

Anna Rossington
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Ofgem
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London
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Dear Anna,

Consultation on reviewing the potential impact of COVID-19 on the default tariff cap

We welcome Ofgem's decision to review the potential impact of COVID-19 on the default tariff cap and we are pleased to respond to this consultation. We set out our key points below and have provided more detail on these points in Annex 1. We agree with Ofgem's proposed 'float and true-up' approach with COVID-19 related bad debt costs arising between April 2020 and September 2021 being allowed for in the price cap for the period April to September 2021. However, we have the following reservations:

- We are concerned that Ofgem's approach to estimating the float based on 'leading indicators' is unlikely to be as robust as using cost data provided directly by suppliers in response to Ofgem's recent RFI, and we would encourage Ofgem to place more weight on the latter.
- We understand Ofgem's rationale for fully socialising costs between customers on standard credit (SC) and direct debit (DD), but we believe this fails to strike the correct balance and would encourage Ofgem to adopt a similar 48% socialisation approach as it did in the original price cap methodology.
- We think Ofgem needs to amend its definition of working capital for the purpose of this exercise, so that debts which have been provided for are not excluded (or in the alternative, include a separate working capital allowance for such debts).
- We strongly disagree with Ofgem's proposed use of lower quartile benchmarking, given that differences between suppliers are more likely to be due to other factors such as customer mix than differences in efficiency. We think a median approach would be more reasonable.
- 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 [X] 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.

- Ofgem's statutory consultation in November on the level of the float and subsequent consultation in 2021 on the true-up will hinge on Ofgem's interpretation and analysis of the data it has gathered. It is vitally important that Ofgem considers how the consultation can be conducted in as transparent a manner as possible, so that Ofgem's proposals can benefit from proper scrutiny and challenge by suppliers.

Finally, we would note that suppliers responded positively at the start of the COVID-19 crisis to requests from BEIS to provide support to customers in payment difficulty. Should BEIS consider making further similar requests this Winter, it will be helpful if Ofgem can liaise with BEIS to provide assurances that any additional costs associated with new measures (not already reflected in the 'float' allowance) can be fully reflected in the true-up process for Period 7.

Please do not hesitate to contact me or James Soundraraju (tel 0141 614 2421, jsoundraraju@scottishpower.com) if you have any questions arising from this response.

Yours sincerely,

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

Richard Sweet
Head of Regulatory Policy

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

1. Introduction

We comment below on the following aspects of Ofgem’s proposals:

- the costs to be included within the scope of the review (section 2);
- the impact of COVID-19 on debt-related costs in ScottishPower’s experience (section 3);
- the approach to setting the debt-related cost adjustment (section 4);
- our concerns about Ofgem’s proposed use of a lower quartile benchmark (section 5);
- the importance of controlling/adjusting for payment method and tariff type (section 6);
- Ofgem’s consultation process (section 7).

2. Costs in scope of the review

Debt-related costs

Ofgem says it has provisionally concluded that the only cost category requiring an adjustment is debt-related costs (working capital, bad debt and debt operations) as other costs are either not sufficiently material, already subject to pass-through in the methodology, or will be dealt with separately in another Ofgem workstream (notably smart, FiT and ECO3 costs). We do not disagree with this conclusion.

FiT costs

We welcome Ofgem’s commitment (paragraphs 6.59 to 6.61) to consult separately on new options for calculating the FiT allowance with effect from 1 April 2021 (Period 6). We agree that the methodology should move from using forecast costs and demand, to using actual costs and actual demand sourced from FiT quarterly invoices, with the result that suppliers’ actual costs (calculated on a £/MWh basis) are passed through on a lagged basis. It is particularly important that the methodology is designed in a way that excess COVID-19-related costs in Q2 2020 resulting from reduced overall demand can be passed through.

ECO3

Ofgem notes that while the Government’s assessment of total lifetime costs for ECO3, as set out in the most recent IA, is not much changed, the costs in each remaining period have increased substantially. Ofgem suggests that is a consequence of fewer than expected installations in ECO3 phase 1 (covering the cap Period 1) with the shortfall being shifted to later periods, and argues (paragraph 6.76) that this would result in a ‘clear and material systematic error’ whereby suppliers receive an allowance twice over, first in Period 1 (based on the original IA) and then in subsequent cap periods (based on the revised IA).

In our view the reasons behind the changes to the IA are more complex than Ofgem suggests, with the result that there is in fact no 'systematic error'. The increased costs in ECO3 phases 3 and 4 are largely driven by changes in the scheme design introduced by BEIS in January 2020. New requirements were introduced around PAS2035/2019 which add significant costs to the delivery of every measure type, estimated in the IA to be an additional £350 per insulation measure or around £200m across the duration of ECO3. The latest BEIS IA had to be creative in addressing these increased costs and ensuring that the overall scheme budget cap, as set by HM Treasury, was not breached in the IA. Ofgem should be wary of relying on the robustness of the IA to make any future changes to allowances in the default tariff cap. If it does so, it will be essential to consult in an open and transparent manner in advance of considering any changes to this element of the default tariff cap to allow for robust scrutiny of its underlying assumptions and rationale.

3. Impact of COVID-19 on debt-related costs

As noted above, we agree with Ofgem's assessment that the most important impact of COVID-19 on suppliers' costs (that is not otherwise catered for) is the impact on debt. We set out below our current assessment of the impact on ScottishPower's debt costs, drawing on the information we submitted in response to Ofgem's 21 September RFI.

Our actual and forecast bad debt charges for domestic customers are shown in Figure 1 (taken from our response to Ofgem's recent RFI).

Figure 1 – ScottishPower domestic bad debt cost

[REDACTED]

Bad debt costs are forecast to be [REDACTED] higher than in 2019. This is almost entirely due to the effects of COVID-19 and in particular:

- voluntary actions taken by ScottishPower (with encouragement from the Government) to alleviate COVID-19 impacts on customers (payment holidays, suspension of debt follow-up actions etc)
- other restrictions on debt recovery activity resulting from lock-down (eg inability to obtain warrants for installation of prepayment meters, inability to visit customers in payment difficulty);
- impact of lockdown, furloughing etc on customer income leading to reduced cash collection.

We have estimated the bad debt costs we would have expected to incur in 2020 and 2021 in the absence of COVID-19 and these are [REDACTED] the bad debt costs in 2019 (Table 1). We estimate that the additional domestic bad debt cost impacts from COVID-19 will be £[REDACTED]m in 2020 and £[REDACTED]m in Q1-Q3 of 2021 (total £[REDACTED]m).

Table 1 – ScottishPower estimated domestic bad debt cost

	Domestic bad debt cost (£m)		
	2019	2020	2021 (Q1-Q3)
Baseline (no COVID)	[X]	[X]	[X]
Impact of COVID:			
Reduced collections driving increased debt	0	[X]	[X]
Increased provision rates driven by COVID	0	[X]	0
Total COVID-19 related	0	[X]	[X]
Total	[X]	[X]	[X]

Our bad debt costs are calculated by multiplying the volume of outstanding debt by percentage provision rates which depend on the age of debt, the payment method and whether the debt is 'live' or 'final'. The increase in bad debt costs due to COVID-19 therefore results from an increase in the volume of debt and also an increase in the percentage provision rates to reflect our changing assessment of the risk of non-payment (reflecting future economic conditions). The provision rates are updated from time to time and the large month-on-month increase in December 2020 (to £[X])¹ reflects our normal end of year review of provision rates (which in turn reflects trends in collection rates due to COVID-19 and our expectation of continuing trends in future).

The £[X]m bad debt cost impact for 2021 reflects post COVID-19 provision rates applied to new debt, ie debt relating to energy consumed in 2021. Should we need to increase our provision rates further in 2021 due to a further deterioration in economic conditions (relative to our 2020 assessment), this would show up in the table as a non-zero entry in the table for 'increased provision rates driven by COVID-19'.

Continued COVID-19 related increase in debt levels

Looking forward to Q4 2020 and 2021, we expect a continued COVID-19-related increase in debt levels driven by lower customer income (as job retention schemes end, unemployment increases, and savings are used up) and increased energy consumption through the winter period.

We also expect an increase in the number of house moves to contribute to an increase in debt levels. As can be seen from Figure 2 there has been a sharp reduction in the number of former customers with outstanding debt since April 2020. This reflects the fact the number of house moves fell sharply during lock-down. This will have reduced bad debt costs for the period in question (because final debt attracts a higher provision rate than non-final debt) but we would expect a degree of 'bounce-back' in house moves following lifting of restrictions and a corresponding increase in bad debt costs.

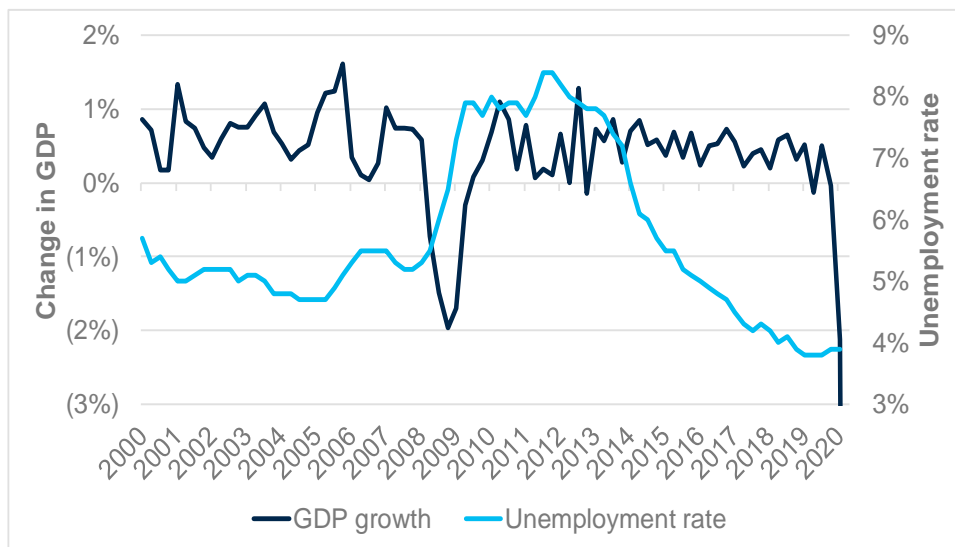
¹ This monthly increase can be seen in Figure 1, where the gradient increases for the green ('2020') line at December 2020.

Figure 2 – ScottishPower former domestic customers with an outstanding debt

[X]

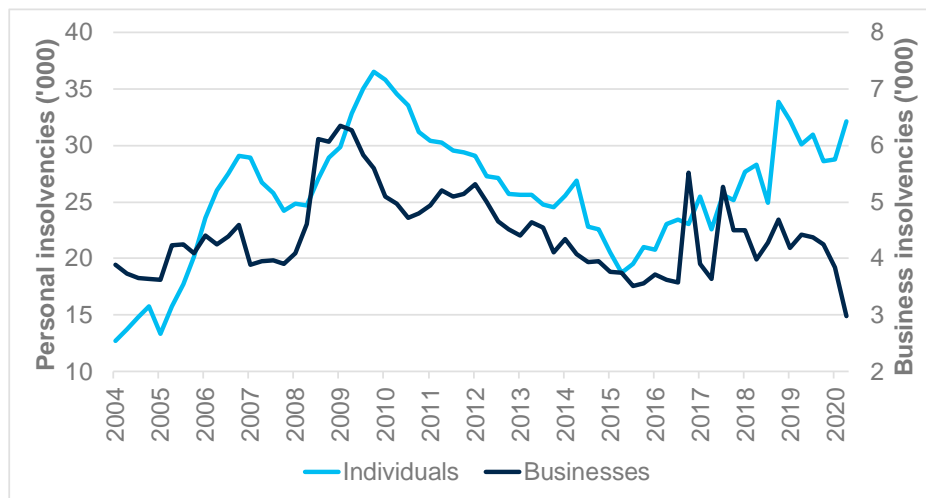
Our forecasts are based on conditions at 1 October 2020. If the economic outlook deteriorates further between now and 2021, this could result in higher bad debt costs in 2021 due to increased provision rates (and vice versa). But we believe the downside risk (worsening economic conditions) is greater than the upside. The experience of the 2008/9 financial crisis suggests that unemployment may peak 1-2 years later and then be sustained for a number of years (Figure 3) with a similar lag in personal insolvencies (Figure 4).

Figure 3 – Change in GDP and unemployment rate 2000-2020



Source: ONS

Figure 4 – Personal and business insolvencies 2004-2020



Source: UK Government, Insolvency Service Official Statistics

Uncertainty over debt levels and bad debt costs underlines the importance of a mechanism to true-up/down debt related costs *ex post*, and we support Ofgem’s proposed float and ‘true-up’ approach.

4. Approach to setting the debt-related cost adjustment

‘Float and true-up’

Ofgem appears to be leaning towards an approach in which an adjustment is introduced in Period 6 based on an *ex ante* estimate of COVID-19 related debt costs, followed by an exercise to estimate actual costs *ex post* and apply a true-up in Period 7 (float and true-up). Of the different options put forward by Ofgem we think this is the most appropriate. The alternative of deferring the entire allowance to Period 7 on an *ex post* basis would mean that suppliers would have to wait far too long and could unnecessarily impair their financial viability. It could also result in a much bigger step change in prices in Period 7.

Ofgem suggests that a high-level approach for setting the float could be to form a judgement based on supplier forecasts, leading indicators, macroeconomic evidence and other stakeholder evidence. We believe Ofgem should attach significant weight to the information suppliers have provided in response to its 21 September RFI when it sets a quantum for the float. Suppliers will have needed to ensure that their estimates of bad debt costs in their RFI responses are aligned with their internal accounting treatment which will be subject in due course to scrutiny by external auditors, the market and shareholders.

Time period

Ofgem appears to be leaning towards an approach in which 18 months of estimated costs (March 2020 to September 2021, Periods 4 to 6) are recovered in Period 6. We agree that this is the most appropriate approach.

Socialisation of costs

Ofgem acknowledges that COVID-19 related bad debt costs are likely to be concentrated amongst customers who pay by SC but proposes to socialise these additional costs across all customers regardless of their payment method. Whilst we understand Ofgem’s rationale for

socialising, on the basis that costs of defaulting customers should be spread fairly across all customers, we note that this will exacerbate the competitive distortions that have already been introduced by partial socialisation of bad debt costs in the existing price cap methodology.

This distortion arises because the larger (former incumbent) suppliers have much higher percentages of customers paying by SC. If costs are socialised across SC and DD, new entrant suppliers with much smaller proportions of SC customers will be over-compensated and larger suppliers with higher proportions of SC customers will be under compensated. We present data below (section 6) to illustrate the magnitude of this effect.

We would therefore suggest that a fairer approach, which balances the short and longer-term interests of consumers (ie short term bill value versus healthy competition) would be to stick with the 48% socialisation adopted in the original price cap methodology.

Working capital adjustment

Ofgem says (paragraph 4.38) that it would also want to allow for the working capital costs a supplier incurs before a debt is written off and it understands that this cost does not depend on whether a supplier has made a provision or not. We agree that increased levels of debt resulting from COVID-19 (whether provided for or not) will increase a supplier's working capital costs and should be allowed for in the price cap. However, the approach to calculating the working capital impact will potentially be different for debts that have been provided for and those which haven't:

- If a debt *has not* been provided for, there is an assumption that it will be recovered in due course, and it will show up as a current asset in Ofgem's measure of working capital ('current assets less current liabilities for the supply business')².
- If a debt *has* been provided for, there is an assumption that the sum will never be recovered, so it is no longer a current asset and will not show up in the working capital. In this case, there is still a cost of capital associated with the debt, but it arises as a result of the time lag between the debt being provided for and the resulting bad debt cost being recovered through the bad debt component of the price cap allowance (most likely in Period 6).

Hence, if Ofgem wishes to retain its current definition of working capital, it will need to include two separate allowances for working capital, one for debt that has been provided for and one debt which has not been provided for. However, a simpler alternative approach would be to adopt a different definition of working capital for the purpose of this exercise, such that debt that has been provided for is *not* excluded. It is important that Ofgem adopts one or other of these approaches: if Ofgem was simply to stick with its current definition of working capital, this would mean that the value of the working capital allowance would be sensitive to the exact timing of when provisions are made – ie it would depend on an accounting decision that has no bearing on the actual cash balance of the supplier – which is clearly problematic.

5. Use of lower quartile approach

We strongly disagree with Ofgem's proposed use of a lower quartile (LQ) benchmark for calculating the *ex post* amount of debt-related costs for the true-up. Ofgem notes (paragraph 4.45) that, to the extent that COVID-19 is a large and unexpected shock and largely outside a supplier's control (e.g. driven by chance or unexpected features of its customer base), an

² As used in Ofgem's 21 September 2020 RFI and in line with the definition used by Ofgem to gather data to set the payment method uplift in 2018

average cost benchmark could be appropriate. Ofgem then goes on to argue that variations in COVID-19 related debt costs are likely to result from differences in supplier efficiency in debt management, and that an average cost benchmark therefore risks rewarding inefficiency, leading it to favour a LQ approach.

Whilst there will inevitably be some differences in debt management efficiency between suppliers, we believe there is strong evidence that differences in debt costs between suppliers are predominantly due to customer mix, including:

- mix of customers by payment method
- mix of customers by sociodemographic characteristics
- geographic distribution of customers.

One important distinction is between large (former incumbent) suppliers and more recent market entrants. Newer entrants have typically biased their customer acquisition strategies towards DD customers with the result that they have a much smaller proportion of customers paying by SC, and a much higher proportion of engaged customers (since customers need to be engaged to switch in the first place). Given the wide difference in debt costs between DD and SC, Ofgem would need as a minimum to control for the mix of payment methods in any supplier benchmarking exercise (as we assume it did in calculating the SC uplift in the price cap).

But even if Ofgem can control for payment method mix, there will be other factors that are harder to control for such as

- **Geographic distribution of customers**, which could also explain differences in COVID-19 related debt costs, given the varying regional approaches taken to lockdown, and given the fact that many of the incumbent suppliers still have a distinct regional bias in their customer base. For example, an important tool for managing debt is the ability to install prepayment meters under warrant, and differing approaches to prioritising warrant applications between the Courts in England & Wales and in Scotland, as result of COVID-19, could give rise to such differences.
- **Level of engagement of customers.** In ScottishPower's experience (see section 6 below) there is a [x%] difference between the bad debt costs of SC customers on SVT and SC customers not on SVT. We believe this largely comes down to the extent to which customers are willing to engage with us when they get into payment difficulty. Those that do engage are encouraged to move to a cheaper non-SVT tariff and take advantage of other debt management options. It is much harder to assist those who do not engage, and the average bad debt costs of SC customers on SVT are currently [x%] of non-SVT customers. Less engaged customers are more likely to have remained with their incumbent supplier and would be another reason (unrelated to efficiency) why incumbents' costs may appear higher than new entrants.
- **Amount and duration of voluntary support provided to customers in hardship during the pandemic.** Ofgem suggests (paragraph 4.48) that suppliers should not be compensated for going beyond the 'baseline level of support that suppliers have agreed with government on a voluntary basis'. We think Ofgem's stance here is unduly harsh and is in effect penalising suppliers who may have responded more quickly or wholeheartedly than others to calls from Government to support consumers. It is not as if the 'baseline' level of support was so clearly defined that anything beyond it can be clearly deemed as inefficient.

Given this range of factors we think it would be more appropriate for Ofgem to adopt an average (eg median) benchmark rather than the LQ benchmark it has suggested.

6. Controlling/adjusting for payment method and tariff type

Ofgem says (paragraph 4.81) that it does not consider it would be feasible to gather data which identifies debt-related costs based on the payment method on which they were incurred (and that a similar difficulty would apply to splitting debt-related costs based on the tariff type on which they were incurred).

Even if Ofgem decides to socialise COVID-19 related debt costs fully across customers paying by DD as well as SC (which we believe would lead to excessive distortion of competition – see above), this does not remove the need for Ofgem to identify how COVID-19 related debt costs vary with payment method and tariff type (default vs non-default tariffs).

- In order to benchmark suppliers in terms of COVID-19 related bad debt costs, Ofgem will need to control for the mix of SC and DD customers of each supplier and take into account the different costs associated with these payment methods – as it did when setting the original SC price cap uplift. Unless it does so, any comparisons between suppliers will be meaningless.
- In setting the resulting price cap allowance, Ofgem will need to take account of the higher proportion of SC customers on default tariffs than on non-default tariffs. When Ofgem originally set the SC uplift it assumed that 35% of default tariff customers were paying by SC (compared to circa 27% for the market as a whole). Ofgem will need to calculate separate £/customer COVID-19 related debt costs for SC and DD customers and weight them according to the mix of SC and DD customers on default tariffs.
- Finally, we believe Ofgem also needs to obtain information on the relative costs for SC customers on default tariffs versus customers on non-default tariffs. In ScottishPower's experience, the average bad debt cost for SC customers on default tariffs is [3x] the cost for SC customers on non-default tariffs (see below). We believe this difference reflects the different levels of engagement of default and non-default tariff customers, and we see no reason why similar trends would not be observed in other suppliers. We would note that when we are able to engage with customers in payment difficulty we will encourage them to move to a cheaper non-default tariff if they are on our SVT as well as offering other debt advice; customers who remain on SVT are therefore more likely to be disengaged and less successful in managing their debt problems. Given the apparent magnitude of this difference, we think Ofgem should give proper consideration to how it can be accommodated in its analysis, at least in time for the true-up process in 2021.

The details of our analysis referred to above are set out in the tables below. Table 2 shows the distribution of non-prepayment domestic customers by payment method and tariff type, and the widely different mix of SC and DD customers in SVT and non-SVT tariffs, [3x]% SC for SVT vs [3x]% for non-SVT.

Table 2 – ScottishPower live services by payment method and tariff type

	ScottishPower live services 2020		
	SVT	non-SVT	Total
Standard Credit	[X]	[X]	[X]
Direct Debit	[X]	[X]	[X]
Total	[X]	[X]	[X]
SC %	[X]	[X]	[X]

Table 3 shows the cumulative bad debt provision at October 2020 for each category of customer. Although we have shown total cumulative bad debt provision rather than COVID-19 related bad debt provision, we would expect the two to be closely correlated.

Table 3 – Cumulative bad debt provision by payment method and tariff type

	Cumulative bad debt provision @ Oct 2020 (£m) [Final added pro-rata to SC and DD]			
	SVT	non-SVT	Total	% SVT
Standard Credit	[X]	[X]	[X]	[X]
Direct Debit	[X]	[X]	[X]	[X]
Total	[X]	[X]	[X]	[X]

Table 4 shows the cumulative bad debt provision per dual fuel customer. The figure for SC customer on SVT (£[X]) is [X] the figure for SC customers on non-SVT (£[X]). As noted above, we believe this reflects the differing levels of engagement and ability to manage payment difficulties between the two categories. The figures for DD are [X] but show [X] trend, with non-SVT [X] than SVT. We have not fully investigated this difference, but it would be consistent with our practice of encouraging customers in payment difficulty to move onto the cheapest tariff possible, which is generally DD non-SVT.

Table 4 - Cumulative bad debt provision per customer by payment method and tariff type

	Cumulative bad debt provision @ Oct 2020 (£/DF customer*)		
	SVT	non-SVT	Average
Standard Credit	[X]	[X]	[X]
Direct Debit	[X]	[X]	[X]
Weighted average	[X]	[X]	[X]

* £/DF calculated as 2*£/service

7. Consultation process

It is important that any final proposals in the November Statutory Consultation include transparent access to the underlying data, so that suppliers can interrogate the assumptions and calculations that Ofgem has made.

It will be even more important that Ofgem provides full transparency (including through use of a 'disclosure room' if appropriate) for any consultation around a true-up process for Period 7.

