

Dan Norton
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20 October 2022

Dear Dan

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

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

We have commissioned NERA to analyse the confidential information disclosed by Ofgem and we understand that they have submitted a separate report to Ofgem based on their analysis. We have not yet had an opportunity to review a redacted version of their report but, subject to any further representations we may make having reviewed their report, we wish their report to be considered alongside this letter as part of our response.

Our full response is in Annex 1, but in summary:

- We remain of the view that the approach proposed in our response of 1 June (*‘Alternative method 1: controlling for payment method mix for default tariff customers’*) represents the most accurate and robust way of estimating the COVID-related debt costs associated with SVT customers. We believe the reasons Ofgem gives for rejecting this approach are flawed, and Ofgem’s proposal to retain its previous methodology is wrong.
- We do not see any merit in Ofgem’s new alternative methodology (*‘Alternative method 2: controlling for payment method mix for credit customers’*) compared to our proposed approach.
- We believe Ofgem should apply the same approach to working capital, at least for the period of time for which it has data. We are disappointed that, despite our arguments to the contrary, Ofgem omitted working capital costs from its Period 7 RFI, thereby prejudging the outcome of its review.

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

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive style with a large initial 'R'.

Richard Sweet
Director of Regulatory Policy

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

1. Introduction

We set out our views on Ofgem’s revised proposals under the following headings:

- our preference amongst the three methodologies considered by Ofgem;
- a critique of Ofgem’s objections to Alternative methodology 1;
- our assessment of Alternative methodology 2;
- Ofgem’s proposed approach to COVID-related working capital costs.

We have commissioned NERA to analyse the confidential information disclosed by Ofgem and we understand that they have submitted a separate report to Ofgem based on their analysis. We have not yet had an opportunity to review a redacted version of their report but, subject to any further representations we may make having reviewed their report, we wish their report to be considered alongside this letter as part of our response.

2. Preferred methodology

Ofgem outlines three possible methodologies for determining the additional COVID-19 debt-related costs for cap periods six and seven and invites stakeholders to comment on which is their preferred method. The three methods are:

1. Ofgem’s May 2022 consultation methodology: no controls for payment method mix
2. Alternative method 1: controlling for payment method mix for default tariff customers
3. Alternative method 2: controlling for payment method mix for credit customers

Our strong preference is for Alternative method 1, which appears to be essentially the same approach as we advocated in our previous consultation response of 1 June (supported by a report from NERA). We explained in detail in our 1 June response why this approach is to be preferred, but in summary:

- There is strong evidence that customers paying by standard credit build up more debt and account for higher bad debt costs than customers paying by direct debit.
- The proportion of credit customers (ie non prepayment) paying by standard credit is significantly higher for customers on SVT than on FTCs.
- Therefore, the average bad debt cost per credit customer on SVT will be higher than the average bad debt costs for credit customers as a whole.

The above observations are true for ScottishPower and were also reflected in the market average data derived by NERA from the confidential data disclosed by Ofgem.

Furthermore, as explained below, ScottishPower was able to provide debt data broken down by tariff type as well as payment method. This meant that we could compare the results derived from Alternative method 1 with a direct calculation of the average bad debt costs of SVT customers. The two approaches gave very similar results, giving extra confidence in the validity of Alternative method 1.

3. Ofgem's objections to Alternative method 1

Ofgem's primary objection to Alternative method 1 appears to be a concern over the robustness of data on debt breakdown by payment method (at least for credit customers). Ofgem's RFI requested debt broken down by the payment method *that the customer is currently on*, which may be different from the payment method the customer was on when they built up some (or all) of the debt. For example customers paying by DD who get into financial difficulties may default on their DD payments and become standard credit customers. If their DD balance was in debit at the time of default, this debt would be transferred to SC and some of the debt reported as SC would actually have originated from DD. There may therefore be some 'cross contamination' of the debt splits.

In addition to the 'methodological uncertainty of allocating debt between [payment methods]', Ofgem also cites the 'intrinsic uncertainty in debt accrual between different types of credit customers' as an additional reason for inaccuracy (paragraph 3.20). We are unsure what Ofgem is referring to here, but it seems to be closely related to the previous point.

We do not disagree with Ofgem that these factors may lead to some inaccuracy in the split of debt between payment methods, which may in turn affect the accuracy of the final estimates. But it is irrational to reject a methodology which is otherwise superior (since it controls for the different payment mix between tariff types) simply on the basis that the input data might not be completely accurate. Ofgem would need to demonstrate that the input data was likely to be *so inaccurate* as to undermine the statistical significance of any difference between the methodologies – and that this could not be mitigated by appropriate adjustments. In particular, we think Ofgem should take into account:

- a) evidence presented by ScottishPower based on actual breakdown of debt by tariff type
- b) sensitivity analysis to determine how much 'cross contamination' of debt by payment method would be necessary to arrive at the same answer as Ofgem's May 2022 methodology.

Evidence previously presented by ScottishPower

In our 1 June response we presented the results of calculating COVID-related bad debt costs for ScottishPower using two different approaches. The first approach was to control for payment method mix as in Ofgem's Alternative methodology 1. The second was to calculate the cost based on actual debt split by tariff type (which was rejected as an approach by Ofgem because most suppliers were unable to provide this split). The second approach does not depend on the allocation of debt to payment method (only to tariff type) and is therefore not susceptible to the 'cross-contamination' issues referred to above. A comparison of the two approaches should therefore provide an indication of the extent to which the results may be distorted by 'cross-contamination'. As can be seen from Table 1 the results are very similar, differing by only 6%. This suggests that any errors introduced by 'cross-contamination' are most unlikely to be sufficiently material to justify Ofgem rejecting this approach. However, Ofgem might consider it was appropriate to 'aim down' slightly to allow for errors at the level of 6% or thereabouts.

Table 1: 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	[X]	[X]	[X]	[X]
All credit data but controlling for SVT mix of payment methods				
Bad debt cost as % of revenue	[X]	[X]	[X]	[X]
Bad debt cost as (£ per DF customer)	[X]	[X]	[X]	[X]
Bad debt cost as % of revenue	[X]	[X]	[X]	[X]
Bad debt cost as (£ per DF customer)	[X]	[X]	[X]	[X]

Clearly, our second approach, using debt split by tariff type, is potentially susceptible to a different type of cross-contamination, where debt built up on SVT is reported as FTC (if the customer moves SVT to FTC and brings debt with them) or vice versa. However, we are confident that this will bias the analysis in the direction of understating the COVID-related bad debt cost for SVT. The reason for this is that when customers get into debt, one of the first things that debt advisors do is to recommend the customer to switch from SVT to FTC in order to reduce their bills.¹ There is no obvious pathway in the other direction, ie customers getting into debt on FTC deciding to switch to SVT. In other words, it is likely that some of the debt allocated to FTC should more accurately be allocated to SVT. For this reason, we think the 6% difference referred to above may represent an upper bound on the impact of data cross-contamination.

Sensitivity analysis

If Ofgem is concerned about loss of accuracy due to cross-contamination of data, it should carry out sensitivity analysis to estimate how much cross-contamination there would need to be in order for the results of Alternative methodology 1 to be invalidated. Ofgem can then consider whether it is plausible (given knowledge of typical customer debt pathways) that the cross-contamination has reached this extent. Ofgem could also postulate a realistic (or indeed conservative) estimate of how much cross-contamination is present in the data, and use that to adjust down the results of Alternative methodology 1.

We have asked NERA to undertake this sort of sensitivity analysis using the aggregate data made available to it by Ofgem. We have not yet had sight of the results, but are cautiously confident that their analysis will support our position that the extent of cross-contamination required to invalidate the results is simply implausible.

Precisely wrong or approximately right

Ofgem concludes (paragraph 3.61) that its May 2022 consultation methodology approach is to be preferred as it is the least susceptible to data quality issues as it uses less granular data and so the calculation is based on the fewest assumptions, lowering the risk of data accuracy or consistency issues.

Ofgem appears to be favouring a methodology which does not rely on potentially inaccurate data but is known to be wrong (because it does not control for payment method differences between SVT and FTC). For the reasons set out above, we believe Ofgem should favour the correct methodology, despite potential inaccuracies, unless it can be shown that those

¹ Prior to the current crisis, when there were still FTC offers available priced significantly below SVT.

inaccuracies are plausibly so large as to invalidate the approach. In other words, it is 'better to be approximately right than precisely wrong'.

4. Alternative methodology 2

Ofgem's 'alternative methodology 2' seeks to control for payment method mix for credit customers. This involves calculating the incremental weighted average bad debt cost per customer account for both standard credit and direct debit customers before using the proportionate breakdown of credit customers on a direct debit and standard credit to weight the calculation based on the makeup of the credit market.²

Our main objection to this approach is that it disregards the difference in payment method mix between FTC and SVT. This difference in payment method mixes is easily ascertained from supplier data and is not subject to any significant doubt. There is therefore no rational reason that we can see to disregard this information.

We accept that 'alternative methodology 2' is preferable to Ofgem's May 2022 approach, since it at least controls for the payment method mix across all credit customers, but for the reasons given above, we think it is clearly inferior to 'alternative methodology 1'.

5. Working capital

As stated in our 1 June response, we believe Ofgem should also control for the different payment method mixes between tariff types in its assessment of working capital costs (ie the 'alternative methodology 1' approach).

We are disappointed that, despite our representations to the contrary, Ofgem omitted working capital costs from its Period 7 RFI, thereby limiting the amount of data available to conduct further true-up analysis. Nevertheless, even based on data to Period 6, NERA's previous report showed that the COVID-related costs of working capital were material when using the 'alternative methodology 1' approach and these should be reflected in the true-up.

Short term debt financing argument

We strongly disagree with Ofgem's proposal to make no adjustment in the cap to true-up additional working capital costs due to COVID-19. Ofgem justifies this proposal on the basis that any working capital cost is based on a need for suppliers to cover the additional risk of a short-term delay in payments, and that suppliers should have had these short-term financing facilities in place as part of their day-to-day business before the COVID-19 pandemic.³

As argued in our June response, it is wrong to characterise the increased debt as a matter for short term financing. As can be seen from Table 2, in ScottishPower's case, the increased debt arising from COVID averaged £[redacted]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.

² Condoc para 3.44

³ Condoc paragraph 4.30

Table 2: 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)	[X]	[X]	[X]	[X]
SC increased debt (£m)	[X]	[X]	[X]	[X]
Total (£m)	[X]	[X]	[X]	[X]

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 $\Delta/365$ by $2 \times$ revenue for period

Ofgem refers to our arguments in passing⁴ but fails to engage in any discussion of the magnitude and duration of the working capital impacts, as to why it considers that impacts of this magnitude should have been covered by suppliers' short-term financing facilities in place as part of their day-to-day business before the COVID-19 pandemic.

Interest rate or WACC

We argued in our previous response that there was no justification for using the SONIA interest rate as 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).⁵

In Ofgem's 'considerations' section it suggests that it will rely on the cost of capital determined through its current review of the EBIT margin allowance. We assume from this that Ofgem has accepted our argument about SONIA, but would appreciate confirmation. If Ofgem is now proposing to use a measure of supplier WACC, we agree that that would be more appropriate.

Determination of additional COVID-related costs

We do not disagree with Ofgem's proposal to use half yearly debtor days to determine additional working capital costs.

ScottishPower

October 2022

⁴ Condoc paragraph 4.32

⁵ Summarised in condoc paragraph 4.34