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Dear Karen,

PRICE CAP CONSULTATION – REVIEWING THE POTENTIAL IMPACT OF COVID-19 ON THE DEFAULT TARIFF CAP: CAP PERIOD SEVEN

Thank you for the opportunity to comment on proposals to update the default tariff cap methodology to account for the impact of COVID-19 in cap period 7.

In its February 2021 decision, Ofgem decided to spread some of the 'float' for COVID-related costs arising in Periods 4 and 5 into the COVID allowance for Period 7, with the possibility that this Period 7 allowance might be topped up to reflect additional COVID-related costs arising in Period 7. Based on its analysis of responses to an RFI issued on 25 February, Ofgem is now proposing not to provide any additional top-up to the Period 7 allowance in respect of Period 7 costs. In analysing this RFI data Ofgem has modified its previous methodology for estimating 'float' in two key ways: inclusion of additional filters to assess whether a supplier's forecast should form part of Ofgem's sample and the introduction of a sharing factor to equally share the impact of the additional COVID-19 costs between suppliers and customers.

We offer the following comments on Ofgem's proposed approach (with more detail in Annex 1):

a) We are disappointed that Ofgem has not modified its approach as we have previously suggested, so that it assesses suppliers' bad debt provisions on a cumulative basis (ie from Period 4 onwards) rather than on a per-period basis. Ofgem's approach risks systematically under-stating the overall LQ costs due to timing differences between suppliers in when they make their provisions.

b) We disagree with the decision to filter suppliers' data. The application of filters will require judgement, and it is unclear how Ofgem will apply these filters in a manner that ensures consistency and transparency, and avoids undermining trust in the fairness of Ofgem's approach.

c) Ofgem's optimistic stance on the economic outlook is wholly inconsistent with the stance in its 'winter commitments' initiative where it is seeking commitments from suppliers to provide additional protection to customers over Winter 2021/22. We would be concerned if Ofgem were to use conflicting arguments to ask suppliers to provide more support to consumers for a temporary period but also to justify not allowing recovery of any additional costs incurred.

d) We disagree with Ofgem's proposal to introduce a sharing factor into its methodology. It is not appropriate for a cost-recovery mechanism such as the price cap, where suppliers are recovering efficiently incurred costs. Supply sector finances have become even more precarious with the recent increases in wholesale energy costs, and it would not be in the interest of consumers to see further supplier insolvencies.

Please do not hesitate to contact me if you have any questions arising from this response.

Yours sincerely,

Richard Sweet
Head of Regulatory Policy

<u>Annex 1</u>

PRICE CAP CONSULTATION – REVIEWING THE POTENTIAL IMPACT OF COVID-19 ON THE DEFAULT TARIFF CAP: CAP PERIOD SEVEN – SCOTTISHPOWER RESPONSE

1. Introduction

We comment below on the following points in Ofgem's consultation.

- additional filters on suppliers' estimates of costs
- inconsistent assessments of economic outlook
- sharing factor

2. Additional filters on suppliers' estimates of costs

Ofgem proposes to use the following additional filters on suppliers' estimates of the costs that are included in its sample:

- completeness and comparability between the baseline period and the relevant cap period
- appropriateness of the supplier's forecast methodology
- reasonableness and up to date assumptions underpinning the supplier's forecast costs
- appropriate justification for any inconsistency in the supplier's forecasts
- consistency of supplier's forecast with the stock of debt older than six months held by the supplier
- comparability of the supplier's forecasts with other suppliers' forecasts.

Ofgem considers that applying additional filters will ensure that supplier data used within the float model is consistent and not based on out-of-date assumptions. In addition, Ofgem believes this will reduce the incentive for a supplier to provide data which is overly pessimistic in respect to the current economic climate.

The application of these filters will require judgement and it is unclear how Ofgem can apply these filters in a manner that ensures consistency. It sets a precedent that lacks transparency and risks undermining trust in the fairness of Ofgem's approach.

We think Ofgem over-states the risk that suppliers will provide overly pessimistic data in order to game the process. In responding to a mandatory RFI suppliers will need to ensure that their forecasts are internally consistent with forecasts used for management accounts and updates to shareholders and investors – where there may be an opposite incentive to take a relatively optimistic view. It is likely that their forecasting methodology will also be subject to review by external auditors.

Without a more comprehensive explanation of how it proposes to apply these filters, Ofgem's approach remains opaque. For instance, Ofgem has not explained how it would adequately control for differences between suppliers, such as mix of payment methods and tariff types.

Therefore, we do not support the introduction of additional filters.

3. Inconsistent assessments of economic outlook

In support of its proposals Ofgem gives a relatively upbeat assessment of the economic outlook over the period October 2021 to March 2022:

> "Current evidence shows a positive economic outlook for cap period seven. The economy is forecast to grow at a faster rate in cap period seven. In addition, unemployment is expected to remain broadly stable and no longer to peak during this period. Our evidence on the financial resilience of customers does not contradict the broader economic metrics."[1]

It is difficult to reconcile this upbeat assessment with Ofgem's recent paper calling for suppliers to provide additional support to customers over Winter 2021/22 where Ofgem says:

> "We recognise there is a significant amount of uncertainty about what will happen this winter, but with many of the COVID-19 support schemes expected to end in the coming months there is a likelihood that unemployment will rise. The Office for Budget Responsibility (OBR) expects unemployment to peak at 6.5% (2.2 million) in the final quarter of 2021, with latest figures suggesting 1.6 million people are currently unemployed. The £20 a week Universal Credit uplift is also due to end in September 2021, whilst the number of claimants is simultaneously expected to rise. These developments create an increased risk of consumers getting into (or further into) debt on their household bills."[2]

Although Ofgem's Winter 2021/22 paper came two weeks after Ofgem's consultation, the sources it cites are mainly from March 2021, the same as would have been available to the consultation. We would be concerned if Ofgem were to use conflicting arguments to justify asking suppliers to do more to support customers for a temporary period of time, but also to not allow the recovery of the costs to suppliers of doing so.

4. Sharing factor

If a float is needed, Ofgem proposes to implement a sharing factor to any calculated incremental cost ahead of converting the cost increment into a cap adjustment. Under this approach, suppliers would share equally the additional costs due to COVID-19 with customers.

Ofgem's reasons for the inclusion of a sharing factor are as follows:
- to ensure that the float is conservative
- to ensure that customers and suppliers share the burden of the additional costs of the pandemic
- to create incentives on suppliers to lower these costs.

The concept of a sharing factor to achieve these goals is relevant when Ofgem sets a financial target for licensees (such as in price controls or incentive schemes) but not in a cost-recovery mechanism where suppliers are simply recovering efficiently incurred costs.

As we noted in our response to the March working paper, supply sector finances continue to be precarious - and we believe they are likely to have deteriorated further in light of recent wholesale price increases (on which we have written separately to Ofgem). We do not believe

[1] Price Cap consultation – Reviewing the potential impact of COVID-19 on the default tariff cap period seven (page 5)
https://www.ofgem.gov.uk/publications-and-updates/price-cap-consultation-reviewing-potential-impact-covid-19-default-tariff-cap-cap-period-seven
[2] 'Voluntary agreement with the energy industry to support domestic consumers in winter 2021/22', Ofgem,1 June 2021

it would be in the interest of consumers to see further supplier insolvencies and we would oppose the introduction of a sharing factor that limits the recovery of efficiently incurred costs.

ScottishPower
June 2021