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By email to: Retailpriceregulation@ofgem.gov.uk

Dear Karen

Final consultations on credit and PPM SMNCC

Centrica welcomes the opportunity to respond to Ofgem's twin consultations on this critically important subject.¹² This is a combined response to both consultations, also taking account of the 'addendum' to these consultations published on 1 June.³

Our key conclusions are summarised immediately below and elaborated further in the following pages and attached reports from our advisers:

- The move to a 'market leader' profile for credit is necessary but not sufficient - Ofgem's current implementation of its market leader approach does not ensure that all suppliers can recover all of their efficient smart costs. This is not an academic concern but one with real world impact. ✗.
- Ofgem needs to (at least) fund the minimum obligations for each supplier for those obligations to be enforceable. Ofgem's stated intention is to ensure that all suppliers can recover the efficient costs of meeting their obligations. But as set out in the accompanying Frontier Economics report, material corrections to credit and PPM SMNCC are needed to achieve this outcome.
- The estimated impact in cap period 7 of Ofgem making the minimum necessary corrections to its approach is to increase the electricity credit SMNCC by £1.45, increase gas credit SMNCC by £1.76 and increase gas PPM SMNCC by at least £5.⁴⁵

¹ [Price Cap - final consultation on updating the credit SMNCC allowance | Ofgem](#)

² [Price Cap - final consultation on updating the PPM SMNCC allowance | Ofgem](#)

³ [Price Cap – addendum to consultations on reviewing the credit and PPM SMNCC allowances | Ofgem](#)

⁴ Frontier report, Figures 1, 2 and 3. The post offset electricity PPM SMNCC is unaffected by necessary corrections because of how the PPM offset works.

⁵ While these estimates are presented in terms of SMNCC, Ofgem should not underestimate their real-world scale ✗

- If Ofgem makes the necessary corrections, \propto . If left uncorrected, however, \propto .⁶ Moreover, as discussed further in the attached legal annex prepared by Towerhouse LLP, failure to make the necessary corrections will render Ofgem's decision susceptible to challenge for breach of its duty under Section 1(6)(d) of the Domestic Gas and Electricity (Tariff Cap) Act 2018.⁷
- The further consultation Ofgem plans for Autumn requires full disclosure – and the ability for stakeholders to retain and draw on current disclosure material to inform responses to the further consultation. Ofgem therefore needs to revise its addendum proposals accordingly.
- We expect Ofgem to address competitive distortion from failure to meet existing 'all reasonable steps' (ARS) obligations through rigorous enforcement against non-compliant suppliers who continue to run unsustainable business models. Ofgem should consider the full range of remedies available to it to ensure sanctions are effective.

Smart metering is a key part of the Government's net zero carbon strategy, with progress towards the market-wide adoption of smart meters being a vital enabler for the green recovery. The Government reaffirmed its commitment to the smart metering programme last year when it determined the future rollout trajectory required, namely market-wide rollout by 2025. BEIS has now also confirmed its final policy decisions in respect of the future smart mandate.⁸ It remains vital to the success of the smart programme that suppliers are able to recover their efficient costs of implementing rollout. Ofgem must ensure the SMNCC allowance in the default tariff cap (cap) is set appropriately to enable realisation of the smart programme and associated consumer benefits. Suppliers cannot sustainably spend more on smart rollout than they are allowed to recover under the cap.⁹

Choice of rollout profile is critical to Ofgem's modelling approach for setting SMNCC allowances as part of the cap. We have previously highlighted that an 'average' rollout profile (as Ofgem previously proposed) would result in slowdown and a systematic deficit in the amount of revenue that can be recovered contrary to Government's policy ambition which requires an acceleration in the programme to meet the goal of market-wide rollout by 2025. As discussed further below Ofgem must adopt a profile that allows each supplier to (at least) meet its minimum legal obligations and recover its own associated efficient costs, otherwise the rollout obligations of that supplier will not be enforceable.

Ofgem cannot enforce unfunded obligations

It is welcome that Ofgem now accepts, in principle, the need to enable each supplier to recover the efficient costs of meeting its minimum legal obligations. Ofgem has clarified that *"suppliers' legal obligations reflect the tolerances, and that we cannot hold suppliers to account for not spending any additional revenue on smart metering above these legal obligations"*.¹⁰ On this basis, and given that the net cost associated with smart credit meters means there is no incentive for suppliers to outperform their minimum obligations, Ofgem proposes to fund what it calls a 'tolerance' rather than a 'target' profile.

⁶ \propto

⁷ Towerhouse legal annex

⁸ [Delivering a smart system: response to a consultation on smart meter policy framework post-2020](https://publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/978482/delivering_a_smart_system_response_to_a_consultation_on_smart_meter_policy_framework_post-2020.pdf) (publishing.service.gov.uk)

⁹ Centrica has consistently sought to dedicate DTC allowances intended to support smart roll-out for their intended purpose (as we believe all suppliers should have been doing). We expect to continue that policy beyond the end of the ARS regime.

¹⁰ Letter from Jonathan Spence, 8 June 2021

There is clearly a risk that this approach results in self-fulfilling prophecy i.e. the minimum effectively becomes a maximum. Even if other aspects of BEIS' policy were to change in a way which unlocked consumer demand, targets before tolerance will remain fundamentally unachievable without sufficient funding.¹¹ The policy intention behind the smart programme may be more a matter for BEIS than for Ofgem, but it is important that BEIS understands the implications of Ofgem's decisions on funding and for Ofgem to validate with BEIS and confirm explicitly that the licence obligations reflects BEIS' policy intention. In particular, BEIS should not be under any misapprehension that market leaders are funded, obliged or incentivised to exceed the minimum obligations recently confirmed.

As we have repeatedly made clear, suppliers cannot be expected to meet unfunded targets; if BEIS intended for targets before tolerance to be met or for performance in excess of minimum obligations to be assured it would have been necessary to frame different obligations and ensure that each supplier is fully funded to meet those obligations. As matters stand, we welcome Ofgem's clear acknowledgement that it cannot require suppliers to 'outperform' their legal obligations. This view is supported by the attached legal annex, which also underlines that Ofgem cannot lawfully take enforcement action unless it provides adequate funding for suppliers to meet their rollout obligations.

Material corrections are required to ensure sufficient funding for all suppliers to recover the efficient costs of meeting their obligations

Our primary concern with Ofgem's current proposals is that the modelling underpinning them materially underestimates the level of SMNCC required to enable the market leader to fully recover efficiently incurred costs. Moreover, Ofgem's definition of market leader may not necessarily ensure sufficient funding for all efficient suppliers meaning Ofgem's own policy intention will not be achieved.

Any assertion that Ofgem is being conservative by adopting a market leader profile could only apply to suppliers with substantially lower cost profiles than the market leader. They offer no comfort to the market leader (by Ofgem's definition) or to any other supplier with similar or indeed higher efficient costs.¹²

This makes it imperative that Ofgem's calculated SMNCC does not materially understate the efficient costs of market leaders. The risks are asymmetric: if Ofgem overestimates SMNCC a market leader may still be able to meet its minimum obligations but if Ofgem underestimates SMNCC those obligations are unlikely to be achievable (or enforceable) and BEIS' policy intention will be defeated.

Two key new modelling issues which Ofgem must correct in relation to credit SMNCC to avoid material understatement are:

- Estimation of Covid-related sunk costs
 - Ofgem's sunk cost methodology is flawed, does not reflect the commercial reality facing suppliers and materially underestimates the sunk costs incurred by the industry in 2020 and 2021. Correcting for this error increases the electricity credit SMNCC by £1.60, the gas credit SMNCC by £1.30¹³

¹¹ For the avoidance of doubt, Centrica's current plans reflect targets as defined in licence obligations (i.e. including tolerance) not targets before tolerance (as Ofgem uses the term target in the consultations).

¹² ✂.

¹³ Frontier report, Figures 6 & 7

- To apply a 'direct' method of estimation Ofgem would need to distinguish correctly between amortised vs non-amortised costs. However, this distinction is not reflected in the data Ofgem proposes to rely on (essentially Ofgem has asked suppliers the wrong question)
 - Ofgem's preferred 'method one' estimate rests on an unfounded assumption ~~✗~~ which Ofgem has not, so far as we are aware, sought to verify with *any* supplier. In relying on an assumption about amortised costs, Ofgem risks its decision being invalidated by reason of an error of fact, rendering it vulnerable to challenge
 - In the absence of reliable supporting evidence for this approach Ofgem must use an alternative method (method 2) to reflect the commercial reality of which costs are sunk from a supplier perspective
- Incorrect use of a combined dual fuel profile
 - Despite having previously adopted separate profiles for gas and electricity, Ofgem has – without explanation or justification – chosen to model the market leader SMNCC using a combined dual fuel profile. The estimated impact in cap period 7 of Ofgem making the necessary corrections is to decrease the electricity credit SMNCC very slightly and increase the gas credit SMNCC by £0.53¹⁴
 - Ofgem's current approach not only ignores the reality that suppliers (including the market leader) will not have a 50/50 fuel split in practice but, critically, fails to reflect the true proportion of higher cost single fuel installs
 - Ofgem's approach will not fully reflect the efficiently incurred costs of the market leader (based on the market leader's actual fuel split profile) and calls into question Ofgem's assumption that its proposed approach axiomatically guarantees sufficient funding to all other suppliers
 - The legal framework clearly recognises the distinction between gas and electricity and strongly supports their separate treatment
 - Ofgem must therefore
 - Apply an appropriate fuel split
 - Undertake further sensitivity checks to ensure no supplier faces a shortfall based on their fuel split profile (which is not a matter of efficiency)
 - Provide an uplift to eliminate any revealed shortfall

While the credit SMNCC has been reviewed several times, there are significant new elements in Ofgem's approach which have not been exposed in previous consultations. For brevity, this response focuses on those new elements. However, that does not imply that we now agree with other aspects of Ofgem's approach addressed in earlier rounds of consultation, on which

¹⁴ Frontier report, Figure 8. Figures are estimates because Ofgem has not provided the data to fully calculate the impact.

we reserve our position. For instance, we continue to have serious reservations about Ofgem's approach to uncertainty as outlined in Appendix 6 to the credit consultation.

In relation to the PPM SMNCC, this is the first time Ofgem will have set a PPM SMNCC using its SMNCC model (PPM SMNCC is currently set to zero on a contingency basis). PPM SMNCC has not been subject to the same level of scrutiny to date as credit SMNCC. Many of the issues, and underlying data, are being consulted on for the first time. As with credit while there are aspects of Ofgem's modelling approach we support there are also errors which must be corrected to better reflect efficiently incurred costs:

- *Rollout profile* - Ofgem has adopted a different approach to credit, using a weighted average profile rather than a market leader or highest net cost approach. We accept that a market leader approach would not be appropriate for PPM. However, the unjustified use of a combined dual fuel profile rather than separate gas and electricity profiles is equally inappropriate for PPM as for credit and must be corrected. This correction is estimated to increase the gas PPM SMNCC by £1.62 in cap period 7.¹⁵
- *PPM offset* - We agree that Ofgem should take action to mitigate the risk of under recovery of efficient costs by those suppliers that face higher efficient costs. Overall, we support Ofgem's proposal on the PPM offset, which limits the impact on PPM customers of unwinding under-recovery of higher PPM costs.
- *PPM cost to serve (CTS) benefit* - Unlike credit, PPM SMNCC is generally negative (before offset) because modelled benefits are expected to outweigh costs.
 - This is the first time that Ofgem has shared the data on which it bases its PPM CTS benefit.
 - We note that there appears to be very wide variation in the CTS data between suppliers. This raises questions about the reliability and credibility of the data and whether Ofgem is comparing 'apples with apples' when it derives its PPM CTS benefit estimate.
 - ✂.
 - Any assumption that over-estimates the CTS benefit will underfund efficient suppliers.
- In addition, the questionable credibility of the PPM CTS data that Ofgem uses, Ofgem has overstated the PPM CTS benefit due to serious flaws in its calculation.
 - Ofgem's approach to calculating the PPM cost to serve (CTS) benefit uses an inappropriate method to weight together cost data from different suppliers.
 - This mathematically flawed method gives undue weight to unrepresentative suppliers with an imbalanced split between traditional and smart meters.
 - The appropriate method weights all PPM customers equally, which has a material impact on the derived CTS benefit – a £3 net decrease on a dual fuel basis (£4 decrease on gas, £1 increase on electricity).
 - Ofgem's treatment of fixed costs is also incorrect – it effectively treats fixed costs as avoidable costs which is wrong because the fixed costs of traditional PPM meters cannot be avoided by installing smart meters.

- *PPM asset lives* - Ofgem's choice of PPM asset life value fails to recognise extreme sensitivity to the summary statistic (i.e. x year asset life) Ofgem has chosen to use for modelling purposes (in reality, traditional PPM asset lives will vary). Whilst there is no final impact on the post offset electricity PPM SMNCC there are material impacts on the final gas PPM SMNCC, causing Ofgem to overstate net benefit to suppliers.

The credit and PPM modelling issues that Ofgem must correct are set out in further detail in the attached report from Frontier Economics. Each issue is material individually, and cumulatively they are very substantial.¹⁶ The estimates are necessarily provisional because Ofgem intends to update with later data which we and our advisers cannot currently access. However, Ofgem should be in no doubt that without correction \propto . By contrast, if Ofgem adopts appropriate corrections \propto . We expect to continue to apply all available funding for its intended purpose (as we believe other suppliers should also be doing).

This response is also accompanied by a legal annex prepared by Towerhouse LLP, highlighting areas where Ofgem is at risk of falling into legal error rendering its decisions susceptible to challenge. In addition to the points summarised above reflecting Ofgem's original consultation proposals, the legal annex highlights serious shortcomings in Ofgem's addendum proposals for further consultation proposed for the Autumn and how these must be rectified. It also underlines why, notwithstanding the new smart mandate set to commence in January 2022, Ofgem must actively enforce existing ARS obligations against non-compliant suppliers to ensure irresponsible business practice does not undermine the smart programme and distort market outcomes.

Yours sincerely

Don Wilson
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¹⁶ The aggregate impact is summarised in Figures 1,2 and 3 of the Frontier report.
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