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23 January 2019

Sent by email to: Rob.Salter-Church@ofgem.gov.uk;
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Dear Rob

Capacity market allowance in the default tariff cap

We understand Ofgem's policy objective driving the consultation on the capacity market (CM) allowance in the default cap, which is to ensure that the cap accurately reflects efficient costs. However, when considering the implications for the cap methodology in light of potential evidence that efficient costs may have changed or may change, Ofgem should:

- Ensure consistency with the Decision[1] on the Default Tariff Cap;
- Ensure consistency with the requirements of the Tariff Cap Act[2];
- Comply with the requirements of general public law; and
- Thoroughly examine and base its view on the best available evidence.

On the basis of these principles, we have the following comments on Ofgem's proposals, which we summarise in this covering letter. We provide further detail in the appendix.

1. **Consistency with Ofgem's Decision on the Default Tariff Cap.** To be consistent with Ofgem's November Decision, the default course of action would be to leave the cap methodology unchanged and to retain the CM allowance. However, if Ofgem has a high degree of confidence that the CM supplier charge will not be incurred in a given cap period, then the allowance should in principle for that period be removed provided that the overall cap meets the requirements of the Act, and other relevant legal requirements are met. Given that Ofgem decided to include a CM allowance following extensive consultation and evidence-gathering, the burden of proof instead sits with the change scenario (scenario b). Ofgem's consultation suggests that it is taking a different approach to what is required, which is to adopt a presumption in favour of changing the

[1] https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview
[2] http://www.legislation.gov.uk/ukpga/2018/21/contents/enacted/data.htm

methodology and removing the CM allowance unless it has "sufficient confidence" that the supplier charge will be incurred in the April-September cap period. This cannot be the correct approach.

2. **Consistency with the requirements of the Tariff Cap Act.**
    a. Sections 4(3) and 5(4) of the Tariff Cap Act provide that in order to make a change to the default cap methodology, Ofgem must consult on the change for a minimum of 28 days and then provide a minimum implementation period of 56 days. It would not be lawful for Ofgem to conduct a truncated consultation or one that does not address all the required issues, contrary to the intent of these provisions, or to deprive licensees of their right to procedural fairness.
    b. To meet the requirements in section 1(6) of the Tariff Cap Act, Ofgem should consider any potential changes in costs in context of the overall level of the cap. We consider that the cap methodology as it stands today does not meet the requirements in section 1(6) of the Tariff Cap Act, particularly the financeability duty in section 1(6)(d). The current cap methodology also does not account for other material unforeseen costs such as the mutualisation of £58.6m in outstanding Renewables Obligation (RO) payments across suppliers[3].
3. **Compliance with the requirements of general public law.** We consider that the proposals under consultation do not satisfy Ofgem's duty to consult, because Ofgem has not set out with sufficient clarity and precision what the proposals are, and the basis on which Ofgem will or will not adopt them. To satisfy the requirements of public law, as a minimum Ofgem should set out the objective criteria which it will apply to determine, and a range of possible scenarios to show, what would constitute "sufficient confidence" that suppliers will *not* need to make CM payments during the April-September period. Within those scenarios, Ofgem should set out a fully reasoned view on whether, and if so why, it in fact considers that the information available at the time of consultation constitutes "sufficient" or "insufficient" confidence that suppliers will *not* be required to make CM payments during the April-September cap period.
4. **Thorough examination of the best available evidence.** The evidence available at the time of publication of Ofgem's consultation suggests that Ofgem cannot be confident that suppliers will not be required to make CM payments during the April-September price cap period on a forward-looking basis. Leaving aside the status of the standstill period, the Government clearly intends for forward-looking CM supplier charges to be started promptly. The two options of enabling CM supplier charges are progressing at pace, and could be implemented as soon as February.

Ofgem has stated that it might consider implementing an additional allowance in future cap periods in the event that suppliers are: (a) required to pay the CM Supplier Charge during the April-September cap period; but (b) without the equivalent allowance being provided concurrently. Ofgem states that it would consider doing so on the basis of whether the event is "sufficiently material, and of a one-off, unusual nature". We agree that Ofgem has the power to allow suppliers to recover shortfalls from past cap periods by increasing the cap in future periods. However, the scenario in which suppliers are required to pay the CM Supplier Charge yet there being no concurrent allowance in the cap should not be allowed to happen. If it did happen, then the case for making up the historical shortfall with a specific new allowance in future periods would be overwhelming, and it would need to be implemented promptly. Similarly, if the CM allowance was removed, Ofgem would need to act promptly to reinstate it once it became apparent that supplier payments were going to be reinstated.

It would not be tenable to suggest that CM supplier charges could be accounted for by headroom. Headroom cannot be said to cover costs that Ofgem has already decided are sufficiently real, material and predictable for an explicit allowance to be provided. In addition, as

[3] https://www.ofgem.gov.uk/publications-and-updates/ofgem-takes-action-over-payment-shortfall

we said in response to Ofgem's September consultation on the default tariff cap[4], we consider that the uncertainty component of headroom is already at least £18 per customer too low to meet the requirements of the Tariff Cap Act, before taking into account other material unforeseen costs such as the £58.6m industry RO mutualisation costs[5].

Yours sincerely

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Head of Regulatory Affairs, UK & Ireland

[4] https://www.ofgem.gov.uk/system/files/docs/2018/10/centrica_-_response_2_-_appendices_2-10.pdf
[5] https://www.ofgem.gov.uk/publications-and-updates/ofgem-takes-action-over-payment-shortfall

Appendix – further detail

Consistency with Ofgem's Decision on the Default Tariff Cap.

As stated in our covering letter, to be consistent with Ofgem's November Decision, the default course of action would be to leave the cap methodology unchanged and to retain the CM allowance. We have two additional builds on what we said in the covering letter on this point:

- In its November Decision, Ofgem confirmed that it would only consider changing the cap methodology if it "expected" significant and unanticipated changes to cause an allowance to materially depart from the efficient level[6].
- On this basis, Ofgem should not change the allowance unless it positively *expects* that suppliers will not have to make CM payments during the April-September 2019 cap period. Ofgem's current proposal is therefore inconsistent with its November Decision, because it suggests that Ofgem will change the allowance unless it has "sufficient confidence" that suppliers will have to make CM payments.

Consistency with the requirements of the Tariff Cap Act

Our understanding is that under scenario b as outlined in the consultation, Ofgem would amend the default price cap methodology. The Tariff Cap Act provides Ofgem with the ability to amend the conditions imposing a cap on standard and variable rates ("tariff cap conditions"), but only following a minimum 28-day consultation (section 4(3) of the Act). Once Ofgem makes a decision on a change to tariff cap conditions, the Act (section 5(4)) provides that there must be a minimum period of 56 days before the change can come into effect.

Ofgem has not said in its consultation under what powers it would make the change to the cap methodology under scenario b in time for price cap period starting on 1 April. However, our understanding is that Ofgem intends to amend the licence by using its powers under 28AD.15(a).[7] Condition 28AD.15(a) says that Ofgem may make certain amendments following consultation, where Ofgem considers that "there has been a significant and unanticipated change of circumstances" such that the relevant part of the licence "no longer reflects an efficient level" of costs.

We consider it important that Ofgem does not attempt to use licence condition 28AD.15 to amend tariff cap conditions without providing the specific protections explicitly set out in sections 4(3) and 5(4) of the Act, or otherwise so as to deprive licensees of their right to procedural fairness and prior notice.

Section 4(1) of the Act provides that, before making any modifications to licence conditions under section 1 (which includes the power to modify tariff cap conditions in section 1(2)(a)), Ofgem must take "the following steps". Those steps include at section 4(3) the requirement for a consultation period of 28 days. For the avoidance of doubt, the fact that licence condition 28AD.15 explicitly provides Ofgem with a right to modify the methodology set out in the Annexes to the licence conditions, does not take such modifications outside the general power to modify tariff cap conditions in section 1(2) of the Act. Similarly, section 5(4) of the Act provides that where a modification is made there must be a 56-day notice period. Put another way, it would be contrary to the clear intent of sections 4 and 5, in providing specific periods for

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[6] https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_3_-_updating_the_cap_methodology.pdf page 14, paragraph 3.6(a)

[7] For gas supply licences. For simplicity, references to '28AD.15(a)' should be read to include the equivalent licence condition in electricity supply licences.

the protection of licensees and interested parties which Ofgem "must" provide, to read the Act as permitting Ofgem to modify licence conditions without providing that protection.

Further, and in any event, licence condition 28AD.15 itself contains a clear requirement for consultation. It is a clear principle of public law that where a statute or other instrument simply requires "consultation", without stating the specific requirements of such consultation, that does not mean that the decision maker is free to conduct as short and cursory a consultation as it wishes.[8] Consultation must (among other things) be conducted at a formative stage; give licensees adequate time to allow a proper and informed response; and the decision maker must give him or herself enough time to conscientiously consider consultation responses with an open mind.[9]

Any consultation would at least need to address the following points:

- First, in making amendments, Ofgem will need to specifically consult on whether there has been a "significant and unanticipated change of circumstances", such that its powers under condition 28AD.15(a) are triggered.
- Secondly, Ofgem appears in its open letter to be suggesting a new test, i.e. that it will make licence conditions based on a judgement about whether Ofgem has "sufficient confidence" about whether supplier payments will restart. It is unclear how this test will apply in any particular case, or how it is consistent with the actual requirements of condition 28AD.15(a). It will be essential that Ofgem clarifies its thinking on these points so that licensees have a fair opportunity to comment.
- Finally, in making amendments, Ofgem must still determine how the mandatory statutory considerations set out in section 1(6) of the Act apply to the circumstances at hand. As Ofgem will be aware from the consultations on the Default Tariff Cap, this is a complex matter on which different stakeholders may have different views, and it is therefore essential that Ofgem properly consults.

Furthermore, as regards the notice period for any changes, Ofgem will be aware that the existing cap updates already provide licensees with very limited time to change their retail tariffs. Significant practical concerns would arise should Ofgem seek to impose changes without providing the full notice period set out in section 5(4) of the Act.

Accordingly, we urge Ofgem to clarify that it will not, in these circumstances, use condition 28AD.15(a) to circumvent or avoid the procedural fairness and notice requirements that would normally apply to licence modifications under the Act.

Consistency with the requirements of general public administration law

We understand that when a public body consults on changes to the legislative or regulatory framework, it should provide consultees with sufficient information to enable them properly to understand the proposal being consulted upon and to express views in relation to it. This requires the public body to set out, for example, the nature of the proposal, the reasons why the decision-maker is putting forward the proposal (including the evidence base for it and any

[8] "When a statute has conferred on any body the power to make decisions affecting individuals, the courts will not only require the procedure prescribed by the statute to be followed, but will readily imply so much and no more to be introduced by way of additional procedural safeguards as will ensure the attainment of fairness": *Lloyd v McMahon* [1987] AC 625, 702H-703A; "the legislature cannot be expected to specify everything that shall … be done in order to comply with natural justice": *Pearlberg v Varty* [1972] 1 WLR 534, 551A-B..

[9] *R b Brent London Borough Council, ex p Gunning* (1985) 84 LGR 168.

assumptions made) and details of the approach that the decision-maker proposes to adopt when deciding whether to implement the proposal.[10]

We consider that the proposals within Ofgem's consultation do not meet these requirements, because it is not clear what might objectively constitute "sufficient confidence" under scenario a, or "insufficient confidence" under scenario b. Therefore, there is no meaningful indication of the circumstances in which Ofgem is likely to include or exclude an allowance for CM supplier payments. It would be wholly inappropriate for Ofgem to decide after the consultation closes what constitutes "sufficient" or "insufficient confidence. Such an approach would deprive consultees of the right to make meaningful submissions by reference to a clear articulation of the objective factors that Ofgem considers are important in assessing the (subjective) concepts of "sufficient" and "insufficient" confidence under scenarios a and b respectively.

Thorough examination of the best available evidence

The evidence available at the time of publication of Ofgem's consultation suggests that Ofgem cannot be confident that suppliers will not be required to make CM payments during the April-September price cap period on a forward-looking basis. Leaving aside the status of the standstill period, the Government clearly intends for forward-looking CM supplier charges to be started promptly. The two options of enabling CM supplier charges are progressing at pace, and could be implemented as soon as February. Given the pertinence of the Government's consultation process and Balancing and Settlement Code (BSC) developments to Ofgem's proposals, we were surprised that Ofgem did not explore these developments in any detail in its consultation.

- On 19 December BEIS published a consultation[11] in which it expressed its clear intent to recommence requiring suppliers to make CM payments as soon as possible.
- In terms of the mechanism to be used to recover CM payments from suppliers during the standstill period, BEIS consulted on two options. Of these two options, BEIS preference was for supplier charges to be collected by the CM Settlement Body (ESC), which did so previously. As an alternative backup option, BEIS suggested a modification to the BSC, which would require suppliers to pay the equivalent of the supplier charge into a trust or escrow account, until State Aid approval is secured and the money can be transferred to ESC to pay out to capacity providers.
- With respect to the likelihood and timing of the ESC option for recommencing CM supplier payments, we understand that BEIS considers that changes to the CM payment regulations may not be necessary, in which case supplier payments under the ESC option could be restarted in February.
- If there are any barriers to prompt use of the ESC option, we would expect Government to press for the BSC option to be used in lieu of that. Elexon has already issued a consultation on the BSC option and the final report is due to be sent to Ofgem on 5 February for a decision. This means that payments under the BSC option could be restarted as soon as February.

We expect BEIS to respond to its consultation shortly.

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[10] See for example, *R (Capenhurst) v Leicester City Council* [2004] EWHC 2124 (Admin) at paras 40-47; *R (Devon County Council) v Secretary of State for Communities and Local Government* [2010] EWHC 1456 (Admin) at para 68.

[11] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767015/proposals-for-technical-amendments-to-the-capacity-market.pdf

Other considerations

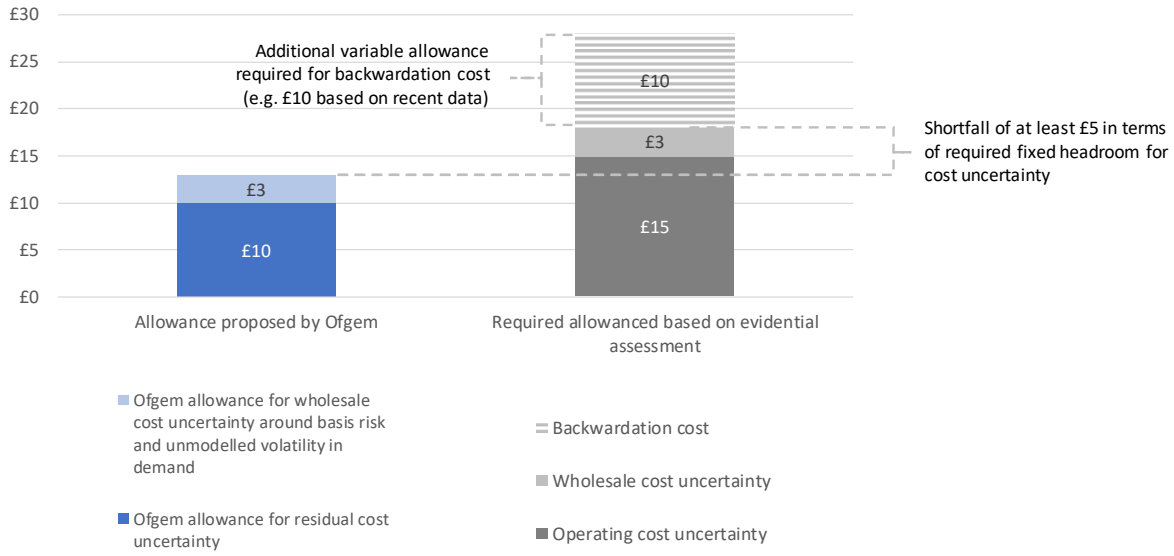
In the covering letter we made three other points that we would like to expand on. These three points were:

- To meet the requirements in section 1(6) of the Tariff Cap Act, Ofgem should consider any potential changes in costs in context of the overall level of the cap. We consider that the cap methodology as it stands today does not meet the requirements in section 1(6) of the Tariff Cap Act, particularly the financeability duty in section 1(6)(d). The current cap methodology also does not account for other material unforeseen costs such as the mutualisation of £58.6m in outstanding Renewables Obligation (RO) payments across suppliers.
- It would not be tenable to assert that CM supplier charges could be accounted for by headroom. Headroom cannot be said to cover costs that Ofgem has already decided are sufficiently real, material and predictable for an explicit allowance to be provided. In addition, we consider that the uncertainty component of headroom is already at least £18 per customer too low to meet the requirements of the Tariff Cap Act, not taking into account other material unforeseen costs such as the £58.6m industry RO mutualisation costs.
- We agree that Ofgem has the power to allow suppliers to recover shortfalls from past cap periods by increasing the cap in future periods. However, the scenario in which suppliers are required to pay the CM Supplier Charge yet there being no concurrent allowance in the cap should not be allowed to happen. If it did happen, then the case for making up the historical shortfall with a specific new allowance in future periods would be overwhelming, and it would need to be implemented promptly. Similarly, if the CM allowance was removed, Ofgem would need to act promptly to reinstate it once it became apparent that supplier payments were going to be reinstated.

To expand on the point regarding the power to allow suppliers to recover shortfalls from past cap periods by increasing the cap in future periods, we believe that it is generally desirable for costs to be spread over as long a period as possible within the cap to smooth costs for consumers. If there is a choice between spreading the same costs over a longer period and a shorter period, Ofgem should choose the longer period. Applying the principle of smooth costs to this example, Ofgem should favour retaining the allowance over recovering shortfalls from past cap periods by increasing the cap in future periods.

To support the points on the financeability duty and headroom, we would like to highlight the following table that we included in our response to Ofgem's September consultation on the default price cap[12], which shows the shortfall in Ofgem's headroom allowance based on a balanced assessment of the available evidence at the time. This balanced assessment of the evidence did not incorporate other material unforeseen costs such as the extra £58.6m of industry RO mutualisation costs. The reasoning and calculations (including granular breakdowns) underpinning our conclusion are fully explained in our consultation response.

[12] https://www.ofgem.gov.uk/system/files/docs/2018/10/centrica_-_response_2_-_appendices_2-10.pdf See Figure 2, page 8


£30
£25
£20
£15
£10
£5
£0
Additional variable allowance required for backwardation cost (e.g. £10 based on recent data)
£10
£3
£3
£10
£15
Shortfall of at least £5 in terms of required fixed headroom for cost uncertainty
Allowance proposed by Ofgem
Required allowanced based on evidential assessment
Ofgem allowance for wholesale cost uncertainty around basis risk and unmodelled volatility in demand
Ofgem allowance for residual cost uncertainty
Backwardation cost
Wholesale cost uncertainty
Operating cost uncertainty