

Centrica response to Ofgem's Consultation on possible wholesale cost adjustment

NON-CONFIDENTIAL VERSION

14 June 2022

1. We welcome Ofgem's recognition that it is in the interest of consumers for suppliers to be able to recover efficiently incurred costs. In this response we respond to Ofgem's request for provision of cost information and views on efficient costs.

Unexpected standard variable tariff (SVT)¹ demand

2. As set out in Ofgem's consultation, increases in wholesale prices above the wholesale allowance may lead to an increase in the number of customers on SVTs above what was expected, as the SVT will have "locked in" lower prices than FTC tariffs. This unexpected increase in SVT customer numbers will require additional commodity to be bought at a higher price than the wholesale cap allowance.
3. Suppliers work to minimise the costs of unexpected SVT demand by hedging their commodity based on a churn forecast, predicting whether the number of customers on default tariffs is likely to increase or decrease. As set out in our response to Ofgem's November 2021 consultation on the potential impact of increased wholesale volatility on the default tariff cap², there will always be an uncertainty about these forecasts. However, this uncertainty, and the potential for associated costs, increases significantly when wholesale prices are volatile.
4. For the previous price cap period, Period 7³, Ofgem found that an adjustment of £41 per dual fuel customer was required to account for unexpected SVT demand costs.⁴ On the basis that unexpected SVT demand costs may also arise for periods 8 and 9, Ofgem is seeking further information in the following areas to inform its understanding of the efficient costs faced by suppliers as a result of recent wholesale price increases and volatility:
 - a. the potential reasons for differences in costs between suppliers, to inform its view on whether a benchmarking approach is appropriate;
 - b. estimates of Centrica's costs; and
 - c. the appropriateness of offsetting costs against existing allowances.
5. We provide evidence on each of these points in the sections below.
6. Although the focus of this consultation relates to unexpected costs resulting from recent increases in wholesale prices, it must be stressed that an unexpected *decrease* in wholesale prices could incur just as much of a cost for suppliers (as they are forced to unwind hedges in a falling market) as the unexpected *increase* that we have currently seen. While we welcome the introduction of the market stabilisation charge (MSC) to limit the

¹ References to SVT include all default tariffs

² Centrica response to Ofgem's Consultation on the potential impact of increased wholesale volatility on the default tariff cap, December 2021, para 18

³ Covering the period from October 2021 to March 2022.

⁴ Ofgem, Price Cap – Decision on the potential impact of increased wholesale volatility on the default tariff cap, February 2022, para 3.0 to 3.2

economic losses associated with a loss of customers following a decrease in wholesale prices, the risk remaining with suppliers may be significant since:

- a. the MSC only covers 85% of the incremental hedging losses incurred after the 10% threshold is reached, such that suppliers are still exposed to the remaining 15% of hedging losses;
- b. if the threshold of 10% is not met (e.g. if the wholesale price falls 9% below the price cap assumptions), none of the incremental hedging losses incurred by suppliers are covered;
- c. in the event of a sudden fall in wholesale prices, suppliers would be required to post additional collateral. This potential cash flow issue is not compensated for by the MSC.

Benchmarking suppliers' unexpected SVT demand costs

7. It is appropriate for Ofgem to continue to take a weighted average of suppliers' unexpected SVT demand costs⁵, rather than carrying out a benchmarking exercise. As discussed in the following sections, this is since:
 - a. suppliers' costs will be driven to a large extent by external, **non-efficiency related drivers**;
 - b. **natural variation in forecasts** (i.e. noise) has also been highly significant; and
 - c. by contrast, there is no evidence of any material variation in costs driven by **efficiency related factors**.
8. As a result (and as set out in our response to the November 2021 consultation), if Ofgem were to benchmark these costs (for example using a lower quartile) then it would risk setting an allowance based on either a supplier with a customer base that happened to have lower unexpected default tariff demand, or one with a strategy which simply happened to perform better (potentially just a "lucky guess" which could have led to an excess purchase of energy which would have been sold at a significant loss had the market not moved in the way that it has). For the same reasons, we consider that the adjustments considered by Ofgem (to exclude estimates seen to be outliers or apply a discount to a benchmarking approach) are inappropriate, unless further evidence can be produced by Ofgem to support them.
9. We discuss these points below.

Non-efficiency related drivers of differences in supplier costs

10. As noted by Ofgem, important factors driving unexpected SVT demand costs are suppliers' starting proportion of FTC customers, and the level of engagement of suppliers' customer bases. Suppliers are not able to influence these factors in response to a price shock.
11. These variations are an argument for benchmarking at the *upper* range of costs. Without doing this, the resulting allowance would be insufficient for some efficient suppliers to recover their unexpected SVT demand costs.
12. Nevertheless, we recognise that Ofgem is limited to setting a single price cap, and there is therefore a precedent for it to set the allowance based on the industry-wide average in cases where some suppliers may experience higher costs for reasons outside their control.

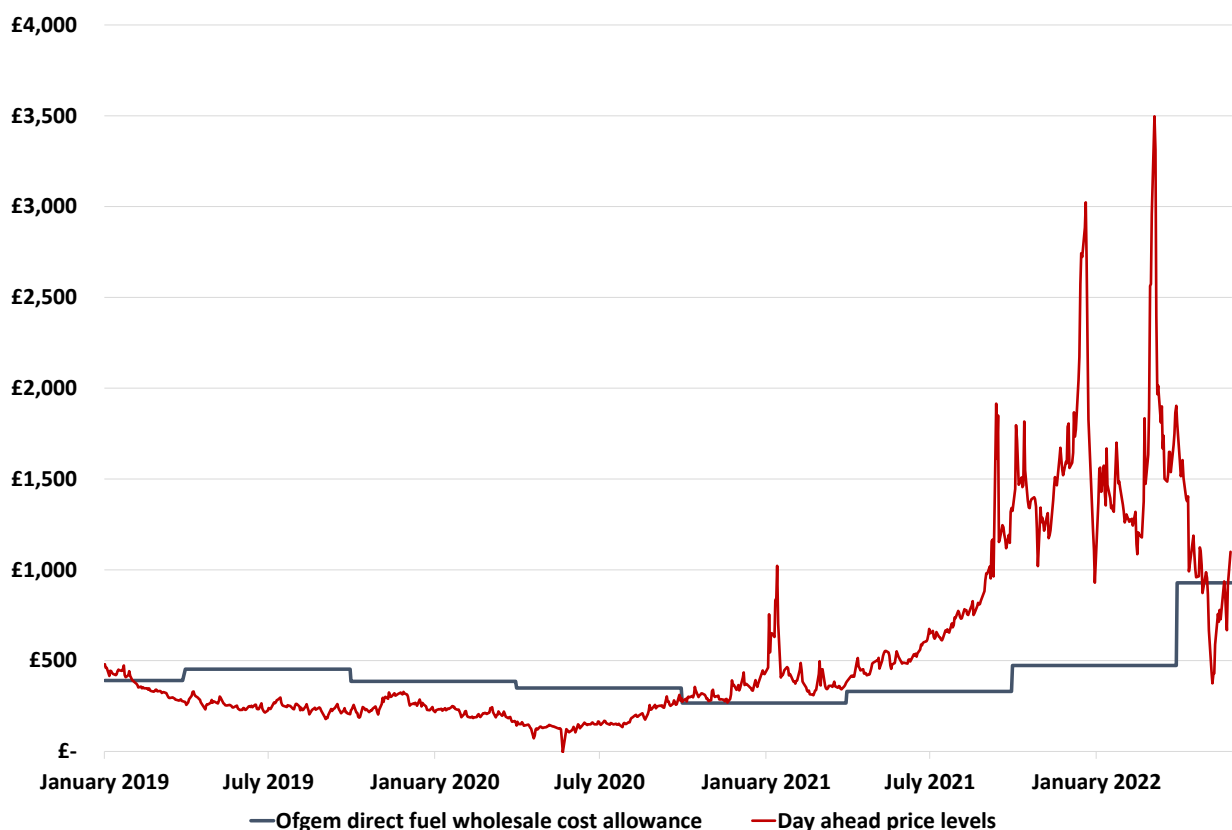
Natural variation in forecasts

13. Ofgem notes that a further non-efficiency driver is natural variation in costs (i.e. noise), for example, due to differences in timing of purchasing additional volumes. This may lead to:

⁵ The costs associated with procuring energy for unexpected and unhedged SVT demand.

- a. differences in supplier costs within a given period; and
 - b. differences in which suppliers have the lowest costs across periods.
14. Ofgem understates the inherent uncertainty involved in making forecasts during a time of unprecedented volatility. Given the unprecedented and unforeseeable nature of global events, it is unrealistic to consider that even an efficient supplier could have foreseen market developments with any degree of accuracy. Even where suppliers may have expected volatile market conditions to continue, they would likely have incorrectly estimated the level of wholesale prices relative to the cap, and therefore the volume of SVT demand. As such, efficient suppliers are likely to produce estimates of SVT demand which substantially vary from one another.
15. Figure 1 below shows how spot market prices have varied relative to the price cap wholesale cost allowance over time. Figure 1 clearly shows the extreme volatility in prices over cap periods 7 and 8. Specifically, we see that, at times, spot market prices have been *below* the wholesale cost allowance during period 8. Wholesale prices could plausibly have stayed at these lower levels for longer, in which case suppliers may have been able to offer FTCs priced below the cap, and large volumes of customers could have moved off of SVTs. Given these sorts of uncertainties, even efficient suppliers could not have accurately predicted market developments.

Figure 1 Comparison of day ahead prices with the direct fuel component of the wholesale costs allowance (£/DF customer per year at TDCV)



16. For as long as it is in force, the MSC will somewhat reduce the impact of these uncertainties: ✕ However, the MSC was only confirmed in February, after the observation window for period 8 had closed. Additionally, the MSC as calibrated in the February decision

would have been even more limited in its ability to reduce these risks for suppliers. As set out in our response to Ofgem's consultation on changes to the MSC, the use of a 30% threshold and 75% derating factor provided protection to suppliers only in extreme downward market movements, leaving large exposure that had to be managed through risk management.

17. Given the substantial noise around suppliers' forecasts of customer numbers, any benchmark based on a single period (i.e. suppliers' unexpected SVT demand costs for period 8) is likely to reflect a forecast which by random chance happened to be close to the outcome, and could not have been replicated with any certainty by an efficient supplier. The most appropriate way to deal with this uncertainty is to take a weighted average cost.
18. If Ofgem were to carry out benchmarking, it would have to do so over a longer period to avoid this noise. For example, it could identify suppliers' unexpected SVT demand costs during each price cap period to date, pick the supplier which had the lowest overall costs to act as a benchmark, and then use this suppliers' costs for period 8 as the benchmark. However the recent volatility in prices mean that any such benchmark would be dominated by suppliers' forecasting performance over the last eight months or so. The benchmark would therefore still likely be set according to the supplier whose forecasts happened to be most accurate over the recent past, rather than one which persistently made better forecasts.
19. Fundamentally, there is not enough data on suppliers' forecasting performance during times of high volatility to be able to assess whether low costs are the result of efficiency, or "luck". This again points to the use of a weighted average.

Efficiency factors

20. Suppliers face an incentive to forecast their SVT volumes in the most accurate way possible (and given any trade-offs, such as the need to avoid costs caused by "over-trading"). A supplier not acting in such a way would effectively be leaving money on the table. Unless there is evidence to the contrary, there should therefore be a presumption that suppliers' forecasting has been carried out efficiently.
21. ✂
22. ✂
23. ✂
24. ✂
25. In the consultation document, Ofgem has stated that *"suppliers already had significant levels of unexpected SVT demand in cap period seven. With this experience and additional time to respond, suppliers should have been able to manage these costs more efficiently for cap periods eight and nine. We are therefore continuing to consider whether a benchmark below the weighted average would help to protect customers."*⁶
26. This statement seems to imply that some suppliers may have responded more (or less) efficiently to this experience, such that a benchmark below the weighted average would be appropriate. We disagree with the implication that volatile prices could have led some suppliers to have carried out forecasting and hedging in a more efficient fashion.
 - a. First, continued volatility in prices does not imply that the efficient approach to forecasting and hedging has changed. ✂ There is no sense in which a supplier can "learn" from the volatility to make more accurate forecasts.
 - b. Second, an implicit assumption is made that suppliers did not respond efficiently in cap period 7, such that they could respond "more efficiently" in cap periods 8 and 9.

⁶ Ofgem, Consultation on possible wholesale cost adjustment, para 3.24

Ofgem has not provided sufficient evidence of areas where further efficiencies could be made in either its period 7 decision or in this consultation document. On the contrary, it approved the period 7 adjustment on the basis that these costs were efficiently incurred.

Further benchmarking considerations

27. In Ofgem's consultation document, it presented two "add-on" options for adjustments that could potentially be applied to the chosen benchmarking approach. In doing so, it noted that it could "*exclude cost estimates provided by suppliers where we consider them to be outliers*" or "*apply a discount (in percentage or absolute terms)*" to one of the benchmarks "*reflecting a judgement about the relative impact of efficiency and non-efficiency factors.*"⁷
28. As set out above, there are a number of non-efficiency related factors that can drive significant differences in suppliers' costs. There is therefore a very wide range of potential efficient outcomes for a given supplier. In order to support the exclusion of any given supplier, Ofgem would need substantial evidence that the excluded supplier(s) is an outlier as a result of efficiency related drivers rather than non-efficiency factors. Without this evidence, it risks inappropriately excluding an efficient outcome and setting a skewed benchmark which is unattainable even for some efficient suppliers.
29. Similarly, the application of a discount to the benchmarking outcome would need to be grounded in substantial quantitative evidence. Given the significant commercial implications that such a decision would have on suppliers, an "instinctive" judgment would be inappropriate.

Centrica's costs

30. In this section, we set out Centrica's estimate of our own unexpected SVT demand costs.

31. ✂

Period 8

32. ✂

33. ✂

34. ✂

Period 9

35. ✂

36. ✂

Offsets against existing allowances

37. In its consultation document, Ofgem states that it needs "to consider whether there have been any other changes as a result of increased wholesale prices, which could offset unexpected SVT demand costs." We address each of the following areas, as raised in the consultation, below:

- a. the 1% additional risk allowance;
- b. switching costs;
- c. CfD costs; and
- d. other indexed allowances.

⁷ Ofgem, Consultation on possible wholesale cost adjustment, para 3.21

1% additional risk allowance

38. As stated in our response to Ofgem's November consultation, there is no surplus in the price cap as a whole, and therefore no justification for this offset. Please refer to that response for further details.

Switching costs

39. It would be inappropriate to offset for any potential savings in switching costs for the following reasons.

40. ✕ The overall effect of this offset is that the cap does not include sales and marketing costs for SVTs – and so there is no allowance that can be offset.

41. Second, while we have seen some decrease in switching rates as previous FTC customers rolled onto the SVT, we expect that this is a *postponement* in switching activity rather than a net reduction. As such, there is likely to be a surge in switching activity at the time when energy markets stabilise and FTCs become available at a lower cost than the cap. This will drive switching rates above the long-run average as price competition among suppliers returns and customers move back onto FTC tariffs. Unless Ofgem intends to provide additional allowances when markets stabilise to compensate for the increased switching costs that suppliers will face at this point, it would be inappropriate to offset these costs in the current period.

CfD costs

42. As outlined in our response to Ofgem's November 2021 consultation, ✕

43. ✕

44. ✕

45. ✕

Other (index-based) allowances

46. In Ofgem's consultation document, it has identified the following allowances which are based on other cap components, such that increases in wholesale costs lead to increases in these allowances: i) Earnings Before Interest and Tax (EBIT); ii) headroom allowances; and iii) a portion of the payment method uplift. It then questioned whether "the costs covered by these allowances have increased at the same rate as the allowances themselves."

47. We set out below why it would not be appropriate for Ofgem to offset changes in headroom and EBIT allowances against unexpected SVT demand costs.

Headroom

48. As set out in our response to the November 2021 consultation⁸, an increase in the absolute level of costs will increase the absolute uncertainties that headroom is designed to cover (for example, uncertainties regarding the appropriate EBIT margin, or wholesale costs that may not be captured in the explicit allowances). It is therefore inconsistent for Ofgem to seek to offset absolute increases in headroom, which will act – as intended – to cover these increased uncertainties.

49. The original purpose of headroom was to allow for "residual net uncertainty"⁹ – for example, this could include inaccuracies in its benchmarking of suppliers' efficient operating costs, or the methodology used to set the various wholesale energy allowances. However, in our response to Ofgem's original statutory consultation,¹⁰ we identified specific, quantifiable

⁸ Centrica response to Ofgem's Consultation on the potential impact of increased wholesale volatility on the default tariff cap, December 2021, para 88 to 92

⁹ Ofgem (2018), Default Tariff Cap: Decision – Appendix 2 p9

¹⁰ Centrica (2018) *Central summary of required changes to Ofgem's proposed Default Tariff Cap methodology*, submitted on 12th October 2018.

issues with the design of the price cap which would lead to under-recovery *even if there were no other uncertainties that headroom was required to cover.*

50. We provided further quantitative evidence of the insufficiency of headroom to cover the costs of an efficient supplier in our response to the November 2021 consultation.

EBIT

51. As outlined in our response to the November 2021 consultation¹¹, as a supplier's costs rise, its required working capital (including risk capital and collateral) will also have to increase. The use of a percentage EBIT margin means that the cash value of the EBIT allowance increases when these requirements increase, to reflect the opportunity cost.
52. As such, any increase in the absolute value of the EBIT allowance is necessary to ensure that suppliers are able to make - based on Ofgem's decision - a normal rate of return (1.9%). If the increase in the absolute value of the EBIT allowance were "offset" against the increase in unexpected SVT demand costs, this would effectively reduce the EBIT allowance below what Ofgem has considered is required for a supplier to make a normal rate of return.

Payment method uplift

53. The percentage component of the payment method uplift (*PAP*) is designed to account for the additional working capital and bad debt costs associated with standard credit customers (over and above direct debit customers).¹² All else equal, these costs will rise proportionately to the rest of the cap, if the same proportion of customers pay their bills late (or not at all). Indeed, significantly higher bills could lead to a higher proportion of customers being unable to pay, so this may be an underestimate of efficient costs.

Shaping and imbalance costs

54. Ofgem is currently minded not to make an adjustment to the price cap in period 9 for additional shaping and imbalance costs incurred in period 8. It is also minded not to make an adjustment in period 9 to account for additional shaping and imbalance costs incurred during period 9, although suggests that it is open to more evidence should it become available at a later date.
55. Shaping and imbalance costs are driven by unexpected variations in demand (mainly caused by the weather) and whether the price of buying and selling energy¹³ on the days these variations occur is above or below the price at which the energy was originally purchased.

56. ✂

57. ✂

✂

Implementation

58. We agree with Ofgem's proposal to use the adjustment allowance as a mechanism to allow these costs to be recovered (which would imply that the additional wholesale risk allowance is removed beyond cap period nine).

¹¹ Centrica response to Ofgem's Consultation on the potential impact of increased wholesale volatility on the default tariff cap, December 2021, para 93 to 96

¹² Ofgem (2018), Default Tariff Cap: Decision – Appendix 8

¹³ Including on the balancing market.

59. However – as we noted in our response to Ofgem’s November consultation – there is a risk that if customers begin moving back from SVTs to FTCs, suppliers will be unable to recover the costs that Ofgem has identified. This risk is especially pertinent now (compared to when the adjustment allowance was first used) due to the substantial volatility in the market, and the large number of customers who have historically been on FTCs but are currently on the default tariff.
60. The costs that need to be recovered (relating to unexpected SVT demand and shaping/imbalance costs) are costs relating to purchasing energy for customers currently on SVTs. The unexpected SVT demand costs relate especially to customers who were previously on FTCs and switched to SVTs – and are so most likely to switch back to FTCs should the market stabilise. It would therefore be most equitable to ensure that these costs are faced by all customers currently on SVTs, not just those who may remain on SVTs after any reversion of the market back to historic patterns.
61. The Market Stabilisation Charge provides a simple way to ensure that this occurs: Ofgem should ensure that, if and when SVT customers move onto FTCs, the supplier that receives a customer is required to compensate the customer’s original supplier for the element of the adjustment allowance which the customer would otherwise pay under the price cap. This could be operationalised as follows:
62. The MSC calculation would be amended as follows:
- The total value of the adjustment allowance, in £/MWh, would be denoted adj .
 - For each week during the price cap periods over which the additional costs are being recovered (i.e. cap periods 9A to 10B in Ofgem’s current proposal), the volume of energy expected to be consumed during the remainder of the periods (based on the standard consumption profiles used by Ofgem) would be calculated as a percentage of the total period. This value (denoted v_{adj}) would therefore be equal to one at the start of period 9A, and zero at the end of period 10B. It represents the proportion of the adjustment allowance which would not be recovered if a customer moves away from the default tariff cap on that day.
 - The MSC calculation would be amended as follows¹⁴:

$$A = x \cdot l \cdot t \cdot c + adj \cdot v_{adj} \cdot u$$

Where u accounts for the headroom, EBIT, and PAP components which would be applied to the adjustment allowance and would be unrecovered if a customer churned away – i.e.

$$u = 1 + HAP(1 + EBIT + PAP) + EBIT + PAP$$

¹⁴ Ensuring recovery of backwardation costs will also need to be incorporated. Please see our response to Ofgem’s Statutory consultation on changes to wholesale methodology.