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Dear Leonardo

Price Cap – Consultation on the true-up process for COVID-19 costs

Thank you for the opportunity to respond to your consultation on the true-up process for COVID-19 costs.

We are disappointed that Ofgem has decided not to analyse the costs incurred for SVT customers as proposed in its November 2021 consultation. Instead Ofgem has adopted a flawed methodology which averages across all credit customers and fails to take account of the fact that the proportion of credit customers paying by standard credit (SC) is much higher for SVT than for all credit customers. This approach is inconsistent with previous Ofgem treatment of debt costs in the price cap and substantially under-estimates COVID-related bad debt costs. As a result, the true up amount will not properly reflect the cost to serve SVT customers.

We set out our critique of Ofgem's proposed approach Annex 1, but in summary, we have identified three key areas where Ofgem has significantly under-estimated costs:

1. failure to take account of SC:DD payment method mix for SVT customers in calculation of bad debt costs;

2. failure to take account of SC:DD payment method mix for SVT customers in calculation of working capital costs;

3. failure to give proper consideration to the appropriate cost of borrowing in setting the allowance for working capital costs.

We have asked our advisers NERA to estimate the impact on SVT bad debt costs of controlling for payment method mix and we expect them to submit their report to Ofgem shortly. We have also asked NERA to draw to Ofgem's attention any other methodological issues and/or errors in Ofgem's approach they may identify.

Ofgem should recalculate the true-up in a way that correctly reflects actual COVID-related costs incurred for SVT customers and set an appropriate allowance in Periods 9 and 10 for recovery of these costs. Ofgem's proposed adoption of *inter alia* such a flawed methodology is, in ScottishPower's assessment, clearly challengeable.

We welcome the fact that Ofgem has given suppliers the option of paying for advisers to analyse the confidential data on which its calculations were based. However, we are concerned that this may have led Ofgem to provide less detail on non-confidential aspects of its methodology than would have been reasonable to expect. We would urge Ofgem to provide full disclosure of such non-confidential information in future consultations.

Finally, we note that Ofgem's current approach to recovery of bad debt costs results in competitive distortions between suppliers, as a result of smearing SC costs across all credit customers. We welcome Ofgem's commitment to review the bad debt allowance more generally in light of rising energy bills and the cost of living crisis, but it should not regard the approach it has taken to date as a precedent. Instead it should consider ways to allow cost recovery to better reflect actual costs incurred, for example by means of a levy mechanism and redistribution.

Yours sincerely,

Richard Sweet
Head of Regulatory Policy

Annex 1

PRICE CAP – CONSULTATION ON THE TRUE-UP PROCESS FOR COVID-19 COSTS – SCOTTISHPOWER RESPONSE

1. Introduction

We set out below our analysis of three key aspects of Ofgem's true-up calculations where we believe Ofgem has very significantly under-estimated costs:

a) failure to take account of SC:DD payment method mix for SVT customers in calculation of bad debt costs

b) failure to take account of SC:DD payment method mix for SVT customers in calculation of working capital costs

c) failure to give proper consideration to the appropriate cost of borrowing in setting the allowance for working capital costs.

The assessment of materiality in this Annex is based on ScottishPower data, but we have asked our advisers NERA to estimate the impact of controlling for payment method mix taking into account all suppliers' data, and we expect NERA to submit their report to Ofgem shortly. We have also asked NERA to draw to Ofgem's attention any other methodological issues and/or errors they may identify.

2. Failure to take account of payment method mix for SVT customers in calculation of bad debt costs

Our primary concern with Ofgem's proposed approach to the true-up is that it has decided not to analyse the costs incurred for SVT customers, contrary to its proposals in its November 2021 consultation. Instead, it has simply calculated costs averaged across all credit customers, and has failed to control for the higher proportion of customers paying by standard credit (SC) in the non-prepayment standard variable tariff (SVT) segment than in the non-prepayment fixed term contract (FTC) segment.

Treatment of bad debt costs in original price cap design

In its original price cap design, Ofgem determined baseline opex costs based on suppliers' costs of serving DD customers. Ofgem then estimated the additional cost to serve SC customers relative to DD and allowed for recovery of these additional costs via separate uplifts for SC and DD customers. The reason for splitting the allocation between SC and DD, rather than allocating all to SC, was to keep the DD-SC price differential similar to pre-price cap market levels. This necessitated smearing 48% of the additional SC costs over SC and DD. This is illustrated in Table 1 below which reproduces Table A8.3 from Ofgem's decision document.[1]

[1] 'Default Tariff Cap: Decision, Appendix 8 - Payment method uplift', Ofgem, 6 November 2018, www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf

Table 1: 'Table A8.3: Breakdown of uplift figures for a dual fuel customer'

Cost Element	Additional Cost	Approach	Uplift to SC	Uplift to DD	Difference
Working capital	£21	Fully allocate to standard credit	£21	£0	£21
Bad debt	£56	Allocate 52% to standard credit and spread the remaining 48% over both payment methods	£37	£9	£28
Admin costs	£40	Allocate 52% to standard credit and spread the remaining 48% over both payment methods	£27	£7	£21
Working capital adjustment			-£5	-£5	£0
Total	**£117**		**£80**	**£11**	**£69**
Total (including EBIT and VAT)	**£125**		**£86**	**£12**	**£74**

In smearing the 48% of costs across DD and SC, Ofgem took into account the average proportion of non-prepayment SVT customers paying by SC of circa 35%:

> "2.41. We spread the costs between the direct debit and standard credit caps using an assumed percentage of customers using each payment method. We refer to this as the assumed customer base. For the assumed customer base, we use the average proportion of non-prepayment default tariff customers paying by standard credit in 2017: 33.7% for gas and 35.9% for electricity."[2]

Hence the amount of bad debt uplift smeared across SC and DD was £56*48%*35% = £9. An additional £56*52% = £29 was allocated to SC, giving a total uplift for SC of £9+£29=£37, after rounding (as shown in Table 1).

The key points to take from this approach are that:

- Ofgem recognised that bad debt costs are significantly higher for SC than for DD and estimated the bad debt costs for SC and DD separately, so that it could control for the mix of SC customers in non-prepayment SVT and allocate some of these costs to the price cap uplift for SC.

- In smearing the costs across SC and DD, Ofgem applied a weighting of 35% to SC costs, reflecting the 35% mix of the SC payment method amongst non-prepayment SVT customers. (It did not use the much lower SC mix that would have applied for credit customers in aggregate, which is effectively what Ofgem is proposing to do for COVID-related bad debt).

- Had Ofgem decided to smear SC working capital costs across SC and DD, it is reasonable to assume that it would have employed the same weighting of 35%.

As explained below, Ofgem should follow these principles in its approach to the true-up of COVID related debt costs (bad debt and working capital).

[2] Ibid, para 2.41

ScottishPower's previous submissions on methodology

In our responses to previous Ofgem consultations on this matter we have always been clear about the importance of controlling for the payment method mix:

- "We are concerned that Ofgem may be underestimating the importance of understanding (and adjusting for) differences between payment method and tariff type. Our analysis of ScottishPower data shows that bad debt per customer on SC is almost twice as high for customers on default tariffs as for customers on non-default tariffs, and we see no reason why similar trends would not be observed in other suppliers."[3]

- "There is a huge difference in debt cost per customer between standard credit and direct debit. It is essential that Ofgem controls for this in calculating the benchmark and adopts an appropriate weighting based on the SVT payment mix"[4]

- "we agree with Ofgem's proposals to […] investigate how additional bad debt costs vary with payment type and tariff type and set the adjustment allowance accordingly"[5]

As Ofgem notes in the present consultation (para 5.49), it said in its November 2021 consultation that it intended to carry out our benchmarking using data on default tariff customers only: "This is because the cap applies to default tariff customers, and so we are most interested in the additional COVID-19 costs related to customers under the cap. This would have addressed concerns from suppliers about default tariff customers being more likely to incur debt than fixed tariff customers."

Had Ofgem adopted this approach, it would not have been necessary to control for the payment method mix for SVT, since this would have automatically been reflected in Ofgem's calculations. If, as Ofgem is now proposing, it abandons this approach and instead carries out its benchmarking using data for all credit customers, it becomes essential to control for payment method, since otherwise the true up amount will not properly reflect the cost to serve SVT customers.

Reasons for controlling for payment method mix

Given the importance of this matter, it is helpful to reiterate the reasons for controlling for payment method mix (in the absence of robust data broken down by tariff type). As Ofgem acknowledges (see quotation above), where the cost of serving SVT and FTC customers is different, the cost allowance in the price cap should reflect the cost of serving SVT customers (and not the average cost of serving SVT and FTC customers).

In a competitive market, the price of FTC tariffs will reflect the costs of serving FTC customers (not the average cost of serving SVT and FTC), and it is not possible for suppliers to cross-subsidise SVT costs from FTC revenues. The tariff cap act requires Ofgem to have regard to the need for suppliers to finance their licensed activities. If the cost of serving SVT

[3] ScottishPower response to 'Consultation on reviewing the potential impact of COVID-19 on the default tariff cap', 12 October 2020
[4] ScottishPower response to 'Reviewing the potential impact of COVID-19 on the default tariff cap: November 2020 consultation', 21 December 2020.
[5] ScottishPower response to 'Price Cap – Consultation on the true-up process for COVID-19 costs',17 December 2021

customers is higher than FTC, this must be reflected in the price cap allowance. (Equally, if SVT costs were lower than FTC, the requirement to protect consumers would also oblige Ofgem to base the allowance on SVT costs).

As explained above, this principle was implicit in Ofgem's approach to the original price cap design, where it set the uplift for SC based on the percentage of SC customers in the SVT segment (approximately 35%) not the percentage of SC customers in SVT and FTC in aggregate (which would have been much less than 35%).

It also appeared to have been accepted in Ofgem's September 2020 policy consultation which said (paragraph 2.3):

> "Although suppliers will have incurred COVID-19 related costs of supplying fixed tariff and non-domestic customers, we are not considering these costs here. These costs are not relevant to the efficient cost of supplying domestic default tariff customers, and it would not protect default tariff customers to bear the costs of other customer groups".

Ofgem's justification for not controlling for payment mix

Ofgem justifies its decision not to control for payment method mix as follows:

> "We were unable to gather tariff type breakdown data [for] all debt-related costs in an accurate and consistent manner across suppliers. We therefore consider that our next best option is to benchmark based on suppliers' entire domestic customer bases."[6]

> "Our proposal to take a weighted average benchmark means that we do not need to control for the difference in impact that each payment method has on additional debt-related costs (unlike if we were proposing to use a lower quartile benchmark)."[7]

We disagree that benchmarking across suppliers' entire domestic customer base is the 'next best option'. The approach we are proposing is entirely feasible and gives a much more accurate result.

We also disagree that the decision to take a weighted average benchmark means that it is not necessary to control for payment method related differences. This is based on flawed logic. If there were no systematic difference in payment method mix between SVT and FTC, with the only differences being between individual suppliers, then adopting a weighted average approach would avoid the need for controls that might otherwise be required for a LQ approach. But the issue here is that the SVT and FTC segments of the market have different payment method mixes, and that difference needs to be controlled for.

Estimated impact of controlling for payment method mix

Without access to individual supplier data, we cannot estimate exactly the impact of controlling for payment method mix. However, as an indication of the likely materiality, we have estimated the impact based on ScottishPower data.

As shown in Table 2, taking an average across all ScottishPower credit customers (SVT and FTC), the COVID bad debt cost is £[✂] per SC customer and £[✂] per DD customer. Using

[6] Condoc para 5.50
[7] Condoc para 5.55

Ofgem's approach which does not control for differences in payment method mix, the weighted average cost is based on the [✂] mix of SC:DD across all credit customers and is equal to £[✂]. If instead we control for the payment method mix and use the SC:DD mix of [✂] for SVT credit customers[8], the weighted average cost increases to £[✂], a 78% uplift. (The equivalent cost for FTC is only £[✂]).

Table 2: Impact of controlling for payment method mix on COVID-related bad debt cost (ScottishPower data)

	COVID bad debt cost per customer (TDCV, DF)	FTC credit [✂]%	SVT credit [✂]%	All credit
SC	£[✂]	[✂]%	[✂]%	[✂]%
DD	£[✂]	[✂]%	[✂]%	[✂]%
Weighted average cost		£[✂]	£[✂]	£[✂]
Relative to all credit		[✂]	1.78	1.00

Methodology:

1. Reallocate 100% of PPM debt costs to SC (as per Ofgem approach)
2. Calculate bad debt costs as percentage of revenue, then Δ% between pre and post COVID periods
3. Multiply Δ% by price capped revenue for period (see Annex 2), and sum over 3 periods to get COVID bad debt cost
4. Payment method and tariff type splits are calculated by % of revenue Apr 20 to Sep 21 (to reflect Ofgem methodology outlined in consultation), however a similar result is obtained using bad debt per customer

The weighted average cost for all credit customers is significantly higher for ScottishPower (£[✂]) than for Ofgem's weighted average across suppliers (£14.49). There are a number of reasons which may account for this, but the key point to draw from this table is the impact of controlling for payment method mix in SVT. If the 78% uplift was applied to Ofgem's estimate of £14.49, the bad debt cost would increase by £11.24 to £25.73 (Table 3).

Table 3: Estimated impact on Ofgem estimated COVID bad debt cost of controlling for payment method mix

Incremental cost (£ per DF customer*) determined in the float	£13.78
Final incremental cost (£ per DF customer*) from Dec 2021 RFI	£14.49
Estimated uplift to correct for payment method mix	78%
Final incremental cost (£ per DF customer*) from Dec 2021 RFI - corrected	£25.73
Increase relative to Ofgem estimate	£11.24

*with consumption of 3.1 MWh elec, 12MWh gas

Sensitivity check

Finally, to illustrate the robustness of our proposed approach, Table 4 shows the results obtained using two different approaches. The first approach 'all credit data but controlling for SVT mix of payment methods' is the approach we believe Ofgem should use (absent a robust segmentation of supplier data by tariff type) and is the same as used in Table *2* above. The second approach 'using SVT data only' calculates the cost using ScottishPower's segmentation of data by tariff type. The fact that these two results are so similar (within 6%) gives confidence that the approach we are proposing is robust.

[8] This [✂] split is based on ScottishPower data but is very close to the market-wide split used by Ofgem when originally setting the payment method uplift.

Table 4: Alternative approaches to calculating COVID-related bad debt cost for ScottishPower

	Apr '20-Sep '20	Oct '20 - Mar '21	Apr '21 - Sep '21	Total
Capped credit revenue per DF customer	£424.13	£652.51	£434.18	£1,510.82
All credit data but controlling for SVT mix of payment methods				
Bad debt cost as % of revenue	[✂]%	[✂]%	[✂]%	
Bad debt cost as (£ per DF customer)	£[✂]	£[✂]	£[✂]	**£**[✂]
Using SVT data only				
Bad debt cost as % of revenue	[✂]%	[✂]%	[✂]%	
Bad debt cost as (£ per DF customer)	£[✂]	£[✂]	£[✂]	**£**[✂]

The small difference between the two approaches could be caused by a number of factors. One possible explanation is that a proportion of SC debt was originally built up while customers were on DD; if this were the case, it might have the effect of biasing upwards the first approach. However, the comparison above suggests that the impact is relatively small.

3. Failure to take account of payment method mix for SVT customers in calculation of working capital costs

Ofgem's estimates of COVID-related working capital costs suffer from the same flawed approach as for bad debt. Instead of calculating the cost for all credit, Ofgem should instead have controlled for payment method mix and calculated the cost for SVT based on a weighted average of SC and DD costs. As can be seen from Table 5, based on ScottishPower data, the cost for SVT is 82% higher than the cost for all credit. The costs in Table 5 assume a cost of capital of [✂]% (see below).

Table 5: Impact of controlling for payment method mix on COVID-related working capital cost (ScottishPower data)

	COVID working capital cost per customer (TDCV, DF)	FTC credit [✂]%	SVT credit [✂]%	All credit
Standard credit (SC)	£[✂]	[✂]%	[✂]%	[✂]%
Direct debit (DD)	£[✂]	[✂]%	[✂]%	[✂]%
Weighted average cost		£[✂]	£[✂]	£[✂]
Relative to all credit		[✂]	1.82	1.00

Methodology:

1. Reallocate 100% of PPM debt to SC (as per Ofgem approach)
2. Calculate debtor days, then Δ between pre and post COVID periods
3. Multiply Δ/365 by price capped revenue for period (see Annex 2) x [✂]% cost of capital, and sum over 3 periods to get COVID working capital cost
4. Payment method and tariff type splits are calculated by % of revenue Apr 20 to Sep 21 (to reflect Ofgem methodology outlined in consultation), however a similar result is obtained using bad debt per customer

4. Failure to give proper consideration to the appropriate cost of borrowing in setting the allowance for working capital costs.

Ofgem says that it intends to include no allowance for additional COVID-related working capital costs as a matter of principle:

> "We propose to make no adjustment in the cap to true up additional working capital costs due to COVID-19. We consider that the cost suppliers are facing due to COVID-19 are related to suppliers' need to cover the additional risk of short-term delays in payments, as opposed to the cost associated with capitalising a full business for providing standard credit."[9]

Ofgem's reasoning for this proposal appears to be based on two assumptions[10]:

- that the additional capital required will be funded via 'short-term financing facilities' which Ofgem assumes suppliers can access more cheaply than normal working capital;

- that suppliers can recover the additional capital costs through some combination of the payment method uplift (PMU), the Earnings Before Interest and Tax (EBIT) allowance and the headroom allowance.

We disagree on both these points.

First, it is wrong to characterise the increased debt as a matter for short term financing. As can be seen from Table 6, in ScottishPower's case, the increased debt arising from COVID averaged £[✂]m over the 18 months from April 2020 to September 2021. This is a substantial amount of capital and a prolonged period which cannot be covered by short term financing, certainly not at the Sterling Overnight Index Average (SONIA) rate suggested by Ofgem.

Table 6:COVID-related additional debt for ScottishPower SVT customers

Payment method	April 2020-September 2020	October 2020 - March 2021	April 2021 - September 2021	Average
DD increased debt (£m)	[✂]	[✂]	[✂]	[✂]
SC increased debt (£m)	[✂]	[✂]	[✂]	[✂]
Total (£m)	[✂]	[✂]	[✂]	[✂]

Methodology:
1. Use ScottishPower segmentation of data between SVT and FTC
2. Reallocate 100% of PPM debt to SC (as per Ofgem approach), allocating to SVT SC and FTC SC pro rata to revenue (reflecting the fact that customers on both SVT and FTC SC move to PPM SVT to manage debt)
3. Calculate debtor days, then Δ between pre and post COVID periods
4. Multiply Δ/365 by 2*revenue for period

Second, Ofgem's stance that suppliers should absorb these costs in the existing uncertainty allowances is inappropriate at a time when suppliers' finances are under unprecedented strain. ScottishPower's retail business made a loss of £294 million in 2021, a loss of £64 million in 2020[11], and [✂] in 2022. In face of these losses, it is untenable to argue that there is additional capacity within the headroom allowance to absorb these working capital costs. Furthermore, it is wrong to characterise the PMU and EBIT allowances as 'uncertainty' allowances. The PMU is intended to cover business as usual bad debt costs and does not contain any headroom (indeed, Ofgem's original methodology adopted a lower quartile benchmark for operational costs). The EBIT allowance is intended to cover the necessary

[9] Condoc para 4.61
[10] Condoc paras 4.63 to 4.68
[11] Figures for aggregate supply business from CSS

capital costs of running a retail business (which were woefully underestimated by the CMA as a result of making no allowance for risk capital).

As noted above, there is no justification for using the SONIA interest rate suggested by Ofgem. No standalone retail business would have been able to borrow the sums of money involved at anything close to this rate of interest given the risks involved in retail supply (even before the onset of wholesale market volatility). In our view Ofgem should use the average WACC faced by suppliers, which would better reflect the risks intrinsic in the business and the likely cost of borrowing, and in our calculations above we used a rate of [✂]% as the internal WACC used by Iberdrola for ScottishPower's retail business. If Ofgem insists on using short term borrowing costs, we estimate that these costs would be in the range 4.5% to 5.5%, reflecting the [✂] status of a standalone retail business.

In summary, we believe Ofgem should include an allowance in the true-up for the additional capital costs of COVID-related debt, calculated using an estimate of supplier average WACC and controlling for SVT payment method mix (not a flat average across all credit customers).

5. Lack of detail in consultation

We welcome the fact that Ofgem has given suppliers the option of paying for advisers to analyse the confidential data on which its calculations were based. However, we are concerned that this may have led Ofgem to provide less detail on non-confidential aspects of its methodology than would have been reasonable to expect. For example, Ofgem could usefully have provided:

- the weighted average bad debt costs as a percentage of revenue and the capped revenue values used to calculate the per customer cost of £14.49 – if Ofgem has used incorrect values for capped revenues (see Annex 2), this would have allowed respondents to identify this without paying advisors to do so;

- sufficient detail of the calculation steps to allow suppliers to replicate with confidence Ofgem's calculations using their own data;

- details of the degree of variation between different suppliers (eg min and max values) – as Ofgem has done in previous consultations (eg wholesale costs).

We would urge Ofgem to provide full disclosure of such non-confidential information in future consultations. Suppliers should not have to pay external consultants in order to critique such aspects of a consultation.

6. Precedent for recovery of future bad debt costs

Recent increases in energy costs may result in an even greater increase in bad debt costs following Winter 2022/23 than was caused by COVID lockdown. Ofgem's approach to bad debt cost recovery (in the original price cap decision and in its proposed approach to COVID-related bad debt) creates competitive distortions between suppliers, as a result of smearing SC costs across all credit customers. Suppliers with a lower proportion of SC customers in their SVT base will over-recover costs and suppliers with a higher proportion will under-recover. As the amount of bad debt involved increases, so does the size of the competitive distortion. We welcome Ofgem's commitment to review the bad debt allowance more generally in light of rising energy bills and the cost of living crisis, but it should not regard the approach it has taken to date as a precedent. Instead it should consider ways to allow cost

recovery to better reflect actual costs incurred, for example by means of a levy mechanism and redistribution.

Annex 2

CALCULATION OF CAPPED REVENUE BY PERIOD

We understand from NERA that Ofgem's methodology for calculating capped revenue (used in calculating £/dual fuel customer costs) differs from ScottishPower's. We set out below how we attempted to replicate Ofgem's approach based on the description in the consultation (with a simplification that we only considered one electricity profile class). If we have misunderstood Ofgem's approach we would welcome clarification from Ofgem as to how it actually did the calculation.

Direct Debit						
	Period 4		Period 5		Period 6	
	April 2020 - September 2020		October 2020 - March 2021		April 2021 - September 2021	
	Elec	Gas	Elec	Gas	Elec	Gas
Revenue at TDCV	£610.66	£495.60	£592.15	£433.36	£646.09	£474.06
Standing Charge	£84.76	£95.05	£84.76	£90.64	£86.52	£92.47
Energy charge	£525.90	£400.55	£507.38	£342.72	£559.57	£381.60
Seasonal demand share of energy (elec profile class 1)	43%	24%	57%	76%	43%	24%
Revenue in period	£268.09	£144.83	£332.00	£304.78	£283.42	£138.93
Dual Fuel	£412.92		£636.79		£422.35	

Standard Credit						
	Period 4		Period 5		Period 6	
	April 2020 - September 2020		October 2020 - March 2021		April 2021 - September 2021	
	Elec	Gas	Elec	Gas	Elec	Gas
Revenue at TDCV	£654.40	£533.13	£634.93	£467.61	£691.81	£510.53
Standing Charge	£100.45	£106.56	£100.45	£106.56	£102.36	£108.55
Energy charge	£553.95	£426.57	£534.48	£361.05	£589.45	£401.98
Seasonal demand share of energy (elec profile class 1)	43%	24%	57%	76%	43%	24%
Revenue in period	£287.97	£156.91	£355.31	£326.62	£304.16	£151.93
Dual Fuel	£444.88		£681.93		£456.09	

Blend of DD and SC (using SC and DD %s from Ofgem 2018 decision)						
	Period 4		Period 5		Period 6	
	April 2020 - September 2020		October 2020 - March 2021		April 2021 - September 2021	
	Elec	Gas	Elec	Gas	Elec	Gas
Weighted average credit capped revenue	£275.23	£148.90	£340.37	£312.14	£290.86	£143.31
Dual Fuel	£424.13		£652.51		£434.18	

ScottishPower
June 2022