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Consultation

Reviewing the potential impact of COVID-19 on the default tariff cap: cap period seven working paper			
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Response deadline:	13 April 2021	**Email:**	retailpriceregulation@ofgem.gov.uk

This working paper is part of the consultation process. We are consulting on whether a float for cap period seven to adjust the default tariff cap to account for the impacts of COVID-19 is necessary, and if so, whether we should include any additional filters on the data we collect or implement a sharing factor before calculating the amount to recover from customers. We would like views from people with an interest in the level of the default tariff cap. We particularly welcome responses from suppliers and consumer groups. We would also welcome responses from other stakeholders and the public.

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

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Executive summary

The default tariff cap (the cap) protects default tariff customers by limiting the amount they can be charged for their gas and electricity. We set the level of the cap to reflect the cost to suppliers of supplying this energy. In our February 2021 decision[1], we concluded that the COVID-19 pandemic had resulted in additional costs for suppliers – specifically debt-related costs arising from domestic default tariff customers – that were material and not allowed for through the existing cap methodology. We therefore included an allowance for some of these costs in the cap period six level (which starts on 1 April 2021).

We noted the uncertainty of 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. We decided to err on the side of caution when setting the allowance to avoid customers unduly bearing the risk of the cost uncertainty. We set the adjustment using an initial estimate of these costs (a float) which was deliberately conservative in favour of customers for cap periods four to six. This will subsequently be adjusted to reflect efficient final costs once they are fully known (the true-up).

Whether a float for cap period seven is necessary

We consider that there is significant uncertainty whether an adjustment for debt-related COVID-19 costs for cap period seven (October 2021 to March 2022) is needed. On the one hand, the economy is likely to be growing during that period, while unemployment would be on a downward trajectory from its forecast peak in last quarter of 2021.[2] On the other hand, COVID-19 is likely to have reduced customers' financial resilience and unemployment is predicted to be higher than in 2020, in particular as the government furlough scheme[3,4] will close at the end of September, which could increase the likelihood of some customers being unable to pay their bills. We will only set a float if we have significant and clear evidence that shows suppliers are likely to incur material additional costs due to COVID-19. We would like

[1] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, executive summary.
https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap
[2] OBR (2021), Economic and fiscal outlook, March 2021. Chart 2.14.
https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/
[3] When we refer to the government furlough scheme, we mean the Coronavirus Job Retention Scheme (CJRS).
[4] This includes both the furlough scheme and the scheme for self-employed workers.

stakeholders' views on whether or not additional debt-related costs are likely to be incurred in cap period seven and, therefore, whether a float is necessary.

Float options

We are considering two options for calculating the float, if we conclude one is required. The first option would be to follow the same methodology as we have used to set the float described in our February 2021 decision. The second option would be to amend that methodology to include additional filters before including suppliers' forecast costs in our sample. For example, we would scrutinise each supplier forecast methodology before including their forecast costs in our sample. We are also considering whether to implement a sharing factor before calculating the amount to recover from customers.

We seek stakeholders' views on whether we should maintain the same methodology from our February 2021 decision or whether to add these filters. We would also welcome views on what filters would be appropriate to apply. In addition, we would welcome views on whether we should consider other changes (beyond those discussed in this working paper).

Prepayment meter customers

We are also revisiting the need for an adjustment for the prepayment meter (PPM) additional costs due to COVID-19. In our February 2021 decision we said we did 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 are therefore considering whether an adjustment for PPM is necessary. We are collecting debt-related costs for PPM for cap periods four to seven through our request for information (RFI). When analysing the data, we propose to follow a similar approach to the one we use for credit meter customers in this paper.

We are seeking your views, in particular, on whether a float is necessary for PPM costs for cap periods four, five, six, or seven and your views on what changes in methodology should be considered when calculating an adjustment for PPM costs.

Going forwards

We invite stakeholder views and supporting evidence on any aspect of this working paper by **13 April 2021**. Stakeholders' responses will inform a further consultation on our substantive proposals, which we intend to publish in May 2021.

1. Introduction

What are we consulting on?

1.1. This working paper sets out our initial thinking on whether we should adjust the default tariff cap (the cap) to account for the potential impacts of the COVID-19 crisis in cap period seven (October 2021 – March 2022), and if so, how we should calculate it.

1.2. In our February 2021 decision,[5] we concluded that the COVID-19 pandemic had resulted in additional costs – specifically debt-related costs – that were material and not allowed for through the existing cap methodology for credit customers in cap periods four to six. We 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 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 efficient final costs once they are fully known (the true-up).

1.3. In our February 2021 decision, we also said we intended 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.[6] This working paper is the first step on the consultation process for this review.

1.4. This working paper sets out our initial thinking on whether a float is required for cap period seven given the latest forecasts on the economic recovery in 2021 as societal restrictions are eased. We also summarise the data and information we are collecting. We describe the two options to calculate the float if needed, whether we follow the same methodology as we have used to set the initial floats for cap periods four to six, or whether to introduce additional filters to suppliers' forecast costs before including them in our sample. We also note that we are considering whether to introduce a sharing factor before calculating the amount to recover from customers.

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

[6] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, 1.16 and 3.37. https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

1.5. This working paper also sets out the steps we intend to follow to assess whether there are any material additional costs that are not accounted for in our methodology for prepayment meter (PPM) customers. We summarise how we intend to analyse the data we are collecting from suppliers to make this assessment. We also set out our proposal to follow a similar methodology for calculating any PPM additional costs related to COVID-19 as used for credit costs.

1.6. This working paper is split into four chapters:

- Chapter 1 explains the purpose of this working paper, provides background on the cap and our February 2021 decision, and outlines our consultation process.

- Chapter 2 summarises the current forecasts on the economic impact of COVID-19 in cap period seven and sets out the different factors that we could consider on whether a float is needed.

- Chapter 3 outlines the options we have to calculate a float for cap period seven, if we need to do so, and describes the data we are collecting through a mandatory request for information (RFI).

- Chapter 4 discusses the COVID-19 related costs for PPM customers, and how we will analyse whether there has been a material increase in PPM costs.

The default tariff cap (the cap)

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

1.8. In August 2020, we decided to introduce a PPM level in the cap to protect default tariff PPM customers beyond the expiry of the Competition and Markets Authority’s (CMA)

PPM cap.[7] As a consequence, since 1 January 2021, the default tariff cap also protects around 4 million households with PPMs on default tariffs.

1.9. We set the cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act). The objective of the Act is to protect current and future default tariff customers. We consider protecting customers to mean that prices reflect underlying efficient costs. In doing so, we must have regard to four matters:[8]

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

1.10. The cap comprises several allowances, each relating to different costs categories. We update the level of each allowance every six months, to reflect changes in the underlying costs.

1.11. The Act requires that we set one cap level for all suppliers.[9]

[7] Ofgem (2020), Decision on protecting energy consumers with prepayment meters. https://www.ofgem.gov.uk/publications-and-updates/decision-protecting-energy-consumersprepayment-meters
[8] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6). http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[9] Domestic Gas and Electricity (Tariff Cap) Act 2018; section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted

Related publications

1.12. The main documents relating to the cap are:

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

1.13. The Reviewing the potential impact of COVID-19 on the default tariff cap:

- February 2021 Decision on the potential impact of COVID-19 on the default tariff cap: https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap.
- 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.

Consultation stages

Working paper

1.14. This working paper sets out our initial thinking. We invite stakeholders to submit comments on any aspect of this working paper on or before 13 April 2021.

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

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

May consultation

1.17. Subject to the responses we receive and the continuing development of the impact of COVID-19 on the industry, we intend to publish an additional consultation in May 2021. We expect that consultation to last around four weeks.

Decision

1.18. We seek to publish a decision at the beginning of August 2021, so that any changes will have effect from 1 October 2021 (the cap period seven).

How to respond

1.19. We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

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

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

Your response, data and confidentiality

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

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

1.24. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 1.

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

General feedback

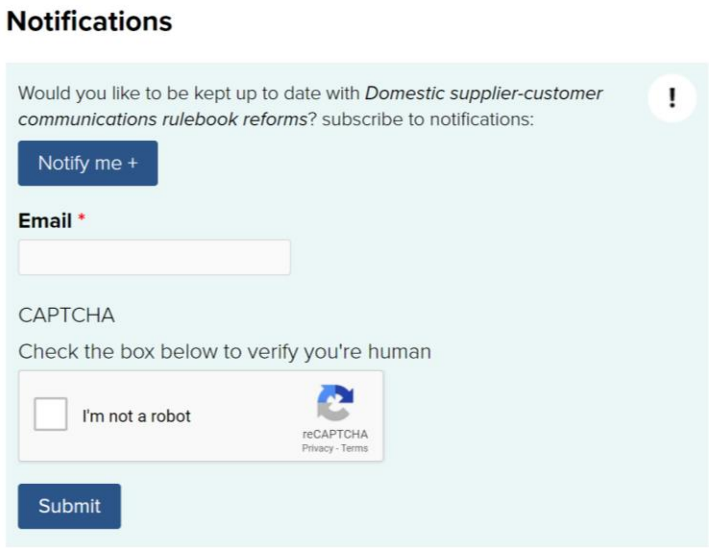
1.26. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

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

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

How to track the progress of the consultation

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



2. Need for additional adjustment for cap period seven

Chapter summary

It is uncertain whether the economic impact of COVID-19 will persist into cap period seven. We review recent external forecasts available on the likely economic impact of COVID-19 in that period and discuss the limitations on developing a position based on information and data we have for now. We would like to seek stakeholders' views, in particular, on the appropriate economic metrics to use to assess whether or not an adjustment for additional costs for cap period seven is necessary.

Summary

2.1. In this chapter, we discuss the uncertainties of how the COVID-19 crisis will evolve and how it is uncertain whether an adjustment for additional COVID-19 costs for cap period seven is needed based on the available information. We then outline the economic metrics we have used to assess whether a float for cap period seven is necessary at this stage. We intend to continue to err on the side of caution when setting the allowance to avoid customers unduly bearing the risk of the cost uncertainty for the reasons set out in our February 2021 decision.[10]

Uncertainty

Context

2.2. We will need to make a decision on whether there are likely to be material additional debt-related costs of COVID-19 in cap period seven, and whether to include an allowance in the cap level which will be announced in August 2021.

[10] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, see the executive summary for the summary of those reasons.
https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

2.3. It is uncertain at this stage whether material additional debt-related COVID-19 costs will be incurred in cap period seven, and, as a result, whether an adjustment will be necessary.

2.4. In our February 2021 decision, we said that the economic effects of COVID-19 could persist into cap period seven, especially as at the time of the publication, it appeared they would last throughout cap period six. Given the timings required for data gathering, analysis and consultation, we expected that we would need to start the process of conducting a review for cap period seven over the first half of 2021.[11]

Considerations

2.5. There is significant uncertainty over how long the economic disruption of the COVID-19 crisis will last. The speed of the anticipated economic recovery in 2021 (after easing of restrictions) depends on a variety of factors including the continued ability to manage COVID-19 outbreaks and vaccinate the population,[12] how quickly customer spending recovers, the effects of government policies to support the economy and how fast the overall economy grows later in 2021. In terms of an adjustment for additional COVID-19 costs for cap period seven, we need to consider how this uncertainty of economic recovery translates into customers' financial resilience and ability to pay their bills.

2.6. The unprecedented nature of both COVID-19 and the restrictions required to mitigate it, and the complex interactions between the two, mean that it is difficult to predict how and when the economy will recover. As a result, we have seen several updates of the economic forecasts as circumstances change. We discuss these forecasts in detail in the section below.

2.7. This also applies to the uncertainties of the impact on individuals' financial resilience. The risk of bad debt arises when customers are unable to pay their bills. The changes in the number of people in financial difficulty (e.g. customers in debt) will be an important indicator to assess whether a float for cap period seven is needed. However, there are

[11] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 1.16 and 3.37.
https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap
[12] Details please see the UK Government's roadmap out of lockdown, four tests.
https://www.gov.uk/government/publications/covid-19-response-spring-2021/covid-19-response-spring-2021-summary. The devolved administrations in Scotland and Wales have their own roadmap plan to lift societal restrictions.

interactions between the different elements, for example the end of the government furlough scheme and when restrictions will be lifted. This makes any forecast subject to significant cumulative uncertainty.

2.8. Due to these uncertainties on the extent and speed of the economic recovery in 2021, it is unclear whether suppliers will incur material additional debt-related costs as a result of COVID-19 in cap period seven. As a result, it is less clear whether an adjustment will be necessary.

2.9. We intend to continue to err on the side of caution when considering whether there are material additional costs as a result of COVID-19 and, if necessary, when setting the additional allowance. This is to protect customers' interests. We will only propose an adjustment for cap period seven if there is significant and clear evidence that suppliers are likely to incur material additional costs due to COVID-19.

2.10. Considering the need for an adjustment for additional COVID-19 costs is only relevant to the extent that these additional costs are large. We continue to expect suppliers to manage ordinary variations in actual costs from forecasts, which can both increase and decrease costs compared to the allowance.[13] We also continue to expect that small changes (increasing and/or decreasing efficient costs) could be covered by existing uncertainty allowances and prudent assumptions in the cap methodology.[14] We need to consider whether the impact of COVID-19 on suppliers' debt-related costs in cap period seven is still beyond what we would expect the cap methodology to take account of.

2.11. We seek stakeholders' views on the uncertainties mentioned in this subsection, as well as information that would enable the review of whether material additional COVID-19 costs will persist into cap period seven.

[13] Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation, paragraph 2.8.
https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation
[14] Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation, paragraph 2.11.
https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation

Economic metrics

Context

2.12. In our February 2021 decision,[15] we noted that unemployment and the effect on customers' ability to pay could outlast the more immediate COVID-19 disruption. We also noted that due to the impact of COVID-19, the unemployment rates were projected to increase significantly relative to both the baseline year used to set the operating cost allowance in the cap (2017) and the first year the cap was in operation (2019). We would expect debt-related costs to also increase as a consequence.

Considerations

2.13. We have reviewed the recent external information available on the likely economic impact of COVID-19 and economic forecasts. We set out the information we collected in the following sub-sections.

2.14. We consider the information available provides a mixed outlook for the UK economy for the periods between the last quarter of 2021 and the first quarter of 2022, during cap period seven. On one hand, the UK economy is expected to rebound in the second half of 2021. On the other hand, the unemployment rate is expected to remain higher than the pre-COVID level in 2021 and 2022.

2.15. When deciding whether to introduce a float for cap period seven, we intend to consider the evidence on the expected growth in the economy, the outlook of the labour market and customers' financial resilience, as well as their inherent uncertainty. This is in addition to our assessment of suppliers' forecasts of additional COVID-19 costs discussed in Chapter 3. We discuss these three factors below. In particular, we seek stakeholders' views on how best to incorporate these forecasts to form a view in determining the need for an adjustment for cap period seven.

[15] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 4.5. https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

Economic outlook

2.16. We intend to use the economic forecasts from the Bank of England, the Office of Budget Responsibility (OBR) and HM Treasury to inform our view on the expected recovery of the economy.

2.17. The latest reports from the Bank of England, OBR, and HM Treasury survey show a positive economic outlook by the end of 2021, when a float for cap period seven would be implemented.

2.18. In February 2021, HM Treasury surveyed investment banks, economic research organisations, and other institutions for their GDP forecasts.[16] Its survey showed an average GDP growth forecast of 4.3 % for 2021 and 5.8 % for 2022.[17]

2.19. The Bank of England[18] also predicted that GDP would recover rapidly towards pre-COVID levels over 2021.[19] It projected a GDP growth forecast of 5% for 2021 and 6.5% for 2022. It predicted the economy would regain its pre-COVID size by the first quarter of 2022.[20] It noted that the rate at which households spend their savings could have a bearing on the rate of economic recovery.[21]

2.20. OBR's forecast, published at the same time as the Budget in March 2021, also showed a similar trend of economic growth as the Treasury's survey and the Bank of England's forecasts. Its March Economic and Fiscal Outlook report predicted a GDP growth

[16] HM Treasury (2021), Forecasts for the UK economy: a comparison of independent forecasts, February 2021
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/962029/Forecomp_February_2021.pdf
[17] These forecasts predate the Budget announcement, which extended government COVID-19 support schemes.
[18] The Bank of England (2021), Monetary Policy Report - February 2021.
https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2021/february/monetary-policy-report-february-2021.pdf
[19] These forecasts predate the Budget announcement, which extended government COVID-19 support schemes.
[20] Please note this report was published before government March Budget, so their assumptions were based on furlough scheme would close at the end of March 2021.
[21]The Bank of England, Speech given by Gertjan Vlieghe at the Durham University on Monday 22 February 2021.
https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/february/an-update-on-the-economic-outlook-speech-by-gertjan-vlieghe.pdf?la=en&hash=4D50354F53FDA4D035082B9B1A844A6B134212D1

forecast of 4% for 2021 and 7.3% for 2022. The OBR expects that GDP will regain its pre-pandemic level in the second quarter of 2022.[22]

2.21. The latest March Budget confirms the continuation of the government furlough scheme in its current form until the end of June 2021 and returning to a similar level of protection in place last summer from then until the end of September. It also confirms further income support for the self-employed, maintaining an increase to universal credit, as well as support for businesses. The measures in the Budget, particularly the extension of the furlough scheme, are likely to provide further support to the labour market and the wider economy.[23]

2.22. More external information will become available by the time of our final consultation in May. We will need to consider the extent this materially changes any forecasts published to date.

Labour market

2.23. COVID-19 has had a significant impact on the labour market. Data from Office for National Statistics (ONS) Labour Force Survey showed the unemployment rate continued to increase, from the pre-COVID level of 4% for January to March 2020 to 5.1% for October to December 2020, while the employment rate continued to fall.[24] However, there were signs that COVID-19's impact on the labour market may be beginning to plateau, with two consecutive (December 2020 and January 2021) monthly increases for people who were on payroll employment and continued increases in the level of vacancies and working hours.[25]

[22] OBR (2021), Economic and fiscal outlook, March 2021. Paragraph 1.3 and table 1.1.
https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/
[23] HM Treasury (2021), Budget 2021. Paragraph 1.2.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966161/Budget_2021_Web_accessible.pdf
[24] ONS (2021), Labour market overview, UK: February 2021.
https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/uklabourmarket/february2021
[25] However, the increase in total hours worked and the number of job vacancies slowed down in November 2020 to January 2021 due to the November lockdown.
ONS (2021), Labour market overview, UK: February 2021.
https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/uklabourmarket/february2021

2.24. In the latest March forecast, OBR expected unemployment to peak at 6.5% (2.2 million) in the final quarter of 2021, after the furlough scheme[26] ends in September 2021.[27] That is both lower and later than the 7.5% (2.6 million) in the second quarter that OBR expected in its November forecast, when the furlough scheme was expected to end at the end of March 2021. It is also lower than the 7.2% unemployment it predicted in November for Q4 2021.[28] The OBR also projected that[29] the unemployment rate would fall to 6.3% for Q1 2022.[30] This is again lower than its November forecast of 7.0% for the same period. Therefore, we could expect a moderate increase in unemployment in cap period seven as a consequence of the extension of the furlough scheme to September.

2.25. In its February 2021 report, the Bank of England expected that there would remain a material degree of spare capacity (the unemployment rate is a key indicator of spare capacity) in the economy in the very near term, which would be eliminated as demand recovered.[31] The unemployment rate was projected to peak at around 7.75% in the middle of 2021 as the job support scheme was assumed to unwind as set out in government plans at the time. Unemployment subsequently was expected to decline gradually over the forecast period. The long-term equilibrium unemployment rate was projected to return to the pre-COVID level in 2023.[32]

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[26] The Budget extends the CJRS in full until the end of June and in a similar form to what was in place last summer between then and the end of September.
[27] OBR (2021), Economic and fiscal outlook, March 2021. Paragraph 2.74. https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/
[28] OBR (2021), Economic and fiscal outlook, March 2021. Chart 1.6. https://obr.uk/download/march-2021-economic-and-fiscal-outlook-charts-and-tables-executive-summary/
[29] OBR (2021), Economic and fiscal outlook, March 2021. Chart 2.14. https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/
[30] OBR (2021), Economic and fiscal outlook, March 2021. Chart 1.6. https://obr.uk/download/march-2021-economic-and-fiscal-outlook-charts-and-tables-executive-summary/
[31] These forecasts predate the Budget announcement, which extended government COVID-19 support schemes.

2.26. The HM Treasury February 2021 survey[33] also included forecasts of unemployment in the UK.[34] The average of the forecasts suggested that unemployment would be 6.6% in Q4 2021 and would fall by 1 percentage point by Q4 2022 to 5.6%.

2.27. The extension of the furlough scheme means that it will remain in operation beyond the point at which the UK Government's Roadmap envisages all but a minimal degree of public health measures being removed. The OBR predicts that most of the shortfall in output relative to pre-pandemic levels over the next six months will result in in lower average hours and higher government borrowing rather than higher unemployment.[35]

2.28. We will not have any further updated unemployment forecasts from the OBR when we consult in May 2021. However, other external information will become available by that time. We will need to consider the extent this materially changes any forecasts published to date.

Financial resilience

2.29. The unemployment rate is only one of the indicators of customers who may be under financial pressure. This is because trends in unemployment do not necessarily indicate whether more customers will become unable to pay their energy bills over time (e.g. given that financial pressures can build up over time to employed and furloughed customers). Therefore, we also seek to collect and consider evidence on the financial resilience of customers in order to determine the need for a float for cap period seven.

2.30. There is evidence that COVID-19 has not impacted people and society equally. This evidence suggests that COVID-19 is having a disproportionate impact on the most vulnerable. Recent research has found that those with precarious employment, aged under 30, and from minority ethnic groups faced the biggest labour market shocks.[36]

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[33] HM Treasury(2021), Forecasts for the UK economy: a comparison of independent forecasts, Feb 2021 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/962029/Forecomp_February_2021.pdf
[34] These forecasts predate the Budget announcement, which extended government COVID-19 support schemes.
[35] OBR (2021), Economic and fiscal outlook, March 2021. Paragraph 2.72. https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/
[36] Low et.al. The heterogeneous and regressive consequences of COVID-19: Evidence from high quality panel data, Journal of Public Economics, 193(2021). https://doi.org/10.1016/j.jpubeco.2020.104334

2.31. Low-income households have not been able to build any financial resilience (on average) during the COVID-19 pandemic. Research on households' savings rate suggests that households with income in the bottom, 2nd and 3rd decile have not accumulated any savings through the crisis.[37] Almost half of the population have experienced declines in household earnings of at least 10%, but declines are most severe in the bottom pre-pandemic income quintiles.[38] We could expect that these low-income households would have low financial resilience in 2021 or even in 2022. According to our 2019 consumer survey, around 40% of customers with low incomes (under £16k) were on standard variable tariffs at that time.[39] However, we do not know yet how COVID-19 has impacted on the proportion of low income customers on standard variable tariffs and whether this would lead to an increase in bad debt costs.

2.32. The Financial Conduct Authority's (FCA) financial lives 2020 survey also indicated that the COVID-19 pandemic has led to considerable financial impacts for many, and more hardship was anticipated. [40] FCA's panel survey showed COVID-19 has had a profound impact on adults' financial situations and has reversed the downwards trend in vulnerability and low financial resilience.[41] By October 2020, there was an increase of 3.5 million people with low financial resilience compared to February 2020.[42]

2.33. We have also carried out polling of domestic energy consumers to understand the impact of COVID-19 social distancing on domestic energy consumption, financial wellbeing and the concerns of energy consumers around managing bills. In the October 2020 update,[43] concern about paying energy bills or energy supply held steady between May and

[37] Hamish Low, University of Oxford, The economic impact of COVID-19 across different households. GES presentation
[38] Low et.al. The heterogeneous and regressive consequences of COVID-19: Evidence from high quality panel data, Journal of Public Economics, 193(2021). https://doi.org/10.1016/j.jpubeco.2020.104334
[39] Ofgem (2020), Consumer survey 2019. Data table 634. https://www.ofgem.gov.uk/publications-and-updates/consumer-survey-2019
[40] FCA (2021), Financial Lives 2020 survey: the impact of coronavirus, February 2021. https://www.fca.org.uk/publication/research/financial-lives-survey-2020.pdf
[41] FCA (2021) defines all consumers are at risk of becoming vulnerable (and hence at greater risk of harm), particularly if they display characteristics of vulnerability to do with poor health, a life event, low resilience or low capability.
[42] FCA (2021), Financial Lives 2020 survey: the impact of coronavirus, February 2021. https://www.fca.org.uk/publication/research/financial-lives-survey-2020.pdf
[43] Ofgem (2020), Consumers' experiences with energy during the Covid-19 pandemic. October 2020. https://www.ofgem.gov.uk/system/files/docs/2020/11/consumer_experiences_during_the_covid_19_pandemic_october_update.pdf

October 2020. Around one in five consumers were worried about paying bills or their supply and a third of PPM customers were worried about topping up.

2.34. Citizens Advice’s December 2020 report[44] also estimated that 2.1 million households were behind on their energy bills at the time of the publication, 600,000 more than in February 2020.

2.35. We are running the Ofgem polling survey again in late March, which should provide us with additional information on customers financial resilience. We intend to continue monitoring the polling result of domestic energy customers’ concerns around managing bills and financial wellbeing.

2.36. While we intend to consider the effect that financial resilience has on the need for a float for cap period seven, we recognise that most of the information available relates to the financial resilience of customers at the time of the publication rather than a forecast. Therefore, we will have to make assumptions on how the forecasted economic growth, the outlook of the labour market and our data collected via a RFI will affect customers’ financial resilience (ability to pay bills) for October 2021 to March 2022. This increases the uncertainty on the need for a float for cap period seven.

2.37. We seek stakeholders’ views in particular on any other source of data on financial resilience that would help inform our assessment. We recognise that any reduction in financial resilience could both increase the potential risk of customers incurring bad debt, and affect our view on whether it was appropriate to set a float which would be an additional cost to customers. We would also welcome stakeholders’ views on how much weight to place on the available financial resilience indicators when deciding whether a float for cap period seven is needed.

[44] Citizens Advice (2020), Recovery, or Ruin? The role of accessible support in helping energy consumers through the crisis, December 2020 https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Recovery%20or%20ruin%20%281%29.pdf

3. Options for calculating the adjustment

Chapter summary

If there is a need for an adjustment allowance (a float) for cap period seven, we are proposing two options for calculating the float. The first option replicates the analysis we conducted which set the initial float in cap period six. The second option applies additional filters when determining whether a suppliers' estimate of costs for cap period seven should be included in the sample which is used to calculate the float.

Summary

3.1. This section outlines the two options we are considering using to calculate any adjustment needed for cap period seven for credit customers. We are considering to either:

- apply the same methodology we used for setting the initial float in cap period six; and
- amend the methodology to include additional filters on suppliers' estimates of costs that are included in our sample.

3.2. For both options we are basing our assessment on data we are collecting through mandatory RFIs to suppliers. We discuss this in the data section below.

3.3. We intend to maintain the majority of the methodological features in the float for cap period six. In this working paper, we focus the discussion on the possible proposed changes. For further information on our initial methodology, please review our February 2021 decision.[45]

[45] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, Chapters 3 and 4.
https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

3.4. In our Call for Input[46] on the true-up we ask for stakeholder input on whether we should apply a sharing factor before calculating the amount to recover. We are also considering if a sharing factor would be appropriate for the float in cap period seven. Under this approach, suppliers would bear some of the additional costs due to COVID-19.

3.5. We discuss the data and methodology for PPM customers in Chapter 4.

Methodology

Context

3.6. In our February 2021 decision, we said that if we need to set a float for cap period seven, we intended to broadly follow the same methodology as we have used to set the initial floats for cap periods four to six.[47]

Considerations

Options

3.7. We consider that suppliers' forecasts continue to provide the best available data source for the additional COVID-19 debt-related costs. This is because suppliers are looking directly at these costs and will have their own experiences of factors that impact their own portfolios.

3.8. We are currently considering two main options to use suppliers' forecasts in the event that we need to set a float for cap period seven. The options are:

- apply the same methodology we used for setting the initial float in cap period six; and

[46] Ofgem (2021) Price Cap – Call for input on the true-up process for COVID-19 costs, cross-cutting considerations.
https://www.ofgem.gov.uk/publications-and-updates/price-cap-call-input-true-process-covid-19-costs
[47] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 3.37.
https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

- amend the methodology to include additional filters on suppliers' estimate of costs that are included in our sample.

3.9. We are also considering whether to implement a sharing factor before calculating the float for cap period seven. This is the same consideration that we are seeking stakeholders' views in our Call for Input for the true up.[48]Under this approach suppliers would bear some of the additional costs due to COVID-19.

Option 1 - same methodology

3.10. If we need to set a float for cap period seven, we consider that taking the existing methodology as the starting point to assessing additional COVID-19 related costs on a float for cap period seven for credit customers would be appropriate and whether they are material. We have already made a recent decision on how to calculate a float for cap periods four to six.[49] We have consulted extensively with stakeholders and addressed stakeholders' responses in our November 2020 consultation and February 2021 decision. Therefore, we consider it is appropriate not to make significant changes to the methodology used in calculating a float.

3.11. At this stage, we do not intend to amend our methodology to consider the split of bad debt by payment methods. This is because we do not consider this additional level of complexity is proportionate given that the float itself is based on a conservative (on behalf of customers) estimation of the bad debt costs suppliers incurred. Therefore, we are not convinced that including this additional complexity at the float is appropriate.

3.12. Nevertheless, we are collecting the estimated bad debt charge split by payment methods in order to further consider this point. We would not seek to include such a split in any of the options unless doing so would materially improve our ability to assess bad debt costs across suppliers, and if we have confidence that the data collected represents bad debt

[48] Ofgem (2021) Price Cap – Call for input on the true-up process for COVID-19 costs, cross-cutting considerations.
https://www.ofgem.gov.uk/publications-and-updates/price-cap-call-input-true-process-covid-19-costs
[49] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, chapters 3 and chapter 4.
https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

from customers' original payment methods (i.e. the payment method where the debt was incurred, rather than customers' current payment methods).

3.13. We are collecting data on working capital costs and debt-related administrative costs again through our RFI. In our February 2021 decision, we did not include working capital costs and debt-related administrative costs in the float for cap periods four to six. We said that we did not have confidence that the RFI data collected was consistent between suppliers. In addition, taking the data at face value did not show a material cost to suppliers.[50] If similar issues arise this time, we will focus on calculating a float for bad debt costs for cap period seven and not include working capital costs and debt-related administrative costs in the calculation. We would then consider these costs in the true-up process.

Option 2 - additional filters

3.14. In our option 2, we would propose to amend the methodology to include additional filters[51] on suppliers' estimate of costs that we collected. Given the underlying uncertainty on the need for a float for cap period seven, we would seek to avoid using forecasts when we have concerns that they may not represent reasonable estimates of the likely additional COVID-19 costs that suppliers will incur. This means, we propose to remove these suppliers' unreasonable forecasts from the sample that we use to benchmark costs.

3.15. There could be several reasons why suppliers' forecasts do not represent reasonable estimates of the likely additional COVID-19 costs. Suppliers may have based their debt-related costs forecasts on out-of-date economic indicators and information. This could overestimate or underestimate the amount of debt-related costs these suppliers are likely to incur as a result of COVID-19. In comparison with other suppliers in our RFI sample[52], some suppliers may also have an overly simplistic methodology that does not appropriately reflect the underlying uncertainty on the COVID-19 related costs. There may also be an incentive on suppliers to have a higher estimate of the debt-related costs. This is because some

[50] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 4.2. https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap
[51] In our original methodology, while we assessed the quality of the data for errors, we did not assess the methodology used to calculate those estimates or compared it with macroeconomic forecasts or other non-forecasted data.
[52] We explain our RFI sample in the Data section below.

suppliers may want to err on the side of caution and not underestimate the impact of COVID-19 on their businesses. If we apply the same methodology, there is a risk that an over inflated sample will lead to an excessive float. As a result, suppliers could over recover their efficient costs and customers would pay more than a fair price for the energy they consume.

3.16. We recognise that different suppliers may forecast their debt-related costs differently and that the underlying uncertainty will lead to forecasts that may differ to some extent. However, we consider suppliers should make reasonable assumptions when forecasting costs. We also consider these assumptions should be updated when major events appear, for example, the extension of the furlough scheme.

3.17. We propose to scrutinise each supplier's forecast methodology before including its forecast costs data in our sample. We intend to check whether the assumptions underpinning suppliers' forecast costs are updated and reasonable (compared to the economic metrics we discussed in Chapter 2). We intend to assess whether any inconsistency on their forecasts is justifiable. We also intend to consider the consistency of the supplier's forecast with the stock of debt older than six months held by the supplier.[53] We propose to exclude any forecast data that we do not deem reasonable in order to produce a meaningful estimate for the float.

3.18. We would like stakeholders' views in particular on whether we should maintain the same methodology from our February 2021 decision or whether to include these additional filters. We also seek stakeholders' views on what filters would be appropriate on a supplier's forecast costs before we include these costs data in our sample.

Sharing factor

3.19. We have launched a Call for Input to provide stakeholders with an opportunity to provide further comments on the true-up.[54] In that document, we are asking stakeholders views on whether suppliers should be able to recover all of the additional COVID-19 costs,

[53] Suppliers face more difficulty in collecting debt as it ages. Six months serve as a proxy for this additional collectability difficulty.
[54] Ofgem (2021) Price Cap – Call for input on the true-up process for COVID-19 costs, cross-cutting considerations.
https://www.ofgem.gov.uk/publications-and-updates/price-cap-call-input-true-process-covid-19-costs

and if not, what would be the appropriate share for customers to pay. A sharing factor would share the economic impact of COVID 19 between customers and suppliers.

3.20. We are also considering whether it would be appropriate to apply a sharing factor at the float stage. This discussion of a potential sharing factor is separate from our benchmarking exercise, which aims to establish a conservative estimate on behalf of customers of the efficient level of costs incurred by suppliers.

Data

Context

3.21. In our February 2021 decision, we said that we would seek further information from suppliers through an RFI[55] to inform our review on whether a float is required for cap period seven and the design of the float if needed.

3.22. On 25 February 2021, we sent RFI requests to suppliers with at least a 1% market share in any fuel in the domestic market segment. Suppliers are required to submit the price cap addendum RFI on 17 March 2021 and 12 May 2021.

Considerations

Working capital costs and debt-related administrative costs

3.23. In our February 2021 decision, we did not include working capital costs and debt-related administrative costs in the float for cap periods four to six. We said that at the time we did not have confidence that the RFI data collected was consistent between suppliers. In addition, taking the data at face value did not show a material cost to suppliers.[56]

3.24. We are collecting data on working capital costs and debt-related administrative costs through our RFI. We have asked suppliers to provide their baseline data (monthly actual

[55] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 1.16 https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap
[56] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 4.2. https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

data from January 2019 to March 2020) and forecast data (monthly forecasts for October 2021 to March 2022) for these costs.

3.25. In our February 2021 decision, we noted the comments from stakeholders about considering breakdown debt-related costs by tariff types and payment methods, as stakeholders who commented wanted us to benchmark costs separately by payment methods. We said that we would consider these issues further when developing our data gathering approach for the true-up.[57] We intended to collect this data for cap period seven, and included the split by tariff types and payment methods in the draft version of the RFI we sent to suppliers. However, we have removed the tariff type and payment method breakdowns for working capital costs and debt-related administrative costs in the mandatory RFIs. We did this as most suppliers who commented on the draft RFI said they were unable to provide the tariff types and payment methods breakdown for these costs.

Bad debt charge

3.26. We are collecting the bad debt charge data from January 2019 to March 2022. We are asking for an extended period of data for the purpose of analysing whether an adjustment is necessary for PPM customers for cap periods four to seven. We discuss the PPM costs in Chapter 4. We do not intend to use this data for the true-up, which is following a separate consultation process.

3.27. We are collecting the bad debt costs that are broken down by payment methods.[58] This is because suppliers mentioned payment methods as a customer base factor could affect debt-related costs, in responding to our November 2020 consultation.[59] We intend to gather this data to consider this issue.

[57] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 3.107, 3.108.
https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap
[58] Direct Debits (DD) and Standard Credit (paid on receipt of a bill, PORB) and PPM.
[59] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 3.84.
https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

3.28. We are also aware that customers move between payment methods over time. We would like to understand the payment methods on which the cost was incurred (rather than the customers' current payment methods).

3.29. We also considered gathering this data split by tariff types. We asked stakeholders for their views as part of our draft RFI. Again, most respondents provided representations that they could not provide this data split by tariff types. Therefore, we have removed this request from our RFI.

May RFI data

3.30. In responding to our draft RFI, suppliers raised concerns on submitting the RFI data every month. We are now asking for two submissions of the RFI data, one on 17 March and the other on 12 May. We intend to design our float if needed based on the first data submission. The second submission will be for the purpose of providing additional context for our decision on whether a float is necessary for cap period seven alongside our continued monitoring of economic forecasts. We are making no commitment at this stage as to whether or not we would use the May data as part of the calculation of any float.

4. Prepayment meter customers

Chapter summary

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

We seek stakeholders' views on our considerations in general.

Summary

4.1. In this section we discuss the COVID-19 debt-related costs for PPM customers, and we consider how we will analyse whether there has been a material increase in these PPM costs.

4.2. We do not view credit (including emergency, friendly hours, and discretionary credit) provided to customers to be a cost in itself if customers repay this credit. The costs incurred by the supplier are the costs of working capital for the credit provided providing the credit and the write-off cost of the credit if customers do not repay it. We still consider that suppliers are better placed than customers to manage cash flow risk as with set out in our February 2021 decision.[60]

4.3. We are proposing to keep the debt-related costs for PPM customers separate to credit. This is because we consider it much harder for a PPM customer to incur debt. If a PPM customer does incur debt, it is unlikely to be as much as the amount a credit customer can accrue over time due to the different payment structure and the ability to access to credit for PPM customers.

4.4. We consider that there has not been a material increase in the debt-related costs for PPM suppliers due to the COVID-19 pandemic. However, we are collecting data and intend

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[60] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 5.15.
https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

to analyse it to see if there is significant and clear evidence of material additional costs as a result of COVID-19:

- if there is no significant and clear evidence of material additional costs, we will not make any adjustment for PPM; and
- if there is significant and clear evidence of material additional costs, we will consider if a float is necessary, and if it is, we will propose to follow a similar methodology to that used for credit for a PPM adjustment.

4.5. We are considering the bad debt charge for PPM customers over cap periods four to seven. However, we will only have data for working capital and debt-related administrative costs for cap period seven for all domestic customers and not split by payment method. This is because most suppliers who responded to our draft RFI said that they were unable to provide a breakdown of this data by payment method, limiting the value of collecting this additional data. If a supplier can provide a breakdown by payment methods of their working capital and debt-related administrative cost for cap periods four to seven, then please provide the data with your response to this working paper. If providing data, please also include a baseline of these costs as described in this chapter.

4.6. If we decide a float is necessary, we will consider whether the cost recovery should be spread over multiple cap periods to avoid a bill shock during the winter months for customers. This is consistent with our conservative approach when setting the initial float to protect customers.

Additional PPM debt-related costs due to COVID-19

Context

4.7. In August 2020, we decided to continue protecting PPM customers using the default tariff cap and set a specific cap level for PPM to ensure 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.[61]

4.8. In our February 2021 decision, we decided not to adjust the PPM cap level in the default tariff cap for 1 April 2021. We considered that the evidence at that time of publication indicated that the effects of COVID-19 on the costs of supplying PPM customers were limited. We, however, did note that we intended to revisit this during our next review, and would make a decision based on additional or updated evidence.[62]

Considerations

Which cap periods to include for the assessment

4.9. We consider that it would be appropriate to consider all COVID-19 cap periods so far (four to seven) in our PPM assessment. However, as noted in paragraph 4.5 above, we will have data to consider the bad debt costs for cap periods four, five, six, and seven, while we will only have data for cap period seven for assessment of any working capital and debt-related administrative costs.[63]

4.10. Our analysis will compare these periods against a baseline year, which will allow us to see if there has been any material increase in debt-related costs for PPM customers due to the COVID-19 pandemic to inform our decision.

4.11. Based on our previous assessment for the February 2021 decision, at this stage we do not consider the extra costs for PPM customers to be material.[64] Therefore, we do not consider that there will be any material additional costs to be allocated to customers. However, if there is significant and clear evidence that there are material additional costs to PPM customers due to the COVID-19 pandemic, then we will consider if a float is necessary.

[61] 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
[62] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraphs 5.4. and 5.5. https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap
[63] As noted above, depending on the amount of data that stakeholders provide us on PPM costs for earlier periods, we may consider whether it is possible to assess earlier cap periods.
[64] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 5.4. https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

If it is, we propose to apply a similar methodology as used for setting the float for credit customers.

4.12. Any float adjustment will only be included within the cap level for PPM if there is significant and clear evidence that the efficient cost of supplying PPM customers has materially risen due to COVID-19. We do not commit now to including a float for PPM and will wait until we have analysed the data.

PPM costs only

4.13. Since PPM customers pay for their energy in advance rather than in arrears, we consider that it is much harder for them to incur a debt in comparison to credit customers.[65] As such, we will be considering PPM and credit separately due to the fundamentally different structure of these payment methods.

4.14. We deem that it would not be fair for PPM customers to pay for the additional debt incurred by credit customers, when it is much harder for PPM customers to incur debt in the first place in comparison to the debt levels credit customers can accrue over time. Therefore, we have requested that the data provided under our RFI reflects the payment method where the debt was incurred. It is important that this is the case in order to give confidence that any float, if necessary, fairly reflects these costs to customers.

4.15. When considering an adjustment, this would only cover the incremental costs from COVID-19 (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) for PPM customers.

4.16. If there is significant and clear evidence of material additional costs which need to be recovered by suppliers from the earlier cap periods of COVID-19 (i.e. cap periods four to six), then we will consider whether we should do this through a float, or whether it would be more appropriate to consider these costs as part of the true-up process. If we do set a float,

[65] For credit customers who pay by direct debit, the timing of payments will vary between suppliers. Some direct debit customers will pay in advance. The difference is that all PPM customers will pay in advance, whereas this will only apply to a proportion of credit customers.

we will consider whether the cost recovery should be spread over multiple cap periods to avoid bill shocks in the winter for customers.

Sharing factor

4.17. Please see the discussion of the sharing factor in Chapter 3. Our current view is that we should apply a sharing factor to the PPM adjustment if it is adopted for credit.

Bad debt charge

4.18. In our November 2020 consultation, we said that we expect to focus on bad-debt costs resulting from additional discretionary credit and debt-related administrative costs during our new review.[66] In this review we have requested, as part of our RFI, data on the bad debt charge and debt over six months old, both broken down by payment type. This will allow us to identify whether there is significant and clear evidence of material additional bad debt as a result of suppliers providing discretionary credit during the COVID-19 pandemic, rather than just the discretionary credit granted.

4.19. When suppliers provide PPM customers with this extra credit, it is possible that a proportion of the credit provided will not be repaid and has to be written-off as a result. This is the main source of bad debt incurred by PPM customers. It is possible for there to be an increased amount of additional credit not repaid due to COVID-19, causing an increase in bad debt. However, we consider this is likely to be relatively small amount when compared to credit customers' bad debt costs where a customer is able to build up debt over a longer period of time.

4.20. If customers access emergency/ friendly-hours or discretionary credit, they generally have to repay it or at least some of it when they top up. Moreover, if customers do not

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[66] Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation, paragraph 5.5.
https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-november-2020-consultation

repay their credit facility, they risk self-disconnecting from their energy supply.[67] This limits the amount of arrears and debt a PPM customer can build up.[68]

4.21. We consider that it is likely that the government furlough scheme has helped customers to maintain their payments throughout the pandemic. This means the risk of additional credit not being repaid is low even if suppliers have provided customers with additional credit facilities during the COVID-19 pandemic.

4.22. We consider that there has not been an increase in costs for PPM suppliers because of the COVID-19 pandemic, but we will review if this is an appropriate consideration when we receive extra data through our RFI. This will allow us to analyse whether there has been a material increase in costs for PPM or not.

4.23. We are considering the additional bad debt charge over the whole pandemic (cap periods four to seven) for PPM as we have requested a breakdown of the bad debt charge by payment method.

Working capital and debt-related administrative costs

4.24. If some PPM customers do not repay debt quickly or are unable to repay the extra credit, this could lead to debt-related administrative costs and additional working capital.

4.25. We consider that if the increase in the amount of debt relating to PPM customers is material, then there could be additional working capital and debt-related administrative costs because of the COVID-19 pandemic.

4.26. We considered requesting data for PPM customers on debt-related administrative costs and working capital. This would have enabled us to consider whether there were any additional costs specific for PPM customers. However, most suppliers that responded to our draft RFI noted that they did not hold this information. Because of this, we have only requested data on the additional working capital and debt-related administrative costs for

[67] Self-disconnection is defined as an interruption to the supply because the credit on the meter has been exhausted or the credit is not easily accessible.
[68] Ofgem has introduced new measures to require suppliers to offer emergency credit to pre-payment meter customers. See here: Ofgem (2020), Self-disconnection and self-rationing: decision. https://www.ofgem.gov.uk/publications-and-updates/self-disconnection-and-self-rationing-decision

cap period seven. However, if a stakeholder can provide a breakdown by payment methods of their working capital and debt-related administrative cost for cap periods four to seven, then please provide this data with your response to this working paper. If providing data, please also include a baseline of these costs as described in this chapter.

Methodology

Context

4.27. In our February 2021 decision, we decided not to adjust the PPM cap level and said that we intended to revisit it during our next review based on additional or updated evidence.[69] We are now revisiting the PPM cap level in this review and considering whether an adjustment for PPM will be necessary.

Considerations

4.28. We are considering two methodology options:

- we will make no adjustment for PPM if there is no significant and clear evidence that there has been a material increase in efficient costs due to the COVID-19 pandemic;
- we will consider if a float is necessary, and if it is, we will propose to follow a similar methodology to that used for credit if there is significant and clear evidence that there has been a material increase in the efficient costs due to the COVID-19 pandemic.

Option 1

4.29. We expect that there has not been a material increase in the efficient costs for PPM suppliers due to the COVID-19 pandemic. If this is true, then we will not make an adjustment for PPM.

[69] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, paragraph 5.5. https://www.ofgem.gov.uk/publications-and-updates/decision-potential-impact-covid-19-default-tariff-cap

4.30. However, we will still use the data we are collecting as a sense check to ensure that there has not been an increase in the debt-related costs for PPM.

Option 2

4.31. If, based on the data, we consider that there has been a material increase in the efficient debt-related costs for PPM, then we will consider whether an adjustment is necessary or not.

4.32. If we decide that a float is necessary, then we propose to adopt a similar methodology for calculating any PPM additional costs related to COVID-19 as used for credit.

Bad debt charge

4.33. We are considering the additional bad debt charge over cap periods four to seven. We will apply either option 1 or option 2 as described above. We will use bad debt data for PPM customers.

Working capital and debt-related administrative costs

4.34. At this stage, we will not be able to separate the additional debt-related administrative costs or working capital for PPM as the data will not be broken down by payment types. However, as mentioned in paragraph 4.26, we would consider other cap periods for these costs if we receive sufficient data from stakeholders on PPM costs for cap periods four to six, as well as an appropriate baseline.

4.35. We recognise that the amount of working capital and the debt-related administrative costs for PPM customers is likely to differ from the requirements for credit customers. We are considering how to reflect those differences in any float we set given the absence of the breakdown by payment methods of this data. We welcome stakeholders' views on how best to reflect the working capital and debt-related administrative costs for PPM customers. We will need to be confident that any float for working capital and debt-related administrative costs fairly reflects the costs to serve PPM customers before deciding to introduce this adjustment.

Data

4.36. At this stage we have requested data from suppliers with at least 1% market share in any fuel in the domestic market segments, through a mandatory RFI.

4.37. The RFI is due to be returned to us on 17 March 2021 and the data we receive from this request will allow us to analyse and consider if an adjustment is needed for the PPM cap.

4.38. In our previous voluntary RFI used for the February 2021 decision, we requested data without a granular breakdown.

Bad debt charge

4.39. We are collecting data on the bad debt charge and debt over six months old broken down by payment methods within the RFI. This will allow us to analyse PPM costs separately. We requested this data for cap periods four to seven with a baseline period (monthly actual data from January 2019 to March 2020).

Working capital and debt-related administrative costs

4.40. We are collecting data on working capital and debt-related administrative costs through our RFI. This data we have requested is for cap period seven with an additional baseline period (monthly actual data from January 2019 to March 2020). This is not broken down by payment methods. Most suppliers who responded to our draft RFI said that they were unable to provide this information broken down by payment methods.

Next steps

4.41. We will wait for the RFI data before deciding whether an adjustment for PPM is needed for cap periods four to seven.

4.42. We welcome stakeholders' views on whether an adjustment is necessary for PPM for cap periods four to seven.

Appendix 1 – Privacy notice on consultations

Personal data

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

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

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

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

2. Why we are collecting your personal data

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

3. Our legal basis for processing your personal data

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

3. With whom we will be sharing your personal data

We may share consultation responses with BEIS.

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

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

5. Your rights

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

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete

- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 0303 123 1113.

6. Your personal data will not be sent overseas.

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

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

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