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By email to: Retailpriceregulation@ofgem.gov.uk

Non-confidential version – redactions marked ✕

Dear Anna

Reviewing smart metering costs in the default tariff cap

Centrica welcomes the opportunity to respond to Ofgem's initial consultation on this important subject.¹ British Gas has been at the forefront of the smart metering programme installing over 7 million smart meters to date, over half the industry's total installations. We continue to believe that smart is an enabling technology for the future energy market and the long-term benefit of customers.

Ensuring adequate allowance for smart metering costs within the default tariff cap (DTC) is critical to the future of the smart programme because the cap necessarily constrains supplier investment in smart deployment which is needed to meet Government ambitions. As a result, it plainly qualifies the application of supplier 'all reasonable steps' (ARS) obligations. Ensuring adequate funding for smart is also integral to the statutory requirements of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act) given the regard Ofgem must have to smart meter deployment in assessing conditions for effective competition, as Ofgem correctly notes.² Our comments on Ofgem's proposals below are framed with the importance of maintaining momentum in the smart programme and customer benefit clearly in mind.

In summary

- We broadly support the proposed short-term rollover for the October cap providing this is not subject to later clawback that would undermine the smart programme;

¹ <https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap>

² Consultation document paragraph 2.7, referencing Domestic Gas and Electricity (Tariff Cap) Act 2018 Section 7 (2)

- Ofgem should work actively with BEIS and suppliers to ensure it has the necessary evidence base for the substantive review, based on the gap analysis suppliers have already provided of areas not properly reflected in BEIS' current Impact Assessment;
- Ofgem cannot rely wholly on BEIS private analysis to provide the necessary independent scrutiny and transparency for its own purposes: the estimation of input assumptions on costs and benefits must be opened for stakeholder consultation. Where this involves the assessment of confidential supplier data, this can be done through the establishment of appropriate confidentiality ring arrangements, keeping restrictions to an absolute minimum. Ofgem must fully justify any proposed restrictions on disclosure and should consult on proposed confidentiality ring arrangements in good time ahead of the first substantive consultation on the approach for P4 and beyond. In addition, Ofgem must also release a non-confidential version of its SMNCC model in time for the first substantive consultation. Without this, it is not possible for stakeholders to make informed representations regarding the estimation of SMNCC.

We support short term rollover that provides certainty

We strongly agree that there is a need for Ofgem to provide an appropriate allowance for non-pass through SMNCC for Period 3 (P3) of the DTC commencing in October 2019. In establishing the non-pass-through SMNCC element of DTC, Ofgem has recognised that this element of Opex needs to be updated to reflect specific cost drivers that a general inflation index would not capture. Since Ofgem has only established non-pass-through SMNCC for periods 1 and 2 in its November Decision, it needs to make appropriate provision for P3 even if it cannot complete the substantive review in time for P3 as originally intended.

We appreciate that BEIS' update to its own CBA is unlikely to be available in sufficient time for Ofgem to consult appropriately on an updated SMNCC estimate in time for the P3 cap (which requires final cap values to be confirmed no later than 7 August 2019). Given the long planning lead times associated with programme adjustments, and the need for continuity and certainty, we think Ofgem's pragmatic proposal to rollover the existing approach to non-pass-through SMNCC for P3 is reasonable in the circumstances providing existing allowances are not subject to clawback. However, we see no basis for changing the gas/electricity apportionment in this case.³

Ofgem's substantive review must be well informed and transparent

Ofgem must, however, ensure that it has available to it and takes due account of all relevant data for the substantive review proposed for P4 and P5, and must also ensure that it conducts a meaningful and transparent consultation process allowing stakeholders to engage fully on the detail while policy is still at a formative stage.

It will not be sufficient for Ofgem to rely uncritically on whatever private quality assurance process BEIS may apply for its CBA update. We agree that BEIS analysis could potentially provide a useful starting point in some respects, but its analysis is directed at a different purpose and appears to be a closed process, not subject to transparent consultation or independent scrutiny by stakeholders.

Ofgem must be proactive to ensure necessary data is gathered consistently

³ Table 3 indicates that the non-pass through allowance for electricity would increase while gas would decrease for P3 compared with P1 and 2. The basis for this change is not explained or justified given Ofgem's intention not to refresh input data for P3.

We welcome Ofgem's recognition that stakeholders have already raised issues that Ofgem should include within its review of assumptions and data contained in BEIS cost benefit analysis.⁴ Indeed, suppliers have already highlighted to BEIS and Ofgem significant gaps in the data that BEIS has collected to date as part of annual supplier returns.⁵ This covers both data that BEIS will need for its updated CBA, but also additional data that Ofgem will need for its SMNCC review.

We understand that BEIS is currently considering what additional data it may require for its own purposes. However, irrespective of what BEIS decides, we believe Ofgem will need these data to conduct a fully informed SMNCC review. It should therefore satisfy itself that BEIS will indeed collect necessary data and make it available to Ofgem in the form Ofgem will need or, failing that, organise its own parallel data collection activity in good time. It is not appropriate to rely on individual suppliers submitting data on an ad hoc basis, especially in circumstances where lack of access to the SMNCC model effectively prevents suppliers from demonstrating materiality in advance.

Accuracy matters, and requires greater transparency than currently proposed

Ofgem must ensure that its own substantive review is transparent, so that modelling errors can be identified and corrected in good time to ensure resulting estimates of efficient cost are as accurate as possible. While we agree that a confidentiality ring may be appropriate where access to individual supplier data is concerned, limiting disclosure to the very final stage of consultation as currently proposed is not consistent with the need to allow stakeholders to engage meaningfully while policy is still at a formative stage.⁶

In addition, Ofgem should be aiming to ensure that an executable version of the underlying SMNCC model it intends to use (stripped of confidential individual supplier data) is made freely available in time for the first substantive consultation. Neither Ofgem nor BEIS has provided any justification for not releasing this.

Clawback is not appropriate - the smart programme requires funding certainty

It is critically important to the success of the smart programme that suppliers can understand and have confidence in whatever non-pass-through SMNCC allowance Ofgem determines. We note Ofgem's suggestion that the approach it proposes for P3 may result in a higher allowance than it subsequently estimates using an updated SMNCC model following its substantive review, and the possibility that it may seek to take account of any perceived 'surplus' allowance for periods 1, 2 and 3 in later cap periods by setting later allowances below its estimate of efficiently incurred costs. This suggestion is misconceived and poses very substantial risks to the smart programme.

Any assumption that cost estimates Ofgem ultimately derives from an updated SMNCC model will turn out to be lower than the allowances it has already established for periods 1 and 2 based on its current model is speculative at this stage. But more fundamentally, the suggestion that any difference between estimates made at different times can be interpreted as providing an 'advance allowance' misunderstands how the allowance Ofgem has already determined impacts the level of efficiently incurred costs now.

⁴ Consultation document paragraph 3.16

⁵ Letter from Dan Alchin EUK to Anna Rossington dated 18 February 2019. For ease of reference, the enclosed gap analysis is attached for reference and forms an integral part of Centrica's present consultation response.

⁶ Ofgem should also rethink its previous approach to disclosure to enable greater flexibility in operation relax unduly onerous restrictions on advisers and suppliers.

Put simply, allowances that have already been invested efficiently in cap periods 1, 2 and 3 will not be available to 'top up' below cost allowances in later cap periods. Irrespective of how they have been derived, the allowances Ofgem has set feed through into current investment. All else equal, a 'high' allowance will translate into 'high' investment, accelerating expected customer benefits rather than increasing supplier margins. If current allowances had to support future period expenditure as well as current spending, current expenditure would have to be reduced accordingly. This is plainly inconsistent with Ofgem's stated rationale for its approach to SMNCC for the first two cap periods where Ofgem insisted

"We have set the SMNCC at a level that gives regards to the need for an efficient supplier to finance their rollout with no reduction in planned rollout pace" (Emphasis added).⁷

Either way, below cost allowances would clearly have damaging negative effects on the smart programme as well as offending the requirement for regulatory certainty.

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Ofgem should, therefore, clarify that whatever the results of its future cost modelling it will not seek to set future non-pass-through SMNCC allowances below efficient cost in the relevant period. To avoid any possible misunderstanding, Centrica's broad support for Ofgem's P3 proposal is subject to this essential proviso.

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
Head of Regulatory Affairs, UK & Ireland

Appendix – responses to consultation questions

Question 2.1: Do you agree with how we propose to consider an appropriate allowance for smart metering costs? Please explain your views.

We agree that Ofgem should set an appropriate allowance for smart metering costs for cap periods 3 and beyond. However, we do not entirely agree with the proposed approach Ofgem outlines. In particular, we do not agree that Ofgem should disregard ‘high’ efficiently incurred costs on the basis that ‘this would not protect consumers sufficiently’.⁸

We recognise that Ofgem is constrained to set a single allowance for all suppliers although their individual costs in any period may vary. However, we do not agree that Ofgem’s approach can be regarded as ‘conservative’ merely because it seeks to benchmark against average rather than lower quartile costs. Given the present lack of transparency as to precisely how Ofgem has derived its estimates of smart costs we continue to have serious reservations as to their reliability. But even if Ofgem’s estimates of efficient cost were perfectly reliable, Ofgem cannot simultaneously maintain that it “ensures the smart metering allowance does not impede the rollout of smart meters” and that its approach is ‘conservative’ when it explicitly proposes not to allow recovery of ‘high’ but nevertheless efficiently incurred costs.

We remain of the view that the consumer protection purpose of the cap is not to deny suppliers the ability to recover their efficiently incurred costs. In fact, the Act specifically requires Ofgem to have regard to that need.⁹ Ofgem maintains that this does not mean it has to achieve the four statutory needs although it appears to accept that they are each desirable in principle and that it has a duty to consider each of these important needs “carefully, rigorously and conscientiously”. In practice, this must involve considering the actual quantum by which ‘high’ efficient costs differ from average efficient costs. Ofgem cannot decide this in abstract without unlawfully fettering its discretion.

In relation to quantitative assessment, we have significant concerns that Ofgem’s proposed approach to ‘ensuring estimates are sufficiently robust’ will not achieve that stated aim. Ofgem’s brief, high level commentary gives the impression that because estimating actual costs is not straightforward Ofgem will allow itself wide latitude not to investigate or check that its estimates are accurate and reliable with any degree of rigour, for example the general assertion that ‘reasonable simplifications will be preferable’.

Such an approach would not be consistent with Ofgem’s assertion that it will seek to consider the statutory needs specified in the Act carefully, rigorously and conscientiously. Even apparently small variations in cap allowances have potentially very large implications for customers, suppliers and the success of the smart programme when multiplied by many millions of customers to whom the DTC applies.

Ofgem has previously sought to rely on the ‘prudence’ of its assumptions and specific further review of smart costs to justify allowing only a small margin for residual cost uncertainty within the overall cap design.¹⁰ However, the combination of conscious decisions not to allow full cost recovery for suppliers with high efficient costs (e.g. due to disproportionate numbers of high cost to serve customers) and mounting evidence of failure to make adequate provision for other costs (such as mutualisation due to failing suppliers, escalating costs of policy driven industry change programmes, and unidentified gas (UIG)) mean even that small margin is illusory.

⁸ Consultation document at paragraph 2.14

⁹ Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6)
https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_2_-_cap_level_analysis_and_headroom.pdf paragraph 2.19

Given the that suppliers' efficient costs are not sufficiently funded within the cap and that there is no headroom 'buffer' to cater for uncertainty or error, Ofgem must ensure that its analysis is as robust as possible. Only by doing so can it, and stakeholders, be confident that resulting smart allowances are indeed 'prudent'.

It is therefore critically important that Ofgem actively gathers all necessary data and opens its analysis to independent scrutiny by stakeholders to ensure that its estimates are as accurate as possible, errors are corrected, and uncertainties minimised. In addition, Ofgem should release a non-confidential executable version of the revised SMNCC model it intends to use for the substantive review in time for the first substantive consultation.

Question 3.1: Do you agree with how we propose to review efficient smart metering costs? Please explain your views.

No, not entirely. We do agree that review is necessary. Indeed, we urged Ofgem to commence this review in January.¹¹ However, we accept that since BEIS' updated cost benefit analysis will not be available in time for Ofgem to use it as a starting point for establishing P3 allowances, an alternative interim approach is needed and broadly support the proposal to rollover existing allowances in the short term on the proviso that these are not subject to later clawback.

We continue to disagree with Ofgem's decision and proposal to continue disregarding high efficient costs, as discussed in answer to Q2.1 above. We consider that, at minimum, this stance must be subject to review in the light of updated data and analysis, without which Ofgem cannot properly judge its consequences.

While we agree that BEIS' analysis could, in principle, provide a useful starting point, it can only be a starting point given that BEIS' analysis is directed at a different purpose from Ofgem's, and presently appears to be a wholly closed process not open to independent scrutiny or validation by stakeholders.

Ofgem cannot simply state that this analysis is the 'best available evidence' and expect stakeholders to accept without question the product of what it describes as an 'extensive process' of assurance which is invisible and lacking external validation. Rather, it must actively engage with BEIS and suppliers to understand and shape what this 'starting point' will comprise, and then conduct a full and transparent process of its own regarding proposed adjustments. While we note Ofgem's current thinking regarding adjustments, the question of what adjustments will eventually be required necessarily depends on what BEIS ultimately does. Therefore, we reserve further comment until there is greater clarity on the starting point.

It is important that the confidentiality ring Ofgem envisages is fit for purpose and considerably less restrictive than the disclosure room Ofgem (belatedly) established alongside the final statutory consultation. The potential value of the previous disclosure room was diminished by the fact it did not ultimately allow advisers access to any confidential data other than that belonging to their client. We continue to believe that previous restrictions placed on the use of any reports from the disclosure room (pre-vetted by Ofgem) are unjustified and disproportionate. Ofgem must ensure that improved and fit for purpose confidentiality ring arrangements are as open as possible and not simply apply previous restrictions in a new form. It should consult on proposed arrangements in good time ahead of the first substantive consultation on smart allowances for P4 onwards providing specific justification for whatever restrictions it may propose so that stakeholders can consider and comment accordingly.

¹¹ https://www.ofgem.gov.uk/system/files/docs/2018/10/centrica_-_response_3_-_smart_inc_appendix_7.pdf paragraph 62

It will not be sufficient, as Ofgem currently proposes, to confine disclosure via a confidentiality ring to the very final stage of consultation.¹² Effective scrutiny to identify and correct errors and enable stakeholders to make fully informed representations requires much greater transparency, much earlier in the process. In addition, stakeholders should have access to an executable version of the updated SMNCC model (stripped of any confidential individual supplier data) Ofgem intends to use by the time of the first substantive consultation on P4 and beyond currently scheduled for August/September.

Question 4.1: Do you agree with how we propose to set the allowance for the third cap period? Please explain your views, and any alternative proposals if applicable.

We broadly accept Ofgem's proposed approach to rolling over current allowances for P3 subject to the proviso that it is not subject to later 'clawback'. There are long lead times associated with smart programme adjustments. ✕

We do, however, query the gas vs electricity split in non-pass through SMNCC envisaged for P3. Given Ofgem's stated intention not to make use of any updated data or assumptions, it is not clear what lies behind this apparent shift and we do not believe it is justified. This is a symptom of more general lack of transparency, including lack of access to the SMNCC model Ofgem is currently employing and underlines the need for much greater transparency for the substantive review ahead.

Question 4.2: Do you agree with how we propose to set the allowance for the fourth cap periods and beyond? Please explain your views, and any alternative proposals if applicable.

As noted above, allowances for the fourth cap period and beyond need to be based on good data and sound analysis supported by an open process that includes access to the updated SMNCC model Ofgem intends to use in time for the first substantive consultation.

We strongly reject the idea that allowances for P4 and beyond should be set below the estimates of efficient cost resulting from updated analysis on the basis that Ofgem's updated model might produce lower estimates for earlier periods than Ofgem's current model. As discussed more fully in the covering letter, in circumstances where Ofgem has set an explicit allowance irrespective of how it has derived that allowance, retrospective adjustments would run counter to Ofgem's November decision and have adverse impacts on smart programme delivery that would not serve the long-term interests of customers.