

Legal & Regulatory

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Hannah Nixon
Director of Regulatory Review
Ofgem
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Dear Hannah

Arrangements for Responding in the Event that an Energy Company Experiences Deteriorating Financial Health: Consultation and Draft Guidance Document 49/09

Please find enclosed Centrica's response to the above consultation and associated draft guidance document which was published on Monday 11 May 2009. It is not confidential and we are happy for this to be posted on the Ofgem website and in the Ofgem library.

We hope that our comments will be helpful to you and your team.

If you have any queries and would like to discuss them further, please do not hesitate to contact me.

Yours sincerely



Philip Davies
Director of Regulatory Affairs

Centrica's Response to Ofgem's Consultation on Arrangements for Responding in the Event that an Energy Company Experiences Deteriorating Financial Health

Summary of key points

1. Centrica spends around £2.2billion on gas and electricity network charges every year, meaning that we therefore pay, on behalf of our customers, a large portion of the revenues that the network businesses earn. We therefore have a keen interest in the processes that would be followed in the event that any protected energy company (PEC) faces financial distress. In addition, as the largest integrated gas and electricity company in Great Britain that does not own any energy network interests in the UK, we are uniquely placed to provide an unconflicted perspective on this consultation.
2. We are very supportive of the need for a clearly defined set of processes to be followed in the event that the financial health of any PEC is found to be deteriorating significantly. Overall, we believe the arrangements proposed in the guidance document are appropriate. However, there are a number of important areas where we believe the arrangements should be amended in order to better protect the interests of our customers.
3. Most importantly, more clarity is needed regarding the criteria that Ofgem will apply in deciding whether the price control of a struggling PEC should be disapplied and subject to an interim review. Specifically, we believe Ofgem should state publicly that requests for the disapplication of a price control will only be considered where the PEC has been subject to adverse events that are *demonstrably* outside of management control.
4. We also believe the arrangements should state that a PEC will be expected to explore all means open to it to refinance its regulated activities *before* seeking a price control disapplication (including exhausting all opportunities to secure additional financing from shareholders). In addition, price controls should not be disapplied if PECs have entered financial distress due to adverse movements in a risk for which adequate provision has already been made (either implicitly or explicitly).

5. Should Ofgem allow price controls to be disapplied for more general reasons than these, we believe the interests of customers may be better protected by instead allowing a struggling PEC to enter Special Administration. Giving the market the opportunity to re-price the assets of a PEC may represent a far better deal for customers than the alternative of locking them into a revised price control at disadvantageous terms (particularly given the energy administrator will ensure that the duties and obligations of the PEC continue to be met).
6. In the event that an interim review is undertaken, the arrangements should also state that Ofgem will maintain an appropriate balance between risk, reward and performance in resetting the control. In practice, this may mean ensuring that should the risk of a PEC be reduced in one area (in response to the exogenous adverse event), then there will be a commensurate reduction in the rewards available to the PEC (e.g. through a reduction in allowed cost of capital). Ofgem should also be clearer how the charging implications of an interim review will be managed.
7. We are concerned that Ofgem fails to view customers and suppliers as being “key stakeholders” in the arrangements. Customers - who will ultimately meet the cost of any reopeners that result from these arrangements - should be involved at least as closely as other stakeholders in this process.
8. In particular, we believe the arrangements could be clearer in stating that – wherever possible – customers will be consulted on interim review proposals. We recognise that the timescales in which Ofgem will be able to reach a decision following a disapplication will most likely be severely restricted, however we still believe it is important for the views of customers and suppliers to be heard.

Introduction

9. We set out our more detailed comments in the following sections:
 - Justification for reopening a price control;
 - Undertaking an interim review; and
 - Stakeholder engagement.
10. We also have a number of more detailed observations on the guidance document that we set out separately at the end of this response.

Justification for reopening a price control

11. An interim review of a price control settlement triggered by the deteriorating financial health of a PEC is likely to have major cost implications for customers. Primarily these costs will be met by customers in the remaining years of the relevant price control (as remedies are put in place to reduce the exposure of PECs to the risks that led to financial distress)¹.
12. As a consequence, a key element of the process for managing a PEC with a deteriorating financial health from the perspective of customers is the set of criteria against which Ofgem will determine whether it is appropriate to disapply the terms of the relevant price control settlement.
13. To protect the interests of customers, it is essential Ofgem preserves the incentive on struggling PECs to explore all means open to it to secure additional funding *before* seeking a price control disapplication. This would include expecting PECs to exhaust all opportunities to secure additional financing from shareholders before seeking to disapply a price control². We believe the incentive for PECs to do this may be compromised if the criteria applied by Ofgem are insufficiently clear.
14. The arrangements currently state that Ofgem will be minded to disapply PEC price controls in the event that the cause of their financial distress is “largely due to factors beyond the PEC’s control”. We believe this drafting is too broad, and may result in customers bailing-out PECs in financial distress caused (at least in part) by poor decision making by PEC management.
15. To remedy this, Ofgem should state publicly that customers will not be expected to meet the cost of a PEC’s financial distress through an interim review unless the underlying cause is *demonstrably* outside of management control. The onus of proof would then be on the PECs to show that the cause of any financial distress was due to factors beyond their control. This would protect the interests of customers more effectively than the arrangements as currently drafted, while still protecting PECs from extreme adverse risks that are genuinely outside of their control.

¹ Although the precise impact of any such review on customer bills will be determined by the relevant charging arrangements.

² We note that there is a recent precedent for injection of equity by shareholders of utilities (in the water sector). Examples include Anglian Water which has received an equity injection of £115m (2.2% of RAV), Southern Water which has received £85m (2.3% of 2009E RAV), and South East Water which has received £15m (2.8% of RAV).

16. We also believe the arrangements take insufficient account of allowances made for risk mitigation at the time the relevant control was set. Price controls should not be disapplied if PECs have entered financial distress due to adverse movements in a risk for which adequate provision has already been made (either implicitly or explicitly).
17. An example of this is the current way in which the cost of capital allowance for the networks is set. Cost of capital is set on a “headroom” basis, meaning that an implicit allowance is made to compensate networks for adverse movements in either the cost of debt or cost of equity. This differs from an approach in which the risk of adverse movements in these components of the cost of capital may be passed on to customers³. PECs with a cost of capital allowed under the current methodology would therefore be expected to bear the cost of significant adverse movements in the market cost of capital, and we would not expect a disapplication request on these grounds to be accepted.
18. In summary, we believe that the conditions that justify the disapplication of a price control should be amended so that a request will only be granted where:
- the underlying cause of financial distress is *demonstrably* outside of management control;
 - all opportunities to secure additional financing from shareholders have been exhausted; and
 - insufficient allowance has been made in the applicable control settlement (either implicitly or explicitly) for the risk that caused the PEC’s financial distress.
19. Should Ofgem allow price controls to be disapplied for more general reasons than these, we believe the interests of customers may be better protected by allowing a struggling PEC to enter Special Administration. Given the energy administrator will ensure that the duties and obligations of the PEC continue to be fulfilled, giving the market the opportunity to re-price the assets of the PEC may represent a far better deal for customers than the alternative of locking them into a revised price control at disadvantageous terms.

³ For example, a component of the cost of capital (e.g. cost of debt) could instead be indexed, and the cost passed through to customers in the event that it breaches a pre-defined “trigger” level. This would effectively remove the risk to networks of cost of debt rising above the trigger level.

Undertaking an interim review

20. We recognise that the specifics of an interim review will largely be driven by the nature of the disapplication request itself. However there are a number of generic aspects of the interim review process that we would expect to be followed in all reviews. In particular, we believe the arrangements would benefit from greater clarity regarding:

- the principles by which the interim review will be conducted (particularly preserving an appropriate balance between risk, reward and performance); and
- measures to ensure transparency of decision making is preserved.

Balance between risk, reward and performance

21. We believe the arrangements should be clear that in any interim review, Ofgem will ensure that an appropriate balance is maintained between the risk allocated to the PEC, the rewards available to it, and performance it is expected to deliver. Should an interim review reduce the level of risk that a PEC faces (in response to an adverse event), then we would expect there to be a commensurate reduction in the rewards available to it (e.g. through a reduction in the PEC's allowed cost of capital).

22. Similarly, should Ofgem permit a PEC to reduce the level of performance that it is expected to deliver over the remainder of a price control, then we would also expect there to be a commensurate reduction in the level of rewards available to it (e.g. through a reduction in expected levels of incentive revenue). Only by maintaining this balance between risk, reward and performance will the interests of customers be properly protected.

Maintaining transparency of decision making

23. We recognise that Ofgem will most likely be expected to undertake an interim review within relatively tight timescales. However, we do not believe that this means that there should be a reduction in the level of transparency of Ofgem's decision making.

24. Indeed, we believe that a thorough and transparent consultation on the proposed terms of any such review will be at least as important as in a normal price control review. This is especially the case given the potential cost to customers of an interim review, and the pressure under which Ofgem will be placed to agree to a new settlement.

25. We recognise that there may be good reasons for reducing the length of consultation periods, but we do not accept that customers should be locked into a revised price control settlement without the opportunity to comment on the proposals being considered. Even when timescales are restricted, customers and suppliers will provide Ofgem with an important counterbalance to the views of other stakeholders.
26. We therefore believe that Ofgem should amend the current arrangements that state it will consult on the revised terms of a review “where appropriate” with:
- a commitment to consult on Interim Review proposals at key stages of the process wherever possible; and
 - an explicit commitment to be transparent in all aspects of the process (including in the assessment of the request to disapply the control settlement, as well as in the development of remedies should the request be accepted).

Stakeholder engagement

27. In Chapter 10 of the guidance document, Ofgem sets out proposed interactions with key stakeholders. This includes, for each stakeholder, a description of their primary responsibilities, funding implications from the arrangements and likely interactions with Ofgem. At present, the stakeholders described in this chapter are limited to “Government departments”, specifically the Department of Energy and Climate Change (DECC), HM Treasury (HMT) and the Health and Safety Executive.
28. We are surprised that customers (and suppliers) have not been included in this chapter as a specific category of key stakeholder. In the event that Ofgem considers it appropriate to remedy the financial distress of a PEC through an interim review, then it will be customers that will be required to bear the resulting cost.
29. We therefore believe customers should be explicitly recognised as being an important stakeholder in the process, and their primary responsibilities (including relating to funding) and likely interactions with Ofgem clarified.

30. In terms of primary responsibilities, we believe Ofgem should recognise explicitly that the cost of any interim review will ultimately be met by customers. Ofgem should also clarify the process by which any such costs will be translated into network charges. This is particularly important given that lack of predictability in network charges imposes significant costs on suppliers as well as customers. We would therefore favour the use of mechanisms to smooth the impact on customer charges as far as possible following an interim review.
31. Ofgem could also be clearer in setting out the extent and timing of expected interactions with customers. In addition to the need for consultation (as discussed above), we would expect Ofgem to make full disclosure of relevant information regarding the nature of financial distress faced by PEC(s), as well as the nature and implications of remedies being considered.

Additional observations

32. We have a number of more specific comments on the detail of the arrangements. These are set out in turn below.
33. One important aspect of the arrangements is the treatment of ongoing capital expenditure projects during the core period of energy administration. The arrangements (in Section 7.2) set out a number of factors that the energy administrator may apply in assessing whether capital expenditure plans remain appropriate. Any suspension of capital expenditure could have very considerable implications on a range of stakeholders (including individual customers and generators), as well as on the likelihood of meeting the Government's renewables targets. The full implications of any such changes in capital expenditure plans must therefore be considered in full by Ofgem before any significant changes are made. We would also expect any significant changes in expenditure plans to be reflected in network charges, as well as being subject to industry consultation (to ensure transparency in decision making is maintained).
34. We also believe it is important to have greater clarity regarding whether it is the Authority or DECC which ultimately takes the decision to apply to the Court for an energy administration order. The arrangements as currently drafted suggest this power rests with DECC (with the Authority only being able to exercise this power if DECC is in agreement).

35. In a number of instances in the arrangements (including section 7.3 and Chapter 10), Ofgem references funding that may be required from DECC and HMT during energy administration. It would be helpful if Ofgem clarified how this funding would be recovered (e.g. through general taxation), and whether there are any implications for customers' network charges.
36. We also note that in a number of places, reference is made to actions within the wider company group causing a PEC's financial problems⁴. However, the financial ring-fence was implemented specifically to prevent this situation from arising. If Ofgem believes this risk is significant, this would suggest that the requirements of the ring-fence need tightening. We would appreciate a clarification from Ofgem on this point.
37. Finally, in the discussion of the calculation of merger taxes (in Section 8.2.2) we would note that there are a number of additional precedents that could be drawn on to calculate the cost to customers of increases in market concentration in the energy sector. These include work undertaken in Ofgem's gas distribution network sales project, as well as work undertaken on loss of comparators in DPCR4.

⁴ For example in paragraph 6.4 (page 13) of the consultation document.