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Consultation

Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation

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Response deadline:	12 October 2020	**Email:**	RetailPriceRegulation@ofgem.gov.uk

We are consulting on whether and how to update the default tariff cap methodology to account for the impact of COVID-19 on the efficient costs of supplying domestic default tariff customers. We would like views from people with an interest in the level of the default tariff cap. We particularly welcome responses from suppliers and consumer groups. We would also welcome responses from other stakeholders and the public.

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

Contents

Executive summary

The default tariff cap ("the cap") protects default tariff customers by limiting the amount they can be charged for their gas and electricity. We set the level of the cap to reflect the cost to suppliers of supplying this energy. However, the COVID-19 pandemic has potentially changed these costs in a way that wouldn't be accounted for in the existing cap methodology. We are therefore undertaking a review to assess whether COVID-19 has materially impacted suppliers' costs, and if so, how we might adjust the cap methodology.

The impact of coronavirus (COVID-19)

The coronavirus pandemic, and the measures put in place to limit its impact, have significantly affected the energy industry. Non-domestic demand has reduced as a result of businesses closing, which has contributed to a fall in wholesale prices. Workers have been laid off, furloughed, or are working from home, increasing domestic energy use. Some customers are struggling to pay their bills. These impacts could increase over winter, as furlough ends, and consumers use more energy.

The cap already allows for a degree of uncertainty, and accommodates certain types of cost change. However COVID-19 is an unforeseen and unprecedented event.

Accounting for COVID-19 in the cap

We are considering each component of the cap to identify potential changes in costs resulting from the impact of COVID-19 versus what has already been allowed for in the cap.

The impacts of COVID-19 could cause both increases and decreases in cost. Debt-related costs are likely to increase if customers are less able to pay. Other costs may have decreased, for example where suppliers have utilised the furlough scheme.

Our initial view is that the only material costs we might need to adjust for are additional debt-related costs. While we have identified other potential impacts, our initial view is that they are either allowed for through the existing methodology, or are not material enough to require adjustment. We propose to make any adjustment using the existing Adjustment Allowance.

There are several challenges to making any adjustment. First, these costs can take a long-time to fully realise and may persist over time. We propose to account for this either by setting an allowance ex-post, or using an initial estimate of these costs and subsequently

adjusting this value to reflect actual costs incurred once they are known. Second, we have to set a single cap level and so, when calculating an efficient benchmark of cost impacts, it will not reflect the different costs individual suppliers will have experienced. When assessing this efficient baseline, we will need to account for the level of costs already included in the cap and also differentiate what cost changes are as a result of COVID-19.

The objective of the Domestic Gas and Electricity (Tariff Cap) Act 2018 ("the Act") is that we protect default customers, so we propose to err on the side of caution when making any estimate of cost increases to avoid customers bearing the risk of the cost uncertainty.

In the cap, the majority of debt-related costs are accounted for in the payment method uplift for standard credit customers. This reflects the additional costs to serve these customers. However, we do not consider it appropriate to account for debt-related costs as a result of COVID-19 in the same way. Suppliers recover the costs of people not paying their bills from people that are paying their bills. In that sense the costs are always socialised across customers that did not cause the problem. In addition, customers may have cancelled direct debits and transferred to standard credit. We therefore propose to recover any adjustment for debt-related costs from all default credit customers.

COVID-19 impacts on serving prepayment customers

While PPM customers have been protected by the CMA's PPM cap during COVID-19, the PPM cap ends at the end of December 2020. From 1 January default PPM customers will be protected by a PPM level in the default tariff cap. Our initial view is that we should consider the impacts of COVID-19 during this transition period (and beyond) in the default tariff cap. We also recognise that potential cost changes due to COVID-19 when supplying prepayment PPM customers are different to those for supplying credit meter customers. Our initial view is that there are no material impacts that would warrant an adjustment to the cap.

Going forwards

It is likely that the impacts of COVID-19 will continue to evolve for some time and so we intend to do at least one further review of its impacts on the cap.

We invite stakeholder views and supporting evidence on any aspect of this consultation by 12 **October 2020**. Stakeholders' responses will inform a further consultation on our substantive proposals, which we intend to publish in November 2020.

1. Introduction

What are we consulting on?

1.1. This consultation sets out our initial thinking on how the COVID-19 crisis might have impacted suppliers' costs, whether we should adjust the default tariff cap ("the cap"), and if so, how.

1.2. This document is split into seven chapters:

- Chapter 1: this consultation, and background;
- Chapter 2: key overarching considerations;
- Chapter 3: cross-cutting methodological considerations;
- Chapter 4: debt-related costs for credit meter customers;
- Chapter 5: issues specific to prepayment meter customers;
- Chapter 6: policy costs;
- Chapter 7: other costs.

The default tariff cap ("the cap")

The cap

1.3. We introduced the cap on 1 January 2019, protecting over 11 million customers on standard variable and default tariffs (which we refer to collectively as "default tariffs"). The cap ensures default tariff customers pay a fair price for the energy they consume, reflecting its underlying costs.

The Domestic Gas and Electricity (Tariff Cap) Act 2018 ("the Act")

1.4. We set the cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act 2018 ("the Act"). The objective of the Act is to protect current and future default tariff

customers. We consider protecting customers to mean that prices reflect underlying efficient costs. In doing so, we must have regard to four matters:[1]

- the need to create incentives for holders of supply licences to improve their efficiency;
- the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- the need to maintain incentives for domestic customers to switch to different domestic supply contracts; and
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

1.5. The cap comprises several allowances, each relating to different costs categories. We update the level of each allowance every six months, to reflect changes in the underlying costs. The Act requires that we set one cap level for all suppliers.[2]

The impact of coronavirus (COVID-19)

1.6. The coronavirus pandemic, and the measures put in place to limit its impact, have significantly affected the energy industry. Businesses have closed, some permanently, reducing non-domestic demand[3] and contributing to a fall in wholesale prices. Workers have been laid off, placed on furlough, or are working from home, increasing domestic energy use.[4] Some customers are struggling to pay their bills. Social distancing has reduced field activities including visits to customers' homes.

[1] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6). http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[2] Domestic Gas and Electricity (Tariff Cap) Act 2018; section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[3] Initial outturn demand was down 19% in April and May 2020 compared to April and May 2019, based on Electricity System Operator demand data. https://demandforecast.nationalgrid.com/efs_demand_forecast/faces/DataExplorer https://www.elexon.co.uk/article/elexon-insight-update-on-demand-reduction-during-covid-19-lockdown/
[4] Some suppliers have told us that domestic demand has increased. Initial indicative Elexon data also

1.7. Ofgem has been working with Government throughout the crisis and has implemented several measures to help industry and consumers manage the impacts. We have reprioritised our forward work programme to allow the industry to focus on their critical operations to keep consumers and staff safe.[5] We have implemented several time-limited measures including working with network companies to give some suppliers the opportunity to defer some network charges, to help suppliers manage the impacts of COVID-19.

1.8. The cap has a headroom allowance and other allowances that incorporate a degree of uncertainty, and adjustment mechanisms to manage certain types of cost change. However we could not reasonably expect suppliers to have anticipated and prepared for an event of this scale. Stakeholders have indicated that the financial impacts of COVID-19 on their businesses are likely to be material and so may require an adjustment to the cap.

Assessing the impact of COVID-19 on the cap

1.9. We are considering each component of the cap to identify potential changes in costs of supplying default tariff customers resulting from the impact of COVID-19. As part of this, we have taken into account the materials provided to us by industry stakeholders since March 2020 regarding the potential impacts of COVID-19, as well as our own judgement and other sources of information.

Related publications

1.10. The main documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018: http://www.legislation.gov.uk/ukpga/2018/21/contents/enacted;

suggests there has been a slight increase in domestic demand in Q2 2020 compared to Q2 2019.

[5] Ofgem (2020), information for energy licensees on coronavirus (COVID-19) response - 30 June update https://www.ofgem.gov.uk/publications-and-updates/ofgem-information-energy-licensees-coronavirus-covid-19-response-30-june-update

- The Default Tariff Cap Decision: https://www.ofgem.gov.uk/publications-andupdates/default-tariff-cap-decision-overview.

1.11. The main documents relating to Ofgem's response on COVID-19 to date are:

- Impact of COVID-19 on retail energy supply companies – regulatory expectations from 1 July 2020: https://www.ofgem.gov.uk/system/files/docs/2020/06/update_on_regulatory_flexibility_framework_for_suppliers_0.pdf;

- Open letter on relaxing network charge payment terms: https://www.ofgem.gov.uk/system/files/docs/2020/06/open_letter_on_relaxing_network_charge_payment_terms_1.pdf;

- Connection and Use of System Code (CUSC) CMP350: Changes to the BSUoS Covid Support Scheme: https://www.ofgem.gov.uk/ofgem-publications/165770.

1.12. BEIS' decision on contracts for difference payments due to COVID-19 is also relevant:

- Government response to consultation on proposed changes to the ESO Regulations in response to COVID-19: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/890134/cfd-proposed-changes-electricity-supplier-obligation-regs-government-response.pdf.

Consultation stages

Initial consultation

1.13. This consultation sets out our initial thinking. We invite stakeholders to submit comments on any aspect of this consultation on or before **12 October 2020**.

1.14. We do not, as a matter of style, ask questions about each aspect of our proposals. We present our proposals where we have them, and the options we are considering (including the thinking behind them). We request that stakeholders structure their responses by chapter of this document. We have highlighted areas where we consider stakeholder views to be particularly valuable, but seek comments and evidence on any and all aspects of this consultation.

1.15. **We invite stakeholders to comment on the contents of this consultation, providing their views and evidence as appropriate**. Please send your response to RetailPriceRegulation@ofgem.gov.uk.

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

Statutory consultation

1.17. Subject to the responses we receive and the continuing development of the impact of COVID-19 on the industry, we intend to publish a statutory consultation[6] in November 2020. We expect this consultation to last around four weeks.

Decision

1.18. We seek to publish a decision **at the end of January 2021**, so that any changes will have effect from 1 April 2021 (the sixth cap period).

Your response, data and confidentiality

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

1.20. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which

[6] A statutory consultation will only be required if we decide to modify the licence. If we use the existing Adjustment Allowance a licence change will not be required, and so this will be a consultation. For simplicity, we refer to our proposed next consultation publication as a statutory consultation throughout this document.

parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.21. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 2.

1.22. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

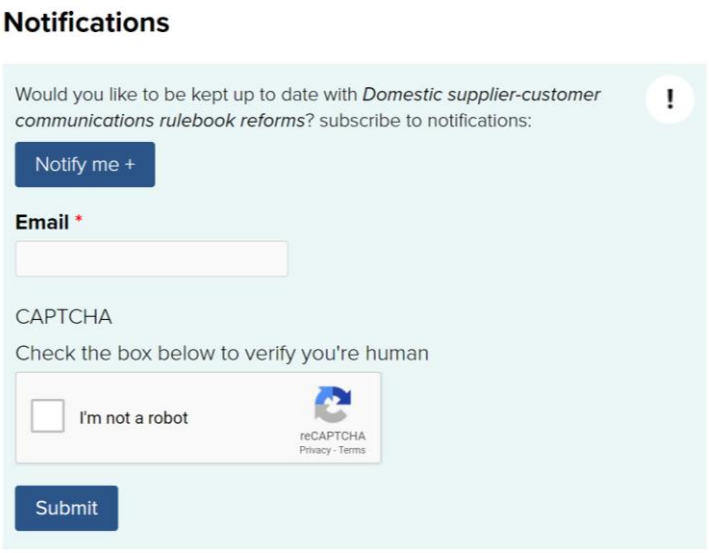
1.23. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

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

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. Ofgem.gov.uk/consultations.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2. Overarching considerations

This chapter sets out the scope of this review, our initial views on whether and how COVID-19 impacts the costs covered by the cap, and how we propose to adjust the cap in the event that an adjustment is required

We seek stakeholders' views on our considerations in general.

2.1. We consider the scope of this review should be limited to efficient COVID-19-related costs incurred supplying domestic default tariff customers; that most of the impacts of COVID-19 with the important exception of debt-related costs are largely addressed within the existing cap methodology; and that we will assess COVID-19 related costs of supplying prepayment meter (PPM) customers on default tariffs in our review.

Costs in scope of this review

Costs of supplying domestic default tariff customers

2.2. The cap is designed to protect customers on default tariffs, by reflecting the efficient cost to supply those customers. This means this review should consider how COVID-19 impacts these costs. The exception to this is non-pass through smart metering costs, which are subject to a separate review process.[7]

Domestic customers with fixed tariffs and non-domestic customers

2.3. Although suppliers will have incurred COVID-19 related costs of supplying fixed tariff and non-domestic customers, we are not considering these costs here. These costs are not relevant[8,9] to the efficient cost of supplying domestic default tariff customers, and

[7] Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision: https://www.ofgem.gov.uk/publications-and-updates/decision-reviewing-smart-metering-costs-default-tariff-cap

[8] Where changes in other customers' activity impacts default tariff customer costs, it is relevant and we consider it here. This principally impacts policy costs, discussed in Chapter 6.

[9] We discuss accounting for customers who transfer between different tariffs in Chapter 4, as this is an issue specific to debt-related costs.

it would not protect default tariff customers to bear the costs of other customer groups.

Principles of the impact of COVID-19 on costs

2.4. Our initial view is that COVID-19 related cost adjustments can be placed 'on top' of the existing cap level, rather than amending individual cap allowance methodologies. We are also proposing, consistent with our previous decisions, to only make changes where there are clear and material systematic impacts of COVID-19 on the costs of supplying default tariff customers that are not appropriately accounted for by the existing cap methodology.

How to consider COVID-19 related cost adjustments

2.5. COVID-19 is expected to be a one-off shock that could have long-lasting economic impacts. Our initial view is that the underlying cap methodology is still appropriate, and that we should consider the impacts of COVID-19 separately to the existing allowances, i.e. on-top of the existing cap level, rather than creating or removing entirely new categories of cost or fundamentally changing the structure of specific costs.

Clear and material systematic impacts of COVID-19 on the cap

2.6. In our November 2018 decision we stated:

"…if in the future we consider there are material systematic issues that require correction, we might modify the licence. This would allow us to make any changes required to correct how the cap was updated, if it systematically and materially departed from an efficient level of costs…..The type of specific systematic errors for which we would adjust the cap would need to be unforeseen, clear, material, and necessitate changes."[10]

[10] Ofgem (2018), Default Tariff Cap decision – Overview, paragraphs 3.14 and 3.17 https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document_0.pdf

2.7. We also set out that we would not include a mechanism in the cap for correcting previous forecast errors, noting that in the long run non-systematic forecast errors should net out, and that suppliers already manage short term forecast risk.[11]

2.8. In subsequent publications[12] we explained that we will conduct reviews where we consider there to be clear and material systematic errors in the cap level. We expect suppliers to manage ordinary variations in actual costs from forecast, which can both increase and decrease costs compared to the allowance.

2.9. We consider this an appropriate standard for assessing the impact of COVID-19. Consequently, whilst we have sought to identify each impact of COVID-19 on supplying default tariff customers, we intend to adjust the cap level only for those costs which would result in a clear and material systematic difference between the cap level and the efficient costs incurred.

Initial view on the impact of COVID-19 on costs

2.10. We are considering all cost components of the cap, and the potential impact of COVID-19 on each. Our initial view is that only debt-related costs are materially impacted. Our initial judgement takes into account the materials provided to us by industry stakeholders since March 2020 regarding the potential impacts of COVID-19, as well as our own judgement and other sources of information.

2.11. The question is not whether COVID-19 has changed any costs, it likely has. Some costs have increased, whilst others have decreased. The question is whether the existing cap methodology sufficiently accounts for these changes. Some changes will be automatically incorporated through the routine 'mechanistic' cap updates every 6 months. Small changes (increasing and/or decreasing efficient costs) could be covered by existing uncertainty allowances and prudent assumptions in the cap methodology.

[11] Ibid, paragraph 3.17
[12] For example in our August 2020 Decision – Reviewing smart metering costs in the default tariff cap, paragraph 5.6 we stated that "We will continue to consider reviews for systematic errors which are unforeseen, clear, material and which necessitate change in the default tariff cap". https://www.ofgem.gov.uk/system/files/docs/2020/08/reviewing_smart_metering_costs_in_the_default_tariff_cap_-_august_2020_decision.pdf

Other COVID-19 impacts may have materially and systematically changed costs compared to the allowance, and we should adjust the cap accordingly.

2.12. Our initial view is that only debt-related costs have changed sufficiently due to COVID-19 (either as a one-off or on an ongoing basis) that not changing the cap would result in a clear and material systematic departure from efficient costs.

2.13. Table 2.1 summarises the cost changes we have identified so far, and signposts where they are discussed in this document.

Table 2.1: summary of impacts of any COVID-19 related costs versus the cap methodology and allowance

Cap component	Description of potential efficient cost changes due to COVID-19	Direction of cost change	Provisional view on if existing methodology sufficient	Detailed discussion location
Wholesale costs	Increased Gross Margin from purchasing additional energy to meet increased COVID-19-related domestic demand during cap period four at a lower wholesale price than allowed for in the cap.	Decrease	Yes	Chapter 7
	Cost changes in both directions from forecasting and losses	Mixed	Yes	Chapter 7
	Capacity market allowance may exceed default tariff customer costs in cap period 4 if domestic demand increases. Future impact depends on change in domestic demand in winter peak relative to revised forecasts.	Decrease	Yes	Chapter 7
Policy costs	Reduced non-domestic demand increases costs of FITs	Increase	No, but the changes already proposed would be sufficient	Chapter 6
	Reduced non-domestic demand increases costs of CfD	Increase	Yes	Chapter 6
	Increased domestic demand decreases cost/MWh of ECO; sunk costs of reduced installations.	Mixed	Yes	Chapter 6
Network costs	Increase in BSUoS costs	Increase	Yes	Chapter 7

Cap component	Description of potential efficient cost changes due to COVID-19	Direction of cost change	Provisional view on if existing methodology sufficient	Detailed discussion location
Operating costs	Increased debt-related costs	Increase	No	Chapter 4
	Reduced cost of staff wages through furlough scheme Reduced acquisition and marketing costs Reduced inbound contacts Reduced meter reading costs	Decrease	Yes	Chapter 7
	Increased back office costs from more estimated bills Increased costs of mobilising a remote workforce	Increase	Yes	Chapter 7
Smart costs	Sunk costs from planned installs which have been delayed/halted due to COVID-19	Increase	No	Addressed in separate SMNCC review[13]
Payment method uplift	Increased debt-related costs	Increase	No	Chapter 4
Headroom	Cost of supplier failure, if COVID-19 results in more domestic suppliers exiting via Supplier of Last Resort (SOLR), and if this increases costs to suppliers with default tariff customers.	Increase	Yes	Chapter 7
Earnings Before interest and Tax (EBIT)	Increase in working capital required due to increased late repayment	Increase	No	Chapter 4
VAT	N/A – fixed percentage increase on revenue included in the cap. Where a customer does not pay, suppliers can claim bad debt relief on the VAT due.	N/A	N/A	N/A

[13] Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision https://www.ofgem.gov.uk/system/files/docs/2020/08/reviewing_smart_metering_costs_in_the_default_tariff_cap_-_august_2020_decision.pdf

Costs arising from prepayment meter customers

2.14. The majority of customers with PPMs will be protected by the default tariff cap from 1 January 2021 (when the current PPM cap expires). As such, any variation due to COVID-19 from the costs included in the default tariff cap allowances only applies from 1 January 2021. However we recognise that the specific circumstance of an unexpected shock during the transition period when the Competition and Markets Authority's cap will soon end is unique, and that we have previously committed[14] to considering the impacts of COVID-19 on customers covered by the default tariff cap, which will include PPM customers. We also recognise that potential cost changes due to COVID-19 when supplying PPM customers are different to those for supplying credit meter customers. We consider this in Chapter 5.

[14] Ofgem (2020), Open letter on relaxing network charge payment terms, June 2020, page 5 https://www.ofgem.gov.uk/system/files/docs/2020/06/open_letter_on_relaxing_network_charge_payment_terms_1.pdf

3. Cross-cutting considerations

In this chapter we set out our initial view on the timing of reviews and adjustments to the price cap, who the adjustments apply to, and how we may adjust the cap.

We seek stakeholders' views on our considerations in general.

3.1. This consultation forms part of our initial review into the impacts of COVID-19, and we will implement our findings for the April 2021 cap period. We are proposing to conduct one or more subsequent reviews to look at the ongoing effects and assess actual data. We are also proposing to use a mixture of methods to reflect any cost adjustments that are necessary. We propose to make these adjustments using the Adjustment Allowance (AA).

3.2. As set out in Chapter 2, our initial view is that we would only need an adjustment for debt-related costs. However, we discuss the principles in more general terms below, in case we decide to make adjustments in other areas.

Timing of reviews and adjustments

3.3. We propose an initial adjustment for the April 2021 cap update, informed by data up to the end of September 2020. We propose to undertake at least one subsequent review. Where necessary, we propose to make ex post adjustments for one-off costs where data is readily available. Otherwise, where adjustment is necessary, we consider both an ex post approach and a 'float and true-up'.

Initial review

3.4. We recognised that there might be immediate impacts of COVID-19 on suppliers' costs, and as set out in our open letter to industry in June 2020, we proposed an initial review to assess whether an adjustment to the cap might be required. Any adjustment would take effect in the April 2021 – September 2021 cap period (sixth cap period).

3.5. We will announce the level of the cap for cap period six at the start of February 2021. To allow time for a statutory consultation (including proposed values) and decision making period, our statutory consultation will be based on information available to us

by the end of September 2020. We will reflect information available after this point in a subsequent review.

Frequency of reviews

3.6. We recognise that much of the impact of COVID-19 will be extended, and may be greater over winter. We therefore propose to undertake at least one subsequent review to more accurately reflect actual costs incurred. We have not yet reached a view on the frequency of any reviews.

3.7. Increased frequency of reviews may improve the timing alignment between costs incurred and the cap level. However more frequent reviews incur additional administrative burden on stakeholders and ourselves. This can lead to additional complexity, with costs incurred in a single period reviewed and amended multiple times as more information becomes available. This is particularly relevant for debt-related costs, where some costs can take over a year to fully crystallise.

3.8. Ideally, we would adopt a mechanical adjustment process that could occur every six months (for as long as required) in line with other cap components with mechanistic adjustments. This would minimise the lag between costs incurred and cap level, and would reduce the administrative burden on stakeholders and ourselves. However at this stage we do not consider it feasible to develop a sufficiently robust calculation approach that could be applied in this mechanistic way, given the highly uncertain nature of COVID-19 and the lag times for available data.

3.9. Our initial view is that we could carry out the next assessment in 12 months (followed by a subsequent one, a year later if required). These assessments would be less mechanistic than the six-monthly cap updates, and use a range of evidence and data sources to appropriately update the cap level through a consultation process. This would strike a balance between timeliness, data availability, and administrative burden on stakeholders.

Accounting for uncertainty in the impacts of COVID-19

3.10. We propose that our initial review will include data up to the end of September 2020.[15] This may not capture the full effects of COVID-19 for March 2020 to September 2020, because there is a lag in the data. We may need an approach for adjusting for changes in the historic data (up to end Sept 2020) and an approach for estimating and potentially subsequently adjusting the values going forwards. We will also consider whether it is proportionate to consider only impacts from April 2020 to April 2021 at this point, if this makes it easier for suppliers and ourselves to assess the impact of COVID-19.

3.11. We see three broad potential approaches:

- Ex ante: use an estimate based on the best available information, with no subsequent correction. This works well when there is sufficient information available and a reasonable degree of certainty. This applies both to estimating historical costs for which the full data is not yet available, and to future costs where the impact is not yet fully known;

- Ex post: use the actual costs incurred, once the data is available. The advantage of this approach is that we would have the best possible understanding of the costs. The disadvantage is that such clarity may take time to emerge, particularly for costs with a very long lag time, such as bad debt write-off. In the meantime, there could be a discrepancy between a supplier's costs and the allowances in the cap, which could lead to cashflow pressures for suppliers;[16]

- A 'float': include an approximate value in the cap period where the costs should be incurred, based on the best information available at that time. We would then 'true-up' the difference between the approximate value and a better estimate or actual value, once more information is available. This approach can better align the cap value to costs incurred in a specific time period, if a reasonable

[15] It is not feasible to incorporate data after the end of September, given the timings for the statutory consultation process.
[16] Under the cap, we assess suppliers' financeability over the medium term. We do not require the timing of the cap allowances to match the timing of suppliers' costs. However, the higher the materiality of a given cost, the greater the potential importance of ensuring that the timing does not get too far out of line.

approximation can be made. This approach also relies on being able to implement the true-up in an unbiased way, including where the true-up is not in suppliers' favour. Otherwise, this approach would risk becoming too high on average. The length of time lags for some costs also means that a full true-up may not be possible for later cap periods, particularly if the Secretary of State decides to end the cap before the latest end date in 2023.

3.12. Our initial view is that an ex ante approach is not suitable for COVID-19 related costs. This is because there is a high degree of uncertainty, and so a material risk of overcharging or undercharging consumers substantially.

3.13. Where the impact of COVID-19 is largely one off and attributable to the specific circumstances linked to the restrictions in place during spring 2020, our initial view is that an ex post adjustment is preferable, provided that there is not a long time lag to obtain sufficiently accurate data. This may be appropriate for policy cost adjustments, if we decide to make any. We discuss this in the relevant cost-specific chapters.

3.14. Where the impact of COVID-19 on a cost is either extended over time (for example, if it is linked to an economic recession) or where timely accurate actual data is not available, we would still prefer an ex post approach, but recognise that a float and true-up approach may be more appropriate. This may be appropriate for some debt-related costs, where the final cost will only be known when a supplier has exhausted recovery options and written off the debt.

Float and true-up considerations

3.15. Providing a float and then conducting a true-up is not straightforward. Where there is a long lead time true costs may not be known until much later. This creates two problems. First, there is a cashflow implication for customers or suppliers, depending on whether the estimated cost is above or below actual costs. Second, the cap is time-bound. If the actual costs of COVID-19 are not fully known until after 2023 (the last possible expiry of the cap), then it is not possible to fully true-up.

3.16. Regarding cashflow, in general we consider that suppliers are better placed than default tariff customers to manage cashflow risk. Companies typically have better access to capital than domestic customers, and at lower cost. We also note that the vast majority of default tariff customers who are charged at the cap level are supplied by large companies with relatively good access to capital compared to domestic

customers.[17] We further note that suppliers have been able to take advantage of several measures designed to improve their cashflow recently, including deferring certain network charges (for suppliers who do not have investment grade credit rating), balancing charges and the furlough scheme. This indicates that, where we do need to provide a float, we should consider the impact on customers and set it lower than we estimate it is likely to be, as it is better for customers to increase the amount later than to charge too much now and then decrease it.

3.17. Regarding the ability to fully true-up in the lifetime of the cap, we note that this will depend on whether the Secretary of State chooses to end the cap prior to 2023.[18] If the cap is in place until the latest possible date (31 December 2023), this gives several years for the impacts of COVID-19 to become known. If necessary we would make a reasonable estimate for the last cap periods where a true-up will not be possible. In the event the cap ends before the last possible date, we will need to consider the implications for trueing up COVID-19 related costs.

3.18. A separate issue is how to set the float. Typically, we would look to utilise historical data. However, historical costs will not reflect the additional costs of COVID-19. Short-term government actions such as furlough may have delayed some impacts of COVID-19 for consumers. Debt-related costs, in particular, are also subject to long time-lags – debts incurred in summer 2020 may not be written off until summer 2021 or winter 2021/22.[19] We particularly welcome evidence from energy suppliers regarding how long debt collection procedures take before they consider a domestic customer's arrears as bad debt.

3.19. An alternative approach to setting the float is for us to form a judgement based on supplier forecasts, leading indicators from stakeholders (e.g. operational data indicating how costs may evolve), macroeconomic evidence (e.g. on the relationship between economic recession and supplier costs), and other stakeholder evidence. We recognise there is a very high degree of uncertainty and judgement that would need to be applied in interpreting any such data. We also recognise that there is a risk that this approach has an upward bias, given the asymmetry in both information and resources

[17] We have undertaken additional monitoring of retailer financial health in recent months, including regular Requests For Information (RFI) on key financial and operational metrics.
[18] Default Tariff Cap Act, Section 8 (1) to 8 (4)
https://www.legislation.gov.uk/ukpga/2018/21/section/8/enacted
[19] We understand that some suppliers do not write off debt for over a year after the debt is incurred.

between suppliers and consumer groups. This means we are likely to be presented with evidence suggesting that a large allowance is merited, whether or not this is accurate.

3.20. Our initial view is that where an ex post adjustment is not possible, we will consider a float and true-up approach. We intend to take a prudent approach to setting a float, using the available data to form a judgement, recognising the balance of risk between customers and suppliers. We will also take into account that some cost impacts of COVID-19 may be incurred through winter 2020/21 or later. In any case, we will subsequently true-up the float, so any over or undercharging will be temporary.

3.21. In setting the adjustment for April 2021, as stated earlier, we will consider historical costs up to September 2020. We will decide how to treat the costs for cap period five (October 2020 to March 2021) – either using float and true-up, or ex post (which means we wouldn't reflect the costs until October 2021 at the earliest). We will consider whether we include a float in April 2021 for cap period six (April 2021 – September 2021), or address ex post in cap period seven.

3.22. We discuss additional details on this for debt-related costs in Chapter 4.

Who and what the adjustment applies to

3.23. We propose to apply any adjustment separately for electricity and gas. We propose to spread payment type costs across credit meter customers but not prepayment meter customers.

Separate adjustments for gas and electricity

3.24. We propose to calculate separate allowances for gas and electricity. This is because there are separate caps for gas and electricity, with different cost allowances. This is particularly relevant for any policy cost adjustments, as most of policy costs apply only to electricity customers. Spreading any additional COVID-related costs borne by a specific fuel across both fuels would introduce a distortion, with no obvious benefit.

Spreading costs between customer groups

3.25. We intend to adjust default tariff cap levels such that suppliers on aggregate recover the additional efficient costs resulting from COVID-19 incurred in supplying default

tariff customers. We do not intend for the cap to recover debt costs incurred by other types of customer. Spreading costs between customers who are and are not covered by the default tariff cap would not protect default tariff customers.[20] It is important to distinguish this point from using simplifying assumptions regarding how costs have been incurred between different customer groups, where the effort to suppliers of splitting out such costs would be disproportionate to the potential gains in accuracy.

3.26. Within the group of customers on default tariffs, we propose to spread payment type specific costs (i.e. direct debit or standard credit) across credit meter customers. Some costs will be incurred by all default customers, for example policy costs. Others will be incurred by customers on a specific payment type.

3.27. This is most important for debt-related costs. Debt-related costs are primarily allocated to standard credit customers in the existing cap methodology. This partly reflects the nature of the payment method – for example it is easier for a standard credit customer to defer payment, as they are in control of the timing of payment. In addition, direct debit customers who get into financial difficulty may be moved by their suppliers onto standard credit (and charged accordingly), or to a prepayment meter. Although any initial debt-related costs might be incurred on the direct debit payment method, these customers may have enduring financial difficulty (e.g. after a job loss), and so might run up debt-related costs on the standard credit payment method as well.

3.28. However, this does not mean that we should recover any additional COVID-19-related costs solely or largely from standard credit customers. Inherently, suppliers recover the costs of bad debt (i.e. the impact of people *not* paying their bills) from people that *are* paying their bills. In that sense the costs are always socialised across customers that did not cause the problem. In our 2018 decision, we socialised a proportion of standard credit bad debt and administrative costs on the basis that standard credit customers *that are paying their bills* were not more responsible for these higher costs than direct debit customers *that are paying their bills.* If we recovered the additional

[20] Where a customer moves between tariff types, we generally attribute the cost to the payment type where the cost was incurred. This is most important for debt-related costs, and we discuss it further in Chapter 4.

bad debt costs solely from standard credit customers, this could lead to a large increase in bills for them.

3.29. Our initial view is to recover these costs from all credit customers equally. Recovering the additional debt-related costs of COVID-19 from all credit meter customers would largely[21] maintain the existing price differential between direct debit and standard credit customers in the default tariff cap. This would mean that we were maintaining the same level of protection for standard credit customers.

3.30. We note that recovering any debt related costs from multiple payment methods could affect individual suppliers in different ways. Some suppliers have more standard credit customers than average. If the actual increase in debt-related costs is disproportionately related to standard credit, then a uniform uplift would disadvantage suppliers with more standard credit customers than average. Our initial view is that any such impact could be acceptable in light of the Act's overall customer protection objective.

PPM customers

3.31. PPM customers have unique considerations. Our current view is that we would not spread costs from other payment methods onto PPM customers at this stage, although we might do so after a later review. This is because these customers do not incur debt in the same way that other customer groups do, and because PPM customers have different characteristics and would not be better protected by bearing the debt-related costs of other payment types. We discuss this further in Chapter 5.

3.32. Our initial view is that if we calculate an adjustment to account for costs arising from serving PPM customers, we will only apply it to PPM customers. Also, we would not allocate any COVID-related costs incurred by the other payment methods onto PPM customers.[22]

[21] If we applied the same debt-related cost percentage to both payment methods, the differential would still grow slightly, given that the level of the cap is higher for standard credit customers. Our initial view is that this simplification would be acceptable, and less complicated than trying to maintain the same absolute differential.
[22] Similarly to paragraph 3.25 it is important to distinguish this point from using simplifying assumptions

Consumption levels

3.33. The cap varies with consumption. Some COVID-19 related costs may also vary with consumption, for example certain policy costs (if an adjustment is required).

3.34. For debt-related costs, all else being equal, customers with higher consumption should bear higher debt-related costs, given they have higher bills (and therefore would have more impact on the supplier by not paying). In contrast, at the nil consumption benchmark, the absolute amount of bad debt should be low.

3.35. However, this assumes that the relationship between bills and debt levels is linear. This would only be the case if a customer's consumption level is independent of their propensity to incur debt. Alternatively, customers with lower consumption might be more likely on average to be financially stretched.

3.36. The existing payment method uplift (which covers most of the debt-related costs) moves proportionally with consumption, and so we consider it appropriate to use the same approach for any additional debt-related costs arising from COVID-19. By adopting this position it would also maintain our approach of keeping the standing charge low (in line with historical practice) to assist customers with low consumption, rather than setting this in a cost-reflective way.[23]

3.37. We discuss the specifics of the split between fixed and variable costs for bad debt in Chapter 4.

How the cap is adjusted

Method for adjusting the cap level

3.38. If we conclude that we need an adjustment in the cap to account for additional costs as a result of COVID, we will consider how to adjust the level of the cap of future cap periods. We propose to make one total, aggregate, adjustment rather than multiple

regarding how costs have been incurred between different customer groups, where the effort to suppliers of splitting out such costs would be disproportionate to the potential gains in accuracy.
[23] Setting the nil consumption cap in a cost-reflective way (i.e. higher) would actually be disadvantageous to suppliers as a group, given that this would lead to a lower implied unit rate.

adjustments to specific allowances. This would be calculated as an absolute (£) value, but we could have separate calculations feeding into it.

3.39. We currently consider that the existing AA[24] would be a suitable mechanism to make any such adjustment. It would allow us to set a single, aggregate adjustment for each of the separate gas and electricity caps, and has the flexibility if necessary to allow us to vary it by payment method, by consumption level, and over time. We could include all relevant calculations in the Methodology for Adjustment Allowance workbook referenced in Annex 8 of SLC28AD.

3.40. This approach also preserves the integrity of the existing price cap methodology, which we still consider to be an appropriate approach, excluding the one-off impacts of COVID-19.

3.41. A single aggregate adjustment appears to be more suitable than changing individual allowances, if the impacts of COVID-19 cut across several parts of the cap. First, we do not currently expect to change the underlying methodology on an ongoing basis – this is an adjustment to recognise extraordinary costs, and so amending an individual allowance would introduce additional unnecessary complexity and may require unwinding later. Second, itemising adjustments separately could require us to make several changes – we consider it to be more feasible and practical to calculate separate adjustments and then aggregate them into one allowance. Collating individual changes into a single adjustment requires an additional calculation step (i.e. to add up each individual change). Our initial view is that this step can be transparent in our consultation and decision documentation, and we do not expect any such calculation to be complex.

3.42. The AA is set in absolute terms, not as a percentage of other cap components. However if we decide that the adjustment (or part of it) needs to vary in line with other cap components over time[25] we could in principle calculate it as a percentage of the relevant values, and then set the absolute (£) allowance as the AA. Overall, the

[24] We created this allowance in order to implement our decision on reassessing the wholesale allowance in the first default tariff cap period.
Ofgem (2020), Decision on reassessing the wholesale allowance in the first default tariff cap period. https://www.ofgem.gov.uk/publications-and-updates/decision-reassessing-wholesale-allowance-first-default-tariff-cap-period

[25] For example, if we were estimating the absolute value of future debt-related costs.

purpose of the adjustment is to enable suppliers to recover the additional (efficiently incurred) costs of COVID-19, which is a fixed absolute amount.

3.43. An alternative approach would be to modify the licence and add a new component to the cap. Our initial view is that the AA is appropriate for our purposes and so a licence modification is not required.

Default tariff customer numbers

3.44. Where we are considering historical costs, there is a question about whether we should take into account changes in the aggregate (market-wide) number of default tariff customers between the period where costs were incurred and the period where costs are recovered. In principle, this would help to ensure that suppliers as a whole recover a better approximation of the costs they incur. We adjusted for customer numbers within our wholesale adjustment for Q1 2019, reflecting that the number of default tariff customers had fallen.

3.45. However, in the present situation, the short difference in time reduces the potential for customer numbers to change significantly. Further, we do not currently have suitable data to make an adjustment - we would only know customer numbers for part of the historical period.

3.46. Our initial view is therefore that we would not adjust for changes in default tariff customer numbers as part of our April 2021 adjustment. We could consider amending this position in future reviews.

4. Impact of COVID-19 on debt-related costs

We consider how we might structure an adjustment for debt-related costs incurred by credit customers from COVID-19. We then consider how we could set the adjustment – both to assess actual costs, and to set any interim 'float'. We discuss the debt-related costs to PPM customers in Chapter 5, as the mechanisms for them are different to credit.

We seek stakeholders' views on our considerations in general.

Summary

4.1. Suppliers incur debt-related costs when customers pay in arrears or do not pay at all. We allow for these costs in the cap through a combination of the operating cost allowance, the payment method uplift and the EBIT allowance. We describe how the costs are split between the allowances in Appendix 1.

4.2. In the cap methodology, these allowances are fixed (either as values or percentages).[26] However, COVID-19 may lead to payment risks being very different to our historic baseline. Specifically, we see three potential cost increases: increasing working capital costs due to late payment, increasing bad debt costs due to non-payment, and additional administrative costs[27] associated with recovering doubtful debt. We refer to these collectively as 'debt-related costs'. There could be a one-off spike in debt-related costs, with these costs then returning to historical levels. Alternatively, higher debt-related costs may persist, e.g. in the event of a prolonged recession.

4.3. We are considering whether to update the cap to take into account higher debt-related costs. In line with our general position,[28] we only correct for unforeseen, clear,

[26] The allowances themselves do change. The EBIT allowance and part of the payment method uplift scale with other components in the cap, and therefore change in line with other components (e.g. wholesale costs). We update the operating cost allowance with inflation.
[27] We use the term 'additional administrative costs' for consistency with our 2018 analysis of the payment method uplift. In practice, the debt recovery costs will include external costs such as legal fees and bailiffs, as well as a supplier's operational costs (e.g. customer service and field activities) of managing debt. We welcome any further detail from suppliers on the types of operational costs they incur as a consequence of dealing with debt.
[28] Ofgem (2018), Decision – Default tariff cap – Overview document, paragraph 3.16.

material, systematic errors. We consider that the effect of COVID-19 on debt-related costs could fall into this category. However, there will be a degree of variation in debt-related costs over time even absent COVID-19, which we would not correct for because it is not systematic. We are therefore not seeking to ensure that the cap aligns perfectly to actual costs.

4.4. Individual suppliers will experience different impacts of COVID-19. However, there is a single cap level for all suppliers. In addition, the design of the cap has regard to the need to drive efficiency and finance an efficient company - the COVID-19 costs experienced by individual suppliers may or may not be efficient. Any adjustment we make will not enable each supplier to recover its actual additional debt-related costs. The question is whether we should adjust the cap to better reflect the additional debt-related costs of an efficient supplier.

4.5. We have an initial view on some, but not all, of the key methodological considerations for setting an allowance for debt-related costs. Our initial view is that some additional allowance is likely to be required for costs incurred in cap periods four, five and six. We would set this using a lower quartile benchmark for the total additional debt-related costs incurred due to COVID-19. We have not yet reached an initial view on whether to set the allowance on an ex post basis or with a 'float with true-up', or on the exact timing of providing the allowance. If we use a 'float with true-up' approach, we will consider a range of indicators and data sources to inform the initial float level. Where we have not yet reached an initial view we set out options and some initial considerations. We welcome stakeholders' views.

Impacts observed so far

4.6. Our initial view is that government support (through, for example, the furlough scheme) has limited the amount of non-payment in the domestic market. As a result, the only impact we have observed on suppliers[29] from COVID-19 so far (March 2020 – June 2020) is a relatively small increase in payment arrears.

https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document_0.pdf

[29] We focus here on the suppliers operating at scale in the domestic segment.

4.7. We recognise that the impacts of COVID-19 could be more significant over the winter period where consumption will increase and government aid, such as the furlough scheme, is due to end. We understand from suppliers that they expect further deterioration in customer arrears. It is possible that we will begin to see more severe impacts of COVID-19 over cap period five (October 2020 - March 2021) and into cap period six (April 2021 – September 2021). In the next section, we consider the options for setting a debt-related COVID-19 adjustment.

4.8. We cannot draw firm conclusions at this stage. COVID-19 is a recent development, so we can only observe any late payment – we will only know the levels of non-payment (i.e. bad debt write-off) at a later stage after suppliers have exhausted debt recovery procedures.

Structure of adjustment

Type of adjustment

4.9. We have considered three potential approaches for accounting for material debt-related costs arising from COVID-19 within the cap:

- ex ante;
- a 'float with a true-up';
- ex post.

4.10. We discuss the relative merits of these approaches in Chapter 3. Given the uncertainty around COVID-19, we do not think using an ex ante adjustment is appropriate. We consider an ex post adjustment and a 'float with true-up' in the context of debt-related costs below.

Periods covered by an adjustment

4.11. If we intend to make an adjustment from 1 April 2021 (cap period six) then we will need to consider the debt-related costs in three cap periods:

- costs incurred in cap period four (April 2020 – September 2020);

- costs incurred in cap period five (October 2020 – March 2021);
- costs that might be incurred in cap period six (April 2021 – September 2021).

4.12. The future impacts of COVID-19 in cap period seven (October 2021 – March 2022) and beyond are very uncertain at this stage. We propose to consider whether any adjustment is required for cap periods seven and onwards in future reviews, when we will have a better understanding on the longer term COVID-19 impacts.

Costs incurred in cap period four

4.13. COVID-19 started to significantly impact GB customers in mid-March 2020, with the advent of the lockdown restrictions in place during spring 2020. However, we consider it unlikely that suppliers incurred a significant amount of costs from COVID-19 in the first two weeks between mid-March 2020 and the start of April 2020. Our initial view is that it would be a sensible (slight) approximation to look at impacts in terms of whole cap periods – i.e. starting on 1 April 2020.

4.14. This means that our first historical period is cap period four (April 2020 – September 2020).

4.15. In theory, suppliers should know the additional costs of COVID-19 incurred in cap period four ahead of our statutory consultation in November 2020 (notwithstanding the eventual debt that suppliers could write off). However, we consider it likely that the data required to make an ex post adjustment will not be readily available in time for our statutory consultation (especially in relation to bad debt). In this case, we will consider setting a 'float' based on our estimate of these costs and look to true-up in a future review. If we do have the data to accurately calculate the costs (e.g. in relation to working capital costs), we will opt for an ex post adjustment.

Costs incurred in cap period five

4.16. In theory by April 2021, cap period five will have ended and we should have a sense of the COVID related impacts on costs for that period. However, to introduce an adjustment for April 2021, we must publish our decision in February 2021. To consult on any proposals for an adjustment, we would need to estimate the level of that adjustment in time for our statutory consultation. This limits our scope to consider new data. We do not consider it is possible to collect any information (for consideration for April 2021) beyond September 2020.

4.17. There are two options for assessing any adjustment for cap period five:

- ex post: calculate the costs incurred in cap period five after they have been incurred and implement them in cap period seven;
- float and true-up: estimate the costs incurred in cap period five then true-up once we can observe the actual costs for cap period seven.

4.18. We expect the debt-related COVID-19 costs will increase over winter from an increase in consumption and the end of the government furlough scheme. Given we are setting the allowance in April 2021, our preferred option is to estimate the impact in cap period five as a float and then true it up in a later cap period (likely cap period seven) when we can observe the actual impacts. This option would reduce any lag between suppliers incurring costs and receiving an allowance.

4.19. Alternatively, we could set any adjustment for COVID-19 costs incurred in cap period five ex post. This means that we would include any adjustment no earlier than cap period seven (October 2021). Only then would we have enough time to collect data, measure the impact, consult on our proposals and introduce the adjustment.

Costs incurred in cap period six

4.20. The April 2021 cap level covers cap period six. There is therefore a question of whether and how we might consider any COVID-19 related costs in this period, given it is in the future.

4.21. We consider three options:

- Ex post: Setting the costs after they had been incurred would mean we would set the allowance in cap period eight (starting in April 2022) to allow us enough time to collect data on the realised impacts.
- Float and true-up: We would set an estimate the impact of COVID-19 in cap period six then true up our estimate with the outturn costs when they are available.
- Delay providing any adjustment for this period until cap period seven: This means that we would not include any adjustment for cap period six in the cap period six

level. We would use updated information to estimate a float for debt related costs incurred in cap period six in cap period seven. We would then true this up at a later date.

4.22. Setting the allowance ex post would provide certainty on the actual costs but as discussed previously, there could be long lag between suppliers incurring any costs and recovering them through an allowance.

4.23. Setting a float for cap period six is potentially challenging. We will have little information on which to base our estimates of a float, especially since the data to date shows a limited impact of COVID-19 on debt-related costs.

4.24. The third option would be to set an allowance float in cap period seven for costs incurred in cap period six. That would give us time to collect updated information on costs incurred over the winter, which could help us to estimate a more suitable float for the costs incurred in cap period six. There would only be a delay of one cap period as we would implement in October 2021 (as opposed to waiting two cap periods for an ex post approach). However, this would still create a delay in cashflow for suppliers.

Assessment of debt related costs

Debt-related costs incurred during COVID-19

4.25. We consider that the debt-related costs comprise of three types of costs:

- cost of working capital – covers the cost to supplier of raising capital to fund customers paying in arrears;
- bad debt – the unrecoverable debt that suppliers write off;
- bad debt administrative costs – the costs of chasing debt before it is written off.

4.26. We propose to look at these three cost categories together when estimating what the COVID-19 additional debt-related costs have been.

Allowances in the default tariff cap

4.27. Our treatment of debt-related costs in the cap is complicated. This is partly because there are several elements to debt-related costs. It also reflects that we consider costs

through more than one allowance, especially when considering the additional costs of standard credit. Furthermore, our approach is not entirely cost-reflective – after calculating the actual costs of standard credit, we spread a proportion of the additional costs back to direct debit. The default tariff cap currently provides an allowances for debt related costs over three allowances:

- payment method uplift – additional bad debt and working capital costs for customers paying by standard credit;
- operating cost allowance – covers direct debit costs of bad debt;
- EBIT allowance – factors in the cost of working capital.

4.28. The payment method uplift mainly covers the additional costs of bad debt, working capital requirement and additional administrative costs of standard credit customers. We spread some of the additional bad debt and administrative costs over all non-PPM default tariff customers. The majority of the debt-related costs are covered in the payment method uplift because they are mainly as a result of standard credit customers who pay in arrears.

4.29. An element of the operating cost allowance reflects a proportion of any direct debit bad debt costs of the suppliers closest to the benchmark.[30] However generally, direct debit customers incur little bad debt costs relative to standard credit.

4.30. The cap includes an EBIT allowance, which represents a normal rate of return for a supplier. The EBIT allowance was based on analysis carried out by the CMA. In calculating this, the CMA assessed capital employed, an element of which would be caused by working capital resulting from late payment.

4.31. We do not intend to re-open the operating cost, payment method uplift and EBIT allowances already provided in the default tariff cap. We propose to only adjust for the

[30] We set the operating cost allowance at £5 below the lower quartile supplier. This makes it difficult to match a specific supplier's bad debt costs to the operating cost allowance, and explains why we only include a proportion of any given supplier's costs.

additional debt related costs incurred from COVID-19 and add the adjustment 'on top' of the total cap level.

4.32. We provide further detail on the existing debt-related allowances in the cap in Appendix 1.

Interaction between costs

4.33. When a consumer does not pay a bill in full, their supplier will not immediately write off the debt. The supplier will have a process to try and collect the debt,[31] which means it may be a significant time before the supplier decides to write off the principal amount. This period will depend on the supplier's accounting policy.

4.34. However, suppliers will make provision for bad debt in their accounts. This will involve an estimate of what level of debt will be recovered late and what will be written off. Any difference between the provision and the final write-off is reflected in the bad debt charge. (Such differences could be larger in relation to COVID-19, given the uncertainty around the ultimate levels of non-payment).

4.35. There are different in-principle options for *when* we provide an allowance for the additional bad debt costs related to COVID-19. This is separate to the question of what we should do in practice, given the availability of data – i.e. whether we should provide a float from the point when we would like to take the costs into account and true this up later, or whether we should wait to provide the entire amount on an ex post basis.

4.36. The first in-principle option is to include an estimate of future bad debt at the point of consumption. This would have some similarities to a provision, in that we would be making a forward-looking judgement, which we would then need to refine over time as more data became available. This would therefore be similar to how suppliers are considering the issue themselves from an accounting perspective. However, it would involve providing funding before suppliers actually write off any debts.

4.37. The second option is to only allow for bad debt once suppliers start writing it off. This would reflect that the write-off is the actual cost to the supplier. For the purpose of

[31] This could include trying to agree a repayment plan with the customer.

setting the cap, we do not necessarily need to align with suppliers' accounting approaches. This approach would lead to suppliers receiving funding for additional bad debt at a later stage (perhaps a year after consumption) – but by this point there would be better information available about the likely scale of any write-offs.

4.38. In either case, we would also want to allow for the working capital costs a supplier incurs before a debt is written-off. Our understanding is that this cost does not depend on whether a supplier has made a provision or not. We would not want to allow for working capital costs after the point of write-off.

4.39. When setting the allowance for additional COVID-19 bad debt costs, we need to be careful not to double count costs. We would not want to include any costs in the final write-off that we had already allowed for through the working capital element.

Calculating the actual level of debt-related costs

4.40. In this section, we consider how we could measure the actual level of debt-related costs. In a 'float and true-up' approach, this would relate to how we measured the ultimate true-up. In the subsequent section, we discuss how we could set any float amount.

Benchmarking separately or collectively

4.41. When setting the payment method uplift in the 2018 cap decision, we looked at the three components of the uplift (bad debt, working capital, and additional administrative costs) together, and selected a single benchmark supplier. This helped to ensure coherence, given that in theory a supplier could incur lower costs in one area as a result of its decisions in other areas. For example, a supplier who spent more on debt collection might have lower bad debt costs.

4.42. Our initial view is that we would do the same for debt-related costs when adjusting for the impact of COVID-19. We would create a combined metric for the additional debt-related costs linked to COVID-19, and use this to benchmark. This approach is simple and reduces the chance of setting an allowance that was not reflective of an efficient supplier's total debt-related costs.

4.43. There are specific challenges about the debt-related additional administrative costs, given that these could be affected by a supplier's actions in response to COVID-19

(e.g. the extent to which it made use of the furlough scheme). However, we do not expect this to affect the benchmarking exercise to such an extent as to invalidate the approach of selecting a single benchmark supplier.

Stringency of benchmark

4.44. Our 2018 analysis used a lower quartile benchmark (for the payment method uplift), or a near lower quartile benchmark (for operating costs). The question is whether we should use a similar level of stringency for our analysis of the additional debt-related costs linked to COVID-19, or whether we should use an alternative benchmark (such as a weighted average, which we used for smart metering costs).

4.45. COVID-19 is a large and unexpected shock. A supplier would not have expected such an event, and it will have challenged each supplier's existing processes in an unprecedented way. To this extent, it could be argued that the outcomes a supplier experiences are largely outside its control (e.g. driven by chance or unexpected features of its customer base), and that an average cost benchmark would be more appropriate.

4.46. The impact of COVID-19 on debt-related costs is also uncertain – certainly more so than the cost of planned activities. This is another factor which could support the use of a less stringent benchmark, although we still consider that a supplier that has a history of efficient debt management will likely have incurred fewer additional debt-related costs as a result of COVID-19 than a less efficient supplier.

4.47. However, while we recognise the challenges of COVID-19, we do not consider that a supplier's response is totally outside of its control. Suppliers will have existing processes for dealing with late or non-payment – and these processes will be more or less efficient. While the initial phase of restrictions in spring 2020 may have required extraordinary processes, the bulk of the debt-related costs are related to recovering bad debt during a recession. Suppliers should have been aware of this as a potential scenario, and should have developed processes accordingly. Our initial view is therefore that variation in suppliers' costs[32] should partly be a matter of efficiency, and

[32] Here, we mean suppliers' final debt-related costs. Efficient behaviour may involve suppliers being proactive about recovering debt and preventing new debt. This could have higher immediate costs, but lower final costs.

therefore that the level of costs we include in the cap should reflect this. Using an average cost benchmark would not protect customers and incentivise efficiency to a similar extent as the operating cost benchmark, which we set just below a lower quartile.

4.48. We recognise that suppliers may have taken different approaches to assisting customers during the pandemic. However, we do not consider that a supplier with a higher level of debt costs should be compensated for this as providing a benefit to customers (e.g. if it had restarted debt prevention and collection activities later). There is a baseline level of support that suppliers have agreed with government on a voluntary basis. Beyond this, suppliers should operate efficiently. A supplier who is less successful at taking debt-related action is not acting in the interests of other customers who are paying on time (if it expects them to bear the costs), nor is it necessarily acting in the interests of customers building up debt (where proactive behaviour may avoid exacerbating the situation).[33]

4.49. Our initial view is therefore that we would use a lower quartile benchmark, in line with the approach elsewhere our 2018 decision, for debt-related costs.

Lower quartile options

4.50. When calculating a lower quartile benchmark we have broadly three options:

- look at the increase in debt-related costs (since 2017 or relative to the situation before COVID-19) for the suppliers closest to the operating cost benchmark;
- look at the increase in debt-related costs (since 2017 or relative to the situation before COVID-19) for the supplier used as the benchmark for our payment method uplift analysis;
- carry out a new benchmarking exercise, to select a new benchmark supplier.

[33] We discussed the issue of restarting debt management activities in our June 2020 letter to suppliers. Ofgem (2020), Impact of COVID-19 on retail energy supply companies – regulatory expectations from 1 July 2020, p5. https://www.ofgem.gov.uk/system/files/docs/2020/06/update_on_regulatory_flexibility_framework_for_suppliers_0.pdf

Using the suppliers closest to the operating cost benchmark

4.51. We could assess the costs of COVID-19 using the change in relevant costs for the supplier(s) closest to the operating cost allowance in 2017. We would do this with the intention of being consistent in the supplier used for the operating cost benchmark (i.e. what we allowed for based on 2017) and any debt-related adjustment (i.e. what we will add on top of the baseline).

4.52. However, most of the debt-related costs are covered by the payment method uplift – not the operating cost benchmark. We did not select the operating cost benchmark based on suppliers' efficiency in specifically managing debt. Although, all else being equal, we might expect the suppliers closest to the operating cost benchmark to be more efficient than average in managing debt (in line with their general efficiency), we have no guarantee of this – and we know that the same suppliers were not closest to the operating cost and payment method uplift benchmarks.

Using the supplier closest to the payment method uplift benchmark

4.53. We could analyse the change in debt-related costs of the supplier we used to set the payment method uplift benchmark.

4.54. The majority of debt-related costs are captured in the payment method uplift allowance. This makes it a much more relevant candidate than the operating cost allowance as a reference point.

4.55. However, even though this supplier may have been efficient in relation to debt-related costs (and the other additional costs of standard credit) in 2017, this does not necessarily mean that it has the same degree of efficiency in relation to the additional debt-related costs of COVID-19. By only looking at a single supplier, we do not know what position it would have among suppliers in 2020 in relation to debt-related costs. For example, if the supplier had a less significant impact from COVID-19 (e.g. due to a

favourable customer base[34]), this could lead to us understating the adjustment required for the market as a whole.

New benchmark

4.56. Under this option, we would carry out a new benchmarking exercise, based on suppliers' debt-related costs. This would be based on suppliers' actual debt-related costs in the relevant period (using the best available data).

4.57. We would look at the suppliers in the market at the time. As we currently intend to use a lower quartile, each supplier included in our benchmarking exercise would have equal importance.[35] If we included a large number of suppliers in our benchmarking exercise, there is a risk that the suppliers with low debt costs (and therefore the supplier setting the lower quartile) might be smaller suppliers with atypical customer bases. We might therefore consider whether we should only look at a subset of large and medium-sized suppliers, so that we avoid selecting a supplier who might not be representative of a supplier operating at scale. Given the market has changed significantly since 2017, the suppliers involved in the benchmarking exercise will be different to those in our 2017 benchmark.

4.58. We then need to decide how to benchmark the data.

4.59. One approach would be to benchmark the suppliers' total debt-related costs. We would then seek to remove the debt-related costs that are already in the cap, and substitute in the new debt-related benchmark. However, as explained above, the existing costs are spread over several allowances. It would be difficult to remove these costs and could possibly remove coherence between the allowances. For example, if we removed costs by calculating the lower quartile on a line by line basis, this would be inconsistent with how we set the operating cost benchmark, i.e. at a total level.

[34] For example, the recession as a result of COVID-19 may have different impacts between regions. Suppliers have regional variation in their customer bases (particularly the historical electricity incumbents), and so suppliers' exposure to debt-related costs could be affected by their customer base. We cannot practically take into account all potential variations in our cap design, but we recognise that the impacts of COVID-19 may vary between suppliers.
[35] This is unlike a weighted average.

4.60. The alternative is to benchmark the lower quartile of the change in costs due to COVID-19 (across all the suppliers in our benchmarking sample), and add this amount to the cap.[36] We could either look back to 2017 (the year of the data we originally used to set the cap), or to compare it against the last full year of data before COVID-19.

4.61. Our initial view is that the latter approach is likely to be preferable. It would enable us to focus better on changes in costs as a result of COVID-19, rather than general changes in efficient costs since 2017. It would also allow us to include all current large suppliers in our analysis, rather than being restricted to only those who were operating at scale in 2017.[37]

4.62. When selecting a new benchmark supplier, there could be some risks of coherence with the existing allowances. For example, a supplier might have low debt-related costs in 2020 because it carried out upfront activities to reduce the risk of debt (e.g. screening customers at the point of acquisition), which could have additional costs. We recognise this as a potential risk, but we do not currently consider that such activities would be likely to be sufficiently expensive to undermine this approach.

4.63. Our current view is therefore that we would collect information from each supplier (above a certain size) for its costs in each of the three debt-related categories. We would do this for 2019 (the last full year before COVID-19), and then for the year where we wanted to calculate the adjustment (e.g. 2020). We would calculate the change in each supplier's debt-related costs between these years, at typical consumption. We would select the lower quartile supplier based on this.[38]

Changes in efficiency

4.64. The Act requires us to have regard to (among other matters) the need for incentives for suppliers to improve their efficiency. Setting an upfront allowance, and then not

[36] In principle, there would be an additional option where we could select a lower quartile benchmark supplier based on its total debt-related costs, and then look at that supplier's change in costs due to COVID-19. The disadvantage of this option would be that a supplier's ranking in relation to overall costs would not necessarily correspond to its ranking in terms of the change in costs, which is what we are interested in. This would risk under- or over-stating the change in costs due to COVID-19.
[37] If a supplier did not exist in 2017, then we could not calculate a change in costs since 2017. If a supplier was small (i.e. not operating at scale) in 2017, then it might not be reliable, as its change in costs might be affected by its growth.
[38] Note that the benchmark supplier could therefore be different between years – for example if we were calculating an adjustment in 2020 and a subsequent adjustment in 2021.

adjusting this over time (except for indexing by inflation), provides suppliers with an incentive to improve their efficiency. This is because suppliers know that if they make efficiency gains, they should be able to keep the additional revenue, rather than us adjusting the cap down in response. Similarly, suppliers know that if they allowed their costs to increase, they would not be able to recover this from customers.

4.65. The issue (under any of the benchmark options discussed above) is that we can only identify whether debt-related costs have changed over time. We cannot identify why they have changed, or separate out the effects of COVID-19 and changes in efficiency (in either direction) that are unrelated to COVID-19. The two effects could be at least partially offsetting, if suppliers have managed to improve their efficiency in dealing with debt-related costs.

4.66. Given the extent of the COVID-19 shock, we assume that the impact of COVID-19 is likely to be greater than any previous changes in efficiency for debt-related costs. The scale of error from not adjusting for the additional debt-related costs related to COVID-19 would therefore be more significant than the impact of reflecting previous changes in efficiency.

4.67. We would mitigate the effect of including changes in efficiency by only looking at the change in costs since 2019, rather than since the original benchmark year of 2017. This is because there would be less scope for efficiency changes over a shorter period.

4.68. The importance of changes in efficiency may also be different depending on which benchmark approach we use. If we use a new benchmark, there could be a risk that a supplier had a low change in costs because it had a large efficiency gain offsetting any COVID-19 related costs. However, if we used the same lower quartile supplier as the payment method uplift calculation, then this supplier would already have been efficient in 2017, and so its scope for further efficiency reductions might be more limited. As set out above, we can mitigate the impact of efficiency changes by looking at the change since 2019 instead, and so we do not consider that this needs to drive our choice of benchmark approach.

Additional administrative costs

4.69. There is a particular challenge with benchmarking additional administrative costs. Bad debt and working capital costs should only have increased as a result of COVID-19.

Even if the full impact has not yet materialised, we can therefore be confident that any adjustment would not have perverse effects.

4.70. In the next year or so, we might expect suppliers to incur somewhat higher administrative costs as a result of COVID-19. However, for the period over which we will have data, it is possible that administrative costs could have actually fallen, due to the furlough scheme and suspension of debt collection. This means that using historical data could misinform us about the direction of future changes.[39] We will bear this risk in mind when interpreting the data.

4.71. In any event, there is also a challenge of gathering data in this area – we do not know whether suppliers will be able to distinguish additional administrative costs relating to debt from their other operational costs. For our 2018 analysis, suppliers were able to identify the additional administrative costs of particular payment methods – but this included both debt-related and other costs.

Calculation challenges

Allocating costs to different customer groups - introduction

4.72. The preceding sections discuss how we could evaluate efficient costs at a company level. In this section, we discuss how we could allocate costs between different tariff types, payment methods, and consumption levels. This involves both the question of which customers we use to calculate the adjustment, and who we apply the adjustment to.

4.73. There are particular challenges when allocating costs between tariff types and payment methods, given that customers can move between them as part of getting into debt. This makes it hard (from a data perspective) to align with our usual approach of allocating costs to the group that incurred them.

[39] Note that it is not any fall in administrative costs that would be the problem. This could genuinely reflect a change in an efficient supplier's costs in spring 2020. Rather, the issue would be using this data to set an allowance for future periods.

Tariff type

4.74. As explained in Chapter 2, default tariffs are in scope of the cap. Fixed tariffs[40] are not. Therefore, any bad debt adjustment in the cap should only cover additional bad debt costs from customers with default tariffs.

4.75. The complication is that customers can move between tariff types. However, we would not want a situation where default tariff customers end up paying for debt-related costs that were incurred on fixed tariffs – i.e. with default tariff customers paying most of the debt-related costs of the whole market. This is particularly true given that default tariff customers are on average more likely to be in vulnerable situations than those on fixed tariffs.

4.76. A cost-reflective approach would assign the bad debt cost to the tariff type the customer was on at the point when they incurred the cost. However, this would require data that identifies costs by the tariff type at the point at which they were incurred (rather than the customer's current tariff type). We consider that providing this granular level of data would be challenging and open to differences in practices between suppliers.

4.77. We consider that a simpler approach would be to estimate the debt-related impact for all domestic credit customers (or failing that all domestic customers), irrespective of tariff, and calculate a cost per customer. This is the same approach we used in 2018 when setting the payment method uplift and operating cost allowance.

Payment method

4.78. It is possible that the additional debt-related costs of COVID-19 may be more likely to fall to standard credit than to direct debit. This partly reflects the nature of the payment method – for example it is easier for a standard credit customer to defer payment, as they are in control of the timing of payment. In addition, direct debit customers who get into financial difficulty may be moved by their suppliers onto standard credit (and charged accordingly).[41] Although any initial debt-related costs might be incurred on the direct debit payment method, these customers may have

[40] Specifically those which customers have made an active choice to be on.
[41] Standard licence condition 22C.11B of the gas and electricity supply licences.

enduring financial difficulty (e.g. after a job loss), and so might run up debt-related costs on the standard credit payment method as well.

4.79. However, this does not mean that we should recover costs solely or largely from standard credit customers. Inherently, suppliers recover the costs of bad debt (i.e. the impact of people *not* paying their bills) from people that *are* paying their bills. In that sense the costs are always socialised across customers that did not cause the problem. In our 2018 decision, we socialised a proportion of standard credit bad debt and administrative costs on the basis that standard credit customers *that are paying their bills* were not more responsible for these higher costs than direct debit customers *that are paying their bills.* If we recovered the additional bad debt costs solely from standard credit customers, this could lead to a large increase in bills for them.

4.80. Recovering the additional debt-related costs of COVID-19 from all customers would largely[42] maintain the existing differential between direct debit and standard credit. This would mean that we were maintaining the same level of protection for standard credit customers.

4.81. We also do not consider it would be feasible to gather data which identifies debt-related costs based on the payment method on which they were incurred. (This is the same difficulty as splitting debt-related costs based on the tariff type on which they were incurred).

4.82. However, recovering any debt-related costs from both payment methods could affect individual suppliers in different ways. Some suppliers have more standard credit customers than average. If the actual increase in debt-related costs is disproportionately related to standard credit, then a uniform uplift would disadvantage suppliers with more standard credit customers than average. Our initial view is that any such impact could be acceptable in light of the Act's overall customer protection objective. This is the same issue that we had when setting the payment method uplift in the 2018 decision, and we reached the same conclusion.

[42] If we applied the same debt-related cost percentage to both payment methods, the differential would still grow slightly, given that the level of the cap is higher for standard credit customers. Our initial view is that this simplification would be acceptable, and less complicated than trying to maintain the same absolute differential.

Prepayment

4.83. We discuss any adjustments we would make for PPM customers in Chapter 5.

4.84. Our current view is also that we would not spread debt-related costs from other payment methods onto PPM customers.

Variable and fixed allowances

4.85. As discussed in Chapter 3, in general the debt-related costs should vary with consumption.

4.86. The only exception might be any additional administrative costs linked to collecting bad debt. We might expect these to be fixed costs which do not vary with a customer's consumption level. Additional administrative costs are fixed costs in the payment method uplift.

4.87. Our initial view is that we would treat all additional debt-related costs linked to COVID-19 as variable costs. This is a slight simplification, but would reduce the complexity of the adjustment. In particular, this reflects our current expectation that the additional administrative costs (the fixed element) would be relatively small, given that suppliers will already have billing and collections teams in place – though we accept that suppliers may incur some new costs as a result of COVID-19.

4.88. Similarly, we would set different benchmarks for single rate and multi-register electricity at typical consumption, given that the level of typical consumption is different in each case. Multi-register customers consume more electricity on average than single rate customers, so would be expected to incur higher absolute levels of debt-related costs.

Data required for ex post or true-up

Existing data

4.89. During the first months of the COVID-19 pandemic, Ofgem gathered weekly data on suppliers' financial health. This included data on customer payments and arrears.

4.90. We are gathering monthly data on bad debt and customer arrears, starting with data up to June 2020. We are also gathering equivalent data on the baseline situation before COVID-19.

4.91. We could use this existing data to assess suppliers' debt-related costs to date. This data has the advantage of being readily available, reducing the time required and minimising the burden on suppliers. As this is an existing request, this increases the likelihood that it is consistent across suppliers, contributing to the accuracy of analysis.

4.92. The main disadvantage of this data is that the financial information is only available at the level of the whole supply business. It does not provide separate financial information about domestic and non-domestic customers, about different fuels, or about different payment methods. (We have information from the weekly returns on various payment-related metrics, e.g. number of failed direct debits, split between domestic and non-domestic customers. However, while useful as indicators of potential trends, it would be difficult to use this information calculate the actual level of debt-related cost).

4.93. The lack of a domestic/non-domestic split is a particular drawback, given that we would expect the non-domestic sector to have different debt-related issues (for example due to businesses going into administration). The non-domestic sector also has a much greater range of customer sizes and business types than the domestic sector, and suppliers will have different mixes of domestic and non-domestic customers. A supplier might therefore have particularly low or high debt-related costs compared to other suppliers, purely as a result of having a different non-domestic business. This would complicate any benchmarking process.

Alternative data sources for a true-up or ex post adjustment

4.94. Given the limitations of the existing data, we consider that we are likely to need a new information request to assess an accurate level of debt-related costs. This applies whether we are carrying out an ex post adjustment, or carrying out a true-up after setting an initial float.

4.95. When we gather further data, we would very likely want additional granularity, including splits between domestic and non-domestic customers, and splits between payment methods. We would also want data which is as consistent as possible across

suppliers – this is likely to mean prioritising data which is more objective and less subject to the application of different accounting policies.

4.96. We discussed the frequency of reviews in Chapter 3. This is particularly challenging for bad debt write-offs, where final data is only available with a lag. We will consider further the best approach to take. However, we do not consider that the data needs to be audited (or to have been published in suppliers' accounts) before we can use it. Instead, what matters for a one-off adjustment (ex post or true-up) is that the data has settled down to a sufficient extent that the likely degree of variation between the data we use and the final data is likely to be reasonably small. If we were to make multiple rounds of adjustments for a given period, this would be less critical – although that approach would have its own issues of complexity.

Calculating a float for debt-related costs

Estimation and stringency

4.97. Any float would be an estimate. There would be a significant degree of judgement and approximation involved. In principle this could open up a range of possible levels at which we could set a float. We could set a high float, to cover the risk of suppliers having cashflow issues from costs being higher than the allowance. Or we could set it lower, preventing customers from having to pay an unnecessarily high amount, but accepting that suppliers could still face some cashflow pressure in certain circumstances.

4.98. We consider that the latter approach is preferable, in line with the Act's objective of protecting customers. We do not consider that – even in the unprecedented circumstances of COVID-19 – customers should be required to insulate suppliers from all potential debt-related risks. Any float which we include for suppliers requires customers to pay upfront, at a time when many customers will be experiencing significant financial pressures. We encourage suppliers to be mindful of this when developing suggestions for approaches we could take.

4.99. The float will be subject to a subsequent true-up. This makes the design challenge different from other policy areas. We would place a lesser weight on accuracy than usual, as this can be refined at a later stage. We would place a greater weight on practicality, given that we need to set the float quickly.

Data required to set a float

Information request

4.100. We discuss above the data we hold already, and explain its limitations. In theory we could remedy this by a significant further information request at this stage, in order to set a float based on the latest data. In practice, we do not consider that this is feasible, given the challenges below. Some of these apply in part to data gathering at any stage, but they are particularly acute at present.

- The final amount of bad debt written off is only known with a lag, after a supplier has exhausted the opportunities to collect the debt. In normal circumstances, historical data might be a good proxy for the amount of debt that will be written off in future – but this is unlikely to be true at present.

- Suppliers will make provisions for future bad debt write-offs. However, even within accounting standards, suppliers will take different approaches. The scope for suppliers to reach different judgements is presumably greater when the situation is uncertain. This makes it difficult to compare data from different suppliers.

- The COVID-19 situation is ongoing, and the ensuing recession may be in its early stages. The impact on bad debt may change over time (e.g. after the end of the furlough scheme). This means that current data may not reflect the potential future situation, and even suppliers' current expectations will be subject to considerable uncertainty.

- We have a limited period to gather and analyse any data. To implement any adjustment from 1 April 2021, we would need to publish a statutory consultation by mid-November 2020. We would need time to analyse the data ahead of this. This means that we would have limited time to develop any information request to gather reliable and consistent data.

4.101. Given these challenges, we therefore do not consider that significant new data gathering at this stage is likely to be feasible or proportionate.

Leading indicators

4.102. Instead, our current view is that we would review a set of leading indicators. Based on these, we would make a judgement about a suitable amount for the float.

4.103. We have some leading indicators already from the weekly returns. We have information on various payment-related metrics (e.g. number of failed direct debits), split between domestic and non-domestic customers.

4.104. We also intend to consider within the next week whether there are further leading indicators we could collect, and to issue an immediate Request For Information (RFI) if there are. Given timings, we would need to gather this information quickly, and so we would need to rely on information that suppliers have 'on the shelf'. We would also be likely to focus on a subset of larger suppliers, which might not correspond to the full set of suppliers that we might include in any future data gathering for actual data. (For example, we might focus on suppliers with a domestic market share of at least 1%). We will communicate with relevant suppliers about any data gathering separately.

4.105. We welcome submission of evidence from all stakeholders as part of their response to this consultation. We particularly encourage suppliers to tell us (based on the data they have provided to us through the weekly returns and through any additional data gathering) which of the indicators they consider to be most relevant for our assessment, and why. We also encourage suppliers to provide any further information they consider relevant. However, when assessing this we will need to bear in mind potential non-comparability of data between suppliers, as well as the risk of selection bias in the data suppliers provide.

4.106. We would be able to use indicators to consider the extent of change in debt since the period before COVID-19. For example, if these indicators suggested that debt had doubled, we could adjust the existing amount of bad debt costs in the cap accordingly. We will also be able to take into account macro-economic forecasts from official publications, and use this as context for interpreting the leading indicators.

4.107. Any comparison of indicators requires us to choose a starting point. This could be 2017, 2019, or the first couple of months of 2020. As discussed above, a longer comparison period risks including the impact of changes in efficiency, as well as changes due to COVID-19. Comparing data from early 2020 could be misleading, given the potential effects of seasonality. Our initial view is therefore that, where indicators

are available on a frequent (monthly/quarterly) basis, we would compare the 2020 data against the equivalent period from 2019.

4.108. It is possible that even leading indicators do not yet show a change in debt, or the potential extent of any future change. In particular, this could reflect the impact of the furlough scheme, as well as the fact that customers' bills are lower in summer. In this event, our current view is that we would consider whether there is other data which we could use to put a floor on the likely eventual change in debt. In particular, we plan to consider whether data on how debt changed over the last recession might be a relevant comparator.

5. COVID-19 costs for PPM customers

In this chapter, we consider the types of PPM specific costs that suppliers might incur because of COVID-19.

We seek stakeholders' views on our considerations in general.

Summary

5.1. We discuss PPM separately to the credit issues presented in earlier chapters because, while the PPM and default tariff caps share the same core methodology, the most significant potential impact of COVID-19, payment difficulties, will have very different impacts with respect to PPM. We note that there is ongoing policy work to improve outcomes for PPM customers who are self-disconnecting.[43] This consultation only considers any additional costs resulting from COVID-19.

5.2. Our initial view is that the effects of COVID-19 on supplying PPM customers are limited. We consider that there could be small additional administrative costs but we believe suppliers could meet these by reallocating under-utilised resources. We also think there could be some ongoing bad debt costs from an increase of discretionary credit provided by suppliers.

5.3. We do not think there are other PPM specific COVID-19 costs incurred by suppliers. We discuss policy costs in Chapter 6 for both credit and PPM, but conclude that any impacts of COVID-19 on these costs would be temporary and sufficiently accounted for by the existing cap methodology.

[43] Ofgem (2020), Self-disconnection and self-rationing final proposals – statutory consultation. Closed 24 August 2020. Awaiting decision. https://www.ofgem.gov.uk/publications-and-updates/self-disconnection-and-self-rationing-final-proposals-statutory-consultation

Scope of review

Background

5.4. The Competition and Markets Authority (CMA) designed and introduced time-limited protection for PPM customers following its findings from the Energy Market Investigation. The PPM cap has been in place since April 2017, protecting all PPM customers.[44] It will expire at the end of December 2020.

5.5. We decided in August 2020 to continue protecting these customers using the default tariff cap. We set a specific cap level for prepayment meter customers.[45] Our decision ensures that default PPM customers will remain protected for the remainder of the default tariff cap.

Scope of COVID-19 review for PPM

Time period and remit

5.6. The current PPM cap is set and updated based on the methodology introduced by the CMA.[46] This means the level of protection provided under the PPM cap reflects the CMA's policy intentions and decisions. Only the CMA can make changes to the PPM cap through the Prepayment Charge Restriction Order 2016.

5.7. The vast majority of customers with PPMs will then be protected by the default tariff cap from 1 January 2021 (when the existing PPM cap expires). We have set the PPM level of the default tariff cap based on our own judgements. We consider that the appropriateness of the level of the PPM cap since its introduction in 2017, was a matter for the CMA and was not in scope when setting the level of the default tariff cap.

[44] Customers with an interoperable smart meter operating in prepayment mode have been in scope of the default tariff cap since its introduction in January 2020. In practice we allow these customers to be charged up to the existing CMA prepayment meter price cap level.
[45] Ofgem (2020) - Protecting energy consumers with prepayment meters: August 2020 decision https://www.ofgem.gov.uk/system/files/docs/2020/08/protecting_energy_consumers_with_prepayment_meters_-_august_2020_decision.pdf
[46] The CMA reviewed and updated its methodology in 2019. https://www.gov.uk/cma-cases/review-of-the-energy-market-investigation-prepayment-charge-restriction-order-2016

5.8. While we consider that the relevant costs are likely to have been incurred during the CMA cap, we recognise that the specific circumstance of a large, unexpected shock during the transition period when the CMA cap will soon end is unique. The CMA would not have been able to make any adjustments to the PPM cap to recognise any impacts of COVID-19 given that the cap ends at the end of 2020. We therefore conclude that it is appropriate that we consider whether to make an adjustment for the exceptional PPM impacts of COVID-19 within the default tariff cap (which we refer to as the "cap" for the remainder of this chapter).

Tariff type

5.9. The cap will apply to PPM customers that are on default tariffs (98% of PPM customers). This means that we can only apply an adjustment to be recovered over default tariff customers. In comparison, the CMA PPM cap protected all PPM customers regardless of their tariff type.

5.10. There are three options for assessing and recovering any material COVID-19 related costs for PPM.

- Consider only default tariff PPM costs and recover them over default tariff PPM customers.
- Consider all PPM costs and recover them over default tariff customers only. Default PPM customers would bear the cost of fixed tariff PPM customers as well.
- Consider all PPM costs and assume they are recovered from all PPM customers (i.e. calculate a cost per customer). We would then set the allowance for default tariff customers assuming that suppliers recover the remaining portion of costs from their fixed tariff PPM customer base.

5.11. We propose to use the third option. We consider it a sensible simplification to calculate any adjustment based on all tariff types and apply the cost per customer to the cap. Suppliers will recover the default tariff portion of costs through the cap. For PPM this should capture the majority of costs given 98% of PPM customers are on default tariffs. This treatment is in line with our proposals for credit debt-related costs covered in Chapter 4.

Policy changes on self-disconnection

5.12. Ofgem is undertaking work to improve outcomes for PPM customers who are self-disconnecting.[47] The final package of proposals presented in the self-disconnection statutory consultation includes new requirements on suppliers to (1) take all reasonable steps to identify PPM customers who are self-disconnecting, (2) make credit facilities more widely accessible for PPM customers (particularly those in vulnerable circumstances), and (3) provide support to customers who are struggling to pay their bills through inclusion of updated Ability to Pay principles in the licence.

5.13. The draft impact assessment published as part of the statutory consultation predicts that the net total costs to suppliers of the proposals will be £1.1m by 2023.[48] When spread across all PPM customers we consider this amount to be immaterial. On that basis, we do not think an additional allowance is needed in the cap. However, Ofgem is currently reviewing responses to the self-disconnection statutory consultation and considering views and evidence on the draft impact assessment. We welcome views with quantitative evidence on whether stakeholders consider that their previous representations on the self-disconnection statutory consultation impact the cap.

5.14. For the rest of this chapter, we consider additional costs only resulting from COVID-19.

COVID-19 related costs

5.15. Most cost components of the cap are identical for all default tariff customers, including those with PPMs. In the event we conclude that any of these costs require an adjustment, we will treat all customers in the same way. At this stage, we do not consider that there are any such costs. We discuss policy costs in Chapter 6 and other costs in Chapter 7.

[47] Ofgem (2020), Self-disconnection and self-rationing final proposals – statutory consultation. Closed 24 August 2020. Awaiting decision. https://www.ofgem.gov.uk/publications-and-updates/self-disconnection-and-self-rationing-final-proposals-statutory-consultation

[48] Self-disconnection and self-rationing – draft impact assessment "Through the estimates outlined in this assessment, we predict that the total net costs to suppliers across the industry by 2023 will be £1.1m. There are currently 8.3m gas and 9.2m electricity customer accounts on fixed tariffs in GB. If suppliers choose to pass on these costs promptly to the rest of their customer base rather than through an uplift in PPM tariffs at the end of the cap period, these figures suggest that the average bill of a fixed tariff customer could increase on average by £0.02p per account, per year (nominal value)."

5.16. We consider that debt and payment-related costs differ between credit customers and PPM customers. The mechanisms for payment-related costs are unique for PPM customers. In general, it is harder for PPM customers to run up a large debt. If customers access emergency/friendly-hours or discretionary credit and do not repay their credit facility they risk self-disconnecting from their energy supply. Self-disconnection is defined as an interruption to supply because the credit on the meter has been exhausted or the credit is not easily accessible. It limits the amount of arrears and debt a PPM customer can build up.

5.17. When considering any costs from COVID-19, we would only include an adjustment for any increase (or reduction) in these costs. For example, the increase in the cost of providing credit facilities to customers rather than the overall cost.

5.18. We consider that the potential payment-related additional costs for PPM as a result of COVID-19 can be split into three categories:

- cost of credit - the cost to the supplier of providing additional credit facilities;
- non-repayment of credit - increase in bad debt from customers not repaying credit facilities;
- credit administration costs – any increase in administration costs of providing a credit function (e.g. sending pre-loaded keys or cards to customers).

5.19. It is possible that suppliers have provided customers with additional credit facilities during the lockdown. However, it is likely that the government furlough scheme has helped customers to maintain their payments since COVID-19 began, meaning the risk of this additional credit not being repaid is limited. We discuss our understanding of the three categories of additional COVID-19 costs below.

Cost of credit

5.20. The credit provided to PPM customers can broadly be split into two groups:

- Emergency/friendly-hours credit – this form of credit facility is intended to support PPM customers after they run out of credit or when they are low on credit. The emergency credit functions are generally built into the meter or sometimes provided through an engineer visiting the property via a 'wind-on'.

Friendly-hours credit is available at specific times (e.g. certain hours in the evenings, at weekends and during Bank Holidays). The amount of credit provided to the customer is limited (typically £5 - £20 per fuel) and importantly, the customer must repay the entire amount of credit immediately when they are next able to top up their meter, unless alternative repayment methods are arranged with the supplier, or else they risk self-disconnection.

- Discretionary credit – suppliers can provide additional credit to customers, which is often added to a customer's meter at their direct request. This function tends to be tailored for customers in vulnerable circumstances who need extra support. The amount of credit provided differs based on the customer's circumstance and it can be higher than the amount offered under emergency credit. The customer does not need to repay the full amount of credit immediately. In some cases, suppliers offer customers the ability to repay the credit in instalments or decide to write-off the credit as a goodwill gesture

5.21. We do not view the credit provided to consumers as a cost in itself, providing the customers repay the credit. The costs incurred by the supplier are the costs of working capital for the credit provided and the write-off cost of the credit if customers do not repay.

5.22. When considering the cost of the credit, it seems unlikely that emergency/friendly-hours credit creates a significant working capital cost for suppliers. The customer must pay the credit back upon their next top-up or they will self-disconnect. We assume this means that either the supplier recovers the credit soon after providing it or in the case of self-disconnection, the level of arrears does not increase for that customer.

5.23. Discretionary credit could have a larger impact on suppliers' costs given the amount of credit is higher than emergency credit. However, we do not think the level of arrears increases over time, and it should be within the supplier's control (i.e. suppliers decide whether to provide further discretionary credit). It is common practice for a supplier to put a repayment plan in place which means that the working capital exposure is reduced.

5.24. Setting an adjustment to account for any additional costs from discretionary credit would be difficult given that providing discretionary credit is currently voluntary for suppliers. We would expect to see significant variation between suppliers on any increases in discretionary credit costs. Benchmarking the level of any increase would

be difficult given lower costs may not imply efficiency but rather differences in the willingness to provide credit. In addition, we would need to consider any benefits from providing additional credit (e.g. increase in reputation from customer service).

5.25. Our initial view is that even if the amount of credit provided has increased because of COVID-19, it is unlikely that the financing costs have materially increased. Customers are likely to repay emergency/friendly-hours credit soon after suppliers provide it (else, the customer would self-disconnect). The cost of discretionary credit might be higher but customers usually repay this through an agreed repayment plan.

Bad debt

5.26. When suppliers provide PPM customers with credit, it is possible that a proportion of the credit provided is not repaid and has to be written-off as a result. This is the main source of bad debt incurred on PPM. However, we expect this to be relatively small when compared to standard credit bad debt costs where a customer can continue to build up debt for longer periods of time.

5.27. If suppliers provide more credit facilities as a result of COVID-19, there could be an increase in the amount of bad debt (i.e. a portion of the additional credit is not repaid).

Credit administration costs

5.28. As a result of the restrictions in place during spring 2020, it would have been difficult for PPM customers to go to stores and top-up their PPM meters (where local stores were closed, or customers were self-isolating or shielding). We have seen an increase in the number of pre-loaded PPM electricity keys and gas cards that suppliers have sent to customers with traditional PPM meters in order to stay on supply.

5.29. There may be an increase in administrative costs associated with sending these keys/cards to customers. However, we consider this cost would be relatively small, given that it was for a limited number of months. Furthermore, suppliers may have experienced reductions in other PPM-related costs, such as inbound contacts, or been able to reallocate resources from elsewhere in the business to minimise an increase in PPM costs, (e.g. from reduced smart meter installations).

Considering an adjustment

5.30. If there were any additional costs from COVID-19, we would consider the options for assessing an adjustment that we presented in Chapter 4. These are:

- ex-post: we would make an adjustment once we can quantify the actual additional costs incurred from COVID-19;
- 'float and true-up': we would estimate the additional costs of COVID-19 using the best information available at the time then look to make any corrections once we know the true additional costs.

5.31. It is likely that the only persistent additional costs would be an increase in bad debt from an increase in the credit facilities provided to customers. For any increases in bad debt, we could treat them ex-post in a future cap period once the debt is written off and costs materialise. Alternatively, we could estimate what the costs will be and provide an allowance for April 2021 (with a 'true-up' in a later cap period when the data is available).

5.32. For any additional costs that are one-off and specific to the lock-down months, we propose to treat these costs ex-post where the data is available to set the adjustment in time for cap period six. If the data is not currently available, we could either estimate a float for cap period six or provide an adjustment based on the actual data in cap period seven.

5.33. At this stage, we think it is unlikely that there are material ongoing costs to PPM customers due to COVID-19. We do not foresee a material increase in the level of debt, even in an economic recession, as customers are still required to pay in advance, with only very limited facility to access credit from their supplier or to accumulate debt. We particularly welcome evidence, quantified where possible, from stakeholders on this point (as well as on any of the considerations set out in this chapter which feed into our initial view).

6. Impact of COVID-19 on policy costs

In this chapter, we assess each policy scheme in turn and discuss the routes through which COVID-19 could impact policy costs and how this interacts with our methodology used to set the policy scheme allowance. We have also set our considerations as to why the existing methodology does or does not account for these impacts.

We seek stakeholders' views on our considerations in general.

Introduction

6.1. Energy suppliers are subject to a number of environmental and social obligations designed to achieve a variety of different policy goals. In most cases these obligations result in additional charges to suppliers, which are then passed on to gas and electricity customers via their energy bills.

6.2. Our initial view is that several of these costs have been impacted by COVID-19. However in general we expect these impacts to be temporary and sufficiently accounted for by the existing cap methodology. In this chapter we summarise each scheme covered by the policy cost allowance, how we calculate the allowance, and set out the potential impact of COVID-19 on the scheme and why the existing methodology does or does not account for these impacts.

Summary

The existing policy cost allowance

6.3. The cap includes a policy cost allowance to ensure that suppliers are able to recover the additional costs related to these obligations. It covers six schemes:[49]

- policies supporting low carbon and renewable energy, including the Renewable Obligation (RO), Contracts for Difference (CfD), and Feed-in Tariffs (FIT);
- delivering energy efficiency measures under the Energy Company Obligation (ECO) scheme;
- Warm Home Discount (WHD) rebates paid to fuel poor customers;
- Assistance for Areas with High Electricity Distribution Costs (AAHEDC, previously known as the 'Hydro Benefit Scheme') which aims to reduce electricity prices in areas of high distribution costs (currently Northern Scotland).

6.4. We set policy costs using forecast data. We don't expect actuals to match forecast for a specific policy exactly in any given year. But overall, we expect the variation to balance out over time.[50] This is what we refer to as non-systematic error.

Measuring the impacts of COVID-19 on policy costs

6.5. In general, data is readily available (albeit lagged in some cases) on the actual costs of policies to energy suppliers, and so it is relatively straightforward to compare this to the size of the allowance.

[49] Capacity market costs are addressed separately in the wholesale cost allowance, discussed in Chapter 7 of this policy consultation.
[50] Ofgem (2018), Default Tariff Cap: Statutory Consultation, Appendix 5 – Policy and network costs, Table A5.3 https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_5_-_policy_and_network_costs.pdf

6.6. However there will be underlying fluctuations in the costs of these policies which are not attributable to COVID-19, e.g. due to the weather. Where possible, we will try to separate these effects. However simplification may be necessary.

Potential impacts of COVID-19 on policy costs

6.7. We have identified two potential ways COVID-19 could impact policy costs:

- changes in demand, e.g. reduced non-domestic demand resulting in domestic customers bearing a larger share of policy costs;
- reduced physical site visits, due to social distancing.

6.8. In this chapter, we assess each policy cost in turn and discuss how these potential impacts interact with the methodology used to set the cost allowance within the cap. We summarise these impacts in Table 6.1.

6.9. The policy scheme allowance also forms part of the existing PPM cap. As explained in Chapter 5 we are proposing to consider the impacts of COVID-19 on suppliers serving PPM customers under the existing PPM cap (as well as under the new PPM level in the default tariff cap from 1 January onwards). Therefore any proposals made in this chapter will also apply to PPM. The exception to this is any discussion on the historical Energy Company Obligation (ECO) costs which is discussed in paragraphs 6.62 to 6.76.

Table 6.1: Summary of costs to suppliers under each scheme

Scheme	Potential COVID-19 impact on cost allowance?
Renewable Obligation Under the RO, suppliers have an obligation to source an increasing amount of electricity from renewable sources. Suppliers can meet their obligation by presenting certificates bought from generators or making payments into a buy-out fund.	No – any changes in demand (MWh) should increase the obligation on suppliers and the cap allowance in tandem. Our allowance is set on the ROC buy-out price. However high renewable generation coupled with a fall in demand could reduce the recycle value.
Contracts for Difference CfDs are designed to give greater certainty and stability of revenues to low-carbon electricity generators. The payments to generators are funded via a compulsory levy on all electricity suppliers.	Yes – this is charged on a £/MWh basis. The interim levy rates and reconciled supply volumes are dependent on demand (MWh). The interim levy rate is also dependant on wholesale prices which will be impacted by COVID-19.
Feed-in Tariffs Under the FIT scheme, owners of small-scale low-carbon generation receive payments for electricity they generate and that which they export to the grid. To fund the scheme, all electricity suppliers are required to make payments into a levelisation fund.	Yes – we spread costs over a forecast of supply volumes (excluding green electricity and EII volumes). Prior forecasts are unlikely to capture COVID-19 impacts on supply volumes.
Energy Company Obligation Under ECO, suppliers have an obligation to meet targets for installing energy efficiency measures to eligible domestic consumers.	Yes – reduced physical site visits, due to social distancing restrictions will impact suppliers' ability to meet installation targets and potentially increase costs after installations resume. ECO scheme allowance is also dependent on domestic demand, which was likely impacted by the specific circumstances linked to the restrictions in place during Spring 2020.
AAHEDC This scheme reduces prices for domestic consumers in areas with high electricity distribution network costs.	Yes – suppliers charged on a p/KWh basis. A decrease in overall demand could lead to a higher p/KWh charge.
Warm Home Discount Under WHD, suppliers provide support to customers at risk of fuel poverty through a rebate of £140 to eligible customers.	No – obligation is based on a supplier's share of domestic customer accounts.

Renewables Obligation (RO)

6.10. The RO pays for the costs of subsidising some renewable generators. Our provisional view is that there is no clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology.

Scheme summary

6.11. Under the RO, suppliers have an obligation to source a proportion of the electricity they supply to their customers from renewable sources. Suppliers can meet their obligation by presenting Renewables Obligation Certificates (ROCs) bought from generators or by making payments into a buy-out fund or a combination of both.

6.12. Ofgem issues electricity generators with ROCs relating to the amount of eligible renewable electricity they generate and the type of technology they use to generate this. Generators sell their ROCs to suppliers, who present their ROCs to Ofgem to demonstrate their compliance with the RO. Suppliers who do not present enough ROCs must make a buy-out payment into the buy-out fund, for each ROC that they do not present for compliance towards an obligation.

6.13. We adjust the buy-out price per ROC in January or February before each obligation period. We adjust it in line with changes in Retail Price Inflation (RPI) over the previous calendar year. Suppliers have an incentive to meet this obligation via presenting ROCs as payments made into the buy-out fund are redistributed to suppliers who presented ROCs.

Approach to setting supplier allowances in the cap

6.14. We estimate the cost of the RO scheme using the buy-out price as a proxy of the cost of a ROC faced by a supplier. This buy-out price is multiplied by the obligation level (ROCs/MWh supplied), to obtain a £/MWh cost of the scheme. We set the allowance on a £/MWh basis.

6.15. For summer price cap periods, we make an estimate of the final buy-out price. We use the previous years' buy-out price and combine it with the most recent Office of Budget Responsibility (OBR) forecast of annual RPI from the previous calendar year to ensure that increase in RPI is accounted for in the £/MWh allowance. This is required due to

the final buy-out price not being published until mid-February, after the level of the cap is published in early February.

6.16. For winter cap periods, we use the final buy-out price (£/ROCs) and multiply this by the obligation level (ROCs/MWh) to calculate the RO scheme allowance (£/MWh).

Discussion on impact of COVID-19 on scheme costs

6.17. The obligation level, the number of ROCs a supplier must provide for every MWh of electricity they supply (domestic or non-domestic), is determined by BEIS and fixed for a given regulatory year. This means that the obligation level, once set, is not influenced by any fluctuations in demand throughout the year but is a fixed obligation level for suppliers to achieve. If the methodology used by BEIS to determine obligation levels results in an increase in future obligation periods, due to the recent decrease in demand, then this will be accounted for in the RO allowance through the existing methodology.

6.18. Setting the RO scheme allowance using the cost a supplier would incur if it were to meet its obligation by paying into the buy-out fund allows all suppliers (other than those facing late payments) to fully recover the costs of the scheme.

6.19. The actual costs suppliers incur will depend on how they choose to meet their obligation, through buy-out payments or by presenting ROCs. This means suppliers' actual costs will depend on the price they pay for ROCs (and any buy-out funds returned to them), and will not just depend on the buy-out price in a given obligation period. Suppliers may make commercial decisions to purchase ROCs at prices above the buy-out payment as they believe this will be netted off by the anticipated recycle value of ROCS from the buy-out fund.

6.20. We note that our approach could overstate the cost for suppliers who have procured ROCs at a net-cost below that reflected at the buy-out price. Suppliers also incur the risk of making losses on ROCs purchased above the buy-out price if their anticipated recycle value is not achieved. The level of this over-recovery or loss depends largely on the price a supplier pays for ROCs and the recycle value they receive from the buy-out fund which is dependent on a number of factors and could be impacted by COVID-19. However the costs of meeting the obligation by paying into the buy-out fund (the method used to set the price cap allowance) is unchanged by COVID-19 on a £/MWh basis.

6.21. A supplier's obligation, the number of ROCs they are required to present in order to meet the obligation level, is calculated by:

Suppliers obligation (ROCs) = Total Electricity supplied (MWh) x Obligation level (ROCs/MWh)

6.22. Given the obligation level is fixed for a period, a supplier's obligation is dependent on its total eligible electricity supplied in a given obligation period. This means that a decrease in total electricity demand due to COVID-19 would likely decrease all suppliers' obligations and would result in a general decrease in overall demand in the market for ROCs.

6.23. A decreased demand in the market for ROCs could lead to a decrease in the recycle value, due to less of the obligation being met by suppliers paying into the buy-out fund. This could possibly lead to the price of ROCs decreasing but this is not guaranteed as there will be forces acting in both directions. A reduction in the recycle value of a ROC purchased could lead to a lower return or possibly a loss for suppliers depending on the price they paid for the ROCs.

6.24. Overall, we do not consider that there is any adjustment required for the RO scheme allowance to account for any changes resulting from COVID-19 as our approach allows suppliers to fully recover the cost of meeting the RO through the buy-out payment method. We have noted that there could be impacts on the actual costs suppliers' could incur if they were to meet some or all of their obligation by acquiring ROCs. Our methodology does not try to take into account the cost of ROC purchasing, so it would be asymmetric to do so now. The purchasing of ROCs involves commercial risk, and it is not the role of the cap to insulate suppliers against the costs of their decisions. We also note that any impacts on future obligation levels from the recent decrease in demand will be accounted for by our current methodology.

Contracts for Difference (CfD)

6.25. The CfD scheme pays for the costs of subsidising some renewable generators. Our provisional view is that there is no clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology.

Scheme summary

6.26. The Contracts for Difference (CfD) scheme is the government's main mechanism for supporting low-carbon electricity generation. CfDs incentivise investment in renewable energy by providing developers of projects with high upfront costs and long lifetimes with direct protection from volatile wholesale prices, and they protect consumers from paying increased support costs when electricity prices are high.

6.27. Successful developers of renewable projects enter into a private law contract with the Low Carbon Contracts Company (LCCC), a government-owned company. The contract sets out the detail of how 'difference payment' will be determined. This payment is determined principally by the strike price and the relevant market reference price, as adjusted for inflation indexation, with adjustments for reconciliation differences and any other payments that are due/owed.[51]

6.28. The payments to generators are funded via a compulsory levy on all electricity suppliers.

Approach to setting supplier allowances in the cap

6.29. For CfDs, the allowance is based on a weighted average of each quarter's Interim Levy Rate (ILR) as published by the LCCC for the year running April to March, uplifted to reflect the estimate of maximum allowable green excluded electricity. To this, we add the operational cost levy as published by the LCCC. We then uplift to reflect costs per MWh of electricity supplied using our estimate of regional transmission and distribution losses for single rate and multi-register electricity customers.

6.30. The operational costs levy rate is a pound per megawatt hour (£/MWh) amount charged to suppliers based on daily eligible demand. The levy funds the annual agreed budget of the CfD counterparty in performing its function of administering the CfD.

[51] Department of Energy and Climate Change (2014), Implementing Electricity Market Reform (EMR) pg 52 and 53. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/324176/Implementing_Electricity_Market_Reform.pdf

6.31. The Green Excluded Electricity (GEE) uplift is determined by dividing the GEE cap by the difference between the total reconciled supply volumes in the most recently completed obligation period and the GEE cap. We use actual outturn supply data from the most recently completed obligation year. This means that actual supply data is accounted for on a lagged basis (e.g. actual supply data for 19/20 financial year is used as in input for the cap periods that fall in the 20/21 financial year periods).

6.32. The ILR payment from suppliers covers the payments made to generators which are derived from the difference between the reference market price and the strike price. The ILR is based on LCCC's estimate of expected payments to CFD generators, expected payments from generators if applicable, and expected supply for the quarter.

6.33. Forecasts and outturn ILRs are both used as inputs in the allowance. LCCC notify suppliers of the ILR three months in advance of the quarterly obligation period. In addition to this, the LCCC also provides forecasts of the expected ILR for at least an additional three quarters. This means that the ILR forecast for an upcoming financial year is published in December of the preceding year and is then updated every three months.

6.34. Due to the timing of which we need to make a decision for each cap period, we use the original forecast of ILRs (i.e. in December of the preceding year) for our summer cap periods. For the winter cap periods, we use actual outturn data for quarters where available and use the updated forecasts for the remaining quarters.

Discussion on impact of COVID-19 on scheme costs

6.35. In general, reflecting the actual CfD costs suppliers incur is inherently uncertain given the relationship between in-quarter CfD costs and wholesale prices. This means that forecasts and actual costs can differ due to the volatile nature of wholesale prices.

6.36. We recognise that the CfD cost could be impacted due to COVID-19. Other simultaneous non-COVID-19 cost changes can also impact the cost of CfDs to suppliers, for example wholesale price changes driven by other causes (e.g. global wholesale commodity prices). Unwinding the COVID-19 and non-COVID-19 impacts of variation in costs between forecasts and actuals is complex, given the way that global commodity markets function.

6.37. Suppliers will not incur any additional COVID-19 costs in relation to the costs they incur to fund the operational cost levy. This rate is consulted and decided upon ahead of the financial year and is fixed prior to it coming into effect. This means there will be no impact from COVID-19 relating to this cost.

6.38. The GEE uplift is based on reconciled supply volume from the previous obligation period. This means that any current decrease in demand due to COVID-19 will be reflected in an increase in the GEE uplift in future periods. This means that any impact will be accounted for in future periods.

6.39. The ILR forecast for a given quarter is based on estimates of expected payments to generators and expected demand. The decrease in overall demand that has resulted from the specific circumstances linked to the restrictions in place during Spring 2020 could have increased the costs that suppliers have incurred beyond those originally forecasted. However this impact is also coupled in with the variations in wholesale prices since the forecast. We acknowledge that some of these wholesale price variations could be due to COVID-19 itself, while others would be more normal variations. The changes in suppliers' costs could have resulted in an under-recovery, especially for those periods for which demand was most impacted.

COVID-19 impacts on variations in forecasts of scheme costs

6.40. We set the policy scheme allowance for cap period four (April 2020 – September 2020) using quarterly ILRs in the 19/20 financial year that were forecasted by LCCC before the impact of COVID-19 could be reflected.

6.41. For cap period five, we calculated the Q2 2020 (April 20 – June 20) ILR figure using outturn reconciled daily levy rates and took into account the effective reduction in charge that resulted from the BEIS loan. For the remaining quarters (Q3 2020, Q4 2020 and Q1 2021) we used updated forecasts of ILRs.

6.42. Table 6.2 sets out the % difference in quarterly interim levy rates between forecasts used for the summer cap periods, represented as column (a) for each financial year,

and the updated ILR figures that are used in the winter period, represented as column (b) for each financial year.[52]

Table 6.2: Forecast vs determined quarterly Interim Levy Rates (£ per MWh)

	2017/2018			2018/2019			2019/2020			2020/2021		
Period in CFD year	(a) Forecast ILR	(b) Updated ILR	(b-a)/a	(a) Forecast ILR	(b) Updated ILR	(b-a)/a	(a) Forecast ILR	(b) Updated ILR	(b-a)/a	(a) Forecast ILR	(b) Updated ILR	(b-a)/a
Apr to Jun	1.51	1.51	0%	3.82	2.65	-31%	4.88	4.89	0%	7.47	7.84	5%
Jul to Sep	1.35	1.55	15%	4.17	3.9	-6%	5.3	5.45	3%	7.86	8.53	9%
Oct to Dec	3.32	2.12	-36%	4.57	4.08	-11%	5.87	6.24	6%	8.77	9.73	11%
Jan to Mar	3.36	3.27	-3%	4.44	3.85	-13%	5.83	5.93	2%	8.22	9.39	14%

6.43. We recognise that the updated quarterly ILR figures for the quarters in the 20/21 financial year period have increased from those originally forecasted and used in cap period four. This will result in a under allowance in cap period four for suppliers. The main driver of the difference between the original forecast and the determined updated ILR rate is due to significant decreases in wholesale prices.

6.44. Some of the decreases in wholesale prices occurred prior to COVID-19, but it is difficult to distinguish the impact COVID-19 had on wholesale prices for any given quarter. We do not think that the variations between forecasts and outturns in the quarterly ILRs experienced in the 20/21 financial year are higher than the pre-COVID-19 risk levels. For example, Table 6.2 shows that the variance seen in quarters in the 20/21 financial year were not significantly larger than the variations seen historically. Table 6.2 also highlights that the opposite impact can occur, in that the original forecast, column (a), can exceed the updated ILR, Column (B), which can result in the supplier being overfunded for the summer cap period. We do not expect actual outturns or updated ILRs to match forecasts for any specific quarter. But overall, we expect the variance to balance out somewhat over time, with wholesale price fluctuations occurring in both directions.

[52] Note that the updated ILR used in each winter period, column (b) for each financial year, contains quarters with a mixture of actual outturn (April to Jun), updated forecasts (Jul to Sep and Oct to Dec) and original forecasts (Jan to Mar).

The impact of the CfD loan from government

6.45. Suppliers will have incurred additional COVID-19 related costs in Q2 2021 (April – June 2020) due to the significant fall in demand following on from the specific circumstances linked to the restrictions in place during Spring 2020. In response to the exceptional circumstances of COVID-19, the government made a decision to defer part of the amount of the increase in suppliers' CfD obligations. The government made a decision to protect suppliers from 80% of the increase in suppliers' obligations (up to the maximum loan amount of £100m) in the second quarter of 2020.[53] They also amended the Electricity Supplier Obligations regulations to:

- defer the increase in suppliers' obligations, so that the total level of the obligation will be increased in Q2 2021;

- allow the LCCC to consider anticipated receipt or repayment of a government loan when setting the interim levy rate and/or the total reserve amount (TRA) for a quarter or making in-period adjustments.

6.46. Government stated that it "considered that providing protection from only a proportion [80%] of these additional costs was appropriate, given that not all the additional costs can be directly attributed to the current situation. Some of the fall in wholesale prices preceded the measures introduced to combat COVID-19 and will have been related to more general patterns in global commodity prices as well as other factors." [54]

6.47. Government noted that they expected the most significant pressure from COVID-19 to be in Q2 2020 (April –June 2020). In addition, they highlighted that at the time of decision LCCC did not envisage that it will need to increase the ILR for Q3 2020 (July – September 2020), where the increase in costs was not forecasted ahead of time. They

[53] Department for Business, Energy & Industrial Strategy (2020), Contracts for Difference: proposed changes to the Electricity Supplier Obligation Regulations in response to COVID-19: https://www.gov.uk/government/consultations/contracts-for-difference-proposed-changes-to-the-electricity-supplier-obligation-regulations-in-response-to-covid-19
[54] Department for Business, Energy & Industrial Strategy (2020), Contracts, Contracts for Difference: proposed changes to the Electricity Supplier Obligation Regulations in response to COVID-19: https://www.gov.uk/government/consultations/contracts-for-difference-proposed-changes-to-the-electricity-supplier-obligation-regulations-in-response-to-covid-19

did mention that they would continue to monitor the situation and will clearly signal any changes to the market if any are required.

6.48. The LCCC confirmed a BEIS loan ('SoS Payment') utilisation of £75,110,169 was provided. This is treated as a negative quarterly charge to suppliers, and has resulted in an effective reduction in the ILR charge in Q2 2020 of £1.307/MWh.[55]

6.49. Considering the government loan and associated changes, we consider that the appropriate proportion of additional COVID-19 related costs in Q2 2020 beyond those already allowed for in cap period four have been accounted for. The in-year variation between the Q2 2020 pre-COVID-19 forecast of the levy rate and the determined ILR including adjustment for the loan only equated to a 5% variance which is a smaller than the variation that has been seen historically. The LCCC will recover the costs of the government loan in Q2 2021 from suppliers and this will be taken into account in their forecast of the ILR for Q2 2021, and consequently into the cap allowance. This means that suppliers will be able to recover the cost of paying back this loan in future cap periods.

6.50. We agree with government in that we expect the most significant pressure on costs to be incurred in Q2 2020, where the increase in costs was not forecasted ahead of time. It is difficult to determine the impact COVID-19 could have above those already allowed for in the published Q3 2020 ILR (July – September 2020). The determined ILR figures we have used for cap period five will already consider some of the changes in wholesale prices which largely determines the rate. In addition, we are comfortable that the variations between forecast and determined ILR are in line with the level seen historically for this quarter.

Summary

6.51. Overall, we do not propose to make any adjustment for the CFD allowance provided in cap periods four or five. We have noted that suppliers' allowance for cap period four may be slightly under-funded due to differences between original forecasts and updated forecasts of quarterly ILRs. COVID-19 increased the underlying costs of the

[55] Low Carbon Contracts Company (2020), Reconciled Daily Levy Rates https://www.lowcarboncontracts.uk/dashboards/cfd/actuals-dashboards/reconciled-daily-levy-rates

scheme in cap period four, but this is largely offset by the government loan that has been provided to suppliers. This resulted in low additional costs for suppliers during cap period four that were within the range of historical variations.

Feed-in Tariffs (FIT)

6.52. The FIT scheme pays for the costs of subsidising some renewable generators. Our provisional view is that there is no clear and material impact of COVID-19 on costs that that will not be taken into account from our upcoming review of the FIT scheme allowance methodology.

Scheme summary

6.53. Under the FIT scheme, owners of small-scale low-carbon generation receive payments from suppliers for electricity they generate and that which they export to the grid. To fund the scheme, all electricity suppliers are required to make payments into a levelisation fund.

6.54. The levelisation fund is calculated as the sum of FIT generation payments, total deemed export payments and total FIT metered export payments minus the value of deemed exports.

Approach to setting supplier allowances in the cap

6.55. In November 2019 we made a decision to calculate the FIT scheme allowance (£/MWh) based on the latest Office for Budget Responsibility (OBR) estimates of total scheme costs (£'s), divided by a forecast of total supply volumes for the given scheme year from BEIS (MWh).[56]

6.56. This approach contains uncertainties in that actual outturn costs will differ from the costs that were forecasted due to both differences in costs and demand.

[56] Ofgem (2018), Default tariff cap: decision –overview Appendix 5 – Policy and Network costs https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

Discussion on impact of Covid-19 on scheme costs

6.57. We spread a forecast of the scheme costs over a forecast of demand in the corresponding period. Following the unforeseen circumstances of COVID-19, a reduction in overall demand (MWh) increases the FIT scheme costs currently being incurred by suppliers beyond those that have been forecasted and so included in the cap allowance, on a per MWh supplied basis. While it is difficult to plan for such events that may cause significant swings in demand, we recognise that there is a risk that our current methodology may not accurately reflect the change in costs associated with such an event.

6.58. This means that suppliers may have incurred costs above those allowed for in cap period four.

6.59. We recently made a decision to consult on new options for how to calculate the overall FIT scheme methodology for the sixth charge restriction period.[57] Stakeholders have already expressed their views that the methodology should move from using forecast costs and demand, to using actual costs and actual demand sourced from FIT quarterly invoices on a lagged basis.

6.60. We note that this approach means we would pass-through suppliers' actual costs on a lagged basis. This method would account for the outturn actual costs currently being experienced by suppliers and recover them in future cap periods, including any additional COVID-19-related costs.

6.61. In light of suppliers' comments, we currently intend to account for any additional FIT costs resulting from COVID-19 through changes to our FIT scheme methodology, following an appropriate consultation process with stakeholders. We consider that allowing suppliers to recover the actual costs of FITs on a lagged basis fully accounts for the impacts of COVID-19 on FIT costs.[58] We will consult in due course on the details

[57] Ofgem (2020), Decision on changes to the Feed-in Tariffs allowance in the default tariff cap https://www.ofgem.gov.uk/publications-and-updates/decision-changes-feed-tariffs-allowance-default-tariff-cap

[58] This is subject to any fluctuations in demand. We can ensure that the £/MWh figure is correct, but recovering the actual costs to suppliers (in £'s) requires demand to be stable.

of the mechanism for calculating lagged costs appropriately, but intend to do so in time for the actual costs of cap period four to be recovered.

Energy Company Obligation (ECO)

6.62. ECO pays for the costs of subsidising energy efficiency measures for domestic customers. Our provisional view is that there is no clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology.

Scheme summary

6.63. ECO is a government scheme that requires suppliers above a given size to deliver energy efficiency measures. The scheme was launched in 2013 and has had several obligation periods. The current obligation period, ECO3, runs for the three and a half year period from October 2018 to March 2022. Under the ECO scheme, suppliers are given targets for delivering energy efficiency measures to the premises of eligible domestic customers.

6.64. The targets are based on lifetime bill savings customers are expected to realise over the given lifetime of the measure installed. Obligated suppliers have the freedom to spend on these installations using third party providers competing on the open market, with the subsequent cost passed onto the wider consumer base. An obligated supplier must achieve its obligations before 1 April 2022.

6.65. Government projects the overall cost of meeting the scheme in their Impact Assessment,[59] which also sets out the projected industry spend in each phase of the scheme.

Approach to setting supplier allowances in the cap

6.66. The cost allowance for ECO is based on the latest government assessment of expected installations and their associated costs. We take BEIS' forecast of the annualised cost of the scheme from the most recent Impact Assessment. These costs are divided by

[59] Department for Business, Energy & Industrial Strategy (2019), ECO3: Improving consumer protection consultation IA https://www.legislation.gov.uk/ukia/2019/163/pdfs/ukia_20190163_en.pdf

our latest estimates of the supply volumes used to calculate supplier's obligations. These estimates are updated to final values for our August update. The forecast annualised costs are inflated to current year prices using latest OBR forecasts of inflation.

6.67. Since April 2019 our methodology has allowed for an updated approach by dividing annualised scheme costs by the total supply volumes of all obligated suppliers, rather than by fully obligated suppliers.[60]

Discussion on impact of COVID-19 on scheme costs

6.68. Similar to other policy costs, any COVID-19-related costs associated with ECO will vary with consumption. For ECO, these costs will vary based on both gas and electricity consumption by domestic customers only.

6.69. As ECO is based on domestic supply volumes it is sensitive to changes in domestic demand, though not non-domestic demand. The ECO allowance is based on an estimate of the supply volumes. If volumes were higher due to an increase in domestic demand as a result of lock-down, this would have the result of decreasing the cost of the ECO scheme per unit of energy supplied. This would mean the ECO cost allowance for the fourth price cap period was higher than the actual cost.

6.70. On the other hand the actual cost of delivering ECO may have increased. COVID-19 has likely impacted the roll out of ECO measures by suppliers. The specific circumstances linked to the restrictions in place during Spring 2020 meant that access to domestic properties to install energy efficiency measures was not possible at the same rates as in ordinary circumstances.

6.71. There was a dip of almost 22% during the period over April and May, compared to the same period last year. With the easing of restrictions, installations rebounded in June 2020 with a nearly 10% increase in the rate of delivery relative to March 2020.[61] This

[60] Ofgem (2018) Default tariff cap: decision – overview Appendix 5 – Policy and network costs pg 9 https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_5_-_policy_and_network_costs.pdf
[61] Department for Business, Energy & Industrial Strategy (2020), Household Energy Efficiency Statistics, headline release August 2020 https://www.gov.uk/government/statistics/household-energy-efficiency-statistics-headline-release-august-2020

is the second highest monthly installation rate since the commencement of the scheme in October 2018. It may be the case that this increased figure for June reflects the fulfilment of some scheduled installations from April and May, somewhat offsetting the temporary dip in installation roll out.

6.72. Suppliers may need to match any dip in installations by a small increase in future installations in order to meet their ECO obligations. The net cost impact will largely depend on whether suppliers were able to reduce their costs during the specific circumstances linked to the restrictions in place during Spring 2020 (e.g. by putting staff on furlough, or pausing outsourced activities with a high variable cost element), and if the increase in future volumes will be at a higher unit cost due to constrained supply-side resources, or increased safety measures, for example. We welcome supplier evidence on what efficient costs of ECO delivery were sunk during this period, and any new costs that suppliers are incurring as installations resume.

6.73. Overall, our initial view is that any increase in domestic demand has led to the ECO cost allowance overestimating actual costs for the fourth default tariff cap period. It is likely suppliers have experienced additional costs during the specific circumstances linked to the restrictions in place during Spring 2020, but these could be somewhat offset by savings due to pausing activities and adoption of the government furlough scheme. The recent dip in the rate of installation roll out could increase costs associated with achieving roll out targets in future, however initial signs suggest this may not have been as significant as expected.

6.74. Our initial view at this stage is that a COVID-19 related adjustment is not necessary. It is likely additional cost impacts due to COVID-19 are balanced out by offsetting factors, as discussed in paragraph 6.69, and any subsequent net cost impact is likely small. However we welcome further evidence based on the points raised in this discussion.

ECO3 cost allowance review

6.75. We noted in our statutory consultation and decision on Smart Metering Net Cost Change (SMNCC), [62] that there was a potential for a "carry forward" in the ECO allowance. This is separate to any COVID-19 impacts.

6.76. The Government's assessment of total lifetime costs as set out in their most recent impact assessment has not changed considerably. However its assessment of the costs in each remaining period has increased substantially. This is because suppliers' installations were much lower than expected in the first ECO3 phase (covering the first cap period). This means that suppliers received the allowance, but did not incur the costs. In other words, the updated Impact Assessment reflected a change to the timing of costs, rather than the total amount of costs. The cap now reflects the increased costs in each remaining phase, but not the fact that customers have paid for a portion of those costs already. This is a clear and material systematic error. We discussed in the SMNCC statutory consultation document that we will consider reviewing this element of the cap.

Assistance for Areas with High Electricity Distribution Costs Scheme (AAHEDC)

6.77. AAHEDC spreads some of the additional costs of supplying electricity to Northern Scotland across all customers. Our provisional view is that there is no clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology.

Scheme summary

6.78. The AAHEDC scheme was introduced in the Energy Act 2004. The scheme, previously known as the 'Hydro Benefit Scheme', aims to reduce electricity prices for consumers

[62] Ofgem (2020), Decision on reviewing smart metering costs in the default tariff cap https://www.ofgem.gov.uk/system/files/docs/2020/08/reviewing_smart_metering_costs_in_the_default_tariff_cap_-_august_2020_decision.pdf

in areas with high electricity distribution network costs (currently limited to the Northern Scotland electricity distribution area).

6.79. All licenced suppliers across Great Britain are obligated to pay to the Electricity System Operator (ESO) the tariff set out in the ESO's annual Charging Statement[63] which is published in July each year. The amount collected is then passed to the relevant distribution network operator (Scottish Hydro Electric Power Distribution).

Approach to setting supplier allowances in the cap

6.80. The cost allowance for AAHEDC is set using the tariffs published by the ESO. For the summer price cap period, the allowance is set using an estimate based on the previous year's charge, as the final tariff is not yet available. This is uprated in line with the OBR's estimate of the annual trend in the RPI. The allowance for the winter price cap period is updated to reflect the actual final charge.

6.81. BEIS have introduced GB-wide funding for the existing Shetland cross subsidy from April 2021. This is an amount that National Grid will add to the AAHEDC tariff that ensures electricity prices for consumers on Shetland are comparable to those on the mainland, and will be £27m in 2021/22. The cost allowance within the price cap will reflect this additional amount. We plan to consult on this in due course in order to reflect any changes from April 2021.

Discussion on impact of COVID-19 on scheme costs

6.82. The level of the tariff is calculated by the ESO depending on expected demand and its administration costs. There is also a mechanism within this calculation that corrects for any under or over recovery from the previous year.

6.83. Tariffs are calculated by the ESO for each financial year but are not published until mid-July, after the start of the financial year. This later publication date allows the

[63] National Grid ESO (2020),The charging statements and accompanying draft and final tariffs https://www.nationalgrideso.com/charging/assistance-areas-high-electricity-distribution-costs-aahedc

previous quarter payment to be reflected in the tariff and taken into account when including any under or over recovery.

6.84. In determining the tariff for 2020/2021, the ESO corrected for inflation, lower outturn demand and unpaid invoices due to supplier failure, as known in July 2020. It also took into account an anticipated decrease in the demand charging base. Additionally, a correction has also been included to take into account the reduction of demand due to the impact of COVID-19.[64]

6.85. Overall, this had the effect of increasing the 2020/21 tariff by nearly 16% on the previous year. This means that the final tariff published in July 2020 for the 2020/21 financial year fully takes into account the impacts of COVID-19 on the costs of the scheme across the entire financial year, therefore the default tariff cap allowance (which is calculated using the final tariff published in July 2020) also does so.

6.86. The AAHEDC cost allowance for the fifth price cap period uses this latest 2020/21 tariff, so this includes an adjustment due to the impacts of COVID-19. We will uplift this tariff for inflation for the sixth price cap period, so this will also reflect an adjustment for the impact of COVID-19.

6.87. We set the cap level for cap period four using the 19/20 tariff published the previous summer and adjusted for inflation. National Grid applied a correction factor to this tariff, however it did not reflect a COVID-19 related decrease in demand. Suppliers may have experienced a shortfall due to the difference in forecast and outturn.

6.88. It should be noted that the correction factor applied by National Grid in the July 2020 tariff took into account a significant reduction in demand due to energy efficiency and growth of embedded generation. So, the difference between the fourth and fifth price cap period cost allowance for AAHEDC may be largely due to this. Any resulting impact of COVID-19 on the costs of AAHEDC during the fourth price cap period is likely small compared to wider considerations.

[64] National Grid ESO (2020), AAHEDC final tariff 2020/2021
https://www.nationalgrideso.com/document/173046/download

6.89. In summary, we do not consider that an adjustment to the AAHEDC cost allowance is necessary. Demand reduction due to the impacts of COVID-19 is already reflected in the tariff used to determine the forthcoming winter price cap period and subsequent price cap periods will incorporate adjustments made as per the existing process. Any impact in the fourth price cap period is likely small and adjusting for this would seem inappropriate given its low materiality.

Warm Home Discount (WHD)

6.90. WHD pays for the costs of subsidising some customers at risk of fuel poverty. Our provisional view is that there is no clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology.

Scheme summary

6.91. WHD allows suppliers to provide support to customers at risk of fuel poverty through a rebate of £140 to eligible customers. Only domestic suppliers above a given threshold are required to participate in the scheme.

Approach to setting supplier allowances in the cap

6.92. The cost allowance for WHD within the price cap is based on target spending for the scheme year, divided by our latest estimates of the customer numbers of obligated suppliers (or the final values, where available). We exclude the part of core group spending accounted for by voluntary suppliers.

Discussion on impact of COVID-19 on scheme costs

6.93. WHD payments are based on a supplier's share of domestic customers. Therefore, due to the fact that the cost a supplier pays does not vary based on consumption, we do not expect that COVID-19 will change the costs of this scheme or the allowance.

7. Impact of COVID-19 on other cost allowances in the cap

In this chapter we consider the cost allowances other than policy costs and debt-related costs, which we have discussed in earlier chapters.

We seek stakeholders' views on our considerations in general.

Introduction

7.1. We are considering each component of the cap to identify potential changes in costs of supplying default tariff customers resulting from the impact of COVID-19. The main potential changes in cost relate to debt and policy costs, which we discuss in Chapters 4 and 6. In this chapter we consider the other cost allowances. In doing so we take into account the materials provided to us by industry stakeholders since March 2020 regarding the potential impacts of COVID-19, as well as our own judgement and other sources of information.

7.2. Our initial view is that no adjustments are necessary for any of the cost allowances discussed in this chapter, though there are some costs on which we have not yet formed a view. We will continue to monitor the impacts of COVID-19 on these costs and may revisit them in subsequent reviews.

Wholesale costs

7.3. The wholesale cost allowance includes the costs of purchasing energy in the wholesale markets, associated costs such as shaping and unidentified gas, and capacity market costs.

7.4. Our provisional view is that there is no clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology, though we have not yet taken a view on some cost components.

Wholesale market costs

7.5. Suppliers incur direct fuel costs of purchasing energy to meet expected demand. The cap allows for these costs using an assumed hedging strategy where 100% of energy is purchased in advance.

7.6. During the specific circumstances linked to the restrictions in place during spring 2020, domestic electricity demand may have increased as consumers spent more time at home. The cap allowance per MWh has not changed. Suppliers will have purchased additional energy at short notice during this period to meet the spike in demand, for example in the day ahead market. This is different to ordinary shaping costs.

7.7. If the prevailing wholesale market prices differ to the cap allowance, the cap allowance will not match efficiently incurred costs. Wholesale prices during the specific circumstances linked to the restrictions in place during spring 2020 were typically lower than the allowance in the cap. This is partially due to reduced non-domestic demand (from COVID-19) reducing wholesale prices.

7.8. Suppliers have therefore likely supplied additional energy to customers at a cost less than allowed for in the cap. This manifests in additional gross margin from default tariff customers.

7.9. We have not reached an initial view on whether to adjust the cap level for this benefit. Suppliers will have their own hedging strategies, and demand forecasts can never be 100% accurate, and so we do not expect their costs to match the cap allowance exactly in any given period. In addition prices may have been higher in some periods and these may be correlated with periods of higher domestic demand. Overall, the size of the combined impact of increased demand and reduced price may be larger than could reasonably be expected under ordinary circumstances. We welcome stakeholder evidence on the materiality of this reduction in costs compared to the allowance. If we do not make an adjustment, we would still consider this additional gross margin as part of an overall assessment of the appropriateness of any adjustment we make.

Additional wholesale allowances

7.10. Suppliers incur additional wholesale costs of shaping, forecast error and imbalance costs, transaction costs, additional risk and uncertainty, and losses and unidentified gas. Each of these is allowed for in the cap, as a fixed percentage of direct fuel costs based on historical analysis.[65]

[65] https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_4_-_wholesale_costs.pdf paragraphs 2.13 to 2.34

7.11. There may be some additional forecasting costs arising from the increased uncertainty in wholesale pricing and demand compared to historical performance, particularly for electricity, which may offset some of the supplier gains in gross margin discussed in paragraphs 7.6 to 7.8. The cap allowance is set based on historical forecast error. However the cap methodology contains a prudent assumption – it assumes suppliers are always on the wrong side of a price change. This increases the allowance and provides some flexibility for increases in such costs. The cap uses the same prudent assumption for imbalance costs.

7.12. We do not consider that transaction costs or shaping costs will have changed due to COVID-19. We note that the pattern of additional domestic consumption during COVID-19 may be unevenly distributed across the day, and that suppliers will have had to manage this change.

7.13. One stakeholder has noted to us that the unidentified gas percentage of throughout has been negative on average since the specific circumstances linked to the restrictions in place during spring 2020, though it has recently normalised. A negative unidentified gas percentage is beneficial to suppliers, as it reduces costs for suppliers compared to the cap allowance for unidentified gas, which is fixed at 2%.

7.14. Overall our initial view is that COVID-19 may have had a modest impact on these costs, but that this could be positive or negative and is likely covered by existing prudent assumptions and uncertainty allowances in the wholesale allowance.

Capacity market

7.15. Suppliers pay charges to cover the costs of capacity payments to generators. These costs are shared across suppliers based on their share of total demand during winter periods of high demand in the delivery year (4pm – 7pm on every working day in November, December, January and February).[66] These charges are set for each delivery year, which runs October to September. The actual charges are adjusted for outturn peak demand.

[66] EMR Settlement Limited (2020), Acronyms and Definitions Master appendix https://www.emrsettlement.co.uk/document/working-practice/acronyms-and-definitions/ page 28

7.16. The cap methodology allows for these costs by calculating the expected aggregate payments in a delivery year, weighting to the relevant fiscal year, dividing by forecast total winter peak demand (giving an implied cost per peak winter MWh on the transmission system), and then combining this with an estimate of the proportion of domestic customers' demand that takes place during the winter peak period for electricity customers.[67]

7.17. The total charges suppliers have paid between April 2020 and September 2020 (cap period four) are based on market share of peak demand during November 2019 – February 2020, and are thus unaffected by COVID-19. Similarly, the proportion of these costs that are incurred by domestic customers (i.e. their share of 2019/20 winter peak demand) are unaffected by COVID-19.

7.18. To the extent that domestic demand has risen during COVID-19, suppliers have been able to recover slightly more money from default tariff customers to cover capacity market payments than the costs incurred by these customers (i.e. their share of winter peak demand).

7.19. For cap period five (October 2020 – March 2021), the cap allowance is based on the Low Carbon Contracts Company (LCCC) forecast of gross demand, which is based on data submitted by suppliers by 1st June 2020 at the latest.

7.20. If aggregate demand is lower than LCCC has forecast in winter 2020/21 due to COVID-19, then the cap period five wholesale allowance will be lower than the costs incurred by default tariff customers in this period. This is because the financial payments to capacity providers must be spread over a smaller volume of consumption than forecast. This impact will be exacerbated if the share of peak demand consumed by domestic customers also increases.

7.21. It is challenging at this stage to form an expectation on whether actual demand will vary substantially, either up or down, from this forecast. Whilst the demand forecasts have been made by LCCC with at least some knowledge of the potential impacts of COVID-19, the path of winter peak demand remains uncertain and will depend on both

[67] The full explanation is given on page 17 of Appendix 4 of our Default Tariff Cap final decision, November 2018 https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_4_-_wholesale_costs.pdf

economic and public health developments. In any case, our preliminary view is that it would take a large shift in aggregate winter peak demand compared to the forecast for the cap allowance to materially diverge from actual costs incurred. This would also need to be balanced with the potential over-recovery in cap period four discussed in paragraphs 7.17 to 7.18.

7.22. Our initial view is that there is unlikely to be a need to adjust the price cap to reflect the impacts of COVID-19 on capacity market costs given the scale of changes required to have a material impact on these costs. However we propose to continue to monitor how actual demand outturns and the extent to which the cap over or under-recovers capacity market payments for default tariff customers over the totality of cap periods four and five.

Policy costs

7.23. Any potential policy cost changes are covered in Chapter 6.

Network costs

7.24. The network cost allowance includes the costs of the transportation of energy, losses, and balancing services.

7.25. Our provisional view is that there is no clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology.

Energy transportation costs (including losses)

7.26. Suppliers are charged on a per MWh basis in accordance with network charging statements.[68] The cap allowance is set using the actual charging statements.

7.27. Some network charges have been deferred partly or fully to March 2021 for some suppliers, to mitigate cashflow pressures resulting from COVID-19.[69] The network

[68] A minor exception to this is the fixed charge component of electricity distribution charges.
[69] Ofgem (2020), Managing the impact of COVID-19 on the energy market – introducing the option of relaxing network charge payment terms for suppliers and shippers https://www.ofgem.gov.uk/system/files/docs/2020/06/open_letter_on_relaxing_network_charge_payment_terms_1.pdf

charge deferral allows suppliers to reduce the amount they pay relative to the costs they would otherwise have incurred even without COVID-19.[70] This means that suppliers will recover these costs from default tariff cap customers in advance of paying the network charges to the network operators. This is a cashflow benefit to suppliers for one cap period, and up to the end of August 2020 18 firms have deferred charges worth a total of £58m.[71] Suppliers will incur interest charges of 8%,[72] and so there is only a very limited working capital benefit relative to the cap allowance (which uses a cost of capital of 10%). However the network costs allowance will still match costs incurred, even though the timing of payments to the network operators has changed.

7.28. One stakeholder has told us that networks will under-recover on charges in 2020 due to reduced non-domestic demand, and that this will increase 2022/23 charges for all customers. As the network costs allowance for this period will be set using the 2022/23 charging statement, the cap will still allow full recovery of these costs. This may increase the cap level.

7.29. We are not currently aware of any reason for electricity losses to have increased or decreased due to COVID-19.

7.30. Our initial view is that there is no need to adjust the price cap to reflect the impacts of COVID-19 on energy transportation costs.

Balancing services

7.31. Suppliers are charged by the ESO for the costs of balancing the network. The cap includes a lagged allowance for these costs, based on actuals in the previous period.

[70] This differs to the Contract for Difference (CfD) cost deferral through the BEIS loans, which is intended to defer 80% of the additional costs of CfDs from recent changes in the wholesale price (due in some part to COVID).
[71] Ofgem (2020), Network Charge Deferral update https://www.ofgem.gov.uk/publications-and-updates/network-charge-deferral-update#:~:text=Network%20companies%20have%20to%20provide,electricity%20distribution%20and%20electricity%20transmission.&text=The%20firms%20are%20required%20to,in%20full%20by%20March%202021
[72] Ofgem (2020), Managing the impact of COVID-19 on the energy market – introducing the option of relaxing network charge payment terms for suppliers and shippers Page 3, https://www.ofgem.gov.uk/system/files/docs/2020/06/open_letter_on_relaxing_network_charge_payment_terms_1.pdf

Specifically, this is a weighted average of Balancing Services Use of System (BSUoS) charges in £/MWh in each settlement period across the preceding calendar year (for summer cap periods) and preceding year running from 1 July to 30 June (for winter cap periods). This charge is then uplifted by forecast losses, before being multiplied by typical domestic consumption to calculate the allowance. A supplier with a stable consumption base will therefore fully recover the costs of BSUoS in the subsequent cap periods.

7.32. Balancing costs have been higher since March 2020, at least in part due to COVID-19. The ESO has forecast balancing costs approximately 2.5 times higher in summer 2020 compared to summer 2019.[73]

7.33. This is a cashflow issue for suppliers, rather than a cost issue. As set out in paragraph 7.31 this allowance is calculated on a lagged basis, which means a supplier will fully recover these costs[74] in the subsequent cap periods if its domestic consumption base is stable. Ofgem has also decided to allow a portion of the additional BSUoS costs to be deferred, which offsets the cashflow issue to some extent.

7.34. We note that domestic electricity demand has risen during the specific circumstances linked to the restrictions in place during spring 2020. If domestic demand returns to normal levels subsequently, then the BSUoS cost (which is £/MWh multiplied by MWh of default tariff cap consumption) will not be fully recovered in the subsequent cap periods, because there are fewer units of consumption to recover it from. Conversely if domestic demand increases next year then suppliers will over-recover BSUoS costs.

7.35. At this stage we consider that the impact of this cost change is unlikely to result in a clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology. If we do look further at this issue, we will consider the impact of increases in domestic demand on both the additional costs and additional saving impacts identified.

[73] Forecasts for 1st April to 1st September for 2019 and 2020 extracted on 3 September 2020 from https://data.nationalgrideso.com/balancing/balancing-services-use-of-system-bsuos-daily-forecast

[74] There would ordinarily be a small additional cost of holding the additional working capital required for the rise in BSUoS charges for, on average, an extra six months. However this is offset by the BSUOS charge deferrals which apply to a portion of the additional BSUoS costs incurred (see Connection and Use of System Code Modifications CMP345 and CMP350)

Operating costs

7.36. Suppliers incur costs in serving customers. These include customer contacts, billing and payment collections, metering, sales and marketing, central overheads, depreciation and amortisation, and industry charges.

7.37. The operating cost allowance accounts for these costs. It is set to a benchmark efficient cost level using 2017 data, and increases with inflation each year. This means that suppliers retain any benefits of reducing costs below this efficient benchmark level. The operating cost allowance includes some debt-related costs. These are discussed in Chapter 4.

7.38. Our initial view is that there is no need to adjust the cap to reflect the impacts of COVID-19 on operating costs. However we are keen to understand stakeholder views on the cost reductions from the use of the furlough scheme in particular.

Possible reductions in operating costs due to COVID-19

7.39. We have identified the following possible sources of cost reduction due to COVID-19:

- reduced staffing costs due to use of the furlough scheme;
- reduced inbound contacts from domestic customers, when suppliers were actively discouraging customers from contacting them with routine enquiries;
- reduced acquisition and marketing costs, for example reduced physical advertising on transport routes during the specific circumstances linked to the restrictions in place during spring 2020, or reduced commission paid to price comparison websites;
- reduced meter read costs due to reduced site visits during COVID-19;
- reduced variable costs of physical locations, such as electricity use at offices;
- reduced management expenses, such as fuel and travel.

7.40. Some reductions in operational activity may not result in cost decreases, for example where some costs are fixed in the short-term, or depending on the commercial terms of existing contracts with the supply chain.

7.41. Regarding furlough, some large suppliers utilised the furlough scheme for several thousand workers, including back office and customer facing staff. Other suppliers did not use the scheme, but have reduced expenditure on outsources services such as sales and some field activities. Both actions will have substantially reduced costs for these suppliers during the specific circumstances linked to the restrictions in place during the spring 2020 period. If we do not make an adjustment for this cost reduction we will consider it in the round alongside other short-term potential changes to costs.

Possible increases in operating costs due to COVID-19

7.42. We have identified the following possible sources of cost increases due to COVID-19:[75]

- additional costs in mobilising a remote workforce, such as additional IT;
- additional back office costs to deal with an increased reliance on estimated bills due to reduced physical meter reads. For example, this could include increased contacts.

7.43. On balance, our initial view is that the net impact of these potential changes is likely to reduce costs for suppliers compared to the allowance, but overall is unlikely to be clearly and systematically materially different.

Payment method uplift

7.44. The payment method uplift captures the additional costs of serving standard credit customers. In particular, three cost elements are identified: bad debt, working capital, and additional administrative costs. Additional administrative costs include the

[75] As discussed in Appendix 1, the additional administrative costs of pursuing late payment of bills, such as legal fees, are largely addressed in the payment method uplift, and so are discussed in that section of this chapter, rather than duplicate materials.

administration and collection costs of bad debt, additional printing and posting and customer service costs from a higher propensity to call, for example to pay their bill.

7.45. The bad debt and working capital elements of the payment method uplift are discussed in Chapter 4. The additional administrative costs associated with bad debt are also discussed in Chapter 4.

7.46. The remaining component of the payment method uplift is the additional administrative costs (excluding bad debt administration and collection) of serving standard credit customers. We are not aware of any evidence that the incremental additional administrative costs of serving standard credit customers have changed systematically and materially due to COVID-19.

7.47. Some stakeholders have suggested there has been a reduction in inbound contacts during the specific circumstances linked to the restrictions in place during spring 2020. If standard credit customers are more likely to make inbound contacts, this could disproportionately decrease their costs more than other customer groups. However suppliers would only be able to realise a cost saving by temporarily reducing staffing numbers, e.g. through furlough. At this stage, subject to our considerations on the impacts of furlough on short-term operating costs (and opportunities to reallocate staff to areas of the business with increased work), we do not consider it likely that there is a clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology. We will take any potential over-allowance into account in the round.

Headroom allowance

7.48. The headroom allowance is, in part, to provide for the net uncertainty in the true costs that efficient suppliers will incur. It is not designed to cover any one specific cost. In our November 2018 decision,[76] we set out possible uncertainties which could increase or reduce efficient costs compared to the cap allowance. We set the headroom allowance to 1.46% of costs excluding network costs.

[76] Ofgem (2018), Default Tariff Cap: Decision – Appendix 2 – Cap level analysis and headroom, paragraph 3.55 https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_2_-_cap_level_analysis_and_headroom.pdf

7.49. Our provisional view is that there is no clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology.

Overall approach to net uncertainty

7.50. Where we have highlighted possible increases or decreases to costs resulting from COVID-19 which we consider are not clearly and materially systematically different to the allowance, the existing headroom allowance is designed in part to allow for smaller movements in costs in either direction. The headroom allowance was explicitly designed to help suppliers to manage net uncertainty. In our November 2018 decision we stated that:

"There is uncertainty in the true costs that efficient suppliers will incur… Where appropriate these uncertainties are addressed directly in specific cost allowances and in the design of the cap. Where this is not appropriate, we have considered them as part of the headroom allowance, alongside consideration of unidentified errors, unavoidable risk of modelling limitations, the need to avoid spurious accuracy, biases and other such factors. In so doing we have taken due consideration that not all uncertainties will occur simultaneously and will not affect each supplier equally, and that as well as uncertainties raised by suppliers that might suggest cost increases, some uncertainties are symmetrical, ie. they could push down on costs and that there are areas in the efficient benchmark where we have taken a more prudent approach to estimating the allowance".

7.51. We consider that the net impact of COVID-19 on the potential uncertainty of efficient "other" costs varying from the allowance is neutral, or slightly positive to suppliers (increasing the allowance compared to where the 'true' costs likely were). This view is based on our consideration of the net impact of where we consider there to be cost changes due to COVID-19 relative to the cap allowance, but which in our initial view are not a source of clear and material change in costs such that we should change the cap methodology.

7.52. Notably, our initial view is not to amend the cap allowance to account for the cost reductions of furlough and paused outsourced contracts. This is a particularly conservative approach in suppliers' favour, given that most suppliers have been able to avoid some costs.

Cost of supplier failure or RO non-payment

7.53. We have identified two potential additional costs of COVID-19 not captured elsewhere in our analysis, relating to the costs of supplier failure and RO mutualisation.

7.54. When a supplier exits the market through the Supplier of Last Resort (SOLR) process, there may be costs passed onto other suppliers, for example, if the failed supplier has bad debts under the industry codes (which exceeded credit requirements that are set out in industry codes). Last Resort Supply Payments are managed through network charges, and so will be included in a future network allowance. This means that if COVID-19 should drive more SOLRs (and we note we have not seen evidence of this to date), the SOLR related costs will be taken into account through the existing price cap methodology.

7.55. Late (or non-payment) to the RO fund can result in a mutualisation of the shortfall – where costs are spread across the industry. This sometimes, but not always, occurs when a supplier fails. This is a complicated mechanism, which makes it difficult to assess the net cost to any supplier. However, we do not have evidence of COVID-19 increasing RO shortfalls. We are working with the relevant team internally to understand how much of the obligation remains compared with the same time last year, following the 31 August and 1 September buy-out payment and ROC presentation deadlines. The early indications, based on unverified financial data, is that the outstanding obligation is less than at the equivalent point in time in 2019. Therefore our view at this time is that no adjustment is required.

EBIT allowance

7.56. The Earnings Before Interest and Tax (EBIT) allowance covers the normal profit of a supplier. It is a fixed percentage of costs, set based on the cost of capital.

7.57. The EBIT allowance is affected by working capital, as working capital is a key element of the capital required by energy suppliers on which they seek to earn a return. We discuss how working capital may be affected by COVID-19 in Chapter 4. We do not consider that there are any other impacts of COVID-19 that would materially impact the existing EBIT allowance.

Smart metering costs

7.58. Smart metering costs are covered in three ways in the price cap: 2017 baseline costs in the operating cost allowance, additional costs since 2017 are captured in the non-pass through and pass-through Smart Metering Net Cost Change (SMNCC) allowances. Our initial view is that no costs in the scope of this review need adjusting to take into account the impacts of COVID-19.

7.59. The 2017 baseline costs are historical, and so cannot change as a result of COVID-19.

7.60. We set out our approach to the non-pass through and pass-through SMNCC in our August 2020 decision on the SMNCC.[77] Regarding non-pass through costs, we included an allowance for the sunk costs efficiently incurred due to the delay in smart metering rollout due to COVID-19. We set out our intention to review the non-pass through allowance for October 2021. As such it is outside of the scope of this policy consultation.

7.61. Regarding pass-through costs, we decided in August 2020 to update the "*SMETS2 meter volume source from the original non-pass-through SMNCC model to the relevant non-pass-through SMNCC model that will apply to the upcoming cap period that we are calculating the DCC charges for*".[78] This means that for cap period five we set the Data Communications Company (DCC) charge element of the pass-through SMNCC on the assumption that smart metering rollout would be 30% of historic (2017 – 2019) annual rollout, our indicative initial value used for the non-pass through SMNCC to reflect the potential impact of COVID-19 on rollout in 2020. It is now apparent that rollout will exceed this in 2020, but the exact value will not be known until 2021. However, this value will not be updated as part of the existing cap methodology.

7.62. If we had assumed rollout at 70% of 2017 – 2019 levels instead of 30% this would have increased the allowance in cap period five by £0.27 dual fuel at typical consumption. We also note that in cap periods one to four, suppliers over-recovered this allowance by £3.23 dual fuel at typical consumption. This is because we set the

[77] Ofgem (2020), Decision on reviewing smart metering costs in the default tariff cap https://www.ofgem.gov.uk/publications-and-updates/decision-reviewing-smart-metering-costs-default-tariff-cap

[78] Ofgem (2020), Decision on minor changes to 'Annex 5 – Methodology for determining the Smart Metering Net Cost Change' of SLC 28AD, page 2 https://www.ofgem.gov.uk/system/files/docs/2020/08/decision_on_minor_changes_to_annex_5_-_methodology_for_determining_the_smart_metering_net_cost_change_of_slc_28ad.pdf

DCC communication hub allowance using the SMETS2 rollout values in Annex 5 of SLC 28AD, and have not adjusted these values for actual rollout. These costs increase with rollout volumes. As actual rollout has been less than forecast in cap periods one to four, the allowance has been higher than actual costs incurred by suppliers.

7.63. As such, we consider the impact of COVID-19 on pass-through smart metering costs to be an ordinary level of variation in costs for suppliers to manage, and so there is no clear and material impact of COVID-19 on costs that is not taken into account through the existing price cap methodology.

Appendix 1 – Existing debt-related costs in the cap

Overview

1.1. Our treatment of debt-related costs in the cap is complicated. This is partly because there are several elements to these costs. It also reflects that the cap methodology accounts for these costs in more than one allowance, especially when considering the additional costs of standard credit. Furthermore, our approach is not entirely cost-reflective – after calculating the actual costs of standard credit, we spread a proportion of the additional costs onto direct debit. (This was in order to maintain the historical differential between these payment methods).

1.2. We discuss the issues in more detail below, but provide a summary in Table A1.1. The description in this appendix is also only a summary of the methodology – for more detail, see our 2018 decision.[79]

Table A1.1: Summary of where we consider different debt-related costs in the cap

Cost	Direct debit costs	Standard credit costs	Spreading of standard credit costs?
Bad debt	Operating cost allowance	Direct debit and standard credit payment method uplifts	Yes – partially spread across direct debit (through PMU)
Working capital	EBIT allowance, Direct debit payment method uplift (for adjustment of working capital benefit)	EBIT allowance, Standard credit payment method uplift	No
Additional administrative costs	Operating cost allowance	Direct debit and standard credit payment method uplifts	Yes – partially spread across direct debit (through PMU)

[79] Ofgem (2018), Default tariff cap: decision - overview. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

1.3. Our analysis for the 2018 decision was based on different sources. In 2018, we collected two sets of information to inform our analysis on operating costs and the payment method uplift:

- 2017 total domestic operating costs incurred by suppliers (aligned to the Consolidated Segmental Statements reporting); and
- 2017 information on the bad debt charge, working capital requirement, and debt administrative costs broken down by direct debit and standard credit.

1.4. On average, suppliers incur additional debt-related costs when serving standard credit customers compared to customers who pay by direct debit. This is mainly relates to the nature of the payment method. Standard credit customers pay in arrears[80] (incurring higher working capital costs) and can incur debts more easily (given that payment is not collected automatically).

1.5. Given that standard credit customers incur a large part of debt related costs, the majority of these costs are captured in the payment method uplift.

1.6. We discuss each of the three debt-related costs in turn below.

Allowances for bad debt

Operating costs

1.7. We collected total domestic operating costs from larger suppliers to calculate the operating costs per customer for each supplier. We made a number of adjustments to the data, one of which included removing any standard credit and PPM costs in order to reflect direct debit costs only.

[80] Direct debit customers may also pay in arrears at certain points in time (e.g. due to the seasonality of consumption). However, on average, direct debit customers pay much earlier than standard credit customers.

1.8. We benchmarked the resulting operating cost allowance at £5 below the lower quartile supplier.[81] However, it is important to recognise that this is a notional benchmark – it is not intended to represent any specific supplier or its circumstances.

1.9. Part of the operating cost benchmark therefore represents direct debit bad debt costs for 2017. Given that direct debit is an automated payment, we expect these costs to be small.

1.10. The operating cost allowance in each cap period is indexed from the baseline allowance by the CPIH inflation measure.

Payment method uplift

1.11. The purpose of the payment method uplift is to provide an allowance for the difference in costs between direct debit and standard credit customers. This includes bad debt write-offs.

1.12. For each supplier, we calculated a bad debt charge as a percentage of revenue for standard credit and direct debit using 2017 cost data. We benchmarked the difference between standard credit and direct debit to the lower quartile supplier for the standard credit cost differential, looking at the overall additional costs of standard credit (bad debt, working capital and additional administrative costs).[82]

1.13. There was significant variation in the data provided by suppliers. Despite the detailed guidance we provided with our Request for Information, this may partly reflect differences in the way suppliers completed the questions in line with their specific accounting practices. It is more difficult to ensure consistency when looking at one relatively small element of suppliers' costs, as opposed to suppliers' total operating costs.

1.14. We decided to spread some of the additional standard credit costs (including bad debt) over both direct debit and standard credit customers. As set out in our 2018 decision, this reflects that "on an individual level it would not be cost reflective to charge a standard credit

[81] This relates to the benchmark at typical consumption. Within the cap design, there is a separate benchmark at nil consumption.
[82] We used the weighted average bad debt across fuels.

customer, who does not exhibit the characteristics of the group, the full cost to serve difference".[83]

1.15. The bad debt aspect of the payment method uplift is captured in the payment method adjustment percentage (PAP) alongside the cost of working capital. We use a percentage allowance because the level of bad debt will depend on consumption (i.e. how much the customer would have to pay is based on their consumption). We apply the PAP term to the benchmark[84] in each cap period – this provides the absolute value of the PAP allowance.[85]

Allowances for debt-related working capital

1.16. The cap has two allowances which include debt-related working capital: (1) EBIT and (2) payment method uplift. These allowances contain the financing cost of working capital rather than the amount of working capital required.

EBIT

1.17. The cap includes an EBIT allowance, based on analysis carried out by the CMA. In calculating this, the CMA assessed capital employed. While part of this capital would have related to working capital, it would also have included capital for other areas – e.g. buildings, IT equipment and vans. The element that related to working capital will have included both debt-related working capital (caused by how long customers take to pay their bills), but also other factors (e.g. a supplier's contractual terms with businesses that provide it with services). The costs of the working capital arising from the time to pay bills therefore forms just one part of the EBIT allowance.

1.18. The CMA calculation was also based on the whole domestic supply business. It therefore included the combined impact of different payment methods – even though these individually have very different effects on working capital. Direct debit customers generally reduce the amount of working capital a supplier needs, as they often pay in advance. Standard credit customers increase the amount of working capital a supplier needs, as they pay in arrears. This impact is more important the longer customers take to pay their bills.

[83] Ofgem (2018), Default Tariff Cap: Decision. Appendix 8 – Payment method uplift. paragraph 3.48. https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf
[84] All costs except EBIT, headroom and VAT.
[85] As the PAP allowance depends on the benchmark, it is different at nil and typical consumption.

Payment method uplift

1.19. Given that working capital requirement varies between payment methods, we included the additional working capital costs for standard credit in the payment method uplift.

1.20. We calculated the cost of working capital element in the payment method uplift by:

i. averaging the working capital requirement for each payment method (measured in each quarter of 2017);

ii. applying the 10% cost of capital;

iii. dividing the cost of working capital by revenue to calculate the percentage figure.

1.21. We benchmarked the difference between standard credit and direct debit to the same supplier that sets the rest of payment method uplift.

1.22. The additional working capital costs for standard credit are an inherent feature of the standard credit payment method so are reflected in the payment method uplift for standard credit.[86]

1.23. As noted above, the average working capital costs across payment methods are already included in the EBIT allowance. To avoid double counting, we calculated the difference between the direct debit cost of working capital and weighted average cost of working capital. We adjusted the difference (0.6%) down on the working capital cost element of the PAP term for both payment methods.

Allowances for additional administrative costs

1.24. Standard credit incurs additional administrative costs relative to direct debit. Some of this relates to the costs of dealing with late or non-payment. However, there are also other costs associated with standard credit customers, such as a greater likelihood of having to issue paper bills.

[86] Ofgem (2018), Default Tariff Cap: Decision. Appendix 8 – Payment method uplift. paragraph 3.46. https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf

1.25. The payment method uplift includes the additional administrative costs related to standard credit, some of which will be debt-related. We collected the additional cost per customer for 2017 then benchmarked the additional administrative costs to the lower quartile supplier for the standard credit cost differential.

1.26. We spread the additional administrative costs of standard credit between the direct debit and standard credit payment methods in the same way as for bad debt. However, we included the additional administrative costs as a fixed term in the cap methodology, rather than varying it as a percentage. This is the Payment method Adjustment Additional Cost (PAAC) allowance.[87] We update this over time using CPIH.

1.27. Any administrative costs for managing late or non-payment for direct debt customers are captured in the operating cost allowance. We would expect such administrative costs to be small, given that levels of bad debt are low for direct debit customers.

[87] The PAAC allowance is therefore the same at both nil and typical consumption.

Appendix 2 – Privacy notice on consultations

Personal data

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

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

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

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

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

3. Our legal basis for processing your personal data

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

3. With whom we will be sharing your personal data

We may share consultation responses with BEIS.

4. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for six months after the project, including subsequent projects or legal proceedings regarding a decision based on this consultation, is closed.

5. Your rights

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

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

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

6. Your personal data will not be sent overseas.

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

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

9. More information For more information on how Ofgem processes your data, click on the link to our "Ofgem privacy promise".