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Dear Leonardo

**RE: Price Cap Consultations – True-up process for Covid-19 Costs & Credit and PPM SMNCC Allowances**

I am writing to you in response to Ofgem's consultation on the true-up process for Covid-19 costs and the May 2022 consultation on credit and PPM SMNCC allowances.

**True-up Process for Covid-19 Costs**

Energy UK is concerned that Ofgem has decided not to analyse the costs incurred for SVT customers as it had proposed in its November 2021 consultation, and instead is adopting a methodology that averages across all credit customers.<sup>1</sup> There is a significant risk that this approach will fail to take into account that the proportion of credit customers paying by standard credit (SC) is much higher for SVT than for all credit customers. This approach is also inconsistent with Ofgem's previous treatment of debt costs in the price cap.

Our members will be best placed to provide information on the exact impacts of this new methodology, but in general our concerns cover three main areas:

- Failure to take account of SC:DD payment method mix for SVT customers in calculation of bad debt costs.
- Failure to take account of SC:DD payment method mix for SVT customers in calculation of working capital costs.
- Failure to give full consideration to the appropriate cost of borrowing in setting the allowance for working capital costs.

When designing the cap methodology previously, Ofgem had recognised that bad debt costs are significantly higher for SC than for DD customers and estimated the bad debt costs for SC and DD separately. Ofgem's new methodology goes against this principle previously underpinning the design of the cap.

As Ofgem notes in the present consultation (para 5.49), it said in its November 2021 consultation that it intended to carry out our benchmarking using data on default tariff customers only: *"This is because the cap applies to default tariff customers, and so we are most interested in the additional COVID-19 costs related to customers under the cap. This would have addressed concerns from suppliers about default tariff customers being more likely to incur debt than fixed tariff customers."*

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<sup>1</sup> Octopus Energy does not support Energy UK's position on the need for a Covid-19 debt adjustment and therefore does not support this response.

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Had Ofgem adopted this approach, it would not have been necessary to control for the payment method mix for SVT, since this would have automatically been reflected in Ofgem's calculations. If, as Ofgem is now proposing, it abandons this approach and instead carries out its benchmarking using data for all credit customers, it becomes essential to control for payment method for both bad debt and working capital costs.

Some of our members have also raised concern with Ofgem's rationale not to include an allowance for additional Covid-related working capital costs. In particular, there is disagreement with Ofgem's reasoning that the increased debt is a matter for short-term financing, and that the substantial amount of capital required over a prolonged period cannot be covered by short-term financing, and certainly not at the Sterling Overnight Index Average (SONIA) rate Ofgem suggest.

Overall, we believe that Ofgem should review any evidence provided by suppliers in response to this consultation and ensure that, as ever, the price cap is set at a level that allows for suppliers to recover their efficiently incurred costs.

### **Credit & PPM SMNCC Allowances**

Energy UK's main concern with Ofgem's proposals is its use of the Gross Domestic Product (GDP) deflator measure of inflation, which Ofgem recognises has known issues as a result of the pandemic on ONS measurement of government output, and are unlikely to be reflective of the changes in prices suppliers and consumers experienced in 2020 and 2021. As noted above, the price cap is intended to allow suppliers to recover their efficiently-incurred costs. There is a strong case for aligning indexation of SMNCC allowances with operating cost allowances in the cap which use CPIH. If Ofgem rejects this, it should set out clearly how its use of the GDP deflator measure of inflation aligns with this underlying principle of the price cap's purpose. In any event, regardless of the inflation measure used in the SMNCC model, Ofgem must consult primary data sources (i.e. the ONS and OBR) directly, and not rely on outdated figures from the Green Book which are already one year out of date.

We hope that these comments on Ofgem's consultations have been useful, and we would be happy to discuss any of the points raised in more detail.

Yours sincerely,

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