

Decision

Decision on the potential impact of COVID-19 on the default tariff cap

Publication date: 02 February 2021

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We have consulted in September and November 2020 on proposals to adjust the default tariff cap to account for the impacts of COVID-19. This document describes our decision to introduce an adjustment for cap period six (April-September 2021) to account for the estimated additional bad debt costs as a result of the pandemic. Once data on final costs becomes available, we will adjust this estimate.

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Foreword

The energy price cap has never played a more important role than during the COVID-19 crisis which has left many households and businesses facing financial hardship. It ensures that the 15 million households it protects pay a fair price for their electricity and gas.

Ofgem adjusts the level of the cap up or down twice a year to allow suppliers to recover no more than reasonable costs of supplying their customers, on the assumption they are run efficiently. This means that when costs fall, consumers benefit from lower energy bills. On October 1 Ofgem reduced the level of the default tariff cap by £84 per year per household for this winter to its lowest ever level after global wholesale energy costs plummeted in the wake of COVID-19.

Equally, when costs go up, suppliers who are run efficiently need to be able to recover them from consumers within the price cap mechanism. This helps ensure that suppliers have the finances to continue to supply energy to their customers and fulfil other licence obligations, including protecting their customers, especially those in vulnerable circumstances.

Ofgem requires suppliers to treat all customers fairly and to provide extra support for those in financial distress or vulnerable circumstances. This has never been more important than during the ongoing pandemic. For example, suppliers are required to provide emergency credit to customers struggling to top up their pre-payment meters, put those who are behind on their bills on affordable repayment plans and should not disconnect their customers. Many have gone further in providing support over the last year – for example helping those who are shielding and on pre-payment meters to access energy top ups.

Due to the impact of COVID-19 and higher levels of unemployment, more households are struggling to pay their energy bills. The existing price cap methodology includes an allowance for suppliers to recover the cost of writing off debt from unpaid bills. However, the pandemic has resulted in anticipated bad debts rising to levels that aren't covered by the existing cap.

Last spring, some suppliers asked Ofgem to include an additional allowance to reflect these higher bad debt costs when we set the current winter's cap level in August. We told suppliers in an open letter that we did not have sufficient evidence to justify amending the price cap then.

Since then, Ofgem has continued to closely monitor the market and supplier bad debt levels. This document, which follows our consultation in November, sets out why we see sufficient evidence of a material increase in bad debt levels due to COVID-19 beyond the level already covered by the existing cap allowance.

We believe it's in customers' interests to allow suppliers to start to recover some of these additional costs from the next price cap period starting on April 1. This is necessary to ensure that consumers continue to benefit from a properly functioning energy market – which is in all of our interests. Given the evidence we have, we have set this additional allowance in the price cap for default tariff customers at the minimum reasonable level. At the same time, in order to minimise the impact on consumers of higher bills, suppliers will have to recover some of the costs in a phased approach between April 2021 and March 2022.

We do not believe it is customers' interest to delay allowing suppliers to start to recover these additional costs. This would mean customers facing a much higher adjustment for the next cap period next winter – the time when energy use and bills are at their highest.

Ofgem will update the next price cap level on February 5, which will include this new allowance. However, the biggest factor pushing up the price cap is the recovery in global wholesale energy prices. Energy bill increases are never welcome, especially as many households are struggling with the impact of the pandemic. Everyone has a part to play during this exceptional time and I expect suppliers to set their prices competitively, treat all customers fairly and ensure that any household in financial distress is given access to the support they need. Ofgem will continue to work closely with government, energy industry, suppliers and consumer groups to ensure that customers remain protected throughout this crisis.

Jonathan Brearley, CEO

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, we consider that the COVID-19 pandemic has changed these costs in a way that is not accounted for in the existing cap methodology.

We have concluded that it’s in customers’ interests to allow suppliers to start to recover some additional costs related to COVID-19 from April 2021. This will help to ensure that suppliers have the finances to continue to supply energy to their customers and fulfil their licence obligations. We do not believe it is customers’ interest to delay allowing suppliers to start to recover these additional costs as it would mean customers facing a much higher adjustment for the next cap period next winter.

The impact of coronavirus (COVID-19)

The COVID-19 pandemic, and the measures put in place to limit its impact, have significantly affected energy customers. Workers have been laid off, furloughed, or are working from home, increasing domestic energy use. Some customers are struggling to pay their bills, and impacts on customer finances may persist as restrictions continue across the UK.

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 the cap already allows for. 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.

We consider that there are additional costs - specifically debt-related costs - that are material and not allowed for through the existing methodology. Therefore, we have decided to make an adjustment for cap period six of £23.69 per customer¹ using the existing adjustment allowance. This adjustment has increased slightly from our November 2020

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

consultation proposal as we have used more recent data on the number of customer accounts.

It is very uncertain what the total 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. Therefore, we have decided to err on the side of caution when setting the allowance to avoid customers unduly bearing the risk of the cost uncertainty. We have therefore decided to set the adjustment using an initial estimate of these costs (a float) which is deliberately conservative in favour of customers. This will subsequently be adjusted to reflect the final costs once they are fully known (the true-up).

We have decided to recover the 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 ended on 31 December 2020. Since 1 January 2021 default tariff PPM customers are protected by a specific PPM cap level in the default tariff cap.

At this time, 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 PPM cap level. We will revisit any need for an adjustment at our next review, based on additional or updated evidence.

Going forwards

It is likely that the impacts of COVID-19 will continue to evolve and that future reviews will be necessary to consider floats for later cap periods, and to true-up previous floats. We intend to conduct a review over the first half of 2021 to assess whether a float is required for cap period seven, so that we can include a float from 1 October 2021 if needed. We expect that the first true-up for cap period four would not take effect until 1 April 2022 (cap period eight). This would be subject to bad debt data availability and further stakeholder consultation. The decision for the float for the next (and subsequent cap) periods does not prejudge the approach we may take to determining the true-up for any cap period.

1. Introduction

What is the scope of this decision?

- 1.1. This document sets out our decision to adjust the default tariff cap (“the cap”) for cap period six (April - September 2021) to account for the additional bad-debt costs incurred by suppliers as a result of the COVID-19 crisis.
- 1.2. We have decided to make the adjustment using ‘Annex 8 – methodology for adjustment allowance’ of standard licence condition (SLC) 28AD of the electricity and gas supply licences. We have published the changes we are making to the annex alongside this decision document.²

Structure of this decision document

- 1.3. This decision document has the following structure:
 - Chapter 1 sets out the scope of our decision document and its background.
 - Chapter 2 explains our decisions on the key overarching considerations. We have decided to retain the approaches proposed in our November 2020 consultation for this area.
 - Chapter 3 covers our cross-cutting methodological decisions. We have decided to retain the approaches proposed in our November 2020 consultation for this area.
 - Chapter 4 sets out our decision to introduce an adjustment for the additional debt-related costs for credit meter customers. We have decided to retain the approaches proposed in our November 2020 consultation for this area.
 - Chapter 5 covers issues specific to prepayment meter (PPM) customers. We have decided to not adjust for PPM specific COVID-19 costs, because we

² Please see the page for this decision on our website for the updates to Annex 8.

consider that the effects of COVID-19 on supplying PPM customers are limited.

- Chapter 6 sets out our decision on other costs. We have decided to not provide adjustments for any of these costs, because the existing methodology is sufficient to take into account the impact of COVID-19 for individual allowances or we are considering the impacts of COVID-19 on a separate document.

The default tariff cap (“the cap”)

- 1.4. 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.
- 1.5. In August 2020, we decided to introduce a PPM level in the cap to protect default tariff PPM consumers beyond the expiry of the Competition and Markets Authority’s (CMA) PPM cap.³ As a consequence, since 1 January 2021, the default tariff cap also protects around 4 million households with PPMs on default tariffs.
- 1.6. 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 of supplying default tariff customers. In doing so, we must have regard to four matters:⁴
 - the need to create incentives for holders of supply licences to improve their efficiency;

³ Ofgem (2020), Decision on protecting energy consumers with prepayment meters. <https://www.ofgem.gov.uk/publications-and-updates/decision-protecting-energy-consumers-prepayment-meters>

⁴ Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6). <http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted>

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

1.7. The Act requires that we set one cap level for all suppliers.⁵

1.8. The cap comprises multiple allowances, each relating to a different cost category. We update the cap level every six months, to reflect changes in the underlying costs.

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. Since the start of the pandemic, businesses closed, some permanently, reducing non-domestic demand.^{6,7} Workers have been made redundant, placed on furlough, or are working from home, increasing domestic energy use.⁸ Some customers are struggling to pay their bills.⁹

⁵ Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 2(2)(b).

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

⁶ Initial outturn demand was down 19% in April and May 2020 compared to April and May 2019, based on Electricity System Operator demand data. Demand fluctuated but overall remained lower than expected pre-COVID-19

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/> https://data.nationalgrideso.com/plans-reports-analysis/covid-19-preparedness-materials/r/operational_transparency_forum_slides_27.01.21

⁷ 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/>

⁸ 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, around 2%.

⁹ Citizens Advice estimates that 600,000 more households were behind on their energy bills in December 2020 compared to February 2020.

Citizens Advice (2020), Recovery, or Ruin?: The role of accessible support in helping energy

Periods of lockdown and social distancing have reduced some field activities including visits to customers' homes.

- 1.10. Ofgem has been working with Government throughout the crisis to help industry and consumers manage the impacts. We have recently implemented rules that provide additional protection to customers.¹⁰ These formally require suppliers to both put consumers in debt on realistic and sustainable repayment plans based on their ability to pay, and offer emergency credit to customers struggling to top up their PPM. This is in addition to actions we took last year to help suppliers manage the impacts of COVID-19,¹¹ which sat alongside action by Government – for example, the loan provided to help suppliers manage changes to the costs of the Contracts for Difference scheme.¹²
- 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. Many suppliers have indicated that COVID-19 has had (and continues to have) a material financial impact on their businesses.

Decision process

September 2020 consultation

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

consumers through the crisis.

<https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-policy-research/recovery-or-ruin-the-role-of-accessible-support-in-helping-energy-consumers-through-the-crisis/>

¹⁰ Ofgem (2020), Self-disconnection and self-rationing: decision.

<https://www.ofgem.gov.uk/publications-and-updates/self-disconnection-and-self-rationing-decision>

¹¹ Ofgem (2020), Network Charge Deferral update.

<https://www.ofgem.gov.uk/publications-and-updates/network-charge-deferral-update-0>

¹² We discuss this further in Chapter 6.

November 2020 consultation

1.13. We published a second consultation in November 2020 that assessed the need for an adjustment to the cap, considering stakeholders' comments to the September 2020 consultation and data collected via a voluntary Request for Information (RFI) to suppliers. We presented our proposal for an adjustment to cap for the impacts of COVID-19.

Future process

1.14. This decision is for the sixth cap period, starting 1 April 2021. We have set a float, which we will true-up in subsequent processes. We expect that the first true-up for cap period four would not take effect until 1 April 2022 (cap period eight). This would be dependent on when final bad-debt data becomes available and further stakeholder consultation.

1.15. In response to our consultation several stakeholders raised issues that we should consider for the true-up. We will consult stakeholders on the true-up at a later stage. At that time, we will consider and respond to the views shared with us as part of this consultation process.

1.16. It is likely that the impacts of COVID-19 will continue to evolve and that future reviews will be necessary to consider floats for later cap periods. We intend to conduct a review over the first half of 2021 to assess whether a float is required for cap period seven, such that we can include a float from 1 October if needed. We will seek further information from suppliers through an RFI.

Related publications

1.17. The main documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018: <http://www.legislation.gov.uk/ukpga/2018/21/contents/enacted;>
- Default Tariff Cap Decision: <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>.

1.18. 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: November 2020 consultation: <https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>;
- 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/publications-and-updates/impact-covid-19-retail-energy-supply-companies-regulatory-expectations-1-july-2020>;
- Updates on the total level of firm uptake of associated deferral schemes by their closing date, September 2020: <https://www.ofgem.gov.uk/publications-and-updates/network-charge-deferral-update-0>;
- Decision to modify the Special Conditions (also known as the Charge Restriction Conditions ‘CRC’) of the electricity distribution licence to recover bad debt resulting from the Network Charge Deferral (NCD) scheme: <https://www.ofgem.gov.uk/publications-and-updates/decision-modify-special-conditions-also-known-charge-restriction-conditions-crc-electricity-distribution-licence-recover-bad-debt-resultant-network-charge-deferral-ncd-scheme>;
- Connection and Use of System Code (CUSC) CMP350: Changes to the Balancing Services Use of System (BSUoS) Covid Support Scheme: <https://www.ofgem.gov.uk/ofgem-publications/165770>;
- Managing the impact of COVID-19 on the energy market – relaxing network charge payment terms: <https://www.ofgem.gov.uk/publications-and-updates/managing-impact-covid-19-energy-market-relaxing-network-charge-payment-terms>.

1.19. 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.

Your feedback

General feedback

1.20. We are keen to receive your comments on the clarity of this report. We'd also like to get your answers to these questions:

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

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

2. Overarching considerations

In this chapter we set out our decisions on overarching considerations. We have decided to only consider costs incurred from serving domestic default tariff customers. Furthermore, we have decided to only adjust for the debt-related costs resulting from COVID-19 to credit default tariff customers. We will keep any additional costs to PPM customers under review.

Scope

Decision

- 2.1. We have decided to consider only the costs incurred from serving domestic default tariff customers. This decision means we do not consider the costs arising from non-domestic customers and domestic customers on fixed tariffs in our review.¹³
- 2.2. The cap is designed to protect customers on default tariffs, by reflecting the efficient cost to supply those customers. This means we should only consider how COVID-19 impacts these costs.¹⁴

November 2020 proposals

- 2.3. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

- 2.4. In response to our November 2020 consultation, stakeholders did not comment on the scope of this review.
- 2.5. In response to our September 2020 consultation, some suppliers took the opportunity to suggest alternative approaches for Ofgem and Government intervention to allow the

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.

¹⁴ We discuss through separate consultation processes the impact of COVID-19 on non-pass through smart metering costs and FIT policy costs. Therefore, these allowances are out of scope of this consultation.

industry to recover other COVID-19 related costs. One supplier also considered that other costs, not related to COVID-19, have increased since we set the cap.

Considerations

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

The impact of COVID-19 on costs

Decision

2.7. We have decided to only adjust for debt-related costs for credit meter default tariff 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 or by a separate process. We will continue to monitor other costs, which may yet be materially impacted by COVID-19.

November 2020 proposals

2.8. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

2.9. In response to our November 2020 consultation, most stakeholders supported our proposal to introduce an adjustment for debt-related costs for credit meter customers. One supplier said that we should also consider an adjustment for the Contracts for Difference (CfD) policy scheme costs and for capacity market costs.

2.10. One supplier stated that the cap was high enough to allow suppliers to retain market share by acquiring new customers at a loss. This supplier also noted that COVID-19 may drive higher than planned margins for suppliers due to higher levels of consumption.

2.11. Two suppliers also said the cap should not be adjusted because of uncertainty around the impacts of COVID-19, and because of the impact of any adjustment on default tariff customers.

2.12. In response to our September 2020 consultation, most stakeholders agreed with our focus on debt-related costs for credit meter default tariff customers but wanted us to monitor other costs carefully.

Considerations

2.13. While the magnitude of the cost increase is still uncertain, we continue to expect that COVID-19 will increase suppliers' efficiently incurred costs. We discussed in our November 2020 consultation the areas we have identified where COVID-19 has impacted suppliers' costs and indicates whether they are accommodated in the existing methodology.¹⁵ Table 1 summarises areas not covered by the existing methodology that we have decided to apply a separate adjustment and those to include in a separate review. It also signposts where they are discussed in this document.

Table 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
Policy costs	Reduced non-domestic demand increases costs of Feed-in Tariffs (FIT)	Increase	No – but addressed through separate decision	Chapter 6, and is discussed further in separate decision ¹⁶
Operating costs	Increased debt-related costs	Increase	No	Chapter 4
Smart costs	Sunk costs from planned installations which have been delayed/halted due to COVID-19	Increase	No	Addressed in separate SMNCC review ¹⁷
Payment method uplift	Increased debt-related costs	Increase	No	Chapter 4 (PPM in Chapter 5)

¹⁵ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, Table 2.1, Chapters 4, 5, and 6.

<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

¹⁶ Ofgem (2020), Decision: Feed-in Tariffs (FIT) scheme allowance methodology in the default tariff cap.

<https://www.ofgem.gov.uk/publications-and-updates/decision-feed-tariffs-fit-scheme-allowance-methodology-default-tariff-cap>

¹⁷ 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>

Cap component	Description of potential efficient cost changes due to COVID-19	Direction of cost change	Existing methodology sufficient?	Detailed discussion location
Earnings Before interest and Tax (EBIT)	Increase in working capital required due to increased late payment	Increase	No	Chapter 4

Considerations- overall cap level

2.14. One supplier stated that while the current cap limit was just over £1000, energy costs for December 2020 were nearer £950. They said that suppliers who were supporting an increase in the tariff cap were also offering acquisition tariffs that were below the wholesale cost. This year, these acquisition tariffs have been consistently offered to new customers, which the supplier saw as suggesting that the energy cap was high enough to allow suppliers to retain market share by acquiring new customers at a loss.

2.15. We note that the wholesale inputs to the supplier’s model to calculate the £950 are different from the ones used in our model, which reduces comparability. Therefore, we do not consider their submission to be evidence in itself that the cap has been set too high.

2.16. We have also confirmed that the supplier did not include all supplier operating costs in its £950 estimate of energy costs. We note that we set a challenging lower quartile less £5 benchmark for the operating costs allowance in the cap, which means that most suppliers pricing at the cap have to become more efficient.

2.17. Moreover, we update the cap in line with underlying costs to ensure that default tariff customers’ bills represent the underlying costs to serve them. The Act requires us to have regard to the need to ensure suppliers who operate efficiently are able to finance their licenced activities. Suppliers’ pricing of acquisition tariffs is a commercial decision for them, and such tariffs are outside the scope of the cap.

Disclosure

Context

2.18. In our November 2020 consultation, we did not publish or disclose suppliers’ individual data. We noted that the information we have published sufficiently allowed

stakeholders to make meaningful comments on our approach and methodology for setting a float.

2.19. We also flagged that we would consider whether a disclosure process is required as part of our true-up process.

Stakeholder responses

2.20. Two stakeholders raised concerns on the transparency of the data used to determine the float. They noted that we had not published the RFI results and that they did not know who responded.

2.21. Three stakeholders asked us to use a disclosure process in the true-up assessment, in order to provide clarity and transparency on the data used.

Considerations

2.22. One stakeholder said that we have not provided ranges for any figures. They wanted to understand how clustered or dispersed the data were and the implications of setting benchmark at the lower quartile. We have decided not to publish or disclose suppliers' individual data, for the reason we set out in our November 2020 consultation.¹⁸ This included that the calculations we have carried out on suppliers' individual data are straightforward and the assumptions are noted in the text. We appreciate stakeholders' comments regarding disclosure of data for the true-up process. We will consider these as part of our future true-up consultation.

¹⁸ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, Appendix 1, paragraph 4-6.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

3. Cross-cutting considerations

In this chapter we set out our decision to adjust the cap to allow suppliers to recover the estimated costs resulting from COVID-19, which will then be followed by a true-up in a later period.

We also set out our decisions on: 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).

Summary

- 3.1. We have decided to use the existing cap adjustment allowance to set the COVID-19 adjustment. We have decided to set an initial float based on an estimate of the COVID-19 additional costs, and to true this up later once more information is available. When setting the adjustment, we have decided not to make any adjustment for changes in the number of default tariff customers over time.
- 3.2. We have decided to include the costs of cap periods four, five, and six when setting the float adjustment that will apply in cap period six. We have decided to recover the costs of cap periods four and five over cap periods six and seven, and the costs of cap period six over cap period six.
- 3.3. For the float, we have decided to benchmark costs using a lower quartile, looking at each cap period separately.
- 3.4. For the float, we have decided to allocate costs equally between the direct debit and standard credit payment methods. We have decided to allocate costs equally between fuels. We have also decided to allocate costs between the unit rate and standing charge in line with the historical split between them in the overall cap level.
- 3.5. We intend to conduct a review to assess whether a float is required for cap period seven in the first half of 2021, such that we can include a float from 1 October if needed. We expect that the first true-up for cap period four would not take effect until 1 April 2022 (cap period eight). This would be subject to when appropriate bad debt

data becomes available and further stakeholder consultation. The decision for the float does not prejudice the approach we may take to calculating the true-up.

How the cap is adjusted

Context

3.6. To introduce an allowance for the additional costs from COVID-19, we need to adjust the cap. We can do this by either adding a new cost component, which would require changes to the licence conditions. Or we can use an existing allowance in the cap.

Decision

3.7. We have decided to use the adjustment allowance to set the COVID-19 related adjustment for the default tariff cap.

3.8. The adjustment allowance 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 revised workbook alongside this decision.

November 2020 proposals

3.9. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

3.10. No stakeholders commented on this aspect of our November 2020 consultation.

3.11. In response to our September 2020 consultation, stakeholders who commented were supportive of our proposals to use the adjustment allowance, noting its simplicity and flexibility.

Considerations

3.12. We are maintaining our November 2020 consultation proposal, for the reasons we set out in the September 2020 consultation.^{19,20}

3.13. We are strongly minded to use the same approach for future floats and true-ups.

Accounting for uncertainty

Context

3.14. We considered how best to adjust the cap given the inherent uncertainty on the impact of COVID-19 on the energy industry.

3.15. We considered three options: setting an allowance in advance using forecasts (ex ante); setting the allowance once data on the final costs 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.

Decision

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

3.17. A float and true-up approach for adjusting the cap means that we initially include an approximate value as a float and then true-up once more information is available. 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.

¹⁹ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 3.9.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

²⁰ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation paragraph 3.38-3.43.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation>

3.18. We have decided to take a conservative approach in favour of default tariff customers when setting the float. 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.

November 2020 proposals

3.19. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

3.20. In response to our November 2020 consultation, most of the stakeholders were supportive of the proposed float and true-up approach. One supplier explicitly supported our view to set the cap adjustment conservatively to reduce the impacts on customers and suppliers. However, another two suppliers stated the proposed adjustment was too conservative.

3.21. One supplier did not support our approach. It stated that an ex post adjustment was appropriate to protect customers' interests. One supplier disagreed with an ex post approach given the current degree of uncertainty.

Considerations

3.22. The supplier that suggested an ex post approach did so because it believed it was too soon to reliably identify COVID-19 related costs that cannot be managed through supplier cash flow. We disagree and consider reasonable to expect that the negative economic impacts of COVID-19 will persist for a number of cap periods. Therefore, we still consider the float and true-up approach the most appropriate to adjusting the cap.

3.23. We recognise the risk of setting a float based on non-final data. Therefore, we have decided to adopt a conservative approach in favour of default tariff customers to setting the float, in order that suppliers bear more of the cost uncertainty around the impacts of COVID-19. Suppliers are better positioned to manage cash flow than customers, and many customers will be experiencing significant financial pressure at present. Nevertheless, under the float and true-up approach, we recognise that there is a risk that the true-up could adjust the float downwards in the event that the data on final costs are lower than those estimated in the float. We discuss the concerns on the evidence for the need for a float at this time in Chapter 4.

3.24. We recognise that the length of time before data on final costs 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.

3.25. One supplier asked Ofgem to engage early with industry and provide full transparency around the true-up process. Another stated that (while it disagreed with the proposed float and true up), if we used a float it would expect the true-up process to be thorough and include the possibility of a reduction in future prices. As noted in our November 2020 consultation, we intend to consult stakeholders on the framework for the true-up.²¹

Timing of reviews and adjustment

Context

3.26. We needed to consider the timing of any adjustment and which periods we would recover it in. We also needed to consider how to calculate the adjustment in annual terms to allow for the recovery of the efficient costs from COVID-19.

Decision

3.27. We have decided to include a cap adjustment (a float) in cap period six (April - September 2021). This float includes an allowance for the forecast of additional COVID-19 costs incurred in cap periods four, five, and six. We consider that it is appropriate to include costs for the historical periods as well as adjust for the expected additional COVID-19 costs for cap period six.

²¹ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 1.5.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

3.28. We have decided to recover the costs incurred in cap periods four and five over two cap periods (cap periods six and seven). We have decided to recover costs incurred in cap period six over cap period six.

3.29. For the amount to be recovered in cap period six, we need to uplift the annualised allowance level so that suppliers can recover the appropriate amount. Therefore, we have decided to uplift the standing charge element on a time-weighted basis and the unit rate element on a demand-weighted basis. This approach uses the same principle that we used when reassessing the wholesale allowance in the first cap period.²² This does not change the total amount that suppliers can recover from customers.

3.30. For the float, we have decided to not include an additional allowance for any costs incurred from timing differences between suppliers incurring costs and receiving an allowance. In principle, we do not consider that the cap allowance needs to match the costs in every cap period. We also do not believe that default tariff customers need to provide an additional allowance due to temporary cash flow differences. Suppliers are better placed than default tariff customers to manage any temporary cash flow differences. We consider, in any event, that the short lags between costs and float allowance (a year for cap period four and six months for cap period five) would not have a material impact.

3.31. We intend to conduct a review to assess whether a float is required for cap period seven in the first half of 2021. We expect that the first true-up for cap period four would not take effect until 1 April 2022 (cap period eight). This would be subject to when appropriate bad-debt data becomes available and further stakeholder consultation.

November 2020 proposals

3.32. This approach is unchanged from our November 2020 consultation.

²² 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>

Stakeholder responses

- 3.33. In response to our November 2020 consultation, stakeholders generally agreed that it was appropriate to recover the costs of cap periods four, five, and six when setting the float adjustment. Suppliers also were supportive of spreading costs for cap periods four and five over cap periods six and seven to prevent customers having a bill shock in April 2021.
- 3.34. Suppliers also commented on our proposal to adjust the unit rate on a demand weighted basis and our expectation on the timing of the true-up process.
- 3.35. In response to our September 2020 consultation, 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.

Consideration

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 2021-22.²³
- 3.37. The economic effects of COVID-19 could persist into cap period seven (October 2021- March 2022), especially as at present it appears they will last throughout cap period six. We may therefore need to set a float for this period as well. However, we do not have information to do this now, which is why we intend to conduct the review later. Given the timings required for data gathering, analysis and consultation, we expect that we would need to start this process over the first half of 2021. At this

²³ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 3.36.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

stage, we intend to broadly follow the same methodology as we have used to set the initial floats for cap periods four to six.

3.38. One supplier asked us to include cost recovery for PPM costs (i.e. administrative costs) at the next review in time for cap period seven. We discuss our view on PPM costs in Chapter 5.

Periods to include

3.39. For the adjustment in cap period six, we have decided to set a float that will include an allowance for the forecasted debt-related costs incurred in cap periods four, five, and six, for the reasons we set out in the November 2020 consultation.²⁴

3.40. Since our November 2020 consultation, societal restrictions have increased, with more businesses having to close or remain closed. We consider that this reinforces our expectations that suppliers will incur additional COVID-19 costs into cap period six, and therefore that we should include it in our float.

Which cap periods to recover over

3.41. We are maintaining our November 2020 consultation proposal of allowing recovery of the float for costs incurred in the cap period four and five over cap period six and seven. We are also maintaining our proposal of allowing recovery of the float for costs incurred in cap period six within cap period six, for the reasons we set out in the September 2020 consultation.²⁵

3.42. One stakeholder said it would expect any increase in costs to be smoothed out even if this involved recovering costs over an extended period. However, a different

²⁴ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 3.39-3.41.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

²⁵ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 3.42-3.47.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

stakeholder agreed that where possible the delay in efficient cost recovery should be minimised.

3.43. We agree with the concept of smoothing, since we consider that including an adjustment for three periods' worth of costs in one period (i.e. cap period six) 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. However, we also want to maintain the principle of aligning the recovery of costs with the period in which they occurred. As mentioned earlier, it would not protect customers to delay cost recovery, particularly if this meant significant costs being recovered in winter 2021-22. We have therefore decided to spread the costs arising from the historical periods (caps four and five) and align the recovery of cap six's costs to cap six.

Demand and time weighting the allowance

3.45. Our position on demand and time weighting the allowance remains unchanged from our November 2020 consultation. 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. We explained this in detail in our November 2020 consultation.²⁶

3.46. One supplier commented on our proposal to adjust the unit rate on a demand weighted basis. It asked us to consider in the true-up process whether the gas and electricity multipliers used in setting the float adjustment were reflective of seasonal consumption data given the high winter gas consumption. The demand share we use when calculating the unit rate captures the difference in gas consumption between summer and winter as it is based on the most recent historical information. We will consider this further in the true-up.

²⁶ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 3.48-3.53.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

Cost incurred from cost/allowance timing differences

- 3.47. We have decided not to adjust the float to reflect a gap between the cost being incurred and the allowance being recovered.
- 3.48. One supplier was concerned about the considerable lag in cost recovery for policy and industry costs²⁷ of up to 15 months. It stated that the long lag before suppliers could recover increases in these costs due to COVID-19 would have a further detrimental impact on suppliers' working capital and cash flow.
- 3.49. One supplier said there were working capital costs associated with the timing difference between suppliers making provisions for bad debt and when the cap provides funding (presumably this adjustment).
- 3.50. As set out in our decision section, we do not consider that the cap allowance needs to match the costs in every cap period. Suppliers are also best placed to manage any resulting temporary cash flow than default tariff customers. In any event, it would be more appropriate to consider the appropriateness of funding any timing difference at the true-up stage.

Timing of true-up

- 3.51. One supplier agreed with our expectation that the true-up process for cap period four is likely to start in late 2021 or early 2022. However, another supplier was concerned about having to wait until cap period eight for the true-up of cap period four, and potentially even longer for the true-up relating to periods five and six.
- 3.52. The supplier that had concerns said that we should set an interim true-up in relation to cap periods four to six. It said that we could implement this in cap period seven. It provided an illustrative timetable for this interim true-up, including a methodology consultation in February 2021, an RFI in April 2021, and a further consultation in June 2021.

²⁷ For example, the FIT levy, BSUoS, and Capacity Market levy.

3.53. We do not intend to conduct an interim true-up for cap periods four to six in cap period seven. Under the proposed timetable, it is unlikely suppliers would have data on final costs impacted by COVID-19 for cap periods four to six. We do not think the interim true-up using data on non-final costs would provide materially more appropriate results. Given the known lag for debt to become bad debt, those costs will still be estimates, albeit more refined. Also, if we were gathering data in April 2021 (as the supplier suggested), then cap period six would only have just begun, so there would be not be significant additional information on the costs suppliers experience in that cap period. We therefore do not consider that an interim true-up would be proportionate.

Accounting for changes in the number of default tariff customers

Context

3.54. We needed to consider 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.

3.55. The number of default tariff customers each supplier has will change across time as customers switch suppliers. This means that it is unlikely that suppliers will have the same number of customers in cap periods four and five when the costs were incurred, and cap period six when the costs are recovered in the float.

Decision

3.56. For the float, we have decided not to make an adjustment for the change in the number of default tariff customers between cap periods four and five and cap period six.

3.57. This is due to the short time difference between the period when costs were incurred and the period when the allowance are provided. It reduces the likelihood of significant change in the aggregate number of default tariff customers during these periods.

3.58. This is different to the adjustment for customer numbers that we are making in order to calculate the float, which we discuss in Chapter 4. That adjustment aims to

help us calculate the additional COVID-19 cost per customer for the relevant cap periods.

November 2020 proposals

3.59. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

3.60. One supplier told us that despite the pandemic, switching is still prevalent and so there is a risk that shifts in customer bases could result in a mismatch in cost recovery. It wanted us to consider accounting for changes in lower quartile in the true-up, believing the increase in accuracy justifies additional complexity.

Considerations

3.61. For the float, the short difference in time reduces the potential for customer numbers to change significantly. Furthermore, the float is deliberately a conservative estimate in favour of default tariff customers, so it would not be proportionate to attempt to adjust for changes in default tariff customer numbers as part of our April 2021 adjustment.

3.62. 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

Context

3.63. To set our adjustment, we need a benchmark to define the efficient additional costs resulting from COVID-19. To calculate which costs are additional, we need to be able to differentiate between COVID-19 costs and the costs which suppliers were incurring previously. To calculate which costs are efficient, we need to set the benchmark at an appropriate level of stringency, taking into account the extent to which variation in suppliers' costs is driven by efficiency and by other factors.

3.64. We also need to consider whether to benchmark costs for each cap period individually or across cap periods, and whether to benchmark costs for default tariff customers specifically or domestic customers in general.

Decision

3.65. We have made the following decisions for setting the float. These do not prejudice the approach we may take to calculating the true-up.

3.66. We have decided to assess the benchmark as the increment since 2019. This allows us to focus on the impact of COVID-19, allowing suppliers to keep any efficiency gains from 2017 to 2019 in line with our original cap decision. Relative to using an earlier year as the baseline, this also allows us to include data from suppliers who have grown to become large suppliers recently.

3.67. We have decided to use a lower quartile²⁸ benchmark. We consider that this is more appropriate than an average benchmark when setting the float, as a lower quartile reduces the risk of customers temporarily overpaying due to limitations in the information available at this stage.

3.68. We have decided to calculate individual benchmarks for each cap period. This is primarily because it allows us to use all the data available to us.

3.69. We have decided to set the benchmark based on the costs of serving domestic customers in general, rather than default tariff customers specifically. This uses the data available to us at this stage. Trying to estimate the specific impacts on default tariff customers would not align with our general position of being conservative when setting the float, in order to protect customers.

November 2020 proposals

3.70. This approach is unchanged from our November 2020 consultation.

²⁸ This means that we use the cost of the supplier that is halfway (in number of suppliers) between the suppliers with lowest and median (i.e. midpoint) costs.

Stakeholder responses

3.71. Most suppliers were opposed to using lower quartile costs, particularly for the true-up. The primary reason given was that their customer bases were a large determinant of additional debt-related costs, meaning that a lower quartile could understate efficiently incurred costs.

3.72. However, one stakeholder supported our proposal of using a lower quartile for the float, and two suppliers said that they understood we were trying to adopt a conservative approach when setting the float, even if they were opposed to a lower quartile in general.

3.73. Two suppliers said that our proposal to calculate individual benchmarks for each cap period could underestimate the level of debt, due to suppliers updating bad debt provisions irregularly.

3.74. Two suppliers said that we should calculate any adjustment based on default tariff customers only, rather than including customers on fixed tariffs. Two suppliers said that we should take into account differences in debt between payment methods.

Considerations – choice of benchmark

3.75. In our November 2020 consultation, we noted three factors which could (among others) lead to variability between suppliers in how their costs change due to COVID-19: efficiency, company policy and customer mix. We also noted two additional factors which could affect the data we are using to set the float – forecasting assumptions and differences in accounting policy. We have largely structured this section looking at each of these factors in turn. We have also noted additional areas mentioned by stakeholders which do not fit into these categories.

Efficiency

3.76. If variation between suppliers' costs was driven only by differences in efficiency, then we would benchmark the additional costs to the supplier with the lowest (frontier) costs. Our November 2020 proposal was to set the benchmark at the costs of the supplier at the lower quartile. This was in line with the approach we used in our

original cap decision to set the payment method uplift (which largely related to debt).²⁹ It is also similar to the approach we took to benchmarking operating costs, where we set the benchmark at the lower quartile minus £5. A lower quartile approach takes into account that efficiency may not be the only factor affecting suppliers' costs. However, it also recognises that some suppliers are more efficient than others in how they collect debt.

3.77. We received limited feedback specifically relating to efficiency. Stakeholders focussed on the relative importance of customer base issues (compared to efficiency) in determining suppliers' costs, which we cover in a later section.

3.78. One supplier said that suppliers' collection processes would be less effective during COVID-19, for example if suppliers are unable to carry out meter readings. We appreciate that COVID-19 will have affected suppliers' usual processes, and may have impacted their effectiveness, at least temporarily. However, if a factor affects all suppliers, then this should limit any impact on which supplier we select through our benchmarking process.

3.79. In response to our September 2020 consultation, one supplier told us that suppliers are strongly incentivised to minimise debt-related costs, and that a lower quartile benchmark will not change this. Another supplier said in response to the November 2020 consultation that suppliers are already heavily incentivised to collect debt efficiently.

3.80. We accept that suppliers have some incentives to become more efficient regardless of the 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.

²⁹ Ofgem (2018), Default tariff cap decision: Appendix 8 – Payment method uplift, paragraphs 2.26-2.31.
<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

Company policy

3.81. In our November 2020 consultation, we said that some companies will have taken more active debt collection steps since the onset of the pandemic.

3.82. We received limited comments in this area, particularly on the extent of variation between suppliers. Two suppliers said that debt-related costs could differ due to any additional assistance provided during the pandemic. We continue to consider that variations in company policy could be a factor leading to variation in suppliers' costs, but we do not have evidence at this stage about the importance of this factor.

Customer mix

3.83. In our November 2020 consultation we said that historically some portfolios have a higher propensity for bad debt (e.g. those with more customers paying by standard credit), though it was unclear whether historical patterns will still apply during COVID-19.

3.84. Four suppliers mentioned various customer base factors which could affect debt-related costs. These included: payment method, meter type (credit or prepayment), geographical location (given local restrictions), employment type (e.g. customers working in sectors like hospitality), socio-economic status, age, vulnerability, and whether a customer was on the Priority Services Register. In response to the September 2020 consultation, 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.

3.85. There are a large number of possible ways in which suppliers' customer bases could vary. Any impact on benchmarking would depend on the extent of variation in these characteristics between suppliers, and on the extent to which these characteristics affect suppliers' COVID-19 costs. For the true-up, we can consider whether additional data gathering would be helpful to understand customer mix further. For the float, we have limited information available. In this situation, our overall position is that using a lower quartile helps us to set a conservative float to protect default tariff customers.

3.86. One supplier said that the evidence suggests that the vast majority of increased debt relates to the same socio-demographic groups who normally build up debt. Another supplier said that suppliers with a more active customer base are less likely to have

customers who have larger economic impacts from COVID-19. It referred to survey data commissioned by Ofgem on the profile of engaged customers. While we have considered the evidence referred to by these suppliers, we would want to consider further information as it becomes available. At present, there is still uncertainty about the impacts of COVID-19 – further information would help to reduce this uncertainty.

3.87. One supplier said that the impact of a restrictive approach to benchmarking could be either a reduction in the support that suppliers provide to customers, or suppliers incurring losses, leading to supplier failures. On the former, this is similar to the issue of providing discretionary credit to PPM customers, which we considered in our November 2020 consultation.³⁰ Suppliers are already subject to some licence requirements (e.g. to treat customers fairly); providing a higher cap level to support additional (discretionary) action would not guarantee that suppliers would spend any revenues on this. On the latter, as set out in our November 2020 consultation, we have not seen evidence at this stage that supplier failure has been impacted by COVID-19. We note that the amount that suppliers are ultimately allowed to recover depends on the true-up, which is not the subject of this decision.

3.88. Three suppliers referred to our summary of responses to the September 2020 consultation (which formed part of the November 2020 consultation), specifically our statement that “most respondents said that customer mix would be the most important driver”. We do not consider this determinative in itself, given that suppliers who price their default tariffs at the cap have an incentive to suggest design choices which would allow them to recover additional revenue.

3.89. Two suppliers said that we should gather additional data to carry out the true-up. We will consider what data we may need to gather at a later stage.

³⁰ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 5.25.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

Other factors affecting variation in costs between suppliers

3.90. In this section, we cover any additional points raised which could affect variation in costs between suppliers. These are factors which could therefore potentially affect both the float and the true-up.

3.91. One supplier said that suppliers' additional debt-related costs could vary due to differences in the amount of investment made in improved debt recovery processes. We agree that suppliers may make investments of different sizes. However, this will directly affect suppliers' debt-related administrative costs, which is why we have signalled our intent to benchmark all debt-related costs together when we true up. We can consider this factor further at that stage.

3.92. One supplier said that the calculation of suppliers' additional costs could be affected by variation in their costs in the baseline year (2019). (In other words, a supplier could have low additional debt-related costs in 2020 because it had abnormally high costs in the baseline year). We agree that any fluctuations in costs over time could affect the baseline. However, if a supplier had abnormally high costs in the baseline year, then we already make it less likely that we would set this supplier as the benchmark through our use of a lower quartile, rather than using the frontier. We therefore do not consider that we need to make any changes to the float but can consider this point further when calculating the true-up.

Forecasting assumptions

3.93. In our November 2020 consultation, we said that some suppliers will have taken a more pessimistic view of macroeconomic circumstances and its impact on bad debt.

3.94. One stakeholder said that suppliers might have natural incentives to be conservative (i.e. on the high side) about the potential scale of the debt that they may face. We agree that this is a possibility, at least for some suppliers. However, our benchmarking sample included some suppliers who considered that we do not need to make an adjustment for debt-related costs. This could reduce the likelihood that the selected supplier in our benchmarking sample is taking a pessimistic view of the macroeconomic circumstances.

Differences in accounting policy

3.95. In our November 2020 consultation, we said that some suppliers may have different accounting approaches, or have varied their policy recently, e.g. writing off some historical bad debt at the same time as reviewing COVID impacts.

3.96. We discuss below (in the section on the number of periods over which to assess the benchmark) the risk that a benchmark could be affected by suppliers' cost allocation between cap periods. We did not otherwise receive comments on suppliers' accounting approaches.

Overall conclusions on the choice of benchmark

3.97. We have decided to use a lower quartile when setting the float. This is a conservative position to protect customers.

3.98. At this stage we consider that using lower quartile at true-up could be appropriate, but we will consider later whether this is the case. We will be able to consider whether additional data gathering would be helpful to understand the relative importance of efficiency, company policy, customer base differences, and any other factors in determining suppliers' costs due to COVID-19.

Considerations – other areas

Assessing benchmark as increment since 2019

3.99. Stakeholders did not raise concerns about our proposal to assess the benchmark as the increment since 2019 (rather than an earlier year), and one supplier said that it supported this proposal. We have not changed our view from our November 2020 proposals.

Number of periods over which to assess benchmark

3.100. To set the float for cap period six, we have analysed costs from three cap periods – four, five, and six. As we have data from multiple cap periods, we had to decide whether to calculate one benchmark across these cap periods, or separate benchmarks for individual cap periods. In our November 2020 consultation we proposed to calculate separate benchmarks to maximise the data available.

3.101. We noted the risk that calculating benchmarks for individual cap periods could mean that the selection of the benchmark supplier could be affected by suppliers' cost allocation between periods, and some suppliers mentioned this point in response to our November 2020 consultation. One supplier provided an illustrative example of how this could lead to the sum of the individual benchmarks being lower than a benchmark calculated across several cap periods together.

3.102. The extent of the risk will depend, in part, on the degree to which suppliers update their provisions at least every six months (i.e. once per cap period). For our purpose of setting a COVID-19 adjustment for each cap period, it does not matter how suppliers make their provisions within a cap period (evenly every month or with greater variability).

3.103. For our decision on the float, we have to set the risk of individual benchmarks being affected by suppliers' cost allocation against the fact that setting individual benchmarks allows us to maximise the amount of data we use. As set out in our November 2020 consultation,³¹ 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.

3.104. We consider that our decision to use individual benchmarks is acceptable for the purpose of calculating a float, given that this will be subject to a later true-up.

3.105. We have not reached a view on what approach we will take when calculating a true-up, and may take a different approach. In our November 2020 consultation, we flagged the practical issues for our future calculations of using a combined benchmark.³² One supplier said that we could, for example, calculate a cumulative total bad debt write-off and update this over time, setting the allowance based on the updated benchmark minus the allowances already provided.

³¹ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 3.79.

<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

³² Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 3.78.

<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

3.106. We will consider this point further as part of our work on the true-up.

Costs of serving default tariff customers

3.107. We note the comments from stakeholders about controlling for tariff type and payment method. For this decision on the float, we do not have data which isolates the impact of COVID-19 on default tariff customers from the domestic customer base as a whole or which splits the costs by different payment methods. (Note that understanding the impact of payment types on the cost benchmark is separate from the question of how we allocate costs between customers on different payment methods).

3.108. We will consider these issues further when developing our data gathering approach for the true-up.

Allocating costs

Context

3.109. In calculating the adjustment, we needed to apportion the costs between the different caps and the cap components. This includes:

- different payment types (i.e. direct debit, standard credit, and PPM);
- differences between electricity and gas;
- single-register and multi-register electricity meters (given they have different levels of typical consumption); and
- whether to allocate costs equally across all customers through the standing charge or to allocate it proportionally to consumption through the unit rate.

Decision

3.110. We have made the following decisions for setting the float. These decisions do not prejudice the approach we may take to calculating the true-up.

3.111. We have decided to spread payment type costs equally across credit meter customers. We consider that doing so equally protects default tariff customers

(particularly those paying by standard credit). We consider that standard credit customers who are paying their bills are not more responsible for these higher COVID-19 costs than direct debit customers that are paying their bills.

3.112. We have decided to spread the cost equally between the gas and electricity caps.

This recognises that 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 decided to spread the cost equally across single-register and multi-register electricity. 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.

3.114. We have decided to recover costs between the standing charge and unit rate in the same proportions as total costs are currently recovered under the cap. 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 typical consumption³³).

November 2020 proposals

3.115. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

3.116. In response to our November 2020 consultation, two suppliers disagreed with our proposals of apportioning the costs between direct debit and standard credit, while a stakeholder said it was appropriate.

³³ 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.

3.117. Stakeholders however agreed with our proposals on allocating costs between the unit rate and the standing charge and with our equal allocation of costs across fuels and meter types.

Considerations

Recovery over payment methods

3.118. In response to our November 2020 consultation, two suppliers disagreed with spreading bad debt costs equally between direct debit and standard credit customers for setting the float. However, one stakeholder agreed with our proposal, as it was not aware of evidence to suggest that direct debit customers are more sheltered from financial difficulty during COVID-19.

3.119. Two suppliers who disagreed with our approach told us that there was a risk of penalising some suppliers with higher proportions of standard credit customers and overcompensating others, which could create further market distortions.

3.120. In our November 2020 consultation,³⁴ we discussed in detail why we consider it appropriate to allocate the costs equally across standard credit and direct debit customers. We have not seen sufficient evidence to justify a change in approach for the float, and, therefore, we have decided to maintain our approach for the reasons set out in that consultation.

3.121. Our decision is consistent with the principle we adopted in 2018 where we allocated costs between payment types in 2018 to maintain the pre-existing price differential between direct debit and standard credit offered by the six largest suppliers in that period.

3.122. We recognise that suppliers may be subject to different costs depending on their customer mix. As we set out in our 2018 decision, it would not be appropriate to set an allowance which covers the costs of the supplier with the maximum possible efficient

³⁴ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraphs 3.105 – 3.110.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

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, meter types and recovery over the unit rate and standing charge

3.123. One supplier supported our proposal on spreading the costs equally across fuel and meter type.

3.124. Two stakeholders agreed with our proposal on the allocating costs between the unit rate and the standing charge.

3.125. We are maintaining our November 2020 consultation proposals, for the reasons we set out in the November 2020 consultation.³⁵

True up

3.126. One supplier stated it accepted our proposal for the float and understood it was constrained by lack of data. However, it considered it was essential for Ofgem to gather data by payment methods and to control the adjustment for payment type costs in the true-up.

3.127. When we true up, we will consider whether any changes to this approach would be necessary.

³⁵ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 3.111-3.127.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

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

This chapter sets out our decision to adjust the cap for cap period six to include a float for the additional debt-related costs resulting from COVID-19. This chapter also sets out the data sources used and how we calculated the adjustment.

Summary

- 4.1. We have decided to include an incremental bad debt forecast for cap periods four, five, and six in the float. We have decided to use suppliers' submissions to our voluntary RFI³⁶ to calculate this. We have decided to use 2019 as the baseline to calculate the increment. We explain in Chapter 3 that we will use a lower quartile benchmark to set the float.
- 4.2. We have decided 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 may consider these costs as a part of our true-up exercise.

The impact of COVID-19 on debt-related costs

Context

- 4.3. In our November 2020 consultation, we proposed to make an adjustment for debt-related costs as part of our float because we have a reasonable expectation that COVID-19 has and will increase them.
- 4.4. COVID-19 is an unexpected shock that is having economic impacts. The subsequent economic downturn caused by COVID-19 has put pressure on consumers' income and

³⁶ 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).

their ability to pay a variety of bills. This has and is expected to continue to increase the number and value of non-payments in the domestic energy market.

4.5. The impact of COVID-19 on consumers' ability to pay could also increase in the future if unemployment significantly rises. For example, 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.

Decision

4.6. We have decided to make adjustments for debt-related costs as part of the float because we have a reasonable expectation that COVID-19 has and will continue to increase these costs.

November 2020 proposals

4.7. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

4.8. In response to our November 2020 consultation most suppliers broadly agreed with our proposal to make an adjustment for debt-related costs. However, two disagreed. Both reiterated their views from previous consultations that in principle the cap should not be adjusted yet. We discuss these points further in our considerations.

Considerations

4.9. One supplier said that it is too soon to reliably identify COVID-19 related costs that cannot be managed through supplier cash flow. It highlighted that they had not experienced a clear impact from COVID related debt and did not think there has been a clear increase in consumers' inability to pay.

- 4.10. We provided considerations for why we consider it is appropriate to adjust for debt-related costs in our November 2020 consultation, following previous similar feedback from some suppliers.³⁷
- 4.11. Since November, societal restrictions have increased, with more businesses having to close or remain closed. We consider that this reinforces our expectations on the potential negative economic impact on customers and additional COVID-19 costs in cap periods five and six.
- 4.12. The supplier also highlighted that the surge in direct debit cancellations they experienced in Q1 2020 was temporary and cancellations have stabilised towards pre-COVID levels. We agree with the supplier that data only showed a temporary increase in direct debit cancellations at the start of COVID-19 and this returned to pre-COVID-19 levels in the months following. However, direct debit cancellations are only one indicator of debt-related costs. Citizens Advice estimated that 600,000 more households were behind on their energy bills in December 2020 compared to February 2020.³⁸ Direct debit customers may be incurring debt by reducing payments below their energy cost. Customers on standard credit may also be in debt. As shown in our November 2020 consultation there is evidence of an increase in failed standard credit payments.

Data source for debt-related costs

Context

- 4.13. In order to make an adjustment for the debt-related COVID-19 costs, we need an appropriate source of data. In our September 2020 consultation, we consulted on whether to use supplier forecast of debt-related costs, or to rely on other data sources, such as leading indicators and other work being done by Ofgem. We subsequently

³⁷ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 4.6-4.14.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

³⁸ Citizens Advice (2020), Recovery, or Ruin?: The role of accessible support in helping energy consumers through the crisis.
<https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-policy-research/recovery-or-ruin-the-role-of-accessible-support-in-helping-energy-consumers-through-the-crisis/>

issued a voluntary RFI to suppliers, and used the resulting data to inform our November 2020 consultation proposals.

Decision

4.14. We have decided to use the forecast cost data collected through the voluntary RFI to set a float for debt-related costs for cap periods four, five, and six. We consider that the supplier forecasts currently provide the best available data source given that suppliers are looking directly at these costs and will have their own experiences of factors that impact their own portfolios.³⁹

November 2020 proposals

4.15. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

4.16. In response to our November 2020 consultation, two stakeholders noted their concerns with using supplier forecasts of bad debt. We discuss this in more detail in the considerations below.

4.17. In response to our September 2020 consultation we received comments from two suppliers. One said that we should attach significant weight to the information suppliers provided through the voluntary RFI to set a float. The other 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 were too far removed from today's industry to guide policy decisions.

4.18. One supplier raised concerns in its response to the voluntary RFI that the data would not produce meaningful answers for this consultation. It said that we should draw on the work Ofgem was undertaking separately to be prepared for a wide range of potential impacts of COVID-19 this winter.

³⁹ We discuss later on in this chapter concerns we have with some of the estimates and the impact this has had on our float decision.

Considerations

Supplier forecasts

- 4.19. One supplier noted its concern with relying on supplier forecasts and said that we need to ensure that the bad debt forecasts do not double count the bad debt allowance already in the price cap.
- 4.20. This decision aims to only assess the additional efficient costs of COVID-19 above those already allowed for in the cap. As outlined in our methodology at the end of this chapter, we assess the supplier forecasts against a pre COVID-19 baseline to mitigate the risk of double counting.
- 4.21. One supplier also recommended that we issue a mandatory RFI to relevant suppliers to collect data on supplier bad debt forecasts and, where available, the historical bad debt data from the 2008-2010 recession. The supplier also said we should incorporate this in time for the April 2021 period.
- 4.22. It was not feasible to issue a mandatory RFI, analyse it and consult on the results in time for the February 2021 decision. In our September 2020 consultation, we stated that we did not consider further data gathering through a mandatory RFI was feasible or practical for the purposes of setting a float at this stage and provided our reasoning.⁴⁰
- 4.23. One stakeholder added that although suppliers will have their own experience of the factors that affect bad debt and a specific understanding of the impacts on their own portfolios, none of them have experienced a pandemic before and it appears likely that a number in the sample will not have experienced the nearest analogous situation, the 2008 global financial crisis.
- 4.24. We recognise that not all suppliers who responded to our RFI will have experienced the last recession. We consider that that these suppliers will still be able to consider

⁴⁰ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation paragraph 4.100 – 4.101.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation>

publicly available data on the impact of the last recession, and consider how this might apply to their own portfolios. We still consider these suppliers have their own experience of the factors that affect bad debt, with a specific understanding of the impacts on their own portfolios. In our November 2020 consultation we provided considerations for why using supplier forecasts was appropriate.⁴¹ We noted that given the supplier forecasts provided,⁴² we are comfortable that they are broadly reasonable, taking into account the macroeconomic situation.

Alternative sources

4.25. In response to our November 2020 consultation, we received no comments from stakeholders advocating the alternative options we identified (leading indicators or Ofgem’s winter 2020 COVID-19 scenarios). Please see the considerations in our November 2020 consultation on why we have decided not to use these sources.⁴³

Debt-related costs in the float

Context

4.26. We considered making an adjustment for three categories of debt-related costs as part of our float:

- bad debt – the unrecoverable debt that suppliers write off;
- debt-related administrative costs – the costs of attempting to collect debt before it is written off; and

⁴¹ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 4.26-4.28.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

⁴² In relation to bad debt

⁴³ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 4.30-4.31 & 4.33.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

- cost of working capital – the cost to the supplier of raising capital to fund customers paying in arrears.⁴⁴

4.27. We gathered data on each debt-related category through our voluntary RFI.

Decision

4.28. We have decided to include an adjustment for the cost of writing off bad debt in the float. We consider the quantity and quality of data provided is sufficient to provide a good estimate of bad debt costs for the purposes of setting a float.

4.29. We have decided to not include an adjustment for the cost of working capital and bad debt administrative costs in the float. This is because of the poor quality of data received from our voluntary RFI. We discuss this in more detail in our considerations below. We will revisit these costs again as part of the true-up exercise.

November 2020 proposals

4.30. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

4.31. Of those suppliers who disagreed with an adjustment, one highlighted its experience and provided evidence of why they thought the float was overly generous. The other raised concerns with the data we used.

4.32. One stakeholder agreed with the principle of setting a float but raised a number of concerns with the data gathered through the voluntary RFI and the impacts this could have on the size of the float.

4.33. One supplier disagreed with our decision to exclude working capital from the float.

⁴⁴ This is different than any cost of timing differences between when suppliers incur costs and we provide an allowance.

4.34. Two suppliers disagreed with our decision to exclude debt-related administrative costs from the float, highlighting that they had experienced an increase in administrative costs since COVID-19.

Considerations: bad debt

4.35. We summarised the data we collected in our November 2020 consultation. We do not replicate the information here.⁴⁵

Data sample

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

- For the incremental bad debt arising from cap period four, the data provided by seven suppliers covers a significant proportion of the market. This includes most of the large legacy suppliers.
- For the calculation of the incremental bad debt arising from cap periods five and six, the five responses means we have a lower degree of coverage. For the purposes of estimating a float that we will true up at a later stage, we consider the numbers of responses to be sufficient.

4.37. In response to our November 2020 consultation, two stakeholders commented that we should not set a float that relies on forecast data from only a subset of suppliers in the market.

4.38. One said that because the RFI was voluntary there was a risk that the data may be skewed due to self-selection (e.g. that there would be stronger incentives on those suppliers incurring or expecting higher bad debts to respond than on those incurring or

⁴⁵ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 4.40 – 4.41.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

expecting lower ones). It highlighted that this should only be a short-term issue if a mandatory RFI is used for the true-up.

4.39. We agree that there is some risk of self-selection due to the voluntary nature of the RFI. However, we consider this risk to be relatively low due to the variety of suppliers who have responded. The bad debt float calculation includes a number of suppliers who have noted in their response that they have experienced limited impacts on bad debt due to COVID-19. We therefore consider the range of responses we have received is sufficient for the purpose of setting a float. However, we will take all points raised with regards to our RFI data gathering into consideration in our future reviews of COVID-19 costs.

Incremental bad debt analysis

4.40. Using the RFI data, we calculated the bad debt increment (compared to the 2019 baseline) for each supplier per customer account⁴⁶ for each cap period. We then selected the lower quartile⁴⁷ incremental cost for each cap period. The lower quartile bad debt increment figures are displayed in Table 2. There is an increase of £0.34 per customer account in the incremental bad debt costs compared to our proposals in the November 2020 consultation. This is as a result of our updates to customer numbers.

⁴⁸ We discuss these updates at the end of this chapter.

Table 2: Bad debt increment figures by cap period

Cost item	Unit	Cap period four	Cap period five	Cap period six
Bad debt	£/customer	2.02	2.41	2.46

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

4.41. At the end of this chapter, we describe how we have translated these incremental costs into the adjustment allowance for cap period six. This explains why the adjustment allowance is larger than the sum of the three incremental figures in the table for each fuel. Cap period six is a summer cap period, when customers consume

⁴⁶ Figures are per customer account. A dual-fuel customer has two accounts (one per fuel).

⁴⁷ This is the cost of the supplier that is halfway (in number of suppliers) between the suppliers with lowest and median (i.e. midpoint) costs.

⁴⁸ The largest impact is in cap period six. This is because the latest customer number data relates to October 2020, which is then used for calculations of the estimated bad debt cost in that cap period.

less than half their annual energy demand (in particular gas for heating). In effect, to recover a particular amount of costs over a smaller amount of demand, we have to set the unit rate higher. This translates to a higher cap level. However, this does not change the total amount recovered from customers.

Considerations: debt-related administrative costs

4.42. In our November 2020 consultation, we noted that the quality of the responses provided was insufficient to enable us to assess whether there was a material and systematic cost or saving that needed to be accounted for in our adjustment.

4.43. We calculated the incremental debt-related administrative cost per customer, and used the lower quartile in each cap period. 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 -£0.59 per customer account).

4.44. In response to our November 2020 consultation, one supplier disagreed with our proposal to not include debt-related administrative costs in the float. The supplier highlighted that it has experienced a significant increase in the number and value of customers in arrears. To tackle this, it ramped up collection activities, which required investment. It also noted a large increase in the number of staff in contact centres and back-office teams to support communication with customers in arrears.

4.45. In our previous consultations 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. Our expectation of the trend in suppliers' costs seem to align with the experience of the supplier who raised their concern.

4.46. However, not all of the data provided by suppliers in response to the RFI for cap period six matches this expectation.

4.47. We outlined our concerns on the quality of the debt-related administrative costs data in our November 2020 consultation.⁴⁹ Our considerations remain unchanged. We intend to consider suppliers' debt-related administrative costs as a part of our true-up exercise.

Considerations: Working capital costs

4.48. For each supplier we calculated the working capital cost increment per customer for each cap period. We then used the lower quartile in each cap period. To convert the amount of working capital into a cost, we applied the 10% cost of capital used in our 2018 cap decision.⁵⁰

4.49. 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 -£0.09 per customer account. This suggests that suppliers are not experiencing a material cost.

4.50. 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 a significant difference in the scale of monthly working capital between suppliers.

4.51. We considered possible explanations, including the different customer mixes of suppliers and possible differences in accounting approaches in our November 2020 consultation. We also asked for clarification from certain suppliers to understand their submissions.

4.52. One supplier disagreed with our November 2020 proposal to not include working capital. It said that the difference in working capital figures between suppliers may be

⁴⁹ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 4.354-4.59.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

⁵⁰ Ofgem (2018), Default tariff cap: decision – overview – appendix 8 – Payment method uplift.
https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf

explained by their size and access to capital and that unsustainable pricing strategies may be a reason for the negative working capital figures.

4.53. We are still not convinced that the differences in working capital figures between suppliers can be explained by these factors given our sample includes a number of roughly similar sized suppliers. Moreover, as we said in our November 2020 consultation, in the limited time available to analyse the data, we were not able to reassure ourselves that suppliers have responded in consistent ways to the working capital question. We also highlighted that our general approach of setting the float on a conservative basis does not require us to use poor-quality data.

4.54. We have not ruled out the possibility of including working capital costs in a true-up. We will consider and consult on possible alternative methods to calculate a potential true-up for working capital costs to ensure consistency between submissions.

Calculation of the adjustment

Decision

4.55. Based on the arguments in the previous section, we have decided to adjust for bad debt costs only. In this section we translate the incremental costs of bad debt into an adjustment level, based on the decisions set out in Chapter 3. Table 3 shows the resulting value of the adjustment allowance for cap period six.

Table 3: Bad debt scaled increments and the resulting cap period six adjustment allowance

Scaled levels	Electricity		Gas		Dual Fuel	
	Nil	TDCV	Nil	TDCV	Nil	TDCV
Cap period four	0.32	2.02	0.32	2.02	0.64	4.04
Cap period five	0.38	2.41	0.38	2.41	0.77	4.82
Cap period six	0.78	5.55	0.78	9.28	1.57	14.83
Cap period six adjustment allowance	1.49	9.98	1.49	13.71	2.97	23.69

4.56. As we are recovering the costs of cap periods four and five over two cap periods, cap periods six and seven, there will 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 below therefore shows the minimum implied adjustment allowance for cap period seven – it is not a forecast of the adjustment that we expect to make in. We will consult on the total adjustment for cap period seven over the first half of 2021.

Table 4: Minimum implied cap period seven adjustment allowance

Scaled levels	Electricity		Gas		Dual Fuel	
	Nil	TDCV	Nil	TDCV	Nil	TDCV
Cap period seven adjustment allowance	0.70	4.43	0.70	4.43	1.41	8.86

4.57. One supplier stated that the scale of the adjustment made was overly generous. It cited Citizens Advice’s report “Recovery or ruin?” that suggests 600,000 more households are behind on their energy bill. It estimated that if each of those households had £500 debt written off, this would give £300 million total bad debt since COVID-19 began. They stated this gave an adjustment of £11, significantly lower than the £21 we proposed in November.

4.58. We understand that the supplier has essentially calculated an estimate of a bad debt increment. This is not comparable with the adjustment allowance we have calculated. To convert the bad debt increment the supplier would need to then adjust this amount to enable suppliers to recover it over cap period six (i.e. a six-month summer period with lower energy demand).

Methodology for calculating a float

Decision

4.59. Based on the decisions we set out in Chapter 3, we benchmark the incremental bad debt cost per customer as follows:

- for each supplier which we have bad debt data for, we calculate a bad debt cost per customer account for each cap period;
- we calculate the change in bad debt cost in the cap period relative to a baseline period, which is the same period in 2019 (i.e. pre COVID-19); and

- we select the lower quartile of these increments for each of cap periods four, five, and six.

4.60. We then convert the benchmark incremental bad debt costs per customer account in the adjustment allowance. In summary, for each fuel, we total the three benchmarks, annualise the total (to ensure the amount is recovered via the annual cap level in six months) and weighted (to reflect the fact that the total amount need to be recovered over a summer period with low demand). The calculations are set out in 'Annex 8 – methodology for adjustment allowance' published alongside this decision.

4.61. We have decided to update the customer numbers we use in the above calculation to reflect latest data, and in doing so, maintain the methodology that is consistent with our November 2020 consultation.

November 2020 proposals

4.62. This methodology is unchanged from the approach taken in our November 2020 consultation. However, in calculating the allowance for the decision, we have updated the customer account assumption with the latest snapshot of data from Ofgem's 'Domestic Customer Account & Tariff RFI'. This impacts the number of customer accounts we use when calculating the bad debt cost per customer. We discuss this in more detail in our considerations below.

Stakeholder responses

4.63. No stakeholders commented on our methodology in response to our November 2020 consultation.

Considerations

How to calculate the increment since 2019

4.64. For each cap period, we have decided 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 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.

4.65. Table 5 shows the baseline we use for each cap period.

Table 5: Details of the months included in our increment calculation

	Cap period four	Cap period five	Cap period six
COVID scenario	April 2020 – September 2020	October 2020 – March 2021	April 2021 – September 2021
Baseline	April 2019 – September 2019	October 2019 – February 2020 (scaled up) ⁵¹	April 2019 – September 2019

Calculating the cost per customer

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

4.67. In our November 2020 consultation, we used snapshot customer account data from Ofgem’s cap compliance RFI, ‘Domestic Customer Account & Tariff RFI’, from April 2020. We stated that for the decision we would update our calculations using the customer data collected in October 2020.

4.68. We discussed two approaches for how we would integrate the new October 2020 snapshot.

4.69. One was similar to the method used to calculate the proposed adjustment allowance for the November 2020 consultation:

- 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);

⁵¹ 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 scaled up the October 2019 to February 2020 period to produce an appropriate six-month baseline.

- 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 customer account data available to us.

4.70. The alternative assumed:

- 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.

4.71. No stakeholders commented on these options.

4.72. Given the inherent uncertainty of the COVID-19 adjustment at this point, we consider that either option could be used for the purposes of setting the float. We have chosen therefore to maintain the methodology that is consistent with the November 2020 consultation. This approach does not determine how we will consider customer accounts in our true-up. We will revisit this as part of that exercise.

5. Prepayment meter customers

In this chapter we set out our decision on whether an adjustment is required for changes in PPM-specific costs resulting from COVID-19, and the reasons for it. We detail how we took into account the stakeholder responses to our November 2020 consultation, as well as analysis based on data from other sources, such as our weekly and monthly Covid-19 RFIs.

COVID-19 PPM adjustment

Context

- 5.1. The CMA designed and introduced time-limited protection for PPM customers following its findings from the Energy Market Investigation.⁵² The PPM cap was introduced in April 2017, protecting all PPM customers. It expired at the end of December 2020.
- 5.2. We decided in August 2020 to continue protecting these customers using the default tariff cap. We set a specific cap level for PPM customers. This ensures that default PPM customers will remain protected for the remainder of the default tariff cap. The PPM level of the default tariff cap came into effect from 1 January 2021.
- 5.3. Ofgem has also decided to improve outcomes for PPM customers who are self-disconnecting, such as through new requirements on suppliers.⁵³

⁵² Competition & Markets Authority (2016), Energy market investigation Final report. <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

⁵³ This includes requiring 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. Ofgem (2020), Self-disconnection and self-rationing: decision <https://www.ofgem.gov.uk/publications-and-updates/self-disconnection-and-self-rationing-decision>

Decision

5.4. We have decided not to adjust the PPM cap level in the default tariff cap for 1 April 2021. We consider that the evidence at this stage indicates that the effects of COVID-19 on supplying PPM customers are limited.

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

November 2020 proposals

5.6. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

5.7. Three suppliers, in response to our November 2020 consultation, stated that they have been incurring additional costs related to PPM customers, including increases in discretionary credit. However, one agreed that the majority of such credit is not likely to become bad debt in the longer term.

5.8. On administrative costs, one supplier stated that it had experienced an increase. Two suppliers also reported an increase in PPM customer contacts due to the pandemic.

5.9. A supplier agreed that many businesses are in a better position to deal with cash flow issues than customers are, particularly with the various Government schemes available to them. However, it said that we need to take into account the impact of seasonality and the fiscal year on suppliers' forecasts when we make this consideration.

5.10. In relation to data, one supplier pointed out that we did not ask for data on additional PPM related costs as part of our voluntary RFI. Another encouraged us to source historic data as part of future COVID-19 cost reviews.

5.11. In response to our September 2020 consultation, 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.

Considerations: overall rationale

- 5.12. We have not seen evidence to suggest that there has been a material increase in the costs of supplying PPM customers resulting from COVID-19, so we have decided not to introduce an adjustment at this point.
- 5.13. We recognise that PPM customers have been facing more problems as a result of the pandemic, leading to an increase in the use of emergency credit. However, we agree with the supplier who said that most of this extra credit is unlikely to turn into bad debt in the long term.
- 5.14. We received little evidence in response to our November 2020 consultation that other PPM-related costs, such as administrative costs, have materially increased due to the pandemic. Where data was provided, it did not include a pre-COVID baseline, so we were unable to use it to assess potential incremental costs.
- 5.15. Moreover, we consider that suppliers are better placed than customers to manage cash flow risk, and note several stakeholders agreed with this general principle across both the September and November 2020 consultations. The objective of the Act is to protect customers on default tariffs. We have therefore decided to err on the side of caution when considering any adjustments, to avoid customers bearing the risk of the cost uncertainty.
- 5.16. 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

- 5.17. 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 uncertainty about whether there will be a material increase in bad debt costs due to COVID-19. Due to this uncertainty, we are being conservative and not providing an adjustment at this stage.

Discretionary credit granted

5.18. In our November 2020 consultation, we explained how we used our weekly and monthly COVID-19 RFIs to calculate an initial estimate of the total amount of financial support provided by PPM suppliers during the pandemic.⁵⁴ Since then we have updated these calculations using more recent information. We calculated that the ten largest PPM suppliers covering 97.6% of PPM customers, as a whole, provided £5.3m of support, on average, per month. If the same level of support was provided for the whole of cap periods four and five, the total for all suppliers would be around £63.1m. This is slightly above the amount we calculated for the November 2020 consultation using March to July 2020 data (£60m). However, not all of this will result in bad debt, and we expect much of it to be repaid promptly.

5.19. These estimates are of total financial support, rather than financial support incremental to 2019. We have very little 2019 baseline data that would enable us to calculate the incremental costs.

5.20. Two suppliers provided evidence that the discretionary credit they had provided to PPM customers was higher than over the same period last year, pre-COVID-19. One supplier mentioned an increase in calls after lockdown which resulted in those customers receiving over £1m incremental discretionary credit.

5.21. We had welcomed suppliers to provide evidence on any of our considerations, including the cost of providing discretionary credit. However, we did not receive any data that would make it possible to work out the cost of providing the incremental discretionary credit in response to either our September or November 2020 consultations. In addition, we do not consider data from two suppliers as being a robust basis on which to set an adjustment.

5.22. We will collect more data on discretionary credit and look at it in greater detail for cap period seven.

⁵⁴ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 5.16 – 5.20.
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation>

Uncertainty in estimating cost increases

5.23. We received little data on PPM-related cost increases in the November 2020 consultation responses, so uncertainty overestimating these cost increases remains.

5.24. One supplier pointed out that we did not ask for data on additional PPM related costs in our voluntary RFI. However, it did not provide any data in response to our consultation. The supplier also considered that our plan to consider evidence and position in respect of costs of supplying PPM customers for the next cap period to be an important step.

5.25. We have also noted the supplier suggestion to source historic data (such as 2019 baseline data) as part of future COVID-19 cost reviews to establish a clearer picture of the impact of debt-related costs due to COVID-19 on PPM customers. We will consider this suggestion when collecting data for cap period seven.

Incentive

5.26. We stated in the November 2020 consultation that we do not consider the lack of an adjustment of the PPM cap level to be a disincentive for suppliers to support customers in payment difficulties. This is because there are other measures in place to maintain a good level of service for customers (e.g. licence requirements).

5.27. One supplier considered these other measures to be extensive support and states that we clearly see it as part of a normal level of service for PPM customers. Therefore, it said that the cost of carrying such support should be recognised within the cap and included as part of the efficient costs of supplying PPM customers. However, in this decision we are only considering the additional costs resulting from COVID-19. This is separate to the decision we made last year on the PPM level in the default tariff cap which reflects the normal costs of serving PPM customers.⁵⁵

⁵⁵ Ofgem (2020), Protecting energy consumers with prepayment meters: August 2020 decision <https://www.ofgem.gov.uk/publications-and-updates/decision-protecting-energy-consumers-prepayment-meters>

5.28. We also stated in the November 2020 consultation that, if a supplier provides limited support at present, there is no guarantee that it would spend any additional funding from the COVID-19 adjustment on supporting PPM customers.

5.29. One supplier disagreed. It stated that there are licence conditions with which suppliers must comply, so if we do not believe suppliers are delivering the expected services, we have powers to investigate and act. The implication of this response is that awareness of our powers will be enough to incentivise suppliers to use the additional funding to provide customers with the required support.

5.30. However, we are only looking to set a float that reflects the efficient additional costs of COVID-19 suppliers incur for serving PPM customers. Therefore, we do not want to incentivise suppliers to spend more. Instead, we want to see if suppliers are incurring material extra costs to provide support as a result of the pandemic.

Considerations: Administrative costs

5.31. We do not consider there to be sufficient evidence or rationale to provide an adjustment for administrative costs for PPM.

5.32. As we discussed in the November 2020 consultation, suppliers may have incurred additional administrative costs in serving PPM customers. However, we also stated that suppliers may have seen some reductions in costs, for example from reduced 'routine' calls, which many suppliers actively discouraged during the lockdown phase of the pandemic. We have not seen evidence that any cost increases have been greater than the reductions.

5.33. Of the two suppliers who mentioned increased PPM customer contacts, one also saw an increase in requests for replacement PPM keys and cards, with some customers self-isolating or unable to access shops to acquire cards. Though we acknowledge this, this is not strong evidence of material increases in administrative costs in the PPM sector as a whole. As we discussed in the November 2020 consultation, administrative cost increases will depend on individual suppliers' policies.

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

In this chapter, we provide our decision and rationale for not adjusting for other non-debt-related costs.

Summary

- 6.1. We have decided that no adjustments are necessary to any of the cost components 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. However, we will continue to monitor the impacts of COVID-19 on these costs and will revisit them in subsequent reviews if we consider that the existing methodology is no longer sufficient.
- 6.2. In this chapter, we discuss a selection of the non-debt-related cost components of the cap. The components we do not discuss here are either addressed in other consultations or are areas on which we received no comments in response to our November 2020 consultation. At the end of the chapter there is a table summarising the non-debt-related cost components we do not discuss, with an explanation for each as to why we did not discuss it in detail.

Wholesale costs: capacity market

Context

- 6.3. In our November 2020 consultation, we discussed the potential impact a decrease in total demand could have on capacity market costs. We noted that the winter peak demand inputs are updated over time which 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).
- 6.4. We also recognised that the supplier allowance for cap period four was lower than if we had been able to use the updated peak demand estimates. However, we noted that higher domestic demand would have allowed suppliers to recover slightly more revenue than predicted, while the costs allocated to suppliers for the 2019-20 capacity market delivery year did not increase.

Decision

6.5. We have decided not to adjust the wholesale allowance to reflect the impacts of COVID-19 on capacity market costs.

6.6. Overall, we do not consider that there is evidence of a material impact on suppliers which would justify including an adjustment. Though suppliers have experienced an increase in capacity market costs due to COVID-19, we expect that they have also had increased revenue, such as through increased demand, that would contribute to covering the cost increases.

6.7. We will continue to monitor the extent to which the cap under or over-recovers capacity market costs in upcoming cap periods.

November 2020 proposals

6.8. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

6.9. We received no direct disagreement on our rationale in the November 2020 consultation for not providing an adjustment for capacity market costs. However, one supplier stated that our assumption that higher capacity market demand allows suppliers to recover more to cover payments only holds if suppliers are paid for usage by their customers.

6.10. Two suppliers commented on this area in response to our September 2020 consultation. One stated that, while capacity market costs have increased, they will be recovered through the existing methodology.

Considerations

6.11. As stated in the November 2020 consultation document, we recognise that capacity market costs incurred by suppliers are larger than allowed for in cap period four due to differences between forecast inputs used and outturn. We also recognise that there could be differences in the forecast inputs used in cap periods five and six which could lead to suppliers on average over or under recovering costs.

- 6.12. The estimate of 2020/21 winter peak demand used in cap period five has reduced compared to the estimates used in cap period four. The estimates for peak winter demand are provided to us by the Low Carbon Contracts Company (LCCC) prior to each cap announcement, which ensures the latest estimates are incorporated for that cap period.
- 6.13. Between cap period four and cap period five the LCCC's estimate for 2020/21 winter peak demand decreased by 6%. This decrease is three percentage points larger than the previous largest adjustment to estimated peak demand (in absolute terms). In the November 2020 consultation we stated that this is likely to be partly driven by COVID-19. However, the electricity system operator has been conducting analysis of the difference between actual peak demand during winter 2020/21 and its pre-pandemic forecasts for the period. To date, for most of this winter, the percentage the actual peak demand was below the forecast peak has been around or below 5%.⁵⁶ At times the difference was even close to 0%. This suggests that the difference between LCCC's pre-pandemic forecast and actual winter peak demand might be smaller than 6%.
- 6.14. Moreover, even before the COVID-19 pandemic there was already a slow downward trend in peak demand, so the impact that COVID-19 alone has had on the reduction in peak demand may be even less. Nevertheless, we acknowledge that actual 2020/21 winter peak demand may be lower than the estimates used to set the capacity market allowance in the cap level for cap period four.
- 6.15. 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. We expect this to help cover the unexpected increase in capacity market costs. This is because the domestic demand increase in spring 2020 would not have affected the November 2019 – February 2020 winter peak demand. The total capacity market charges suppliers have paid over cap period four have been based on peak demand in this winter period. This means that, while these costs were not affected by COVID-19, the pandemic resulted in a demand increase for default tariff customers that allowed suppliers to recover more revenue from the capacity market allowance under the cap. We consider the point raised by a supplier that this is

⁵⁶ National Grid ESO (2021), ESO Operational Transparency Forum: 27th January 2021. <https://data.nationalgrideso.com/plans-reports-analysis/covid-19-preparedness-materials/r/operational-transparency-forum-slides-27.01.21>

the case only if customers pay their bills to be an argument related to unpaid bills, which we cover in Chapter 4.

6.16. Overall, we do not believe there has been a material and systematic increase in either costs or revenue from impacts on the capacity market.

Policy costs

Renewables Obligation (RO)

Context

6.17. In our September 2020 consultation, we acknowledged that 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.

6.18. In our November 2020 consultation, we discussed Ofgem’s announcement that mutualisation had been triggered again in 2020 in respect of the 2019-20 RO compliance period. While the total shortfall amount and hence the mutualisation amount had not yet been published at the date of publication of that document, we noted that the shortfall as of the initial compliance deadline was substantially smaller than in the year before.

Decision

6.19. We do not consider that an adjustment to the RO cost allowance for the impacts of COVID-19 is required.

November 2020 proposal

6.20. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

6.21. In response to our November 2020 consultation, we received comments from one supplier on this area. It mentioned that COVID-19 could have a bigger impact on RO payments going forward than seen in previous years.

6.22. In response to our September 2020 consultation one stakeholder stated that 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

6.23. We have not yet seen evidence of COVID-19 having a bigger impact on RO payments. Ofgem announced on 11 November 2020 that mutualisation had been triggered again in respect of the 2019-20 RO compliance period. The total shortfall amount as of the 31 October 2020 RO late payment deadline had not yet been published when we published our November 2020 consultation. However, we now know that the total shortfall was £33m, which was considerably less than the £98m shortfall in the 2018-19 RO compliance period.

Contracts for Difference (CfD)

Context

6.24. In our September and November 2020 consultation, we discussed the potential impacts of COVID-19 on CfD costs. We noted that there could be differences between the forecast interim levy rates (ILRs), that we use to determine our CfD allowance, and the costs suppliers incur due to changes in demand resulting from COVID-19.

6.25. We also discussed how 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. Our analysis highlighted that the loan resulted in low additional costs for suppliers in cap period four that were within the range of historical variations.

Decision

6.26. We have decided that no adjustment is required to the CfD allowance for the impacts of COVID-19.

6.27. We consider that the current methodology sufficiently covers the impacts of COVID-19 on suppliers' CfD costs. The impacts of COVID-19 costs are largely mitigated due to the loan provided by Government. Any remaining additional costs for suppliers due to differences in forecast and outturn in cap period four are within the range of historical variations. We also note that any changes in costs in subsequent periods would be captured by the existing methodology.

November 2020 proposal

6.28. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

6.29. In response to our November 2020 consultation, one stakeholder commented that the impact of COVID-19 on suppliers' CfD costs is not sufficiently accounted for through our current methodology.

6.30. We also received responses from two stakeholders on this area during our September 2020 consultation which highlighted potential increases in CfD costs.

Considerations

6.31. In response to our November 2020 consultation, one stakeholder commented that the impact of COVID-19 on suppliers' CfD costs are larger than we have outlined due to the appreciation of the loan. In addition, it stated that it was not possible to compare present costs with those at the time of the loan due to the time difference between the two.

6.32. We do not consider it to be an issue that CfD costs will appreciate due to the loan.

This one-off loan was provided to LCCC by Government on an interest free basis.⁵⁷ Suppliers will repay the loan in Q2 2021. This expected cost is reflected in the ILRs which we use to set the CfD allowance in the cap. We also do not agree at this stage that the costs at the time of the loan are not comparable with those today. This is because of the short period between when the loan was made and when it will be repaid.

6.33. The supplier also restated its points from its response to our September 2020 consultation, that the loan only covered the period between April to June 2020, but suppliers continued to see demand decrease between June to September 2020. It also noted that the large changes driven by COVID-19 decreases in national demand could not be hedged for and as a result no mitigations could be put in place.

6.34. Our considerations on the suppliers' restated points remain unchanged from our November 2020 consultation.

Operating costs

Context

6.35. COVID-19 is likely to have impacted suppliers' operating costs in both directions. In our November 2020 consultation, we noted that suppliers may have experienced increased costs from facilitating working from home, and back office costs to deal with reliance on estimated bills and increased customer contacts. We also discussed possible operating cost savings due to COVID-19 from suppliers using the furlough scheme or alternatively reducing their outsourced services.

Decision

6.36. We have decided to not make an adjustment to the operating cost allowance for the impacts of COVID-19.

⁵⁷ LCCC (2020), Annual Report and Accounts for Low Carbon Contracts Company Ltd. <https://www.lowcarboncontracts.uk/sites/default/files/2020-09/LCCC%20Annual%20Report%202019-20.pdf>

6.37. We are aware that operating a business under COVID-19 related restrictions is likely to increase some operational costs. However, we have also noted a number of possible cost savings. On balance we do not consider that any operating cost increases are likely to have outweighed the savings, or vice versa.

November 2020 proposals

6.38. This approach is unchanged from our November 2020 consultation.

Stakeholder responses

6.39. We received one comment on operating costs in response to our November 2020 consultation. The supplier acknowledged that suppliers have saved money to some extent from furloughing staff and that suppliers had fewer calls to handle during the lockdown period. However, the supplier said that there are other costs related to its operational response to COVID-19 that it would like us to consider, including in future cap periods. These include increases in customer calls once lockdown ceased.

6.40. We received responses from three stakeholders to our September 2020 consultation. One agreed that in some areas the impacts of COVID-19 may have resulted in operating cost increases, but stated that there are also areas where decreases are likely. It agreed that the widespread adoption of the furlough scheme by industry could lead to reductions in operating costs.

Considerations

6.41. We still do not consider any increase in customer calls to have had a significant impact on suppliers' operating costs. One supplier agreed that suppliers had fewer customer calls to handle during the lockdown period as emergency calls were prioritised. However, it stated that once the initial lockdown period ceased, the volume of customer calls increased again as customers still had unanswered queries. Suppliers had to facilitate these - even with reduced resources. We see no evidence that the increase in calls after lockdown would have increased operating costs more than the decrease in calls during it would have decreased costs.

Other cost components

6.42. Table 6 summarises all other non-debt-related cost components where we are also not changing our position from the November 2020 consultation. For each component,

we have signposted where we discussed this in our November 2020 consultation and have provided a reason for not discussing it in more detail in this document.

Table 6: Non debt-related cost components that are not discussed further

Non debt-related cost component	Location in November 2020 consultation	Reason for not discussing cost category further
Wholesale costs: energy	6.6 - 6.14	No responses to November 2020 consultation proposal.
Policy costs: Feed-in Tariffs	6.38 – 6.41	COVID-19 impacts considered in separate decision. ⁵⁸
Policy costs: Energy Company Obligation	6.42 - 6.48	No responses to November 2020 consultation proposal.
Policy costs: Warm Home Discount	6.49 – 6.54	No responses to November 2020 consultation proposal.
Policy costs: Electricity Distribution Costs scheme (AAHEDC)	6.55 – 6.62	No responses to November 2020 consultation proposal and considered in separate decision. ⁵⁹
Network costs	6.63 – 6.68	No responses to November 2020 consultation proposal.
Smart metering net cost change (SMNCC) costs	6.77 – 6.82	COVID-19 impacts considered in separate consultation and no responses relating to pass-through SMNCC costs. ⁶⁰
Payment method uplift	6.83	Debt-related costs covered in Chapters 4 and 5.
Headroom allowance	6.84 - 6.90	No responses to November 2020 consultation proposal.
EBIT allowance	6.91 - 6.93	No responses to November 2020 consultation proposal.

⁵⁸ Ofgem (2020), Decision: Feed-in Tariffs (FIT) scheme allowance methodology in the default tariff cap.

<https://www.ofgem.gov.uk/publications-and-updates/decision-feed-tariffs-fit-scheme-allowance-methodology-default-tariff-cap>

⁵⁹ Ofgem (2020), Decision on changes to 'Annex 3 – Methodology for determining the Network Cost Allowance' and the allowance for the Shetland Cross Subsidy in the default tariff cap.

<https://www.ofgem.gov.uk/publications-and-updates/decision-changes-annex-3-methodology-determining-network-cost-allowance-and-allowance-shetland-cross-subsidy-default-tariff-cap>

⁶⁰ Ofgem (2020), Updating the allowance for smart metering costs in the default tariff cap: working paper.

<https://www.ofgem.gov.uk/publications-and-updates/updating-allowance-smart-metering-costs-default-tariff-cap-working-paper>