to account for the differences in customers between when costs were incurred and when they were recovered under the float. (e.g if customer accounts grew between the period of cost origin and the period of recovery, we would have over recovery as the cost was apportioned over fewer customers than recovered over).

1.37. Cells B46:B49: updated the formula such that it calculates multipliers which converts cap period 4, 5, 6, and 7, cost increments into cap period 4 customer accounts and prices. The formula multiplies cells B14:H14 (CPIH inflation for cap periods 4 – 7 relative to cap period 4) and cells B23:B26 (customer account proportions for cap period 4 – 7 relative to cap period 4).

1.38. Cell B56: 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.

1.39. Cell B58: calculates the implied factor to adjust cap period four customer numbers to cap period nine/ ten.

1.40. Cell B60: calculates the factor to adjust cap period four prices and customer numbers to cap period nine/ ten by multiplying cell B58 and B13. This converts cap four prices and customer numbers into cap period nine/ ten prices and customers.

Appendix 5 – Inclusion and exclusion criteria in our sample

Inclusion and exclusion

1.1. In our May 2022 consultation, we had proposed to check data consistency and remove any supplier’s 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.¹⁰¹

1.2. We had issued both our December 2021 and June 2022 RFI to suppliers 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 had then broken down our filters for inclusion and the individual reasons why suppliers have been excluded for certain debt-related costs below.

Table A5.1: Percentage of domestic credit energy market represented in the included sample for each debt-related costs.¹⁰²

Cap period	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

¹⁰¹ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, Appendix 4, Inclusion and exclusion.

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

¹⁰² We have used the credit customer accounts from Ofgem’s analysis on the October 2021 Domestic customer accounts and Tariff RFI to calculate these proportions.

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.

- 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.

1.8. This is the same approach that we had taken in our May 2022 consultation.¹⁰³

Bad Debt Charge

1.9. One supplier in response to our May 2022 consultation said that itself should be removed from the sample due to one-off benefits within the baseline period. It was concerned

¹⁰³ Ofgem (2022), Consultation on the true-up process for COVID-19 costs, Appendix 4, Exclusion criteria.

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

that the one-off benefits recognised in the winter baseline period from October 2019 to April 2019 may suppress our calculation of the suppliers baseline bad debt figure which would increase the potential allowance.

1.10. We enquired with the supplier and received information about the one off benefit to adjust their winter baseline figure. The supplier informed us that if these adjustments were adopted, our overall baseline would change for the period October 2018 to March 2019. We incorporated this into their baseline figure, which means that we can continue to include them in our sample as their baseline has been normalised.

Appendix 6 – Privacy notice on consultations

Personal data

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

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

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

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem").

The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

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

3. Our legal basis for processing your personal data

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

4. With whom we will be sharing your personal data

We may share your 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 6 months after the project, including subsequent projects or legal proceedings regarding a decision based on this consultation, is closed.

6. Your rights

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

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

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

7. Your personal data will not be sent overseas

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

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

10. More information

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