Annex A – Financeability

Centrica submits that there is a significant gap in Ofgem's thinking regarding the financeability of its proposals. At high level that there has been a failure by Ofgem to properly understand and take into account the mandatory consideration of financeability, and a failure to take into account the relevant evidence available to it, including:

a. The fact that the industry was structurally loss making even prior to the full effects of Covid-19 being felt – meaning that suppliers have no buffer to absorb any further financial shocks;

b. The effect of Covid-19 on the financial position of suppliers, in particular the significant impacts on bad debt; and

c. The arrangements by which suppliers finance the roll-out of smart meters though contracts with meter asset providers ("MAP").

These effects either alone or together will put extraordinary strain on the financial position of suppliers, in particular in the context of their ability to withstand periods when their efficient costs of smart metering are not able to be covered (within that period or at all). In addition, the third factor also affects the costs of smart meters ✂.

In this context, stakeholders will naturally expect that Ofgem would be paying particularly close attention to its financeability duty. As Ofgem is aware, Section 1 of the Domestic Gas and Electricity (Tariff Cap) Act 2018 ("DTCA") requires Ofgem when setting the cap to have regard to a number of matters, which include the 'need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence'.

Ofgem, however, has failed to properly understand its duty to take into account financeability, much less to properly discharge that duty. The only way in which Ofgem has any regard to financeability is by equating it to ensuring that suppliers, as a whole, can recover their efficient costs. This fundamentally misconstrues its duty. The statutory duty is to take into account 'the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.' This is an individual duty that applies to <u>each supplier</u> in its circumstances. It does not apply to suppliers 'on average'. It requires that Ofgem identifies any financeability issue and determines whether or not it is solely attributable to lack of efficiency.

Ofgem knows that some suppliers have higher than average efficient costs and that its decision to fund only an average supplier's efficient costs will therefore cause some suppliers not to be able to recover their full efficient costs. It is under a duty in those circumstances to properly justify its approach by reference to the individual circumstances of those suppliers whose efficient costs will not be sufficiently funded, including to make reasonable inquiries about the financial situation of those suppliers. The analysis in Appendix 1 also shows the perfunctory consideration given to <u>actual issues</u> of financeability (rather than just reciting the duty) in the Consultations.

As will be set out in more detail in the consultation response, Centrica considers that, contrary to the assertions in the Consultation, the smart metering allowance in the default tariff cap is insufficient and will leave suppliers unable to fund their roll-out.

Ofgem's proposals, if adopted unchanged, would reduce smart funding next year by ✂ for credit and a further ✂ for PPM compared to current allowances. Although Centrica has planned prudently based on what Centrica have understood from Ofgem's methodology, the proposals leave a substantial reduction ✂ in funding which impacts on what Centrica can deliver next year.

As data already submitted to Ofgem by Centrica demonstrates, the industry is at breaking point. The allowance Ofgem intends to set will mean that, very likely, many suppliers will not be able to recover their efficient costs of rolling out smart meters. That possibility is in fact repeatedly acknowledged by Ofgem, yet is passed off as a ‘necessary’ outcome to meet Ofgem’s decision that protecting consumers means that consumers should not pay more than efficient costs require on average.

However, Ofgem cannot reach a decision about balancing its statutory duties in this way without proper analysis. It is incumbent on Ofgem systematically to gather detailed information about the financial position of all suppliers, and in that context to assess financeability explicitly and in detail.

Evidence on the loss-making nature of the market, and effects of Covid-19 on financeability for suppliers is also set out in Appendix 1.

✂

✂ Ofgem takes the view that – other than in 2020 due to the Covid-19 crisis – it can ignore any wasted sunk costs because these can only be the result of inefficiency: ‘*Sunk costs should be low or avoidable in normal circumstances*’ (para 4.18).

These costs are not the result of inefficiency. They are the *quid pro quo* for achieving low meter rental costs. Ofgem cannot take into account one set of costs in its model and ignore the other set of costs.

This cherry-picking approach, tellingly, is at odds with Ofgem’s approach in analogous contexts. In the SMNCC consultation document, for example, Ofgem sets out at paragraph 6.16 that:

> *“<u>We calculate the lower quartile for each cost category within installation and asset costs separately.</u> This means that we allow different suppliers to set the lower quartile benchmark for each category. <u>This risks setting an unrealistically low set of benchmarks, as we may pick low costs that no single supplier could achieve at the same time. In our total operating cost analysis we compared suppliers’ total costs to avoid cherry-picking</u>. This aspect of our ‘stricter’ assessment of smart metering costs is conservative, because <u>it biases the lower quartile assessment downwards, which increases the upward adjustment to the SMNCC allowance</u>”* [Emphasis added]

At paragraph 6.25, Ofgem goes on to set out that:

> *“we bias those calculations downward, by taking the lower quartile of each category independently of each other”*

Ofgem is required to “take reasonable steps to acquaint himself with the relevant information”.[1] Yet, it has simply failed to do so. For example, Ofgem has made no allowances for the financial commitments that suppliers have made, the fees associated with those commitments, and the costs they will face due to the significant cut in the allowance. The fact is that the financial impact of Ofgem’s proposals on suppliers will be significant, and Ofgem should have taken these into account when setting the allowance, both generally and specifically in light of Ofgem’s duty to take financeability into account.

In light of this, we would be grateful if Ofgem would now confirm that it will:

[1] see R (Campaign Against Arms Trade) v Secretary of State for International Trade [2019] EWCA Civ 1020 at §58 (and see §145: duty breached).

a. Identify the suppliers whose efficient costs have been assessed as being above average, or who have rolled out sooner and therefore have greater ongoing net costs, or who for any other reason will not have their full expenditure covered at any point in the rollout;

b. Identify, for each such supplier, the extent to which the supplier's efficient costs will not be covered;

c. Identify whether, for each supplier, this situation is temporary (and if so the length of time that efficient costs will not be covered) or permanent;

d. Conduct inquiries into the likely financial positions of each of those suppliers, including their financial capability of complying with their regulatory obligations without funding for the required period and the assessment of how this will impact those suppliers' financial metrics including their cost of capital and resilience; and

e. Reach a conclusion as to whether, in each such case, the imposition on each such supplier is consistent with Ofgem's duties including its duty of financeability.

a. ✂.

Appendix 1: The loss-making nature of the energy markets, the effects of Covid-19 on financeability for suppliers, and Ofgem's assessment of financeability

As demonstrated by the recently published Consolidated Segmental Statements, the five largest energy suppliers in aggregate had an EBIT of -£376m in 2019. The structurally loss-making nature of the retail market at present means suppliers have no "buffer" whatsoever to absorb any further financial shocks, which has been further exacerbated by Covid-19. Centrica submits that it is against this context that Ofgem should be considering how it should set the cap level.

Whilst Centrica acknowledges that Ofgem has proposed some short-term solutions to help suppliers overcome short term financial difficulties; there are some significant underlying issues that need resolution, namely,

a. the risk of rapidly escalating bad debt resulting from the impact of Covid-19, and the importance of Ofgem developing and sharing analysis describing how it intends to respond to a range of outturn scenarios;

b. that Ofgem's recent decision[2] regarding Balancing Services Use of System (BSUoS) charges that will mitigate only a small proportion of the additional costs that suppliers will face; and

c. the impact that the severe reduction in the smart metering allowance in the price cap will have on Centrica's rollout plans (as highlighted above).

It is against this backdrop that Centrica has announced a number of job cuts; and that it must also make some crucial decisions on key investments, which including smart meter rollout.

Set out below is an overview of the effect of Covid-19 on the financial position of suppliers, in particular the significant impacts on bad debt; the impact of Ofgem's recent decision on BSUoS changes, and an assessment of how Ofgem's has met its duty under section 1(6)(d) of the DFTCA in the Consultations.

Escalating bad debt and the impact of Covid-19

As Ofgem is aware, because of Covid-19, the GDP for April dropped by 20.4%[3] and the impact is being felt across sectors. Indeed, Centrica announced 5,000 job cuts at the start of June. It is clear that the market will contract, and the impact of the pandemic will take some time to clear. This means that there will be a rise in unemployment (and associated financial difficulties faced by households) in the foreseeable future, which will have a significant impact on the UK market. Whilst many sectors are facing financial pressures at this time, there are particular features of the energy market that put it at risk.

As explained to Ofgem by Centrica already, the risk of non-payment is already on the rise. Late live" (i.e. debt >180 days, owed by customers who have progressed through the debt path) has been increasing by ✂ per week, now reaching ✂ in 12 – 13 weeks.

It is also important to bear in mind that:

a. energy is an essential service, and retailers are not permitted to disconnect vulnerable customers that do not pay and are electing not to disconnect others;

---

[2] Connection and Use of System Code ("CUSC") CMP345: Defer the additional Covid-19 Balancing Services Use of System ("BSUoS") charges, dated 23 June 2020.

[3] See: https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/april2020#gdp-fell-by-204-in-april-2020

b. there is often a lag between when energy suppliers are required to pay for the costs associated with providing energy to their customers and when those customers are required to pay. This means that any financial shock that results in a household needing to cease payment will result in the supplier facing immediate bad debt, and given that energy is an essential service the bad debt will continue to grow;

c. the supplier of last resort arrangements mean that the failure of one energy supplier increases the costs for all other suppliers (this in turn could mean that financial distress is transmitted through the energy retail market and could drive more failures); and

d. the cap on energy retail prices means that suppliers cannot simply recover increasing costs through raising tariffs. There is currently no provision to update the cap for any increase in bad debt or working capital cost – Ofgem would need to collect new cost data and consult on any changes in what is a fast-changing situation. Therefore, any adjustment would be unlikely to take effect until April 2021, at the earliest.

This means that energy suppliers are likely to face more significant challenges than undertakings in other sectors.

Whilst new emergency measures with the energy industry have been agreed by Government to protect only certain suppliers of domestic supply of those most in need during the disruption caused by Covid-19, this does not remove the fact that suppliers will face two significant challenges if / when increasing numbers of customers fail to pay their bills on time:

a. An immediate drop in revenue and potential cash flow crisis for many suppliers, given that most suppliers rely on their customers' payments for financing, and are unlikely to be able to raise the significant amounts of extra funding. This could result in significant numbers of suppliers exiting the market, with significant numbers of customers impacted.

b. A longer-term profitability reduction due to increased bad debt charges, debt administration costs, and working capital costs which will affect those suppliers able to finance the initial hit to cashflows. Given that many suppliers were already loss-making even before the tariff cap was put in place, and there are other negative impacts on profitability which we do not model, this may lead to additional businesses becoming unsustainable.

As Ofgem is aware, Centrica has sought to engage with Ofgem on these problems previously, and has shared a report from Frontier Economics[4] which sets out more detailed analysis on the impact of Covid-19 on the energy sector, and possible policy considerations that Ofgem could utilise to assess how best to help suppliers survive the crisis. For ease, we reattach Frontier's analysis, and Centrica's letter to Ofgem of 17 June 2020 to this submission.

Separately, Centrica has urged Ofgem to consider the points set out in that analysis in more detail, work to develop adjustments to the default tariff cap to allow suppliers to mitigate their risks as bad debt escalates, and consult on these potential adjustments and supporting analysis as soon as possible.

BSUoS and Covid-19

As noted above, Covid-19 has significantly added to the financial challenges faced by suppliers in a market that is already structurally loss making. The impact of Ofgem's decision on BSUoS charges will further compound those problems faced by suppliers.

Whilst Centrica understands that reductions in demand due to the pandemic led to increases in the cost of balancing electricity transmission system and forecasts costs over the summer; we would note that the National Grid's Electricity System Operator's delayed actions have led to

[4] This report was sent from David Kirwan to Mary Starks on 06 April 2020.

substantial additional costs to the sector. The costs to industry for the summer of 2020 alone totals £271m.[5]

Ofgem's decision on the CUSC modification proposal will, in practice, mitigate only a very small proportion of that additional cost. Centrica estimates that of the ✂ increase in BSUoS charges, Ofgem's decision will mitigate no more than ✂ of those costs.

Tables setting out an analysis of Ofgem's consideration of the issue of financeability in the Consultations

Ofgem's May 2020 consultation - Protecting energy consumers with prepayment meters This table assesses Ofgem's analysis relating to their duty under section 1(6)(d) of the DTCA		
References	**Direct Quotations**	**Any actual analysis of financeability issues?**
4.84	In principle, we are not opposed to the effect created by allocating a portion of PPM costs to other customers and therefore we propose a tariff differential approach. We consider the impact for customers and suppliers to be consistent with section 1 of the Act, of which the primary objective is to protect customers. In our 2018 decision on the default tariff cap, we decided to set the uplift for standard credit customers using a tariff differential approach that was not fully cost reflective. We considered that this approach protected customers, and in doing so, we had regard to suppliers' finances, notwithstanding the potentially distorting impact the approach has on cost-recovery.	No.
6.4	We must set a single cap level, but suppliers' efficient net costs vary because their progress with the rollout varies. Suppliers whose rollout of smart meters in prepayment mode (which we refer to as 'smart PPMs' for the remainder of this chapter) is higher than average will have higher efficient costs than we allow for, as they incur the additional cost of installing more smart meters. Suppliers whose smart PPM rollout is below average will have lower efficient costs than we allow for, unless they still need to install new traditional PPMs to replace expired traditional meters (i.e. they do not replace expired traditional meters with cheaper smart meter). This is an unavoidable consequence of setting a single allowance that protects customers, in accordance with Section 1(6) of the Act.	No. Implication is that financeability means ensuring suppliers as a whole have their efficient costs covered.
6.71	We must protect default tariff customers and set a single allowance for all suppliers. In doing so, we must have regard to the costs of an efficient supplier. This is a challenge when suppliers' efficient (total) costs vary. In this situation, we propose to have regard to suppliers' average	No.

[5] This figure is based on a comparison between the National Grid's forecasts from February 2020 to their forecast of 12 June 2020.

	costs – otherwise customers would pay more in aggregate that the total underlying costs.	Again, the implication in theses paragraphs is that the extent of Ofgem taking supplier's financeability into account only goes so far as to have regard to suppliers' average costs.
6.72	If we set the allowance at the level of the supplier with the highest efficient costs then all other suppliers could over-recover their lower efficient costs from customers, and customers as a whole would pay more than the efficient aggregate costs of the rollout.	
6.73	If we set the allowance at the lowest level of efficient costs (in this case, the suppliers installing smart PPMs only when traditional PPMs expire), then all other suppliers would under-recover their costs, and customers as a whole would pay less than the aggregate efficient costs of the rollout. We do not consider that would protect customers or have regard to suppliers' efficient costs.	
6.74	On that basis, in accordance with Section 1(6) of the Act, we consider it protects customers and has regard to efficient costs to set the allowance considering an average rollout profile. That ensures that customers as whole pay allowances that align with the aggregate net costs of the rollout.	
7.52	………. we have a continuing obligation to set the cap, and in doing so, to protect default tariff customers as well as having regard to the matters in section 1(6) of the Act. It would also be inappropriate to set a Smart Metering Net Cost Change allowance at a level that substantially differed from our current understanding of suppliers' efficient costs (in either direction), to the detriment of consumers	No. Passing reference only

Ofgem's May 2020 consultation - Reviewing smart metering costs in the default tariff cap: May 2020 statutory consultation This table assesses Ofgem's analysis relating to their duty under section 1(6)(d) of the DTCA[6]		
References	**Direct Quotations**	**Any actual analysis of financeability issues?**
2.5	The Act requires us to protect current and future customers on default tariffs. This is the objective of the Act. We consider that our proposals must, and do, achieve this objective. (Footnote to section 1 (6).	No.
3.53	Despite uncertainty, we have a continuing obligation to set the cap, and in doing so, to protect	No. Passing reference only.

[6] ***Note.*** we are aware that Ofgem mentions the uncertainty regarding the scale of the impact of Covid-19 at paragraph 3.19; and has taken a separate high level assessment of sunk costs due to Covid-19 at paragraph 4.54, but we do not cover these in this table.

	default tariff customers as well as having regard to the matters in section 1(6) of the Act. It would also be inappropriate to set an SMNCC allowance at a level that substantially differed from our current understanding of suppliers' efficient costs (in either direction), to the detriment of consumers.	
4.4	We must set a single cap level, but suppliers' efficient net costs vary because their progress with the rollout varies. Suppliers with above average rollout profiles will have higher efficient costs than we allow for. This is an unavoidable consequence of setting a single allowance that protects customers, in accordance with section 1(6) of the Act.	No. Implication is that financeability means ensuring suppliers as a whole have their efficient costs covered.
4.65	………. in accordance with section 1(6) of the Act, we consider it protects customers and has regard to efficient costs to set the allowance considering an average rollout profile. That ensures that customers as a whole pay allowances that align with the aggregate net costs of the rollout.	No. Again, the implication in theses paragraphs is that the extent of Ofgem taking supplier's financeability into account only goes so far as to have regard to suppliers' average costs.
7.25	As discussed in Chapter 4, suppliers with above average rollout have higher than average costs. In this context, that means that suppliers with higher than average rollout will have a lower balance to carry forward, as they have installed more meters. Suppliers with lower than average rollout will have a larger balance of advanced payments to carry forward. Ultimately, we must set a single allowance that protects customers, even when suppliers' efficient costs vary. We have taken the statutory needs in section 1(6) of the Act into account when considering this proposal, but have to give each of these appropriate weight against the overriding objective of protecting customers.	