IN THE MATTER OF THE DOMESTIC GAS AND ELECTRICITY (TARIFF CAP) ACT 2018

AND IN THE MATTER OF THE SMART METER NET COST CHANGE ALLOWANCE

JOINT OPINION

A. INTRODUCTION AND SUMMARY

1. We are asked to advise British Gas Trading Limited (which we refer to as 'British Gas') on the lawfulness of certain proposals by Ofgem for setting an allowance in the default tariff cap applicable to energy suppliers. Specifically, this concerns the level of the allowance in the default tariff cap for changes in the efficient net costs to energy suppliers of the smart meter rollout, as set out in Ofgem's consultation published on 18 May 2020 ("**the SMNCC Consultation**").

2. We have been asked to opine on the following questions:

   2.1. To what extent is the allowance in the default tariff cap for rolling out smart meters relevant in construing suppliers' obligations to take all reasonable steps to roll out smart meters?

   2.2. Is the rollout profile that Ofgem proposes to adopt lawful, having regard to:

      2.2.1. the decision of the Department of Business, Energy and Industrial Strategy ("**BEIS**") that suppliers will be subject to specific rollout targets (with individual profiles) from 30 June 2021; and

      2.2.2. the impacts of Ofgem's proposals in the consultation on the overall future development of the smart meter rollout in the UK, and their compatibility with the rollout targets set by BEIS, and under EU law?

   2.3. Is the lawfulness of Ofgem's proposals impacted by the fact that suppliers cannot ascertain what they need to do in order to comply with the "ARS obligation" (see paragraph 4 below), at the time they are required to comply with that obligation?

   2.4. Even assuming the lawfulness of Ofgem's "clawback" proposal in principle, can Ofgem lawfully apply the clawback proposal with effect from 1 October 2019?

3. In summary, our views on these questions are as follows:

3.1. First, the obligation to take all reasonable steps to roll out smart meters to all premises must be applied taking account of the level of funding provided by Ofgem under the default tariff cap. In the context of enforcement proceedings, to the extent that a supplier's efficient expenditure on smart meter rollout to relevant premises matched the amount allowed under the default tariff cap, Ofgem could not lawfully object that the supplier ought to have spent more.

3.2. Secondly, Ofgem cannot lawfully adopt its proposed rollout profile:

3.2.1. Now that BEIS has published its decision indicating that suppliers will be subject to specific rollout targets from 30 June 2021, Ofgem cannot lawfully set the Smart Meter Net Cost Change ("**SMNCC**") without regard to the BEIS targets. Nor can Ofgem rationally or proportionately set an allowance by reference to a rollout profile which would not be sufficient to fund efficient suppliers to meet the rollout targets applicable under their licence conditions. As far as we understand it, Ofgem has presented no justification at this juncture as to why this outcome is proportionate.

3.2.2. Ofgem's consultation document contains no consideration of the impact that its methodology for setting the rollout profile may have on the overall rollout of smart meters in the UK. If Ofgem proceeds as currently proposed, it would, in our view, be acting unlawfully in failing to have regard to the effect of its SMNCC proposals on the overall future smart meter rollout; and in failing to set the SMNCC by reference to the levels of rollout required to meet the targets set by BEIS, and under EU law.

3.3. Thirdly, Ofgem's current proposal is unlawful by virtue of being unreasonable in the public law sense and contrary to the EU law principle of legal certainty, in that the proposal renders it impossible for suppliers to ascertain what it is that they need to do in order to comply with the "ARS obligation".

3.4. Fourthly, Ofgem's proposal to apply clawback with effect from 1 October 2019, if adopted, would be in breach of suppliers' legitimate expectations, and would

unlawfully fail to take account of an important relevant consideration, namely the period of time required by suppliers in order to adjust to Ofgem's change of approach.

B. FACTUAL AND LEGAL CONTEXT

B(1) Smart Meter Rollout Obligations

4. Currently, energy suppliers are subject to licence conditions imposing an obligation to take all reasonable steps to install smart meters at each domestic premises or designated premises in respect of which it is the supplier by 31 December 2020 ("**the ARS Obligation**"): see Electricity Standard Licence Condition 39; Gas Standard Licence Condition 33.1.

5. On 18 June 2020, BEIS announced its decision as to the regulatory obligations which will apply from 1 January 2021, when the ARS Obligation is due to expire ("**the BEIS Decision**"):

   5.1. Given delays to installation and uncertainty caused by the COVID-19 pandemic, BEIS has decided to extend the ARS Obligation for a further six months to 30 June 2021.

   5.2. Thereafter, from 1 July 2021 to the end of the rollout programme on 30 June 2025, suppliers will be subject to percentage rollout targets which must be met, subject to a specific tolerance level, towards a final target of 100% rollout.

   5.3. BEIS has indicated that the targets for each year prior to the end of the programme will be determined individually for each supplier based on the number of premises in which a smart metering system or advanced meter that are yet to be installed: see BEIS Decision paragraphs 134-136.

   5.4. BEIS will carry out a further consultation on tolerance levels; however, it is clear that BEIS's target is for a 100% rollout by the end of that period.

B(2) Default Tariff Cap

6. Ofgem is required to set and revise the level of the default tariff cap under the Domestic Gas and Electricity (Tariff Cap) Act 2018 ("**Tariff Cap Act**").

7. In setting the cap, Ofgem is obliged to have regard to four "needs" specified at s.1(6) of the Tariff Cap Act, which provides:

> *(6) The Authority must exercise its functions under this section with a view to protecting existing and future domestic customers who pay standard variable and default rates, and in so doing it must have regard to the following matters—*
> *(a) the need to create incentives for holders of supply licences to improve their efficiency;*
> *(b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;*
> *(c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts;*
> *(d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.*

8. In conventional public law terms, the objective of protecting existing and future domestic customers, and the four identified "needs" in (a)-(d) above, are mandatory considerations, i.e. considerations to which Ofgem must have regard. Ofgem may exercise judgement as to the weight to be given to each of those considerations in a particular context, but may not disregard them: see *R (Hurst) v London Northern District Coroner* [2007] UKHL 13 per Lord Brown at [57].

9. In view of s.1(6)(d), which we refer to as the "**financeability consideration**", Ofgem has acknowledged the need to set the default cap, and specifically the allowance in respect of smart meters, at a level which allows suppliers to recover the costs of complying with the ARS Obligation and to support the rollout to completion: see SMNCC Consultation at paragraphs 2.6, 2.8 and 2.12.

10. Importantly, the Tariff Cap Act precludes Ofgem from imposing default tariff cap provisions that '*make different provision for different holders of supply licences*': see s.2(2)(b). It is not possible for Ofgem to set different caps for different suppliers (to take account of their differing costs bases or for any other reason). Ofgem is required to set a single cap for all suppliers.

11. In practice, Ofgem revises the level of the cap at six-monthly intervals (summer and winter periods). The default tariff cap will last until at least 31 December 2020, and may be extended in annual increments, to no later than 31 December 2023: see s.8(3) Tariff Cap Act.

12. The trigger for these annual extensions is that, in each year from 2020 to 2022, Ofgem must review, and the Secretary of State must decide, whether conditions for effective competition are in place in the market, and unless the decision is to the effect that conditions for effective competition are in place the default tariff cap must be extended for the following year: see ss.7 and 8 Tariff Cap Act.

13. In conducting its review as to whether conditions for effective competition are in place, Ofgem is specifically required to "*consider the extent to which progress has been made in installing smart meters for use by domestic customers*": see s.7(2) Tariff Cap Act.

B(3) The SMNCC and Ofgem's proposals

14. Under the default tariff cap, the allowance for the net costs or benefits[1] of smart meters consists of (i) the overall operating costs allowance benchmarked in 2017, which included an estimate of the efficient net costs of smart metering in 2017;[2] and (ii) an allowance for how net costs of smart metering have changed since 2017, in view of installations. The second element is the SMNCC allowance, on which Ofgem is consulting.

15. We understand that the precise model for determining the SMNCC allowance is complex. However, in broad terms, in setting that allowance Ofgem must consider the following two factors:

    15.1. First, the efficient net costs to suppliers of installing and operating smart meters. In the light of its obligation to set a single cap for all suppliers, Ofgem proposes "*to benchmark 'efficient' cost and benefit categories to suppliers' average experience*", using an adjusted version of a cost benefit analysis produced in 2019 by BEIS. Ofgem acknowledges that each supplier's efficient costs and benefits may differ from the average.

---

1 The rollout of smart meters is considered to have both costs to suppliers (e.g. the costs of purchasing or renting the meters themselves, costs of installation and operating costs) and benefits (e.g. saved costs of traditional metering, meter reading, customer interventions etc). It is understood that, in respect of credit meters (which are currently subject to the default tariff cap), the balance of these costs and benefits results in a net cost for suppliers. In respect of pre-payment meters, Ofgem considers that the balance results in a net benefit for suppliers.

2 We understand that at the time of setting the default tariff cap, Ofgem did not separately identify or disclose the level of smart meter costs within the operating costs allowance.

15.2. Secondly, what rollout profile it is assuming. This will determine the overall number of meters that suppliers are expected to install, and how many of those meters are deemed to be installed in any future cap period.

16. In the SMNCC Consultation, Ofgem proposes, in relation to those two factors, to "*have regard to net efficient costs for a supplier with an average rollout profile*"; and to "*project a rollout profile and installation productivity rate that reflects suppliers' historical performance between 2017 and 2019 (under the current obligation)*": SMNCC Consultation Executive Summary, page 5 (emphasis added).

17. Importantly for this advice, two further features of Ofgem's proposal should be noted.

17.1. First, Ofgem proposes to review the SMNCC allowance every 12 months, adjusting both (i) net costs on the basis of the latest data and (ii) the projected rollout profile, on the basis of the weighted average installations actually achieved: see SMNCC Consultation paragraph 3.34. Thus, in effect, the rollout profile, and therefore the level of the SMNCC allowance, will be set on the basis of a constantly updating industry average installation rate. For convenience we refer to this feature below as the "**historic rolling industry average"**. We note that for future years Ofgem states that it "*would set the profile consistent with suppliers' performance to date and their expected performance in light of rollout obligations".* It is unclear what this means and what the balance would be between the use of the historic rolling industry average and any adjustment in the light of future regulatory obligations.[3]

17.2. Secondly, Ofgem proposes to reduce future allowances where installations in each cap period do not keep pace with levels that Ofgem has projected on the basis of the historic rolling industry average. This is justified on the basis that suppliers are treated as having received 'advance payment' for installations which are yet to be achieved (and the same is true in reverse, if installations in a cap period exceed the levels Ofgem has projected). We refer to this second feature below as "**clawback**".

[3] For the avoidance of doubt, to the extent that Ofgem set the profile for future periods entirely by reference to expected costs in the light of suppliers' rollout obligations, the legal difficulties set out further at sections C(2)-C(4) below would not arise. However, if the profile is set predominately by reference to the historic rolling industry average, albeit with some adjustment to take account of the rollout obligations, these problems would still arise.

B(4) Planning and funding smart meter rollout

18. We understand from British Gas's response to Ofgem's Consultation, which we have seen in draft form, that the exercise of planning and funding smart meter rollout is a complex and major investment for suppliers, which cannot readily be adjusted in the short term.

19. In particular, one highly significant aspect of rolling out smart meters is the purchase of the meters themselves. In the case of a supplier such as British Gas, this involves the purchase of millions of items of equipment, at a very substantial aggregate asset cost – the total funding British Gas has secured specifically in relation to the smart meter rental exceeds [redacted]. Both the purchase itself and the financing of that purchase have to be planned, and relevant contracts entered into. These arrangements are likely to place significant constraints on the extent to which suppliers can adjust rollout up or down in the short term.

20. By way of example, we are instructed that British Gas's contracts with its two meter asset providers ("**MAPs**") each impose requirements to draw down a certain amount of finance each year. [redacted]

21. As we further explain below, the result of setting future allowances on the basis of the historic rolling industry average with clawback is that suppliers cannot know what level of funding will be available to support the rollout of smart meters within any period until after the relevant period has concluded:

    21.1. Suppliers have to plan their smart meter rollout, including such matters as entering into agreements to finance the purchase of smart meters and agreements for the purchase of the smart meters, employing engineers, call centre staff and managers and investing in measures to encourage uptake of smart meters. Installing a smart meter in the current cap period does not just entail costs of installation in the present cap period, but also entails ongoing future costs across all cap periods, in particular since the cost of the smart meter itself will be spread across future cap periods, whether by way of rental payment or amortisation.

21.2. Since the level of funding in future periods will be determined by reference to the historic rolling industry average, it is, at present, fundamentally uncertain what funding will be available in future periods to support the ongoing costs of meters which are presently being installed. For example, by installing a smart meter in the current cap period (summer 2020), a supplier will be incurring costs which must be accounted for in (inter alia) summer 2023. However, under Ofgem's proposal to use the historic rolling industry average, the SMNCC allowance in summer 2023 will be determined by reference to the industry average installation rate for the years 2020-2022, which have not yet occurred and which cannot yet be known.

21.3. Moreover, as a result of clawback, even once the allowance for a given period has been set, suppliers do not know if those funds are actually available to fund the smart meter rollout within that period. Even if the supplier in question uses all the funding available in that period efficiently to roll out smart meters, and achieves the level of rollout projected by Ofgem's average profile, if the industry as a whole underperforms by reference to Ofgem's projected rollout profile, part of the allowance for that period will be treated as an 'advanced payment' and funding for future periods will be correspondingly reduced.

C. ANALYSIS

C(1) Implications of Ofgem's SMNCC decision for the fulfilment of the ARS obligation

22. As noted above, until 30 June 2021, the smart rollout will continue to be implemented in the UK through an obligation on energy suppliers to take all reasonable steps to roll out install smart meters.

23. In our view,[4] (a) this ARS obligation must be applied taking account of a supplier's ability to invest in the rollout of smart meters as a result of the default tariff cap; and (b) in the context of enforcement proceedings, to the extent that a supplier's efficient expenditure on smart meter rollout to relevant premises matched the amount allowed under the default tariff cap. Ofgem could not lawfully object that the supplier should have spent more.

[4] This was also the view taken in a previous counsel opinion (provided by Michael Fordham Q.C., Josh Holmes Q.C., Philip Woolfe and Stefan Kuppen) dated 8 October 2018, which British Gas submitted as part of its response to Ofgem's statutory consultation ahead of Ofgem's initial setting of the cap.

24. On its plain meaning, the ARS obligation requires a supplier to take only such steps as are reasonable. We consider that it would not be reasonable to require efficient suppliers to spend money on their smart meter rollout programme which they are unable to recover from their customers. Specifically in respect of customers covered by the default tariff cap, an efficient[5] supplier that spent more on the smart meter rollout than is allowed by Ofgem would be unable to cover its costs, because of the cap. We do not consider that a supplier which refused to do so could be characterised as having acted unreasonably.

25. That common sense conclusion is strongly reinforced by the statutory context. Enforcement of the ARS obligation is a function of Ofgem under Part 1 of the Electricity Act 1989 and Part 1 of the Gas Act 1986. S.3A(2)(b) of the Electricity Act 1989 and s.4AA(2)(b) of the Gas Act 1986 require GEMA to have regard, in the exercise of its functions under Part I of each of those Acts, to the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part I of each of those Acts.

26. In addition, we consider that both the imposition of a financial penalty and (for the reasons further set out at paragraph 29 below) any requirement on suppliers to roll out smart meters to a greater extent than can be efficiently funded by the allowance under the Tariff Cap Act, would engage the protection of Article 1, first protocol ("**A1P1**") of the European Convention on Human Rights ("**ECHR**")**;** and would in our view require a proper justification to be considered lawful. We have not as yet seen such a justification.

27. Ofgem's position is that it would be "*inappropriate*" for suppliers to reduce rollout to fit within the funding that is provided (see paragraph 7.52). We consider that aspect of Ofgem's reasoning to be incorrect: as set out above, the ARS obligation does not define absolute levels of rollout that are required but must be applied with regard to the funding that is available. This reasoning would not constitute the kind of justification referred to in the previous paragraph. Ofgem's labelling of such a course as "*inappropriate*" also fails to engage with the point, explained at section C(4) below, that it is unclear to suppliers what steps are in fact "reasonable" to take in circumstances where it is not clear what funding will be available to support the meter rollout in future.

[5] i.e. a supplier that was as efficient in all other respects as assumed by Ofgem.

C(2) Can Ofgem lawfully set an allowance by reference to levels of rollout that are not aligned with BEIS' requirements for the period after 30 June 2021?

28. As noted above, after 30 June 2021, BEIS's decision is that suppliers will be required to meet enforceable rollout targets (subject to a tolerance).[6] Ofgem proposes to apply its proposals for one year and to update them from 1 October 2021, some 3 months after the ARS obligation expires and is replaced by these specific rollout targets. Moreover, Ofgem appears to indicate that, although it will review the SMNCC annually, it will continue to set the SMNCC in line with the same methodology, in particular, taking account of the historic rolling industry average.

29. Ofgem does state that for future periods it will also have regard to suppliers' "*expected performance in light of rollout obligations"*: see SMNCC Consultation paragraph 3.34.[7] It remains unclear how Ofgem will take this "*expected performance*" into account. To the extent that the rollout profile is not determined exclusively by reference to what is required to meet the suppliers' rollout obligations, but is instead determined, in whole or in part, by reference to historic performance (or something else), the rollout profile and therefore the allowance will not be calibrated so as to meet the new regulatory obligations.

30. Simply put, we consider that Ofgem cannot lawfully set an allowance by reference to a rollout profile which would not be sufficient to fund suppliers to meet the rollout targets applicable under their licence conditions.

31. Furthermore, the application of the default tariff cap to the suppliers engages their rights under the Human Rights Act 1998, and specifically the right to property which is a qualified right protected by A1P1. A1P1 applies here, in that the default tariff cap amounts to a control on the use of the suppliers' assets.[8] If the public authorities require spending on

---

6 We understand these targets will actually become effective, following further consultation, upon an implementing decision of the Secretary of State setting the tolerances.

7 Ofgem also appears to consider that if suppliers' efficient costs increase (as a result of efforts to meet any future regulatory obligation), then that will feed through into Ofgem's future reviews of the SMNCC: see SMNCC Consultation paragraph 3.54. For the reasons set out at paragraph 37 below, Ofgem cannot assume that average rollout under this level of funding will be sufficient to meet the BEIS rollout targets. Although Ofgem's approach may ensure that, in aggregate, the industry recovers its costs, any individual supplier seeking to meet the 100% target will face the risk that, if the industry average (over which it has no control) is a lower level of rollout, it will not recover its costs of seeking to achieve the 100% rollout.

8 See, for example, in the context of rent control, *R&L, SRO and othes v Czech Republic*, Applications nos. 37926/05 etc), Judgment of 3 July 2014 at paragraph 98-109.

smart meter rollout above the level of the costs allowed to suppliers in the default tariff cap, this would seem to fall within the intrusive second category set out by the ECtHR in *Sporrong and Lonnroth v Sweden* (1982) 5 EHRR 35, ECtHR, namely the "deprivation of possessions". Measures which *prima facie* breach A1P1 may in principle be justified by considerations of the general interest, provided that the measure is proportionate. This, in turn, requires a "fair balance" to be struck between the policy goal and the interference: see *Sporrong* at paragraphs 69 and 73. However, the deprivation of possessions is only in exceptional cases considered to be proportionate in the absence of appropriate compensation: see *James v United Kingdom* (1986) 8 EHRR 123, ECtHR, at paragraph 54. In setting the default tariff cap, Ofgem must not act in a way that is incompatible with any Convention right, including A1P1, unless it could not have acted differently under the Tariff Cap Act: see s.6(1)-(2) Human Rights Act 1998.[9] Moreover, the Tariff Cap Act must be interpreted compatibly with Convention rights insofar as it is possible to do so: see s.3 Human Rights Act 1998.

32. So far as we are aware, Ofgem has not addressed this point. It follows that it has not presented a justification as to why it would be proportionate to fund suppliers below the level of the costs they are required to incur.

C(3) Ofgem's proposals fail to pay regard to the policy implications for Smart Rollout

33. As we explain below, we consider that Ofgem is required both (a) to have regard to the effect on smart meter rollout of its proposal to set the SMNCC by reference to the historic rolling industry average and with clawback, and (b) so far as possible, to set the SMNCC so as to fund the levels of rollout required to meet the targets set by BEIS and under EU law. It appears that Ofgem's proposals are in breach of those obligations: Ofgem has failed to conduct any analysis of the impact of its proposals on smart meter rollout in its SMNCC

[9] For the avoidance of doubt, we do not consider that it could sensibly be argued that the Tariff Cap Act does not permit Ofgem to set the SMNCC at a level which provides funding which is set in advance by reference to the levels of rollout envisaged and required by BEIS. Although Ofgem's primary obligation under the Tariff Cap Act is to exercise its functions "*with a view to protecting existing and future domestic customers who pay standard variable and default rates*" (s.1(6)), Ofgem considers the smart meter rollout is in the long term interests of customers (SMNCC Consultation paragraph 2.11). Moreover, Ofgem is specifically required to have regard to the financeability consideration (s.1(6)(d) Tariff Cap Act).

Consultation; and there is also good reason to believe that, all other things being equal, Ofgem's proposals will undermine the policy aim of smart meter rollout.

Ofgem's duties to consider and to seek to promote smart meter rollout

34. In our view, Ofgem is required both to consider the effects of its proposals on smart meter rollout and to seek to achieve the policy aims which have been articulated by BEIS, and the targets set out in the EU legislation in this field. It is an unavoidable feature of the factual context that UK government policy is to encourage a full rollout of smart meters, and that BEIS is taking specific regulatory action to require the rollout of smart meters beyond 30 June 2021. In our view, it would be unreasonable, as a matter of public law, for Ofgem to fail to have regard to that policy in general and the existence of the specific targets which will apply to suppliers post-1 July 2021 in setting an allowance both (i) for periods after 1 July 2021 and (ii) for periods up to 30 June 2021:

    34.1. The clear policy goal has been set of achieving 100% rollout by mid-2025, subject to a tolerance which remains to be determined. The allowance under the default tariff cap up to (potentially) the end of 2023 will play a central role in determining the funds which are available to deliver that policy and to fulfil those regulatory requirements. We consider that Ofgem cannot reasonably ignore that policy goal in deciding upon the level of the SMNCC allowance.

    34.2. For the avoidance of doubt, we consider it is the policy goal of 100% rollout that is relevant, rather than the (lower) enforceable tolerance threshold on which BEIS is continuing to consult. To state the obvious, if funding is only provided in line with a rollout toward (say) an 85% threshold, suppliers cannot reasonably be expected to spend more in order to work towards the 100% policy goal. Moreover, to do so would be inconsistent with the purpose of a tolerance, which is to account for unexpected difficulties or cases where rollout is economically impossible.

35. Ofgem is also obliged to have regard to binding EU law imposing obligations to roll out both gas and electricity smart meters and to meet a specific target in respect of the rollout of electricity smart meters by the end of 2024:

35.1. For at least the period relevant to the default tariff cap (at the latest to 31 December 2023), obligations arising under EU law will continue to be enforceable against Ofgem via judicial review in the Administrative Court.[10]

35.2. The UK must ensure that 80% of final customers are equipped with electricity smart meters by 2024, and is under an obligation to roll out gas smart meters.[11] UK domestic legislation must therefore, so far as it is possible to do so, be interpreted in accordance with both the wording and the purpose of these directives so far as it is possible to do so (Case 106/89 *Marleasing* [1990] ECR 4135).

35.3. The level of the allowance for smart meters in the tariff cap the effective implementation of those EU law obligations. Therefore, in setting the default tariff cap, Ofgem must interpret its duties in accordance with the purpose of achieving the smart meter rollout required by EU law. Ofgem's duty under s.1(6) of the Tariff Cap Act can readily be interpreted in this way.[12]

---

10 Until the end of the implementation period as defined by the UK-EU withdrawal agreement (which is at least 31 December 2020), EU law will continue to apply fully in the UK pursuant both to that agreement and the present text of the European Union (Withdrawal) Act 2018 ("EUWA 2018"). Accordingly, both (i) general principles of EU law and (ii) obligations on public authorities arising under directives continue to apply insofar as Ofgem is acting within the scope of EU law. Further under the terms of section 4 of the EUWA 2018 (as amended by amendments that been enacted but which have not yet been brought into force), general principles of EU law and such obligations arising under directives will continue to apply after the end of the implementation period to the same extent as under the European Communities Act 1972, save for certain specific exceptions. One of those exceptions is that, in the future, courts will be unable to quash any conduct or otherwise decide that it is unlawful, on the ground that it is incompatible with any of the general principles of EU law (see EUWA 2018 Schedule 1 paragraph 3). However, this is subject to transitional provisions which will provide that any acts prior to the end of the implementation period may, for a period of three years following the end of the implementation period, be quashed on this ground (see EUWA 2018, Schedule 8 paragraph 39, as amended by pending amendments).

11 Directive 2009/72/EC Annex I.2, Directive 2009/73/EC Annex I.2 and Directive 2019/944 Articles 19-21 and Annex II. See specifically in respect of electricity metering, Annex II paragraph 3 of Directive 2019/944. The UK has positively assessed the rollout of smart meters and which started its rollout before 4 July 2019.

12 In addition, to the extent relevant, provisions of directives are capable of having vertical direct effect against all emanations of the state: see for example Case C-188/89 *Foster v British Gas* [1990] ECR I-3313 at paragraph 20; Case 152/84 *Marshall v Southampton No1*[1993] ECR I-4367.

Failure to consider implications for rollout

36. Unfortunately, Ofgem's consultation contains no consideration of the impact that its methodology for setting rollout profile may be expected to have on the rollout of smart meters in the UK.

37. To state the obvious, the legal and policy objectives to achieve smart meter rollout are forward-looking. *Prima facie*, the relevant levels of rollout for Ofgem to consider, in setting the SMNCC, would be (for the purposes of Ofgem's obligations as a matter of EU law) a rollout profile which would be sufficient to achieve the levels of rollout set out in the relevant directives and (b) (as a matter of rationality) the 100% rollout target by mid-2025 set by BEIS. It cannot be assumed that a historic average rollout trajectory is in line with those objectives.

38. However, Section 4 of the SMNCC consultation, which specifically addresses rollout profile, contains no consideration of the forward-looking impacts of the proposals on rollout. For example, paragraphs 4.37-4.40 only address the question of whether using the rollout profile from BEIS's 2019 cost-benefit analysis would overestimate the efficient costs that suppliers have incurred in the period 2018-2020.

39. Section 2 of the SMNCC Consultation specifically, if briefly, considers the implications of Ofgem's decision as to the level of the net costs of smart meters for rollout: see SMNCC Consultation paragraphs 2.10-2.12. Ofgem there concludes that supporting an efficient rollout is in customers' (long term) interests and thus helps protect them. Ofgem further concludes that it should not support the rollout "*at any cost*" and specifically that it should not set the SMNCC allowance above efficient costs as to do so would reduce the net benefits to customers of installing smart meters. However, Ofgem conducts no substantive consideration of the implications for rollout of using the historic rolling industry average as the assumed rollout profile.

40. Ofgem's justification for the use of the historic rolling industry average, with clawback, is based on ensuring that consumers should not, by the end of the default tariff cap, have paid more than the average cost that suppliers have actually (efficiently) incurred. Thus, it states at paragraph 2.12 that "*we do not seek to provide suppliers with funding above the net impact of the smart meter rollout on the operating costs of an efficient supplier with an average rollout profile. If we did so, the SMNCC allowance would not protect default tariff*

customers." And at paragraph 4.4 it considers that the fact that suppliers with above-average rollout profiles will have higher efficient costs than is allowed for "*is an unavoidable consequence of setting a single allowance that protects consumers*".

41. In our view, this reasoning is not persuasive, and would be unlikely to satisfy a Court applying judicial review standards:

    41.1. The objective of protecting current and future customers does not necessitate that the allowance be set by reference to historic average costs. Rather, one would naturally expect Ofgem to pay regard to the expected efficient costs of meeting the rollout targets (which will benefit future as well as current consumers). Nor does fulfilment of this objective require that the allowance should be subject to clawback in the manner that Ofgem envisages.

    41.2. By setting the allowance by reference to a historic rolling industry average and subject to clawback, Ofgem appears to be seeking to ensure that, *ex post*, consumers have not "overpaid" across the life of the default tariff cap, in the sense that the industry – regarded as a single entity – will not receive more than the average costs which have actually been efficiently incurred. Of course the industry is not a single entity, and it appears to us misconceived to regulate as though it is.

    41.3. Moreover, Ofgem's approach assumes that the issue is only about ensuring efficient conduct on the part of suppliers, rather than also aiming meet the policy objective of smart meter roll-out. Ofgem has not explicitly had regard to other relevant factors in this regard. In particular, Ofgem ought to have regard to the following matters in accordance with its duties under s.1(6) Tariff Cap Act:

        41.3.1. benefits to future customers beyond the lifetime of the default tariff cap. It is recognised that these benefits will be substantial, including reducing customer expenditure[13] and allowing effective competition - BEIS considers that a household that has a smart meter installed in 2020 is expected to realise bill savings of £290 between 2020 and 2034; and

[13] BEIS Smart Meter Rollout Cost-Benefit Analysis (2019).

41.3.2. the financeability implications for those individual suppliers who will not have their efficient costs covered, either because their efficient costs are higher than average or because they have rolled out greater than the industry average, and the associated implications for consumers.

41.4. We are instructed that the approach of using this historic rolling industry average with clawback is apt to present significant difficulties for an individual supplier (see paragraph 43 below). An individual supplier planning to roll out smart meters in pursuit of the BEIS 100% rollout objective will be at risk of not recovering its efficient costs of doing so, if it turns out that the industry average rollout is at a lower level, even if the industry average rollout is within the tolerance which BEIS allows.

41.5. There is no available consideration of these points by Ofgem, so far as we are aware. Nor does Ofgem consider whether any alternative solutions would be better suited to achievement of the rollout whilst still being compatible with the objective of protecting existing and future consumers (who have an interest in the effective rollout of smart meters), such as seeking to set the allowance by reference to the expected efficient costs of meeting applicable rollout targets.

42. Ofgem questions the importance of funding to future rollout. However, its reasoning in this respect is in our view unsustainable, and would be found to be such by a reviewing court:

42.1. This issue is addressed laconically with the statement that "*suppliers [have] argued that delays to the rollout are due to consumer resistance and technical barriers. That would suggest a lack of funds is not a binding constraint. Suppliers have received more than sufficient funding to date, but have still not managed to increase their rollout, which could indicate that other factors are more important at present*." (SMNCC Consultation paragraph 2.12).

42.2. Ofgem's analysis draws from suppliers' statements that they have encountered consumer resistance and technical barriers the inference that funding has not been a constraint on rollout. Ofgem's logic is flawed. Funding may itself be effectively used to address "consumer resistance" and "technical barriers", depending on what those are: it is not a separate issue. What is required is an empirical assessment of whether

funding at a lower level is required to meet the EU and/or BEIS targets will impair suppliers' ability to meet those targets.

42.3. Relatedly, Ofgem does not take account of the consequences of the change in the regulatory regime. Ofgem needs explicitly to confront the fact that BEIS has announced its decision that suppliers should meet a rollout target of 100% by mid-2025, and the decision in principle that they will be subject to specific and binding targets in the interim, unqualified by "all reasonable steps".

Ofgem's proposals will undermine the policy objective of smart meter rollout

43. There are good reasons to think that, if the SMNCC is set by reference to historic rolling industry average levels, and subject to clawback, the policy objective of smart meter rollout will be undermined:

43.1. There is a clear incentive, all other things being equal, for a supplier to fund rollout at a level no higher than its estimate of the historic industry average, since it will be unable to recover its costs if it funds rollout at a higher level.

43.2. Moreover, in respect of periods after 30 June 2021, setting the rollout profile by reference to the historic rolling industry average may lead to funding substantially below what is required to reach BEIS's policy target of 100% of gas and electricity meters in homes and small businesses by mid-2025 (or the EU target of 80% of final customers' electricity meters being smart meters by the end of 2024). Table 1 of the SMNCC consultation indicates a rollout profile culminating in a rollout to 68% of premises by 31 December 2023. That would leave a substantial gap to either the BEIS or the EU target.

43.3. If over time the industry average underperforms the projection of a 68% rollout by 31 December 2023, for example if rollout becomes progressively more difficult, the paradoxical result will be that funding is <u>reduced</u>, rather than <u>increased</u> to encourage rollout.

43.4. Indeed, we understand from British Gas's response to Ofgem's Consultation, which we have seen in draft form, that in the light of the current financial situation of suppliers, British Gas predicts that very significant reductions in rollout capacity –

including significantly reduced investment, job reductions and a fall in installations in 2021 – will be inevitable if Ofgem maintains its current course. Unless there is some good answer to this, it presents a grave problem.

C(4) Uncertainty faced by suppliers under Ofgem's proposals is both unreasonable and contrary to the principle of legal certainty

44. It is a feature of Ofgem's proposals that suppliers cannot know whether the programme of rollout that they put in place will be met with sufficient funding.

45. This is, very simply, an unreasonable approach for a sectoral regulator to take. In our view, it would be considered to be *Wednesbury* unreasonable under public law by a Court. Specifically, when determining now how many meters to install in pursuance of its ARS obligation, a supplier does not know what level of funding will be available in future periods to support the stock of smart meters which it is now engaged in installing, since the funding will be set on the basis of a historic industry rolling average that is unknown to the supplier and outside its control. Moreover, the level of funding in current periods cannot be relied upon even once determined, as it may be subject to clawback.

46. The same regulatory approach also is contrary to both EU law and ECHR principles of legal certainty.

    46.1. As already noted, Ofgem is acting within the scope of EU law and therefore must comply with general principles of EU law: see *R (Lumsdon) v Legal Services Board* [2015] UKSC 41, [2016] AC 697 at paragraph 25, citing with approval Case C-427/06 *Bartsch v Bosch and Siemens* [2008] ECR I-7247, Opinion of A-G Sharpston at paragraph 69. Of particular significance are the principles of proportionality and legal certainty.

    46.2. Ofgem must act proportionately in designing retail price regulation, by virtue of applicable EU law (see Case C-265/08, *Federutility*, EU:C:2010:205, paragraph 33) and A1P1 ECHR. Its decision must pursue a clearly defined objective, must be appropriate for achieving that objective, and must go no further than is necessary to achieve that objective: see *Case C-331/88 R v MAFF ex p FEDESA* at paragraph 13.

    46.3. The general principle of legal certainty, which is a fundamental principle of EU law, requires that rules should be clear and precise, so that individuals may ascertain

unequivocally what their rights and obligations are and may take steps accordingly (see Case C-308/06 *R v Secretary of State for Transport ex p Intertanko* [2008] ECR I-4057 at paragraph 69).

46.4. Further, A1P1 has been held to incorporate analogous requirements of legal certainty: see e.g. *Parvanov and Others v. Bulgaria*, ECtHR, judgment of 7 January 2010 at paragraph 50. This concept of legal certainty includes qualitative requirements of accessibility and foreseeability: see *Spacek v Czech Republic* (2000) EHRR 1010, ECtHR at paragraph 54. As the ECtHR put it in *Sun v Russia*, judgment of 5 February 2009 at paragraph 27, "*a norm cannot be regarded as a "law" within the meaning of the Convention unless it is formulated with sufficient precision to enable the citizen to regulate his conduct; an individual must be able – if need be with appropriate advice – to foresee, to a degree that is reasonable in the circumstances, the consequences which a given action may entail*".

C(5) Application of Clawback from 1 October 2019

47. In addition to the legal difficulties with the clawback mechanism which are identified above, there is an additional legal problem in relation to Ofgem's proposal to apply the clawback in relation to the 6-month cap period which commenced 1 October 2019 (in respect of credit meters).

48. We would firstly observe that Ofgem's clawback proposal appears to assume that suppliers either have unused funds from previous periods, or that the lack of such funds is due to inefficiency. As far as we are aware, this assumption has not been verified. We are instructed that it is incorrect. It therefore appears that Ofgem is proceeding on an incorrect factual basis, or has not properly investigated this assumption.

49. However, even if the application of clawback in relation to past periods is properly justified, Ofgem appears to have accepted that doing so may run counter to suppliers' legitimate expectations, arising from Ofgem's clear indication in November 2018 that '*... we will not include a mechanism in the cap for correcting previous forecast errors – whether or not*

they benefit suppliers'.[14] Ofgem considers, however, that no legitimate expectation exists from 1 October 2019 onwards:

> *"7.38…we proposed in our April 2019 consultation that we would account for advanced payments when setting the SMNCC allowance in future cap periods (and set out the impact of those proposals in our October 2019 consultation). We therefore consider that no legitimate expectation can exist in respect of cap periods after that point that we would not adjust the SMNCC allowance to reflect the excess payments." (emphasis added)*

50. Once a public authority has established a legitimate expectation (which Ofgem appears to accept it has done in this instance), the public authority may be required to comply with it unless there is the overriding interest justifying the change of policy outweighs the requirements of fairness: see *R v North and East Devon Health Authority, ex p. Coughlan* [2001] QB 213 at paragraph 58.

51. In this analysis, a key question is whether sufficient notice was granted of the change, including whether the length of notice and the transitional arrangements are sufficient to avoid Ofgem crossing the threshold of 'unfairness' in the light of its policy reasons for changing its approach. We consider that there are strong arguments that Ofgem has not presented a sufficient justification for departing from its previous position:

    51.1. Ofgem had made repeated statements that suppliers must have *'stretching*' in-year targets and that it would not revisit the allowance retrospectively, giving suppliers the certainty that they could spend the full allowance on smart rollout in the relevant cap period. As explained above, a result of clawback being applied on the basis of a historic rolling industry average is that suppliers lose any up-front certainty about the amount being allowed for smart rollout in a given cap period. They do not know whether they will need to 'save up' some of the allowance, to reflect future reductions in the allowance, and they do not know how much they may need to 'save up'. In our view, to make such a profound change lawfully would require Ofgem to provide clear

[14] Ofgem, Decision – Default tariff cap – Overview document, 6 November 2018, paragraph 3.17.

and unambiguous notice, in order to avoid conflicting with the suppliers' legitimate expectations.

51.2. In the April 2019 consultation,[15] Ofgem went no further than to say that the current allowance '*may be somewhat above actual efficient costs*' and that Ofgem would '*estimate, and give regard to, the extent to which the allowance in the first three cap periods provided advance funding*'. This falls short of properly explaining the clawback proposal. Indeed, Ofgem in fact confirmed that '*we would not automatically include any such impact in the calculation of the allowances*', implying that the decision as to whether or not to do so would be taken at a later date. We therefore do not consider that the April 2019 paper is capable of constituting adequate notice to suppliers.

51.3. Significantly, it appears that Ofgem has reached its conclusion that no legitimate expectation could persist beyond October 2019, without carrying out any investigation or analysis of the timescale over which suppliers are able to adjust their level of installation of smart meters. As set out at paragraphs 18-21 above, each supplier's rollout programme is an expensive and complex undertaking, in which many months are required to make any significant adjustments. Such changes unavoidably require many months to enact. It is our understanding that British Gas has previously drawn this point to Ofgem's attention. We are not aware that it has been dealt with.

D. CONCLUSION

52. A summary of our advice has already been provided at paragraph 3 above. If we can be of any further assistance in connection with this matter, those instructing should not hesitate to contact us.

Towerhouse LLP

JON TURNER QC
JOSH HOLMES QC
PHILIP WOOLFE
Monckton Chambers
26 June 2020

[15] Please see: https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap.