Decision

Making a positive difference for energy consumers

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

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In 2022, we consulted on our approach to determine the additional debt-related costs resulting from COVID-19, and whether we should include an additional one-off adjustment allowance in the default tariff cap to true up our initial February 2021 estimate of these costs.

This document sets out our decision to include an adjustment allowance from cap period 10a (April 2023 – June 2023) to true up the additional debt-related costs from the COVID-19 pandemic for credit customers. This one-off COVID-19 true-up allowance will be included in the default tariff cap for 12 months.

We have carefully considered all responses to our consultation. We have published non-confidential responses alongside this decision.

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Contents

Executive Summary

On 19 July 2018, the Domestic Gas and Electricity (Tariff Cap) Act 2018[1] (the 'Act') came into force. This legislation required the Gas and Electricity Markets Authority (GEMA) to design and implement the default tariff cap. We 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 cost to supply that energy.

The Energy Price Guarantee (EPG) is a scheme where the government will pay energy suppliers the difference between what can be charged to consumers through their bills, with the unit price of electricity and gas capped by the EPG, and what would otherwise be payable under the cap. This means that the costs in this decision will be covered by the government if the cap level remains higher than the EPG. If the cap level falls below the EPG level at any time before March 2024, then some of these costs would be borne by customers.

In our February 2021 float decision[2] we concluded that the COVID-19 pandemic had created additional debt-related costs associated with supplying credit meter default tariff customers. We concluded that these costs were material in cap periods four to six (April 2020 to September 2021), and that suppliers were unable to recover these additional costs through the existing cap methodology. We therefore included an additional allowance in the cap for cap period six and seven (April 2021 – March 2022). We set this as an initial float, and we said that it would be "trued up" later using final costs.

The cash value of the COVID-19 float adjustment allowance was £13.78 per typical dual fuel credit customer, and was recovered over cap periods six and seven.[3]

COVID-19 true-up adjustment

The data we gathered on debt-related costs for cap periods four to seven (April 2020 – March 2022) to assess the impact of COVID-19 suggests that there were material increases in incremental costs above what we had already allowed suppliers to recover in

[1] Domestic Gas and Electricity (Tariff Cap) Act 2018.
https://www.legislation.gov.uk/ukpga/2018/21/enacted
[2] 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
[3] The float was applied to the cap non-uniformly and therefore had to be uplifted by time and demand weights. This means that the cap went up in annualised terms by £23.69 and £8.86 per typical dual fuel credit customer in cap periods six and seven.

the initial float. We have therefore decided to set an allowance to true up the initial float provided for the additional debt-related costs due to COVID-19.

We have decided to include all three debt-related costs (bad debt charge, debt-related administrative and working capital costs) in the allowance. We consider the difference between the final incremental costs due to COVID-19 and the float to be material and systematic and we consider this adjustment appropriate in the circumstances of COVID-19 where there was a sudden and unexpected impact on some customers' incomes.

There is evidence that the increase in bad debt costs during the COVID-19 pandemic (April 2020 – March 2022) was likely to be significantly greater for standard credit customers. However, we have decided to equally split the true-up allowance across credit customers on default tariffs which will avoid significantly increasing standard credit customers' bills who are more likely to be vulnerable than direct debit customers. We recognise that this will have a material impact on direct debit customers, however we consider this approach is most appropriate given the nature of the COVID-19 pandemic. We have also decided to allocate none of the individual additional debt-related costs to PPM customers, as we consider that it was much harder for a PPM customer to build up similar levels of debt to that of a credit customer over this period.

This adjustment will be £12.02 per typical dual fuel credit customer, and it will be recovered over 12 months from cap period 10a to 11b (April 2023 – March 2024).

Table 1: COVID-19 true-up allowance breakdown by payment method

	Initial float	**True-up**	**Final increment***
Standard credit	£13.78	£12.02	£30.01
Direct debit	£13.78	£12.02	£30.01
Prepayment meter	£0.00	£0.00	£0.00

Note: All numbers are £ per typical dual fuel customer.

**: The final increment is not equal to the sum of the initial float and true-up because of the time elapsed between when the costs were initially incurred and when they will be recovered. This means that we adjusted the true-up allowance for changes in default tariff customers and inflation.*

We have concluded that it is in customers' interest to allow suppliers to recover the additional debt-related costs related to COVID-19 from April 2023. We consider that these costs were efficiently incurred due to the unforeseen and unprecedented impact of COVID-19 on some customers' incomes.

We have applied a downward adjustment to account for methodology inaccuracies and included the reduction in debt-related administrative costs in the overall allowance both of which reduce the overall allowance in the customers' interest.

Our decision will help ensure that suppliers have the finances to continue to supply energy to their customers and fulfil their licence obligations. As part of reaching this decision, we have carried out an impact assessment, and have had due regard to the Public Sector Equality Duty which is outlined in Chapter 8.

1. Introduction

Section summary

This chapter provides the background for this decision, highlights our key decisions and the structure of the document.

Background

1.1 The default tariff cap ('the cap') protects approximately 27 million[4] 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 that reflects the underlying costs to supply that energy.[5] We set the cap by considering the different costs notional suppliers face. The cap is made up of a number of allowances which reflect these different costs.

1.2 The Energy Price Guarantee (EPG) is a government scheme where suppliers are paid the difference between what can be charged to consumers through their bills and the cost of supply. If the cap level falls below the EPG level (currently set at £3,000 per customer from April 2023) at any time before March 2024, then some of the costs resulting from this decision would be borne by customers.

1.3 We set an initial float to adjust the cap for potential impacts of COVID-19 on additional bad debt costs due to the sudden and unexpected impact on some customers' incomes. This float was for costs incurred in cap periods four to six (April 2020 to September 2021). This initial adjustment allowance had a cash value of £13.78 per typical dual fuel credit customer which was recovered over cap periods six and seven.[6]

1.4 The adjustment we made in our February 2021 float 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 were fully known (ie a 'true up').

1.5 We consider it is prudent that a float and true-up is not our preferred approach for price cap allowances, and we only consider them in exceptional or unforeseen

[4] This number is up to date as of December 2022.
[5] The cap is one of the key activities which fall within the outcome "deliver fair prices for consumers" within our draft Forward Work Programme for 2023-24.
Ofgem (2022), Consultation on Ofgem's draft Forward Work Programme for 2023/24. https://www.ofgem.gov.uk/publications/consultation-ofgems-draft-forward-work-programme-202324
[6] 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

circumstances. However, we followed this approach at the time of our initial review,[7] as there was uncertainty about what the additional debt-related costs of COVID-19 would ultimately be, given we could not anticipate the severity of the COVID-19 pandemic nor how long it would last for. We, therefore, decided to err on the side of caution to avoid customers and suppliers unduly bearing the risk. We favoured using the float and true up approach in this instance.

Overview of this decision

Overall allowance adjustment

1.6 We have decided to make an adjustment in cap period 10a (April 2023 – June 2023) to true up the initial float provided for additional COVID-19 costs. The COVID-19 true-up allowance is worth £12.02 per typical dual fuel credit customer, and will be recovered over a 12 month period.

1.7 The data we gathered on debt-related costs in cap periods four to seven suggests that there was a material increase in debt-related costs from what we had already allowed suppliers to recover in the COVID-19 float.

Table 1.1: COVID-19 true-up allowance breakdown by debt-related cost

	Final Increment	**Initial Float**	**Adjustment allowance[8]**
Bad debt charge	£24.40	£13.78	£7.91
Working capital costs	£7.37	£0.00	£5.49
Debt-related administrative costs	-£1.76	£0.00	-£1.38
Total	**£30.01**	**£13.78**	**£12.02**

Note: all numbers are £ per typical dual fuel credit customer. This is at benchmark TDCV split evenly between gas and electricity. £0.82 of the COVID-19 true-up adjustment allowance is at Nil consumption.

[7] Ofgem (2022), Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation, paragraphs 5.30 – 5.33. https://www.ofgem.gov.uk/publications/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation

[8] To calculate the adjustment allowance, we subtracted the initial float from the final incremental cost. Then we adjust for the changes in the aggregate number of default tariff credit customers/ inflation between the cap periods when the costs were incurred, the cap periods in which the initial float was recovered, and the expectations for cap periods in which the final costs are trued up. We discuss our method for these minor decisions in Appendix 1.

1.8 We are making this adjustment using 'Annex 8 – methodology for adjustment allowance' of standard licence condition (SLC) 28AD of the electricity and gas supply licences. We have published the changes we are making to this annex alongside this decision.[9] In Appendix 4, we summarise the model modifications to Annex 8.

Methodology

1.9 We have decided to use a method that accounts for the payment method mix for default tariff customers when calculating the additional bad debt costs due to COVID-19. This is because the increase in bad debt costs during COVID-19, cap periods four to seven (April 2020-March 2022), was significantly greater for standard credit customers, and there is a greater proportion of standard credit customers on default tariffs relative to other tariffs.

1.10 This method includes a downwards adjustment to the increment of 6%, to account for potential inaccuracies in the method's allocation of debt between payment methods.

Bad debt charge

1.11 We have decided to include an allowance in the cap to true up the additional bad debt costs incurred during COVID-19 for credit customers only. The bad debt cost element of the allowance is worth £7.91 per typical dual fuel credit customer.

Working capital costs

1.12 We have decided to make an adjustment in the cap to true up the additional working capital costs incurred during COVID-19 for credit customers. This was calculated using a 10% cost of capital assumption, consistent with the cost of capital used in other parts of the cap during the period when these costs were incurred eg the EBIT allowance at the time the additional costs were incurred.

1.13 The working capital element of the allowance is worth £5.49 per typical dual fuel credit customer.

Debt-related administrative costs

1.14 We have decided to make an adjustment in the cap to true up the incremental debt-related administrative costs incurred during COVID-19 for credit customers.

[9] Please see the web page for this decision on our website for the Annex 8 model.

The debt-related administrative cost element of the allowance is worth -£1.38 per typical dual fuel credit customer, a cost saving for customers.

Structure of this decision

1.15 This decision document has the following structure:

- Chapter 1 introduces our decisions and the structure of this document.
- Chapter 2 outlines our decision-making process.
- Chapter 3 outlines our decision on the timespan of the COVID-19 true-up.
- Chapter 4 discusses our chosen methodology for calculating the additional bad debt costs due to COVID-19, and our decision on the subsequent bad debt allowance.
- Chapter 5 outlines our decision on the working capital and debt-related administrative cost allowances.
- Chapter 6 outlines our decisions on allocating debt-related costs across the different payment method caps.
- Chapter 7 discusses our decision on the recovery period length for the COVID-19 true-up allowance.
- Chapter 8 explains our analysis of the impacts of introducing a COVID-19 true-up adjustment.
- Chapter 9 summarises our approach to the other decisions which are discussed in more detail in Appendix 1.

2. Decision-making process

Section summary

This chapter summarises our decision-making process and related publications.

Our decision-making process

February 2021 float decision

2.1 We published a decision in February 2021 ('February 2021 float decision') that set out our decision to adjust the default tariff cap to account for the estimated additional bad-debt costs incurred as a result of COVID-19 in cap periods four to six (April 2020 - September 2021).[10] This adjustment was applied to credit customers only, and took place in cap periods six and seven (April 2021 - March 2022).

March 2021 call for input

2.2 We published a call for input in March 2021 ('March 2021 call for input') on the true up process for COVID-19 costs.[11] This was to give stakeholders an opportunity to inform our planning and future work.

June 2021 working paper

2.3 We published a working paper in June 2021 ('June 2021 working paper'), setting out our thinking on the options for the data source for bad debt costs that we could use to calculate the true-up.[12]

August 2021 float decision

2.4 We published a decision in August 2021 ('August 2021 float decision') that set out our decision to not introduce a further float to account for the potential impacts of COVID-19 in cap period seven.[13]

[10] 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
[11] 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
[12] 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
[13] 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

November 2021 consultation

2.5 We published a consultation in November 2021 ('November 2021 consultation') setting out our initial proposals for the true up of additional debt-related costs.[14] This provided stakeholders with an opportunity to comment on a more detailed proposal for the true-up.

May 2022 consultation

2.6 We published a statutory consultation in May 2022 ('May 2022 consultation'), that set out proposals for truing up the additional debt-related costs due to COVID-19.[15] This provided stakeholders with an opportunity to comment on the proposed process for the true-up.

August 2022 letter

2.7 We published a letter in August 2022 ('August 2022 letter') stating that we had decided to delay[16] the COVID-19 true-up decision until February 2023, and that we would be issuing a further consultation in autumn 2022.[17]

September 2022 supplementary consultation

2.8 We published a supplementary consultation in September 2022 ('September 2022 consultation'), after we received feedback from stakeholders to our May 2022 consultation proposing an alternative methodology to calculate the COVID-19 true-up allowance.[18]

Ongoing engagement with stakeholders

2.9 We hosted four rounds of calls with suppliers and stakeholders. The first three rounds of calls were in 2021 to discuss the data source options and benchmarking, which we raised within the March 2021 call for input and the June

[14] 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
[15] Ofgem (2022), Consultation on the true-up process for COVID-19 costs. https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs
[16] In our May 2022 consultation, we said that intended to initially publish our decision in early August 2022.
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
[17] 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
[18] Ofgem (2022), Supplementary consultation on the true-up process for COVID-19 costs. https://www.ofgem.gov.uk/publications/price-cap-supplementary-consultation-true-process-covid-19-costs

2021 working paper. The fourth round of calls was held in April 2022, and was to discuss debt on prepayment meters (PPM).

Disclosure process

2.10 We carried out two separate disclosure processes alongside each of the May and September 2022 consultations.[19, 20] This enabled stakeholders' advisers to inspect the disclosed COVID-19 true-up model and data, which was subject to confidentiality restrictions.

Related publications

2.11 The main documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018: https://www.legislation.gov.uk/ukpga/2018/21
- Default tariff cap 2018 decision: https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview
- Energy Prices Act 2022: https://www.legislation.gov.uk/ukpga/2022/44/enacted

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

- September 2022 supplementary consultation on the true-up process for COVID-19 costs ('September 2022 consultation'): https://www.ofgem.gov.uk/publications/price-cap-supplementary-consultation-true-process-covid-19-costs
- 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

[19] Ofgem (2022), Price Cap - Disclosure arrangements for Spring 2022 consultations. https://www.ofgem.gov.uk/publications/price-cap-disclosure-arrangements-spring-2022-consultations
[20] 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

- 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
- August 2021 decision on the potential impact of COVID-19 on the default tariff cap: cap period seven ('August 2021 float decision'): https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-covid-19-default-tariff-cap-cap-period-seven
- June 2021 working paper on the true-up process for COVID-19 costs ('June 2021 working paper'): https://www.ofgem.gov.uk/publications/price-cap-working-paper-true-process-covid-19-costs
- March 2021 call for input on the true-up process for COVID-19 costs ('March 2021 call for input'): https://www.ofgem.gov.uk/publications/price-cap-call-input-true-process-covid-19-costs
- February 2021 decision on the potential impact of COVID-19 on the default tariff cap ('February 2021 float decision'): https://www.ofgem.gov.uk/publications/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation

The default tariff cap

2.13 We set the cap with reference to the Act (Tariff Cap).[21] The Act requires us to put in place and maintain the licence conditions which give effect to the cap. The objective of the Act is to protect existing and future default tariff customers. We consider protecting customers to mean that prices reflect underlying efficient costs of a notional supplier.

2.14 Under the Act, we must have regard to five matters when setting the cap:

- 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;

[21] Domestic Gas and Electricity (Tariff Cap) Act 2018. https://www.legislation.gov.uk/ukpga/2018/21

- the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence;
- the need to set the cap at a level that takes account of the impact of the cap on public spending.[22]

2.15 The requirement to have regard to the five 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.

2.16 Following the passing of the Energy Prices Act 2022, those specified considerations to be taken into account include 'the need to set the cap at a level that takes account of the impact of the cap on public spending'.[23] This consideration reflects the fact that while the government's EPG is in place and is lower than the price cap level, the cap level directly affects the levels of payments by government to energy suppliers.

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

General feedback

We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this decision. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Are its conclusions balanced?
5. Did it make reasoned recommendations?

[22] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6)(e) as inserted by Schedule 3 to the Energy Prices Act 2022. In performing the duty under section 1(6)(e) we must have regard to any information provided by the Secretary of State, or any guidance given by the Secretary of State on this matter (section 1(6A)).
[23] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6)(d) as inserted by Schedule 3 to the Energy Prices Act (2022).
https://www.legislation.gov.uk/ukpga/2022/44

6. Any further comments

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

3. Timespan of the COVID-19 true-up

Section summary

In this chapter, we explain our decisions on defining the timespan of the COVID-19 true-up, and which cap periods are in scope for each specific debt-related costs.

Context

3.1 In our May 2022 consultation, we proposed to collect data for cap periods four to seven (April 2020 to March 2022) for the bad debt charge and debt-related administrative costs. We said that cap periods four to six would be the main cap periods, and cap period seven would be the additional cap period considered to capture any later materialisation of costs.[24]

3.2 For working capital costs, we proposed to collect data for cap periods four to six only.

Decision

3.3 We have maintained our consultation position and decided that the cap periods in scope of our COVID-19 true-up review for the bad debt charge and debt-related administrative costs are cap periods four to seven (April 2020 to March 2022).

3.4 We have decided that the cap periods in scope of our COVID-19 true-up review for the working capital costs are cap periods four to six.

3.5 These are unchanged from our proposals in the May 2022 consultation.

Stakeholder response

3.6 One supplier who responded to our May 2022 consultation said that bad debt contains a high amount of variability, which made it uncertain when the COVID-19 bad debt would fully enter the profit and loss statement.

3.7 Another supplier said in response to our May 2022 consultation that we should consider making an allowance for debt-related administrative costs incurred in cap period eight as well, given the likelihood of a deferral of costs.

3.8 In response to our September 2022 consultation, one supplier said that omitting the working capital question from our June 2022 RFI was prejudging the review

[24] Ofgem (2022), Consultation on the true-up process for COVID-19 costs, paragraph 3.64 – 3.65. https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs

outcome. This same supplier said that it did not necessarily agree with not gathering working capital data beyond cap period six, however, it did state that it had no evidence to the contrary. We address this response in paragraphs 3.14-3.16.

Considerations

General considerations

3.9 It may take some time for the debt impacts of COVID-19 to be made clear. We also consider that customer price rises since April 2022 and any resulting impact that may have on changing the propensity for customers to incur debt, should not be in scope of our review.

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

3.11 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 intend to issue a consultation on debt-related costs incurred during the gas price crisis if we find evidence which suggests there was a material and systematic change in debt-related costs in the round of other evidence. We continue to monitor debt-related costs on an ongoing basis.

Bad debt

3.12 We recognise that due to their nature, bad debt costs may involve some lags and therefore our selection of time period should account for some of these residual impacts. However, we also consider that the impact of non-COVID-19 factors on customer debt, such as recent energy price rises, is not in scope of our review.

3.13 We therefore consider that we should gather data up to cap period seven for the bad debt charge, such that it could be used to capture any residual impact of COVID-19, while not risking non-COVID-19 effects, such as recent high gas and electricity prices, significantly distorting the calculation.

Working capital cost

3.14 The working capital costs associated with delayed payments which are repaid will materialise in the accounting cap period they are incurred. Therefore, unlike the

other debt-related costs, we consider that working capital costs do not have a lag in fully materialising.

3.15 We therefore consider that there will be minimal residual impact that flows through to cap periods beyond cap period six, as the debt will likely have been repaid or become bad debt. We have also not seen any evidence to suggest otherwise.

3.16 This means that for working capital costs, it is more appropriate to only consider the main periods we consider to be impacted by COVID-19, which are cap period four to six.

Debt-related administrative costs

3.17 We also recognise that COVID-19 may have some residual impacts on debt-related administrative costs, as by nature these costs can be incurred over a time beyond a particular period of billed consumption.

3.18 However, in each of the cap periods four to seven (April 2020-March 2022), data from our sample of suppliers show there was a reduction in debt-related administrative costs against the baseline, and we have not seen evidence to suggest that there has been a deferral of costs since the pandemic began in 2020.

3.19 Therefore, we consider that we should only gather debt-related administrative cost data up until cap periods seven, consistent with bad debt. We do not consider that the benefits presented for collecting additional data beyond cap period seven outweigh the risks of capturing non-COVID-19 effects.

4. Bad debt costs

Chapter summary

In this chapter, we explain our decisions on how to calculate the additional bad debt charge due to COVID-19, and the subsequent bad debt charge allowance.

Methodology

Context

November 2021 consultation

4.1 In our November 2021 consultation and subsequent December 2021 RFI, we requested debt-related cost data from suppliers broken down by payment method and tariff type.[25, 26]

4.2 However, the breakdowns provided were not sufficiently accurate or comparable across suppliers. We therefore did not have meaningful data on the differences in bad debt by tariff type.

May 2022 and September 2022 consultations

4.3 In our May 2022 consultation, we proposed to not use suppliers' breakdown of bad debt cost data by tariff type or payment method, and instead to allocate all additional bad debt costs equally across credit customers (standard credit and direct debit) only. This would have meant equal allocation between default and fixed tariff customers.

4.4 In response, four stakeholders said that they were concerned with our proposed methodology. They believed that the approach outlined in the May 2022 consultation did not account for the higher proportion of customers paying by standard credit on default tariffs than other tariff types.

4.5 Three of these 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.

[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
[26] We explain the two RFIs which were used to collect debt-related cost data in Appendix 2.

4.6 In our September 2022 consultation, we therefore consulted on three methodology options for calculating the additional bad debt due to COVID-19:[27]

- May 2022 consultation methodology: top-down approach which spreads costs over all domestic credit customers.
- Alternative method 1: proxy method accounting for the payment method mix for default tariff customers. This method uses the proportional split of revenue between default tariff customers on a standard credit and direct debit payment method.
- Alternative method 2: proxy method accounting for the payment method mix for all domestic credit customers. This method uses the proportional split of revenue between credit customers on a standard credit and direct debit payment method.

Decision

4.7 We have decided to use the alternative method 1 to calculate the additional bad debt charge due to COVID-19. This proxy method seeks to account for the payment method mix for default tariff customers by using the proportional split of revenue received via standard credit and direct debit payment methods.

4.8 We have also included a downwards adjustment to the increment of 6% to account for any inaccuracies in the allocation of debt.

Stakeholder responses

4.9 In response to our September 2022 consultation, three suppliers and an economic adviser[28] supported alternative method 1. They considered that we should account for the payment method mix of default tariff customers, stating that a calculation which did not properly account for the different payment methods would be inaccurate.

4.10 An economic adviser said that failure to remunerate suppliers for payment method differences in bad debt costs would materially impact suppliers' ability to recover their efficiently incurred costs.

4.11 No suppliers directly supported the May 2022 consultation methodology. However, one supplier said that at a minimum the true-up should not increase

[27] We explain the methodology options in Appendix 2 and 3.
[28] This economic adviser was acting on behalf of two suppliers.

costs for customers (ie implicitly suggesting we adopt the May 2022 consultation methodology as we previously proposed no allowance with this method).

4.12 One supplier and an economic adviser on behalf of two suppliers in response to our September 2022 consultation said that they did not see any merit in the alternative method 2 compared to the alternative method 1.

4.13 We go further into specific supplier responses in the considerations section of this chapter.

Considerations

Data source

4.14 In principle, having data split by tariff type would allow us to focus on the costs of default tariff customers only.

4.15 We attempted to gather this data in our December 2021 RFI,[29] but the volume and quality were limited, and we did not receive comparable breakdowns across suppliers. We therefore could not look at tariff type costs directly.

Methodology choice

4.16 There were several methodologies considered when calculating the additional bad debt charge, and these are detailed fully in Appendices 2 and 3.

4.17 As an overview:

- The May 2022 consultation uses a cumulative bad debt approach to calculate the additional bad debt costs due to COVID-19. The calculation considers the difference of the bad debt charge per unit of credit revenue between the COVID-19 periods and their respective seasonally matched baseline period. This method estimates that the additional bad debt charge for cap periods four to seven was £3.09 per typical dual fuel credit customer higher than our initial float estimate.
- Alternative method 1, which follows the same steps as the May 2022 consultation methodology except we separate out the calculation by payment method (direct debit and standard credit) and use a proxy for the payment method mix for default tariff customers. This method estimates that the additional bad debt charge for cap periods four to

[29] In Appendix 2, we outline our data requests.

seven was £10.62 per dual fuel credit customer higher than our initial float estimate.

- Alternative method 2, which follows the same steps as the alternative method 1 methodology, except we account for the payment method mix for credit customers only. This method estimates that the additional bad debt charge for cap periods four to seven was £6.88 per dual fuel credit customer higher than our initial float estimate.

Table 4.1: Final weighted average bad debt costs using the methodology options[30]

	Final incremental cost	**Float**	**Difference**
May 2022 consultation methodology	16.87	13.78	3.09
Alternative method 1	24.40[31]	13.78	10.62
Alternative method 2	20.66	13.78	6.88

Note: £ per typical dual fuel credit customer. Numbers have not been adjusted for the changes in default tariff customers or inflation.

Customer base

4.18 In our November 2021 consultation, we said that we wanted to focus on default tariff customers' costs only.[32] The May 2022 consultation method spreads the total bad debt uniformly overall credit customers, and therefore assumes that the propensity to accumulate debt is identical across different tariff and payment types. This means that if default tariff and/or standard credit customers have a higher propensity to accumulate debt, then the May 2022 consultation method could understate the additional bad debt charge due to COVID-19.

4.19 Although we do not have data split by tariff type across a representative sample of suppliers, suppliers were able to split the bad debt charge by payment method (see table 4.2 below).

[30] The output is using data from our June 2022 RFI which covers the COVID-19 periods of cap periods four to seven.
[31] We have included the downward adjustment here which is discussed in more detail below.
[32] 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

Table 4.2: Share of revenue and bad debt costs by payment method and tariff type

	Revenue split		Additional bad debt charge
	Default tariff customers	**All domestic credit customers**	**All domestic credit customers**
Direct debit	73%	79%	£4.53
Standard credit	27%	21%	£83.10

Note: Bad debt charge numbers are £ per typical dual fuel credit customer, with no adjustments.[33] Numbers are based on our bad debt charge sample only.[34]

4.20 As shown in Table 4.2, the reported additional bad debt charge resulting from COVID-19 was significantly higher for standard credit customers than direct debit customers. As well as reflecting the different characteristics of customers on these payment types, this partly reflects intrinsic differences between credit payment methods. Suppliers have previously told us standard credit customers can build up debt easier than direct debit customers, as they must actively arrange payment on receipt of the bill, whereas direct debit customers pay by default.[35, 36]

4.21 Table 4.2 also shows that a greater share of default tariff customers pay by standard credit than other tariff types. This means that even if the propensity to incur debt was constant between tariff types, the additional bad debt charge for default tariff customers would still be higher due to the greater proportion of customers on standard credit.

4.22 Therefore, we consider that using a method that accounts for the payment method mix of default tariff customers is necessary to allow suppliers to recover their efficiently incurred costs.

Bad debt origin

4.23 If a customer changes payment method after accumulating the debt, then the bad debt charge would be categorised on a payment method that the initial debt wasn't incurred on. This creates a limitation for the alternate method, as it relies

[33] By 'no adjustments', we mean that it is not net of the float and has not been adjusted for the changes in default tariff credit customers or inflation.
[34] In Appendix 5 we discuss our bad debt charge sample.
[35] 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
[36] Ofgem (2019), Consumer Survey 2019. https://www.ofgem.gov.uk/publications/consumer-survey-2019

on data which records the current payment method, not the payment method at the point of billing (ie the point at which the debt was first incurred).

4.24 Through engaging with suppliers, we concluded that it would be difficult for them to apply assumptions on reallocating costs back to where the debt was incurred. Therefore, the alternative methodology must rely on debt allocation assumptions, with the validity of these assumptions dependent on whether data at the point of consumption is materially and systematically different from data at the point of billing.

Customer flow evidence

4.25 We received evidence from two suppliers on the number of customers flows between credit payment methods (direct debit and standard credit). One supplier provided evidence indicating that its direct debit cancellations did not materially increase during COVID-19 compared to before COVID-19. A different supplier provided evidence which showed that the total number of customers moving between direct debit and standard credit and vice versa was similar.

4.26 One supplier in response to our September 2022 consultation also presented qualitative evidence on two of the most common types of customer movements in debt accrual:

- Type 1: a direct debit customer fails to maintain their payments and defaults onto a standard credit payment method before building up further debt on a standard credit payment method.
- Type 2: a standard credit customer who built up a debt is moved to direct debit where they additionally set up a debt repayment plan though regular payment. Some customers in this situation would then be unable to maintain the direct debit and debt-repayment plan payments and then default back to standard credit where they continue to build up a debt.

4.27 We consider that this evidence together suggests that the scale of debt misallocation could be limited, given debt can flow in both directions between standard credit to direct debit, and those gross flows may be similar in scale.

4.28 An economic adviser acting on behalf of two suppliers provided an analysis of how debt being allocated on the incorrect payment method (within credit) would affect the final true-up, which we have reproduced in Table 4.3. This shows the effect of moving a proportion of reported standard credit debt back to direct debit.

4.29 The economic adviser said, according to its clients, the levels of misallocation needed to make the alternative method less accurate than the May 2022

consultation method are unrealistic, and therefore this analysis is clear evidence that an adjustment would be needed.

Table 4.3: Debt flow sensitivity analysis

Share of standard credit debt moved to direct debit	Alternative method 1 increment	True-up (increment – float)
0%	£25.93	£12.15
10%	£25.04	£11.26
25%	£23.71	£9.93
50%	£21.49	£7.71
75%	£19.27	£5.49
100%	£17.05	£3.27

Note: Numbers are per typical dual fuel customer, with no adjustments[37]

4.30 We consider this debt flow analysis demonstrates that even with misallocation of 50%, a significant true-up would still be required when using the alternative method 1. This indicates it is unlikely that debt flows are extreme enough to render the alternative method 1 not robust.

Accuracy of the alternative methodology

4.31 Alongside this evidence, we also sought to test how well the alternative method 1 predicted the additional bad debt costs for default tariff customers only. Using actual data from the only three suppliers who could break down the bad debt costs by tariff type in our December 2021 RFI, we sought to see how closely the alternative method 1, which uses a proxy for payment split, could predict the suppliers' default tariff bad debt levels.

4.32 The alternative method 1's incremental calculation was on average 6% higher. This suggests that there may be some moderate upwards bias in the alternative method 1, its estimate of additional bad debt related to COVID-19 is unlikely to be materially inaccurate.

4.33 However, in order to ensure the allowance reflects efficient costs only and protects consumer interests, we include a downward adjustment of 6% to the increment to account for potential inaccuracies in the method's allocation of debt between payment methods. An economic adviser said that if we were concerned

[37] By 'no adjustments', we mean that it has not been adjusted for the changes in default tariff credit customers or inflation. We have also not applied the downward adjustment to the data in the table which is discussed later in this chapter.

with debt misallocation, then we could consider making a conservative adjustment. In Appendix 3, we discuss in more detail the calculation behind this and an alternative downward adjustment method which we rejected.

Conclusion

4.34 We consider that we should seek to focus on the payment method mix for default tariff customers by using the alternative method 1 to calculate the additional bad debt costs due to COVID-19. This is because the evidence suggests that a) the increase in bad debt costs due to COVID-19 was significantly greater for standard credit customers, b) there was a greater proportion of standard credit customers on default tariffs during the period, and c) the scale of customer movements between payment methods is unlikely to be causing large-scale misallocation of costs to standard credit.

4.35 While noting that the proxy method is supported by evidence and generally accurate, we also consider it to be in consumers' interest to include a downward adjustment of 6% to account for potential inaccuracies in the method's allocation of debt between payment methods. This adjustment reduces the size of the increment and is in the customer's favour.

Bad debt charge allowance

Context

4.36 In February 2021, we concluded that the COVID-19 pandemic had resulted in additional debt-related costs of £13.78 per typical dual fuel credit customer, and that suppliers were unable to recover these additional costs through the existing cap methodology. This float was recovered in the cap over cap period six and seven.[38]

4.37 We said that we would adjust this initial estimate to reflect the final costs once they were fully known, ie a true-up. This means that the true-up allowance will be net of the initial float suppliers received.

Decision

4.38 We have decided to include an allowance in the cap to true up the additional bad debt costs incurred over COVID-19 for credit customers.

[38] 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

4.39 This bad debt cost allowance for the COVID-19 true-up will be £7.91 per typical dual fuel credit customer.

4.40 We recognise that the COVID-19 pandemic had an impact on some customers' incomes and therefore on some suppliers' cashflow which resulted in temporary additional bad debt costs. When we set the initial float, we erred on the side of caution to avoid customers unduly bearing the risk of the cost uncertainty, which was conservative in the favour of customers. We consider that it is now appropriate and in the customer's interests to allow suppliers to recover the remaining weighted average additional bad debt costs. This will ensure that the cap does not deviate from an efficient level of costs in a situation where there is a sudden and unexpected reduction in some customers incomes.

Stakeholder responses

4.41 In response to our September 2022 consultation, one supplier said that the true-up allowance should be set to £0, but its preference would be for the float to be fully refunded as it had not seen an increase in debt-related costs.

4.42 A different supplier said that there was a significant disparity between the final incremental bad debt cost from the initial float.

Considerations

Table 4.4: COVID-19 true-up bad debt allowance[39]

	Bad debt charge
Final incremental cost	24.40
True-up (increment – float)	10.62
Allowance	7.91

Note: all numbers are £ per typical dual fuel credit customer.

4.43 The final incremental bad debt cost is estimated to be £24.40 per typical dual fuel credit customer.

4.44 To reach the true-up allowance we subtract the initial float from the final incremental cost. Then we adjust for the changes in the aggregate number of default tariff credit customers/ inflation between the cap periods when the costs

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

were incurred, the cap periods in which the initial float was recovered, and the expectations for cap periods in which the final costs are trued up.[40]

4.45 We consider that the change in costs between the final incremental cost and what was already provided for in the float is material and systematic, and therefore we consider it appropriate to introduce a temporary adjustment in the cap.

4.46 Although one supplier stated that the float should be fully refunded to customers, we consider that there is clear evidence to suggest that bad debt costs materially increased during COVID-19 when taking a weighted average benchmark[41] across our sample of suppliers. As we are obligated to set one cap for all suppliers, we consider that refunding the initial float would therefore reduce the cap's accuracy and would not reflect efficiently incurred costs of a notional supplier.

4.47 The specific bad debt allowance is worth £7.91 per typical dual fuel credit customer at the cap benchmark consumption.

[40] Our considerations of these and other smaller decisions are included in Appendix 1 of this decision. In Appendix 4 we also explain how we have translated those decisions into the Annex 8 model.
[41] We consider that a weighted average benchmark is an appropriate efficient benchmark given the sudden and unexpected nature of COVID-19. We discuss our choice of benchmark in Appendix 1.

5. Other debt-related costs

Chapter summary

In this chapter, we discuss our decisions on working capital and debt-related administrative costs. We discuss our definitions of them, and the subsequent allowances.

Working capital costs

Defining working capital costs

Context

5.1 In our November 2021 consultation, we considered three different ways of determining the additional working capital costs, the three options were:[42]

- Option 1 - using the 2018 decision working capital definition
  - this approach is consistent with the approach we used to calculate the payment method uplift in the 2018 cap decision;[43]
  - working capital = current assets - current liabilities, for the supply business;[44]
  - we would then apply a cost of capital, to convert the working capital value into a cost.
- Option 2- request data on half-yearly 'debtor days'[45]
  - this is a measurement of the average amount of time it takes customers to pay suppliers;
  - $Debtor\ days_{half-yearly} = \frac{Average\ accounts\ recievables_{half-yearly}}{Revenue_{half-yearly}} * \frac{365}{2}$
  - then covert it into a monetary value by combining it with suppliers' revenue and a cost of capital.

[42] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, Paragraph 4.32. https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
[43] Ofgem (2018), Appendix 8 - Payment method uplift. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[44] This excludes items: additional cash and working capital requirements relating to trading, taxation balances, and derivatives.
[45] Accounts receivable is the balance of money due to a firm for goods or services delivered or used but not yet paid for by customers. Revenue is the money generated from normal business operations. We asked for accounts receivable (debtors) and revenue for the domestic energy supply business only.

- Option 3 - a bespoke approach.
    - this requests repayment data by using the same approach as the bottom-up option for measuring bad debt costs;[46]
    - we would calculate how the average time for late payment had changed since COVID-19, then convert it into a monetary value.

5.2 In our May and September 2022 consultations, we proposed to use half year debtor-days to determine the additional working capital costs due to COVID-19.

Decision

5.3 For the COVID-19 true-up decision, we have decided to maintain our consultation position and to use option 2 (half yearly debtor-days) to determine the additional working capital costs due to COVID-19.

Stakeholder responses

5.4 In response to our May 2022 consultation, one supplier said that it did not disagree with using half yearly debtor days to determine the additional working capital costs due to COVID-19.

5.5 In response to our November 2021 consultation, three suppliers supported the debtor days approach, and one supplier disagreed with the approach, stating that it does not consider seasonal fluctuations that impact direct debit payments.

Considerations

5.6 We still consider that the debtor days approach (option 2) is more focused on debt than the 2018 decision working capital approach (option 1) and it is also a more proportionate approach for collecting data compared to the bespoke approach (option 3).

5.7 We calculate the increment relative to the same months before COVID-19. This means each summer or winter cap period included in our calculation will remove an equivalent baseline period in the increment calculation, netting off any seasonal effects. This means that our calculation should capture the seasonal variability of direct debit payments.

[46] In the bottom-up bad debt approach, we would have asked each supplier for their level of outstanding debt from a particular period of billed consumption in the past. We would then assess the recoverability of the outstanding debt.
Ofgem (2021), Working paper on the true-up process for COVID-19 costs, paragraphs 3.20 – 3.31. https://www.ofgem.gov.uk/publications/consultation-true-process-covid-19-costs

5.8 The remainder of our considerations are unchanged from our November 2021 consultation.[47]

Working capital cost allowance

Context

5.9 In our February 2021 float decision, we decided to not include working capital costs in the float allowance. This was because we did not have confidence that the RFI data collected was consistent between suppliers, and the data did not show a material change in costs to suppliers. We also noted in our February 2021 float decision that we would consider working capital costs as part of the true-up.[48]

Decision

5.10 We have decided to make an adjustment in the cap to true up the additional working capital costs incurred over COVID-19 for credit customers. We recognise that the increase in delayed payments due to COVID-19 had an impact on suppliers' cashflow which resulted in temporary additional costs, and it would not be in the interest of customers or suppliers to prevent its recovery.

5.11 The additional working capital allowance element of the COVID-19 true-up allowance will be £5.49 per typical dual fuel credit customer. This was calculated using a 10% cost of capital assumption.

Stakeholder responses

5.12 In response to our September 2022 consultation, one supplier disagreed with our proposal to make no adjustment in the cap to true up additional working capital costs. This supplier said that due to COVID-19 there was a substantial amount of additional capital which short term financing or the Sterling Overnight Index Average rate could not cover, given the risks involved in a retail supply business.

5.13 In response to our May 2022 consultation four suppliers disagreed with our proposal to not include an adjustment for the additional cost of working capital

[47] Ofgem (2021), Consultation on the true-up process for COVID-19 costs, paragraphs 4.38 – 4.50.
https://www.ofgem.gov.uk/publications/price-cap-consultation-true-process-covid-19-costs
[48] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraphs 4.2.
https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap

due to COVID-19. They disagreed that these costs could be covered by short term financing or uncertainty allowances.

5.14 One supplier in response to our May 2022 consultation, said that a 0-5% cost of capital range did not consider the indirect impacts which could increase the marginal cost of raising future capital. Another said that if we did insist on using short term financing costs, then it expected the cost of capital to be in the range of 4.5-5.5%.

5.15 One economic adviser and one supplier recommended that we account for the payment method mix to calculate the additional working capital costs using the alternative method 1 approach to calculate the additional working capital costs. This adviser said that the incremental working capital cost due to COVID-19 would be £1.10 greater using the alternative method with a 10% cost of capital assumption.

Considerations

Cost of capital

5.16 We consider that the scale of working capital costs generated by COVID-19 was material and sustained, and that some retail energy supply businesses would have found it difficult to sustain the increased capital required through short term financing facilities.

5.17 On balance, we have decided to use a 10% cost of capital assumption to calculate the additional working capital costs due to COVID-19. This keeps our calculation consistent with the cost of capital assumption used in other parts of the cap (eg the EBIT margin) at the time the costs were incurred.

Methodology

5.18 In our December 2021 RFI, we requested and received debtor days inputs[49] broken down by payment method. Therefore, we can also account for the payment method mix for default tariff customers when calculating the additional working capital costs due to COVID-19 (using the alternative method 1).

5.19 This is because like bad debt, the additional working capital costs were reported to be higher for standard credit customers. Using this method also ensures consistency with the additional bad debt calculation. This means that we use the

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

alternative method 1 to calculate final incremental cost per dual fuel credit customer of working capital.

5.20 We have also removed PPM related revenue from our calculation to reflect our decision that this allowance will be recovered over credit customers only. Our approach here is consistent with our calculations for the additional bad debt and debt-related administrative costs. Removing PPM revenue has increased the incremental value since the denominator in our calculation is now lower.

5.21 Given our decision to apply the additional working capital adjustment through the Annex 8 model, there would normally be a small consequential increase in the size of the EBIT and headroom allowances. We have decided to exclude the subsequent compounding effect of the EBIT margin on this specific allowance, given both aspects focus on the capital employed.[50]

Decision

Table 5.1: COVID-19 true-up working capital costs allowance[51]

	Additional working capital costs
Allowance	£5.49

Note: £ per typical dual fuel credit customer.

5.22 The specific working capital cost allowance is £5.49 per typical dual fuel credit customer at the cap benchmark consumption. This has had the EBIT uplift removed, and has been adjusted for changes in customer numbers and inflation.

5.23 We consider that this cost is material and should be included in the COVID-19 true-up allowance.

[50] The EBIT margin is applied to allowances in the default tariff cap model which Annex 8 feeds into. We cannot directly scale back the EBIT margin from this specific allowance in the default tariff cap model without amending the licence conditions. Therefore, our decision excludes the compounding effect of the EBIT margin on the working capital element in this allowance.
[51] The output is using data from our December 2021 RFI which covers the COVID-19 periods of cap periods four to six.

Debt-related administrative costs

Defining debt-related administrative costs

Context

5.24 In our December 2021 and June 2022 RFIs we asked for breakdowns of individual cost categories,[52] while allowing suppliers to put forward any additional debt-related administrative costs not covered by these categories.[53] We called this the hybrid approach which was a combination of the flexible and prescriptive approaches (see next paragraph).

5.25 The flexible approach would have only asked for a high-level description of debt-related administrative costs without specific definitions and the prescriptive approach would have only set out a number of defined categories requiring suppliers to provide specific breakdowns.

Decision

5.26 For the COVID-19 true-up adjustment, we have decided to define debt-related administrative costs, at a high level, as administration costs incurred by suppliers when seeking to recover debt (hybrid option).

5.27 We have decided not to use the breakdown of debt-related administrative costs by either payment method or tariff type, as we were unable to gather this data on a consistent basis across suppliers. We therefore use the total debt-related administrative costs in our calculation.

Stakeholder response

5.28 One supplier in response to our November 2021 consultation agreed with our proposed hybrid option for collecting debt-related administrative cost data, noting that many of the categories are similar to suppliers' management accounts, while allowing for differences in suppliers' approach.

[52] 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.
[53] Ofgem (2022), Supplementary consultation on the true-up process for COVID-19 costs, paragraph 4.5. https://www.ofgem.gov.uk/publications/price-cap-supplementary-consultation-true-process-covid-19-costs

Considerations

5.29 We still consider that the hybrid option to gather data appropriately balances the trade-off between giving suppliers the flexibility to define relevant debt-related administrative costs, and the increased comparability available when we are more prescriptive.

Debt-related administrative costs allowance

Context

5.30 In our February 2021 float decision, we decided to not include additional debt-related administrative costs in the float allowance. This was because we did not have confidence that the RFI data collected was consistent across suppliers, and the data at the time did not show a material change in costs to suppliers.[54]

Decision

5.31 We have decided to make an adjustment in the cap to true up the incremental debt-related administrative costs incurred during COVID-19 for credit customers.

5.32 The incremental debt-related administrative costs element of the COVID-19 true-up allowance is -£1.38 per typical dual fuel credit customer. We consider that it is in the customer interest to include this cost reduction as part of the total COVID-19 true-up allowance.

Stakeholder response

5.33 In response to our September 2022 consultation one supplier said that suppliers were generally able to realise savings on administrative costs during the COVID-19 period, for example through usage of the Coronavirus Job Retention (furlough) scheme.

5.34 In response to our May 2022 and September 2022 consultations, a supplier and three suppliers' economic advisers said that it would have been unlikely that debt-related administrative costs reduced during COVID-19 given bad debt costs rose. They said that we should assume COVID-19 had no impact on administrative costs.

[54] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraphs 4.2.
https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap

Considerations

Table 5.2: Debt-related administrative costs[55]

	Incremental debt-related administrative costs
Allowance	-£1.38

Note: £ per typical dual fuel credit customer.

Payment method allocation

5.35 When we requested debt-related administrative cost data, we wanted to assess if the incremental cost differed among payment methods. However, the majority of suppliers who submitted data could not split debt-related administrative costs by payment method. Some suppliers noted that they do not report these costs by payment method, and they were unable to apportion them accurately.

5.36 As the alternative method 1 relies on payment method breakdowns, we cannot use it to calculate the incremental debt-related administrative costs. Given these data limitations, we use the May 2022 consultation approach, which we still consider to be suitable to calculate the incremental change in debt-related administrative costs (see Appendix 2 for further detail on the method).

5.37 The specific debt-related administrative cost allowance is -£1.38 per typical dual fuel credit customer at the cap benchmark consumption. This has been adjusted for changes in customer numbers/ inflation.

Evidence of changes in debt-related administrative costs during Covid-19

5.38 Two stakeholders said that we should assume there had been no impact on debt-related administrative costs, and we should instead not include it in the total COVID-19 allowance as any reduction in costs was likely to be a deferral of costs, rather than a permanent saving.

5.39 However, data from our sample of suppliers show there was a reduction in debt-related administrative costs in all four COVID-19 cap periods between April 2020-March 2022, and we have not seen evidence to suggest that this was simply a deferral of costs.

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

5.40 We also can identify several reasons why suppliers may have seen a decrease in their debt-related administrative costs during Covid-19, such as the suspension of certain debt collection activities and the furlough scheme.

5.41 While it is possible that some collection activities could have increased during the later stages of the COVID-19 pandemic, the data also shows a reduction in debt-related administrative costs in the final cap periods of the COVID-19 pandemic as well. Therefore, there is no evidence to suggest a deferral in costs, and as per Chapter 3 we do not consider that suppliers would incur further debt-related administrative costs due to COVID-19 beyond cap period seven (ie a full 2 years after the beginning of COVID-19).

5.42 Given this evidence, we have decided to include the reduction of debt-related administrative costs in the true-up allowance, as we consider it to be in the consumer interest and will ensure the cap reflects the efficient costs of a notional supplier.

6. Payment method allocation

Chapter summary

In this chapter we outline our approach for allocating debt-related costs to different payment methods.

Context

6.1 We need to consider how we should split the additional debt-related costs between the different payment methods.

6.2 We have identified that the additional debt-related costs are likely to vary by payment method, with debt-related costs generally higher for standard credit customers than direct debit customers. Further, suppliers have said that debt-related costs are likely to be much lower for PPM customers.

6.3 In our February 2021 float decision, we decided to adopt an equal allocation approach across credit payment methods (standard credit and direct debit customers), with no allocation to PPM customers.

6.4 In our May 2022 consultation, we proposed to allocate each individual additional debt-related cost equally across credit meters only.

Decision

6.5 We have decided to allocate an equal allocation across credit meter customers (ie the same pound uplift to the standard credit and direct debit caps).

6.6 We have also decided to allocate all PPM debt-related costs to credit customers, given evidence that the vast majority of PPM debt was accrued originally on credit meters.

6.7 This means no true-up allowance will be added to PPM customers' bills.

Stakeholder responses

6.8 In our May 2022 consultation one supplier said that it had incurred additional debt from PPM customers during COVID-19 as a result of the measures it took to support vulnerable customers. This supplier said that we should give PPM customers consideration in our review.

6.9 One supplier in response to our May 2022 consultation said that PPM customers accrue debt as a result of additional supplier support and also from accruing debt on a credit meter before being transferred to a PPM. It agreed that the initial debt

was accumulated on credit meters, but said that repayment of debt was over a prolonged period for prepayment customers.

6.10 In response to our March 2021 call for input, one supplier said that there should be a fair sharing of COVID-19 true-up costs across all domestic customers and that the costs should be equally allocated.

Considerations

General allocation

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

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

PPM and credit allowance

6.13 We consider that it is much harder for a PPM customer to build up similar levels of debt to that of a standard credit or direct debit customer. This is because PPM customers typically pay before delivery of energy, and therefore a supplier has to take action to allow a PPM customer to build up material levels of debt.[56]

6.14 During our April 2022 supplier calls, suppliers told us that between 90-95% of the bad debt on PPMs was built up while the customer was on a credit meter.[57] They said that this debt was transferred across to PPM when the customer transferred payment methods. The remaining PPM bad debt costs could be attributed to debt that was built up whilst on a PPM meter through credit facilities.

6.15 If we did keep 5% of PPM debt on PPMs, then our estimated additional cost would be £1.60[58] per typical dual fuel PPM customer. There could also be small consequential impacts on debt-related administrative and working capital costs.

[56] PPM customers can claim small amounts of credit automatically, through emergency and friendly credit arrangements. However, these could only lead to small amounts of debt.
[57] This represents a range of estimates provided by suppliers.
[58] We also included the PPM specialist which was excluded from our credit bad debt sample to calculate this additional PPM cost.

6.16 We consider that it is uncertain about what costs would be accurately allocated to PPM. PPM customers are more likely to be vulnerable than credit customers, so we would want to avoid inaccurately allocating costs to them.

6.17 Moving away from allocating all costs for one payment method to that specific payment method could lead to a shortfall for those suppliers with above-average proportions of that particular payment method. This risk is mitigated for credit as there is less variation in suppliers' credit customers compared to PPM.

6.18 We outlined in Chapter 4 and 5 that we allocated all PPM debt-related costs to standard credit customers within our calculations for the additional bad debt charge, and working capital. For our calculation of additional debt-related administrative costs, we used the total figure which already includes PPM debt-related administrative costs (so PPM data was already apportioned in this calculation).

6.19 One supplier submitted evidence on the average debt held on its PPMs and the expected repayment period of this debt. We do not consider this to be a useful metric, as we want to determine the flow of additional debt due to COVID-19 rather than identify the stock of accrued debt.

Attribution of PPM debt-related costs

6.20 In our May 2022 and September 2022 consultations we proposed to allocate all PPM debt-related costs to standard credit customers. This reflects that the vast majority of these costs were incurred while customers were on credit meters. To check this assumption, we conducted sensitivity analysis on this by moving a proportion of the debt-related cost from PPM to standard credit and the remainder to direct debit, rather than moving all to standard credit.[59] This had a non-material impact, so we decided to continue apportioning all PPM debt-related costs to standard credit.

6.21 Finally, one supplier was concerned with revenue leakage on prepayment meters and that we should determine a specific allowance in the cap for this. However, we consider the need of a revenue leakage allowance to be out of scope of this decision, as it does not relate to the impacts of COVID-19.

6.22 This decision on payment method allocation is specific to the assessment of additional debt-related costs during the COVID-19 pandemic, and it does not pre-

[59] This was calculated by dividing standard credit bad debt by total credit bad debt. We tested the same sensitivity for working capital costs using accounts receivables data.

judge a future decision on debt-related costs. We are in the process of assessing the level of bad debt-related costs associated with the gas price crisis, and how it relates to the existing debt-related costs allowance in the cap.[60] This assessment will include debt-related costs specific to PPMs, as well as credit meters.

6.23 Finally, one supplier was concerned with revenue leakage on prepayment meters and that we should determine a specific allowance in the cap for this. However, we consider the need of a revenue leakage allowance to be out of scope of this decision, as it does not relate to the impacts of COVID-19.

Equal allocation across credit customers

6.24 Suppliers have told us that debt-related costs are generally higher for standard credit customers than for direct debit customers. RFI data supported this notion.

6.25 We consider that we need to strike a balance when applying cost-sharing across credit customers. At an individual level, a standard credit customer who pays their bill is not more responsible for the higher debt-related costs associated with standard credit customers than a direct debit customer who also pays their bill. This is especially the case in the context of COVID-19 with a sudden and unexpected impact on some customers' incomes.

6.26 Stakeholders previously told us that a standard credit customer is typically more likely to have vulnerable characteristics than a direct debit customer such as being fuel poor, elderly or having limited access to the internet.[61] We have carried out a distributional analysis on two recovery options, which we discuss in our impact assessment in Chapter 8.

6.27 Given these considerations, we have decided to follow the precedent of the February 2021 float, and set the COVID-19 true-up allowance at the same level for each credit payment method (direct debit and standard credit). This method of allocating costs avoids standard credit customers facing a significantly larger true up. We also consider it reflects the efficient costs of a notional supplier serving an average customer base. However, where suppliers have a non-average customer makeup, there is potential for either an over allowance or an under allowance. The range in suppliers' customer base splits between direct debit and

[60] Ofgem (2022), Price cap - Programme of Work, Annex 2. https://www.ofgem.gov.uk/publications/price-cap-programme-work
[61] Ofgem (2018), Appendix 12 – Payment method uplift. https://www.ofgem.gov.uk/publications/default-tariff-cap-policy-consultation-overview

standard credit is relatively small. We therefore do not consider that there are likely to be large over or under allowances in practice.

6.28 Table 6.1 sets out the COVID-19 true-up allowance for each payment method and we set out the distributional impact of these options in the section below.

Table 6.1: COVID-19 true-up allowance allocation by payment method

	COVID-19 true-up allowance
Standard credit	£12.02
Direct debit	£12.02
Prepayment meter	£0.00

Note: all numbers are £ per typical dual fuel customer

7. Recovery period length

Chapter summary

In this chapter, we explain our decisions on how long the recovery period the true-up adjustment will be.

Context

7.1 In our February 2021 float decision, we decided to recover the initial float over 12 months only.

7.2 In our September 2022 consultation, we proposed to recover the true-up adjustment over the remainder of the cap, which at the time of publication would have been 9 months from April 2023 (cap periods 10a, 10b, and 11a).[62]

7.3 However, we did note that we favoured recovering any true-up allowance over 12 months instead of 9 months, as it would more closely align with how the cap is calculated on an annual basis, and it would also be consistent with our recovery of the float. Therefore, we said that we would revisit this in our decision, taking into account any legislative developments in the meantime.

7.4 The Energy Prices Act 2022 amended the Domestic Gas and Electricity (Tariff Cap) Act 2018 such that there is no longer a set end date for when the cap conditions cease to have effect. Instead, the Secretary of State may give notice that the tariff cap conditions cease to have an effect at any point.[63]

Decision

7.5 We have decided to recover the true-up adjustment over 12 months from April 2023. This means that the true-up adjustment will be included in the cap for cap periods 10a, 10b, 11a and 11b.

7.6 This is a change from our proposal in our September 2022 consultation.[64]

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[62] When we published the September 2022 consultation The Domestic Gas and Electricity (Tariff Cap) Act 2018 was due to expire at the end of 2023.
Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 8(3).
https://www.legislation.gov.uk/ukpga/2018/21/section/8/enacted

[63] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 8(1).
https://www.legislation.gov.uk/ukpga/2018/21/section/8

[64] Ofgem (2022), Supplementary consultation on the true-up process for COVID-19 costs, paragraph 1.15 – 1.17, Appendix 1.
https://www.ofgem.gov.uk/publications/price-cap-supplementary-consultation-true-process-covid-19-costs

Stakeholder responses

7.7 No stakeholders commented on this aspect of our May or September 2022 consultation.

Considerations

7.8 The COVID-19 true-up allowance will lead to an increase in the cap, and therefore recovering it over a longer timeframe protects consumers, including those most vulnerable, from sharp rises in costs. However, recovering the true-up over an extended period means suppliers would need to wait longer to recover costs they have incurred. The risk of inaccuracy also increases over time, as suppliers' customer bases are more likely to change between when costs were incurred and when they are recovered through an allowance.

7.9 The cap is set on an annual basis, which means that recovering the true-up allowance over either 6 months or 18 months, would add complexity into our calculations, as we would need to apply demand and time uplifts.

7.10 We therefore consider that it is favourable to recover the additional allowance over a 12 month period, as it balances protecting consumers from sharp rises in costs, with ensuring supplier financeability, and is consistent with our approach to the float allowance.

8. Impact assessment

Chapter summary

In this chapter, we summarise how we assessed the impact of introducing a one off COVID-19 true-up adjustment.

Context

8.1 As outlined in Chapter 2, we act with a view to protect existing and future consumers who pay standard variable and default rates. In doing so we must have regard to the five matters identified in section 1(6) of the Act in our decision-making process.

8.2 In reaching our decisions, we have been mindful of the trade-offs between customers' interests in minimising the immediate impact on energy bills and their interests in ensuring resilient suppliers who can efficiently manage risks. As part of our decision-making, we conducted an impact and equalities assessment.

8.3 In this section, we focus on the analysis of the impacts of introducing a COVID-19 true-up adjustment from cap period 10a (April 2023 - June 2023). For the purpose of this analysis, we make assumptions related to the EPG and we specify these in the respective section.

8.4 We carried out three assessments:

- High-level qualitative analysis: we assess the potential impact of the COVID-19 adjustment on default tariff customers and suppliers.
- Bill impact analysis: we assess the potential impact on bills for a number of different respective domestic users.
- Potential impact on public spending.

Considerations

Qualitative assessment

8.5 We have assessed the customer and supplier impacts of the factual scenario of introducing the COVID-19 true-up adjustment, against the counterfactual scenario of not introducing one.

8.6 We note that while the EPG is in place, and the cap level remains above the EPG, that the cost of this adjustment would be covered by the government. If the cap

level falls below the EPG level at any time before March 2024, then some of these costs would be borne by customers.

8.7 Due to the impact of the COVID-19 pandemic including the higher levels of unemployment, more households struggled to pay their energy bills. The existing price cap methodology includes an allowance for suppliers to recover the cost of writing off debt from unpaid bills and other debt-related cost allowances. However, the pandemic resulted in debt-related costs rising to levels beyond what suppliers incurred before the pandemic.

8.8 In the factual scenario, suppliers would be able to fully recover the efficient costs of the notional supplier that they would otherwise have not been able to recover. We do not consider that it would be in the customers interest to prevent suppliers from recovering their efficiently incurred additional costs during COVID-19. From customers' perspective, we consider that they would experience a temporary increase in their energy bills, although the impact might be partly mitigated by the EPG.

8.9 While in the counterfactual scenario, of not including a true-up adjustment in the cap, suppliers would not be able to recover their efficiently incurred additional debt-related costs resulting from the COVID-19 pandemic.[65] However, we consider that this would not be beneficial to both existing and future customers by potentially increasing the future additional costs that they would incur due to the Supplier of Last Resort ('SoLR') and/or Special Administration Regime ('SAR') processes. We consider this not to be in customers' interests, as ultimately it could add costs to customers' bills in the future.

8.10 In light of the above qualitative assessment, we consider the net benefits of a COVID-19 true-up adjustment to outweigh the costs of not including one.

Bill impact analysis

8.11 We have carried out a distributional analysis of introducing the COVID-19 adjustment to customer energy bills. It is difficult to determine precisely how much consumers would pay due to the uncertainty around the price cap level (resulting from wholesale price volatility) and its interaction with the EPG level (which is currently set at £3,000 between April 2023 and March 2024).

[65] Similar considerations would also apply in the case of refunding the float.

8.12 We have considered two bad debt true-up recovery options which we discussed earlier in Chapter 6:

- Option 1: equal allocation across credit meter customers (ie the same pound uplift to the standard credit and direct debit cap).
- Option 2: unequal allocation across credit meter customers (ie recover additional bad debt costs that were reported on standard credit/ direct debit by its own customer base).

8.13 We assume that the price cap level is below the EPG level (ie the costs would be borne by customers) in both options 1 and 2 for the analysis of allocation options. This is a simplifying assumption for the presentation of this impact assessment, and not a forecast of future price cap levels.

8.14 If the price cap level remains above the EPG level, then the costs would not directly impact customers through their energy bills. We present the potential impact on public spending in Table 8.1 at the end of this chapter.

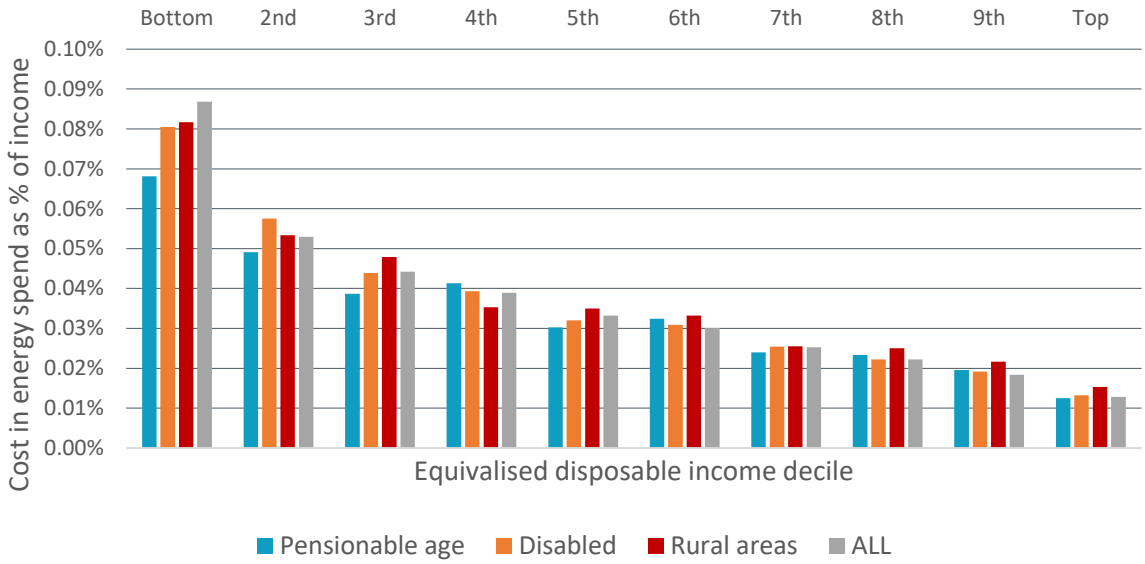
Option 1: Equal allocation

8.15 Figure 8.1 shows the distributional impact of the specific bad debt element of the COVID-19 true-up allowance against the counterfactual of not introducing one. We have had particular regard to the interest of the individuals who are disabled or chronically sick; of a pensionable age; of low incomes; and residing in rural areas.

8.16 The allowance costs consumers at the lower end of the income distribution significantly more on a relative income basis. Within each decile, the disabled group is impacted the most while the pensionable age group is impacted the least. The bad debt element of the COVID-19 true-up allowance would cost the bottom income decile 0.09% of their income.

8.17 Under the Equality Act 2010 we are required to have regard to the public sector equality duty and consider how our policies or decisions affect default tariff customers protected under the Act. As noted earlier, although the adjustment would be an additional cost for customers, these costs are efficient costs suppliers are yet to recover. Therefore, as noted earlier, if these costs are not recovered, it would increase the risk of supplier failure and reduce suppliers' ability to manage risks and support customers. Such failures would result in additional costs to future and current customers, including customers with protected characteristics.

Figure 8.1: Estimated impact of COVID-19 bad debt true-up allowance using equal allocation among credit customers



The bar graph shows the change in energy expenditures as a percentage of income following the introduction of COVID-19 true-up allowance using equal allocation among credit customers for pensionable age, rural area, disabled, and all customers. It assumes equal income distribution among payment methods. It indicates that those in the equivalised bottom income decile will incur the highest costs.

Option 2: Unequal allocation

8.18 We can see that the allowance would cost the bottom decile of standard credit customers 0.59% of their income in Figure 8.2. While the allowance would save the bottom decile of direct debit customers 0.08% of their income in Figure 8.3. Direct debit customers would see a reduction in their bills, as the initial float was applied evenly to both credit payment methods, so choosing an unequal allocation now would lead to them effectively being refunded part of that previous allowance.[66]

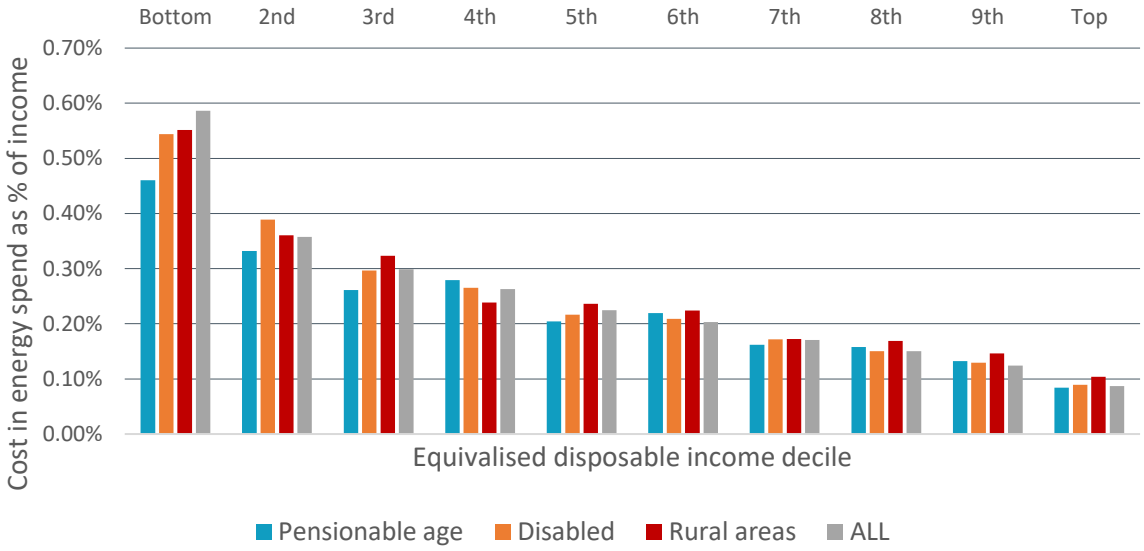
8.19 The impact using unequal allocation is greater for standard credit customers compared to equal allocation. The extent of the cost increase for standard credit customers reflects the evidence we received that the vast majority of bad debt costs were incurred by customers on standard credit meters at the time we collected the data. However, as noted already, at an individual level a standard credit customer who pays their bill is not more responsible for the higher debt-

[66] The initial float was applied evenly between standard credit and direct debit customers.

related costs associated with standard credit customers than a direct debit customer who also pays their bill.

8.20 Further we have evidence that standard credit customers are more likely to be fuel poor and on lower incomes than direct debit customers.[67] Stakeholders have previously said that standard credit customers are more likely to be vulnerable. We therefore consider that equal allocation would provide protection for standard credit customers, and it would allow for suppliers on average to recover their additional costs.

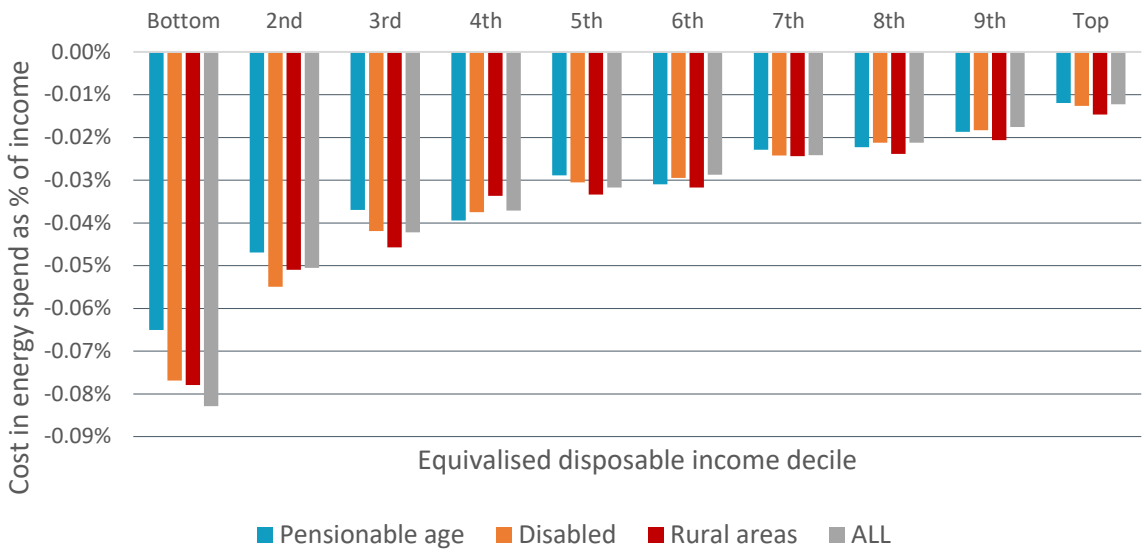
Figure 8.2: Estimated impact of COVID-19 bad debt true-up allowance using unequal allocation among standard credit customers



The bar graph shows the change in energy expenditures as a percentage of income following the introduction of COVID-19 true-up allowance using unequal allocation among standard credit customers for pensionable age, rural area, disabled, and all customers. It assumes equal income distribution among payment methods. It indicates that those in the equivalised bottom income decile will incur the highest costs.

[67] BEIS (2022), Annual Fuel Poverty Statistics in England, 2022 (2020 data), Figure 3.26. https://www.gov.uk/government/statistics/annual-fuel-poverty-statistics-report-2022

Figure 8.3: Estimated impact of COVID-19 bad debt true-up allowance using unequal allocation among direct debit customers



The bar graph shows the change in energy expenditures as a percentage of income following the introduction of COVID-19 true-up allowance using unequal allocation among direct debit customers for pensionable age, rural area, disabled, and all customers. It assumes equal income distribution among payment methods. It indicates that those in the equivalised bottom income decile will incur the highest savings.

Potential impact on public spending

8.21 We are required to exercise our functions under the Act with a primary focus on protecting consumers on default rates, while having regard to specified considerations (see s. 1(6) of that Act). Following the coming into force of the Energy Prices Act 2022, those specified considerations to be taken into account include "the need to set the cap at a level that takes account of the impact of the cap on public spending".

8.22 That new consideration reflects the fact that, while the Government's EPG is in force, the cap level affects the levels of payments by Government to energy suppliers. While the EPG is in place, and the cap level remains above the EPG, the cost of this adjustment would be covered by the government. If the cap level falls below the EPG level at any time before March 2024, then some of these costs would be borne by customers.

8.23 We have therefore provided the opportunity for the Department for Energy Security and Net Zero (previously the Department for Business, Energy and Industrial Strategy (BEIS)) and HM Treasury to provide representations on the impact of any aspect of our proposed decision on public spending, having regard to the new consideration in the Act. We did not receive any representations from

the Department or the Treasury. We therefore sought confirmation from both that they did not have any representations. The Department has confirmed that they do not have any representations to make. The Treasury has not provided such confirmation, but we consider that they have been provided with appropriate opportunity to make representations.

8.24 Table 8.1 shows our estimate[68] of the potential impact of this decision on government spending for each cap period which the EPG level remains below the price cap level. We do however note, that even if this cost is paid for by the exchequer, then it will ultimately impact taxpayers who are also domestic energy customers as well.

Table 8.1: Estimated impact on public spending for cap periods where the cap level is above the EPG level

Cap period	**Cost per individual cap period**
10a (April 23 – June 23)	£45m
10b (July 23 – September 23)	£34m
11a (October 23 – December 23)	£65m
11b (January 24 – March 24)	£75m

8.25 If the price cap level were to fall below the EPG level between April 2023 – March 2024, then the cost to the exchequer would be £0 in each cap period, and the cost would instead be borne by default tariff customers.

8.26 We consider that this decision takes proper account of the impact the proposed true-up allowance may have to public spending. Overall, this decision is intended to enable suppliers to recover efficient costs of supplying energy (which are affected by higher bad debt costs). The adjustment proposed is no more than appropriate for that purpose. Furthermore, enabling suppliers to recover the efficient costs of their supply activities is likely to reduce the risk of suppliers failing and becoming insolvent, which may impact public spending (such as through the cost to the taxpayer of a special administration regime).

[68] We have calculated this by weighting the allowance with quarterly gas and electricity demand shares from Annex 2. We have also assumed that the number of default tariff credit customers is constant throughout the recovery period of our allowance using numbers from the October 2022 customer account and tariff RFI. The true cost would depend on several factors, such as changes in default tariff customers, and seasonal weather variations.
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

9. Other decisions

Section summary

In this chapter, we summarise our decisions on: how we adjust the cap, how we allocate costs, accounting for the changes in the number of default tariff customers, and whether we should account for changes in consumption over time.

Decision

9.1 In table 9.1 below, we outline all our remaining decisions. Please see Appendix 1 for our considerations of these decisions.

Table 9.1: Other decisions

We have decided to:	**Has this decision changed from our September 2022 consultation proposal:**
not include a sharing factor	Unchanged
use the 'Annex 8 – adjustment allowance' to set the COVID-19 true-up adjustment in the cap	Unchanged
allocate the adjustment equally across meter and fuel types	Unchanged
allocate the adjustment equally between the standing charge and unit rate elements of the current cap	Unchanged
not account for costs resulting in timing differences between when a cost is incurred and when the allowance is received	Unchanged
account for inflation when determining the amount to recover through the allowance adjustment	Unchanged
adjust for the changes in aggregate number of default tariff customers between the cap periods when the costs were incurred and the cap periods when the allowance will be recovered.	Unchanged
account for changes in consumption and energy prices between the baseline and the COVID-19 period	Unchanged
Not control for changes in consumption between the COVID-19 cap period and the cap period in which we set the true-up allowance.	Unchanged
use a weighted average benchmark and to set a combined benchmark across each cap period which we are truing up	Unchanged

Appendices

Index

Appendix 1 – Other decisions

Sharing factor

Context

A1.1 A sharing factor is a mechanism which would share the impact of the additional COVID-19 costs between suppliers and customers. If it were introduced, then suppliers would bear a percentage of the additional costs due to COVID-19.

Decision

A1.2 We have decided to not include a sharing factor when calculating the amount to recover in the true-up. This is unchanged from our May and September 2022 consultations.

Stakeholder responses

A1.3 No stakeholders commented on this aspect of our May or September 2022 consultation.

A1.4 One stakeholder in response to our November 2021 consultation was disappointed that we rejected the sharing factor.

Considerations

A1.5 Our considerations remain unchanged from our previous consultations; however, we outline a summary of these below.

A1.6 We consider that a sharing factor would prevent suppliers from recovering their efficiently incurred additional debt-related costs due to COVID-19, which was unforeseen and had an unprecedented impact on some customers' incomes. Given current market conditions, we are also conscious that suppliers' ability to bear a shortfall in relation to additional debt-related costs due to COVID-19 is likely to be lower now than when we initially raised the possibility of a sharing factor in our March 2021 call for input.[69]

[69] Ofgem (2021), Call for input on the true-up process for COVID-19 costs, Page 4. https://www.ofgem.gov.uk/publications/price-cap-call-input-true-process-covid-19-costs

A1.7 We therefore consider that not including a sharing factor, finds the right balance between protecting customers and having regard to the ability of an efficient supplier to finance its licenced activities.[70]

How the cap is adjusted

Context

A1.8 In our February 2021 float decision, we decided to use the existing cap adjustment allowance to set the adjustment for the initial COVID-19 float.

A1.9 The adjustment allowance is included in 'Annex 8 – Adjustment allowance methodology' of SLC 28AD of the electricity and gas supply licences.

Decision

A1.10 We have decided to use the existing cap adjustment allowance ('Annex 8 – Adjustment allowance methodology') to set the COVID-19 true-up in the default tariff cap.[71]

Stakeholder responses

A1.11 No stakeholders commented on this aspect of our May or September 2022 consultation.

Considerations

A1.12 We consider that using the adjustment allowance is the simplest and most flexible method for adjusting the cap for the COVID-19 true-up. We are also not aware of any compelling reason to use any other component of the cap to implement the COVID-19 true-up.

A1.13 It will also ensure that the recovery of the COVID-19 true-up will be consistent with the initial float which was set in 2021.

[70] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6). https://www.legislation.gov.uk/ukpga/2018/21/section/1

[71] We have provided details of our changes to 'Annex 8 – adjustment allowance methodology' in Appendix 4 of this decision.

Allocating costs over the other cap levels

Context

A1.14 We do not have the debt-related cost data broken down by the cap components of either fuel type or meter type. We therefore considered two options:

- Equally allocate across each cap component. This means that we would use the same weighted average figure for each fuel and meter type cap component allowances.
- Allocate costs across cap components based on the estimated revenue per customer in the cap periods we are truing up.

A1.15 In our February 2021 float decision,[72] we decided to adopt an equal allocation across fuel type and electricity meter type. One reason for this was because the data we gathered was not broken down by fuel or meter type.

A1.16 We also considered whether to allocate equally across all customers through the standing charge or allocate it proportionally to consumption through the unit rate. In February 2021, we decided to recover costs between the standing charge and unit rate in the same proportions as total costs that were currently recovered under the cap.

Decision

A1.17 We have decided to adopt equal allocation across fuel and electricity meter types (ie the same pound uplift to each fuel and electricity meter type caps).[73]

A1.18 We have decided to allocate the incremental debt-related costs due to COVID-19 between the standing charge and unit rate in the same proportions as the total costs are currently recovered under the cap.

Stakeholder responses

A1.19 No stakeholders commented on this aspect of our May or September 2022 consultation.

[72] 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
[73] The cap has two fuel type cap levels: one for gas and another for electricity. Within the electricity cap level there are two electricity meter type cap levels: one for single-rate and another for multi-register.

Considerations

Recovery over fuel type

A1.20 We expect that when a customer stops paying, the debt they build up is proportional to their bill (ie how much they should have paid). The level of the cap at typical consumption was higher for electricity than for gas in the periods we are truing-up (cap periods four to seven). Therefore, debt-related costs for electricity could be higher than for gas. However, we could not control for any differences in the propensity to incur debt across fuels, as we did not request for the data to be broken down by fuel type.

A1.21 We consider that equal allocation of costs between fuel types is the simplest approach and would avoid us introducing potentially uncertain assumptions that we cannot evidence.

A1.22 Since most customers are dual fuel, cost allocation between fuels should have a relatively limited impact on individual customers. However, we recognise that suppliers can have variations in their customer bases between fuels.

Recovery over electricity meter type

A1.23 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 is set at a higher level of consumption.

A1.24 Debt-related costs are likely to be proportional to customers' bills. This means that multi-register 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).

A1.25 However, as with fuel types, we consider that equal allocation of costs across single-rate and multi-register electricity meter types will avoid us introducing uncertain assumptions that we cannot evidence, and that may create inaccuracy. We consider that this is the simplest approach, and it will also protect electricity customers on multi-register meters from facing a sharper increase in their bills.

Recovery over the unit rate and standing charge

A1.26 We consider that recovering the COVID-19 true-up costs based on the proportional unit rate and standing charge split at the nearest cap periods[74] to when the costs are recovered. This best reflects a fair way of allocating costs across all customers in the context of the current structure of the cap.

Accounting for the timing difference between costs and the allowance

Context

A1.27 There will be a timing difference between when suppliers incurred costs and when they receive an allowance through the original float and subsequent true-up adjustment.

A1.28 This timing difference may generate costs. For example, working capital costs or costs due to the changes in the price level between when suppliers incurred costs and when they receive an allowance.

Decision

A1.29 We have decided to not account for costs resulting from timing differences between when a cost was incurred and when the allowance is received.

A1.30 We have decided to account for inflation when determining the amount to recover through the adjustment allowance. This is done by uprating using the consumer price index, including owner occupiers' housing costs (the 'CPIH Index'). This approach is also consistent with our simultaneous decision on reflecting the potential changes to Balancing Services Use of System (BSUoS) charges.[75]

Stakeholder responses

A1.31 No stakeholders commented on this aspect of our May or September 2022 consultation.

[74] This means splitting cost recovery between the unit rate and standing charge based on the proportions of the cap at nil and Typical Domestic Consumption Values (TDCV). We do this by taking the average Nil and TDCV rates for the latest two cap periods (cap periods 9a and 9b).
[75] Ofgem (2023), Decision on reflecting changes to BSUoS charges in the price cap. https://www.ofgem.gov.uk/publications/price-cap-decision-reflecting-changes-bsuos-charges-price-cap

Considerations

A1.32 We consider that suppliers will have the tools to manage temporary cashflow issues in the normal course of their business and so we do not see a need to provide a specific allowance for this in the COVID-19 true-up. We also note that the initial float, and subsequent true-up allowance, are uplifted by headroom, VAT and EBIT.[76]

A1.33 We adjust for the change in the inflation rate between the cap periods when the costs were incurred, the cap periods in which the initial float was recovered, and the cap periods in which the costs are trued up.

A1.34 We also consider that accounting for inflation allows us to accurately compare costs that were incurred during COVID-19 and will be recovered from April 2023. We consider that the most appropriate way of doing this is by uprating using the CPIH index, given that this is the inflation measure generally used elsewhere in the cap, eg operating costs allowance.[77]

Accounting for changes in the number of default tariff customers

Context

A1.35 The aggregate number of default tariff customers changes over 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 period in which the costs were incurred. The cap period in which suppliers were able to collect the float, and the cap periods when the final costs are recovered for the true-up.

Decision

A1.36 We have decided to adjust for the change in the aggregate number of default tariff credit customers between the cap periods when the costs were incurred, the cap periods in which the initial float was recovered, and the cap periods in which the costs are trued up. This is to improve the accuracy of the true-up.

[76] This is with the exception of the working capital element of the COVID-19 true-up allowance. We remove the EBIT uplift from it which is discussed in further detail in Chapter 5.
[77] This does not prejudice the use of other inflation measures for specific cap allowances. For example, where we need to forecast future inflation or when the allowance is subject to specific scheme rules.

Stakeholder responses

A1.37 No stakeholders commented on this aspect of our September 2022 consultation.

A1.38 In response to our May 2022 consultation, one supplier said that they supported our proposal to account for changes in the number of default tariff customers.

Considerations

A1.39 We cannot account for the change in each supplier's number of default tariff customers, given that the Act requires that the cap is a single level for all suppliers.[78] This means that we can only calculate an average from the aggregate change in default tariff credit customer numbers.

A1.40 This means there is no way of recovering the correct amount for both customers and all suppliers through a retrospective adjustment. However, we do consider that accounting for the changes in default tariff customer numbers ensures that the adjustment better approximates the costs that suppliers incurred.

Accounting for changes in consumption and energy prices over time

Context

A1.41 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.

A1.42 To calculate incremental debt-related costs, we compare costs during COVID-19 to a relevant baseline, to isolate the impact of COVID-19.

Decision

A1.43 We have decided to account for changes in consumption and energy prices between the baseline and the COVID-19 cap periods by taking an approach that calculates the incremental costs as a percentage of revenue.

A1.44 We have decided to not account for changes in consumption between the COVID-19 cap periods and the cap period we set the allowance for.

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

Stakeholder responses

A1.45 No stakeholders commented on this aspect of our May or September 2022 consultation.

Considerations

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

A1.46 Both consumption and energy prices affect the level of consumer bills, and we would therefore expect changes in them to affect the amount of debt (all else being equal).

A1.47 Domestic consumption levels were impacted by COVID-19. For example, lockdown restrictions kept more people at home, and this resulted in an increase in domestic consumption. The debt-related cost per customer could therefore increase between the baseline and the COVID-19 cap periods due to changes in consumption levels.

A1.48 Similarly, to the extent that retail energy prices had changed between the baseline and the COVID-19 cap periods we are truing-up, this could also affect the debt-related cost per customer.

A1.49 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 control 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

A1.50 We consider that converting the increment percentage to a pounds per customer figure is best achieved by applying the increment to different cap levels at TDCV[79] in the cap periods which we are truing-up. This position is unchanged from our November 2021 consultation.

[79] 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 the COVID-19 periods and the cap period we set the allowance for

A1.51 We noted in our November 2021 consultation that we could 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 was higher during the COVID-19 period for reasons related to temporary restrictions than it is likely to be in future, then suppliers would under-recover.

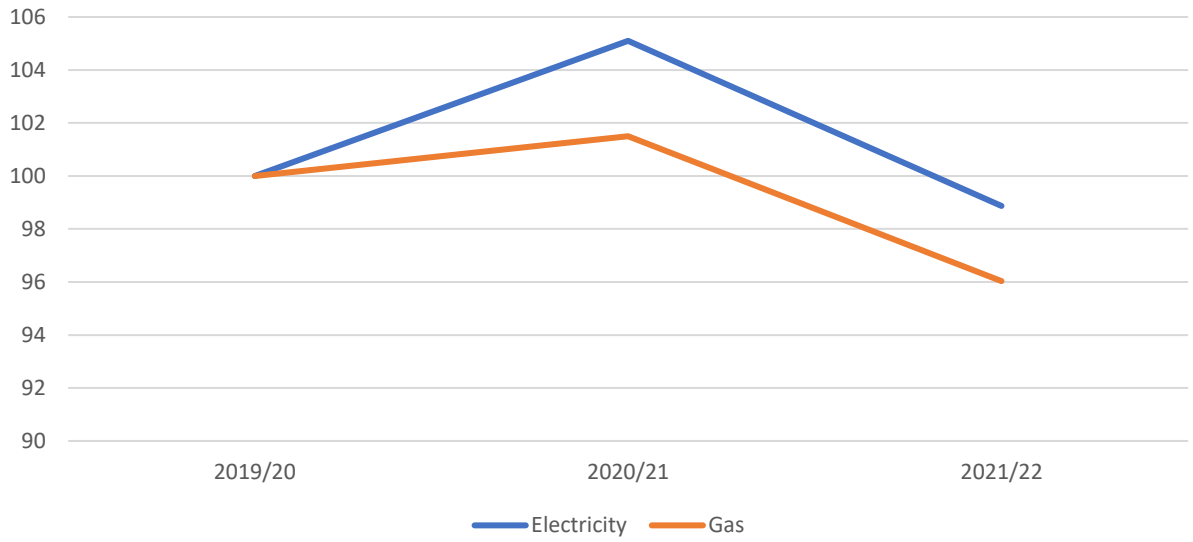
A1.52 BEIS publishes their energy consumption statistics annually in December. We have data up to the beginning of 2022; for electricity the latest data available is February 2021 to January 2022, and for gas it is mid-May 2021 to mid-May 2022.

A1.53 Therefore, we do not have data on the changes in domestic consumption patterns for the full time period between when the costs were incurred (ie April 2020 – March 2022) and when they will be fully recovered (ie April 2023 – March 2024[80]). This means that we do not know how consumption has changed to reflect the current energy prices, the EPG, and hybrid working.

A1.54 We have analysed the data available from BEIS, which suggests that there was not a significant change in energy consumption between 2020/21 and 2021/22 (approx. -6% for electricity, and approx. -6% for gas). The below chart shows the non-material nature of energy consumption changes between 2019/20 to 2021/22.

[80] We would ideally want to use consumption data as close to this future period as possible.

Figure A1.1: Energy consumption change, 2019/20 = 100



This line graph shows the change in Electricity and Gas consumption from 2019/20 to 2021/22. It indicates that energy consumption increased in 2020/21 and then decreased in 2021/22.

A1.55 We were unable to conclude the impact beyond the pandemic,[81] and therefore consider that this data alone is not sufficient to assess how the general levels of consumption have changed between when the cost was incurred and when the allowance will be recovered. We also consider that this could require a wider review of consumption levels used within the cap.

Benchmarking

Context

A1.56 The reason for carrying out benchmarking is to assess an efficient level of additional debt-related costs due to COVID-19, while taking into account that suppliers' costs may also vary for reasons unrelated to efficiency. In our May 2022 consultation, we described how we could set the benchmark at different levels:

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

[81] We considered the COVID-19 impact periods to be cap periods four to seven (April 2020 – March 2022).

- A benchmark at or near to the lower quartile in the cap which is the cost of the supplier that is halfway (in number of suppliers) between the suppliers with the lowest and median (ie midpoint) costs; or
- An average benchmark, such as a weighted average. A separate type of average benchmark would be a median.

A1.57 In our May 2022 consultation, we proposed to use a weighted average benchmark.

Decision

A1.58 We have decided to use a weighted average benchmark to calculate the additional debt-related costs due to COVID-19. We consider that this is an appropriate efficient benchmark given the sudden and unexpected nature of the COVID-19 pandemic.

A1.59 We have decided to benchmark separately among each debt-related cost we are truing up.

Stakeholder responses

A1.60 No stakeholders commented on the choice of benchmark in our May or September 2022 consultation.

A1.61 From our November 2021 consultation, six suppliers supported our proposal to adopt a weighted average benchmark, rather than a lower quartile. This was on the basis that they consider that factors not related to their efficiency eg their customer base, would affect their debt-related costs.

A1.62 One supplier disagreed with our proposal to use a weighted average benchmark rather than a lower quartile, noting that the former could worsen customer detriment.

Considerations

A1.63 Our general considerations remain unchanged from our November 2021 and May 2022 consultations. We have outlined a summary of these considerations below.

Stringency of the benchmark

A1.64 When considering the appropriate stringency of the benchmark, the high-level issue is whether a supplier's debt-related costs are primarily due to its efficiency or factors outside its control.

A1.65 We consider that there are a number of non-efficiency factors that could affect the suppliers' additional debt-related costs. These include:

- Customer base factors.[82]
- Voluntary support from suppliers.[83]
- Baseline period, for example, if a supplier had a high debt-related cost baseline period then this could reduce its incremental costs of COVID-19, making it appear more efficient.
- Natural variations (ie noise).

A1.66 We also consider that suppliers' additional debt-related costs will be affected in part by their level of efficiency. For example, actions that suppliers could control might include:

- setting direct debits at the right level and reviewing them regularly.
- effectively prompting customers paying by standard credit to pay their bills.
- reacting quickly when a customer stops paying.
- encouraging customers in arrears to agree a repayment plan, and collecting debt effectively.
- efficiency in relation to debt could also be influenced by suppliers' general efficiency, including their IT systems and data capabilities.

A1.67 We have decided to adopt a weighted average benchmark to ensure that an efficient supplier can recover these costs. This is primarily due to the unique and exceptional circumstances of COVID-19, which makes it harder than usual to be confident on the link between a supplier's efficiency and its costs.[84]

A1.68 However, this decision is entirely specific to the COVID-19 true-up work on additional debt-related costs, and it does not pre-judge a future benchmarking method used on debt-related costs or elsewhere in the cap.

[82] Suppliers have different customer bases, and COVID-19 has affected customers in different ways. The additional debt-related costs that a supplier faces as a result of COVID-19 could vary by its customer base, not just the level of efficiency. We discuss tariff type and payment method in Chapter 5 of this decision.
[83] Differences in company policy towards providing voluntary support (beyond licence requirements) could lead to a variation in suppliers' costs.
[84] A supplier may have developed an efficient process for normal circumstances, but it might not function as well in the unexpected disruption caused by the pandemic.

Number of benchmarks

A1.69 As discussed earlier, we have decided to include an allowance to true up three different debt-related costs (bad debt costs, debt-related administrative and working capital costs). We have the option between benchmarking these separately or in a combined benchmark across all debt-related costs.

A1.70 There is a trade-off between two risks from these options:

- Benchmarking separately presents a possible risk of understating efficient costs if a benchmark below average costs were adopted. This is because there could be interactions between the debt-related costs. For example, a supplier which reduced its spending on debt-related administrative costs, may potentially increase its working capital costs. This point is not relevant given our decision to use a weighted average benchmark.
- For a supplier to be included in a combined benchmark calculation, they would need to have submitted good quality data for all three debt-related cost data sets. This could result in more suppliers being excluded from a combined benchmark calculation sample, leading the sample to no longer be fully representative of the market. This would present a risk of inaccuracy in determining the efficient cost level.

A1.71 Taking a combined benchmark would result in us excluding five suppliers' debt-related cost data from a sample of eleven. We consider that this would reduce the robustness of our benchmark and that would risk misrepresenting the efficient level of costs. Therefore, we consider that benchmarking separately produces the most robust benchmark by maximising the sample size used.

Appendix 2 – Detailed explanation of the May 2022 consultation methodology

Methodology

A2.1 We have not made changes to the May 2022 consultation methodology since our previous consultation. We have included a summary of this methodology below.

Data requests

A2.2 We issued two RFIs to collect suppliers' debt-related cost data:

- June 2022 RFI:
  - We requested bad debt charge, debt-related administrative cost, revenue and customer account data for cap periods four to seven (April 2020 – March 2022) accompanied by a pre-COVID-19 baseline period.
  - We requested debt-related cost data broken down by payment method. We also requested that suppliers' revenue and customer account data were broken down by payment method and tariff type.
  - We requested that suppliers excluded debt-related cost data relating to SoLRs.
- December 2021 RFI:
  - We requested bad debt charge, debt-related administrative cost, working capital cost[85], revenue and customer account data for cap periods four to six (April 2020 to September 2021) accompanied by a pre-COVID-19 baseline period.
  - We requested all data broken down by payment method and tariff type.

A2.3 Table A2.1 outlines the COVID-19 impact periods and their relevant seasonal baselines.

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

Table A2.1: 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

Additional bad debt charge methodology

A2.4 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.

A2.5 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.

A2.6 We decided to take a cumulative bad debt approach in Chapter 4. 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 provides an incremental bad debt charge per unit of credit revenue for the COVID-19 cap periods.

A2.7 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' at the end of this appendix for this calculation). This is multiplied with the incremental bad debt charge per unit of credit revenue, to provide an incremental bad debt charge (£) per customer account for each COVID-19 cap period.

A2.8 We follow the same process for our calculation of additional debt-related administrative costs. However, the method used to calculate the additional working capital costs is different and is described in the section below.

Additional working capital costs methodology

A2.9 From our December 2021 RFI, we gathered accounts receivables at the beginning and end of each cap period, and revenue across payment and tariff types, for the main COVID-19 cap periods and baseline cap periods.

A2.10 For each supplier, we sum accounts receivables and revenues. The working capital measure we use is half-yearly debtor days matched with the time duration

of cap periods. We input each included supplier's data into the formula below for each main COVID-19 and baseline cap periods. Please note average accounts receivables refer to the simple average at the beginning and end of cap periods.

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

A2.11 To calculate the COVID-19 impact on working capital, we subtract half-yearly debtor days between the main COVID-19 cap periods and their respective seasonal baseline cap periods for each supplier in our sample. This results in an incremental half-yearly debtor days for each supplier across the COVID-19 cap periods.

A2.12 To monetise the cost of financing working capital, we apply a capped credit revenue per customer account assumption per day for each COVID-19 cap period. This is multiplied with the incremental half-yearly debtor days and a cost of financing assumption (10%) for each supplier in our sample.

A2.13 To calculate the weighted average working capital costs per customer account we first calculate the aggregate working capital costs for included suppliers. This is achieved by multiplying included suppliers' incremental working capital costs per customer account with their respective customer accounts across the main COVID-19 cap periods. We then sum the aggregate working capital costs for each COVID-19 cap period to calculate the total aggregate working capital costs for all the COVID-19 cap periods.

A2.14 The weighted average working capital cost per customer account is calculated by dividing the total aggregate working capital costs with the simple average of total customer accounts across the COVID-19 cap periods for suppliers in the sample.

Cap levels workings

A2.15 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.

A2.16 Please note that credit revenues/ customer accounts are defined as the sum of standard credit and direct debit revenues/ customer accounts.

Data input

A2.17 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);[86]
- customer accounts from the domestic customer & tariff RFI; and
- seasonal demand shares, split by fuel type.[87]

A2.18 Before we get to the calculation stage, we calculate the net TDCV value for cap periods four to seven. We subtract the nil consumption value of the cap from the TDCV resulting in a figure which is only the variable component of the cap. This is to allow us to consider the implied unit rate and standing charge separately, given consumption varies seasonally.

A2.19 We also calculate the average customer accounts for cap periods four to seven for each respective payment method, fuel type and meter type.

Calculations

A2.20 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.

A2.21 We calculate the estimated standing charge revenue for each cap period. This is achieved by multiplying the direct debit and standard credit nil rate by 50% since half of the respective standing charge is applied in the winter cap period and half in the summer cap period.

A2.22 We then take the sum of expected direct debit and standard credit unit rate and standing charge revenues per customer account multiplied with their respective credit customer proportions, matched by meter and fuel types for the COVID-19 periods. This provides the weighted average credit capped revenue assumption.

A2.23 Using the same method, with respect to payment method (direct debit & standard credit), we calculate the capped revenue per customer account, which is used in the alternative method calculation (see Appendix 3).

[86] Suppliers are able to recover VAT on bad debt, so it is not a cost and has therefore been excluded from our input.
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
[87] 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

Appendix 3 – Detailed explanation of the alternative methodologies

A3.1 In this appendix we explain the alternative methodologies which we discussed in Chapter 4. These methods use a weighted average approach and then attempt to control for the payment method mix for a specified customer base (default tariff customers and credit customers for the alternative methodology 1 and 2 respectively).

A3.2 We also describe the method to aim down the increment when using the alternative methodology 1 in this appendix.

A3.3 For both alternative methods, we use the same data request which was described in Appendix 2. For cap periods four to seven we requested debt cost information broken down by payment method (direct debit, standard credit, and prepayment meter). We also gathered information on suppliers' revenues and customer accounts broken down by payment method and tariff type (fixed and default tariff).

A3.4 Consistent with the May 2022 consultation methodology, we focus on the same COVID-19 impact periods with their associated baseline periods which is outlined in table A2.1.

Alternative method 1

Default tariff customer revenue split proxy

A3.5 To estimate the percentage of default tariff customers on standard credit and direct debit:

- We aggregate the sample's[88] total revenue from default tariff customers, for both standard credit and direct debit respectively, for each COVID-19 impacted cap period.
- We then calculate the percentage of standard credit and direct debit customers on default tariffs across all COVID-19 impacted cap periods (cap periods four to seven). This is done by dividing the individual standard credit and direct debit revenues associated with default tariffs by the total credit (standard credit + direct debit) revenue associated with default tariffs.

[88] We discuss our sample selection in Appendix 5.

Bad debt charge

A3.6 Firstly, to calculate the weighted average incremental bad debt cost (£) per customer account for default tariff customers, we need to calculate the standard credit and direct debit incremental costs separately.

A3.7 To calculate the incremental standard credit and direct debit bad debt cost (£) per customer account for our sample, we have followed the steps below for standard credit and direct debit separately:

- We aggregate bad debt charge for the given payment method, for each baseline and COVID-19 impacted cap period, which includes PPM bad debt.[89]
- We aggregate the associated revenue across included suppliers (matched by payment method[90]), 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 period (see table A2.1).
- 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[91] 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.

A3.8 We sum the product of the total standard credit and direct debit incremental bad debt charge (£) per customer account multiplied with its respective payment

[89] We assign 100% of debt which suppliers allocated to the PPM payment method to standard credit. See Chapter 5 for our discussion on PPM apportionment.
[90] We do not include PPM revenue in the calculation given the allowance will be recovered over credit customers only.
[91] Paragraphs A2.15-A2.23.

method default tariff revenue split (as calculated in default tariff customer revenue split proxy). We include an illustrative example and formula at the end of this appendix.

A3.9 The step above results in the weighted average total incremental bad debt charge (£) per customer account.

Downward adjustment to the alternative method 1 bad debt charge increment

A3.10 To estimate the level of inaccuracy using the alternative method 1, we consider two different methods that could be used as an estimator of accuracy of the alternative method's level of accuracy.

- Alternative method 1;
- Bad debt charge broken down by tariff type.

A3.11 Three suppliers were, however, able to provide bad debt charge broken down by tariff type. Therefore, we can calculate the bad debt increment using both methods for this smaller sample of suppliers, and then compare the difference.

A3.12 This incremental difference can be used for two purposes. Firstly, it can be used to determine the approximate materiality of inaccuracy between the alternative method 1 and the method using the bad debt charge split by tariff type (which the alternative method 1's use of proxy is attempting to predict). Secondly, we can use the difference between the two methods to adjust the alternative method 1 (with the full sample of suppliers) upwards or downwards to account for any inaccuracy.

A3.13 The table below shows the bad debt charge for both methods in our smaller sample. The increment using the alternative method 1 is 6% higher than the increment using the tariff type method, with the implication being that the alternative method 1 calculates the bad debt charge increments 6% too high. We discuss in Chapter 4 further details about how we use this figure to aim-down the alternative method 1 incremental cost to account for inaccuracies.

A3.14 We did also receive an additional response from the supplier who initially suggested that we look into making a conservative aim-down adjustment. In their additional response, it suggested that we reallocate 10% of the standard credit debt to direct debit and it viewed this as an 'appropriately conservative' assumption that would favour customers.

A3.15 Although this supplier suggested that movement of customers from direct debit to standard credit as a percentage of standard credit hovered around 10%, this evidence is only from one supplier. The original aim-down method firstly includes

a larger sample, but further it compares the whole method, rather than just one aspect of it (payment method allocation). For example, there could be a degree of inaccuracy in the use of revenue as a proxy. We therefore consider that the downward adjustment method is a more appropriate approach to account for method inaccuracies than reallocating debt.

Table A3.1: Comparison of Alternative method 1 and tariff type method

	Bad debt charge increment	**Difference factor**
Tariff Type method	£30.19	
Alternative method 1	£32.09	+6%

N.B: both calculations are using the same sample of three suppliers who were able to provide tariff type data for cap periods four to six in the December 2021 RFI.[92]

All figures are £ per typical DF credit customer, and not net of the original float.

Working capital costs

A3.16 To calculate the additional working capital costs due to COVID-19 we used the method described in the additional working capital costs methodology section of Appendix 2 but separated out costs to calculate the additional working capital costs for both direct debit and standard credit. This included apportioning all PPM working capital costs to standard credit (consistent with our approach for the bad debt charge calculation).

A3.17 We followed the same process as described in calculating the bad debt charge alternative method 1 for the specific working capital cost sample using data from the December 2021 RFI.

A3.18 We estimated the percentage of default tariff customers on direct debit and standard credit using our working capital sample (rather than the sample used in the bad debt charge calculation).

Alternative method 2

Credit customer revenue split proxy

A3.19 To estimate the percentage of credit (standard credit + direct debit) customers on standard credit and direct debit:

[92] We did not request the bad debt charge split by tariff type in the June 2022 RFI. This means that for both calculations we rely on data from the December 2021 RFI.

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

Bad debt charge

A3.20 We follow steps outlined in paragraphs A3.5 and A3.6 from alternative method 1 in this appendix. This will provide a £ per direct debit customer and £ per standard credit customer, across our COVID-19 impacted cap periods.

A3.21 We multiply and sum the product of the total standard credit and direct debit 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 cost (£) per customer account.

Illustrative example

A3.22 Equations A3.1 and A3.2 display a simplified version of how we have calculated the weighted average bad debt cost for both alternative methods 1 and 2. For example, alternative method 1 in Equation A3.1 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.

A3.23 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

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

A3.24 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 debit.
- RS = Revenue split.[93]
- A1 and A2 are both the terms for alternative methods 1 and 2.

[93] NB: $RS_{SC} + RS_{DD} = 1$

Appendix 4 – Annex 8: detailed model explanations

Model modifications

A4.1 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).

A4.2 A revised version of Annex 8 has also been published alongside this decision.

A4.3 The key amendment to this version of Annex 8 is that we have decided to recover the COVID-19 true-up allowance over 12 months.[94] In our September 2022 consultation, we had proposed to recover any allowance over 9 months only given the cap was at the time due to expire at the end of 2023. This amendment has simplified the model, since we no longer need to make assumptions for weighting the specified costs by time and demand.[95]

Tab '1a Adjustment Allowance'

A4.4 We have extended our tab '1a Adjustment Allowance' tab to cover the COVID-19 true-up recovery period. This is using a quarterly approach from winter 2022/23 until cap period 11b (January 2024 – March 2024). We have recently consulted on extending the cap models.[96]

A4.5 Cells AD13:AG264: We have updated the cells such that it draws in the COVID-19 true-up allowance for each fuel, charge restriction region, benchmark metering arrangement, payment method and 28AD charge restriction period from cells F343:I354 in tab '2e COVID-19 true-up'

Tab '2e COVID true-up adjustment'

A4.6 This tab sets out the input value and our calculations to convert the weighted average increment into an allowance figure.

A4.7 Cells F10:I33, F36:I59, F62:I85 in section 1: added to input the true-up increment for each debt-related cost (bad debt, debt-related administrative cost, and working capital) from our analysis of supplier data in the true-up model.

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[94] We describe our reasoning for this change in the 'Timing of recovery' section in Appendix 1.
[95] The cap is set in annual terms, which meant that when we proposed to recover the allowance over 9 months, then we would have to uplift the allowance to account for timing and demand weights.
[96] Ofgem (2023), Price Cap – Removal of the cap end date from licence conditions. https://www.ofgem.gov.uk/publications/price-cap-removal-cap-end-date-licence-conditions

A4.8 Cells C91:C92 in section 2: New table which draws the EBIT margin percentage from the default tariff cap model. This is used to remove the EBIT uplift.

A4.9 Cells F96:I119 in section 2: New table which removes the EBIT uplift and from the final additional COVID-19 working capital costs.

A4.10 Cells F125:I148 in section 3: New table which sums up the bad debt, debt-related administrative costs and working capital (with EBIT uplift removed), to give the final additional COVID-19 working capital cost in cap periods 10a-11b.

A4.11 Cells F154:F157 in section 4: input table which draws the relative proportion of customers in cap periods four, five, six and seven compared to the cap period the float was recovered in (cap periods six and seven), from tab '3k CPIH & attrition'. This is used to account for the under/over recoveries caused by the change in customers between when the cost was calculated and when the float was recovered.

A4.12 Cells F162:F185 in section 4: multiplies the costs that were recovered under the float by their relative customer account proportions (matched by the cap period of cost origin) from cells F154:157.

A4.13 Cells F192:F195 in section 5: draws the proportion of customers in cap periods four, five, six and seven compared to cap period four, from tab '3k CPIH & attrition'. These values are used to convert all cost increments net of the float into cap period four prices and customers' accounts, so that we can convert them into the latest prices and customers later on in this sheet.

A4.14 Cells F201:I224 in section 5: calculates the allowance net the float (difference between section 3 and section 4) and multiplies the net allowance with the factors from cells F192:F195 to convert into cap period four prices and customer numbers.

A4.15 Cell F231 in section 6: inputs a multiplier from tab '3k CPIH & Attrition' to convert the net allowances at cap period four prices and customer numbers into cap period current prices and customer numbers.

A4.16 Cells F237:I260 in section 6: multiplies the net allowances at cap period four prices and customer numbers with the multiplier in cell F231 to convert into cap period current prices and customer numbers.

A4.17 Cells C267:D268 and cells C271:D272 in section 7: inputs the cap period 9a and 9b cap level, Nil and TDCV consumption from tab '3f Cap Levels'.

A4.18 Cell C283 in section 7: calculates the average Nil level of the cap as a proportion of TDCV for cap period 9a and 9b.

A4.19 Cells F288:I311 and cells F314:I337 in section 7: calculates the Nil and TDCV consumption for the COVID-19 true-up allowance.

A4.20 We have removed the weighting by time and demand section in our previous draft Annex 8 model. This is because we have decided to recover the allowance over 12 months only, so we do not need to uplift the allowance anymore to account for timing/ demand differences.[97]

A4.21 Cells F343:I354 in section 8: sums the adjustment values across the cap periods of cost. This gives us the total allowance per cap parameter for each period where we are setting an allowance split by fuel, payment method and benchmark annual consumption.

Tab '3e CPIH'

A4.22 Cells C306:C315 – we have updated the consumer price index including owner occupiers' housing costs (CPIH) inputs using the CPIH time series dataset release from the Office for National Statistics (ONS).

Tab '3f Cap levels'

A4.23 Cells C15:D16 – New row inputs for electricity direct debit cap period 9a and 9b TDCV[98] and Nil rate of consumption cost from the default tariff cap.

A4.24 Cells C27:D28 – New row inputs for gas direct debit cap period 9a and 9b TDCV and Nil rate of consumption cost from the default tariff cap.

A4.25 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 Additional COVID-19 costs'

A4.26 New tab created to show our analysis of supplier RFI as an input.

A4.27 Cells E7:H30, E33:H56, E59:H82: new tables created to show the final additional COVID-19 bad debt, debt-related administrative and working capital costs in cap periods four-seven, for each cap period (10a-11b) nominal prices.

[97] Please see our reasoning behind this in the 'timing of the true-up' section in Appendix 1.
[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.

Tab '3k CPIH & Attrition'

A4.28 This tab calculates 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.

A4.29 Cells B11:H11: inputs CPIH values from '3e CPIH' for cap periods four to ten.

A4.30 Cells B13:H13: calculates the ratio between cap nine/ten prices and the cap period prices for each column.

A4.31 Cells B14:H14: calculates the ratio between cap four prices and the cap period prices for each cap period.

A4.32 Cells B23:B26: contains the proportion of customers in cap periods four, five, six and seven relative to cap period four.

A4.33 Cells B38:B41 calculates 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 would be apportioned over fewer customers than recovered over).

A4.34 Cell B40 is hard coded to one since the cap period six float was recovered over cap period six only, so the period of cost origin was the same as the recovery period. Cell B41 is also hard coded to one, since there was no float or recovery period for costs incurred in cap period seven.

A4.35 Cells B46:B49: formula calculates multipliers which converts cap period four, five, six, and seven, cost increments into cap period four customer accounts and prices. The formula multiplies cells B14:H14 (CPIH inflation for cap periods four – seven relative to cap period four) and cells B23:B26 (customer account proportions for cap periods four – seven relative to cap period four).

A4.36 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.

A4.37 Cell B58: calculates the implied factor to adjust cap period four customer numbers to cap period nine/ ten.

A4.38 Cell B63: 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.

A4.39 We have updated attrition numbers in this tab since our previous consultation to account for the updated October 2022 Customer Account & Tariff RFI. We have also removed PPM customers from our attrition calculation since the allowance will only be recovered over credit customers.

Appendix 5 – Inclusion and exclusion criteria of our sample

A5.1 In our sample, we have checked data consistency and removed any suppliers' data if they were not representing reasonable estimates or not comparable between the baseline and the cap period assessed or with other suppliers in the sample that we used to benchmark costs.

A5.2 We issued two mandatory RFI to supplies with at least 1% market share in any fuel in the domestic market segment to gather data on debt-related costs. We collected data from eleven suppliers.

A5.3 We break 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 customers represented in our sample for each debt-related cost[99]

Cap period	**Bad debt charge**	**Debt-related administrative costs**	**Working capital**
Number of suppliers included in our sample	9	8	7
Percentage of credit customers included	97%	92%	80%

Exclusion criteria

A5.4 We consider the additional filters below to scrutinise whether the assumptions underpinning suppliers' costs are 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

[99] To calculate this, we used the April-22 Customer Account & Tariff RFI.

- comparability of suppliers' submitted debt-related costs with other suppliers.

A5.5 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.

A5.6 We have highlighted suppliers' general data quality, consistency, and comparability concerns in each of the debt-related costs sections below.

A5.7 Where we have been unsure on the consistency of supplier data, we have engaged with them. This includes asking suppliers specific questions about their data, assumptions over email and calls.

Bad debt charge

A5.8 We have included nine suppliers out of a possible eleven. This reflects 97% of the domestic credit energy market in terms of customers.

A5.9 We excluded one supplier as it did not provide a complete response to our RFI.

A5.10 We excluded one supplier due to the lack of comparability between the suppliers' bad debt charge with other suppliers' due to the composition of their customer base being PPM heavy.

A5.11 One supplier did not support our exclusion of a PPM specialisation from our calculations. It said if we had intended on excluding this PPM specialist from the offset, then we should not have required it to respond to our mandatory RFI.

A5.12 At the time of our data requests, we had not decided on our exclusion criteria or overall policy decisions, and we gathered the data in this case to give us the flexibility to make different inclusion decisions.

Debt-related administrative cost

A5.13 We have included eight suppliers out of a possible eleven. This reflects 92% of the domestic credit energy market in terms of customers.

A5.14 We have excluded one supplier due to the lack of comparability between the suppliers' debt-related administrative costs with other suppliers' due to the composition of their customer base being PPM heavy.

A5.15 We have excluded one supplier as it did not provide a complete response to our RFI.

A5.16 We have excluded one supplier due to their inability to provide data for the baseline cap periods which severely impacts the comparability and completeness of the data. This prevented us from being able to determine how its debt-related administrative costs changed due to COVID-19.

Working capital cost

A5.17 We have included seven suppliers out of a possible eleven. This reflects 80% of the domestic credit energy market in terms of customers.

A5.18 We have excluded one supplier due to the lack of comparability between the suppliers' working capital costs, with other suppliers' due to the composition of their customer base being PPM heavy.

A5.19 We have excluded one supplier as it did not provide a complete response to our RFI.

A5.20 We have excluded one supplier as it was not able to separate credit balances against unbilled balances which inflates the debtor days calculations. This makes their data less comparable to other suppliers in the sample. This supplier's debtor days increment was therefore high due to an acquisition, and we removed them as we were not able to isolate change in debtor days due to COVID-19.

A5.21 We have excluded one supplier as we are not confident in their submitted data on comparability concerns.