centrica

Centrica plc

Millstream
Maidenhead Road
Windsor
SL4 5GD
www.centrica.com

Dan Norton
Deputy Director, Retail Price Regulation
Ofgem
10 South Colonnade
Canary Wharf
London E14 4PU

28 July 2023

By email to : RetailPriceRegulation@ofgem.gov.uk

Dear Dan

Price cap – Consultation on technical changes to the price cap methodology – June 2023[1]

Centrica welcomes the opportunity to respond to Ofgem's consultation.

We have no issue with the proposed changes regarding the calculation of allowances for unidentified gas (UIG) and inflation indexing of policy costs associated with the Great British Insulation Scheme (GBIS).

We do, however, have **substantial concern with Ofgem's proposals regarding Contracts for Difference (CfD)**. As we explain further below:

- Ofgem's proposals fail to grapple adequately with the material and systematic volume risk suppliers face due to the Low Carbon Contracts Company's (LCCC) approach to forecasting;[2]

- Contrary to the stated rationale, Ofgem's proposals do not effectively mitigate supplier exposure to CfD hedge timing price risk between the allowance being set and the actual CfD cost/benefit incurred/received.

[1] Price cap – Consultation on technical changes to the price cap methodology – June 2023 | Ofgem
[2] We have highlighted this risk to Ofgem repeatedly as detailed in our response to Ofgem's further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance.

Reconcilliation is still needed to address material and systematic risk in consumers' interest

We remain firmly of the view that Ofgem's rejection of LCCC forecast error reconciliation is misconceived.[3] We strongly urge Ofgem to revisit this decision and introduce a reconciliation mechanism to true up any difference between forecast and outturn CfD costs.

As we have previously explained, in a world where power prices increase significantly above generator strike prices generators are systematically inentivised to use the flexibility inherent in the CfD contract delay their start date. This allows them to sell volume at the prevailing high market prices, without paying significant sums back into the CfD scheme.

The Department for Energy Security and Net Zero (DESNZ) has recognised this generator behaviour and has revised the CfD contract terms[4] to prevent this practice for Allocation Round 5. However, the start date flexibility remains for all existing CfD contracts awarded in earlier allocation rounds and rational profit maximising generators will use it.

Therefore, by failing to forecast on the assumption of rational behaviour by generators, the current LCCC forecasting approach will systematically overstate CfD credits and Ofgem's approach to cap allowances will result in material losses for suppliers.

To demostrate the materiality of the issue, the CfD price cap allowance of -£57/customer for 2023 Q2 (Apr-Jun) was based on the LCCC's forecast that five offshore wind projects (1.8GW capacity) would become operational in Q2 of 2023. However four of these projects (1.4GW capacity) delayed their expected start dates by a year at very short notice, with the LCCC generation register only reporting the delays at the end of March 2023. It is also worth noting that the one generator that did trigger its start date had a higher strike price and has received net payments from the LCCC. We estimate that the LCCC volume forecast error associated with the four generators that delayed their start dates reduced the price cap allowance by ~£17/customer for the quarter.

LCCC volume forecast error is not limited to generator start dates. The LCCC has also materially over forecast biomass generation output and associated CfD credits in recent quarters. Volatile power prices create an option for baseload CfD generators to buy back their CfD hedge if prevailing power prices are materially lower than the baseload reference price. The LCCC has been unable to accurately forecast this behaviour in its determinations. In its 2022 Q4 ILR determination it forecast 2,054 GWh of biomass output for Oct-22 to Mar-23, equating to £275m of CfD credits. The price cap allowances for 2022 Q4 were based on these assumptions. However actual biomass output and credits for the Oct-22 to Mar-23 period were just 191 GWh and £53m, representing a ~90% volume forecast error which reduced the price cap allowance by ~£3/customer. Similarly, the price cap allowance for 2023 Q1 was based on the same Oct-Dec assumptions as above along with the Jan-Mar assumptions from the 2023 Q1 ILR determination. This resulted in an effective forecast inherent in the 2023 Q1 price cap of 1,718 GWh of biomass output for Oct-22 to Mar-23, equating to £352m of CfD credits. As a result the biomass volume forecast error in the 2023 Q1 price cap was ~£4/customer.

---

[3] Appendix 1 to Ofgem's present consultation states explicitly that Ofgem is maintaining the rejection of reconciliation articulated in its June 2022 Decision on the Contract for Difference (CfD) allowance methodology in the default tariff cap

[4] [Government_response_to_ar5_cfd_contract_changes_consultation.pdf]

A true-up mechanism is, therefore, needed to account for any difference between: (a) CfD costs assumed in the Interim Levy Rate (ILR); and (b) outturn CfDs costs. If implemented as we have proposed, it would remove the need (and associated cost) to hedge against CfD volumes. Unlike Ofgem's current proposals, it would effectively mitigate the risk of material shortfall in the recovery of suppliers' efficiently-incurred costs. As Ofgem has previously acknowledged that *"a competitive market where suppliers can recover their efficient costs is in the long-term interests of all consumers".*[5]

Ofgem's rejection of a reconciliation mechanism might have been more understandable had it intended to address the material and systematic risk due to CfDs via its review of EBIT. However, rather than addressing this risk, Ofgem's statutory consultation on EBIT effectively assumes it away.[6] Given that Ofgem's approach to EBIT leaves CfD risk unaddressed, the case for retrospective reconciliation to allow recovery of efficiently incurred costs in the consumer interest is all the more compelling.

In any event, hedging requires date certainty

Notwithstanding the requirement for a reconciliation mechanism that would obviate the need for hedging, we consider Ofgem's present proposals are flawed even in their own terms. Put simply, this is because suppliers remain exposed to price risk between the allowance being set and the actual CfD cost/benefit incurred/received.

To hedge this risk, suppliers need to be able to "lock" the power prices used by the LCCC to calculate the ILR. But this would only be possible if Ofgem and the LCCC provide certainty as to what market price snapshot LCCC will use <u>before</u> it calculates the ILR. Currently this information is only available after the LCCC publishes the ILR, circa two weeks later.

This delay requires suppliers to make assumptions on the date being used by LCCC and exposes them to price risk. The price risk was relatively small when prices were stable, but recent increases in power price volatility have added significant risk to suppliers whilst not providing any benefit to customers.

Ofgem proposes to account for before-period adjustments published at least 30 working days prior to the subsequent period. However, this does not provide suppliers with the certainty they would need to hedge because there is no certainty whether there will in fact be any 'before-period' adjustments until this cut off date, by which time the option to hedge at the time of the quarterly determination is no longer available. Ofgem's proposals therefore increase rather than reduce uncertainty.

If, as Ofgem suggests, it wishes to provide suppliers with the certainty they need to hedge it will need to inform suppliers <u>unequivocally</u> of the date used to calculate the allowance *ex ante.* One option would be to use the date of the original determination, published three months in advance of the quarterly period. Another option might be to use LCCC weekly updates published on a specified date even though these are not formal determinations.

---

[5] Price Cap - Decision on possible wholesale cost adjustment | Ofgem Paragraph 3.146

[6] For example, Ofgem's working capital model explicitly assumes cost categories match associated DTC revenue allowances.

Conclusion:

Ofgem's present proposal is both unsatisfactory and erroneous in purporting to provide greater certainty while not providing sufficient certainty to support hedging in practice. We therefore urge Ofgem not to proceed with it.

Ofgem should, instead, revist and reverse its decision not to adopt a reconciliation mechanism, particularly in light of its minded-to position not to address material and systematic risk due to CfDs via its review of EBIT.

Please do not hesitate to contact me if you wish to discuss further.

Yours sincerely,

Alun Rees
Head of Wholesale & Retail Market Policy