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By email to: Retailpriceregulation@ofgem.gov.uk

Dear Anna

Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation[1]

Centrica welcomes Ofgem's recognition that the Covid-19 pandemic, and the measures put in place to limit its impact, have already significantly affected the energy industry. As Ofgem notes, non-domestic demand has reduced as a result of businesses closing, which has contributed to a fall in wholesale prices; workers have been laid off, furloughed, or are working from home, increasing domestic energy use. Some customers are already struggling to pay their bills. These impacts could increase over winter, as furlough ends, and consumers use more energy.

We have previously highlighted to Ofgem the significant challenges posed to energy suppliers if and when an increasing proportion of customers fail to pay their bills on time, both in terms of immediate impacts on revenue and cashflow and additional strains on funding - in a sector which was structurally loss-making pre-Covid-19.[2] We therefore welcome Ofgem's review and agree with the following provisional conclusions

- Additional debt-related costs, while uncertain, are likely to be material;
- Covid-19 is an unforeseen and unprecedented event – outside the range of uncertainties the cap was intended to accommodate;
- In these circumstances it is necessary and appropriate to consider adjustments to the default tariff cap in time for the next cap period starting in April 2021.

We further agree with Ofgem that in these unique circumstances

[1] https://www.ofgem.gov.uk/system/files/docs/2020/09/reviewing_the_potential_impact_of_covid-19_on_the_default_tariff_cap_-_september_2020_consultation.pdf
[2] Aggregate pre-tax domestic supply margins of large suppliers in 2019 was -1.48% (Ofgem data portal)

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- A 'float and true-up' approach towards recovering additional debt-related costs is justified;
- This will require estimation of the appropriate provisional 'float' based on a combination of leading indicators and wider economic forecasts;
- There is a case for setting the initial float conservatively to soften impacts on customers and suppliers by spreading them over time.

We consider a 'float and true-up' is appropriate in this instance, given:
- the extreme uncertainty facing the sector at present; and
- that funding levels for bad debt do not need to be known with absolute certainty in advance for the purposes of business planning.

For the avoidance of doubt, we view the 'float and true-up' proposal as being fundamentally different to Ofgem's prior proposals for 'historic clawback' of smart metering costs, which we consider should be abandoned on the basis this offends the principle of legal certainty. If suppliers are to rollout smart meters efficiently and at scale, it is essential there is certainty over the level of funding that will be available (to enable the programme to be scaled appropriately – including the recruitment and training of sufficient engineers). This is very different to the focus of this consultation – which is seeking to forecast levels of bad debt that may result from the further effects of Covid-19.

On this topic, we appreciate that Ofgem is still in the process of assembling the evidence base necessary to support more concrete proposals and look forward to working constructively with Ofgem to that end. Therefore, in the limited time available we do not comment extensively in this response on every aspect of Ofgem's proposals and reasoning, though we reserve the right to provide views and evidence as necessary and appropriate in due course.

The main issue we wish to register at this stage is our serious concern with Ofgem's proposal to use a lower quartile benchmark for additional debt-related costs. We think this approach is completely misconceived for several reasons, notably:

- As Ofgem recognises, Covid-19 impacts could not reasonably have been predicted and impacts on individual suppliers will be driven to a large extent by factors (such as customer mix) outside their reasonable control;
- Suppliers are strongly incentivised to minimise additional debt related costs in any event – though their freedom of action is heavily conditioned by regulation and additional voluntary commitments required by government (particularly in the context of Covid-19);
- The lower quartile change in debt-related costs pre- and post-Covid-19 based on a single supplier is unlikely to provide an appropriate measure of efficiently incurred costs for the industry in the circumstances

We elaborate these concerns further in the attached appendix to explain why we consider Ofgem should instead use a weighted average of representative (scale) suppliers to benchmark additional debt related costs, as it did for the recent wholesale cost adjustment.

We look forward to engaging with Ofgem as it develops its proposals further ahead of the statutory consultation planned for November.

Yours sincerely

Tim Dewhurst
Director of Regulatory Affairs & Policy

Appendix: Why lower quartile is not an appropriate benchmark

In Chapter 4 of the consultation document, Ofgem discusses various aspects of how it might go about establishing an adjustment for additional debt-related costs. In relation to benchmarking Ofgem's initial view appears to be

- that it should carry out a new benchmarking exercise, comparing pre-Covid-19 reference costs with those in subsequent periods
- that it should consider the change in debt-related costs across a range of suppliers currently active in the market above a minimum threshold size
- rather than considering the average picture, Ofgem should select a single lower quartile supplier as its benchmark – noting that the lower quartile supplier could be different for each period

Ofgem appears to base its preference for a lower quartile benchmark on the belief that

- the drivers of additional debt related costs are largely within suppliers' control
- it is necessary to incentivise efficiency on the part of suppliers in order to protect customers.

We explain below why we believe Ofgem's approach is fundamentally misconceived and at odds with the reasoning it advances elsewhere in Chapter 4 for rejecting alternative benchmarks based on a single supplier. The evidence underpinning the view that customer mix outweighs relative efficiency in determining the final outturn is sufficiently strong to suggest a weighted average rather than lower quartile benchmark is the appropriate policy to adopt in this context.

Variation in individual supplier outturn is more likely to reflect customer mix than relative efficiency

Ofgem's initial view in favour of a lower quartile benchmark is surprising given its acknowledgement of factors that would tend to support an average approach, notably:

- The potentially large and unexpected impacts of Covid-19 on individual suppliers are likely to reflect factors beyond their immediate control
- The eventual impacts are also highly uncertain and challenging to forecast accurately[3]

Despite this, Ofgem asserts that because it does not consider that variations in cost are totally outside of suppliers control and thus may partly reflect differences in efficiency:

> *"the level of costs we include in the cap should reflect this. Using an average cost benchmark would not protect customers and incentivise efficiency to a similar extent as the operating cost benchmark, which we set just below a lower quartile."*[4]

This simply does not follow, however. The issue is not whether suppliers may be able to exercise any degree of control over the level of additional debt-related costs that eventuate but rather the extent to which they are driven by factors within or outside of suppliers' reasonable control.

[3] Condoc 4.45-4.46
[4] Condoc 4.47

If, as we would expect, the key drivers of additional debt-related costs on individual suppliers are very largely factors such as customer mix that are to a large extent outside of suppliers' immediate control, observed variations will also be primarily driven by such factors and not by relative efficiency.

Supplier impacts depend on customer impacts – so a single benchmark supplier is inherently unrepresentative of aggregate impact on efficient costs

Ofgem recognises the risk that the outturn position of a lower quartile benchmark supplier may be driven by external factors more than relative efficiency in rejecting use of the current benchmark operator for payment uplift:

> *"By only looking at a single supplier, we do not know what position it would have among suppliers in 2020 in relation to debt-related costs. For example, if the supplier had a less significant impact from COVID-19 (e.g. due to a favourable customer base), this could lead to us understating the adjustment required for the market as a whole." (emphasis added)*[5]

This point is elaborated further in the associated footnote

> *"For example, the recession as a result of COVID-19 may have different impacts between regions. Suppliers have regional variation in their customer bases (particularly the historical electricity incumbents), and so suppliers' exposure to debt-related costs could be affected by their customer base. We cannot practically take into account all potential variations in our cap design, but we recognise that the impacts of COVID-19 may vary between suppliers." (emphasis added)*

Ofgem is correct to recognise that additional debt-related costs due to Covid are likely to reflect such underlying differences in customer mix, and to draw the conclusion that this makes a single supplier lower quartile benchmark inappropriate in this case – because customer mix is not a matter of supplier efficiency. It should also recognise that the same factors reflecting customer selection bias apply equally to a lower quartile benchmark supplier derived from any new benchmarking exercise.

Uncertainty means all suppliers have strong incentives to minimise additional exposure

Ofgem seeks to portray its preference for a lower quartile benchmark as being 'in line with the approach elsewhere in our 2018 decision'[6] but without sufficiently considering the very different nature of the present exercise.

In 2018, Ofgem faced the challenge of setting a prospective cap to apply from 1 January 2019, signalling that it did not expect its methodology to be subject to retrospective revision or 'reopeners' (except in very limited and exceptional circumstances). In this situation, Ofgem relied on advance certainty to provide incentives to improve efficiency, as it acknowledges in the present consultation

> *"4.64. The Act requires us to have regard to (among other matters) the need for incentives for suppliers to improve their efficiency. Setting an upfront allowance, and then not adjusting this over time (except for indexing by inflation), provides suppliers with an incentive to improve their efficiency. This is because suppliers know that if they make*

[5] Condoc at 4.55
[6] Condoc at 4.49

> *efficiency gains, they should be able to keep the additional revenue, rather than us adjusting the cap down in response. Similarly, suppliers know that if they allowed their costs to increase, they would not be able to recover this from customers."*

The present situation is different. Ofgem's initial view is firmly against an ex ante allowance, with the remaining choice between a purely ex post adjustment or a float and true-up approach. There is thus a potential feedback loop between the additional debt related costs suppliers ultimately experience and the final level of adjustment to the cap.

However, it does not follow that suppliers lack incentives to minimise the additional debt-related costs they experience were Ofgem to use an average rather than lower quartile benchmark. Under an average cost benchmark, it remains the case that the final value of any adjustment cannot be known by suppliers in advance.

Individual suppliers have no reliable means of knowing whether their outturn additional debt related costs will be above or below whatever final adjustment Ofgem allows, and in any event cannot be confident their efficiently incurred additional debt-related costs will be fully covered through any one-size-fits-all adjustment based on an industry average. So long as any float is set relatively conservatively (as we suggest should be the case), meaning there is a consequent need to manage cash flow tightly, all the incentives on suppliers will be to manage additional debt-related costs efficiently. .

Ofgem should not therefore be concerned that a weighted average approach dampens incentives to be efficient in minimising additional debt-related costs to the extent possible. Rather, it should recognise that within the constraints of a single adjustment applicable to all suppliers that is set conservatively, a weighted average of outturn additional debt-related costs already creates strong supplier incentives towards cost minimisation.

Why customer mix matters

Despite universal service obligations, there is scope for suppliers to influence the credit characteristics of new customers they acquire at the margin through the terms and conditions they offer. For instance, some suppliers require advance payments from customers with direct debits commencing on the date supply starts. This not only has the effect of providing a cash flow benefit to the supplier and providing a buffer against debt build up, it may also serve to filter out customers who lack the financial resources to support advance payment.

However, new customers acquired on fixed term contracts are unlikely to be representative of customers on default tariffs to which the price cap applies. In respect of existing customers, the degrees of freedom available to suppliers to manage late payment and bad debt are more limited, and this is especially true in respect of vulnerable customers.

Ofgem no longer publishes data on the proportion of PSR customers by supplier, although it still collects it. Nevertheless, the most recent data Ofgem published revealed wide variation between suppliers in the number of PSR customers recorded, suggesting PSR proportions do not correlate simply with market share.[7] As Centrica pointed out in response to Ofgem's September 2018 consultation, at the end of 2017 ten suppliers had a higher proportion of PSR customers than Ofgem's opex benchmark supplier.[8] These suppliers accounted for 36 million

[7] https://www.ofgem.gov.uk/system/files/docs/2018/06/externalreport2017.pdf

[8] https://www.ofgem.gov.uk/system/files/docs/2018/10/centrica_-_response_2_-_appendices_2-10.pdf
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accounts or 79% of the market (excluding the benchmark supplier itself). Ofgem estimated that the median additional cost to serve a PSR customer in 2017 was £10 per dual fuel customer, but the range of variation was much larger at £46 per DF customer.

Variations in proportion of PSR customers (and consequent variations in cost to serve) are not a matter of relative efficiency, but nevertheless bear directly on the options available to suppliers to pursue payment arrears and prevent further accumulation of debt. Disconnection is often precluded and options short of disconnection such as a requirement to switch to prepayment are also frequently inappropriate due to specific customer circumstances, and are subject to stringent regulatory restrictions.

Centrica has previously presented evidence to Ofgem on so-called 'brick wall' cases of persistent non-payment, where there is little or no prospect of repayment of debt due to customer circumstances. While pre-existing chronic non-payment may be less impacted by Covid-19 than customers newly facing acute affordability constraints, the prevalence of customers prone to experience payment difficulties as a result of Covid-19 is unlikely to be uniform across suppliers.

To date, immediate financial pressures on households have been eased by support through furlough schemes which has limited the knock-on impact on payment. We expect this position to change if economic activity remains heavily restricted while existing support schemes are withdrawn but it is not possible to evidence the precise pattern of impact in advance of it occurring. In principle, however, Ofgem's proposal to canvass information from all suppliers currently in the market over a minimum size threshold and then benchmark against a single lower quartile supplier clearly runs the risk of producing a benchmark dominated by customer mix rather than relative efficiency. This reinforces the case for preferring an approach based on weighted average costs – as Ofgem recently did in relation to wholesale costs which, similarly, were not fundamentally a matter of efficiency.