

Leonardo Costa
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Ofgem
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13 April 2021

Dear Leonardo,

**REVIEWING THE POTENTIAL IMPACT OF COVID-19 ON THE DEFAULT TARIFF
CAP: CAP PERIOD SEVEN WORKING PAPER**

Thank you for the opportunity to comment on your working paper which considers whether a float for Period 7 is necessary and the approach to be taken if Ofgem concludes one is required. This response should be read in conjunction with our 2 April response to Ofgem's working paper consultation on truing up the float for P4 to P6.¹

Our main points are as follows (some covered in more detail in Annex 1):

- (a) We believe Ofgem should provide a conservative float in Period 7 following a similar methodology as it used to set the initial floats for Periods 4 to 6, with two changes:
 - Ofgem should benchmark cumulative bad debt provisions from Periods 4 to 7, rather than considering Period 7 in isolation.
 - Ofgem should make use of the additional data it has requested in its RFI and control for payment method mix.
- (b) We suggest Ofgem should keep open the option of using the RFI data submitted on 12 May in its design of a float for Period 7.
- (c) We do not agree with the option of including additional filters on suppliers' estimates of costs in Period 7 that are included in Ofgem's benchmarking sample. It changes the basis on which the floats for Periods 4 to 6 and Period 7 would be calculated and creates unnecessary barriers to a cumulative approach to true-up.
- (d) We do not support the introduction of a sharing factor that would limit the recovery of efficiently incurred costs. As we stated in our response to the true-up consultation, supply sector finances continue to be precarious and it would not be in the interest of consumers to see further supplier insolvencies.

¹ Price Cap – Call for input on the true-up process for COVID-19 costs (March 2021)
<https://www.ofgem.gov.uk/publications-and-updates/price-cap-call-input-true-process-covid-19-costs>

Please do not hesitate to contact me or James Soundraraju (tel 07548707639, 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, flowing style.

Richard Sweet
Head of Regulatory Policy

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

1. Introduction

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

- Basis for setting a float for Period 7
- Which RFI data set to use
- Use of additional 'filters' (alternative Option 2)
- Sharing factor

2. Basis for setting a float for Period 7

We agree that Ofgem should provide a conservative float in Period 7 and that it should follow a similar methodology as it used to set the initial floats for Periods 4 to 6, drawing on suppliers' actual and forecast bad debt provisions. As explained in our response to the true-up consultation, we believe bad debt provisions represent the best and most reliable source of data on the overall bad debt costs that suppliers will face due to COVID lockdown. Alternative measures which look at more granular metrics (movement in debt older than 6 months, payments received vs payments expected to be received etc) all suffer from the disadvantage that they only capture short-run impacts and do not reflect the longer run impact of COVID on the ultimate collectability of debt.

To explain this point further, the reports Ofgem references in the working paper shows a positive economic outlook by the end of 2021, when a float for Period 7 would be implemented. However, the financial shock to customers resulting from the COVID lockdown will potentially impact suppliers' bad debt costs over a significant number of years and in various ways. For example:

- reduced income and unemployment may have left some customers unable to pay pre-existing debts which they would otherwise have paid;
- reduced income and unemployment may have caused some customers to build up additional debt which they will ultimately default on, in whole or in part;
- suppliers' inability to undertake normal debt management activity may have caused customers to build up additional debt which they will ultimately default on;
- customers may have defaulted from direct debit (DD) to less secure payment methods (such as 'payment on receipt of bill') where they will be less likely to repay debt;
- customers may have used up their buffer of household savings leaving them less resilient and more likely to default on debt in the future.

However, although we would support the float being calculated based on bad debt provisions, we would suggest two important modifications to Ofgem's methodology to date:

- a) We believe Ofgem should look at suppliers' cumulative bad debt provision from Periods 4 to 7 and benchmark based on this cumulative amount. We explained in our response to the true-up consultation (Annex 2) how this could be done in practice.
- b) We believe Ofgem should take this opportunity to start controlling for payment method mix. Ofgem has requested the necessary data as part of its recent RFI, and it should start to make use of this data at the earliest opportunity. Whatever methodology Ofgem adopts

for adjusting for payment method mix, there will be further opportunity (at the true-up stage) to fine tune it.

3. Which RFI data set to use?

Ofgem says (paragraph 3.30) that it intends to design the float, if needed, based on the first (17 March) data submission in response to its RFI. It will use the second (12 May) submission to provide additional context for its decision on whether a float is necessary for cap period seven, alongside continued monitoring of economic forecasts, but it will not use the May data to estimate the amount of any float.

In the absence of any major shifts in economic outlook and sentiment between March and May, we would not expect the two data sets to present materially different views for most suppliers, and we can see that it may be easier from a timing perspective to start the analysis two months earlier.

However, it is possible that some suppliers may identify errors or discrepancies which they are able to correct between March and May, and in those circumstances, we think it would be appropriate for Ofgem to retain the flexibility to make use of the more recent data set. Equally, if there is a material shift in economic outlook, it would be desirable for Ofgem to reflect that. Therefore, we would suggest that Ofgem should keep open the option of using the May data if the circumstances warrant it.

4. Use of additional ‘filters’ (alternative Option 2)

Ofgem puts forward (paragraph 3.14) an alternative ‘Option 2’ approach to calculating the float in which it amends the methodology to include additional filters on suppliers’ estimates of costs that it collects via the RFI. Ofgem would exclude a supplier’s data from the sample used to benchmark costs if it did not consider that the forecasts were ‘reasonable’. We disagree with this approach for three main reasons.

First, as explained in our response to the true-up consultation, the bad debt provisions suppliers have made in Period 7 are inextricably linked to the provisions made in prior periods and cannot be considered in isolation. If a supplier adopted unduly pessimistic (with hindsight) assumptions in setting provisions in period 4 and 5, this may result in a negative adjustment to provisions in Period 7 when the economic outlook has improved (and vice versa). If Ofgem is to apply a filter, it would need to consider the reasonableness of cumulative bad debt provisions, not simply Period 7 in isolation.

Second, Ofgem’s option of filtering supplier forecasts risks introducing a degree of subjectivity, and suggests that Ofgem lacks confidence in the robustness of suppliers’ auditing process, given that suppliers’ methodologies for bad debt provisions will be subject to regular scrutiny by auditors. We do not think Ofgem needs to be concerned that an incentive exists for suppliers to game the RFI by providing higher estimates of debt-related costs. Most suppliers are part of a listed company and will therefore have an incentive to present a balanced view of profitability to investors (in addition to the need to satisfy auditors).

Third, Ofgem’s proposed filtering approach will be particularly prone to subjectivity unless Ofgem is able to adequately control for differences between suppliers, such as mix of payment methods and tariff types. Ofgem suggests (para 3.11) that it is not intending to control for these at this stage.

On a point of detail, Ofgem says (para 3.17) that it intends to consider the consistency of supplier forecasts with the stock of debt older than 6 months held by the supplier. Such a comparison may be useful as a broad check, but we would caution against placing too much reliance on it. Bad debt provisions are intended to reflect the best estimate of total bad debt costs associated with the current stock of debt, integrating forward in time. Movements in bad debt provisions may be significantly greater than movements in the stock of bad debt older than 6 months for a number of reasons. For example, if the mix of payment methods associated with the stock of debt shifts towards higher risk payment methods, this would (quite reasonably) increase the bad debt provisions. Furthermore, if there has been a deterioration in the economic outlook, such that higher rates of default on the debt are expected in the coming years, this may show up in movements of provisions but not in movements of the stock of debt.

5. Sharing factor

Ofgem is considering the use of a sharing factor which would result in suppliers bearing some of the additional costs due to COVID-19.

We disagreed with the use of sharing factors in our response to the true-up consultation and we take the same view in relation to a float for Period 7. Ofgem has not explained why it thinks it might be appropriate to introduce a sharing factor, nor why it is considering its introduction in hindsight.

Supply sector finances continue to be precarious and we do not believe it would be in the interest of consumers to see further supplier insolvencies. Therefore, we do not support the introduction of a sharing factor that would limit the recovery of efficiently incurred costs.

ScottishPower
April 2021