Ofgem's Review of COVID-19 Impacts on the Default Tariff Cap

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Introduction

Energy UK is the trade association for the GB energy industry with a membership of over 100 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership covers over 90% of both UK power generation and the energy supply market for UK homes. We represent the diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 27 million homes and every business in Britain. Over 680,000 people in every corner of the country rely on the sector for their jobs, with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry invests over £12.5bn annually, delivers around £84bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to HMT.

This is a high-level industry view; Energy UK's members may hold different views on particular aspects of the policy consultation. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

Energy UK welcomes Ofgem's review into the potential COVID-19 impacts on the default tariff cap. Energy UK and suppliers have worked throughout the pandemic to ensure that customers remain on supply and receive the best service possible in difficult times, particularly those customers in the most vulnerable circumstances.

Energy UK welcomes Ofgem's recognition that an allowance may need to be made for any significant and material debt-related costs due to the impact of COVID-19 that is evidenced in the data. We also recognise that during the wider economic impact of the pandemic Ofgem will look to ensure that customers are protected from paying unnecessarily higher energy prices. However, it is essential that suppliers are able to recover efficiently-incurred costs (and only efficiently-incurred costs, as far as they can be robustly estimated), and that the economic impact upon suppliers of COVID-19 caused debt is appropriately accounted for in the default tariff cap.

It will be essential that Ofgem's calculations and assumptions to strike this balance between supplier financeability and customer protection are open to transparent access in its November Statutory Consultation, to allow for robust scrutiny by suppliers and stakeholders.

Impact of COVID-19 on Debt-related Costs

Energy UK welcomes Ofgem's intention to ensure that significant additional debt-related costs that result from COVID-19 and its wider impacts on the economy are accounted for appropriately within the default tariff cap. We are of course aware of wider economic pressures that customers may be under in the coming months, and agree that impacts of COVID-19 may be more significant over the winter period where consumption will increase, and Government support such as the furlough scheme are ended. However, it is essential to ensure that suppliers are able to recover efficiently-incurred costs (and only efficiently-incurred costs, as far as they can be robustly estimated), including any significant and material additional costs as a result of COVID-19, to protect customers and competition from the greater costs and impacts of supplier failure.

There will be a clear need for a balance between ensuring efficient suppliers can recover these costs, and protecting customers against paying an unnecessarily high amount based upon an estimation. Any adjustment must be made based upon the best data available, and we would urge Ofgem to ensure that its Statutory Consultation includes transparent access to the underlying data, including bad debt costs, for stakeholders to effectively scrutinise the final proposals. If Ofgem does pursue the 'float and true-up' approach, any further reassessment of debt-related costs ahead of trueing-up will need to also be transparently conducted.

Periods Covered by an Adjustment

As we have previously noted, there are certain aspects of the price cap methodology (such as the smart meter allowance) where we do not believe that true-up mechanisms are appropriate as they can undermine suppliers' ability to invest and price with certainty over the life of the cap. However, given the huge uncertainty around any forecast of COVID-19-related debt costs, an approach based on *ex ante* estimates and subsequent *ex post* true-up ('float and true up') for costs incurred in price cap periods four, five and six would seem the most sensible approach if supported by the data available to Ofgem. It would ensure that suppliers can recover at least some of their efficiently-incurred costs close to the time at which they are incurred and minimise the wider market impacts and additional costs of a supplier failure/s as a result. We believe that it will be important for Ofgem to differentiate between the economic impacts of debt-related costs on suppliers, and the eventual accounting costs once debt is written off. Given the shock nature of the pandemic and its impact, a 'float and true-up' approach could alleviate the cashflow and debt-related cost risks that could have a much greater impact on suppliers' ability to finance operations than the uncertainty a clawback mechanism would normally create.

A purely ex-post approach may see suppliers unable to recover efficiently incurred debt-related costs for over a year, and lead to wider cost impacts to customers and the market as a whole. However, if a float cannot be robustly estimated based upon the data available to Ofgem to the end of September, then an ex-post approach would allow Ofgem to collect a more definitive set of data that will also include winter and post-furlough evidence. Ofgem would then be able to make a more confident decision, whether that be to start a float and adopt a true-up approach, hold out for ex post implementation or indeed do nothing if it is not required.

In either case, we note that Ofgem has not laid out in specific details how it would undertake any analysis to produce the proposed float estimate. Ofgem must be transparent with the relevant data and assumptions to ensure that stakeholders are able to robustly scrutinise Ofgem's proposals and their impacts on customer and suppliers, and provide detailed input into its decision-making in these extreme circumstances.

We acknowledge that Ofgem will need to balance the short-term impact on customers and suppliers when deciding upon the most appropriate approach, and setting the level of any provisional float if this route is chosen. If Ofgem's estimate errs on the conservative side for the float, this would mitigate any price increase for consumers in the short-term and would at least smooth the impacts overall for customers and suppliers alike.

Calculating the Actual Level of Debt-related Costs

We would welcome greater clarity from Ofgem on how it has determined that a lower quartile approach for the benchmarking is the appropriate approach. Suppliers are strongly incentivised to minimise additional debt related costs in any event – though their freedom of action would be somewhat conditioned by regulation and additional voluntary commitments required by Government. If the relevant differences between suppliers are predominantly due to differences in efficiencies, then such an approach would likely be most suitable. However, if differences in debt-related costs are predominantly due to customer types or other factors unrelated to efficiency, then this approach may not be the most appropriate, and could unduly penalise suppliers for the make-up of their customer base. Ofgem has not provided sufficient detail of its analysis in this area to enable us to provide definitive feedback. The lower quartile change in debt-related costs pre- and post-COVID based on a single supplier may be unlikely to provide an appropriate measure of efficiently-incurred costs in these extreme circumstances. At a minimum, it will be necessary for Ofgem to control carefully for suppliers' differing mixes of customers on standard credit and direct debit when conducting any benchmarking of COVID-related debt costs to ensure its calculations are appropriate.

COVID-19 Costs for PPM Customers

In principle, we would note that there have been additional costs for serving PPM customers during the COVID-19 pandemic, which are also likely continue or increase as we enter the winter period, such as the provision of discretionary credit and increased customer contacts. However, our members are best placed to provide the data to evidence this directly to Ofgem.

Impact of COVID-19 on Policy Costs

Energy UK welcomes Ofgem's plans to consult on changes to the FiT scheme costs methodology, to ensure that the actual costs of FiTs scheme are recovered on lagged basis.

Industry has, however, previously raised serious concerns with BEIS about its latest ECO3 Impact Assessment. We would, therefore, strongly disagree with Ofgem's assertion that there is a 'clear and material systematic error' in the default tariff cap. The increased ECO cost in ECO periods 3 and 4 are largely been driven by changes in the scheme design introduced by BEIS in January 2020. In particular, new requirements around PAS2035, 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 £200mn across the duration of ECO3. The latest BEIS IA, therefore, 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, therefore, 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.

Impact of COVID-19 on Remaining Cost Allowance

We are concerned that Ofgem may be overlooking increased operating costs for suppliers due to their required operational responses to the COVID-19 restrictions, such as facilitating working from home, equipment costs, staffing reallocations rather than furloughing, and increased customer contacts. We would welcome clarification as to whether Ofgem's initial view, that the net impact on operating costs would be a decrease, is substantiated by the data it has previously collected. Ofgem must be transparent in its November Statutory Consultation to enable suppliers to scrutinise all the data on which it is basing any assumptions or assessment of the cap level.

If you would like to discuss the above or any other related matters, please contact me directly on 020 7747 2931 or at steve.kirkwood@energy-uk.org.uk.