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By email to: Retailpriceregulation@ofgem.gov.uk

Dear Anna

Reviewing smart metering costs in the default tariff cap

Centrica welcomes the opportunity to respond to Ofgem's consultation on this critically important subject.[1] Centrica remains an advocate for the smart programme, which enables many benefits for our customers, as well as being a critical part of Government's net zero carbon strategy. We adopted the technology early and have been providing our customers with smart meters since 2010 and rolling out in earnest since 2012.

Our ability to continue to deliver on the programme's ambitions depends critically on provision of sufficient, reliable and sustainable funding. In this respect, we have very substantial concerns about Ofgem's present proposals, the analysis behind them and consultation process Ofgem has followed to date. Given the inevitable adverse impact on rollout if allowances are set too low, we have real concerns that it is consumers who will ultimately lose out from a failure to set the SMNCC cost allowance at a level necessary for an average efficient supplier.

In summary:

- We have identified **numerous and significant errors** in the consultation that fundamentally undermine the proposals. These include:
    - errors and omissions across the majority of costs and benefits set out in the consultation. Analysis setting these out in full can be found in the Appendix to this response.
    - these issues are particularly apparent with regards to the benefits described in the consultation. Ofgem has failed to seek evidence about actual benefit realisation and is instead relying on unevidenced assumptions made by BEIS as part of its cost benefit analysis (CBA). Although it may be appropriate for a CBA that is designed to

[1] https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-october-consultation

inform policy development to be set on the basis of hypothecated benefits, it is not appropriate for a price cap to be determined in this way. Indeed, the use of the inputs and assumptions underlying the BEIS CBA for Ofgem's purpose requires a much greater level of assurance that the quantification of supplier costs and benefits is accurate, and Ofgem places an unlawful reliance on them (these concerns are set out more fully in a Legal Annex to this document). These assumptions are a major source of error and are an important reason why we believe the level of SMNCC will not cover the costs of an average efficient supplier.

  - the cost allowances also have significant errors. There are cost categories for which allowances should be made that are simply omitted and errors in the way a number of the costs have been calculated. Ofgem's thinking is also based on an incorrect assertion that there is no additional cost associated with undertaking a rollout faster than average.
  - together, these errors add up and result in a very material reduction in SMNCC. We have estimated the impact of a subset of these errors and present the results in Table 3 of the Appendix. This shows that the quantum of the overall reduction in allowance due to overstated benefits and understated costs is significant, with SMNCC increasing almost three-fold if these errors are corrected. This means that Ofgem cannot simply dismiss these errors on the basis that other assumptions it has made are 'conservative'.

- Ofgem's "**clawback**" proposal to treat previous SMNCC allowance levels as including 'advanced payments' for the future is unlawful and based on a fundamental error of fact. As set out more fully in the Legal Annex (paragraphs 30-40), this approach (among other errors) is based on a fundamental mistake of fact, breaches the legitimate expectations of suppliers and is irrational. Such an approach is also inconsistent with public law considerations of consistency, predictability and regulatory certainty and with both Ofgem's stated objectives and the relevant statutory objectives.
- These errors are compounded by a number of **process concerns**, including:
  - no evidence Ofgem has checked that the SMNCC cost allowance resulting from its modelling meets the cost of any supplier in practice;
  - a continuing lack of transparency regarding Ofgem's underlying assumptions, including data missing from the disclosure process and data being unnecessarily anonymised, hampering validation analysis; and
  - a lack of independent validation of assumptions in the BEIS CBA.
- These process concerns are so severe that the consultation as a whole fails to meet the basic legal requirements in relation to Ofgem's duty to properly inform itself (as set out in paragraphs 6-14 of the Legal Annex) and in relation to consultation (as set out more fully in paragraphs 15-29 of the Legal Annex). The seriousness of such process concerns is illustrated starkly by Ofgem's admission that the choice of "lower quartile" efficient opex benchmark in the original price cap was incorrect due to errors identified in treatment of IT costs. Had Ofgem been transparent about how the opex benchmark had been set at the time, this material error could have been avoided.
- If these errors are not addressed and Ofgem proceeds as proposed ✂
- With SMETS2 fully rolled out and enrolment underway, momentum should be building towards the rollout. ✂
- Finally, we have major **policy concerns** regarding this consultation. In particular, it is unclear why Ofgem is insisting on proceeding now, even though fundamental changes are being considered to the underlying rollout obligations, which will inevitably require Ofgem to rethink the SMNCC. As you will see from the submission we recently made to BEIS (shared alongside this response), our primary concern focuses on the proposed movement away from the All Reasonable Steps (ARS) framework.
- Ofgem's current proposals are not compatible with BEIS's current proposals, which assume that suppliers will reach a rollout of 100% by 2024, while allowing a 15% "tolerance". What Ofgem is allowing is an 86% target for gas and an 87% target for electricity. On this basis,

the "tolerance" Ofgem is setting is *de minimis* and contrary to BEIS's stated policy. This illustrates why, if Ofgem and BEIS both maintained their respective proposals, Ofgem would very shortly be required to fundamentally review the SMNCC: see paragraph 51 of the Legal Annex.

- As long as there is an ARS framework, the implication would be that the rollout achieved by suppliers with higher than average efficient costs will be lower than for the suppliers with average or lower efficient costs. It is this flexibility that allows the two regimes to co-exist. The legal opinion appended to our BEIS response concludes that moving away from an ARS framework as proposed suffers from significant public law flaws and would, if adopted, be susceptible to successful legal challenge.
- In conclusion, Ofgem cannot prudently proceed with its primary proposals at the present time. Instead, for the reasons set out in paragraphs 41-54 of the Legal Annex, Ofgem would be required to reconsult fully once BEIS' post-2020 policy is confirmed, ensuring that the funding envelope allowed is consistent with the wider policy framework, enabling targets to be met. Equally, it cannot allow a hiatus in SMNCC allowances to arise in the short term.
- Ofgem must, therefore, invoke the contingency option of rolling over current allowances for a further period.

Our more detailed views on the consultation are set out below.

Ofgem's analysis is simply not reliable as it stands

It is evident that there are significant areas where Ofgem's assessment of net cost is implausible, at variance with Centrica's experience and/or not underpinned by reliable evidence. These shortcomings are discussed in detail in the attached appendix.

It is inappropriate for Ofgem to resist detailed criticism by presenting its analysis as 'conservative' and to be considered 'in the round'. Even accepting some need for approximation and simplification, without quantification there is no basis for assuming that errors and approximations in opposite directions net out. We illustrate this in our appendix where we show that the scale of the errors that Ofgem has made will have a material impact on the value of non-pass-through SMNCC. On this basis they cannot be dismissed on the basis of an 'in the round' consideration.

Ofgem continues to imply that timing variations from the rollout profile it has adopted are neutral and can be disregarded on that basis. But such profile neutrality is not borne out; there remains a net cost penalty to front loading. However, it would be wrong to characterise front loading as inefficient in the light of the policy framework and expectations at the time.

We welcome Ofgem's recognition that it is possible to have higher than average efficient costs. But Ofgem's casual rejection of funding anything above its modelled average efficient cost on grounds that this would 'not protect customers' is plainly insufficient. The requirement for a single 'one-size-fits-all' allowance does not axiomatically constrain Ofgem to an average cost benchmark. Ofgem needs to consider the extent of divergence in efficient costs, the reasons behind such divergences and consequent impact on suppliers and customers of failing to provide adequate funding. It is not enough for Ofgem to say – as it does repeatedly – that it is up to suppliers to manage divergences with the assumed linear profile it has modelled.

For example, we remain concerned at the highly material divergence between Ofgem's proposed estimates for PRCs and the actual charges reported by suppliers. In particular, Ofgem's stated reasons for preferring its modelled estimates over weighted average actual costs only explain why actual costs may be too low (for electricity). Ofgem provides no explanation for preferring modelled costs over actual in the case of gas, where actual costs are materially higher. Without compelling reasons to prefer modelled costs to actual costs in the

case of gas, Ofgem risks materially understating the true extent of gas PRCs, discriminating against suppliers ✂ with a disproportionately high share of gas PRCs. ✂

Ofgem's characterisation of 'advance' payments and proposed recovery mechanism remains misconceived

We do not accept Ofgem's characterisation of previous allowances as – with the benefit of hindsight – incorporating an 'advance' that is available for future investment. This approach was never communicated to stakeholders in November 2018. It was roundly rejected by stakeholders responding to Ofgem's subsequent preliminary thoughts on the SMNCC review, and Ofgem confirmed when rolling over allowances for the third cap period that it had taken no decision regarding future 'recovery' of any such putative advance. Since Ofgem cannot lawfully fetter its discretion prior to making a final decision, that must still be the case now.

In any event, signals from Ofgem that it 'might' conclude there had been advance payments to be recovered through lower forward allowances are of little practical help for business planning. Suppliers had to submit forecasts to Ofgem in January 2019 pursuant to 'all reasonable steps' licence obligations based on some assumption – albeit 'best guess' – regarding future funding. In Centrica's case, it was explicit on the face of our ARS submission that – in the absence of any other viable planning assumption – we assumed a continuation of SMNCC allowances at their initial level.

Had we known in January the extent of the 'advance' allowance Ofgem now perceives, and proposes to recover, we could potentially have submitted less ambitious short-term forecasts consistent with ARS reflecting the fact that part of the initial allowance was intended as an advance for future periods. But we couldn't possibly have known any of that at the time, so we responded to Ofgem's clear urging to maintain momentum and Ofgem accepted those forecasts. We agree with Ofgem that SMNCC allowances should be dedicated to the smart programme, and in Centrica's case they clearly have been. But having committed to invest the available allowance – however calculated – efficiently, we repeat that <u>there is no surplus or 'advance' funding available for future use.</u>

Against this background, we consider clawback for past cap periods to be wholly inappropriate and manifestly unfair. ✂ Furthermore, the Legal Annex sets out that Ofgem's proposal has serious legal flaws, given there simply was no 'advance payment' (and it is a mistake of fact to assume there was) and in light of Ofgem's contrary representations to stakeholders during earlier cap periods; the irrational assumption that suppliers would have risked enforcement action by Ofgem in earlier cap periods; the failure to act with consistency; and the fact that the outcomes of this approach are difficult to reconcile with Ofgem's own stated objectives and the statutory objectives. It is also grossly at odds with accepted standards for economic regulation in the UK. These points are set out in more detail in paragraphs 30-40 of the Legal Annex.

More generally, suppliers cannot sustainably spend more than the cap allows, even if the match between allowance and investment in any single period is not exact. We are particularly concerned about the proposed immediate sharp downward reduction, exacerbated by clawback. It should be recalled that this is the first time stakeholders have seen any quantification of the putative 'advance' Ofgem now proposes to recover.[2] However, the true extent of any putative 'advance' currently remains a matter of conjecture given concerns over reliability of model and supporting data.

[2] Absurdly, we remain prohibited by Ofgem's compulsory disclosure room undertakings from making use of Ofgem's SMNCC model for business planning (or any other 'non-permitted' purpose, including policy representations to BEIS). This remains wholly unjustified, and we call on Ofgem to think again and relax these restrictions.

We do not accept Ofgem's assertion that it should now adjust future allowances to below the level of average efficient cost on the grounds that to do otherwise 'would not protect consumers' who will have 'paid twice'. Protection of consumers under the cap necessarily involves balancing their short term and longer-term interests. To the extent allowances have been invested in programme, they have accelerated realisation of consumer benefits and may also hasten the point at which conditions for effective competition are met. As noted in the legal annex, Ofgem is required to have regard to the rollout of smart meters when considering conditions that allow the cap to be lifted. If Ofgem fails to provide sufficient allowance for smart costs while the cap remains in place, it risks stifling continued roll-out – at odds with BEIS' policy intentions – and prolonging price regulation unnecessarily, which will not serve consumers' long-term interests.

Ofgem's process is not fit for purpose – requiring further consultation to remedy deficiencies

Centrica has consistently pressed for Ofgem to commence its substantive review of smart allowances promptly, emphasising the need not only to collect the necessary data to inform review but also the need to expose both data and modelling to proper scrutiny – in good time, and while proposals are at a formative stage.

It is therefore extremely concerning that Ofgem has ignored its own guidelines and elected to allow the bare minimum of 28 days required by statute for stakeholders to engage with a highly complex subject matter. Ofgem cannot plausibly claim that the highly unusual and unsatisfactory process it adopted prior to its Decision in November 2018 established an acceptable precedent. On the contrary, it was Ofgem's recognition that analysis of appropriate smart allowances under the default tariff cap is particularly challenging and could not be dealt with satisfactorily within Ofgem's self-imposed timetable for cap introduction that resulted in Ofgem committing to carry out the present review in time for cap period three (an undertaking that has not, in the event, been met).

The highly compressed timetable Ofgem has imposed on stakeholders is exacerbated by two significant process failings.

First, we understand that Ofgem does not in fact have the full data set which informed the BEIS CBA and its assumptions[3]. Ofgem cannot simply take refuge in claimed 'quality assurance' of BEIS' CBA model as the best evidence available, especially in circumstances where it is now being deployed by Ofgem for a different purpose than the one for which it was designed and where BEIS' analysis has not been consulted on, remains obscure to external stakeholders, and has previously been criticised by the National Audit Office (see paragraph 10 of the Legal Annex). This approach is particularly inappropriate where Ofgem has selectively scrutinised and modified certain inputs and assumptions in the model, while apparently not possessing the data underlying other inputs and assumptions. Our legal advisers conclude that, in these circumstances, Ofgem does not appear to be in a position to reach a decision in an informed and lawful manner (see paragraph 14 of the Legal Annex).

Secondly, Ofgem has failed to provide full data to stakeholders' advisers to scrutinise – the data is incomplete and, in some cases, anonymised without justification. This failure in the consultation process inhibits the ability of consultees to respond meaningfully in turn depriving Ofgem of important inputs necessary to make a lawful decision (see paragraphs 15-29 of the Legal Annex).

[3] This understanding is based on Ofgem's letter of 4 November to Towerhouse LLP, paragraph 11 – see further discussion at paragraphs 6 to 9 of the Legal Annex to this response.

The Legal Annex sets out our legal advisers' view that, in these circumstances, Ofgem cannot have diligently and lawfully reached any conclusion that the BEIS CBA inputs and assumptions are suitable.

The High Court has already found that aspects of the way Ofgem set the default tariff cap initially were unfair and left suppliers 'in the dark', and resulted in assumptions that bore no resemblance to reality.[4] And Ofgem has now identified that its own assessment of the SMNCC was previously subject to errors – which could have been corrected if the relevant data was provided to consultees or their advisers. It is therefore particularly surprising that, in this case, Ofgem would *again* fail to allow consultees to verify that the assumptions it relies on are appropriate and realistic.

This and other process concerns are elaborated more fully in the Legal Annex.

Conclusion and next steps

Given our numerous and serious concerns with Ofgem's approach, and the impending changes to the underlying regulatory obligations, it is difficult to see how Ofgem can proceed with a change to the SMNCC methodology at this stage. We consider that applying the contingency allowance is the only appropriate course of action. It would enable Ofgem to coordinate its changes to reflect the underlying regulatory obligations and allow Ofgem the time to adopt a more rigorous approach. We would suggest such an approach would necessarily involve:

- gathering information from BEIS and suppliers in order to properly assess the appropriateness of the assumptions in the SMNCC model and ensure those assumptions correlate with real-world suppliers;
- disclosing 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
- revisiting and reassessing its proposals to ensure that they are robust, defensible and properly reasoned, taking into account all the evidence and concerns of consultees.

We look forward to engaging further with Ofgem in the context of this consultation and further consultations to come. If you have any immediate questions on our present response, please contact me or don.wilson@centrica.com in the first instance.

Yours sincerely

Tim Dewhurst
Regulatory Affairs Director

[4] *British Gas Trading Limited v Gas and Electricity Markets Authority* [2019] EWHC 3048 (Admin).