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By email to: Retailpriceregulation@ofgem.gov.uk

Dear Anna

Smart allowance working papers

Centrica welcomes the opportunity to respond to Ofgem's two further working papers on this critically important subject.¹²

Smart metering is a key part of Government's net zero carbon strategy, with progress towards the market-wide adoption of smart meters being a vital enabler for the green recovery. The Government reaffirmed its commitment to the smart metering programme last year when it determined the future rollout trajectory required, namely market-wide rollout by 2025.³ **It remains vital to the success of the smart programme that suppliers are able to recover their efficient costs of implementing rollout. Ofgem must ensure the SMNCC allowance in the default tariff cap (cap) is set appropriately to enable realisation of the smart programme. Suppliers cannot sustainably spend more on smart rollout than they are allowed to recover under the cap.**

Choice of rollout profile is critical to Ofgem's modelling approach for setting SMNCC allowances as part of the cap. We have previously highlighted concern that an 'average' rollout profile, as previously proposed, will result in slowdown and a systematic deficit in the amount of revenue that can be recovered contrary to Government's policy ambition which requires an acceleration in the programme to meet the goal of market-wide rollout by 2025. We therefore welcome the fact that Ofgem is considering a move away from this approach (albeit that it has not taken a firm position at this stage). As discussed further in the attached appendices, **Ofgem must adopt a profile that allows each supplier to (at least) meet its minimum legal obligations and recover its own associated efficient costs, otherwise the rollout obligations of that supplier will not be enforceable.**

¹ [Smart meter rollout and the default tariff cap: working paper \(ofgem.gov.uk\)](#)

² [Setting the level of rollout for the PPM smart meter cost allowance – working paper \(ofgem.gov.uk\)](#)

³ [Delivering a smart system: response to a consultation on smart meter policy framework post-2020 \(publishing.service.gov.uk\)](#)

Ofgem is also seeking views on whether, in the light of BEIS' consultation⁴ on setting the tolerances which will apply as part of its post-2020 smart meter policy framework, it should calibrate allowances based on targets net of 'tolerance' – the legal minimum each supplier will be required to achieve – or based on the underlying targets before tolerance. **We reiterate that funding must be based on targets before tolerance – otherwise the very concept of tolerance is meaningless and there is no prospect whatever of targets being achieved.**

We appreciate that Ofgem is grappling with how to accommodate the fact that suppliers' efficient costs vary according to their own rollout profile within the constraints of a 'one-size-fits-all' cap. We also recognise that there is an inherent tension between minimising short-term price impacts on consumers and maximising the long-term consumer benefits from smart rollout consistent with Government's clear policy objective. However, **it is vital that Ofgem's approach to price protection under the cap is consistent with meeting smart policy objectives, not at the expense of them.** In this context we question Ofgem's assertion that it cannot require smart allowances to be dedicated to investment in smart rollout.⁵ We believe **further consideration should be given to a separate levelisation mechanism which would ensure that allowances intended to support rollout are effectively applied for that purpose.**

Finally, while we provide initial views now to assist Ofgem's policy development, we note that stakeholders are being asked to respond to stylised options in abstract with no meaningful quantification (there are virtually no numbers in the working papers and stakeholders currently have no access to Ofgem's SMNCC model). **It remains vital that Ofgem provides full disclosure of its modelling and underlying data within a confidentiality ring as part of the statutory consultation planned for May.** We therefore reserve the right to make further representations as necessary in due course once a fuller picture emerges.

While the above comments apply generally, we set out more specific comments on the proposals for credit and PPM SMNCC respectively in appendices 1 and 2. For ease of reference we also enclose a copy of our confidential response to BEIS' consultation on the post-2020 framework with this response.

We look forward to engaging further on these issues in due course. In the meantime, do please let me know if you have any immediate questions.

Yours sincerely

Don Wilson
Head of Retail Market Policy

⁴ [Smart meter policy framework post 2020: minimum annual targets and reporting thresholds for energy suppliers: Annex A: Impact Assessment \(publishing.service.gov.uk\)](#)

⁵ Credit working paper at 2.26. Ofgem also references paragraph 2.64 of its original decision 2018 document but on inspection this provides no reasoning to support Ofgem's assertion.
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Appendix 1 – Comments on credit working paper

We welcome the fact that Ofgem is looking afresh at the appropriate rollout profile to adopt in the light of Government's clear reaffirmation of its objective of a market-wide rollout "as soon as practicable"⁶ and Ofgem's own commitment to reconsider whether it is in customers' interests to maintain its current (average) approach or to use a higher rollout profile.⁷

While rollout profile is only one element of Ofgem's cost modelling, it is highly material to the resultant calculation of SMNCC. Suppliers cannot sustainably invest more than the cap allows them to recover, so funding remains a critical constraint on the rollout suppliers can achieve in practice however rollout obligations are framed. Consequently, as noted in our response to BEIS' consultation on tolerances, Ofgem's ability to enforce the rollout obligations – and BEIS's policy objective of seeing market-wide rollout – will be compromised to the extent Ofgem fails to allow each supplier to recover its efficient costs to deliver its target."⁸

Allowances should support smart programme objectives to deliver customer benefits

Ofgem suggests four principles might inform the choice between competing options (on which Ofgem does not yet have a minded to position), namely:

- Reducing costs to default tariff customers;
- Increasing the benefits of smart metering;
- Supporting suppliers to deliver their obligations;
- Ensuring cost effectiveness.

We appreciate that Ofgem may be seeking to expose trade-offs between what it perceives as advantages and disadvantages of different options. However, we do not think the price protection objective of the cap can properly be equated with reducing costs to default tariff customers if that is at the expense of the other suggested principles. Rather, Ofgem's guiding aim ought to be to support Government policy objectives which are intended to deliver consumer benefits. As Ofgem notes:

*"The objective of the Act is to protect current and future default tariff customers. When considering protection for default tariff customers, we can take into account both any near-term increase in costs from rolling out more smart meters earlier than otherwise and the benefits they will receive through this earlier rollout. This includes both their private benefits and their share of the societal benefits. However, rolling out more smart meters earlier than otherwise will also deliver wider benefits beyond default tariff customers (both private benefits to non-default tariff customers, and the remainder of the societal benefits). There is a strategic question about how to balance the impact on default tariff customers with the wider impacts on non-default tariff customers."*⁹

⁶ [Delivering a smart system: response to a consultation on smart meter policy framework post-2020 \(publishing.service.gov.uk\)](https://publishing.service.gov.uk/government/consultations/delivering-a-smart-system-response-to-a-consultation-on-smart-meter-policy-framework-post-2020)

⁷ Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraphs 3.2 and 3.3.

⁸ Centrica response to BEIS' consultation: Delivering a Smart System: Consultation for a Smart Meter Policy Framework post 2020, 15 January 2021

⁹ Credit working paper, paragraph 2.41

Allowances need to cover ongoing costs as well as new installs

We welcome Ofgem's clear exposition of the way in which rollout profile impacts the efficient costs cap allowances need to cover.

Rollout profile affects net costs through the stock of meters already installed (driving meter rental charges to recover asset and installation costs) as well as the flow of meters installed in-year (driving premature replacement charges for traditional meters and one-off cost of in-home displays). This is important because cap allowances need to provide for the ongoing costs of meters already installed as well as the in-year costs associated with new installs.

As Ofgem acknowledges, for credit meters the former effect generally dominates so that the supplier with the highest proportion of smart meters per customer will also tend to have the highest net cost per customer in a given year.¹⁰

Need for a new approach

Ofgem's current methodology takes an average approach to determining the single rollout profile driving its SMNCC model (excluding unrepresentative small suppliers). However, as well as committing to review whether this is appropriate, Ofgem has also committed to use an above average profile when assessing advanced payments for the period 1 October 2020 to 31 September 2021.¹¹

As we have previously highlighted, there is an obvious problem if Ofgem defines cap allowances by reference to an 'average' profile – namely that it will not allow a supplier with an above average profile to recover its efficient costs. Yet, as Ofgem notes, it must have regard to the ability of an efficient supplier to finance its licensed activities. This necessitates an above average profile that allows each supplier to recover its own efficiently incurred costs, recognising that the efficient costs of each supplier will vary according to their own rollout profile and that Ofgem is constrained to set a single cap.

Centrica has consistently sought to ensure that cap allowances intended to support smart rollout are effectively applied for that purpose, as we believe all suppliers should be doing. In these circumstances, Ofgem's apparent concern about possible 'overfunding' does not arise. If, however, Ofgem considers that other suppliers are not investing cap allowances appropriately in smart roll out it should look to require improved future performance from those suppliers to accelerate customer benefits.

A 'market leader' approach

Given the clear problems associated with an 'average' profile, we welcome Ofgem's consideration of alternatives. Ofgem's leading alternative to an average profile for credit SMNCC is what it describes as a 'market leader' approach.¹² Ultimately, what matters is the outturn allowance which is not solely a product of the rollout profile but of the modelling approach as a whole. While we welcome Ofgem's search for an appropriate above average profile, we note that there is a feedback loop between the identification of the 'market leader' and other aspects of Ofgem's modelling (which we cannot currently access or comment on).

¹⁰ Credit working paper 1.10-1.11

¹¹ Credit working paper 1.12-1.15

¹² Credit working paper, paragraph 2.6

We understand that Ofgem intends to use modelled costs to determine which supplier is the market leader based on cumulative SMNCC over the maximum life of the cap. Given the number of errors we have previously identified with Ofgem's modelling we reserve judgement on the detail pending necessary disclosure of Ofgem's model and underlying data.

We note that Ofgem initially determined SMNCC not by reference to the profile forecast by individual suppliers or suppliers collectively, but rather by reference to an EU target. Indeed, it did so deliberately so as not to constrain rollout.

"Rollout assumption for 2019: We have decided that a forecast rollout profile based on using the EU target for installing electricity meters by end 2020 is a prudent minimum end point modelling assumption. This provides a 25.10% (electricity) and 25.80% (gas) rollout profile uplift for 2019 from the 2018 average forecast end point. This exceeds the supplier-produced forecast rollout profiles in gas for all of the six largest suppliers and five of the six largest suppliers for electricity. We estimate that using the EU target as opposed to a lower supplier-forecast average rollout profile increases the level of the dual fuel SMNCC by £7.38 and therefore should not restrict supplier's ambitions to meet or exceed their current forecasts."¹³ (emphasis added)

While Ofgem considers the question of target or tolerance separately in the present working paper, it is not clear that it is constrained to approach the choice of profile in this way. The contrast between 'average' and 'market leader' as described in the working paper results from Ofgem's proposal to move away from its original target based approach in favour of a retrospective rolling average, and the present need to reconsider the appropriateness of such an approach in light of criticism (from Centrica among others) that it would perversely penalise those suppliers who have done most to deliver on the smart programme to date and that it is inconsistent with timely delivery of Government policy objectives.

Ofgem must fund the target, not the 'tolerance'

The working paper presents four options, combining a choice between 'average' and 'market leader' historic profiles with a choice between a 'tolerance' approach or a 'target' approach to determining future profile from July 2021 onwards.

As noted above, there is clear precedent for the target approach, even where the ability to fully meet the stated target remains highly uncertain. We still believe that the outcomes BEIS anticipates do not align to realistic expectations based on the data. As described in further detail below, our plans are formed based on the best that can realistically be achieved based on experience and without change to policy to encourage smart meter acceptance. Critically, BEIS also appears to assume that Ofgem will make sufficient allowances available. It follows that if sufficient allowances are not made available this would jeopardise attainment of minimum tolerance rollout, let alone the more demanding targets before tolerance.

We appreciate Ofgem is trying to second-guess what policy change BEIS might enact to encourage smart take-up in setting the approach to allowances. However, it should be clear that if Ofgem were to curtail allowances to what it considers an efficient supplier would need to meet the bare legal minimum obligation, the tolerance threshold becomes a ceiling rather than a floor. This deprives the concept of 'tolerance' of meaning.

We expect that suppliers would need to aim to exceed the bare minimum in order to ensure they can meet their obligations. However, this will simply not be possible if allowances are determined on the basis of a 'tolerance' rather than a 'target' profile. Even if other aspects of

¹³ [Appendix 7 - Smart metering costs FINALISATION \(ofgem.gov.uk\)](#)

policy were to change in a way which unlocked consumer demand, targets will remain unachievable without sufficient funding.

Use best available data to estimate H1 21 rollout

All Ofgem's proposed options require it to estimate an appropriate profile for H1 21 – to bridge the gap between historic data up to the end of 2020 and forecast data based on proposed targets/tolerance from H2 2021 onwards.

Ofgem presents three options

- Using average 2017-2019 profile
- Extrapolating from 2020 actuals (Covid impacted)
- Using 2021 plan submissions

We think the most appropriate approach would be to combine actual data for Q1 21 – which should be available to Ofgem in time for its next consultation – with an estimate for Q2 21 based on 2017-2019 performance (on the assumption that Q2 21 will not be significantly impacted by Covid-19 restrictions).

Adverse impact of insufficient allowances on rollout

Ofgem's August 2020 decision communicated indicative SMNCC levels for the periods Oct 21 onwards.¹⁴ The SMNCC allowances shown represent a significant reduction to the level currently in place and would therefore have a major impact on our future Smart programme. ✂ It is imperative that any future SMNCC allowances are calibrated to the volume expectations set by BEIS as part of the wider mandate.

Plans depend on adequate allowances

Ofgem has expressed interest in evidence from suppliers with above-average historical rollout on what level of rollout they are currently (i.e. before the SMNCC decision) planning for under the new smart meter framework: in line with their obligations, in line with their targets, or somewhere in between.¹⁵

As explained to Ofgem in our previous forecast submissions, our forecasts are 'bottom-up' based on how much demand we think we can generate rather than 'top down' based on targets. We then overlay our capacity to produce regional plans. The only constraints on our ability to install smart for all our customers are customer appetite and ability to re-coup costs under the cap.

We always aim to deliver as many smart installs as possible within the constraints above. ✂ We remain of the view that the target will not be achievable unless Government delivers additional policy measures to improve customer uptake.

Critically, however, our forecasts assume we are able to re-coup costs to a level that allows us to convert all the demand we are able to generate. If this is not the case, deficits will inevitably impact what we can achieve in practice.

¹⁴ [Decision on reviewing smart metering costs in the default tariff cap | Ofgem](#) page 6 Table 1

¹⁵ Credit Working Paper at 2.43

Separate mechanism parallel to the cap

Ofgem invites views on the possibility of a separate mechanism operating outside of the cap as a means of addressing the fact that suppliers' efficient costs vary according to their individual profile while the cap constrains Ofgem to set a single 'one-size-fits-all' allowance.

We have previously suggested Ofgem should consider such a mechanism and remain of the view that this (or some other 'top-up' mechanism) would be required if Ofgem were to stick with an average profile that, by definition, fails to allow suppliers with above average profiles to recover their efficiently incurred costs.

As a supplier with an above average profile leading to higher than average efficient costs our primary concern is to ensure that we are able to recover costs to meet (at least) our minimum obligations. We continue to question why Ofgem has not been more vigorous in its pursuit of suppliers whose rollout performance (and associated net cost) lags our own despite facing the same All Reasonable Steps obligations. Centrica has consistently sought to devote allowances intended to support smart rollout for that purpose.

If Ofgem considers that other suppliers have not done so it should look to require improved future performance from those suppliers, not penalise market leaders through clawback of 'advanced payments'. Ofgem has not explained its assertion that it cannot require suppliers to ring-fence allowances intended to support smart rollout for that purpose. Ofgem already requires suppliers to submit large amounts of information on their efforts in rolling out. Asking for cost data is a simple matter. If Ofgem considers that suppliers with below average profiles receive allowances that they do not themselves invest, and cannot be made to invest, in smart rollout it should consider a mechanism to redistribute allowances to support the higher efficient costs of market leaders.

Ofgem should not adopt BEIS productivity assumptions which are unevidenced

In our response to BEIS' consultation on tolerance values in the post 2020 framework, we explained our significant concerns with BEIS' ungrounded assumptions regarding operational fulfilment and productivity gains because they were not supported or evidenced with substantive data. BEIS suggested that the assumed productivity gains were calculated based on information provided to them in discussion with suppliers. We do not recognise their analysis, nor, as we understand it, do other EUK members. We therefore requested BEIS provide the full analysis they used in their conclusions. In the absence of this these assumptions remain ungrounded and should not be used in any context.

Indeed, our own analysis is likely to contradict BEIS' assumptions. We recognise that continual improvement of supplier processes and engagement is crucial to a successful rollout and we have shared with Ofgem and BEIS (in great detail) the initiatives we have implemented to maximise success rates and improve productivity. However, successful installs are intrinsically linked to customer appetite and we are increasingly approaching the 'hard to reach' base and relying more on deemed appointments to convert these customers. These channels naturally incur higher levels of aborts and incomplete jobs and so only when customers are more accepting of smart meters will we see significant improvements in operational fulfilment.

Appendix 2 – Comments on PPM working paper

We welcome the fact that Ofgem is proposing to use a PPM-specific profile rather than use the profile applied to credit. However, we are concerned that Ofgem appears to be prejudging the choice of profile for PPM in a way it says it is not for credit, notably by appearing to reject a 'highest net cost' profile in favour of an 'average' profile.¹⁶

For credit, Ofgem's proposed 'market leader' approach seeks to identify the supplier profile with the highest cumulative SMNCC over the maximum life of the cap – on the grounds that an average profile will not allow suppliers with higher than average efficient costs due to their individual rollout profile to recover their efficiently incurred costs. For PPM, however, Ofgem appears to dismiss an analogous approach for reasons which are not well explained in the working paper.

Ofgem appears to rest its support for an average PPM profile on the argument that *"the market average should reflect the aggregate cost of the rollout to PPM consumers for a given level of efficient costs"*¹⁷ despite the fact that this consideration is not determinative in the case of credit.

We see no reason in principle why Ofgem should not adopt a highest net cost approach for PPM, analogous to the market leader approach proposed for credit. Ofgem does not suggest that an average profile will improve suppliers' incentives to favour PPM rollout over credit rollout, and it offers no explanation as to how suppliers with higher than average efficient costs (which apparently may be due to early as well as late rollout profiles) can recover their efficiently incurred costs.

We note Ofgem's statement at 3.15 that *"We do not consider it appropriate to overfund the majority of suppliers because of an individual supplier's commercial decision to not prioritise rolling out smart meters to PPM customers" (emphasis added)*. If this reflects a concern that a single supplier is a clear outlier whose profile does not represent an efficient choice, a case might possibly be made for excluding that particular supplier from the sample – but Ofgem has not exposed the data to make such a case in the working paper. In any event, excluding a single outlier would not justify failure to reflect the higher than average efficient costs of other suppliers implied by Ofgem's stated preference for an average profile. The proportionate response would be to discount the outlier, if justified, rather than reject all profiles with higher than average net cost.

In section 4 of the working paper, Ofgem considers two options for setting the PPM SMNCC:

- using a single rollout profile; and
- taking the average of the PPM SMNCC allowances generated by using a sample of rollout profiles.

Ofgem's discussion of these options leans heavily towards the first option – a single rollout profile using the weighted average. However, Ofgem's view seems to be coloured by the additional complexity it perceives with the second option and Ofgem's prior discounting of a highest net cost rather than an average profile. The difficulties Ofgem identifies with averaging multiple profiles would not arise if – analogous to the 'market leader' proposal for credit – Ofgem adopted the profile of the single supplier with highest cumulative efficient net cost. For the reasons discussed above, we believe Ofgem should give this approach further consideration.

¹⁶ Ofgem uses different terms in different places. Here we use the term highest net cost rather than 'lowest PPM rollout supplier' – in part because Ofgem suggests that suppliers with both early and late PPM profiles may have higher efficient costs than those associated with an 'average' profile.

¹⁷ PPM working paper 3.10

Ofgem's discussion of target vs tolerance is also infected by its clear preference for an average profile. Ofgem states that average target would generate higher SMNCC than average tolerance.¹⁸ Presumably, the same would also apply if Ofgem were to adopt a highest net cost approach, although Ofgem does not consider this overtly. However, Ofgem also notes that, in aggregate, suppliers would not be able to collect enough revenue to reflect the costs of delivering market-wide rollout (for a set level of efficiency). This option would therefore not align with BEIS' policy ambition for the smart meter framework.¹⁹

As with credit, if Ofgem restricts allowances to those necessary to meet the bare legal minimum this effectively precludes any improvement on the minimum tolerance threshold – and indeed may put achievement of the tolerance in peril. This risk would be compounded if Ofgem persists with its proposal to adopt an average rather than highest net cost approach which, as noted, needs reconsideration.

Finally, Ofgem invites views on how to estimate H1 21 rollout for PPM, as it does for credit. We recommend the same approach for PPM as we recommend for credit, namely using Q1 21 actuals (which should be available in time for Ofgem's next consultation) and estimating Q2 21 with reference to historic 2017-2019 (pre-Covid) performance.

¹⁸ PPM working paper 3.25

¹⁹ PPM working paper 3.28