Making a positive difference
for energy consumers

Suppliers, consumer groups,
other interested parties

Email: retailpriceregulation@ofgem.gov.uk

Date: 2 March 2021

Dear stakeholder,

Call for input: approach to true-up for COVID-19 adjustment to default tariff cap

This call for input follows on from our consultations on adjusting the default tariff cap (the cap) for the impacts of COVID-19.[1] Some stakeholders have already provided initial comments on how they consider we should calculate the final costs (the "true-up"). This call for input provides stakeholders with an opportunity to provide further comments to inform our planning and future work.

We are seeking written comments by **30 March 2021**.

Context

On 2 February 2021, we published a decision (our February 2021 decision) to introduce an adjustment in the default tariff cap to account for the estimated additional bad debt[2] as a result of COVID-19.[3] This was an initial estimate, which we referred to as a float. This decision related to the additional costs incurred in cap periods four to six (April 2020 to September 2021).

[1] Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation.
https://www.ofgem.gov.uk/publicationsand-updates/reviewing-potential-impact-covid-19-default-tariff-capseptember-2020-policy-consultation
Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation.
https://www.ofgem.gov.uk/publications-andupdates/reviewing-potential-impact-covid-19-default-tariff-cap-november2020-consultation
[2] In line with the terms used in our February 2021 decision, bad debt is the unrecoverable debt that suppliers write off. We use the term 'debt-related costs' to include debt-related administrative costs and costs of working capital, as well as bad debt.
[3] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap.
https://www.ofgem.gov.uk/system/files/docs/2021/02/decision_on_the_potential_impact_of_covid-19_on_the_default_tariff_cap.pdf

We said that we would adjust this initial estimate to reflect the final costs once they are fully known (a true-up). We are starting to consider our approach to the true-up, in order to inform our planning and future work.

Before our February 2021 decision, we consulted twice. These consultations were focussed on the immediate adjustment – i.e. the float. However, many of the same concepts are relevant to setting both the float and the true-up. We have therefore already covered many of the issues relevant to the true-up through our previous consultations. In response to these consultations, some stakeholders have already provided some comments on the true-up as well as the float.

This call for input therefore follows on from our previous consultations. It is an opportunity for stakeholders to provide further information and comments, which will feed into our development of the true-up.

We are considering separately whether a float is required for cap period seven (October 2021 to March 2022). This is a separate consultation process. We intend to engage with stakeholders separately on that issue.

Areas for comment

The overarching issue is how to design the true-up for the COVID-19 adjustment in the default tariff cap. This is the subject of this call for input.

There are many different design elements which feed into the true-up design. Our previous consultations and our February 2021 decision already describe many of the design elements for setting a COVID-19 adjustment, so this section provides a high-level reminder of the elements covered there. For more information on these issues, please refer to the previous documents (especially the November 2020 consultation and the February 2021 decision). For ease of reference, the section below follows the same overall structure as the February 2021 decision.

In this section, we also mention some particular aspects where we are especially interested in initial views – for example, to inform our planning.

We welcome any comments on how to design the true-up, including any comments on the areas mentioned below. We also welcome views on whether there are additional key areas that we should be considering as part of our design work.

Overarching considerations

For the **scope** of our work on the true-up, we intend to maintain our position from the float of only considering the costs incurred from serving domestic default tariff customers.[4]

We will need to consider our approach to **disclosure** for any true-up proposals. This area would be particularly relevant towards the end of our work on the true-up (e.g. at the final consultation stage). However, we still welcome any initial comments in this area as they may help with our planning – e.g. to understand the timescales that may be required. We note that any disclosure process will need to have appropriate safeguards around commercially sensitive information. In our previous work on the smart metering allowances in the cap, we have managed this through the use of undertakings, and by disclosing certain information to suppliers' external advisers (rather than to suppliers directly).

Cross-cutting considerations

We will need to consider **which allowance to use** to perform the true-up. However, as indicated in our February 2021 decision, we are strongly minded to use the existing adjustment allowance in the cap.[5]

We will need to consider issues related to the **timing of the review** (i.e. the timing of the true-up).

- This includes considering which cap periods should be in scope for the first true-up. We could carry out a true-up for cap period four[6] alone, or for several cap periods at once. This choice could have an impact on when we would be able to start the true-up process. If we true up more cap periods at once, it is likely that we would need to start the true-up process later.
- One aspect for timing is data availability – we discuss this in relation to the data source below.
- We would also need to consider the period over which to recover the true-up. If we implemented a true-up over a period shorter than one year, we would need to consider how to account for demand and time weighting in the adjustment.
- We will need to consider whether it is appropriate to consider any costs incurred from timing differences between costs and the allowance, and how to account for

[4] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 2.1. https://www.ofgem.gov.uk/system/files/docs/2021/02/decision_on_the_potential_impact_of_covid-19_on_the_default_tariff_cap.pdf

[5] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 3.13. https://www.ofgem.gov.uk/system/files/docs/2021/02/decision_on_the_potential_impact_of_covid-19_on_the_default_tariff_cap.pdf

[6] Cap period four was the first cap period in relation to which we have set a float adjustment.

changes in the number of default tariff customers over time. For each of these issues, in principle, we could consider both the time between the original costs and the float, and also the time between the float and the true-up.

We will need to consider the approach to **benchmarking efficient costs**. A key issue is whether to use a lower quartile benchmark (as for the float) or another option. To help with our planning, we particularly welcome any views on whether there is analysis (which we can practically carry out) which would help to inform our consideration of the extent to which variation in suppliers' additional costs arising from COVID-19 is due to efficiency, or other factors such as company policy and customer mix. We may also need to consider the extent to which variation in how customers are affected by COVID-19 beyond customer mix could lead to variation in outcomes between suppliers – or whether this would largely be averaged out at a supplier level. We will also need to consider: whether to continue assessing additional costs as the increment since 2019, whether to calculate individual benchmarks for each cap period, and whether to set the benchmark based on domestic customers in general (or instead whether to take into account tariff type and/or payment method).

We will need to consider whether we should apply a **sharing factor** (or other similar mechanism) before calculating the amount to recover. Under this approach, suppliers would bear some of the additional costs due to COVID-19. We welcome views from stakeholders on whether suppliers should be able to recover all of the additional COVID-19 costs, and if not, what would be the appropriate share for customers to pay.

Once we have determined what the costs are, we will need to consider how to **allocate costs between customers**. This includes allocation between: payment types, fuels, single-register and multi-register electricity, and the standing charge and unit rate. We particularly welcome comments on what principles we should use for allocation between payment types. This is complex because customers can move between payment types, and because debt-related costs are paid by customers who are paying their bills (rather than by the customers who are unable to pay their bills).

Impact on debt-related costs

We will need to consider what **data source** to use.

- We would like to understand what data would provide us with sufficient clarity on the final debt-related costs for COVID-19. In particular, for bad debt costs, we would like to understand what constitutes an appropriate measure of the final costs that suppliers will incur. This includes considering whether there is a suitable existing category from suppliers' accounts that we can use (e.g. bad debt written off) or whether we will need to develop a bespoke definition. We also welcome any comments on whether the bad debt charge could be relevant to calculating the true-up, given that suppliers will update the provision for doubtful debts over time.

- We also welcome any views on which bad debt should be in scope. We could focus on the bad debt incurred in relation to consumption during a given cap period (e.g. unpaid bills for consumption during cap period four). Alternatively, we could also take into account changes in the amount of debt from previous cap periods that becomes bad debt in a given cap period, relative to previous expectations. This alternative would take into account that COVID-19 may have affected recovery of existing debts. A supplier would have had a stock of debt from previous cap periods at the start of cap period four. Even without COVID-19, the supplier would already have expected that some of this stock of debt would become bad debt. However, the supplier's expectation for the proportion of existing debt which would become bad debt might have changed during cap period four.
- Under any approach, we would need to use a consistent definition between the baseline period and the period where we were carrying out the true-up. For example, if we were only looking at the new debt which was incurred in relation to consumption during cap period four, we would only look at the new debt which was incurred in relation to consumption during the baseline period.
- The data source used is likely to affect when we can gather data, and therefore when we can carry out a true-up. Some data might not be available in time for us to carry out analysis, consult, and take a decision in time for implementation in cap period eight (April 2022). To help us with planning, we particularly welcome comments on when data would be available.
- When considering data sources, we also welcome comments on how we could ensure that data was robust and verifiable.

We will need to consider **which debt-related costs to include** in a true-up adjustment. These could be the costs of working capital and bad debt administrative costs, as well as the bad debt estimates that we included in the float. We decided not to include an adjustment for the costs of working capital and bad debt administrative costs in the float, because of the poor quality of the data we received.[7] We therefore particularly welcome comments on how we could improve the quality of any data we gather in these areas. For working capital, this includes considering which is the best metric to use, such as the amount of working capital, or an alternative approach such as debtor days. We also

[7] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 4.29. https://www.ofgem.gov.uk/system/files/docs/2021/02/decision_on_the_potential_impact_of_covid-19_on_the_default_tariff_cap.pdf

welcome comments on what definitions we could use to gather comparable data across suppliers.

We will also need to consider the detailed **methodology** for any true-up adjustment. This includes how to calculate the increment (since whichever year we select as the baseline), and which customer account numbers to use to calculate the cost per customer account.

Prepayment meter customers

The question is **whether to make an adjustment** for customers with prepayment meters – especially in relation to additional discretionary credit or administrative costs. We welcome any comments on how we could gather robust data on the final costs in these areas.

Impact on other cost allowances in the cap

In our February 2020 decision, we concluded that no adjustments were necessary for the **non debt-related cost components** of the cap. However, we said that we would continue to monitor the impacts of COVID-19 on these costs.[8] We will consider any evidence that we receive from stakeholders on these costs. However, we would consider the need for any adjustment in the round, including taking into account any areas where costs have decreased.

Next steps

We welcome any further comments on the approach to the true-up, particularly the areas mentioned above.

- Some stakeholders may have chosen to focus their comments in response to previous consultations on the float – this call for input allows them to provide views on the true-up. (If a stakeholder's previous comments apply to the true-up as well as the float, but this was not explicit previously, then they can provide a short response confirming that we should take their previous representations into account for the true-up as well).
- Other stakeholders have provided some comments on the true-up – this call for input allows them to provide additional comments. We will consider comments in response to this call for input alongside those comments stakeholders have already

[8] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 6.1. https://www.ofgem.gov.uk/system/files/docs/2021/02/decision_on_the_potential_impact_of_covid-19_on_the_default_tariff_cap.pdf

made on the true-up. Stakeholders therefore do not need to resubmit the same comments that they have already explicitly made in relation to the true-up.

We welcome any written comments by **30 March 2021**. Please send any comments to retailpriceregulation@ofgem.gov.uk. Please include detail and supporting evidence in your comments wherever possible. As part of your comments, please explain how any suggested approaches would be deliverable in practice.

We are also keen to speak to stakeholders to hear views on how we should develop the approach to the true-up. If you would like to arrange a call, please contact us through retailpriceregulation@ofgem.gov.uk. We are happy to speak either before or after you submit written comments.

There will be further opportunities for stakeholders to provide input as our work progresses. Once we have considered comments from stakeholders and continued to develop our own thinking, we will draw up plans for further stakeholder engagement. We are therefore not providing an illustrative timetable at this stage.

If you have any questions, please contact us using: retailpriceregulation@ofgem.gov.uk.

Yours faithfully,

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