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Consultation

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

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Response deadline:	21 December 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.

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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 would not be accounted for in the existing cap methodology. In September we consulted on how we planned 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 COVID-19 pandemic, and the measures put in place to limit its impact, have significantly affected the energy industry. 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 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 have considered each component of the cap to identify potential changes in costs resulting from the impact of COVID-19 compared to what has already been allowed for in the cap. Our view is that there are additional costs – specifically related to debt – that are material and not allowed for through the existing methodology. Therefore we propose to make an adjustment for cap period six (i.e. summer 2021), of £21 per customer,[1] using the existing Adjustment Allowance.

Debt-related costs can take a long time to fully realise. However, a supplier faces an immediate cash flow shortfall when a customer does not pay their bill, even if it takes time to recognise this as bad debt. We therefore propose to set the adjustment using an initial estimate of these costs (a float) which we will subsequently adjust to reflect the actual costs once they are known.

[1] Dual fuel, at the typical consumption values used to set the cap (3,100kWh for single-rate electricity and 12,000kWh for gas).

It is very uncertain what the debt-related costs of COVID-19 will ultimately be. The objective of the Domestic Gas and Electricity (Tariff Cap) Act 2018 is that we protect default tariff customers. We therefore propose to err on the side of caution when setting the float, to avoid customers bearing the risk of the cost uncertainty. We have calculated the £21 adjustment on this basis.

In the cap, the majority of debt-related costs are currently 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 spread 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 tariff credit customers.

COVID-19 impacts on serving prepayment customers

While prepayment meter (PPM) customers have been protected by the Competition and Markets Authority's PPM cap during COVID-19, the PPM cap ends at the end of December 2020. From 1 January 2021 default tariff PPM customers will be protected by a PPM level in the default tariff cap. We have therefore considered the impacts of COVID-19 during this transition period (and beyond) in the default tariff cap.

COVID-19 will have affected the cost of supplying PPM customers differently to the cost of supplying credit meter customers. We do not have adequate evidence of material increases in PPM costs as a result of COVID-19 that would warrant an adjustment to the cap. We propose to revisit any need for an adjustment at our next review.

Going forwards

It is likely that the impacts of COVID-19 will continue to evolve and that we will need to review of its impacts on the cap in six months' time.

We invite stakeholder views and supporting evidence on any aspect of this consultation by 21 December 2020. Stakeholders' responses will inform our decision, which we will publish at the start of February 2021 to take effect in the new cap level from 1 April 2021.

1. Introduction

What are we consulting on?

1.1. This consultation sets out our proposals for how we should adjust the default tariff cap ("the cap") to account for the potential impacts of the COVID-19 crisis.

1.2. In our September 2020 policy consultation,[2] we considered the potential impact of COVID-19 on all cost components of the cap. We considered that an adjustment was only required for debt-related costs. We discussed the possible options for recovering any additional costs in this area.

1.3. We have considered stakeholders' responses to our September 2020 consultation. We have also analysed the data that suppliers provided on debt-related costs in our voluntary Request for Information (RFI) issued on 21 September 2020.[3]

1.4. This consultation sets out our proposals. It also summarises the responses to our September 2020 consultation, findings from suppliers' data and our considerations.

1.5. We propose to use an estimate, a float, to set the adjustment. We will then make a correction, a true-up, later when actual data is available. In this document we focus on how we propose to calculate the float. We will consult on how we plan to conduct the true-up closer to the time.

1.6. We propose to make the adjustment using 'Annex 8 – Adjustment Allowance' of standard condition 28AD of the electricity and gas supply licences. We have published the changes we propose to the annex alongside this consultation.[4]

[2] Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation. https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation

[3] We issued this RFI to suppliers with a domestic market share of at least 1% (with the exception of one supplier due to the specialist nature of its customer base).

[4] Please see the page for this consultation on our website for the proposed updates to Annex 8.

Structure of this consultation document

Chapter	Chapter detail
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The default tariff cap ("the cap")

1.7. 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.

1.8. 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:[5]

- 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.

The cap comprises of several allowances, each relating to different cost 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.[6]

The impact of coronavirus (COVID-19)

1.9. The COVID-19 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[7,8] and contributing to a fall in wholesale prices. Workers have been made redundant, placed on furlough, or are working from home,

[5] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6).
http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[6] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 2(2)(b).
http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[7] 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/
[8] Similarly, Elexon data shows electricity supplied to smaller non-domestic premises (non-half hourly profile classes 3 and 4) was down 23% in Q2 2020 compared to Q2 2019.
https://www.elexon.co.uk/documents/industry-insights/gross-supplier-market-share-data-reports/2020-gross-supplier-market-share-data-reports/supplier-market-share-data-q1-2020/
https://www.elexon.co.uk/documents/industry-insights/gross-supplier-market-share-data-reports/2019-gross-supplier-market-share-data-reports/auto-draft-16/

increasing domestic energy use.[9] Some customers are struggling to pay their bills. Social distancing has reduced field activities including visits to customers' homes.

1.10. Ofgem has been working with Government throughout the crisis and implemented several measures to help industry and consumers manage the impacts. We reprioritised our forward work programme[10] and 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. This sat alongside action by Government – for example, the loan provided to help suppliers manage changes to the costs of the Contracts for Difference scheme.[11]

1.11. 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.

Related publications

1.12. The main documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018: http://www.legislation.gov.uk/ukpga/2018/21/contents/enacted;
- Default Tariff Cap Decision: https://www.ofgem.gov.uk/publications-and-updates/ofgem-information-energy-licensees-coronavirus-covid-19-response-30-june-update.

[9] Some suppliers have told us that domestic demand has increased. Elexon data also suggests there has been a slight increase in domestic demand in Q2 2020 compared to Q2 2019, by around 2%.
[10] 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
[11] We discuss this further in Chapter 6.

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

- Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation: https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation;

- Impact of COVID-19 on retail energy supply companies – regulatory expectations from 1 July 2020: https://www.ofgem.gov.uk/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.

1.14. The Department for Business, Energy and Industrial Strategy's (BEIS) decision on changes to 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

September 2020 consultation

1.15. We published a policy consultation in September 2020 that set out our initial thinking on reviewing the potential impact of COVID-19 on the default tariff cap. Stakeholders provided responses in October 2020.

This consultation

1.16. This consultation sets out our revised proposals. We invite stakeholders to submit comments on these proposals and on any aspect of this consultation on or before **21 December 2020**.

1.17. We do not, as a matter of style, ask questions about each aspect of our proposals. We present our proposals (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.

1.18. **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.

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

Decision

1.20. Subject to consultation, we intend to publish a decision **at the start of February 2021**, so that any changes will have effect from 1 April 2021 (the sixth cap period).

Your response, data and confidentiality

1.21. 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.

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

published. We might ask for reasons why.

1.23. 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 3.

1.24. 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

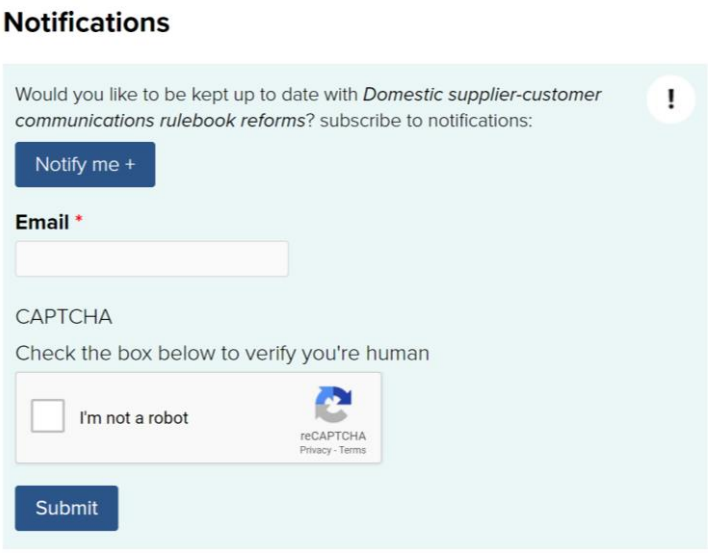
1.25. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

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

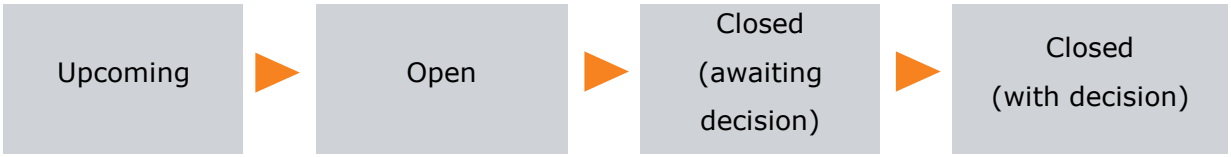
Please send any general feedback comments to stakeholders@ofgem.gov.uk.

How to track the progress of the consultation

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



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



2. Overarching considerations

This chapter sets out the scope of this review and summarises our view on cost changes resulting from COVID-19.

We seek suppliers' views on our considerations in general.

Scope of this review

Proposals

2.1. We propose to consider only costs incurred serving domestic default tariff customers.

September 2020 consultation proposals

2.2. In September, we proposed that our review should cover only how COVID-19 impacts the cost of serving default tariff customers.[12] We proposed to exclude costs arising from non-domestic customers and domestic customers on fixed tariffs.[13] We proposed to look at all cost components of the cap. We also proposed to include PPM default tariff customers in our scope.

Stakeholder responses

2.3. Stakeholders generally agreed that we should limit the scope of our review to the costs of serving domestic default tariff customers. Some suppliers took the opportunity to suggest alternative approaches for Ofgem and Government intervention to allow the industry to recover other COVID-19 related costs. One supplier also said that other costs, not related to COVID-19, have increased since we set the cap.

[12] We excluded smart metering, as this is covered by a separate review process. See 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

[13] 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.

Considerations

2.4. Where stakeholders have proposed additional mechanisms outside the scope of the cap we have passed these to the relevant teams within Ofgem. We do not consider evidence regarding cost changes unrelated to COVID-19 as part of this review.

The impact of COVID-19 on costs

Proposals

2.5. We propose to maintain our September proposal to only adjust for debt-related costs for credit meter customers. This is the only area where we have seen clear evidence of a likely increase in efficient costs of serving default tariff customers that is not addressed in the existing cap methodology. We will continue to monitor other costs, which may yet be materially impacted by COVID-19.

September 2020 consultation proposals

2.6. In September, we proposed 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.

2.7. Our initial view was that only debt-related costs for credit meter customers 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.

Stakeholder responses

2.8. Most respondents agreed with our focus on debt-related costs for credit meter customers but wanted us to monitor other costs carefully. Two suppliers said the cap should not be adjusted – for example because of uncertainty around the impacts of COVID-19, and because of the impact of any adjustment on default tariff customers. Two suppliers said we should also make adjustments for other costs. Stakeholders welcomed our position that smart metering and Feed-in-Tariffs (FIT) cost changes will be addressed in separate review processes. We discuss more detailed comments in the relevant chapters of this consultation.

Considerations

2.9. Table 2.1 summarises the COVID-19 related cost changes we have identified and indicates which we propose to include in the adjustment or include in a separate review. It also signposts where they are discussed in detail in this document.

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

Cap component	Description of potential efficient cost changes due to COVID-19	Direction of cost change	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 6
	Cost changes in both directions from forecasting and losses	Mixed	Yes	Chapter 6
	Mixed impacts on the capacity market allowance in cap period four; Future impact depends on change in domestic demand in winter peak relative to revised forecasts	Mixed	Yes	Chapter 6
Policy costs	Reduced non-domestic demand increases costs of Feed-in Tariffs (FIT)	Increase	No – but to be addressed through separate review	Chapter 6, and will be discussed further in separate review
	Reduced non-domestic demand increases costs of Contracts for Difference (CfD)	Increase	Yes	Chapter 6
	Increased domestic demand decreases cost per MWh of Energy Company Obligation (ECO); sunk costs of reduced installations	Mixed	Yes	Chapter 6
Network costs	Increase in Balancing Services Use of System (BSUoS) costs	Increase	Yes	Chapter 6
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;	Decrease	Yes	Chapter 6

Cap component	Description of potential efficient cost changes due to COVID-19	Direction of cost change	Existing methodology sufficient?	Detailed discussion location
	Reduced meter reading costs			
	Increased back office costs from more estimated bills; Increased costs of mobilising a remote workforce[14]	Increase	Yes	Chapter 6
Smart costs	Sunk costs from planned installations which have been delayed/halted due to COVID-19	Increase	No	Addressed in separate SMNCC review[15]
Payment method uplift	Increased debt-related costs	Increase	No	Chapter 4 (PPM in Chapter 5)
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 6
Earnings Before interest and Tax (EBIT)	Increase in working capital required due to increased late payment	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

[14] These are examples of potential increased costs due to COVID-19. Stakeholders told us that there had been cost increases in other areas as well – see Chapter 6 for more details.
[15] 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

3. Cross-cutting considerations

In this chapter we set out our proposals on: how we adjust the cap, how we account for changes in the number of default tariff customers, the timing of reviews and adjustments, benchmarking costs, and how we allocate costs (between payment methods, fuels, and the unit rate and standing charge).

We seek suppliers' views on our considerations in general.

Summary

3.1. We propose to use the Adjustment Allowance (AA)[16] to set a COVID-19 adjustment in the cap. We propose to set an initial float, and to true this up later. When setting the adjustment, we propose not to make any adjustment for changes in the number of default tariff customers over time.

3.2. We propose to consider the costs of cap periods four, five and six when setting the float adjustment that will apply in cap period six. We propose to recover the costs of cap periods four and five over one year, and the costs of cap period six over six months.

3.3. For the float, we propose to benchmark costs using a lower quartile, looking at each cap period separately.

3.4. For the float, we propose to allocate costs equally between the direct debit and standard credit payment methods. We propose to allocate costs equally between fuels. We propose to allocate costs between the unit rate and standing charge in line with the historical split between them in the cap.

3.5. We will consult later on how to set the true-up. We provide some initial comments in this chapter.

[16] The AA is an existing allowance in the cap – see below for more details.

How the cap is adjusted

Proposals

3.6. We propose to use the AA to set a COVID-19 related adjustment for the default tariff cap. This is the same as our September proposal.

3.7. The AA is defined in the Methodology for Adjustment Allowance workbook referenced in Annex 8 of standard licence condition 28AD of the electricity and gas supply licences (SLC28AD). We have published a draft revised workbook alongside this consultation.

September 2020 consultation proposals

3.8. In September, we proposed to make one aggregate adjustment rather than multiple adjustments to specific allowances. This was because we did not expect to change the underlying methodology on an ongoing basis. We also considered that itemising adjustments separately could require us to make several adjustments, which we considered to be less feasible than collating them into a single allowance.

3.9. We proposed to make any adjustment using the existing AA. It has the flexibility if necessary to allow us to vary it by fuel, payment method, consumption level, and over time. It also maintains the integrity of the existing cap methodology.

Stakeholder responses

3.10. Stakeholders who commented were supportive of our proposals to use the AA, noting its simplicity and flexibility.

Considerations

3.11. We are maintaining our September proposal, for the reasons we set out.

Accounting for uncertainty

Proposals

3.12. We propose to use a 'float and true-up' approach to adjusting the cap. We discuss how we propose to calculate the float in Chapter 4.

September 2020 consultation proposals

3.13. In September we considered three options for adjusting the cap: setting an allowance in advance using forecasts (ex ante); setting the allowance once actual data is available (ex post); or a float and true-up approach, where we initially include an approximate value and then true-up once more information is available.

3.14. We did not consider ex ante to be suitable because of the high degree of uncertainty and risk of overcharging or undercharging consumers substantially. We considered that both ex post and float and true up had strengths and weaknesses. We preferred an ex post approach for one-off impacts where there was not a long time lag to obtain sufficiently accurate data. However, we recognised that if the impact of COVID-19 was extended, or timely data would not be available, a float and true-up might be more appropriate.

3.15. Where a float was required, we proposed to be prudent and consider the balance of risks between consumers and suppliers. We noted that suppliers are better placed to manage cash flow risk than default tariff customers are. Companies typically have better access to capital and at lower cost.

Stakeholder responses

3.16. The vast majority of stakeholders were supportive of our float and true-up proposal, due to the level of uncertainty in costs, and the time lag that would be necessary to calculate actuals, which would have a consequent impact on supplier cash flows.

3.17. One of the suppliers which did not agree with the principle of making an adjustment for COVID-19 impacts stated that if we decided to make such an adjustment we should use an ex post approach. It reasoned that it had not yet seen a material increase in costs as a direct result of COVID-19, and that suppliers would have a better understanding of the costs later, in particular when debt is written off.

Considerations

3.18. We consider that float and true-up is the most appropriate approach to adjusting the cap. We have a reasonable expectation, based on the evidence, that suppliers' efficient costs could have increased. This approach can more closely align the cap level in a specific time period to the costs incurred in that period (if a reasonable approximation

can be made), than waiting for an ex post adjustment.

3.19. As we discussed in September, we propose to adopt a prudent approach to setting the float, in order that suppliers bear more of the cost uncertainty around the impacts of COVID-19. This is given that suppliers are better positioned to manage cash flow than customers. This also reflects that many customers will be experiencing significant financial pressures at present.

3.20. While an ex post approach would ensure that customers pay the correct amount, it could require suppliers to wait several years to recover the increase in their efficiently incurred costs. This is because it will take time for final data to become available for the costs that we are proposing to adjust for (i.e. debt-related costs).

3.21. We recognise that the length of time before actual data becomes available could also affect our ability to carry out a full true-up in later cap periods, particularly if the Secretary of State decides to end the cap before the latest end date in 2023. However, a float and true-up approach is less exposed to this risk than an ex post approach.

Timing of reviews and adjustments

Proposals

3.22. We propose to include a cap adjustment in the April 2021 cap level (i.e. cap period six). We propose to include costs forecast to be incurred during cap periods four, five and six in this adjustment.

3.23. We propose to recover the costs incurred in cap periods four and five on an annual basis (over cap periods five and six). We propose to recover costs incurred in cap period six over a six month basis (over cap period six).

3.24. When recovering over less than a year (i.e. for cap period six), we propose to uplift the costs in order to set the allowance level. We propose to uplift the standing charge element on a time-weighted basis and the unit rate element on a demand-weighted basis.

3.25. For the float, we propose not to include an additional allowance for costs incurred because of timing differences between suppliers incurring costs and receiving an allowance, or to adjust for inflation.

3.26. We propose to conduct a review to assess whether a float is required for cap period seven in early 2021, in order that we can include a float, if needed, from 1 October 2021.

3.27. We do not consider that actual data will be available at that point[17] for us to true-up for cap period four – so we plan to wait until late 2021 or early 2022 before starting the true-up process. We expect that the true-up for cap period four would not take effect until 1 April 2022 (cap period eight).

September 2020 consultation proposals

3.28. In September, we proposed to implement an initial adjustment for cap period six. We recognised the impact of COVID-19 will be extended, and may be greater over winter, so we also proposed to undertake at least one subsequent review, in 12 months' time.

3.29. When considering reviews we recognised the trade-off between using more, or less, frequent reviews – and the fact that debt-related costs could take over a year to fully materialise. We considered the main trade-off being between a closer alignment between costs incurred and the cap level, compared against an additional administrative burden on stakeholders and ourselves. While a mechanical adjustment process would be ideal, we did not consider it feasible to develop a sufficiently robust process given the highly uncertain nature of COVID-19.

3.30. We discussed which cap periods' costs might be included in the float for 1 April 2021, with cap periods four and five being included, but cap period six being more challenging due to the uncertainty of COVID-19 impacts into the future. We said that we would consider whether to include a float in April 2021 for cap period six, or to address the costs of cap period six in cap period seven.

3.31. We did not make proposals on: which cap periods costs should be recovered over, the approach we should take to uplifting costs when setting an allowance, or whether to

[17] Cap period four (April to September 2020) will be the first cap period to true up. If bad debt write-offs occur at least 12 months after the debt is incurred, then a full dataset of actual write-off information for this cap period would only be available at the end of September 2021. We would then need to gather this information from suppliers, analyse it, and consult on the resulting true-up value. Subject to consultation, we would then we able to include it in the next cap update.

address any discrepancy between the timing of costs and allowances.

Stakeholder responses

3.32. Suppliers were generally supportive of any initial adjustment coming into effect in April 2021. They stated that they are already incurring additional costs, and these are likely to increase over winter. They also stated that the lag between additional costs being incurred and recovery under the cap should be minimised. One supplier said that we should delay any adjustment until October 2021, to allow us to use more actual data and so make a more informed decision.

3.33. Suppliers were also supportive of further reviews, generally preferring a further review in time for the update taking effect in October 2021.

3.34. Most stakeholders supported allowing for costs incurred in periods four, five and six, but did not comment on the recovery period. One supplier said that we appeared to be leaning towards an approach of recovering the costs of cap periods four to six in cap period six, and said it agreed with this.

3.35. One supplier, in replying to our Request for Information (RFI), stated that there is a working capital cost associated with the timing difference between suppliers making provisions for bad debt and when the cap provides funding.

Considerations

Timing of implementation and reviews

3.36. We consider that, where COVID-19 has increased costs compared to the allowances provided in the cap, we should where possible minimise the delay in efficient cost recovery. It would not protect customers to delay cost recovery, particularly if this meant significant costs being recovered in winter 2021-22. Delays to cost recovery would also mean that future default tariff customers would be paying for the costs of

current default tariff customers.[18]

3.37. We consider that future reviews will be necessary, to both set floats for later periods (if COVID-19 impacts continue), and to true up previous floats. We will set the scope of each review as part of the review itself, considering the evidence available at the time. We expect these to be substantive rather than mechanical reviews, involving consultation, and using a range of evidence and data sources. As such, we will need to strike a balance between timeliness and data availability (for example, reflecting the lags required to accurately true up certain costs). We will also need to consider the administrative burden on stakeholders and ourselves (given competing priorities).

Periods to include

3.38. For the adjustment in cap period six, we propose to set a float that will include an allowance for the costs incurred in cap periods four, five and six.

3.39. Cap period five is largely in the future, and cap period six is entirely in the future. We therefore do not know what the economic consequences of COVID-19 may be in these periods. However, it is reasonable to expect that the negative economic impacts will persist for a number of cap periods. (For example, during the 2008 recession, unemployment levels remained high for a considerable period of time). It is also plausible that the government schemes to help businesses (e.g. the furlough scheme, which was recently extended to March 2021) could have delayed the economic impact of COVID-19 on customers. Suppliers may therefore face increased costs at some point in the future. Therefore, we consider it appropriate to include all three cap periods in any initial adjustment.

3.40. In the September consultation we considered setting an allowance for cap period five ex post. However this would mean an adjustment would be introduced no earlier than cap period eight, to allow for enough time to collect data, measure the impact and consult on proposals. We consider that it is more appropriate to reduce the lag between suppliers incurring costs and receiving an allowance, by setting a float for cap

[18] Over the space of a couple of years, we would expect that many current default tariff customers will still be on default tariffs. However, there will be some changes in the group of default tariff customers over time, e.g. as customers switch between default and fixed tariffs.

period five and then trueing-up.

3.41. Similarly, we could set an allowance for the costs incurred in cap six at a later date (either ex post or by setting a float in cap period seven). At present, there is significant uncertainty about the level of costs that suppliers will be incurring in cap period six. However, we still consider that the forecasts available to us are useable, and a better reflection of expected costs than not setting an allowance for cap period six at this stage. Setting a float for cap period six is the way we can best allow recovery in the period when costs are incurred. We are mitigating the risk that customers overpay due to uncertainty by taking a conservative approach to setting the float.

Which cap periods to recover over

3.42. In general, the cap methodology is designed to allow for costs in the cap period in which they will be experienced. This is to best reflect the underlying costs of supplying energy in that period.[19] We consider that we should apply the same principle to the COVID-19 adjustment. However, cap periods four and five will be complete before the adjustment is applied, which means this is not possible in these cases.

3.43. In theory, this means that we could recover the full floats for the costs incurred in cap periods four, five and six in cap period six. We consider that including an adjustment for three periods worth of costs in one period would create a substantial bill shock to customers – when we want to set the float at a level which takes a conservative approach to protect customers.

3.44. Therefore, we propose to allow recovery of the float for costs incurred in the historical[20] cap periods (cap periods four and five) across two cap periods, namely cap periods six and seven. We propose to allow recovery of the float for costs incurred in cap period six within one cap period - cap period six. We would then maintain the principle of aligning the recovery of costs with the period in which they occurred, if COVID-19 costs continue in future.

3.45. We could also spread cap period six costs over two cap periods, which would further

[19] This is a general approach – not an absolute rule. For example, we recover Balancing Services Use of System charges on a lagged basis.
[20] At the point the adjustment takes effect.

lessen the immediate bill shock to consumers. However, we risk increasing costs for consumers over a winter cap period (particularly if we include a float for cap period seven as well).

3.46. Recovering cap period six costs over two periods would not allow us to align the costs incurred in cap period six with the recovery of these costs. We would therefore be less reflective of the underlying costs of supplying energy in that cap period. Furthermore, spreading these costs over two periods would complicate any future adjustments, and potentially mean that customers still face higher bills at a later date. For example, in cap period seven we could then be recovering parts of the costs from cap periods four, five, six and seven.

3.47. For the true-up, we have not decided how many cap periods to recover costs over. If data to carry out a true-up becomes available gradually, meaning that we can only true up one cap period at a time, our initial view is that we might be more likely to recover these costs over one cap period. However, if we were calculating true-ups for two (or more) cap periods at the same time, then our initial view is that we might consider recovering over more than one cap period, so as to avoid a sharp change in bills for default tariff customers.

Demand and time weighting the allowance

3.48. The cap is set in annual terms. This means that when we set an allowance for a given cap period, a supplier would need to charge that level for two cap periods to recover the expressed amount. Where we wish to recover costs over a single cap period, we need to set a higher cap level in annualised terms, so that suppliers recover the relevant amount in a single cap period. We applied this principle when adjusting the cap after reassessing wholesale costs in cap period one (following the judicial review).[21]

3.49. As discussed earlier, we propose to recover the costs incurred in cap periods four and five over cap periods six and seven. The amount to recover is the same as the annualised adjustment, because we are recovering the costs over two cap periods (12

[21] 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

months). However, since we are proposing to recover costs incurred in cap period six over cap period six only, we need to uplift the costs so that the resulting adjustment allows suppliers to recover the cap period six costs over six months.

3.50. When uplifting costs, we need to consider the importance (weighting) to attach to cap period six. There are two types of weightings we apply.

3.51. Where cost recovery does not depend on consumption (i.e. a cost is recovered using the standing charge), we use time weighting. For recovery over a six month period we simply multiply the cost by two. For example, £10 of costs recovered over six months would require a cap level (in annualised terms) of £20.

3.52. Where cost recovery depends on consumption (i.e. a cost is recovered using the unit rate), we use demand weighting. Energy demand is not uniform across the year – customers tend to use more energy in winter rather than summer months. Therefore, we need to consider what proportion of annual energy consumption is consumed in the period we want to recover the costs over. The lower demand is in a cap period, the larger the uplift we have to apply to enable suppliers to recover a given amount of costs. This appears as a larger annualised cost for that cap period. However, this does not affect the amount of costs to be recovered – it is simply about setting the allowance at a level which allows suppliers to recover these costs over six months.

3.53. In our case, we are proposing to recover cap period six costs over cap period six, a summer cap period. Less than half of energy demand occurs over the summer period – 43% of annual demand for electricity and 24% of annual demand for gas. This means for the element of the adjustment that varies by consumption (i.e. the amount recovered using the unit rate), we need to multiply it by 2.30 for electricity and 4.11 for gas. These are calculated as: 1 / summer demand as a fraction of annual consumption.[22]

Costs incurred from cost/allowance timing differences

3.54. In principle, we do not consider that a supplier requires additional working capital

[22] We calculate these uplift figures using the exact demand proportions, rather than the rounded values reported in this document.

funding to cover the delay between incurring costs and receiving an allowance. Suppliers will have to manage temporary cash flow issues in the normal course of business, and will have tools in place to do this (e.g. credit lines).

3.55. However, we note that suppliers will receive a small cost of capital uplift as part of the cap design. The Earnings Before interest and Tax (EBIT) allowance in the cap covers the cost of the capital employed, including working capital. It is applied as a percentage of other allowances, including the AA.

3.56. In any event, we can consider this issue further when determining the true-up. At that point, we will also consider whether or not it is necessary to adjust for inflation when determining the final value of the true-up. In each case, we do not consider that this degree of precision is necessary when setting a float.

Float for cap period seven

3.57. The economic effects of COVID-19 may persist into cap period seven (winter 2021-22). We may therefore need to set a float for this period as well. We do not have information to do this now, so we would need to consider whether to do this as part of a future review.

3.58. Given the timings required for data gathering, analysis and consultation, we expect that we would need to start this process in spring 2021.

3.59. Our initial view is that we would follow the same methodology as we have used to set the initial floats for cap periods four to six. We do not consider that developing a more intricate methodology would be effective, given that we would still be dependent on inherently uncertain forecasts. In any event, we intend that any float would be subject to a later true-up – this allows a greater degree of approximation.

Accounting for changes in the number of default tariff customers

Proposals

3.60. For the float, we propose to not make an adjustment for the change in the number of default tariff customers between April 2020 and April 2021.

September 2020 consultation proposals

3.61. In our September consultation, we considered whether we should adjust for changes in aggregate number of default tariff customers (between the period when costs were incurred and the period when the allowance is provided) to ensure that suppliers as a whole recover a better approximation of the costs they incurred.

3.62. We proposed to not make any adjustment for the change in the number of default tariff customers between April 2020 and April 2021 given the short difference in time between the cost period and the allowance period reduces the potential for customer numbers to change significantly.

Stakeholder responses

3.63. No stakeholder commented on our proposal regarding the number of default tariff customers.

Considerations

3.64. We maintain our proposal in relation to the adjustment for cap period six, for the reasons set out in our September consultation.

3.65. We intend to consider this further when carrying out a true-up. As part of this, we may consider whether the scale of changes in aggregate default tariff customer numbers is significant, and whether any increase in accuracy from taking this into account is likely to justify the additional complexity.

Benchmarking efficient costs

Proposals

3.66. We propose to:

- assess the benchmark as the increment since 2019;
- calculate individual benchmarks for each cap period;
- use a lower quartile benchmark; and

- set the benchmark based on the costs of serving domestic customers in general, rather than default tariff customers specifically.

3.67. These proposals relate to setting the float, and do not prejudge the approach we may take to calculating the true-ups – although we currently consider that we would be likely to take the same approach.

September 2020 consultation proposals

3.68. We proposed to set a benchmark by considering the increment in costs compared to costs incurred in 2019. This was to focus on the impacts of COVID-19, allowing suppliers to keep any efficiency gains from 2017 to 2019 in line with our original cap decision. It also enabled us to include data from suppliers who have grown to become large suppliers recently.

3.69. We proposed to benchmark the debt-related costs collectively if we made an adjustment, rather than as separate cost categories, given the potential interactions between the cost categories.

3.70. We proposed to use lower quartile costs to set a benchmark. We considered that a supplier's response to COVID-19 was not totally outside of its control and therefore using a lower quartile was appropriate for driving efficiency and protecting customers. We did not comment on whether we would calculate this lower quartile for individual cap periods or for a number of cap periods collectively.

3.71. We proposed to only consider changes in the costs of supplying default tariff customers. For example, in relation to bad debt, we said that any adjustment should only cover additional costs from customers with default tariffs – not costs from customers with fixed tariffs.

Stakeholder responses

3.72. Suppliers who commented were supportive of using the increment in costs compared to 2019. Two suppliers also agreed that any adjustment should reflect the additional bad debt cost incurred from supplying default tariff customers at an efficient level. However most stakeholders did not comment on these issues, except for the type of benchmark.

3.73. Most stakeholders were opposed to using lower quartile costs for benchmarking. The primary reason given was that suppliers' customer bases will affect the debt-related costs they incur due to COVID-19, and that this is unrelated to their efficiency. Customer base factors mentioned included: levels of vulnerability, employment status, geographical location (given local restrictions), and payment method. One supplier also told us that the actions suppliers could take when a customer got into debt were more limited when that customer was vulnerable.

3.74. One supplier also told us that suppliers are strongly incentivised to minimise debt-related costs, and that a lower quartile benchmark will not change this.

Considerations

Assessing benchmark as increment since 2019

3.75. We have not received any feedback that would lead us to change our previous position of calculating the benchmark based on the incremental cost since 2019 (rather than since an earlier year). This remains our proposal, for the same reasons as before (as mentioned above).

Number of periods over which to assess benchmark

3.76. For setting a float for cap period six, we are proposing to consider costs from three cap periods – four, five, and six. As we have data from multiple cap periods, there is a question about whether we should calculate one benchmark across these cap periods, or separate benchmarks for individual cap periods.

3.77. If we calculate benchmarks for individual cap periods, there is a risk that the selection of the benchmark supplier could be affected by suppliers' cost allocation between periods. For example, if a supplier updates bad debt provisions irregularly, then it could have low costs in one cap period and high costs in another cap period. This supplier could be selected as the benchmark supplier in one cap period, whereas it would not have been the benchmark supplier when assessed over a longer period.

3.78. Taking a combined benchmark over a number of cap periods would reduce the extent to which a supplier's costs could be affected by cost allocation. However, it would cause problems in the future, if we were to maintain this as a principle – either in setting future floats or true-ups.

- We may need to set floats for future cap periods (e.g. cap period seven). If we used a combined benchmark now, then we would either need to use the same supplier for the next float (which might not be efficient in that period), or face the same risk of the new benchmark being affected by cost allocation between periods.

- The information we require to true up will become available gradually – i.e. on a cap period by cap period basis. To maintain the principle above we would need to wait until we had actual data for all three cap periods. We consider that this would be too long a lag – particularly for cap period four.

3.79. In addition, when setting the float for the cap period starting on 1 April 2021, we want to maximise the amount of data we use. Of the suppliers who provided data, not all provided it for each of the three cap periods. Calculating the benchmark separately for each period allows us to use all the data provided. We therefore propose to take this approach. We consider that this is acceptable for the purpose of calculating a float, given that this will be subject to a later true-up.

3.80. We have not reached a view on what approach we will take when calculating a true-up, and may take a different approach from the one we use to set a float.

Benchmarking costs collectively

3.81. In principle, combining cost components before assessing the benchmark is appropriate where there could be interactions or trade-offs between the cost components. This would ensure that the benchmark reflects the options available to a supplier – e.g. if a supplier can achieve lower costs for one component by incurring higher costs for another component. This is the approach we took when assessing similar costs in the payment method uplift.

3.82. However, as discussed in Chapter 4, we are only proposing to include bad debt costs within the float (in part due to the limited amount and poor quality of the data provided), meaning this issue is not relevant at this stage.

3.83. In the event that we decided to include another component of debt-related costs for the float, we would still not benchmark these components collectively. This is because of the limitations of the data provided. The same suppliers have not necessarily provided usable data for each component. To benchmark collectively, we would

therefore only be able to consider the subset of suppliers who have provided data for both components. We consider that reducing the amount of data considered in this way would be likely to reduce the accuracy of our float calculation.

3.84. For the true-up, we currently intend to benchmark related cost components together. However, we will consider this further in light of the data available to us when calculating the true-up.

Choice of benchmark

3.85. In our September consultation we noted that in our 2018 cap decision we benchmarked the payment method uplift using an overall lower quartile benchmark. (The bulk of the costs related to debt). We also benchmarked operating costs at the lower quartile minus £5. We recognised that we had used an average efficiency benchmark for the SMNCC allowance, but said that this was due to the rollout profile driving costs, rather than efficiency. We explained why we considered a lower quartile was appropriate for benchmarking any COVID-19 adjustment – for the same reasons as the payment method uplift.

3.86. Additionally, in our September consultation, we considered three options for benchmarking costs: using the same benchmark supplier as the operating cost allowance, using the same benchmark supplier as the payment uplift and setting a new benchmark. We propose to set a new benchmark and maintain our position of rejecting the other two options, for the reasons set out in our September consultation. We do not discuss the other proposals further here.

3.87. There is likely to be substantial variability between suppliers in how their costs change due to COVID-19.[23] This variability could be driven by, among others:

- Efficiency. We understand that some suppliers are more efficient than others in how they collect debt – e.g. depending on the extent of their debt collection capabilities.

[23] We already observed significant variability between suppliers when setting the payment method uplift. Here, we are therefore talking about reasons why there might be variability in the incremental impact of COVID-19 – not why there might be variability in suppliers' absolute costs.

- Company policy. For example, some companies will have taken more active debt collection steps since the onset of the pandemic.

- Customer mix. Historically some portfolios have a higher propensity for bad debt (e.g. those with more customers paying by standard credit), though it is unclear whether historical patterns will still apply during COVID-19. In response to our September 2020 consultation, suppliers also mentioned other customer mix factors, as described in the stakeholder responses section above.

3.88. Most respondents said that customer mix would be the most important driver of any variability in COVID-19 related costs, and that a lower quartile would understate efficient costs.

3.89. When calculating a true-up, we can consider whether additional data gathering would be helpful to understand the relative importance of the factors above. For example, if we gathered additional data split by the payment method on which debt was incurred,[24] we would be able to control for the impact of differences in the proportion of each supplier's customer base on different payment methods. We would also be able to consider whether there were additional factors we should take into account – for example, suppliers' regional distribution of customers could potentially be important if the economic impacts of COVID-19 are significantly greater in some regions than others. This could also include taking into account any factors which affect the extent to which suppliers can recover debt. For the avoidance of doubt, these are simply options that would be available to us – we have not reached a view about which factors we would consider in practice.

3.90. At this stage, we consider that efficiency could still be the greater driver, and that using lower quartile at true-up could be appropriate. But as stated above, this consultation is focussed on setting the float, and we will consider later whether a lower quartile is the right approach for the true-up.

3.91. In relation to the comment about suppliers' incentives to become more efficient – we accept that suppliers have some incentives to become more efficient regardless of the

[24] Customers can move between payment methods when they go into debt – we would need to be able to gather data about the payment method where debt was incurred to avoid this.

benchmark used, but we consider that those incentives are stronger when the benchmark is lower. This is in line with the position we took in 2018 for both operating costs and the payment method uplift, and we have seen no evidence to date that a different position is required in this context.

3.92. When setting the float, the factors mentioned above could affect the data we have gathered. In addition, our float data may also be affected by:

- forecasting assumptions. Some suppliers will have taken a more pessimistic view of macroeconomic circumstances and its impact on bad debt (both new debt, and any existing debt that may now be harder to collect in cases where the financial situation of customers in debt has deteriorated due to COVID-19).

- differences in accounting policy – some suppliers may have different accounting approaches, or have varied their policy recently, e.g. writing off some historic bad debt at the same time as reviewing COVID impacts.

3.93. Given our view that a lower quartile may be the right approach in the long-term, the uncertainties around these short-term factors, and, most importantly, our overall position of setting a conservative (i.e. lower) float to protect customers, we consider that using a lower quartile is more appropriate than an average when setting the float. This is because setting a conservative float would reduce the risk of customers temporarily overpaying due to limitations in the information available at this stage.

Costs of serving default tariff customers

3.94. The additional costs of serving default tariff customers due to COVID-19 may be different compared to those for domestic customers as a whole. In particular, the additional costs may be influenced by different proportions of payment methods among these groups. Historically, standard credit customers have had higher bad debt costs than direct debit customers, and a higher proportion of default tariff customers pay by standard credit than the market average.

3.95. When setting the payment method uplift in 2018, we used the average proportion of standard credit customers for default tariffs. It would be consistent for us to take into account payment methods when setting an adjustment for the costs of COVID-19.

3.96. However, we do not have data which isolates the impact on default tariff customers

from the domestic customer base as a whole. When setting a float, using the data available to us, we would need to make assumptions to try to adjust for differences in characteristics between default tariff customers and the customer base as a whole. In particular, we would need to assume that the historical cost drivers (e.g. paying by standard credit) are still driving additional costs in the context of COVID-19. This may no longer be true – for example, the types of customers who are unable to pay their energy bills as a result of COVID-19 may not be the same as those who were facing payment difficulties previously. This would limit the extent to which we could be confident that we were in fact increasing the accuracy of our allowance by trying to take payment methods into account.

3.97. We therefore propose to set the float based on the costs of serving domestic customers in general, rather than trying to estimate the specific impacts on default tariff customers. This aligns with our general position of being conservative when setting the float, in order to protect customers.

3.98. When assessing the true-up, we will consider what data we should gather. We recognise that it would be desirable for the cap to reflect the specific costs of serving default tariff customers. However, we will keep in mind the objective of protecting customers, and will consider the best means of achieving this, for example given data limitations.

Allocating costs

Proposals

3.99. In calculating the adjustment, we need to decide how to apportion the costs between the different caps and the cap components. We propose to:

- spread payment type costs equally across credit meter customers;
- spread the cost equally across gas and electricity;
- spread the cost equally across single-register and multi-register electricity; and
- recover costs between the standing charge and unit rate in the same proportions as total costs are currently recovered under the cap.

3.100. These proposals relate to the float – when we true up, we will consider whether any changes to this approach would be necessary.

September 2020 consultation proposals

3.101. In September we proposed:

- to spread payment type specific costs (i.e. direct debit or standard credit) equally across credit meter customers, but not PPM customers, because this maintains the same level of protection for standard credit customers;
- to apply any adjustment separately for electricity and gas because some policy costs only apply to electricity and spreading costs across fuel could introduce distortions;
- to apply different levels of the adjustment for single-register and multi-register electricity given they had different levels of typical consumption; and
- to treat all additional costs as variable (in relation to debt-related costs), i.e. adjust the unit rate and not the standing charge.

Stakeholder responses

3.102. Stakeholders did not comment on how we spread the cost across fuels or across consumption levels.

3.103. Regarding how we spread costs across different payment methods, one supplier said that our proposal to allocate costs equally between customers on standard credit and direct debit does not strike the correct balance, as bad debt costs are likely to be concentrated amongst customers who pay by standard credit. It proposed that we adopt the same allocation approach as we did for the payment method uplift in the 2018 decision. It also said that fully spreading costs between customers will exacerbate competitive distortions that arise from suppliers having differing proportions of customers who pay by standard credit.

3.104. We discuss stakeholder comments regarding PPM – the other payment method – in Chapter 5.

Considerations

Recovery over payment methods

3.105. In our 2018 consultation, we allocated costs between payment types to achieve a specific outcome, the pre-existing price differential between direct debit and standard credit offered by the six largest suppliers in that period. We did this by allocating a percentage of standard credit additional costs to direct debit customers. The consistent approach is to maintain this differential, rather than apply the same percentage adjustment to COVID debt-related costs (which would yield a much larger price differential). To apply the same percentage, as one stakeholder suggests, would confuse the method with the aim.

3.106. Our September 2020 position of increasing all caps by the same absolute amount (pounds per customer account at benchmark consumption) would achieve this aim. It would largely maintain the existing price differential between direct debit and standard credit customers in the default tariff cap.

3.107. We expect that most of the additional debt-related costs due to COVID result from customers now paying by standard credit (including both customers who historically paid by standard credit, and former direct debit customers who moved to standard credit after getting into payment difficulties). In extremis, putting all of the additional cost onto this payment type would increase the standard credit cap by more than £100 per dual fuel customer, due to the need to spread all of the cost increase over a minority of customers.

3.108. In practice, some of the additional costs will be due to direct debit customers. Further, and as we reasoned in our 2018 decision, while standard credit customers as a group have additional costs, on an individual level it would not be cost reflective to charge a standard credit customer the entirety of these costs. 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 allocated to customers that did not cause the problem. In our 2018 decision, we allocated a proportion of standard credit bad debt and administrative costs to all credit customers. This was on the basis that standard credit customers who are paying their bills were not more responsible for these higher costs than direct debit customers that are paying their bills.

3.109. Therefore, we consider that spreading the costs of bad debt across credit meter

customers on default tariffs provides an appropriate level of protection to customers (particularly those paying by standard credit) and enables a supplier with a typical customer base to recover its efficient costs.

3.110. We note that suppliers with greater than average exposure to standard credit customers are likely incur higher costs. However, the higher the allowance we set, the larger the potential windfall to those suppliers (who price at the level of the cap) with few standard credit customers. We consider that our 2018 approach regarding the impacts on suppliers of their customer mix is still valid. That is, it would not be appropriate to set an allowance which covers the costs of one supplier with the maximum possible efficient costs, where that means substantially increasing the cap above the typical cost of supplying the majority of default tariff customers. If we did this, suppliers would on aggregate recover more than their efficient costs from default tariff customers, and this would not protect customers.

Recovery over fuels

3.111. Debt-related costs could differ between fuels. We expect that when a customer stops paying, the debt they build up is proportional to their bill (i.e. how much they should have paid). The level of the cap at typical consumption is higher for electricity than for gas. Therefore electricity bad debt costs could be higher than gas bad debt costs.[25]

3.112. However, our RFI collected debt-related cost information without splitting costs between gas and electricity. This means we can only calculate a cost per customer account – thereby treating gas and electricity equally.

3.113. We have considered two options for how to allocate costs across fuels.

- No adjustment – so that the costs are split equally between gas and electricity.
- Weight the cost per consumer proportionately to the split between fuels in the cap. (We calculate this as the percentage of each fuel as a proportion of the dual

[25] We do not think it likely that there would be significant differences in debt build-up between fuels due to differences in customer characteristics. Most customers have both a gas and an electricity supply, and so average customer characteristics should be very similar between fuels.

fuel cap level. This is 55% electricity and 45% gas, averaged over cap periods three and four – the latest periods where the calculation of the cap level was unaffected by COVID-19).[26]

3.114. We prefer the first option to set a float because it uses the data provided. Splitting this between fuels adds an additional assumption,[27] which we do not consider to be warranted given we are setting a float. The additional assumption might also not be accurate in relation to each cap period, given that the split between fuels in the cap will change over time.

3.115. Furthermore, allocating costs using the relative size of historical cap levels across fuels results in changing the gas and electricity cap by less than one pound.

3.116. Given the small differences between the options, we also do not expect this proposal to have a significant effect on suppliers. Suppliers with more electricity-only customers than average will be slightly worse-off under the first option than the second one. We do not consider that the scale of the impact is likely to be sufficiently large to justify using a more complex approach to set a float, given we will carry out a true-up later.

3.117. When carrying out a true-up, we will consider whether it is feasible to gather data which separates costs between gas and electricity.

Recovery of single-register and multi-register electricity

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

3.119. Given we consider bad debt costs to be proportional to customers' bills, multi-register customers could incur a higher bad debt per customer than single-register customers (driven by the amount of their bill rather than their propensity to incur debt). We

[26] We set the level of cap period four in early February 2020, which was before COVID-19 restrictions in the UK. Therefore, even though suppliers experienced the impacts of COVID-19 during cap period four, the cap period four level was unaffected by COVID-19.
[27] Even this assumption would not take account of all the factors. For example, customer numbers differ between fuels.

reflect this in the current payment method uplift by applying a percentage allowance to the single-register and multi-register benchmarks separately. This gives a higher allowance for the multi-register typical consumption benchmark than for the single-register typical consumption benchmark.

3.120. For the purpose of setting a float, we propose to allocate the costs equally across single-register and multi-register electricity customers. The data we collected is not split by fuel or benchmark arrangement so the cost per customer we calculate is a weighted average across fuels and benchmark arrangements. For the purposes of a float, we consider equal recovery a necessary simplification. Attempting to split out costs by single-register and multi-register meters would add complexity but would not necessarily improve accuracy. We intend to review this position in our true-up.

Recovery over the unit rate and standing charge

3.121. The cap is defined at two levels - nil and typical consumption. These values are used to calculate the standing charge (the element of the cap that does not differ with consumption) and the unit rate (the element of the cap that varies with consumption). We need to consider how the adjustment is recovered across these consumption levels.

3.122. We have considered three options:

- recover all costs in the standing charge;
- recover all costs in the unit rate;
- recover costs in the unit rate and standing charge based on the historical proportions of the cap at nil and the medium Typical Domestic Consumption Value (TDCV).[28]

3.123. We do not consider that recovering the adjustment in the standing charge protects consumers with low consumption. Adding a cost to the cap at nil consumption leads to customers paying an equal share of the adjustment regardless of how much energy

[28] By TDCV, we mean the typical consumption values used to set the cap. (3,100kWh for single-rate electricity, 4,200kWh for multi-register electricity, and 12,000 kWh for gas). These are not the same as the current typical consumption values, which we have updated since we introduced the cap.

they consume. This would result in a spike in prices for low consumption customers.

3.124. In addition, the amount of debt from low consumption customers should be low, given their bill sizes. It is possible that low consumption customers may be more likely to be financially stretched than customers on average (to the extent that low consumption is associated with lower average incomes). This could plausibly affect the proportion of low consumption customers going into debt. However, we consider that the effect of lower bill sizes is likely to be more important than any differences in the propensity of customers to go into debt. In other words, low consumption customers are likely to create lower amounts of debt per customer than a customer with average consumption – and therefore we consider that it would not be appropriate for them to pay for more debt than they create.

3.125. The second option, recovering all of the costs from the unit rate, is better than the first option, because it takes into account that customers with higher levels of consumption are likely to have higher levels of debt. However, this option would mean that a consumer who does not consume anything will not contribute to the adjustment. We do not think this option is appropriate, because a customer who does not consume any energy can still incur debt based on the costs of the standing charge. This is a refinement of the position we set out in September, where we did not consider the effect of debt incurred on the standing charge. We now consider that we should take this into account.

3.126. We consider recovering the costs over the standing charge and unit rate is the best option. This better reflects how customers might build up debt and is in line with how we treat the payment method uplift for debt-related costs (applied as a percentage to the cap at nil and TDCV). It is worth noting that we are recovering the costs of bad debt from customers who pay their bills. The issue is about how best to allocate the costs for the debt that is built up by other customers. We consider that looking at how consumption might affect debt build-up gives us a reasonably fair way of doing this.

3.127. As with other areas, we will consider later what approach to take for the true-up. However, our initial view is that recovering costs through a mixture of the standing charge and unit rate is likely to remain appropriate.

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

We consider whether COVID-19 is likely to have a significant impact on debt-related costs. We consider what data source to use to set a float. We consider which debt-related costs to adjust for as part of the float.

We seek suppliers' views on our considerations in general.

Summary

4.1. We propose to include the incremental bad debt charge forecast for cap periods four, five and six in the float. We propose to use suppliers' submissions to our voluntary Request for Information (RFI)[29] to calculate this. We propose to use 2019 as the baseline to calculate the increment.

4.2. We propose to not include working capital costs and debt-related administrative costs in the float. We do not have confidence that the RFI data collected is consistent between suppliers. In addition, taking the data at face value does not show a material cost to suppliers. We propose to consider these costs as a part of our true-up exercise.

The impact of COVID-19 on debt-related costs

Proposals

4.3. We propose to make adjustments for debt-related costs as part of the float.

September 2020 consultation

4.4. Our initial view was that an additional allowance was likely to be necessary for debt-related costs.

Stakeholder responses

4.5. Most stakeholders agreed with our proposal. However, two suppliers disagreed. One of

[29] We issued this RFI on 21 September 2020. We issued this RFI to suppliers with a domestic market share of at least 1% (with the exception of one supplier due to the specialist nature of its customer base).

these suppliers stated it was too soon to fully assess the impact of bad debt that can be directly attributed to COVID-19. It did not support our proposal to estimate for future bad debt at the point of consumption rather than waiting for write-offs. The supplier said it had not yet seen a material increase in debt and had not confirmed a view on the collectability of any debt incurred from COVID-19 or any subsequent recession.

Considerations

4.6. We consider it is appropriate to adjust for debt-related costs, because we have a reasonable expectation that COVID-19 will increase them.

4.7. COVID-19 is an unexpected shock that could have long-lasting economic impacts. The subsequent economic downturn caused by COVID-19 is likely to put pressure on consumers' income and their ability to pay a variety of bills. This would increase the number and value of non-payments in the domestic energy market.

4.8. We cannot draw firm conclusions at this stage on the impact of COVID-19 on debt-related costs. In particular, we will only know the final bad debt write-off at a later stage, once suppliers have exhausted debt recovery procedures. Recovery procedures differ between suppliers, but write-offs can take 12 months or longer. However, suppliers could see cash flow impacts much sooner than this if the proportion of customers paying on time or paying at all decreases.

4.9. As part of understanding what impacts COVID-19 has had on whether domestic energy customers pay their energy bills, we asked suppliers to provide additional data on leading indicators[30], including:

- number of payments on receipt of bill (i.e. standard credit) failing; and
- number of direct debit instruction cancellations.

[30] This was an extension of information previously collected through a regular RFI that Ofgem has sent to suppliers to monitor the impacts of COVID-19. We gathered additional data so that we had an historical baseline for comparisons.

4.10. The number of failed payments on receipt of bill increased over summer 2020 relative to summer 2019 by 30%.[31] Direct debit cancellations spiked in March 2020 and then fell back to normal levels by July 2020.

4.11. We recognise that the future impacts on suppliers' debt-related costs could be more significant than the impacts on customers' ability to pay discussed in the previous paragraph might indicate. This is especially since the impacts of COVID-19 may have been mitigated over the summer due to Government support (through, for example, the furlough scheme).

4.12. Following the 2008 financial crisis, unemployment increased, and this increase was persistent for several years. The level of debt-related costs also increased, due to non-payments of bills resulting from financial difficulty. Macroeconomic forecasts suggest that the UK could experience unemployment rates in 2021 which are similar to those observed in the years after the financial crisis.[32] The impacts of COVID-19 are at an early stage and highly uncertain, but this historical experience indicates that we should consider the possibility of persistent impacts.

4.13. We also note that unemployment rates are projected to increase significantly relative to both the baseline year used to set the operating cost allowance in the cap (2017) and the first year the cap was in operation (2019).[33] We would therefore expect debt-related costs to also be higher as a consequence.

4.14. In addition, engagement with suppliers suggest that they largely expect the level of non-payment of bills and debt-related costs to increase in the future because of the macroeconomic impacts from COVID-19.

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[31] We only have data up to July 2020. The 30% figure was calculated as the percentage difference between the April-June period in 2019 and 2020.

[32] For example, the Bank of England's latest expectation is for the LFS unemployment rate to peak in Q2 2021 at 7.75%. The post-2008 peak in this series was 8.6% (2011 Q4).
Bank of England (2020), Monetary Policy Report November 2020, p5.
https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2020/november/monetary-policy-report-nov-2020.pdf?la=en&hash=0CD444F53D57E0C3660AC34666D8F88CC1C6E81A
Office for National Statistics, LFS unemployment series. Series ID: LF2Q.
https://www.ons.gov.uk/employmentandlabourmarket/peoplenotinwork/unemployment/timeseries/lf2q/lms

[33] The LFS unemployment rate was around 4.5% in 2017, and around 4% in 2019.

Data source for debt-related costs

Proposals

4.15. We propose to use the cost data collected through the voluntary RFI to set a float for debt-related costs.

September 2020 consultation

4.16. In our September 2020 consultation, we proposed to review a set of leading indicators to make a judgement about a suitable amount for the float.

4.17. We outlined that we had some leading indicators from weekly returns, but considered they were not appropriate to set the float because they did not split data between the domestic and non-domestic segments.

4.18. We also mentioned we could use wider macroeconomic indicators (e.g. levels of bad debt during the last recession) to forecast potential impacts of COVID-19.

4.19. While we considered an RFI to collect more information, we did not consider a new significant data gathering exercise would be feasible.

4.20. We have since used a voluntary RFI to collect additional information on leading indicators, as well as suppliers' forecasts of debt-related costs.

Stakeholder responses

4.21. One supplier raised concerns in its response to the voluntary RFI that this would not produce meaningful answers to the question in the consultation. It noted that it was unable to provide reliable forecasts. It stated that this work was linked to the work that Ofgem is doing on potential different impacts of COVID-19 on suppliers this winter and that we should draw on that work.

4.22. Another supplier welcomed the proposal to gather data through the voluntary RFI and said that we should attach significant weight to the information suppliers provided for the purposes of setting a float.

4.23. One supplier disagreed with the concept of using data relating back to previous recessions. It said that it expected that circumstances within the industry at the time

of the last recession are too far removed from today's industry to guide policy decisions.

Considerations

4.24. We have considered three sets of data for setting the float for future costs:

- supplier forecast cost data from the voluntary RFI;
- leading indicator data (combination of RFI indicators and macroeconomic indicators); and
- work Ofgem is separately doing to be prepared for a wide range of potential different impacts of COVID-19 this winter.

Supplier forecasts

4.25. In September we did not think it was feasible to carry out a new significant data gathering exercise in the time available. However, we have been able to gather this data by requesting it at a less granular level, and making the RFI voluntary. We collected the debt-related cost data for suppliers' domestic supply businesses without asking for further breakdowns (e.g. fuels and payment methods).

4.26. We recognise that these are only forecasts. Suppliers will have therefore needed to apply judgement when developing them, particularly in an uncertain environment. In principle this could create a risk of upward bias (given we are setting a cap which affects suppliers' revenues). In practice, given the forecasts provided,[34] we are comfortable that they are broadly reasonable, taking into account the macroeconomic situation.

4.27. We also recognise that suppliers are likely to have taken different approaches to preparing their forecasts. Suppliers may have used different data, and applied different assumptions. However, in such an uncertain environment, this is not necessarily a drawback. We do not know what the correct set of assumptions to use is – a diversity

[34] In relation to the bad debt charge.

of approaches could actually be preferable.

4.28. We consider that the supplier forecasts are the best available data source.

- We are trying to estimate the debt-related costs that suppliers will face. Supplier forecasts are looking directly at this.

- Suppliers have their own experience of the factors that affect bad debt, with a specific understanding of the impacts on their own portfolios. Although the current situation is unprecedented, suppliers will still be able to draw on years of data.[35] This includes data on how much debt can ultimately be recovered.

- Suppliers will often need to develop forecasts for their own business planning or accounting purposes. To this extent, suppliers will have established processes. In the time available to develop a float, it may be more robust for us to rely on existing forecasting methods rather than developing our own approach from scratch.

Leading indicators

4.29. One advantage of leading indicators (e.g. direct debit cancellations) is that they use operational data. This reduces the role of judgement in preparing the figures. Another advantage is that they could help to provide an early indication of future debt build-up.

4.30. However, we do not consider that using leading indicators is preferable to using the supplier forecasts for setting the float.

- Leading indicators would provide us with a trend. However, we would then need to translate this trend into an impact on customers' willingness or ability to pay their energy bills. This would require assumptions. Leading indicators are therefore not a mechanical way of setting the float, and so would not avoid

[35] This may include data from the last recession, for those suppliers who were operating then. We consider that such data could be one useful input to a supplier's forecasting approach (given it provides actual experience of the impacts of a recession), even though a supplier's forecasting would also need to take into account how its business had changed since then.

judgement.

- Leading indicators are available to suppliers, and are part of the information they can take into account when making their own bad debt forecasts. Unless there is a strong risk of bias in how suppliers develop these forecasts, we might not want to focus on one type of input, as opposed to a forecast drawing on several inputs.

- Leading indicators may give an idea of near-term trends. However, we are setting an allowance which extends around a year beyond our last leading indicator data point. In a fast-moving environment, recent trends may be not be a good way of forecasting this far into the future. This is particularly given changes in Government support schemes.

4.31. Similarly, we do not consider that macroeconomic indicators (e.g. gross domestic product, GDP, forecasts) are the best way to set the float. The first two points above would also apply to them.

Winter 2020 COVID-19 scenarios

4.32. Separate to this review, Ofgem has considering a wide range of scenarios on how COVID-19 might impact the energy market this winter.

4.33. Our approach to this work has been developed for a different purpose to the work we are doing to assess the impacts of COVID-19 on costs covered by the cap. We do not consider that this separate piece of work is a suitable basis for setting a float for additional debt-related costs due to COVID-19. In particular they do not look at the amount of bad debt that is likely to be written off.

Debt-related costs in the float

Proposals

4.34. We propose to include an adjustment for the cost of writing off bad debt in the float.

4.35. We do not propose to include a float for the cost of working capital and bad debt administrative costs. We propose to consider these costs again when calculating the true-up.

September consultation

4.36. In our September 2020 consultation, we considered that debt-related costs would increase due to COVID-19. We divided these costs into three categories:

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

4.37. We proposed to look at these three cost categories together when calculating the actual level of COVID-19 additional debt-related costs (i.e. the true-up). We did not set out a proposal for which types of costs we would consider when setting a float, although we gathered data in each category through the voluntary RFI. However, we noted we would have to be careful not to double count costs where they interact.

Stakeholder responses

4.38. Stakeholders did not provide any comments relating to the cost categories that we should consider in our assessment of debt-related costs.

Considerations: introduction

4.39. We propose to include the costs of bad debt in the float, but not the debt-related administrative costs or working capital. This was due to the data we collected. In order to explain our considerations we first discuss the voluntary RFI, and then discuss the data for each cost component.

Summary of voluntary RFI

4.40. Table 4.1 summarises the number of suppliers who submitted data that could be used

for each cap period.[36] We report the number of historical large suppliers separately from other suppliers, because these suppliers supply the majority of default tariff customers.

4.41. Not all suppliers who received the RFI responded. Under normal circumstances, we would gather data from all suppliers above a certain size (using a formal RFI). However, unlike other components of the cap, we are estimating a float that will be trued-up at a later stage. This means that we are able to tolerate greater simplifications and approximations.

Table 4.1: Submission details on debt-related costs

	Item	Bad debt	Working Capital	Debt-related admin costs
Cap period four increment calculation	Number of historical large suppliers[37]	4	4	4
	Number of other supplier submissions	3	1	3
	Total	**7**	**5**	**7**
Cap period five and six increment calculation	Number of historical large suppliers	3	2	3
	Number of other supplier submissions	2	1	2
	Total	**5**	**3**	**5**

Considerations: bad debt

Data sample and analysis

4.42. We requested monthly data, from January 2019 to September 2021 (including forecasts), on the bad debt charge figure (£m). The bad debt charge reflects movements in provisions for bad debt, including any adjustments for differences between write-offs and previous provisions.

[36] We have only included data for suppliers who have provided data for the specific cap period and the respective baseline. We have excluded one supplier's submission completely. This was because it was not able to provide an appropriate baseline for to any cap period.
[37] By historical large suppliers, we mean the suppliers who were the six largest suppliers before recent transactions.

4.43. We consider the data we received is sufficient to provide a good estimation of bad debt costs for the float.

- For the cap period four increment, the data covers of a significant proportion of the market. This includes most of the historical large suppliers.

- For the cap period five and cap period six increment calculations, we have a lower degree of coverage. However, for the purposes of estimating a float that we will true-up at a later stage, we consider this sufficient.

4.44. Suppliers' data suggests an approximate increase in the bad debt charge of £90 million between cap period four and the relevant baseline, £74 million between cap period 5 and the relevant baseline and £40 million between cap period 6 and the relevant baseline.

4.45. For each supplier, we calculated the bad debt increment per customer for each cap period. The bad debt increment figures are displayed in Table 4.2. The outputs show an incremental increase in bad debt charges in each cap period under consideration.

Table 4.2: Bad debt increment figures by cap period

Cost item	Unit	Cap period 4	Cap period 5	Cap period 6
Bad debt	£/customer	2.03	2.46	2.08

Notes: Increments assessed at the lower quartile. Figures are per customer account (i.e. per fuel). Increment calculations do not take into account inflation.

4.46. At the end of this chapter, we describe how we have translated the incremental costs into our proposed adjustment.

Discussion of limitations

4.47. The bad debt charge data is based on suppliers' expectations for the amount of debt that they will eventually write off. The amount of debt that will actually be written off is likely to be different to this, meaning that a further adjustment will likely be required at the true-up stage. Despite this, we are comfortable with using the bad debt charge as the best initial estimate of costs.

4.48. The bad debt charge data we collected is not specifically in relation to consumption from cap period four onwards (i.e. post-COVID). Part of the bad debt charge in a given

cap period will relate to movements in provisions (or final write-offs) based on debt incurred in relation to consumption in previous periods (i.e. pre-COVID). These provision movements could also be seen as a consequence of COVID-19 – for example if the deterioration in the economic situation reduced the assumption for the future recoverability of older debt.

4.49. However, if suppliers have reviewed their debt books as a result of COVID-19, there is also some risk that this has influenced the timing of when they have updated provisions for debt incurred in relation to consumption in previous periods (relative to their usual processes). This could affect which cap period costs fall into – even if the underlying bad debt levels had not changed. Given this appears to be purely a timing impact, we are not concerned that this would affect the overall size of the float provided. This is because, if suppliers would have needed to write off this debt at a later stage anyway, then a higher bad debt charge in cap period four should be followed by a lower bad debt charge in subsequent cap periods.

4.50. The bad debt data includes suppliers of different sizes, who vary in terms of the proportion of their customers who are on default tariffs. However, we note that when we removed the mid-tier suppliers (i.e. those who were not the historical large suppliers), it made only a small difference to the results. We propose to use all the suppliers for whom we have data, given that our dataset is not complete in any case.

Considerations: debt-related administrative costs

4.51. We requested monthly data, from January 2019 to September 2021 (including forecasts), on suppliers' total debt-related administrative costs (£m). These are a combination of internal collections, external collections and warrant costs.

4.52. We received slightly fewer RFI responses for debt-related administrative costs than we did for the bad debt charge. Having fewer responses makes benchmarking less robust. However, in principle we consider that the number of responses could still have been sufficient for the purpose of setting a float. As discussed below, the problem is the quality of the responses provided.

4.53. As generally, we calculated the incremental debt-related administrative cost per customer, and then took the lower quartile. The debt-related administrative cost increment was negative for cap period four, positive during cap period five and then negative again for cap period six. In aggregate, this resulted in a negative increment

(approximately -£0.50 per customer account).

4.54. In our September 2020 consultation, we set out our expectation that suppliers may experience a decrease in their debt-related administrative costs in cap period four, due to the suspension of certain debt collection activities and the furlough scheme. We also noted that suppliers may experience increased debt-related administrative costs in the future, as debt begins to rise and requires increased collection activity.

4.55. The data provided by suppliers for cap period six therefore does not match the expectation we set out in the September 2020 consultation. It also does not correspond to the bad debt charge forecasts – if suppliers are expecting to incur more bad debt, we would also expect the cost of collections activity to increase.

4.56. There are large variations in the debt-related administrative costs provided by suppliers in cap period six. Given we only have data from a relatively small number of suppliers, each supplier can have a significant effect on the calculation, and so any data quality issues are magnified. It therefore seems likely that the counterintuitive result for cap period six is due to the quality of the data provided (rather than because our initial expectation of an increase in debt-related administrative costs was incorrect).

4.57. In the time available to analyse the data, we have not been able to reassure ourselves that data is consistent or of the quality necessary to include in the float. We are also not aware of any other adequate data source for debt-related administrative costs to use to set the float in the time we have available. We therefore do not propose to set a float for debt-related administrative costs.

4.58. As set out elsewhere, our general approach when setting the float is to take a conservative approach, so that customers do not bear the uncertainty around the costs due to COVID-19. Given the calculated increment is negative, including an adjustment in this case would actually reduce costs to customers. Nevertheless, we do not consider that the calculation is robust, for the reasons set out above. We do not consider that being conservative requires us to use poor-quality data, and therefore we do not consider that our position is inconsistent with our general approach.

4.59. We propose to consider the developments of suppliers' debt-related administrative costs as a part of our true-up exercise. As explained above, we expect that suppliers will incur costs in this area, and so any true-up adjustment (beyond cap period four)

may be a positive number.

Considerations: working capital costs

4.60. We requested monthly data, from January 2019 to September 2021 (including forecasts), on the total working capital cost figure (£m). We defined this as current assets minus current liabilities, in line with the definition we used for the payment method uplift.

4.61. We received the smallest number of responses for working capital, relative to the other cost areas. We received a particularly small number of responses for cap periods five and six. This could limit the usefulness of the data available. However, again, our main concern with using this data to calculate a float was the quality of the data provided, rather than the quantity.

4.62. For each supplier we calculated the working capital cost increment per customer for each cap period. We then took the lower quartile. To convert the amount of working capital into a cost, we applied the 10% cost of capital.

4.63. Most suppliers' data showed a general seasonal trend in working capital, which we would expect. However, there were some large differences in the submitted data which concerned us. One supplier provided figures that were extremely positive and another provided figures that were extremely negative. There was also notably a significant difference in the scale of monthly working capital between suppliers.

4.64. We considered possible explanations, including the different customer mixes of suppliers and possible differences in accounting approaches. We also asked for clarification from certain suppliers to understand their submissions.

4.65. However, in the limited time available to analyse the data, we have not been able to reassure ourselves that suppliers have responded in consistent ways to the working capital question. We recognise the challenge for suppliers in providing coherent data given the nature of the request and the tight timelines. We also remain cautious about any double counting between bad debt and working capital 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.

4.66. Taking the submissions at face value, most suppliers experienced a very small

incremental change in their working capital costs. In aggregate, we calculated a negative incremental cost of approximately -£0.11 per customer account. This does not suggest that suppliers are experiencing a material cost (and therefore the risk of not allowing a float is more limited than if the cost was significantly larger).

4.67. We are also not aware of any other reliable data sources that could be used to set a float for working capital in the time we have available.

4.68. In the same way as for debt-related administrative costs, while technically including the calculated increment would have reduced the size of the float, we do not consider that our general approach of setting the float on a conservative basis requires us to use poor-quality data.

4.69. This does not rule out the possibility of including working capital costs in a true-up. We will also consider and consult on possible alternative methods to calculate a potential true-up for working capital costs to ensure consistency between submissions, e.g. using a different measure such as debtor days.

Proposed adjustment

4.70. Based on the section above, we are proposing to adjust for bad debt costs only. We therefore need to translate the incremental costs of bad debt into an adjustment level, using the approach proposed in Chapter 3. Table 4.3 shows the allowance we propose to implement for cap period six.

Table 4.3: Bad debt scaled increments and the cap period six adjustment level

Scaled levels	Electricity		Gas		Dual Fuel	
	Nil	TDCV	Nil	TDCV	Nil	TDCV
Cap period four	0.32	2.01	0.32	2.01	0.64	4.02
Cap period five	0.39	2.46	0.39	2.46	0.78	4.92
Cap period six	0.66	4.69	0.66	7.85	1.32	12.54
Cap period six adjustment level	**1.37**	**9.16**	**1.37**	**12.32**	**2.75**	**21.48**

4.71. As we are proposing to recover the costs of cap periods four and five over 12 months (two cap periods), there would also be an adjustment for cap period seven. At a minimum, this will recover the residual costs from cap periods four and five. However,

to the extent that the impacts of COVID-19 are expected to continue, we might also need to set a float for cap period seven as well. Table 4.4 below therefore shows the minimum implied adjustment for cap period seven – it is not a forecast for the adjustment that we expect to make in cap period seven. We will consult on the total adjustment for cap period seven at a later stage.

Table 4.4: Minimum implied cap period seven adjustment level

Scaled levels	Electricity		Gas		Dual Fuel	
	Nil	TDCV	Nil	TDCV	Nil	TDCV
Cap period seven adjustment level	**0.71**	**4.47**	**0.71**	**4.47**	**1.42**	**8.94**

Methodology for calculating a float

Proposals

4.72. We propose to take the following steps to implement our proposal to benchmark the incremental cost per customer (see Chapter 3):

- for each supplier which we have data for, we calculate a cost per customer for each cap period;
- we then calculate the change in this cap period relative to a baseline period, which is the same period in 2019 (i.e. pre COVID-19); and
- we then then calculate the lower quartile (see Chapter 3) of these changes for each of cap periods four, five and six.

4.73. We then convert the lower quartile figures into an adjustment by following the steps set out in Chapter 3.

September 2020 consultation

4.74. We did not go into detail on how we would implement our proposal to calculate the incremental costs relative to 2019.

Stakeholder responses

4.75. We did not receive stakeholder comments on how we would calculate the incremental costs to 2019.

Considerations

How to calculate the increment since 2019

4.76. For each cap period, we propose to calculate the increment relative to the same months before COVID-19. The alternative would have been to look at costs throughout 2019. One reason for our proposed approach is that debt-related costs may have seasonal patterns (reflecting the seasonality of consumption). Another reason is that some suppliers appear to review their bad debt provisions on a cycle linked to their financial results (half year and full year). Using the same months when comparing costs in a cap period and in the baseline should help to reduce the importance of these factors.

4.77. Table 4.5 shows the dates we considered for our cap periods and respective baseline.

Table 4.5: Increment calculation details

	Cap period 4 (April 2020– September 2020)	Cap period 5 (October 2020 – September 2021)	Cap period 6 (April 2021– September 2021)
COVID scenario	April 2020– September 2020	October 2020 – March 2021	April 2021– September 2021
Baseline	April 2019– September 2019	October 2019 – Feb 2020 (scaled up)[38]	April 2019– September 2019

[38] We chose to not include March 2020 data in the cap period five baseline because the data in this month could be impacted by COVID-19, given restrictions were put in place from late March. Instead, we propose to scale up the October 2019 to February 2020 period to produce an appropriate six-month baseline.

4.78. We only included a supplier's data in the increment calculation for a given cap period if it provided full data for both the COVID scenario and the baseline.[39]

4.79. We have only excluded a supplier's submission completely from the calculation if it has provided inconsistent data across the baseline and the COVID period.

Calculating costs per customer

4.80. We calculate the incremental debt-related costs on a pound per customer account basis. This means that we have to divide each month's debt-related cost by a number of customer accounts.

4.81. We collected monthly customer account data in the RFI. However, as this used the same definition as the previous Ofgem COVID-19 RFI for consistency, it records all customer accounts in the same way, whether they are dual fuel or single fuel. We would expect dual fuel customers to have higher debt-related costs than single fuel customers, given their bills are generally larger. We would therefore ideally like to take into account a supplier's number of customer accounts, weighting for dual fuel customers as two accounts.

4.82. We do not have monthly data in order to do this. However, we do have snapshot data from our cap compliance RFI, 'Domestic Customer Account & Tariff RFI', which we issue in April and October each year. We currently only have the April 2019, October 2019 and April 2020 snapshots of customer accounts available to use.

4.83. In our current calculation, we made assumptions on how to apply this snapshot data when calculating the cost per customer account in each month:

- the number of customer accounts for all months in 2019 is set equal to the average of the customer accounts from the April and October 2019 snapshot data; and

[39] The only exception was one case where a supplier had provided data for five out of the six months for summer 2020, missing only September 2020. We did not consider it reasonable to ignore this data completely, given it was almost complete. Instead, we assumed the September 2020 figure was the average of the monthly submissions between April and August 2020 (i.e. the other months in the same cap period).

- the number of customer accounts for all months in 2020 and 2021 is set equal to the April 2020 snapshot, as this is the latest available customer account data available to us.

4.84. For months after April 2020, individual suppliers may gain or lose customers. The forecast total debt-related costs that suppliers have provided to us may take into account how they expect their customer account numbers to change over time. By dividing through by a static number of customer accounts, we may understate the cost per customer account for suppliers who expect a net decrease in their customer base, and overstate the cost per customer account for suppliers who expect a net increase in their customer base. This could affect the results of our benchmarking exercise.

4.85. This is only an issue for setting a float. For the true-up, we will be able to request actual data on customer accounts, and we intend to request this on a basis which weights dual fuel accounts as two accounts.

4.86. Given we will carry out a true-up later, we are prepared to tolerate the imprecision resulting from the customer account data when setting the float.

4.87. We are also aware that the October 2020 snapshot of the 'Domestic Customer Account & Tariff RFI' will become available and we consider that we should update our calculation to include this in time for the decision. Including more up to date customer account data would improve the accuracy of the pounds per customer forecast. It reduces – but does not eliminate – the issues discussed above on changes in suppliers' customer bases after our last snapshot, as it means our last snapshot is more recent.

4.88. Including the October 2020 snapshot data in our current calculation would change the assumptions slightly so that:

- all months in 2019 would be equal to the average of the customer accounts from the April and October 2019 snapshot data (as in our current calculation);

- all months in 2020 would be equal to the average of the customer accounts from the April 2020 and October 2020 snapshot; and

- all months in 2021 would be equal to the customer accounts from the October 2020 snapshot as this is the latest available customer account data available to us.

4.89. Given the availability of the new October 2020 snapshot, we may also want to consider an alternative approach to our customer account assumption that could better align the snapshots of customer accounts with the cap period increments they are being applied to. This alternative approach could be applied as follows:

- all months between April 2019 – September 2019 are set as the average from the two snapshots in April 2019 and October 2019;
- all months between October 2019 – March 2020 are set as the average from the two snapshots in October 2019 and April 2020;
- all months between April 2020 – September 2020 are set as the average from the two snapshots in April 2020 and October 2020; and
- all months after October 2020, including the 2021 months, are set equal to the October 2020 snapshot.

4.90. We welcome any comments from stakeholders about the options for how we should use the October 2020 snapshot of the 'Domestic Customer Account & Tariff RFI' in our calculation for the float adjustment.

Converting the incremental figures into a cap adjustment figure

4.91. After calculating the suppliers' incremental costs broken down by period, we convert these into an adjustment, using the approach proposed in Chapter 3.

5. Prepayment meter customers

In this chapter, we consider if an adjustment is required for changes in PPM-specific costs resulting from COVID-19.

We seek stakeholders' views on our considerations in general.

5.1. 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. It will expire at the end of December 2020.

5.2. We decided in August 2020 to continue protecting these customers using the default tariff cap rather than through a separate cap. We set a specific cap level for PPM customers.

5.3. Recently, Ofgem has also decided to improve outcomes for PPM customers who are self-disconnecting.[40] This 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.

COVID-19 PPM adjustment

Proposals

5.4. Our view is that the effects of COVID-19 on supplying PPM customers are limited. We therefore propose not to adjust the PPM cap level in the default tariff cap for 1 April 2021.

5.5. We propose to revisit this in our next review, based on additional or updated evidence.

[40] Ofgem (2020), Self-disconnection and self-rationing: decision https://www.ofgem.gov.uk/publications-and-updates/self-disconnection-and-self-rationing-decision

We expect that we would focus on administrative costs and bad-debt costs resulting from additional discretionary credit.

September 2020 consultation proposals

5.6. We proposed to consider the costs of COVID-19 on PPM customers, despite these costs being incurred before PPM customers were covered by the default tariff cap. We also proposed to consider the costs of all PPM customers on a per customer basis, as a simplification, rather than the 98% of PPM customers covered by the default tariff cap.

5.7. Our initial view was that the effects of COVID-19 on supplying PPM customers were limited. We considered that there could be small additional administrative costs but we considered suppliers could meet these by reallocating under-utilised resources. We also thought there could be some ongoing bad debt costs from an increase of discretionary credit provided by suppliers. Please see our September 2020 consultation for a more detailed description of these cost categories.[41]

5.8. We considered 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.

Stakeholder responses

5.9. Three suppliers and one industry body commented on our PPM proposals for the COVID adjustment.

5.10. One supplier said that a COVID adjustment would be unnecessary due to the very low bad debt risk, but requested that we keep this under review.

5.11. Two suppliers and one industry body disagreed with our initial view that there are no additional costs for PPM customers from COVID-19. They said that suppliers had been

[41] Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation, paragraphs 5.15 – 5.30. https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation

under pressure to provide additional support. They said that the following PPM-specific costs have increased:

- discretionary credit and any associated costs;
- administrative costs, including the increase in customer contact from customers in vulnerable situations or in order to arrange discretionary or emergency credit, and increased replacement of prepayment keys and cards;
- cost to serve, given that, with COVID-19, suppliers have been unable to install as many smart meters as expected, which would have reduced their costs; and
- adopted debt arising from Debt Assignment Protocol (DAP) (we note the respondent was not identifying this as a cost increase, but rather as a source of bad debt for PPM customers).

Considerations: overall rationale

5.12. We have not seen evidence to suggest a material increase in costs for PPM customers resulting from COVID-19 so we do not think an adjustment is required at this point. The objective of the Act is to protect customers on default tariffs. We therefore propose to err on the side of caution when considering any adjustments, to avoid customers bearing the risk of the cost uncertainty. We consider that suppliers are better placed than customers to manage cash flow risk, and note several stakeholders agreed with this general principle.

5.13. However, we do not rule out making an adjustment in our future reviews if there is clear evidence that the efficient cost of supplying PPM customers has risen due to COVID-19. This would only cover the incremental costs (e.g. the incremental bad debt write-off as a result of providing discretionary credit during COVID-19, not the entirety of discretionary credit granted during COVID-19).

Considerations: discretionary credit

5.14. In this section, we cover discretionary credit. We do not discuss emergency credit. While the amount of emergency credit suppliers provide may have increased, we consider it unlikely that there are significant costs. Emergency credit is generally provided in lower amounts and typically repaid when the customers top up their

meters. Discretionary credit is provided in larger amounts and is often repaid over longer periods through repayment plans.

5.15. We consider that the evidence base for a PPM adjustment for discretionary credit write-off due to COVID-19 is relatively limited. Whilst there is a cost to providing discretionary credit, there is more uncertainty than for credit meters about whether there will be a material increase in bad debt costs due to COVID-19.

Discretionary credit granted

5.16. Our weekly and monthly COVID-19 RFIs regarding supplier financial data show the total amount of PPM financial support (preloaded keys/cards and discretionary credits) provided to customers over 15 weeks between March and July 2020. We considered data from the ten largest PPM suppliers covering the vast majority of PPM customers.[42]

5.17. Some of the data points provided by some suppliers look potentially unreliable when compared to the figures from other suppliers. However, excluding these from our calculations does not have a substantial impact on the results.

5.18. From the RFI data, suppliers provided £1.2m of discretionary credit, on average, per week. If the same level of discretionary credit was provided for the whole of cap periods 4 and 5, this would total around £60m. However, not all of this credit will result in bad debt, and we expect that much of it will be repaid promptly.

5.19. Different suppliers could have adopted quite different policies regarding discretionary credit. Additionally, suppliers' policies on whether discretionary credit needs to be repaid before returning for additional discretionary credit may also vary, as may be the amount of discretionary credit granted per customer. Even if all suppliers were equally efficient, there would likely be a high degree of variance in costs.

5.20. Importantly, this is total discretionary credit, not incremental to 2019. We do not have 2019 baseline data. As such, it is not possible at this point to say how much of this discretionary credit is incremental due to COVID-19. We welcome stakeholder evidence

[42] The ten suppliers in the sample have approximately 7.5 million customer accounts across them and cover around 98% of the PPM market.

on comparable discretionary credit provided in 2019.

Uncertainty in estimating cost increases

5.21. As we have noted above, we have limited evidence on the increase in discretionary credit that is written off due to COVID-19. We have therefore explored scenarios based on the data we have.

5.22. At one extreme, if prepayment discretionary credit has a similar recovery rate as short term debt for credit meter customers, we estimate that around 12% could be written off. At the other extreme, one supplier told us (in data it provided to us) that it applied a working assumption of 50% write-off for the financial relief granted during COVID-19, and noted it could not predict recovery with any accuracy. Using a weighted average of data from suppliers who provided expectations of unrecoverable debt from financial relief granted during the pandemic (from the weekly RFI data) suggests suppliers typically expect around 17% write-off.[43]

5.23. As an indication, taking an assumption of the debt level that is written off to be 17%, this would result in a total annual cost of writing off discretionary credit to around £2.80 per dual fuel PPM customer on average.[44] However, this is the total cost – the incremental cost due to the impacts of COVID-19 could be much lower.

Incentive

5.24. It could be argued that by not providing an adjustment for discretionary credit we remove any incentive for suppliers to support customers in payment difficulties. However, this problem still exists if we made an adjustment. Depending on the level of the adjustment, it could lead to under-recovery for those suppliers who provided large increases in the amount of discretionary credit, even if their recovery process is efficient, and conversely for over-recovery for suppliers who provided very limited

[43] This is based on suppliers' views of unrecoverable financial relief over all payment methods rather than specifically PPM.
[44] This is not the cap adjustment itself. This would particularly depend on the number of periods the cost is recovered over, and how the recovery is split between fuels and between the standing charge and unit rate.

increases in discretionary credit.

5.25. We do not consider that providing an adjustment at this stage is an appropriate means of encouraging suppliers to provide support in future. There are other measures in place to ensure suppliers maintain a good level of service for customers (e.g. licence requirements). In addition, we expect there to be reputational and customer retention benefits from providing customers with support, which would also serve as an incentive. Where suppliers provide limited support at present, there is no guarantee that they would spend the additional funding on supporting PPM customers. For suppliers who provide significant support at present, the adjustment could only cover their costs if we set it at a high level, which would mean customers over-paying in aggregate.

Considerations: administrative costs

5.26. Suppliers may have incurred additional administrative costs in serving PPM customers. These could include processing additional credit requests and subsequently managing and collecting payment, and providing additional prepayment keys and cards during the lockdown phase of the pandemic in spring 2020. We accept that in principle these costs could have risen, although as we noted in our September 2020 consultation, the lockdown was for a relatively short period. Equally, suppliers will have seen some reductions in costs, for example reduced 'routine' calls, which many suppliers actively discouraged during the lockdown phase of the pandemic, or from furloughing staff. Suppliers may also have been able to reallocate resources from elsewhere in the business where workload was reduced.

5.27. For purposes of setting a float, we have not systematically collected data on these costs. This would have been challenging for suppliers to produce robustly in the time available, and stakeholders have emphasised the need for timeliness in this adjustment. One stakeholder provided some estimates of its increase in administrative costs, specifically relating to prepayment keys and cards. However, we do not consider that we could set a float based on this data alone.

5.28. To some extent, administrative cost increases will depend on supplier policies. For example, we mention above that there are differences between suppliers regarding how they administer discretionary credit. We might expect suppliers who provide small but frequent amounts of discretionary credit to incur higher administration costs (such as customers calling regarding credit), than those suppliers who provided larger

amounts less often.

5.29. On balance, we do not consider there to be sufficient evidence and rationale to provide an adjustment for administrative costs for PPM. We consider any cost increases are likely to be limited, and offset by reductions in other costs of serving these customers. We welcome further evidence on this (alongside administrative cost areas where costs have reduced), and will consider this as part of a later review.

Considerations: cost to serve

5.30. One supplier stated that COVID-19 would delay the roll-out of smart prepayment meters and so suppliers would not incur the benefits from reduced administrative costs. This issue is addressed in our smart metering net cost change review, where we consider the change in rollout profile due to COVID-19 and the resulting impacts on costs and benefits.

5.31. Another supplier said that PPM customers cost more to serve than other customers, both before and after COVID-19. This is correct, but this additional cost is accounted for in the existing operating cost allowance and PPM payment method uplift. Aside from specific points discussed in this consultation, there is no evidence that COVID-19 has changed the incremental cost of serving PPM customers compared to credit meter customers.

Considerations: Debt Assignment Protocol (DAP)

5.32. One supplier mentioned that PPM customers could incur debt via the DAP. Under the DAP PPM customers may join a supplier with existing debt of up to £500 per fuel.

5.33. We consider that a COVID-related adjustment is not needed at this time for the DAP for two reasons:

- a supplier that is gaining and losing equal values of debt through the DAP would not require an adjustment – and clearly the aggregate industry position will be neutral, given that the DAP involves transfers between suppliers; and

- often, this debt has been accrued while on a credit meter, and then transfers with the customer onto a prepayment meter. Suppliers should be able to recover the cost of the debt from credit customers. To allow for this debt again in the PPM

cap would double count costs. A supplier with an average mix of customers should be able to recover their costs.

5.34. While we do not propose to make an adjustment for PPM in this review, we propose to consider DAP costs in more detail in the future.

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

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

We seek suppliers' views on our considerations in general.

Summary

6.1. In our September 2020 consultation, we considered each component of the cap to identify potential changes in the costs of supplying default tariff customers resulting from the impact of COVID-19. Our view then was that no adjustments are necessary to any of the cost components set out in this chapter. However, we stated that we would continue to monitor the impacts of COVID-19 on these costs and may revisit them in subsequent reviews.

6.2. We received several comments from stakeholders regarding our considerations on both policy costs and other costs. Some of these comments were supportive of our approach set out in the September 2020 consultation, and some highlighted areas that we should consider further. Most stakeholders agreed with our focus on debt-related costs for credit meter customers, but wanted us to monitor other costs closely.

6.3. After considering stakeholder responses our view is that an adjustment is not required at this stage for any of the cost allowances set out in this chapter. For the most part the existing methodology is sufficient to take into account the impact of COVID-19 for individual allowances. We will however continue to monitor the impacts of COVID-19 on these costs and may revisit them in subsequent reviews.

6.4. In this chapter, we discuss each non debt-related cost component of the default tariff cap in turn.

6.5. We focus below on cap periods four and five, given we have already determined the allowances for these periods. We have not yet set the allowances for cap period six. At this stage, we expect the allowances for cap period six to be accurate, as they will reflect the latest information available. However, there is always the possibility that new COVID-19 related developments after the point when we set these allowances affect suppliers' costs. We will continue to monitor for any material discrepancies due to COVID-19.

Wholesale costs: energy

Proposals

6.6. After further consideration, our view has not changed since the September 2020 consultation. We do not consider that an adjustment to the wholesale cost allowance for the impacts of COVID-19 is required.

6.7. We may however still consider the additional gross margin made by suppliers as part of an overall assessment of the appropriateness of any future adjustment we might make.

September 2020 consultation proposals

6.8. In our September 2020 consultation, we considered the impacts of COVID-19 on the wholesale cost allowance. This included consideration of the costs of purchasing energy in the wholesale markets and also additional costs such as shaping and unidentified gas. Our initial view was that there was no clear and material impact of COVID-19 that is not taken into account through the existing cap methodology.

6.9. We discussed how suppliers have potentially benefitted from increased demand by purchasing energy at a cost less than allowed for in the cap, and consequently making additional gross margin. This was in order to supply additional energy to customers due to the likely increase in domestic demand during the specific circumstances linked to the restrictions in place during spring 2020. We did not reach an initial view on whether to adjust the cap for this benefit.

6.10. We also discussed the impact of COVID-19 on additional wholesale costs such as: shaping costs, forecast error and imbalance costs, transaction costs, additional risk and uncertainty, and losses and unidentified gas. Our view was that COVID-19 may have a modest impact on these costs. However, we considered that this could be positive or negative, and is likely to be covered by existing prudent assumptions and uncertainty allowances in the wholesale allowance.

Stakeholder responses

6.11. One supplier stated that there have been spikes in wholesale costs as the system has reacted to lower levels of demand, in particular balancing costs which are passed

through to suppliers. It also highlighted that its hedging strategy takes into account Industrial and Commercial costs, while the wholesale cost allowance in the cap does not. Another supplier highlighted that COVID-19 may drive higher than planned margins for suppliers due to higher levels of consumption.

Considerations

6.12. While we recognise that system balancing (BSUoS) costs have increased, our cap methodology allows for these costs on a lagged basis, so these costs will be reflected in a future cap period. Any increase in a supplier's shaping costs during cap period four will have been carried out in relation to a lower average wholesale price level compared to that which is allowed for in the cap. We have included shaping and imbalance allowances in the wholesale cost allowance methodology, and these are set at a conservative level.

6.13. We understand some suppliers may hedge based on total energy demand rather than specifically for domestic demand. However, we do not consider it is appropriate for domestic default tariff customers to bear the costs associated with a total demand hedging strategy. We have a requirement to protect domestic default tariff customers. We do this by assessing the costs of supplying them. Costs from other segments of some suppliers' businesses are not relevant to this assessment.

6.14. We agree with the supplier who commented that there could be an overall benefit to suppliers due to potential increased levels of domestic demand during the specific circumstances linked to the restrictions in place during spring 2020 and potentially beyond. Wholesale prices during spring 2020 were typically lower than the allowance in the cap. Suppliers have therefore likely supplied additional energy to customers at a cost less than allowed for in the cap, which manifests in additional gross margin from default tariff customers. We do not make an adjustment for this now, but we may still consider it as part of assessing the overall appropriateness of any future adjustment.

Wholesale costs: Capacity Market

Proposals

6.15. We do not propose to adjust the cap to reflect the impacts of COVID-19 on capacity market costs. However we will continue to monitor demand 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, five and six.

September 2020 consultation proposals

6.16. In our September 2020 consultation, we considered the impacts of COVID-19 on the capacity market cost allowance. We considered it unlikely that we would need to adjust the cap to reflect the impacts of COVID-19, given the scale of changes required to have a material impact on these costs. We proposed to continue to monitor how 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.

Stakeholder responses

6.17. One supplier commented on this and said that the capacity market allowance is determined on a fiscal year basis, meaning the allowance for cap period four was partly affected by costs from the next capacity market delivery year. It therefore said that the cost for cap period four was impacted by the reduction in the Low Carbon Contracts Company's (LCCC) estimates for the next winter's peak demand.

6.18. Another supplier told us that capacity market costs have increased, but will be recovered through the existing methodology.

Considerations

6.19. We agree that the estimate of 2020-21 winter peak demand used in cap period five has reduced compared to the estimates used in cap period four. LCCC provides us with the estimates for peak winter demand prior to each cap announcement, which ensures the latest estimates are incorporated for that cap period. Historically, these estimates have been adjusted both up and down, by as much as nearly 3%.

6.20. We also agree that the capacity market allowance is determined on a fiscal year basis. This means that a given winter's peak demand is used in the calculation of the capacity market allowances in several cap periods. As the estimates for a given winter's peak demand are updated over time, this creates the potential for differences between the total allowances provided and the capacity market costs that suppliers incur (each in relation to a given capacity market delivery year).

6.21. Between cap period four and cap period five the LCCC's estimate for 2020-21 winter peak demand decreased by 6%. This is three percentage points larger than the previous largest adjustment to estimated peak demand (in absolute terms). It is likely COVID-19 was a driver of this unusually large change in winter peak demand. However, even before the COVID-19 pandemic there was already a slow downward trend. It is hard to isolate the impact that COVID-19 alone has had on this reduction in peak demand. Whatever the cause, we acknowledge that the reduction in 2020-21 winter peak demand means that the capacity market allowance for cap period four was lower than if we had been able to use the updated demand estimate.

6.22. However, as discussed in our September 2020 consultation, to the extent that domestic demand has risen, suppliers have been able to recover slightly more money from default tariff customers to cover capacity market payments than the costs incurred. This is because the domestic demand increase in spring 2020 would not have affected winter peak demand. This means that the demand increase allowed suppliers to recover more revenue from the capacity market allowance under the cap, while the costs allocated to suppliers for the 2019-20 capacity market delivery year did not increase.

6.23. Overall, we do not consider that there is evidence of a material impact on suppliers which would justify including an adjustment. However, we will continue to monitor the extent to which the cap under or over-recovers capacity market costs, including in upcoming cap periods.

Policy costs

Renewables Obligation (RO)

Proposals

6.24. After further consideration, our view has not changed since the September 2020 consultation. We do not consider that an adjustment to the RO cost allowance for the impacts of COVID-19 is required.

September 2020 consultation proposals

6.25. In our September 2020 consultation, we considered the impacts of COVID-19 on the RO cost allowance. We arrived at the view that an adjustment to the RO cost allowance

was not required as our current methodology allows suppliers to recover the cost of meeting the RO in full. We acknowledged there could be impacts on the costs suppliers incur if they were to meet some or their entire obligation by acquiring Renewables Obligation Certificates (ROCs). However, purchasing ROCs is a commercial decision and it is not the role of the cap to insulate suppliers against the risk associated with this. We also noted that any impacts on future obligation levels from the recent decrease in demand will be accounted for by our current methodology.

Stakeholder responses

6.26. One stakeholder commented on this, and said it generally agreed with our proposal, but expressed concern about the risks of mutualisation if some suppliers did not plan for their future obligations under the RO.

Considerations

6.27. Ofgem announced on 11 November 2020 that mutualisation has been triggered again this year in respect of the 2019-20 RO compliance period.[45] While the total shortfall amount and hence the mutualisation amount has not yet been published, as at the date of publication of this document, we know that the shortfall as of the initial 1 September 2020 compliance deadline was substantially smaller than last year's (£105.6m this year compared with £206m last year). We do not consider there is any evidence to suggest that COVID-19 has increased mutualisation, and therefore there is no need for an adjustment as part of this review.

Contracts for Difference (CfD)

Proposals

6.28. Our view has not changed since the September 2020 consultation. We do not consider that an adjustment to the CfD allowance for the impacts of COVID-19 is required.

[45] Ofgem (2020), Renewables Obligation 2019/20: Mutualisation. https://www.ofgem.gov.uk/publications-and-updates/renewables-obligation-201920-mutualisation

September 2020 consultation proposals

6.29. In our September 2020 consultation, we proposed not to make any adjustment for the CfD allowance for cap periods four or five. We noted that the CfD allowance for cap period four may be slightly underfunded due to the difference between forecasts of quarterly Interim Levy Rates (ILRs).[46] Any increase in underlying costs of the scheme in cap period four due to COVID-19 would be largely offset by the government loan that was provided to suppliers via the LCCC. This resulted in low additional costs for suppliers in cap period four that were within the range of historical variations.

6.30. We stated that any changes in costs in subsequent periods would be captured by the existing methodology.

Stakeholder responses

6.31. Three suppliers commented on CfDs. One supplier said that the absolute difference between the allowances for cap periods four and five was significant and is not comparable with historical periods, with differences in previous periods being driven by other specific factors.

6.32. It also expressed concern that the effects of the decreased demand are still being felt and will continue throughout winter. Another supplier suggested that we calculate the increase in costs resulting from the national demand reduction and allow for recovery of this variance in future cap periods.

6.33. A third supplier told us that CfDs were an example of a scheme where costs would only be partially recovered under the current methodology.

Considerations

6.34. Given the CfD scheme is growing over time with new generation capacity coming online, it is likely that recent differences in costs between cap periods will be greater in absolute terms compared to historically. However, as we set out in the September 2020 consultation, the percentage difference is within the extent of historical variation

[46] Interim Levy Rates are the charges suppliers pay under the CfD scheme.

and we expect the variation to balance out somewhat over time, with wholesale price fluctuations occurring in both directions.

6.35. It is worth noting that the Government loan for the increase in costs for Q2 2020 covered only 80% of additional costs in this period.[47] This was on the basis that not all additional costs can be directly attributed to the impact of COVID-19, and that is appropriate that suppliers should share some of the additional costs relating the COVID-19.[48] We therefore do not consider that it is the role of the cap to mitigate any residual impact on suppliers, when these factors were already taken into account when determining the size of the loan.

6.36. As we set out in our September 2020 consultation, we recognise that the increase in CfD costs is likely to be due to the decrease in overall demand related to COVID-19. However, CfD costs will also have been affected by reductions in wholesale prices since the forecast, some of which pre-date COVID-19.

6.37. While there may be additional costs for suppliers in cap period four, we consider that any expected impact of COVID-19 on subsequent quarters over winter 2020-21 will have been captured by using the updated ILRs, as per our existing methodology. The updated ILR forecasts for subsequent periods have taken into account both wholesale price variation and a reduction in demand. The ILR actual values released for Q3 and the most recent forecast determination of the ILR for Q1 2021[49] are higher than the previous forecast values used to set the CfD allowance for cap period five. This would suggest that the CfD allowance for cap period five has overfunded for these periods, meaning suppliers may potentially benefit over cap period five.

[47] I.e. 80% of additional costs across the market.
[48] BEIS (2020), Contracts for Difference for low carbon electricity generation. Proposed changes to the Electricity Supplier Obligation Regulations in response to COVID-19: government response. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/890134/cfd-proposed-changes-electricity-supplier-obligation-regs-government-response.pdf
[49] LCCC CFD dashboard: https://www.lowcarboncontracts.uk/dashboards/cfd/levy-dashboards/interim-levy-rate-and-total-reserve-amount

Feed in Tariffs (FITs)

Proposals

6.38. We plan to change the FIT scheme allowance methodology in the cap, and will consult separately on the changes. We intend for these changes to take effect from April 2021, in time for the costs of cap period four to be recovered.

September 2020 consultation proposals

6.39. In our September 2020 consultation, we considered the impacts of COVID-19 on the FIT cost allowance. We recognised that suppliers might have incurred costs above those allowed for in cap period four. We indicated that we intend to account for any additional FIT costs resulting from COVID-19 through changes to our FIT scheme methodology. The changes would allow suppliers to recover the actual costs of FITs on a lagged basis. We stated that we would do so through an appropriate consultation process with stakeholders, in time for the actual costs of the cap period to be recovered.

Stakeholder responses

6.40. We received two comments from stakeholders, both of which were broadly in agreement with our proposed position.

Considerations

6.41. We will consider comments associated with the FIT cost allowance in the upcoming separate consultation.

Energy Company Obligation (ECO)

Proposals

6.42. We do not consider that an adjustment to the ECO cost allowance for the impacts of COVID-19 is required. This position is unchanged from our September 2020 consultation.

September 2020 consultation proposals

6.43. In our September 2020 consultation we considered the impacts of COVID-19 on the ECO cost allowance. Our view was that a COVID-19 related adjustment for the ECO scheme was not necessary. We recognised it was likely that any additional cost impacts due to COVID-19 would be balanced out by offsetting factors, and that any subsequent net cost impact would likely be small.

6.44. We also noted the potential for a "carry forward" in the ECO allowance, due to the cap now reflecting increased costs for the remaining periods of the scheme of which consumers have already paid a portion. We stated that this was separate to any COVID-19 impacts.

Stakeholder responses

6.45. We received one comment from a supplier on the impacts of COVID-19 on the ECO scheme cost allowance. It expressed general agreement with our position on ECO and stated that no amendment is needed to the methodology.

6.46. We received two comments relating to the potential "carry forward" in the ECO allowance. They both disagreed that there was a clear and systematic error in the ECO allowance of the cap. They said that the increased costs in the remaining phases of the scheme were due to the introduction of additional safety standards. They also questioned the robustness of the BEIS ECO Impact Assessment (IA) for the purposes of making adjustments to the cap. They indicated any change to this allowance should be consulted on in an open and transparent manner.

Considerations

6.47. As stated above, we do not propose to make an adjustment to the ECO cost allowance for the impacts of COVID-19.

6.48. With respect to the potential "carry forward", the 2019 BEIS ECO IA shows a sizeable difference between what was funded through the cap (using the 2018 BEIS ECO IA) and what was delivered. We recognise that for the cost increases in the 2019 BEIS ECO IA, it could be difficult to separate unit cost increases from the cost of additional installations that were not delivered in cap period one. We are not proposing to treat this as a "carry forward", but will consider it as part of general uncertainty within the

cap. We note that we consider the BEIS IA to remain the best source of information available for setting this allowance in the cap.

Warm Home Discount (WHD)

Proposals

6.49. We propose not to make an adjustment to the WHD cost allowance for the impacts of COVID-19.

September 2020 consultation proposals

6.50. In our September 2020 consultation, we considered the impacts of COVID-19 on the WHD cost allowance. Our view was that a COVID-19 related adjustment for the WHD scheme was not necessary. As the cost a supplier pays does not vary based on consumption, we did not expect that COVID-19 would change the costs of this scheme or the allowance.

Stakeholder responses

6.51. We received two comments from suppliers on this. One supplier expressed general agreement with our position and stated that no amendment is needed to the methodology.

6.52. The other supplier said that there has been a significant impact on the WHD broader group, with many more customers on eligible benefits and applying for the payment. It said that there has been an increase in the costs of managing higher volumes of applications.

Considerations

6.53. We recognise there may be a change in costs associated with the administration of certain schemes, such as WHD. To date, we have received no substantive evidence that there has been a widespread increase in WHD administrative costs specifically because of COVID-19. Furthermore, we do not expect that any increase in administrative costs would be likely to be material in the context of suppliers' overall costs.

6.54. Our view remains that there is no clear and material impact of COVID-19 on the WHD cost allowance that is not already taken into account through the existing cap methodology. The scheme budget is fixed in advance and this will not change with an increase in applications.

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

Our proposals

6.55. We do not consider that an adjustment to the AAHEDC scheme cost allowance for the impacts of COVID-19 is required. There is no clear and material impact of COVID-19 on costs that is not already taken into account through the existing cap methodology.

September 2020 consultation proposals

6.56. In our September 2020 consultation, we considered the impacts of COVID-19 on the AAHEDC scheme cost allowance. Our view was that a COVID-19 related adjustment for the AAHEDC scheme was not necessary. Demand reduction due to COVID-19 is already reflected in the tariff published by National Grid Electricity System Operator (ESO) and used to determine the AAHEDC allowance in the (then) forthcoming winter cap period. Subsequent cap periods will incorporate adjustments made as per the existing process. We recognised that in cap period four there might be an impact that was not reflected in the allowance, due to the difference in forecast and outturn costs arising from the COVID-19 related decrease in demand. However we considered that any impact in cap period four would likely be small and adjusting for this would seem inappropriate given its low materiality.

Stakeholder responses

6.57. One supplier responded, saying that it did not believe we had considered any pick-up in consumption, and that during the lockdown period a reduction in meter readings would have led to a lag in accurate figures leading to volatility in the settlement process. It further noted the increase in the AAHEDC cost allowance between cap period four and five which it indicated was due to the difference between demand forecasts and outturn. The supplier also highlighted that the Shetland cross subsidy should be explicitly incorporated in our methodology.

Our considerations

6.58. The AAHEDC scheme is set on a consumption (p/kWh) basis. If customers' consumption changes, the amount of money suppliers must pay under the AAHEDC scheme will scale accordingly.

6.59. At a high level, the impact on suppliers under the AAHEDC scheme from higher consumption should be neutral. Suppliers will receive higher revenues from the increase in consumption. They will also incur higher AAHEDC scheme costs.

6.60. The precise sequencing of these revenues and costs might be affected by the settlement process. To the extent that restrictions linked to COVID-19 meant a decrease in the number of meter readings, then there could be a greater likelihood of temporary volatility. However, it is unclear that any reduction in meter readings was material. Home visits were restricted for only a limited time. With increasing numbers of smart meters, fewer home visits are needed. Furthermore, to the extent that customers are spending more time at home, this could plausibly increase the proportion of successful meter reading visits in subsequent months (in cases where this requires the customer to provide access). In addition, any impact on meter readings should only affect the timing of when customers are billed accurately, and not the overall level consumed. Any mismatch between revenues and costs should therefore be temporary.

6.61. In our September 2020 consultation we recognised that there would likely be an increase in the actual costs for cap period four (relative to the value used to set the allowance for cap period four) due to the difference in forecast and outturn for demand. It should be noted that the difference between the tariffs for periods four and five is largely due to the significant reduction in demand due to energy efficiency and growth of embedded generation. This means that the correction made by National Grid ESO due to COVID-19 related demand reduction is only one part of the overall increase in this cost allowance between the two periods.

6.62. As discussed in our September 2020 consultation, we plan to consult on the impacts of the Shetland cross subsidy in due course in order to reflect any changes from April 2021.

Network costs

Proposals

6.63. We consider that an adjustment to the network cost allowance for the impacts of COVID-19 is not required. There is no clear and material impact of COVID-19 on costs that is not already taken into account through the existing cap methodology.

September 2020 consultation proposals

6.64. In our September 2020 consultation, we considered the impacts of COVID-19 on the network cost allowance. We considered the costs of transporting energy, losses and balancing services. Our view was that there is no clear and material impact of COVID-19 on network costs that is not taken into account through the existing cap methodology.

Stakeholder responses

6.65. One supplier broadly agreed with our approach. However, it raised a concern that the network charge deferral scheme may increase pressure on mutualisation.

6.66. Another supplier told us that the costs of BSUoS would only be partially recovered under the current methodology.

Considerations

6.67. Please see the sections on the RO scheme and headroom for our considerations around mutualisation.

6.68. We pass through BSUoS costs with a lag, so the charges (£/MWh) in future periods will reflect those that suppliers incurred historically. We recognise that customers' demand in a future cap period may not be the same as it was historically, and that this affects the total (£m) amounts that suppliers recover through the cap, relative to the costs they incurred. In particular, domestic demand may fall when COVID-19 restrictions are relaxed. We do not consider that this effect is likely to be sufficiently material to require an adjustment. Demand would fluctuate over time anyway.

Operating costs

Proposals

6.69. We do not consider that an adjustment to the operating cost allowance for the impacts of COVID-19 is required. On balance we do not consider any operating cost increases are likely to have outweighed the savings. We do not consider any difference to be material enough to warrant an adjustment in the cap.

September 2020 consultation proposals

6.70. In our September 2020 consultation, we considered the impacts of COVID-19 on the operating cost allowance. We identified possible sources of both cost increases and cost decreases.

6.71. Our view was that the net impact of these potential changes is likely to reduce costs for suppliers compared to the allowance (e.g. reduced staffing costs due to use of furlough). However, overall these are unlikely to be clearly and systematically materially different.

Stakeholder responses

6.72. We received several comments from stakeholders who expressed concern that we were overlooking costs associated with suppliers' operational response to COVID-19 restrictions. These included: facilitating working from home, staffing reallocations rather than furloughing, equipment costs, increased customer contacts, the inability to physically read meters, Personal Protective Equipment (PPE), making sites safe, staff special leave and Prepayment Meter Infrastructure Provision (PPMIP). One supplier provided an estimate of its increased costs.

6.73. One supplier agreed that while in some areas the impacts of COVID-19 may have resulted in operating cost increases, there are also areas where decreases are likely. It also agreed that the widespread adoption of the furlough scheme by industry could lead to reductions in operating costs.

Considerations

6.74. We are aware that operating a business under COVID-19 related restrictions is likely to

increase some operational costs. In our September 2020 consultation we highlighted likely additional costs such as those associated with mobilising a remote workforce and additional back office costs to deal with reliance on estimated bills and increased customer contacts.

6.75. However, it is also likely that suppliers have experienced cost savings linked to the restrictions in place during the spring 2020 period. For example, suppliers that used the furlough scheme will have experienced reduced staffing costs and those that did not use the scheme may have reduced expenditure in outsourcing services. These actions have likely led to a significant reduction in costs and must be considered in the round alongside other cost changes.

6.76. On balance we do not consider any operating cost increases are likely to have outweighed the savings. We do not consider any difference to be material enough to warrant an adjustment in the cap.

Smart metering costs

Proposals

6.77. We will consider the impact of COVID-19 on non-pass-through smart metering costs separately, as part of our next review of the Smart Metering Net Cost Change allowance in the cap.

6.78. For pass-through costs, we do not propose to make as adjustment, as there is no clear and material impact of COVID-19 on costs that is not taken into account through the existing methodology

September 2020 consultation proposals

6.79. In our September 2020 consultation we considered the impacts of COVID-19 on the costs associated with smart metering. For non-pass-through costs, we said that we would review these separately. For pass-through costs, we considered the impact of COVID-19 on 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 methodology.

Stakeholder responses

6.80. There were several general comments from suppliers on the impact of COVID-19 on smart metering costs. Suppliers recognised that the impact of COVID-19 on smart metering costs is being dealt with in a separate consultation and review process.

6.81. One stakeholder raised the concern that the smart meter rollout has decreased during lockdown. It said this will result in the total smart programme costs increasing, particularly due to the underutilisation of resources. It indicated that it will have higher costs of servicing prepayment meter customers due to them now not having smart prepayment meters installed.

Our considerations

6.82. We will be reviewing the impact of COVID-19 on non-pass-through smart metering costs separately. We still do not consider that there is an impact on pass-through costs to take into account.

Payment method uplift

6.83. We cover debt-related cost issues in Chapters 4 and 5. We therefore do not have a separate discussion of the payment method uplift here.

Headroom allowance

Proposals

6.84. We do not consider that an adjustment to the headroom allowance for the impacts of COVID-19 is required. We consider that there is no clear and material impact of COVID-19 on headroom that is not already taken into account through the existing cap methodology.

September 2020 consultation proposals

6.85. In our September 2020 consultation, our view was 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. (This took into account that we were not proposing to amend the cap allowance for the cost reductions available through the furlough scheme and changes to outsourced contracts. We referred to this as a particularly conservative approach in suppliers' favour). Our provisional view was that

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

6.86. We also identified two potential additional costs of COVID-19 not captured elsewhere in our analysis, relating to the costs of supplier failure and RO mutualisation. We discussed how if the impact of COVID-19 drives more Supplier of Last Resort (SOLR) events, the costs of such events are covered by the existing methodology. We also discussed how we had not seen evidence of COVID-19 increasing RO shortfalls which would lead to mutualisation.

Stakeholder responses

6.87. Three suppliers provided general comments regarding the sufficiency of the headroom allowance to deal with cost uncertainty, in particular how suppliers consider that supplier failures and subsequent mutualisations are not properly accounted for in the headroom allowance.

Considerations

6.88. We have not seen significant evidence to suggest that COVID-19 has impacted the costs covered in the headroom allowance such that it has made the allowance insufficient to provide for the net uncertainty in the costs that efficient suppliers will incur.

6.89. Similarly, we have not seen further evidence that supplier failure has been impacted by COVID-19. Even if it has done so, then it is our view that the related costs will be taken into account through the existing methodology.

6.90. On 11 November 2020 Ofgem announced that RO mutualisation had been triggered. We note that this does not appear to be as a result of COVID-19. However, early indications suggest that the level of this RO shortfall and therefore subsequent mutualisation may be less than that of last year.[50] We therefore consider that this level of cost is still covered by the headroom allowance.

[50] See the RO section for more detail.

EBIT allowance

Proposals

6.91. Our position on the impacts of COVID-19 on the Earnings Before Interest and Tax (EBIT) allowance in the cap has not changed since the September 2020 consultation. Please refer to Chapter 4 for our discussion on the impacts of COVID-19 on working capital.

September 2020 consultation proposals

6.92. In our September 2020 consultation, we considered the impacts of COVID-19 on the EBIT allowance. We did not consider that COVID-19 would materially affect the existing EBIT allowance, other than working capital, which we discussed separately in the consultation.

6.93. We did not receive any stakeholder comments on this.

Appendices

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1	Disclosure
2	Alternative options
3	Privacy notice on consultations

Appendix 1 – Disclosure

Overview of information provided to stakeholders

1. Table A1 summarises the information we have published. This is to help stakeholders understand how we have used the RFI data to calculate a float for COVID-19 costs in the cap.

Table A1: Information published on COVID-19 adjustment

Information published	Explanation
Proposed cap adjustment	We have provided stakeholders with the total proposed cap adjustment. Stakeholders are able to assess the level of the proposed adjustment and compare it with the incremental change in costs that they have incurred as a result of COVID-19. (To do this, a stakeholder would need to convert its costs into cap level terms, using the Annex 8 model).
Explanation of the calculations	In Chapters 3 and 4, we have provided detailed explanations of the calculations that we have applied, as well as reasons for any exclusions of data. This enables stakeholders to understand the steps we have taken to calculate the adjustment.
Data sources	We have explained in this consultation the types of data that we have used to calculate our proposed adjustment. Stakeholders have the opportunity to comment and provide comments on the data sources used. (The suppliers who received the voluntary RFI received the template we used to gather data).
Options considered	In Appendix 2 we have published the alternative options we considered when making our decision. This includes displaying the outcomes of choosing alternative options for efficiency and how to spread costs. This should enable suppliers to see how the chosen option compares with the alternative option(s) considered.
Adjustment Allowance (AA) calculation	We have published the AA model. This shows how we converted the incremental change in debt-related costs in given cap periods to an adjustment in cap level terms. This should enable stakeholders to understand the impact of the design decisions within this model. In other words, we are publishing the non-confidential elements of the calculation.

Overview of data that has not been published or disclosed to stakeholders

2. Suppliers submitted data through the voluntary RFI sent on 21 September 2020. As discussed in this consultation, we use this data to determine a float for debt-related costs.

3. We have decided to not publish or disclose suppliers' individual data.

Considerations

4. We consider that the information we have published sufficiently allows stakeholders to make meaningful comments on our approach and methodology for setting a float.

5. We are not publishing suppliers' individual data because it is confidential to each supplier and given its sensitivity we do not consider it to be in the interests of consumers to publish such information.

6. We are also not disclosing suppliers' individual data. This is because of the following main reasons, among others:

   - we are setting a float, so the numbers are not definitive and will be subject to a true-up process;
   - the calculations we have carried out on suppliers' individual data are straightforward and the assumptions are noted in the text;
   - we do not consider there is a need for suppliers or their advisers to be able to QA our calculations; and
   - in the context of this data not being essential to the process, we do not consider it appropriate or proportionate to disclose the limited data we have used to set the float.

7. Separately, as part of the true-up process, we will consider whether or not a disclosure process is required.

Appendix 2 – Alternative options

1. In this appendix we provide stakeholders with more information on some of the options we considered, but did not select for our proposals in Chapter 3. This will provide stakeholders with an understanding of the results generated by these options in comparison to our proposals.

2. In Chapter 3 we have not presented numerical results, to keep the chapter focused on our considerations of the principles and to maintain clarity. Instead, we provide numerical information in this appendix. We have focused on key options which have a high materiality and received a significant amount of comments in response to the September 2020 consultation.

Choice of benchmark

3. For the purposes of setting a float we have proposed to use a lower quartile benchmark. The other option we considered was an average cost benchmark. Please refer to the relevant section of Chapter 3 for all considerations.

4. In Table A2 we show the bad debt increment per customer for each cap period depending on whether the efficiency measure is lower quartile or average. To calculate an average, we follow the same steps to calculate the increment in each cap period, as detailed in Chapter 4, but calculate a simple average instead of a lower quartile.[51]

Table A2: Bad debt increment for each choice of benchmark

Title	Unit	Cap period four increment	Cap period five increment	Cap period six increment
Lower quartile	£/customer account	2.03	2.46	2.08
Average	£/customer account	2.93	4.08	2.10

[51] Stakeholders can used the published Annex 8 model to convert these increments into cap level terms, should they wish to do so.

Number of periods over which to assess a benchmark

5. In Chapter 3 we proposed to calculate the benchmark for each cap period. The alternative that we considered was a combined benchmark over a number of periods.

6. The methodology for calculating a lower quartile for each cap period involves calculating the bad debt increment for each supplier for each cap period, as outlined in Chapter 4, and taking the lower quartile of the available values in each period. To calculate the lower quartile benchmark across periods we start by following the same process of calculating the bad debt increment for each period. We then add the cap period increments together, and exclude any suppliers who do not have a full dataset of increments across periods. We then take the lower quartile of the remaining suppliers' aggregated values, and set this supplier as the benchmark supplier for all periods. This means that the increment in each cap period is the increment for this benchmark supplier.[52]

7. In Table A3 we show the bad debt increment per customer for the two different methods of calculating the lower quartile benchmark.

Table A3: Bad debt increment per customer for benchmarking across periods

Title	Unit	Cap period four increment	Cap period five increment	Cap period six increment
Lower quartile for each individual cap period	£/customer account	2.03	2.46	2.08
Combined lower quartile supplier over a number of periods	£/customer account	2.14	2.46	3.75

[52] We note that for the lower quartile of the aggregated value to be equal to a particular supplier's value, i.e. to select a specific benchmark supplier, we require a certain number of submissions and for this to be an odd number. It is worth noting that if the number of submissions had been different the lower quartile may not have been a specific supplier. This would have created an added complication for determining what the benchmark increment should be for each cap period (which is necessary given we are proposing to recover costs in different ways between cap periods).

Which cap periods to recover over

8. In Chapter 3 we propose to allow recovery of the float for costs incurred in cap period four and five across two cap periods (cap periods six and seven). We propose to allow recovery of the float for costs incurred in cap period six across one cap period – cap period six.

9. We considered two alternative options:

    - recovering the floats for the costs incurred in cap periods four, five and six in cap period six; and

    - recovering the floats for the costs incurred in cap periods four, five and six across two cap periods, cap periods six and seven.

10. When comparing the proposal with these alternative options, we keep other assumptions fixed. These are:

    - using a lower quartile benchmark;

    - spreading the cost equally across gas and electricity;

    - recovering costs between the standing charge and unit rate in the same proportions as total costs are currently recovered under the cap; and

    - spreading payment type costs equally across credit meter customers.

11. Changing the periods we recover over affects our calculation.

    - Where we wish to recover costs over a single cap period (the first alternative option), we need to set a higher cap level in annualised terms. We therefore uplift the total increment (weighting the standing charge element by time and the unit rate element by demand) – in the same way that our proposal treats the costs of cap period six.

    - Where we wish to recover costs over two cap periods (the second alternative option), the amount to recover is the same as the adjustment in annualised terms.

12. In Table A4 we display our proposal and the two other discarded options that we considered. We show their impacts on the cap period six adjustment level. As noted in Chapter 3, these options only affect how we recover costs – they do not affect the underlying amounts to recover.

Table A4: Cap period six adjustment allowance with different recovery scenarios[53]

Scenario	Cap period four and five recovered over two periods and cap period six recovered in cap period six (dual fuel)		All periods recovered in cap period six (dual fuel)		All periods recovered over two periods (dual fuel)	
	Nil	TDCV	Nil	TDCV	Nil	TDCV
Cap period four	0.64	4.02	1.28	12.12	0.64	4.02
Cap period five	0.78	4.92	1.57	14.83	0.78	4.92
Cap period six	1.32	12.54	1.32	12.54	0.66	4.16
Total cap period six adjustment	**2.75**	**21.48**	**4.17**	**39.48**	**2.08**	**13.10**

[53] These cap period adjustments are calculated on a dual fuel basis and would apply to both standard credit and direct debit customers

Appendix 3 – 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".