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Dear Daniel,

### **Energy price cap operating cost and debt allowances consultation**

We welcome the opportunity to respond to Ofgem's consultation on the energy price cap operating cost and debt allowances. Our views on Ofgem's proposals are set out in the annexes to this document but we have summarised below our views on the two main elements of the proposal, the core operating cost allowance and the debt-related costs allowance.

#### *Core operating cost allowance*

1. We welcome Ofgem's use of a weighted average benchmark but have **concerns about the newly introduced approach to calculate payment method differentials**, especially since it appears to have a significant impact. The new approach restricts the sample of suppliers used as well as introducing a new approach at this late stage in the consultation process, giving limited time and opportunity for suppliers to assess and comment on it. In addition, we do not have access to the data to assess the impact of this which is a transparency issue and exacerbates our unease. Ofgem should have provided this data in the consultation document in a similar way to what was provided in the previous statutory consultation on the debt allowance.
2. Selecting 2023 as the baseline year significantly underestimates future sales and marketing costs as the market opens up, switching increases and competition returns to historical levels. It also underestimates depreciation as a result of 2023 year having exceptionally low depreciation (See Annex 1, section 1). **Ofgem is not correct that the 2023 baseline is generous and therefore Ofgem should not apply a higher bar to any future review. In our view, Ofgem should make an adjustment to the allowance for this reason or commit to re-opening the allowance soon to update for new data from 2024 and 2025.**

### *Debt related cost allowance*

1. We encourage Ofgem to calculate the baseline for the debt related cost allowance differently. Currently, Ofgem is minded to take the mid-point of the range between the average of the most recent four quarters and the most recent eight quarters. The baseline for debt related costs is over a period where ScottishPower has made large changes to provisions, initially (end 2023) to correct provisions to cover the [X], and latterly (end 2024) to adjust these provisions in light of [X]. To the extent that this applies to suppliers in general, and certainly in ScottishPower's case, it would be disproportionate to give too much weight to bad debt costs in the most recent four quarters, which are lower than they otherwise should be. (See Annex 2 section 1 Setting the baseline.) We propose that **Ofgem amends the quarterly weighting to address this issue.**
2. Ofgem has used the current differential between payment methods to set payment method allocations, which is significantly different to the more cost-reflective approach to calculating the differential. Overall, we do not agree with the arguments given against using the reported costs to set the initial price cap value for the different payments methods and consider that not doing so deters suppliers from taking on SC customers. In our view, a cost-reflective differential should be the starting point. Ofgem should then determine an appropriate cost differential considering incentives on both suppliers and customers, and **implement levelisation phase 2** to achieve this differential in a similar way to PPM/DD standing charge levelisation. If levelisation is not implemented, the non cost-reflective allocation will cause significant competitive distortions, giving large DD focused suppliers a competitive advantage that can be used to undercut competitors. (See Annex 2 section 3, Allocating costs across payment methods.)
3. Ofgem has deducted weighted average working capital costs to avoid double counting them in the EBIT and the debt allowance. It is unclear whether the estimated working capital costs deducted align with those included in the EBIT allowance, and there is no evidence confirming this alignment. If actual costs exceed those assumed in the EBIT allowance, there is a risk of undercompensating suppliers. **Ofgem should calculate the working capital / EBIT overlap and cost more precisely, provide a full explanation of its methodology to stakeholders, and ensure the full allowance is included in the price cap.**

### *Transparency*

Finally, although we welcome Ofgem's decision to make confidential data available to suppliers and their consultants subject to confidentiality undertakings, we have been disappointed in the level of detail provided both in the confidential data and the published documents. As a general principle we consider Ofgem should provide enough detail to permit suppliers to replicate/validate key steps in the methodology, should they wish to do so. In particular:

- Ofgem could have provided significantly more information in the published documents at a non-confidential level. (We are grateful to Ofgem responding to our queries).
- We consider that the Disclosed Model provided to supplier representatives was unnecessarily labelled as confidential. As far as we are aware, all the supplier-specific information had been replaced by dummy values, leaving only the model structure which cannot reasonably be regarded as confidential.

- As far as we are aware the information provided to consultants was less comprehensive than in previous exercises and in particular did not allow them easily to discern how operating cost values had been extracted from RFI responses.

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive, flowing style.

**Richard Sweet**  
Director of Regulatory Policy

# ENERGY PRICE CAP OPERATING COST AND DEBT ALLOWANCES CONSULTATION – SCOTTISHPOWER RESPONSE

## Annex 1: Core operating costs

### 1. Setting the baseline

#### *Baseline period used*

Ofgem has chosen to use 2023 as the baseline year, whilst recognising that it is also likely to be atypical. In particular, our evidence shows that sales and marketing costs in 2023 are likely to still be lower than expected future costs due to the lower than historical levels of switching. Sales and marketing costs are a result of the competitive environment in the retail energy. Indeed, on Monday 27 January, ElectraLink published its electricity switching statistics, highlighting that switching rates increased in 2024 by 38% (at 3.21 million), when compared to 2023. This is a systematic change and should be reflected in the baseline.

**Figure 1: Trends in ScottishPower sales and marketing costs  
(including costs to capture new customers “capture costs”)**

[REDACTED]

Note 1: [REDACTED]

Note 2: [REDACTED]

Figure 1 shows that our sales and marketing costs are forecast to [REDACTED]. In addition, when market switching increases we would expect levels of back office support, customer service (call volumes) and fees to price comparison websites to [REDACTED] casting further doubt on the appropriateness of a 2023 baseline as well as the “high bar” to change it going forward.

Our proposal is that Ofgem uses historic data to calculate a suitable upward adjustment or commits to a review of sales and marketing costs in 2 years’ time.

Our comments on the baseline in relation to MHHS is considered below.

#### *Sample used*

Ofgem collected data from 12 suppliers with over 100,000 customer accounts. Three of these suppliers were excluded from the benchmarking sample. We do not understand the rationale for excluding Bulb from the benchmarking sample.

Ofgem has not mentioned any further restriction of the sample used to calculate the initial baseline, eg restricting the sample to only suppliers with certain number of customers. However, we note that further restrictions are introduced when calculating the payment

method differential. We have concerns regarding this inconsistency that are discussed further in Section 3 below.

### *Cost lines and adjustments*

#### Sales and marketing costs

We support the inclusion of sales and marketing costs which are essential expenses for any business aiming to promote its products or services and acquire and retain customers. As noted above, we expect sales and marketing costs to [§<] in future years, and we believe this should be reflected in the allowance, either by an updated RFI or via an adjustment using historic data prior to the energy crisis.

We would like Ofgem to confirm that ScottishPower sales and marketing costs were appropriately considered in the data since these were capitalised in our RFI response, appearing in our response to Question 1 of the RFI. Note that a resurgence in switching levels will bring a [§<] in switching-related operational costs, including sales and marketing, and fees to price comparison websites.

#### Market-wide half hour settlement (MHHS) costs

Ofgem has proposed not to make any adjustment for MHHS costs which suppliers have borne up until now and which in ScottishPower's case were capitalised and will only begin to depreciate over the next few years when the assets come into use. Ofgem acknowledges (Appendix 1, para 6.40) that suppliers may have incurred costs in 2023 which they had not started to depreciate or amortise, but argues that suppliers will make investments every year in assets which they will then depreciate or amortise in subsequent years, and notes that it has not seen evidence that 2023 is an exceptional year. The costs involved are material and it is not sufficient for Ofgem simply to assume that 2023 was unexceptional without seeking evidence.

ScottishPower data is shown in Figure 2 below. We have excluded capture costs from both capital expenditure and depreciation as they are included in sales and marketing costs above. Our capital expenditure and depreciation forecasts extend to 2030 and we consider to be cost items that are straightforward to forecast with reasonable accuracy and are considered less volatile. [§<] Post-2023, ScottishPower expects costs related to MHHS and other capital programmes to [§<], driven by the need to adapt to the changing energy market, requiring increased investment for flexibility, innovation in tariffs, and AI use cases.

**Figure 2: Trends in ScottishPower capital and depreciation costs excluding capture costs (£m)**

[§<]

As a result of this, we consider that using 2023 data underestimates the baseline operating cost level and Ofgem should commit to a review of the baseline in 2 years' time.

## **2. Benchmarking:**

### *Benchmarking at aggregate level*

Instead of benchmarking across separate parameters, Ofgem has decided to benchmark at an aggregate cost level, with the single aggregate benchmark allocated across payment methods and fuel types. Our concerns about using the aggregate methodology (we support Option D<sup>1</sup>) are less acute as a result of the weighted average methodology selected. However, we have not been given data relating to the impact of using the aggregate methodology and would have concerns if the different benchmarking approaches resulted in very different outcomes. In the interests of transparency, Ofgem should enable suppliers to assess these impacts by publishing the outcome of the different options or allowing suppliers' appointed consultants access to the raw data. As part of Ofgem's disclosure process, we have been unable to assess whether some suppliers' cost allocation is flawed which makes it difficult for us to critique the approach. Ofgem's rationale for benchmarking at an aggregate level, relies quite heavily on its assessment that some of the data is flawed.

### *Benchmarking metric*

We agree with Ofgem's proposal to use a benchmark based on weighted average costs rather than lower quartile. As Ofgem notes, an unduly stringent approach to benchmarking would jeopardise the investment and innovation needed to make retail markets fit for the future and would not maximise consumer protection in the medium to long term. In our view, short-term savings were made in the early years of the price cap and it is likely that some of these came at the cost of wider system resilience and contributed to the large number of supplier market exits. Suppliers will still have an incentive to improve their efficiency with a weighted average benchmark as this will enable them to increase their profits.

## **3. Allocating core operating costs across customer groups**

### *Payment method cost allocation – approach and methodology*

For fuel type allocation, Ofgem uses suppliers' allocation across fuel types to calculate the weighted average core operating costs for electricity and gas customers, as per its Option 2. However, for payment method allocation, an alternative approach is used, one that was not consulted on in the previous consultation<sup>2</sup>. Ofgem refers to this as the 'differential approach' and as part of this new methodology it restricts the sample even further (see below for the discussion on sample).

In the previous consultation, Ofgem noted that the weighted average approach is less sensitive to supplier allocation methodologies, which we agree with, and we therefore do not, see the need to introduce this new approach at this late stage.

We do not have the data to assess the impact of the decision not to use Option 2 and the impact of restricting the sample and would expect that our consultants NERA (and other suppliers' consultants) may be able to provide more detail around this issue.

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<sup>1</sup> Option D: split cost by fuel and payment method – for this option, we would benchmark costs at the fuel type and payment method level.

<sup>2</sup> [Energy Price Cap: Operating cost allowances review](#)

### *Payment method cost allocation – sample*

When calculating the payment method differentials, after calculating the aggregate benchmark, Ofgem reduces the sample size again, moving from ten suppliers to six. Ofgem notes that this enables it “*to exclude suppliers who have very small number of customers on certain payment methods from our benchmarking sample*”. The rationale given is that those suppliers with a smaller number of customers may have costs which are unrepresentative and do not reflect the differential. In our view, this is not necessary since using a weighted average automatically applies less weight to suppliers with small customer numbers and negates the need to cherry pick the sample.

Ofgem implies (Appendix 1, paragraph 4.29) that the lower number is preferable since the differential is more appropriate and claims the outcome is broadly cost-reflective. The data provided (Table 1) shows that this new approach makes a substantial difference to the calculated premium. We consider that this approach is unjustified and that if Ofgem wants to move away from cost-reflectivity to deliver an appropriate differential it can do this by implementing a levelisation scheme.

**Table 1: Payment method differential calculation**

	Using all suppliers	Using only suppliers with >100k SC/PPM customers
DD-SC premium	£54	£38
DD-PPM premium	£78	£55

As noted above, we have not been able to fully analyse the impact of the sample restriction or see which suppliers with which customer numbers have been excluded. However, Ofgem considers (Appendix 2 paragraph 4.31) how to mitigate the impact of non-efficiency factors on the benchmark by either “*1) restricting the sample or 2) applying a weighted average benchmark*”. The view there was that a sample restriction leads to a less robust benchmark, because it reduces the sample further from 8 suppliers to potentially 5 suppliers. We have similar concerns in this context especially since a weighted average means that those with smaller numbers and potentially atypical costs have less impact on the number.

### *Standing charge and unit rate*

We agree with Ofgem’s decision, not to implement any immediate shift in operating costs from standing charges to unit rates (Overview, paragraph 4.6).

### *Vulnerable customers*

Ofgem recognises that differences in suppliers’ customer bases can lead to differences in operating costs which do not relate to efficiency. We consider the proportion of vulnerable customers has a significant impact and should be addressed by Ofgem using a levelisation mechanism. Without levelisation, there will be competitive distortions baked into the cap and a disincentive for suppliers to compete to serve vulnerable customers.

## **4. Updating the Allowance Over Time**

### *CPIH Index*

We agree with Ofgem that it would not be appropriate to apply additional stringency measures to CPIH. We agree that the most significant efficiencies have already been captured and a

focus on growth and investment means it would not be appropriate to make the allowance more stringent over time.

### *Revisiting the allowance*

Ofgem claims that its proposed approach to setting the core operating cost allowance, using a 2023 baseline, a weighted average benchmark and cost-reflective allocation across payment methods, will account for foreseeable uncertainties in core operating costs. We do not agree that this is the case or that there should be a high bar to review. This is because:

- The benchmarking approach is not a straightforward weighted average cost-reflective benchmark and at every level of the calculation another stringency is introduced. The approach also bakes into the allowance the cross subsidy between SC and DD customers.
- The 2023 base year selected means that higher costs are likely in the future. For example, we consider that sales and marketing costs in 2023 are likely to increase since levels of switching remained relatively low during that year.
- Costs associated with MHHS are not fully included in 2023 baseline year, at least for ScottishPower.
- In addition to the costs of implementing Market-wide Half Hourly Settlement (MHHS), suppliers will incur significant new costs associated with designing, communicating and administering ToU tariffs and associated flexibility services that make use of MHHS. These will include inter alia keeping track of consents, providing HH consumption data to customers and third party advisers, engaging with customers to explain the suitability of different tariff options and fielding increased levels of inbound billing queries.
- Our central overhead costs are increasing as a result of the increase in National Insurance Contributions and National Living Wage. Our costs are expected to increase by c. [X] of personnel costs as a result of these changes.

In summary, we view downside risks (ie operating costs increasing) as just as likely as upside risks. As such, we think Ofgem should leave the option open of a review of the allowance in the future.



**1. Baseline**

To calculate the baseline, Ofgem is minded to take the mid-point of the range between the average of the most recent four quarters and the most recent eight quarters. For the final allowance, Ofgem plans to take into account the most recent industry data which it will receive in Spring 2025. The following section comments on:

- The baseline period used – including how typical this time period is and the combination of data used
- Cost components included in the baseline calculation

*Baseline period used – choosing a baseline period and assessing the range*

Ofgem suggests that debt-related costs have started falling since a peak in 2023 (Overview, para 2.29), though it acknowledges (Appendix 2, para 4.20) that this could also be due to changes in provisioning assumptions. Ofgem’s total debt and arrears data shows consistent increases in debt and arrears<sup>3</sup>, and debt-related cost data appears to show a peak in 2023 with levels declining since<sup>4</sup>. ScottishPower data for debt and arrears shows [X] and our domestic billed debt shows [X] since 2021 (see graph below).

**Figure 3: ScottishPower domestic live billed debt (£m)**

[X]

[X] As such, we recognise that bad debt levels in the profit and loss account are likely to be stabilising. However, we also agree with Ofgem that the last 8 quarters of data will be affected by suppliers’ approach to provisioning. Ofgem has noted that there will have been “*rapid changes in provisioning policy and large one-off write-offs*”. In ScottishPower’s case,[X]. We expect that this will be typical of most suppliers.

**Figure 4: ScottishPower domestic profit and loss bad debt profile (£m)**

[X]

<sup>3</sup> See [Debt and arrears indicators | Ofgem](#)

<sup>4</sup> See Appendix 2 Figure 21.2

As highlighted in the chart above, the provisioning reviews happen once per year meaning that there is a peak/trough depending on the outcome. So, not only can there be year on year corrections, but even without any corrections there can be a need to profile provision changes over the course of the year if selecting a period to use as representative. In our view, this means that both 2023 and 2024, if taken separately, are not good predictors of costs going forward and this must be taken into account when setting a baseline.

To assess how best to calculate this, we have created a smoother path of debt cost by apportioning provisions and write-offs more smoothly over time with the smoothed compared to actuals in the graph below:

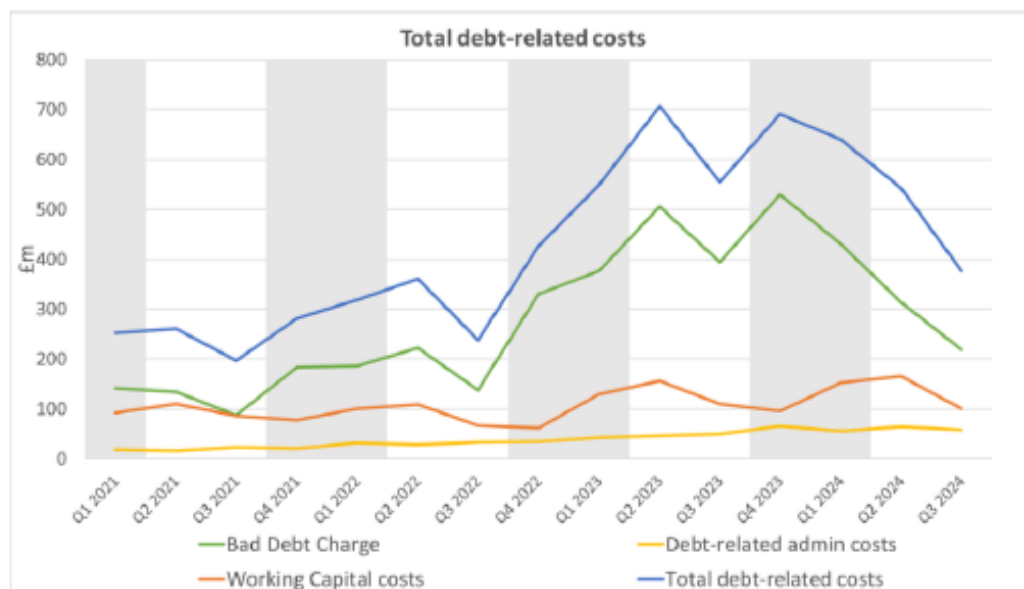
**Figure 5: ScottishPower domestic profit and loss bad debt profile actual and smoothed (£m)**

[✂]

This approach smooths the provisions over the full two year period to more accurately reflect how an appropriate level would have looked. It also smooths the accelerated write-off over the period to reflect a steadier approach to writing off these customer accounts. It is possible to separate these effects and we can share this with Ofgem on request.

Therefore, looking back at Figure 21.2 from Ofgem's consultation document, replicated below, we can see that the peak could well be too high and the trough too low.

**Figure 21.2: Trend in supplier reported total debt-related costs**



*The graph shows the debt-related costs for all tariff types and payment methods from the latest debt-related cost RFI. The grey areas represent winter seasons.*

The approach that Ofgem is minded to take, ie the mid point between the averages of the most recent four quarters and the most recent eight quarters, effectively means that bad debt costs in Quarters 5 to 8 are given three times the weight of Quarters 1 to 4. See Table 2 below:

**Table 2: Ofgem’s approach to setting a baseline**

	Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8
<b>8 Quarter</b>	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%
<b>4 Quarter</b>					25.0%	25.0%	25.0%	25.0%
<b>Mid point</b>	6.25%	6.25%	6.25%	6.25%	18.75%	18.75%	18.75%	18.75%

This could only be justified if there was evidence that Quarters 5-8 are much more representative of future quarters than Quarters 1-4. However, as discussed above, in the case of ScottishPower (and we suspect most other suppliers) the approach to provisioning means that reported costs in 2024 are likely [X] and costs in 2023 [X]. We can show the impact of this by looking more closely at our data and the averages.

**Table 3: ScottishPower data via Ofgem baseline setting methodology**

	SP data as reported	SP data restated
<b>8 Quarter</b>	[X]	[X]
<b>4 Quarter</b>	[X]	[X]
<b>Mid point</b>	[X]	[X]

Ofgem is now requesting additional data for Q4 2024 to include in its calculation of the baseline. In our view, if other suppliers, [X] have adjusted their provisions to correct previous over-provisioning in Q4 2024, then the Ofgem minded to approach to calculate the baseline could well become more materially incorrect.

Therefore, we consider that it is likely that Q1-4 overstate underlying bad debt costs (because of provisioning assumptions which proved pessimistic with hindsight) and Q5-8 understate underlying bad debt costs (because previous pessimistic provisioning assumptions are being unwound). As such we consider that Ofgem could do the following to set a more appropriate baseline than originally proposed:

- A. Weight the 4 quarters vs 8 quarters differently by, for example, using a 1.5:1 or 2:1 ratio rather than the 3:1 ratio that is currently being proposed
- B. Extend the number of quarters that it is averaged over. We would suggest an average of 10 quarters. Ofgem has said (para 3.17) *“were we to incorporate data from a longer timeframe in our calculation of the baseline, this would further mitigate the impact of provisioning decisions in any particular period”*.

We would support Option A as being the cleanest approach but think Option B is the next best if A is deemed not to work.

#### *Cost components included*

**Bad debt:** We agree with the proposal to use bad debt costs Option A.2 (‘Profit and Loss charge incurred’). The data is audited and from a ScottishPower perspective subject to stringent controls. [X] However, we recognise that provisions, which are accounting judgements, can be corrected over time.

**Debt-related administrative costs:** we agree with the Option Hybrid selected by Ofgem.

**Working capital costs:** We agree with the selection of Option C.1 that uses supplier net accounts receivable and applies the most recent cost of capital. In our view, only customer working capital should be included in this assessment as customer balances will include billed debt, unbilled debt, and customer credits. Everything else is in non-customer balances and should not be included, for example, energy costs and ROCs both assets and liabilities.

## 2. Benchmark

*Using a weighted average benchmark:*

Ofgem has proposed benchmarking debt-related costs using a weighted average benchmark of total costs as was used for the Covid true-up. Ofgem has provided various reasons for its support of a weighted average benchmark. As we have responded to Ofgem, this rationale applies in relation to the adjustment allowance also.

- We agree with Ofgem that there is correlation between debt related cost elements. *“For example, high debt-related admin costs could lead to lower bad debt charge and working capital costs, if spending more on collecting debt leads to faster and higher recovery of debt.”* And as such we should benchmark these together.
- We agree with Ofgem that customer mix is a non-efficiency factor which we consider has a significant impact on debt related costs.
  - Vulnerability: We agree that the proportion of vulnerable customers has a significant impact on supplier costs for both debt related costs and operating costs. In our view, this should be more formally recognised in the design of the price cap and its surrounding structures by using a levelisation mechanism. Without levelisation, there will be competitive distortions baked into the cap and a disincentive for suppliers to compete to serve vulnerable customers.
  - Payment method mix: Ofgem claims there is a *weak* correlation between costs and payment method mix since suppliers with widely different payment method mixes can have similar debt-related costs per customer (Appendix 2, para 4.29). We discuss this claim in more detail below in relation to payment method differentials. We consider that payment method mix is an important non-efficiency factor.
- We agree with Ofgem that a weighted average benchmark delivers better consumer protection.

Overall, we support a weighted average benchmark given that costs are largely driven by customer mix (levels of deprivation, transience and payment method mix<sup>5</sup>) rather than efficiency. A weighted average benchmark still retains incentives to improve efficiency.

We agree with Ofgem’s view that when there are high levels of uncertainty it should be open to reviewing the allowance with the potential for an ex-post allowance if costs have deviated materially.

*Benchmarking across parameters:*

Whilst we agree with the approach to using weighted average, we consider it should be done at payment method level. Ofgem proposes to benchmark costs at an aggregate level since in its view, benchmarking cost at the payment method level would be impacted by suppliers’ allocation methodologies, and it could risk setting an unachievable benchmark in practice,

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<sup>5</sup> Payment method and transience are linked

particularly under a lower quartile benchmark. As a result of using a weighted average benchmark, the latter argument is no longer relevant and, in our view, applies even less if the three debt-related costs are combined for each supplier. Ofgem also claims that it observed a weak correlation between supplier overall debt costs and payment method mix (Appendix 2, paragraph 4.57) and in paragraph 5.17 it confirms that this means “*the proportion of Standard Credit customers and average debt costs*”.

**Figure 6: ScottishPower bad debt costs by payment method (£/customer)**

[X]

Figure 6 shows the variation in ScottishPower bad debt costs. Depending on the analysis Ofgem has done which we do not have access to, it is possible that this was not considered over a long enough period of time and that a peak period was taken for one supplier and a trough for another.

Ofgem posits that the weak correlation could be a result of the dilution effect of prompt paying Standard Credit customers which is high amongst legacy suppliers and low amongst challenger suppliers (Appendix 2, paragraph 5.17). ScottishPower has [X], and therefore we would expect ScottishPower to appear [X] in this respect.

It is our view that payment methods should be benchmarked separately on a weighted average basis and consider that suppliers are a good judge of their allocation.

### 3. Allocating costs across payment methods

The data provided by Ofgem on the different allocation options in Appendix 2, Table 5.1 shows large differences between them. Ofgem’s preferred option is to maintain current price differentials with the discussion on this preference focused on why the apparent differences in cost for SC customers are either not cost-reflective or should not be reflected in the price cap. We consider the allocation across payment methods from these two angles:

1. Firstly, cost-reflectivity, how should costs be allocated in principle from a supplier perspective so that they can recover efficiently incurred costs.
2. Secondly, how should costs be charged to customers

#### *Cost-reflectivity:*

- Ofgem implies that it is not cost-reflective to focus on payment types since customers move between types and this is not tracked, and the provisions made relate to the payment type not the customer themselves or their characteristics and a further example of PPM vs DD bad debt costs is given. We do not find these arguments to be convincing, as a customer’s movement between payment types (SC to DD or DD to PPM) reflects their reduced ability to pay and potentially increased financial vulnerability meaning that the customer is now a higher risk of accruing significant debt which it could not do on the previous payment method. On DD it is very hard to accrue debt hence the lower risk to suppliers and the lower overall debt.

Ofgem justifies using historic differentials rather than the ones taken from reported costs since it does not observe suppliers with predominantly SC customer base in the market (Appendix 2, para 5.18). In our view, a supplier that is focused on serving SC customers would not be viable. This is both now, as a result of the current cross subsidies between DD and SC customers, as well as in the future, since in the future these cross subsidies would be exacerbated without a levelisation mechanism in place. We consider that Ofgem's rationale for why equal allocation is not feasible<sup>6</sup> would also apply to not using the cost-reflective allocation in this situation and would indeed put off any supplier considering specialising in serving those on SC. In Appendix 5 paragraph 4.35, Ofgem rejects equal allocation on the basis that this would give Notional Supplier C an EBIT uplift of 2.0pp and this would allow the supplier to over-recover costs and give it a competitive advantage. but Ofgem disregards the impact on competition of giving Notional Supplier B a 2.8pp uplift in EBIT via the proposed allocation.

**Table 4: Change in EBIT as a proportion of revenue at benchmark consumption (percentage points) taken from Ofgem Appendix 5 Table 8**

	Notional Supplier A	Notional Supplier B	Notional Supplier C
Ofgem minded-to (Option 1)	-0.4	-0.5	-0.5
Cost-reflective (Option 3)	0.1	-2.8	-0.1
Minded-to vs cost-reflective	-0.5	2.3	-0.4

**Table 5: Competitive advantage**

Supplier B competitive advantage relative to Supplier A	2.8
Supplier B competitive advantage relative to Supplier C	2.7

This reflects a failure on Ofgem's part to take into account the competitive dynamics. If Supplier B has a 2.9pp advantage compared to Notional Supplier A it can use this advantage to offer prices below SVT. Notional Supplier A will then either lose customers or have to drop its prices below SVT to stem customer losses. Further, Ofgem's assertion that lack of a predominant SC customer base in the default tariff market mitigates the impact of allocation choices regarding SC is incorrect since it doesn't take account of the relative sizes of the different suppliers in particular, Supplier B in this example. The more customers Supplier B has, the more additional profit from the price cap allocations it can use to outcompete its competitors.

#### *Customer fairness*

- Ofgem considers that customers paying by SC are a small group and focusing too high a differential on this payment method would mean that those who do pay promptly would be **disproportionately impacted**. We agree that using the cost-reflective value could be an issue in this way. Whilst it may, on average, be more cost-reflective to charge the full amount to customers, the size of the price differential could negatively impact customers. This is behind the rationale for our preference to implement levelisation phase 2. It is important to have a cost-reflective basis initially and then

<sup>6</sup> since it would mean that those with relatively high cost to serve customer base would not achieve efficient cost recovery, with risk to supplier financeability and competitive distortion

layer over the levelisation mechanism to adjust the differential to achieve policy goals and avoid an unbalanced approach.

- Ofgem has concerns that increasing the DD-SC differential (eg to be more cost-reflective) would create a **perverse incentive** on suppliers to keep high profit paying customers on SC. We do not think this is a significant concern since there are real additional costs and risks associated with paying by SC, meaning that suppliers prefer the certainty of DD. Furthermore, in a competitive market, suppliers will still be incentivised to move customers onto DD to reduce the risk of the customer switching to another supplier's DD tariff. Retail is a low margin business and therefore suppliers try to reduce their risk. However, to the extent that Ofgem does consider this to be an issue, levelisation phase 2 could be designed to avoid it. For example, Ofgem could levelise in relation to the level of financial vulnerability of the customer base. For this, a measure that is being developed to target DRSS could be used.
- Ofgem states that different suppliers' SC customer bases may well have different propensities to build up debt as a result of their different reasons for using this payment method. Whilst we recognise the concern that there is a **cross-subsidy** from this between those who have incurred debt related costs and those who haven't, this is part of how the cap as a one size fits all mechanism works for all cost items. In addition, we consider that Ofgem could control for this by implementing levelisation.

Overall, we do not agree with the arguments given against using the reported costs to set the initial price cap value for the different payments methods and consider that not doing so deters suppliers from taking on SC customers. In our view, a cost-reflective differential should be the starting point. Ofgem should then determine an appropriate cost differential considering incentives on both suppliers and customers, and implement levelisation phase 2 to achieve this differential in a similar way to PPM/DD standing charge levelisation. If levelisation is not implemented, the non cost-reflective allocation will cause significant competitive distortions, giving large DD focused suppliers a competitive advantage that can be used to undercut competitors.

#### 4. Fuel meter and tariff type allocations

We agree with the revenue based split for fuel type and the equal split for meter type with the scale by consumption.

In terms of splitting between FTC and SVT, Ofgem said that 38% of the SVT customer base did not provide a tariff type split and that is used as a rationale to split costs between FTC and SVT equally.

Whilst we understand that in the Covid 19 temporary debt allowance, Ofgem controlled for SVT vs FTC customers via revenue which had a low material impact, this allowance was temporary. For an enduring allowance, setting the allowance based on total costs and recovering only over SVT customers would impact cost recovery given SVT numbers are reducing and this will result in higher bad debt costs per customer for SVT (because the more engaged, paying customers will likely move onto FTCs). In our view, the difference between FTC and SVT should be accounted for, if this is not possible for some suppliers then Ofgem could approximate their split by using revenue as with the Covid 19 precedent.

## **5. Updating debt allowances:**

We agree with Ofgem's minded to position to treat debt related costs and operating costs separately. Ofgem has proposed to update bad debt and working capital debt allowances based on bill size, using the relevant EBIT cost of capital and for debt administration to update by CPIH. This is similar to how things work currently. Ofgem has also recognised the potential for ex post adjustments due to uncertainty of future costs. We agree with this approach. Bad debt could scale with bill size but only to an extent. As we have seen in the recent crisis, external factors can lead to a step change in debt costs and this is hard to forecast ahead of time and therefore we consider that being open to changing the allowance either prospectively or with an ex post adjustment is appropriate.

## **6. Estimating the allowance**

Section 7 of appendix 2 details the steps Ofgem used. We have comments on the following elements:

1. Ofgem has confirmed that working capital costs were calculated as the sum of customer and non-customer working capital costs. In our view, only customer working capital should be included in this assessment as customer balances will include billed debt, unbilled debt, and customer credits. Everything else is in non-customer balances and should not be included, for example, energy costs and ROCs, both assets and liabilities.
2. Ofgem uses a weighted average approach based on average number of customer accounts for estimating the proposed benchmark. Although we support benchmarking separately for payment method and fuel type, our concerns about using the aggregate methodology are less acute as a result of the weighted average methodology selected. However, if Ofgem were to change to the lower quartile, which we do not support, we would strongly advocate the separate benchmarking by payment method. This would ensure cost allowances reflect the different debt-related risks and administrative costs associated with each payment type. This segmentation would be essential to avoid unfairly penalising suppliers with portfolios skewed to higher-risk payment methods.
3. We raise caution over Ofgem's treatment of working capital in Appendix 2 para 7.13, particularly regarding the deduction of weighted average working capital costs to avoid double counting. It is unclear whether the estimated working capital costs deducted align with those included in the EBIT allowance, and there is no evidence confirming this alignment. If actual costs exceed those assumed in the EBIT allowance, there is a risk of undercompensating suppliers. Should this misalignment be the case, we advocate that Ofgem take corrective action to ensure that future adjustments properly account for any inaccuracies, thereby safeguarding suppliers from financial imbalances and maintaining confidence in the allowance-setting process. In event, we urge Ofgem to provide a more detailed explanation of what it has done in the interests of stakeholder transparency and confidence.



### **Annex 3: SMNCC**

We broadly support OFGEM proposals but would highlight the importance of reviewing the NPT SMNCC allowance based upon the outcomes of the DESNZ framework decision. It is essential that the SMNCC allowance aligns with required investment in Smart technologies resulting from the revised framework.

We agree with Ofgem that Option 3 would be the most robust approach and would most effectively balance simplicity and accuracy. It is important for transparency that the cost of In-Home Displays and any net operational benefits for debt handling, customer enquiry, customer switching, avoided site visits and the prepayment cost to serve (for PPM only) are correctly attributed to the smart meter rollout.

#### **Annex 4: Industry Charges**

We support setting an allowance for Industry Charges as a separate pass-through component, as an element within the revised Annex 5.

As noted within our earlier response to Annex1: Operating Costs, we believe it would be appropriate to implement an additional allowance to allow suppliers to recover MHHS costs, which would naturally align with the Industry Charge allowance component.

**ScottishPower**  
February 2025