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Reviewing Smart Metering Costs in the Default Tariff Cap
Legal Annex to submission by Centrica plc

## Introduction

1. The Domestic Gas and Electricity (Tariff Cap) Act 2018 (**TCA**) requires Ofgem to impose a price cap on energy suppliers' default tariffs. Ofgem intends to set the cap at a level that allowed suppliers to recover the costs of complying with their licence conditions requiring the rollout of smart meters (the **Rollout Obligations**) and to support the rollout.[1]

2. The Rollout Obligations have costs and benefits for suppliers. In setting the allowance, Ofgem determined the net cost in 2017 of installing and operating smart meters under the Rollout Obligations (which formed part of the overall operating cost allowance). Ofgem then determined the 'Smart Metering Net Cost Change' allowance (**SMNCC**), which sets out how the net cost changes from the 2017 baseline. Ofgem is now consulting on the elements of the SMNCC which are not directly passed through in the cap from 1 April 2020 to the end of 2023.

3. This Legal Annex sets out several fundamental legal concerns with the process and substantive proposals in the consultation document:

   a) Unlawful reliance on the BEIS CBA inputs and assumptions: Ofgem's consultation proceeds on the basis of an unexplained and unevidenced conclusion that the BEIS CBA is 'fit for purpose' and its assumptions are suitable, except in connection with specified and selective areas where Ofgem has chosen to scrutinise those inputs and assumptions. It is incumbent on Ofgem, as the decision maker, to obtain the correct information on which to base its decision. In this case, the BEIS CBA is being appropriated for a purpose for which it was never designed or intended and this puts a stronger onus on Ofgem to investigate the CBA and its underlying inputs. However, Ofgem has implied to us that in many cases it may not even possess many of the basic inputs used by BEIS (nor has it indicated to us that it made any

[1] Ofgem said in its decision setting the initial cap that '*We include the net cost of installing smart meters up to 2017 in our operating cost benchmark [and] we provide an additional allowance so that suppliers can complete the smart meter rollout*' (Overview Document, page 8). In its current consultation, 'Reviewing smart metering costs in the default tariff cap: October consultation' (the **Consultation document**), it says it intends the allowance to 'support' the rollout: para 2.11.

efforts to obtain inputs which BEIS did not provide).[2] Ofgem cannot properly have reached the conclusion that the BEIS CBA inputs and assumptions are suitable without having seen those basic inputs for itself; still less so where is has not even attempted to get sight of them.[3] These failures are likely to render any decision based on the BEIS CBA unlawful.

b) Failure to meet the basic legal requirements for consultation: Ofgem has failed to provide for consultees all of the relevant datasets and inputs to the SMNCC model and in other cases the data is unnecessarily anonymised (the **Undisclosed Data**).[4] The fact that information available to consultees is incomplete means that suppliers are unable to comment on key datasets which they are best placed to scrutinise and validate. This is especially concerning given that:

   i. it now transpires that Ofgem has not obtained the Undisclosed Data from BEIS itself, so it cannot have made any informed independent assessment about its accuracy, validity or suitability;

   ii. the Undisclosed Data has never been disclosed nor subjected to consultation, including when they were first used in the BEIS CBA; and

   iii. Ofgem accepts in the consultation that its 2017 baseline net costs assessment was flawed and now requires correction. This relates to information which Centrica specifically requested be available to suppliers to scrutinise, and which Ofgem refused to disclose on the basis it was unnecessary. The need for and benefits of proper industry scrutiny have therefore now been clearly established.

   It is essential, given Ofgem's public law duties and the statutory requirements for consultation in the Act, that Ofgem take all reasonable steps to allow consultees to properly scrutinise the data Ofgem is relying on, before reaching any final decision to update the cap methodology. Such consultation is essential to ensure that the level of the SMNCC meets Ofgem's own stated objectives and therefore that its analysis is 'sufficient for our purposes'. The importance of fair and open disclosure and consultation has been noted by the Administrative Court, in the context of the default tariff cap (**DTC**).[5] Given the Court's finding that Ofgem had acted unlawfully in not properly disclosing materials for consultees, it is imperative that Ofgem not repeat that failing in this case.

[2] Ofgem letter to Towerhouse LLP, 4 November 2019.
[3] Consultation document para 2.4.
[4] We explain why anonymised data is insufficient for suppliers to properly assess whether the data has been used correctly in paragraph 19 below.
[5] *British Gas Trading Limited v Gas and Electricity Markets Authority* [2019] EWHC 3048 (Admin).

c) Ofgem's proposal to treat the previous SMNCC allowance level as including 'advanced payments' for the future is unlawful and based on a fundamental mistake of fact. Furthermore, this approach breaches the legitimate expectations of suppliers, who were consistently urged by Ofgem to accelerate their rollout plans in a number of specific and targeted interventions at suppliers, in order for those rollout plans to be accepted. Suppliers relied on these interventions to inform their rollout plans. It is legally unsustainable for Ofgem to now recharacterize the position and demand that suppliers should have underspent in previous periods. Such an approach is irrational, in that it assumes that an efficient supplier would have put themselves in potential breach of their regulatory obligations (by not rolling out as quickly as reasonably possible). Finally, such an approach is inconsistent with public law considerations of consistency, predictability and regulatory certainty, and is inconsistent with Ofgem's statutory objectives.

4. Our conclusion is that there are significant legal deficiencies in the consultation process; the scope of information disclosed to consultees to date; and the substantive proposals put forward in the consultation document. As such, the current consultation does not comprise a proper and informed basis for a decision to change the cap methodology. Ofgem will need to (i) make proper inquiries and take proper steps to obtain the Undisclosed Data; (ii) allow consultees a full and proper opportunity to comment; and (iii) remove the elements of the proposed decision which relate to the clawback of 'advanced payments'. It appears to us inevitable that significant further analysis and consultation will be required before Ofgem will be in any position to make a legally defensible decision.

5. In closing, we note that Ofgem is proceeding in the shadow of likely imminent changes to the underlying Rollout Obligations. Any changes to the Rollout Obligations are likely to result in Ofgem's new methodology quickly becoming inconsistent with the TCA's statutory objectives and will need review. Applying the contingency allowance, and undertaking this review later, would allow Ofgem to coordinate changes to the smart allowance with the timing of any new Rollout Obligation taking effect. It would also allow Ofgem the opportunity to gather information, consult in a full and open manner, and revisit its proposals relating to clawback, so as to ensure that any subsequent proposals are robust, defensible and lawful.

## Reliance on suitability of the BEIS CBA

Ofgem does not have data to verify all of the assumptions behind the BEIS CBA

6. In the consultation document, Ofgem explains that it proposes to use the BEIS CBA as the '*starting point of our review of costs*'.[6] It justifies this approach on the basis that the BEIS CBA is '*a well-constructed and high quality analysis of the additional net costs and benefits of the rollout*'.[7]

7. However, Ofgem also acknowledges that this does not mean its estimates are suitable for Ofgem's purposes[8] and that it has had to critically review and make adjustments to the BEIS CBA. As such, Ofgem explains that it takes steps to adjust the BEIS CBA where necessary, such as identifying and excluding certain categories of cost and benefit, and modifying certain categories of cost and benefit. In many cases, having reviewed the data underlying *some* assumptions, Ofgem has, where appropriate, amended those assumptions. Ofgem states that the modifications '*do not mean that the assumptions in the new CBA are inappropriate for its purpose, which differs from the purpose of our review*'.[9]

8. In performing this critical review, it is of course essential that Ofgem has access to the underlying data and assumptions in the BEIS CBA – so it can properly determine which assumptions are appropriate and 'fit for purpose' and which are not. However, it now appears (from responses to questions we have asked Ofgem relating to the disclosure room) that Ofgem may *not* possess key information and data in respect of all assumptions. This data is essential for Ofgem to properly satisfy itself that the assumptions used in the BEIS CBA are fit for purpose in reviewing the SMNCC. This is despite the fact that:

    a) We wrote to Ofgem on 30 October 2019 to inquire why the information had not been disclosed to consultees, and what steps Ofgem had taken or was proposing to take to obtain the information;

    b) The information is highly relevant, indeed, essential, and

    c) in at least some cases, the assumptions appear on their face to warrant further investigation for their appropriateness and/or there are good reasons to consider that the assumptions for which Ofgem does not have underlying data may be inappropriate for Ofgem's purposes. For example, some assumptions appear to be based on data which is grossly out of date; some manual adjustments appear to be hard-coded into the model with no explanation about how BEIS has determined the extent of the adjustment; and some information appears to have been redacted /

[6] Consultation document, para 3.8.
[7] Consultation document, para 3.9.
[8] Consultation document, para 3.10.
[9] Consultation document, fn 19.

anonymised by BEIS before being given to Ofgem, for no discernible reason, making it impossible to review how the data of particular suppliers has been treated.

9. In responding to our request to provide the additional information, Ofgem implied that it did not have the relevant information and was instead drawing a broad conclusion about the quality of the model:

> *In general, we have therefore received assurance through the overall quality of BEIS's process, rather than by scrutinising each individual assumption … Our approach has therefore been to avoid the unnecessary and disproportionate step of duplicating the analysis and assurance already carried out by BEIS, whilst at the same time allowing us to refine our proposals where appropriate.*[10]

<u>It is inappropriate and unlawful for Ofgem to rely on assumptions that it has not verified</u>

10. Of course, it may in some circumstances be appropriate for a public authority to rely on an independent analysis as its starting point. However, the difficulty with Ofgem's position is as follows:

    a) Ofgem acknowledges that it is using the BEIS CBA for an entirely different purpose than the one for which it was intended and designed. The BEIS CBA was designed and undertaken for the purpose of informing a government impact assessment and shaping future government policy. It measures overall impacts on all relevant stakeholders of smart metering. Ofgem is using the BEIS CBA for the purpose of determining the net costs to suppliers of smart metering and therefore the specific allowance which suppliers require to fund the rollout. This is a much more specific purpose and one which has direct financial impacts on one relatively small group of stakeholders. It is also being prepared for the purpose of Ofgem making an administrative decision (i.e. to set the level of the tariff cap) rather than to inform general government policy. Regardless of whether the BEIS CBA is of appropriate quality for its intended, broader purpose, that does not mean it is appropriate for a more specific and targeted purpose. Specifically, the use of the BEIS CBA for Ofgem's purpose requires a much greater level of assurance that the quantification of supplier costs and benefits is accurate;

    b) Seemingly accepting this principle, Ofgem has accepted that this is not a situation where the BEIS CBA can be applied without modification. Having accepted that some assumptions require modification, Ofgem appears to be concluding that other assumptions require no modification, even though Ofgem appears not to have reviewed the underlying data that supports those assumptions and Centrica's response to this consultation highlights areas of concern. The decision by Ofgem about which assumptions require refinement and which do not is therefore selectively ill-informed;

[10] Ofgem letter to Towerhouse LLP, 4 November 2019, para 11.

c) the BEIS CBA itself has never been subject to consultation, nor have its inputs or assumptions been reviewed by industry. Furthermore, the National Audit Office heavily criticised the 2016 BEIS CBA, noting that the benefits of the programme were uncertain and that even in 2018 there was 'already some evidence that costs were underestimated'[11] and that certain assumptions about suppliers costs in the 2016 BEIS CBA could not be evidenced by BEIS.[12] Our understanding is that not all recommendations made by the NAO were adopted by BEIS when it prepared the updated BEIS CBA on which Ofgem now relies. This intensifies the need for Ofgem to properly satisfy itself that the assumptions are appropriate for its own purposes; and

d) It is unclear why Ofgem has failed to obtain from BEIS all the relevant information which it knows BEIS possesses. This is particularly alarming in circumstances where Ofgem recognises there is uncertainty about whether it should make an adjustment: in those cases it is especially inexplicable that Ofgem has apparently not sought additional information which would or could resolve that uncertainty.

11. Having failed to obtain the data from BEIS itself, we do not consider that Ofgem could have made an informed assessment about the BEIS CBA model's validity and suitability for the purposes of the SMNCC review. Ofgem has said that it '*would not uncritically assume that the new CBA will be appropriate*'[13] and yet for important parts of the BEIS CBA, this appears to be exactly what Ofgem has done.

12. Public authorities have a duty to properly inform themselves ahead of making a decision. This includes taking reasonable steps to obtain and acquaint themselves with all relevant information to make an informed decision.[14] In this case:

a) Ofgem has accepted that it is using the BEIS CBA for a different purpose than the one for which it was intended, and therefore it is required to assess whether adjustments are necessary.

b) It is clear that the information is relevant – indeed there are areas of Ofgem's assessment which it says are 'uncertain' and therefore to which more information could be pertinent.

c) It is clear that Ofgem could take simple steps to obtain the relevant information – namely, requesting it from BEIS.

d) Ofgem has provided no justification for failing to ask for it, other than its overall 'faith' in the quality of the BEIS CBA. Yet the quality of the BEIS CBA, as Ofgem acknowledges itself, does not imply all aspects of the BEIS CBA are suitable for the

[11] NAO, 'Rolling Out Smart Meters' (23 November 2018) p 9.
[12] NAO, 'Rolling Out Smart Meters' (23 November 2018) para 2.34.
[13] Consultation document, para 3.5.
[14] Thameside; R (Law Centres Network) v The Lord Chancellor [2018] EWHC 1588 (Admin).

SMNCC review without adjustment, especially where it is using the BEIS CBA for a purpose to which it was not designed or intended.

13. Ofgem has already been found, in the context of the DTC, to have unlawfully relied on untested and incorrect assumptions. The High Court recently found that, in assessing wholesale costs, Ofgem relied on '*an assumption about the 'typical' behaviour of a notional supplier that bears no resemblance to reality*.'[15] And as we note below, there are elements of the existing SMNCC which Ofgem has now realised were incorrectly determined. It is therefore surprising that Ofgem would not seek to ensure that all of the BEIS CBA assumptions are valid and representative for the purposes for which Ofgem now seeks to use the BEIS CBA, i.e. for the SMNCC model. Having failed to do so, we do not consider that Ofgem could have properly and lawfully determined that any generalisations and assumptions can be appropriate, or that the consequent analysis was '*sufficient for our purposes*'.[16]

Conclusion

14. Therefore, Ofgem does not currently appear to be in a position to diligently and lawfully conclude that the BEIS CBA inputs and assumptions are suitable, or that the consequent level of efficient costs it has assumed are appropriate and meet Ofgem's stated objectives. For any final decision to be lawful, Ofgem would need to verify the assumptions in the BEIS CBA and do so by ensuring that those assumptions reflect the real-life position of suppliers. It does not currently appear that Ofgem has the information and data to be able to reach such a decision in an informed and lawful manner.

## Failure to provide a fair consultation process

15. As a necessary consequence of Ofgem's failure to obtain and assess the information itself, it has also failed to disclose the information to consultees. This is despite Ofgem's acceptance that '*disclosure of the new SMNCC model is an important part of the consultation on our substantive proposals*'.[17]

16. Specifically, Ofgem has failed to provide consultees with of the relevant datasets and inputs to the BEIS CBA and Ofgem's SMNCC model; and in other cases the data is unnecessarily anonymised (collectively, we refer to this as the Undisclosed Data). This failure in the consultation process inhibits the ability of consultees to respond

[15] *British Gas Trading Limited v Gas and Electricity Markets Authority* [2019] EWHC 3048 (Admin) para 65.
[16] Consultation document, para 2.4.
[17] Ofgem, 'Reviewing the allowance of the smart metering rollout in the default tariff cap: Disclosure Arrangements', para 8.

meaningfully in turn depriving Ofgem of important inputs necessary to make a lawful decision.

Failure to allow fair consultation on datasets and inputs

17. The fact that information available to consultees is incomplete means that suppliers are unable to comment on key datasets which they are best placed to scrutinise and validate. This is especially concerning given that the Undisclosed Data has never been disclosed nor subjected to consultation, including when they were first used in the BEIS CBA. It is self-evident that suppliers will be better placed than Ofgem to verify and validate certain of the inputs and assumptions into the model.

18. In many cases, Ofgem has said that industry-wide figures are sufficient and that suppliers can '*compare [these] against their own experience*'.[18] However, Centrica and its advisers have asserted numerous times that this is not sufficient to enable consultees to respond intelligently.

19. In Centrica's letter to Ofgem of 14 September 2018 (para 14), and its earlier letter of 10 September 2018, Centrica responded that:

> *'it is not sufficient only to get suppliers to verify any data manipulation relating to its own data: it is critical that stakeholders are able to compare the basis on which different suppliers have provided the data, so as to ensure that it is consistent and that differences in supplier costs cannot, for example, be attributed to different assumptions or methodological approaches'.*

20. That response reflects, in our view, the correct legal position. Ofgem's approach does not, for example, allow suppliers any ability to understand how individual supplier data has been handled, manipulated or standardised to reach industry-wide figures. We do not consider that a consultation process which (without reasonable justification, none of which has been put forward) denied consultees or their advisers the ability to make intelligent responses on these matters could comply with public law principles.

21. The example of IT costs (where Ofgem now accepts errors were made) demonstrates precisely the dangers of refusing to open up Ofgem's full analysis to proper scrutiny. Ofgem's existing position is unacceptable and unsustainable and shows the very real harm caused to industry by inadequate consultation processes. It is imperative that Ofgem now open up the full relevant data set to proper scrutiny. The need for, and benefits of, proper industry scrutiny of Ofgem's thinking and the inputs into its decisions have now been clearly established.

[18] Ofgem letter to Towerhouse LLP, 4 November 2019, Annex A.

Full and fair consultation is essential to ensure the SMNCC is consistent with Ofgem's stated objectives

22. Whether or not stakeholders are able to verify whether the assumptions in the BEIS CBA and SMNCC model are realistic is of particular concern in this case, because it is directly relevant to Ofgem's assessment of how the SMNCC level achieves the statutory objectives of the TCA.

23. Ofgem states in the consultation document that, in protecting customers, it is desirable for the allowance to '*reflect, and not exceed, the efficient costs of rolling out smart meters*'.[19] Ofgem acknowledges that its view of efficient costs is not likely to match any particular supplier's level of costs. However, Ofgem states that '*we propose to use 'average' costs as an appropriate benchmark for the purpose of our review of efficient costs*'.[20] And Ofgem also makes clear that its view of efficient costs will lie somewhere between the lowest-efficient-cost and highest-efficient-cost supplier.[21]

24. However, it does not appear to be possible for Ofgem to verify (based on the information it has), and certainly not for suppliers to be able to verify based on the information provided to them and their advisers, that the assumptions in Ofgem's SMNCC model are representative of any 'real world' supplier, whether any supplier will be able to recover their costs of rollout, nor even whether the average supplier's costs are recoverable. In order to reach this assessment, Ofgem would need to be in a position to verify whether each assumption in the SMNCC model (including where they are directly taken from the BEIS CBA) is realistic and 'typical', and also whether the combination of assumptions collectively is itself realistic and 'typical' and can be properly said to reflect average costs. Consultees are, in particular, denied the opportunity to undertake this assessment where data has been unnecessarily anonymised. It is essential, therefore, that in determining the level of the SMNCC, Ofgem make appropriate enquiries about suppliers' actual positions, so that it can determine the implications of leaving the current funding proposals unchanged and compare these to its proposed new allowance, and therefore whether the SMNCC model is appropriate.

25. The need for Ofgem to undertake that enquiry is all the more critical against the backdrop of the TCA. This is not just a matter of complying with legal requirements for fair consultation, and therefore of ensuring the level of the cap meets Ofgem's own stated objectives, but fundamentally whether Ofgem can be satisfied that the SMNCC is set at a level consistent with the statutory objectives in the TCA. The smart rollout is relevant in an important respect beyond financeability. Namely, the cap must be set at a level that enables effective competition. It is well accepted by the CMA and by

[19] Consultation document, para 2.11.
[20] Consultation document, para 3.35. See also para 4.9.
[21] Consultation document, para 2.20.

Parliament that smart meter rollout is important to improving competition – and the TCA itself states that the progress of the smart meter rollout is an essential consideration when Ofgem is reviewing whether there are conditions for effective competition.[22] Furthermore, the cap is intended to be a temporary, safeguard cap. Any slowing of the smart meter rollout (which is envisaged to lead to a continuation of the cap), for example through insufficient funding, would therefore undermine a key objective of the Act.

26. Ofgem acknowledges the importance of supporting the smart meter rollout in the consultation document. It states that, in protecting customers, it is desirable that the allowance will not merely finance but also '*support suppliers to roll out smart meters*'.[23] Ofgem acknowledges, in this respect, that it has considered how its proposals affect the smart meter rollout in determining whether its proposals protect consumers.[24] We set out below (from paragraph 42) how the amount of the SMNCC allowance is highly relevant to the meaning of 'all reasonable steps'.

27. Ofgem is therefore wrong to say that it does '*not consider it appropriate for a supplier to present the SMNCC in the cap as an excuse to constrain its plans or ambitions relating to the smart meter rollout*',[25] except insofar as this can be understood to be a statement by Ofgem that it considers that smart meter rollout has been adequately funded for all suppliers to maintain their current plans. Ofgem has conceded itself that the level of the cap will affect the rollout of smart meters, and so any other reading of this statement is untenable.[26]

28. Accordingly, any failure by Ofgem to properly ensure that the level of the SMNCC suffices to cover suppliers' average costs – a finding which it is essential that suppliers are able to verify –, is not only a failure to meet the objectives Ofgem has set itself, but will result in Ofgem misdirecting itself in understanding whether the level of the cap meets the statutory objectives of the TCA.

Conclusion

29. Given Ofgem's public law duties and the statutory requirements for consultation in the Act, Ofgem must take all reasonable steps to allow consultees to properly scrutinise the data Ofgem is relying on. This is an essential part of ensuring that the level of the cap meets Ofgem's stated objectives, and the statutory objectives of the TCA. The recent

[22] TCA section 7(1).
[23] Consultation document, para 2.11.
[24] Consultation document, para 2.12.
[25] Consultation document, para 2.13.
[26] We further note that the Counsel Opinion of Michael Fordham QC, Josh Holmes QC, Philip Woolfe and Stefan Kuppen of 8 October 2018, submitted by Centrica in response to the statutory consultation on the initial DTC, agreed that a supplier would in principle be acting reasonably in point to the fact that its (efficient) expenditure matched a demonstrable allowance for smart meter rollout, within the allowable cap. We discuss this further below.

High Court decision on Ofgem's failure to consult fairly demonstrates the consequences of an approach which is inexplicably and unreasonably secretive. We do not see how any final decision to update the cap methodology could be lawfully made at this point without further candid disclosure of relevant information to consultees and without Ofgem being in a position to understand the actual impact of its proposal (compared to the counterfactual of continuing the existing allowance) on *real world suppliers*' rollout plans.

## Retrospective clawback of SMNCC allowance for past periods

30. Ofgem determines in the consultation document that the SMNCC allowance for the first three cap periods is higher than it ought to have been. Ofgem states that it intends to reduce future SMNCC allowances to account for this:

> '*The non-pass-through SMNCC in the first three cap periods provided sufficient money for suppliers installing smart meters to 12.5% of their default tariff customers every six months. Suppliers installed fewer meters resulting in a substantial advanced payment.*'[27]
>
> …
>
> *'We propose to adjust for advanced payments provided in the first three cap periods. This reduces future non-pass-through SMNCCs in proportion to the money customers have already paid. This ensures customers are not charged twice for costs already allowed for.*'[28]

31. Ofgem therefore proposes that it will clawback 100% of the 'advance' funding for smart in past periods, by allowing less in future, so that consumers do not 'pay twice'.

32. This treatment of past SMNCC allowances as 'advance payments' is, in our view, misconceived and would be unlawful.

33. Firstly, we note that suppliers have been (since before the introduction of the DTC) operating under a regulatory obligation that requires them to take 'all reasonable steps' to roll out smart meters (the **ARS Obligation**). It is self-evident that the steps which are 'reasonable' for a supplier to take will be determined, at least in part, by the extent to which the costs of those steps can be recovered from customers – that is, the scope of the smart meter allowance in the DTC for that period.

34. That means that the amount of the allowance in a given period (or the extent to which it differs from the 2017 baseline), and any statements made by Ofgem about its views of the appropriate use of such funds, would be a key consideration informing the steps that it is reasonable for the supplier to take in that period. Absent any other signals,

[27] Consultation document, p 5.
[28] Consultation document, p 7.

suppliers could only prudently have aimed to efficiently spend the amount they estimate the DTC provides for. They could not prudently have slowed their rollout deliberately in order to store up 'advance payments' for the future. By doing so, they may well have putting themselves at risk of breaching the ARS Obligation. Ofgem actively enforced the ARS Obligation (and similar obligations), bringing multiple enforcement proceedings against suppliers for not taking 'all reasonable steps'.[29]

35. Secondly, we note that the concept of an 'advanced payment' is not one that is found in any Ofgem documents prior to April 2019:

    a) ✂.

    b) The idea that parts of this allowance might be treated as 'advance' payments was first raised by Ofgem in April 2019. Ofgem's consultation document of that month proposed that '*any excess allowance could be viewed as paying suppliers in advance for installations that will occur later*'.[30]

    c) There was no indication at all within that paper of the potential *amount* of the 'advance payments'. Therefore, even if a supplier knew in principle that some amount might have been intended for a 'savings pot' for future periods, the potential amount was entirely unknown and Ofgem did not even attempt to provide a possible range.

    d) The first attempt to quantify the amount is in the current consultation document. However, even that amount is uncertain: both because it is only an Ofgem proposal (and Ofgem cannot have fettered its discretion as to changing the proposal), and because of the substantial errors in the underlying analysis identified in Centrica's submission. Therefore, it is unclear even now how a supplier is expected to change its rollout plans in response to the proposal.

36. Thirdly, we note that – contrary to issuing warnings that the amount incorporated in the DTC for smart meters rollout – Ofgem repeatedly insisted that suppliers must not slow down their rollout (including, after the DTC was announced, on account of the DTC). For example:

    a) At the time of setting the DTC, Ofgem's position was that *'We have set the SMNCC at a level that gives regards to the need for an efficient supplier to finance their rollout with no reduction in planned rollout pace'* (emphasis added).[31]

[29] See, for example, Ofgem Enforcement Decision Panel decision against npower (14 September 2018) (**Npower Enforcement Decision**). Enforcement proceedings were also brought against British Gas (published 27 January 2017) and E.ON (published 17 December 2015) in relation to advanced meters.

[31] DTC decision, appendix 7, para 3.177.

b) Suppliers were required to submit annual plans for smart meter rollout targets that Ofgem demanded to be 'ambitious' and 'stretching'. Not only did Ofgem provide no indication that funds should be held back, but it actively insisted that suppliers impose these stretching targets on themselves, at risk of having those annual plans rejected by Ofgem. These statements were made in respect of suppliers generally, but also made to Centrica specifically and in bilateral correspondence.[32]

c) As an example, Ofgem previously wrote to Centrica criticising it for failing to rollout smart meters as quickly as possible. Ofgem said that Centrica's '*approach to the foundation stage in particular showed a clear intent for your customers to enjoy the benefits of smart meters as early as possible. We recognised and welcomed this approach*.' In response to Centrica's plans to roll out more smart meters later in the rollout, Ofgem said that this was '*significant and concerning*'.[33]

37. Fourthly, we note that this change in approach produces unfair results for reasons set out in more detail in Centrica's submission and which do not appear to have any reasonable justification (indeed, which are unacknowledged by Ofgem).

a) Ofgem does not accept that a supplier may have higher than average efficient costs as a result of undertaking a rollout faster than average. However, Centrica has already shown Ofgem that such a supplier *would* have higher than average efficient costs, due to there being ongoing net costs to suppliers associated with operating a smart meter (instead of a traditional meter). Centrica's submission to the current consultation in fact goes further and demonstrates why Ofgem can no longer sensibly argue that there is no ongoing cost or that its model is neutral to how quickly suppliers rollout.

b) Ofgem's approach retrospectively assumes a slower profile than the profile it assumed previously (i.e. it now assumes that suppliers rolled out more slowly than the allowance provided to it assumed at the time). By slowing the rollout profile, given Ofgem's approach is not 'profile neutral', Ofgem penalises suppliers that were going faster than the profile Ofgem now assumes as there will be no long term 'net out' of the costs associated with going faster.

c) There is no rational or fair basis on which suppliers should now be penalised for rolling out smart meters sooner; on the contrary, given such an approach was

[32] E.g. Ofgem's public letter of 1 December 2017 stated that suppliers' annual rollout plans were required to be 'ambitious'; Ofgem's letter to British Gas dated 18 July 2016 noted concerns regarding British Gas's level of ambition; Ofgem's letter to British Gas dated 9 June 2016 referred to 'the need for suppliers to have stretching and challenging annual milestones to drive progress'. Numerous letters raised the prospect of enforcement action and none mentioned in any way that suppliers should or could 'underspend' to create a fund for future rollout.

[33] Ofgem letter to Centrica, 8 April 2016.

intended to support Government's and Ofgem's stated policy objectives, such an approach is plainly unfair.

38. The analysis set out in Centrica's submission validates what can sensibly be assumed even without detailed analysis:

    a) Some suppliers may have reasonably taken a different approach to suppliers that rolled out later. It is obvious that a supplier which spends its allowance earlier might achieve fewer results than a supplier which 'saves up' its allowance and spends its later. For example, the supplier who spends later can learn from the lessons of suppliers who spend earlier.[34] And suppliers that rolled out early may have agreed long-term contracts which reflected the best available terms at the time, even if more attractive commercial terms are now available on the market. The mere fact that lower cost options emerge later does not mean that decisions taken earlier are necessarily inefficient.

    b) Equally, it is perverse to treat the supplier who spends earlier as being inefficient. This would have incentivised all suppliers to spend slower (so as not to be 'first') and would have slowed down the rollout, contrary to Ofgem's stated concern that suppliers have not been rolling out smart meters quickly enough.

39. Viewing these four points together illustrates the serious legal flaws with Ofgem's proposed approach:

    a) First, it is a simple mistake of fact because the allowance at the time was not in fact an 'advance payment'. Indeed, in now purporting that there were such 'advance payments', Ofgem is failing to meet the legitimate expectations of suppliers, who were consistently and repeatedly directed by Ofgem to impose challenging targets on themselves. It was clear from these statements that Ofgem would not have approved a suggestion by suppliers to 'underspend' in order to roll out more smart meters in some unspecified later period (and indeed Ofgem could have decided to take enforcement action against such a supplier for failure to take 'all reasonable steps' in these circumstances). Accordingly, suppliers relied on Ofgem's interventions and incurred expenditure to their detriment – because (as explained elsewhere in Centrica's submission) those suppliers would have been better off if they had spent the funds later in the rollout.

       The principle of legitimate expectations upholds the proposition that '*where a public body states that it will do (or not do) something, a person who has reasonably*

[34] The concept of reasonableness takes into account that suppliers may adopt different rollout strategies and that taking 'all reasonable steps' does not necessarily mean taking identical steps – the steps that are reasonable must be understood in light of the supplier's (reasonable) decisions about its overall approach. This differs from Ofgem's approach to 'efficiency' which is determined on a 'one size fits all' basis.

*relied on the statement should, in the absence of good reasons, be entitled to rely on the statement and enforce it*'.[35] Ofgem's statements to suppliers generally and to Centrica in particular meet the threshold of being '*clear and unambiguous*' and without qualification,[36] insofar as they made it clear that it was unacceptable for suppliers to slow their rollout in order to 'save up' for future periods. Ofgem specifically stated that Centrica's attempt to do so was '*concerning*'. These were specific, targeted interventions by Ofgem, made to a small and defined class of people – namely, licensed suppliers. They were not expressed to be qualified in any relevant way. Furthermore, Ofgem knew that suppliers would have relied on Ofgem's representations – indeed, self-evidently, the very purpose of its statements to suppliers was to discourage them from slowing down their rollout plans. Following Ofgem's guidance would have been the only rational thing to do, given that Ofgem was entitled to bring enforcement action against suppliers – and, indeed, has already done so in relation to the ARS Obligation. These are therefore exactly the type of 'pressing' representation, with 'focussed' impacts, that are described in relevant case law.[37]

There is no proper justification put forward in the consultation document for departing from Ofgem's prior statements[38] (indeed, Ofgem neither acknowledges its past statements nor the unfairness that results from departing from them). In our view, given the nature of the exercise Ofgem is now undertaking and its stated objectives of supporting the smart meter rollout, there could be no such proper justification absent evidence that suppliers actually had treated earlier allowances as an 'advance payment'.

Accordingly, it is not sustainable now for Ofgem to now recharacterize the position and demand that suppliers should have done something differently. An approach which reduces future funding on the assumption that suppliers have not (or should not have) spent their past allowances, breaches the legitimate expectations engendered by Ofgem by its past statements.

b) Secondly, such an approach is irrational and disproportionate. Ofgem assumes that an efficient supplier would have put themselves in potential breach of their regulatory obligations (by not taking all reasonable steps to roll out). It is clear from Ofgem's correspondence and representations at the time that it would have considered any deliberate 'underspend' to have been inconsistent with suppliers' obligations. Even without specific representations by Ofgem, it would have been

[35] *United Policyholders Group v Attorney-General of Trinidad and Tobago* [2016] 1 WLR 3303, para 37.
[36] *R v Inland Revenue Comrs, Ex p MFK Underwriting Agents Ltd* [1990] 1 WLR 1545, 1569.
[37] See *R (Bhatt Murphy) v Independent Assessor* [2008] EWCA Civ 755.
[38] See *United Policyholders Group v Attorney-General of Trinidad and Tobago* [2016] 1 WLR 3303, para 121.

clear to any reasonable supplier that deliberately underspending would have put the supplier at significant risk of enforcement action (and, as noted above, Ofgem was actively enforcing meter rollout obligations). No reasonable supplier could have taken that approach.

c) Thirdly, such an approach is inconsistent with public law considerations of consistency, predictability and regulatory certainty, in a way which Centrica has demonstrated will cause significant, quantifiable harm to certain suppliers. Economic regulators across the UK have acknowledged the harm caused by retrospective adjustments of this type and the threat that retrospective clawback poses to business and investment certainty.[39]

d) Fourthly, ✂.

40. In summary, we do not consider that this proposal can be justifiable or proportionate and, indeed, we consider that it would be unlawful for Ofgem to proceed with this proposal.

## It is inappropriate for Ofgem to proceed with its proposals at this stage

41. For the above reasons, we consider that Ofgem is not currently in a position to lawfully reach a decision about the future SMNCC methodology. Significant further analysis and consultation is required before any such decision could be legally defensible.

42. However, we note in concluding that there is a further important reason why it would be inappropriate for Ofgem to proceed with its proposals at this point. As Ofgem is aware, BEIS has now proposed a fundamental change to the rollout of smart meters. The changes currently proposed would remove the obligation to take 'all reasonable steps' to install smart meters, and replace the obligation with a strict obligation to reach a 100% rollout target (with a 15% tolerance).

43. This would represent a profound change in the relationship between the rollout obligations and the corresponding allowance under the DTC. In assessing which steps are 'reasonable', the ability to fund those steps is clearly relevant – for example, a step which financially imperils a supplier's competitive position in the market cannot be

[39] For example, Ofcom has previously stated that it will 'seek to avoid choices that would be similar to applying a rate of return regulation' and therefore 'does not seek to align charges with costs at all points in time'. Ofcom noted that this approach is likely to produce significant dynamic and productive efficiency benefits. It is noteworthy that these comments were made in the context of immediate forward-looking adjustments (i.e. rather than applying a glide path) and this caution would be warranted to an even greater extent where changes are retrospective. See Ofcom, BCMR (2016) vol 2, para 7.52.

reasonable. The scope of the obligation is therefore informed by the corresponding allowance set by Ofgem.

44. In assessing which steps are 'reasonable', the ability to fund those steps is clearly relevant – for example, a step which financially imperils a supplier's competitive position in the market cannot be reasonable. Indeed, Centrica has previously provided Ofgem with a joint counsel opinion of Michael Fordham QC, Josh Holmes QC, Philip Woolfe and Stefan Kuppen which makes this point.[40] The counsel advice notes at paragraphs 5-6:

> *Centrica has asked us: 'In applying the licence obligation upon suppliers to take 'all reasonable steps' to ensure that smart meters are installed in its domestic customers' premises … would a supplier be acting reasonably if it pointed to the fact that its expenditure matches the element for this activity which Ofgem demonstrably allowed it when setting the cap?*
>
> *…*
>
> *Our answer to the question is 'yes'.*

45. Counsel go on to note at paragraph 6.1 that '*The amount that Ofgem has demonstrably modelled on an informed basis for the roll out of smart meters would be highly relevant when considering what steps it would be reasonable for a supplier to take under the 'all reasonable steps' licence obligation. Reasonableness cannot be assessed in a vacuum*.'

46. The scope of the obligation is therefore informed by the corresponding allowance set by Ofgem. As we note above, ✂

47. The fact that under the current ARS framework, the smart meter allowance informs the rollout obligation (rather than merely reflecting that obligation) is important and highly relevant to how Ofgem discharges its statutory duties in setting the cap. Under the existing ARS framework, the amount of the allowance under the cap is less likely to create a risk that suppliers becoming financially or competitively imperilled in order to comply with their regulatory obligations. This is because, under an ARS framework, if a supplier would be imperilled if it took a particular step, that step would no longer be reasonable for that supplier to take. Ofgem's own enforcement panel's findings support the view that 'reasonableness' is flexible enough to reflect such circumstances – it found that:

[40] Entitled 'Joint opinion on some core substantive law matters'. This accompanied both our response to Ofgem's statutory consultation on the default tariff cap on 8 October 2018.

a) 'There [is] no fixed measuring stick by which the reasonableness of any particular measure at any particular time could be assessed. It would depend upon all the circumstances';[41] and

b) 'Whether a particular step would be proportionate [including having regard to its cost] might be relevant to whether it was reasonable to take it at that time'.[42]

48. Under the absolute obligation now proposed by BEIS, there would no longer be any such flexibility. Suppliers would be required – no matter what their current position, cost base, rollout strategy, the amount of the Ofgem allowance, or the impact of achieving rollout on their competitive or financial position – to meet the rollout targets, in line with the rollout profile assumed in the new licence conditions. If this proposal proceeds, the role of the SMNCC will fundamentally change – as will the effect of the statutory considerations. For example, there would be significantly greater risks of the cap failing to ensure financeability; and Ofgem would need to consider whether the need to create incentives for efficiency still justifies 'locking in' losses for suppliers, even where (given their current position) there is no realistic forward-looking possibility of them achieving the efficiencies implied by the cap. It would become inevitable that Ofgem would need to undertake another review of the SMNCC. Indeed, the same would be true of any change to the current Rollout Obligations which required a different average rollout profile to the one assumed by Ofgem.

49. Furthermore, there are even more basic inconsistencies between the SMNCC model and BEIS's current proposals. For example, BEIS proposes to require suppliers to reach a 100% penetration by 2024, while allowing a 15% 'tolerance'. However, Ofgem is allowing an 86-87% target. On this basis, the SMNCC proposals are plainly not in line with BEIS's proposed policy and would need adjustment if the BEIS proposals proceed.

50. Our view that Ofgem would necessarily need to review the SMNCC again, upon any such substantial change to the Rollout Obligations, is true regardless of Ofgem's statements that it would place a 'high bar' on reopening the SMNCC in future.[43] Specifically, Ofgem states that:

> *We have proposed allowances for the remainder of the potential life of the Cap (up to the end of 2023). We recognise that future pace and costs of the rollout are uncertain, so we cannot rule out another review. However, we would place a very high bar on reviewing the allowances proposed in this consultation, as further reviews may undermine incentives for suppliers to improve their efficiency.*[44]

[41] Npower Enforcement Decision, para 43(b).
[42] Npower Enforcement Decision, para 43(d).
[43] Consultation document, para 2.28.
[44] Consultation document para 2.5.

51. Ofgem has not explained what the basis of any review would be, nor why a 'high bar' is the appropriate threshold. Such a statement does not comprise a lawful excuse for Ofgem failing to reopen the SMNCC, if it is no longer aligned with the Rollout Obligations. If that occurred, and it became clear that an alternative SMNCC allowance would better deliver the objectives of the TCA, in our view, Ofgem could not lawfully refuse to review the SMNCC. We note that, in the context of interpreting the meaning of the ARS Obligation, Ofgem's enforcement panel rejected Ofgem's attempts to characterise the obligation as a '*high threshold*', finding that it was not helpful and an unwarranted gloss.[45] The same is true, in our view, of Ofgem's attempts to pre-empt whether it would undertake a further review of the SMNCC. Such a gloss does not change Ofgem's duty to reopen the SMNCC if it no longer reflects the Rollout Obligations.

52. To be clear, we have profound concerns about the legality of the changes currently being proposed by BEIS. However, regardless of whether they proceed (and regardless of the particular form in which they ultimately proceed) it is surprising that Ofgem has decided to continue with its review of the SMNCC in light of the uncertainty about whether the outcome of its review will remain 'fit for purpose' even in the short term.

53. In our view, the obviously appropriate course is for Ofgem to apply the contingency allowance, rather than proceed in the shadow of imminent likely changes to the Rollout Obligations which are not yet certain and which Ofgem is unable to lawfully pre-empt. Waiting until these changes are clear would have the benefit of allowing Ofgem to coordinate changes to the smart allowance with the timing of any new Rollout Obligation taking effect. Furthermore, and most importantly, it would provide Ofgem with additional time in order to correct the deficiencies identified in this legal annex, given that questions around smart meter rollout funding will remain an important matter going forward, by:

    a) gathering all relevant information from BEIS and suppliers so that it can properly assess the appropriateness of its approach;

    b) disclose all relevant models and data in full to stakeholders without unreasonable restrictions, so that Ofgem can meet its legal obligations to consult in a full and open manner; and

    c) revisit and reassess its proposals relating to clawback, so as to ensure that any subsequent proposals are robust, defensible and lawful.

54. Finally, we note that Centrica's submission identifies a significant number of errors in Ofgem's model, including from basic quality assurance checks and specific line items which do not appear realistic. A failure to address these concerns, with a sufficient degree of detail and explanation commensurate with their significance to the overall

[45] Npower Enforcement Decision para 43(f).

SMNCC, would involve a failure to engage with and take account of compelling evidence and to provide proper reasons for Ofgem's decision. In light of the concerns raised in the Centrica's submission, it would appear most appropriate for Ofgem to conduct a rigorous quality assurance process and ensure its final decision is well-justified rather than to push ahead with the use of a model which is demonstrably flawed in numerous respects.

Towerhouse LLP
19 November 2019