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By email to: Retailpriceregulation@ofgem.gov.uk

Dear Anna

Reviewing smart metering costs in the default tariff cap

Centrica welcomes the opportunity to respond to Ofgem's consultations on this critically important subject.[1] Please note that this response is confidential and commercially sensitive, and must not be shared or published without our explicit consent.

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 critical enabler for the 'green recovery.' Government's commitment to the smart metering programme was also reiterated in the decision published by BEIS last week[2], in which the rollout trajectory required for the smart programme was determined: suppliers are required to target 100% rollout of smart metering (i.e. 'market wide') by 2025.

Given the importance of the smart metering programme, we are extremely concerned that – taken together – Ofgem's proposals represent a major and unwarranted reduction in overall allowance. If implemented, they will result in a damaging and irreversible impact on programme capacity, both immediately and in the longer term, to the detriment of consumers.

Ofgem's positions rely heavily on three concepts:

1. that the level of smart allowance permitted under the default tariff cap does not constrain rollout;

[1] This response addresses two Ofgem consultations – the review of credit SMNCC and proposed PPM-specific SMNCC discussed in a separate consultation document. For convenience, this response considers proposals for future smart allowances across both consultations. Our views on other matters covered by the PPM consultation are contained in our previous response to Ofgem's initial consultation.
[2] 'Delivering a Smart System: Response to a Consultation on Smart Meter Policy Framework Post-2020', BEIS, 18 June 2020.

2. that it is appropriate to use a historic rolling industry average rollout profile as the basis on which to set the smart allowance; and
3. that it is a) possible and b) in the interests of consumers to 'clawback' calculated over-funding from past price cap periods.

This response (and associated attachments including a Legal Opinion) demonstrate that all three of these concepts are fundamentally flawed. As such, should Ofgem proceed on the basis of the proposals as set out, it will be in breach of its duties and obligations regarding the rollout of smart meters, as well as its wider duties under public admin law and the Default Tariff Cap (DTC) Act.

For the avoidance of doubt, we believe that any decision that proceeds on this basis would be unlikely to withstand judicial scrutiny.

Given the inherent flaws in Ofgem's position, we believe Ofgem will need to undertake a number of actions ahead of determining after reflecting on responses to this consultation. In summary:

- Ofgem's position is that it would be "inappropriate" for suppliers to reduce rollout to fit within the funding allowed is fundamentally incorrect. As a consequence, Ofgem has failed to take into account the mandatory consideration of **financeability**. Annex A sets out how we believe this shortcoming will need to be addressed.
- Ofgem's proposals on **rollout profile** are inconsistent with the BEIS decision published last week and would be unlawful if implemented, for the reasons set out in the attached Legal Opinion. Ofgem must reconsult on this critical aspect of the consultations.
- Ofgem's **'contingency' options for the credit SMNCC allowance**, as described in the consultation, are also unlawful and cannot be implemented. Instead, Ofgem must specify an interim level for the allowance. This should be consistent with current levels of funding, for the period through to the end March 2021, pending conclusion of a new consultation.
- Ofgem must implement the **contingency option for PPM** and consult further on PPM SMNCC. This is due to uncertainty about the true level of efficient costs and their combined effect, and the existence of numerous cost and benefit assessments in the model that appear to be poorly evidenced or unevidenced. Ofgem has also created the legitimate expectation that it will apply its contingency proposal in the event it cannot implement its proposals.
- The proposals for **historic clawback** should be abandoned on the basis this is unlawful as it offends the principle of legal certainty. For the same reasons it should also abandon the concept of a **rolling annual review**.
- Finally, Ofgem should **correct the errors and omissions** we have identified, which affect both SMNCC and smart opex.

As noted above, we append a Legal Opinion to this consultation response, setting out the legal basis on which we have reached these conclusions.

Ofgem has failed to take account of financeability implications of its proposals

Suppliers cannot sustainably spend more than the cap allows. Contrary to Ofgem's assertion, it is entirely appropriate for suppliers to match rollout levels with whatever funding is allowed.

It should be obvious to Ofgem that allowances that have already been spent provide no 'surplus' funding to carry forward, especially when suppliers are already operating on negative margins. On this last point and by way of context, we would note:

- suppliers as a whole are struggling to finance their activities. The combined 2019 EBIT of the five suppliers who have published their CSS is -£377m;
- this picture is not confined to larger established suppliers. In 2019 Bulb made a loss of around £130m and Octopus a loss of around £30m; and
- a number of suppliers, including several which have failed, have been and continue to operate unsustainable business models by using customer credit balances. Yet the cost of such business failures is not borne fully by the businesses in question but 'mutualised' across industry.

Centrica is not immune from these pressures, having recently announced 5,000 job losses across the group.[3]

The stark reductions in levels of SMNCC proposed by Ofgem would therefore have a direct and adverse effect on the smart rollout.

Ofgem's current proposals, if adopted unamended, would reduce Centrica's smart funding next year by ✂ for credit and a further ✂ for PPM compared to current allowances. We estimate this could result in 2021 installs reducing by well over ✂% from our current plan, ✂. The estimated impact on our rollout plans ✂ is set out in Table 1.

✂

As we set out in more detail below, and because Ofgem's proposals as set out are so deeply flawed, we believe Ofgem's safest option is to maintain funding allowances that approximate to current levels (i.e. c.£21 credit DF). This would enable even higher levels of efficient spend on smart, and therefore unlock even more ambitious levels of smart meter installations. However, failing that, we believe the absolute minimum level of allowance necessary to maintain our current smart meter installation capacity would be to set it at a level commensurate with that signalled in the January 2020 consultation (i.e. £14.90).

Cuts in rollout capacity that would result were Ofgem to proceed with its proposals are not easily or quickly reversed. Such actions would certainly be inconsistent with the recent BEIS decision requiring suppliers to refocus on a new target of 100% rollout by mid-2025. The inevitable result is that Centrica would be unable to keep funding at levels required to maintain rollout at its current pace. The inconsistency between this inevitable outcome and Government's ambitious requirements for future rollout raises important financeability questions (described further in Annex A) which Ofgem's consultation has failed to even recognise, much less engage with in any meaningful way.

Ofgem must adjust its rollout proposals to reflect confirmed policy

There is a fundamental disconnect between the BEIS decision for suppliers to meet a 100% rollout target by mid-2025 and Ofgem's funding proposals. With the publication of the June document "Delivering a Smart System", the government objective of delivering "a market-wide rollout of smart meters as soon as practicable" could not be clearer.

Ofgem is also aware from suppliers' submissions that smart rollout programmes are expensive and complex and require long-term planning – it is simply impossible to quickly ramp up or down, and suppliers' financial situations do not allow them to run their programmes at a loss for any material period of time.

[3] https://www.centrica.com/media-centre/news/2020/centrica-announces-a-simpler-and-more-customer-focused-business-model/

It is therefore deeply concerning, as the evidence we set out in this submission makes clear (such as Table 1), that Ofgem's proposals will have a significant and immediately negative impact on our rollout programme. The outcomes likely to result from Ofgem's proposals are fundamentally at odds with the DTC Act and the broader EU and UK policy and legislative framework. Furthermore, they pose serious concerns in relation to financeability of suppliers. For these reasons alone, Ofgem cannot proceed with its proposals as described, and must reconsult on this critical aspect of its proposals.

Ofgem's rollout proposal is further flawed by the methodology it has applied in calculating its proposed rollout profile. Given the public policy imperative of universal smart meter rollout – and the consumer benefits that will flow from achieving this objective - Ofgem must not set the rollout profile as if it were undertaking an opex efficiency benchmarking exercise.

By adopting an approach using historic rolling industry average levels, Ofgem necessarily includes poor-performing suppliers in its rollout calculation. As set out in more detail in the attached Legal Opinion, historic underperformance by some suppliers must not be used as the basis for informing the level of SMNCC allowance. Underperformance should instead be a prompt for regulatory scrutiny (and ultimately enforcement action where such underperformance is deemed sufficiently serious).

Fundamentally, Ofgem is obliged to set a rollout profile that is sufficient for suppliers to achieve the Government-mandated outcomes. As the attached Legal Opinion notes, it cannot be assumed that a historic average rollout trajectory is in line with those objectives. In fact, such an approach ignores the need to maximise smart meter penetration in line with policy objectives and perversely has the most negative impact on suppliers who achieve above-average rollout or who rollout earlier.

If Ofgem were to proceed on the basis proposed, this would have the perverse effect of driving convergence towards a low average, not support additional investment to drive the average up as it clear BEIS now requires. The profile Ofgem assumes will effectively sets an upper limit on what can be achieved – which plainly falls well short of what is required to meet policy goals. The SMNCC allowance should instead be determined on the basis of the performance of suppliers who are strong performers, as would be the case if the allowance was based on top quartile performance. To the extent poor performers fail to spend the resulting allowance efficiently, we would expect this to be returned to consumers through enforcement action.

Contingency options proposed for the credit SMNCC allowance cannot be implemented

For the reasons set out above, it is clear that Ofgem will need to adopt some form of contingency option for credit SMNCC pending the outcome of the further consultation that Ofgem must undertake. However, <u>none of the contingency options which rely on the model[4] put forward by Ofgem can be lawfully implemented</u>. This is for two reasons.

Firstly, they all suffer from specific errors about costs and benefits which Ofgem will now be 'on notice' about and able to address. If Ofgem sets an allowance – regardless of whether or not this is a 'final' decision or a 'contingency' decision – it must do so in a way that represents Ofgem's best view of suppliers' actual efficient costs and benefits of smart metering.

In relation to the detailed modelling errors identified in our response, Ofgem has no discretion but to immediately reflect these. To deliberately leave unaddressed errors in any contingency decision would result in Ofgem making an unlawful decision.[5]

[4] I.e. excluding the option of 'freezing' the allowance.
[5] R (British Gas Trading Limited) v Gas and Electricity Markets Authority [2019] EWHC 3048 (Admin).

Secondly, the contingency options all fail to reflect the BEIS decision, and the necessity of suppliers now planning to target 100% rollout by mid-2025. As set out above, adopting any of the contingency options would have severe financeability implications for suppliers and jeopardise the ability of suppliers to rollout smart meters consistent with the target. Indeed, there is no lawful way in which Ofgem can reduce the rollout profile from its current trajectory in the short term given:

- Ofgem has made no attempt to understand the financeability implications of the proposals. Financeability is a mandatory statutory consideration and yet any analysis of whether suppliers will cope with short-term underfunding is completely lacking; and
- Ofgem has not considered whether suppliers will be forced to scale back their rollout plans. A scale-back at this time would be to the serious detriment of consumers. It would also seriously compromise suppliers' ability to scale their rollout programme back up at a later date.

Ofgem therefore has no other choice but to maintain the status quo in terms of rollout profile, on the basis that no other decision can be safely made at this time.

This would require Ofgem to continue the existing rollout trajectory, hitting 80% of installations at the end of 2020 as was originally envisaged, and holding installations at this level until it is in a position to make a lawful decision. This is simply a continuation of the rollout profile which Ofgem originally adopted in its November 2018 decision and has since extended on a contingency basis on the basis that it continued to be the most appropriate option.

It is also a profile that protects the momentum and trajectory of the rollout, in light of the evidence Ofgem has available to it that – given suppliers' financial positions ✂. This option therefore best serves the objective of contingency, which is to protect rollout while Ofgem reaches a concluded view.

Ofgem must adopt the contingency option for PPM and consult further on PPM SMNCC

The points set out above also apply to PPMs. However, we additionally note two points.

Ofgem has rightly stated that if it needs to revise its PPM proposals, it will instead introduce the PPM cap level setting a non-pass-through SMNCC of £0.[6] Suppliers therefore now have a legitimate expectation that, unless Ofgem believes it is appropriate to implement the PPM proposals unchanged, an SMNCC of £0 can be assumed. This is an important expectation because, if the proposed value of the PPM SMNCC changes, Centrica (like all suppliers) will have to adjust their smart rollout programmes accordingly, including adjusting the trajectory with which it will roll out smart meters to its PPM customers.

Secondly, it is even more clear in the case of the PPM proposals, that they cannot stand in their current form. This is unsurprising – and appears to have been contemplated by Ofgem – since it is the very first-time stakeholders have seen any modelling of PPM smart costs. There is therefore much greater uncertainty about the combined effects and, in particular, there are still areas of fundamental uncertainty about the true level of efficient costs.

In particular, we have written separately to Ofgem about its assumption that the average rollout profile for PPM customers is similar to the average rollout profile for credit customers. We are pleased that Ofgem has confirmed that it has obtained separate rollout figures for credit and PPM customers from BEIS (and provided by suppliers). However, the updated rollout profile is likely to produce a material impact on SMNCC. This is therefore a very substantial change from the proposals set out in the PPM Consultation – one that suppliers will require significant time to reflect in their rollout plans, following Ofgem providing finalised figures for the new values – and

[6] PPM Consultation para 8.4.

which may well require additional consultation to ensure that suppliers' ASR data has been reflected accurately.

Furthermore, as discussed further at Annex B, there are numerous cost and benefit assessments in the model (such as the assumed reduction in customer communications and the impacts of enrolling and adopting SMETS1 meters) which appear to be poorly evidenced or unevidenced.

Accordingly, we agree with Ofgem's view that - in such circumstances where the existing proposals cannot be taken forwards - it will apply its contingency proposal. We are currently planning our rollout, in reliance on the statements on the PPM Consultation to this effect, on this basis.

The proposals for historic clawback are unlawful

As set out more fully in the attached Legal Opinion, Ofgem's clawback proposals represent an unreasonable approach for an economic regulator and would be found to be unlawful by a Court.

It is unreasonable that a supplier, when determining now how many meters to install in pursuance of its All Reasonable Steps (ARS) obligation, cannot know what level of funding will be available in future periods to support the smart meters it is installing now, 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 and, in any event, may be subject to clawback. Consequently, the approach breaches both EU law and ECHR principles of legal certainty.

Aside from this fundamental concern, Ofgem's proposal to apply clawback with effect from 1 October 2019, if adopted, would be in breach of suppliers' legitimate expectations. Ofgem has pointed to no clear and ambiguous statement before October 2019 that clawback would apply. It also fails to take into account an important consideration, on which Centrica has previously made representations, namely that suppliers' smart rollout programmes are expensive and complex undertakings and that suppliers require significant time to adjust to any change in approach.

Ofgem must correct errors and omissions that we have identified

Finally, as set out in Annex B, Ofgem's quantification of the costs and benefits of the proposal are in numerous respects unlawful and unsustainable. For example, Ofgem includes several categories of 'benefit' for suppliers which appear to have no underlying evidence whatsoever (or any evidence which does exist has never been disclosed to suppliers) and which are only justified by reference to another decision (namely, that BEIS included those benefits in its cost benefit analysis). This is an unacceptable practice for an economic regulator.

Furthermore, Ofgem's justification for its quantification of costs and benefits in other cases is irrational and appears to misunderstand the data it is using. The appendix to this response sets out a number of serious instances where we have identified that the consultation has failed to meet the requirements of procedural fairness.

Conclusion

In the absence of a fundamental rethink by Ofgem of its proposals, we will have no choice but to consider our legal options. We will take the necessary action to protect our position, and that of our customers if necessary through recourse to the courts. Given the nature of Ofgem's errors, we expect that any decision would be set aside on legal challenge.

We therefore call on Ofgem to rethink its consultation proposals urgently and fundamentally in order to avoid an abrupt and premature halt to the momentum of the smart programme which is neither in the long-term interest of consumers nor consistent with government policy ambitions.

In the appendix to this response and accompanying annexes, we set out our concerns in more detail, and the corrective steps we believe Ofgem should take in the long-term interest of consumers.

Yours sincerely

Tim Dewhurst
Regulatory Affairs Director

Appendix

This appendix addresses the following points

- The need to directly address the impact of Ofgem's decisions on the delivery of the smart programme
- The need to take account of confirmed policy decisions regarding the future mandate and differences in credit and PPM rollout profiles
- The need to provide reasonable certainty by abandoning clawback and rolling annual reviews
- The need to consider financeability and sunk costs in a wider context than current Covid lockdown

It is supplemented by further detail in the accompanying annexes:

- Annex A on financeability;
- Annex B on technical modelling errors and omissions; and
- a joint Legal Opinion by Jon Turner QC, Josh Holmes QC and Philip Woolfe (Monckton Chambers) and Towerhouse LLP.

Ofgem's consultation paper fails to grapple with the basic question of how its proposal will affect the delivery of the smart programme

The smart programme offers long term benefits to consumers and the economy and remains a key plank of Government policy, as confirmed in last week's decision on the future policy framework.[7] However, the programme as a whole imposes costs on suppliers – who are constrained to price in line with the default tariff cap (DTC).

We understand Ofgem can only set a single cap for all suppliers even though their efficiently incurred costs differ, as Ofgem acknowledges. But it is a fundamental error to conclude that restricting funding based on low historic average rollout performance is acceptable on the grounds that anything else "would not protect consumers". Ofgem's failure to recognise the consequences of this funding decision is based on the flawed premise that funding is no constraint on rollout.

This position is unsupported by any evidence or serious attempt at reasoning (as recognised in the attached Legal Opinion) and it is a fundamental mistake of fact. The obvious reality is that – especially in a context when suppliers are operating on negative margins, and especially for suppliers whose customers are mainly covered by the price cap – the allowance for smart metering under the price cap *will determine* how much those suppliers can afford to spend on the smart metering programme.

As we have made clear repeatedly in response to previous consultations, suppliers cannot sustainably spend more than the cap allows. There is no financial buffer enabling suppliers to sustain additional net costs if they cannot recover those costs from customers. Contrary to Ofgem's assertion otherwise, funding is therefore a binding constraint on the smart programme. A denial of this reality is a fundamental mistake of fact and leads Ofgem to ignore relevant (indeed essential) considerations about how its proposals will affect rollout.

Once it is acknowledged that the available funding will determine how much suppliers can spend – and therefore the allowance affects rollout – it is an unescapable conclusion that

[7] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/893124/delivering-smart-system-post-2020-govt-response-consultation.pdf

Ofgem's current proposals incentivise an industry-wide loss of momentum. Since there is an on-going net cost to support existing installations, an allowance based on historic industry average rollout performance severely constrains the funding available for new installations. Indeed, suppliers who have done most to deliver smart meters to date will now have to slow down rather than accelerate rollout – dramatically so in Centrica's case where cuts of well over ✂% compared to current plans for 2021 will be necessary (as described in Table 1).

Such sharp cut backs will not serve the wider policy objectives – objectives Ofgem is committed to because it believes them to be in the longer-term consumer interest. We therefore call on Ofgem to reconsider its current approach, recognising the serious real world impact the sharp reductions in funding it proposes will precipitate.

Finally, Ofgem's proposals can reasonably be assumed to lower the standard required by the ARS obligation for all suppliers, because the 'industry average' it will fund to may well include suppliers who are non-compliant. Ofgem is responsible for monitoring and enforcing suppliers' smart meter obligations. In that capacity, it should of course seek to ensure that price cap allowances for smart are dedicated to efficient investment in smart. What it should not do, however, is frustrate the achievement of the smart programme by curtailing funding to such an extent that the industry is forced to lose its momentum, and those suppliers who have done most are unable to recover their efficient costs.

Ofgem must revisit the rollout profile driving the allowance

The roll out profile Ofgem now proposes is a key driver of the sharp reduction in allowances. Having originally used a profile assuming roll out would be complete by the end of 2020, Ofgem's October consultation proposals would have reduced allowances in each cap period by extending the assumed completion date to 2024, thereby 'flattening' the profile.

In response to the October consultation, we criticised those proposals as inconsistent with BEIS' policy proposals – because they did not allow any material 'tolerance' – and premature, given that future policy remained to be confirmed. Policy had still not been confirmed when the present consultations issued. But rather than seek to understand the likely parameters of future policy and take them into account, Ofgem has instead swung to an opposite extreme – abandoning a profile based on policy goals in favour of proposing an allowance based on an extrapolation of a low historic average rollout performance.

If Ofgem were to proceed on this basis, it would have the perverse effect of driving convergence towards the low average, not support additional investment to drive the average up. Therefore, the profile Ofgem assumes effectively sets an upper limit on what can be achieved – which plainly falls well short of what is required to meet policy goals.

Since Ofgem's consultations were published, BEIS has concluded the consultation that was open at the time of Ofgem's previous SMNCC consultation, deciding to extend the current ARS obligation in the short term and confirming the policy target of achieving 100% (market wide, or universal) coverage by mid-2025. In particular, it seems clear that suppliers will be subjected to challenging individualised targets under the new rollout obligations that are intended to apply from June 2021. Ofgem also knows from suppliers' submissions that their smart rollout programmes are expensive and complex, and require long-term planning – it is simply impossible to quickly ramp up or down, and suppliers' financial situations do not allow them to run their programmes at a loss for any material period of time (even if funding is delivered later under clawback).

It is obvious that these circumstances, collectively, mean that Ofgem's proposal is redundant. This is confirmed by the attached legal opinion, which concludes that it would be unlawful for Ofgem to adopt its proposed rollout profile:

Ofgem cannot lawfully adopt its proposed rollout profile:

- Now that Government has decided suppliers will be subject to specific rollout targets from 30 June 2021, Ofgem cannot lawfully set the SMNCC without regard to the BEIS targets, or in a way that would not sufficiently fund efficient suppliers to meet their regulatory obligations. Ofgem's proposed approach is liable to require some suppliers to spend above the level of costs they are allowed to recover. The Legal Opinion notes that, where this is the case, those suppliers' rights under Article 1, first protocol in respect of property will be breached and yet Ofgem has provided no justification for why such an approach is proportionate.
- Ofgem has failed in its public law duty to consider the impact of its proposals on smart meter rollout and to seek to achieve the policy aims articulated by Government in respect of rollout. Its claims that the allowance will have no impact on rollout are based on flawed logic and lack any empirical assessment.
- Furthermore, Ofgem does not appear to have had regard to important factors such as the financeability implications for those individual suppliers who will not have their efficient costs covered – including, egregiously, where this outcome results from the supplier achieving greater performance than industry average.
- 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.

As we note in the main part of our submission, it is therefore clear that further consultation is urgently required before any decision about rollout profile can be made. A proper consideration of these issues will require a proper investigation of suppliers' financial positions and realistic rollout options. This will take time.

In the SMNCC consultation, Ofgem contemplates four contingency options for credit meters:

- using the original SMNCC model;
- freezing the SMNCC allowance at the cap period four level;
- setting the SMNCC allowance as proposed but without clawback; and
- setting the SMNCC allowance entirely as proposed.

However, <u>none of the contingency options Ofgem presents in the consultation can be lawfully implemented</u>.

Firstly, none of the contingency options which rely on the model put forward by Ofgem can be lawfully implemented because they all suffer from specific errors about costs and benefits which Ofgem will now be 'on notice' about and able to address. If Ofgem sets an allowance – regardless of whether or not this is a 'final' decision or a 'contingency' decision – it must do so in a way which represents Ofgem's best view of suppliers' actual efficient costs and benefits of smart metering.

In relation to the detailed modelling errors identified in our response, Ofgem has no discretion but to immediately reflect these. They do not require Ofgem to collect additional information which it does not currently have access to, nor do they require significant questions of judgement of the type which would normally require consultation. To deliberately leave unaddressed errors in any contingency decision would simply be to make an unlawful decision.

Secondly, in relation to the rollout profile (unlike quantification of costs and benefits, where Ofgem ought to be able to readily correct errors) the regulatory environment informing Ofgem's

proposals has profoundly changed. Ofgem's current contingency proposals do not (and could not have) properly reflected the 'hard targets' that it now knows will apply from 1 July 2021.

Furthermore, as explained in the Legal Opinion, Ofgem has failed to properly investigate or take into account fundamental issues relevant to the rollout profile, such as the impacts on rollout or the effects on financeability of suppliers. This requires Ofgem to properly engage with its statutory duties and to undertake a new decision-making exercise.

Ofgem therefore has no other choice but to implement an alternative form of contingency while is reconsults, which maintains the status quo in terms of rollout profile. No other decision can be safely made at this time. This will require Ofgem to continue the existing rollout trajectory, hitting 80% of installations at the end of 2020 as was originally envisaged, and holding installations at this level until it is in a position to make a lawful decision.

Ofgem must abandon historic clawback

Ofgem's proposed approach involves revisiting smart cost allowances derived using its previous SMNCC model, substituting them with the outputs of its updated model – reflecting higher unit costs but a markedly lower rollout profile, and treating the difference (if this assessment results in what Ofgem perceives as overfunding) as an 'advance' payment. It then proposes to reduce future allowances to below the level of efficient cost suggested by its model so as to remove the advance payment over future cap periods. For simplicity, we call this clawback.

This proposal is fundamentally misconceived. It is predicated on the notion that suppliers were allowed to recover over and above what was required to support efficient rollout and that there are unused funds that will support future installations. This is wrong. Centrica has fully used such funding efficiently on the smart programme. This is exactly what was intended and what Ofgem urged. We are confident such funding was used efficiently.

Accordingly, the clawback proposal ignores reality. It is seeking to recoup funds that do not exist. We have consistently expressed our opposition to clawback, emphasising that funds that have already been invested are, by definition, not available a second time to support future investment. Because those funds do not exist, if Ofgem reduces future allowances, the inevitable result is that Centrica will not be able to keep funding rollout at its current pace. If Ofgem considers that suppliers have not used their allowance efficiently, that is a separate question for Ofgem to investigate, rather than imposing a punitive approach across industry as a whole.

Even leaving these points aside, Ofgem's proposed approach fails to comply with the basic principle of legal certainty for the reasons set out in the attached legal opinion. The funding available for rollout informs the standard required by the ARS Obligation. But suppliers will have no reasonable basis on which to understand or estimate the amount they should efficiently spend to maintain compliance with the ARS Obligation, because they will not know until the end of any cap period how much they have *effectively* been allowed to recover by way of funding for that cap period. The attached legal opinion concludes that, in the context where suppliers are installing meters the cost of which will be recovered in future periods where the amount of the allowance is unknown, its proposal is so unreasonable that it would be found to be unlawful.

There is a further problem created by Ofgem's proposal for rolling annual review involving retrospective adjustment, even if in principle such adjustment could be in either direction. Ofgem's proposals in this regard deny the regulatory certainty suppliers require to plan and invest with confidence. While we accept that a further review will be required next year when recovery from lockdown can be assessed, Ofgem should not institutionalise perpetual retrospective review.

The combination of annual review and clawback means allowances are effectively determined retrospectively, which is not consistent with the intent of the TCA or practical certainty suppliers require to be able to plan and execute any policy mandate effectively and efficiently. Rolling review means no certainty beyond 12 months as to future allowances. And even that limited certainty is qualified by the prospect of retrospective adjustment determined by the aggregate outturn of other suppliers' performance (assuming Ofgem maintains its use of an average 'ARS' profile coupled with clawback).

The scope of review is also unclear, on one hand apparently precluding any further examination of modelled supplier benefits while at the same time potentially including perpetual review of the underlying smart element of opex - but with no additional opex to compensate. As discussed further at Annex B there is a continuing lack of transparency in Ofgem's revised view of smart costs embedded in its opex baseline. There is good reason to believe the smart element of opex is overstated, and in any event Ofgem cannot simply increase the share of the opex allowance that it attributes to smart cots without considering whether the level of non-smart opex it leaves for suppliers to fund their operations is reasonable.

This degree of uncertainty and retrospection is not acceptable from an operational standpoint and is completely at odds with Ofgem's original position in the November 2018 Decision. The legal opinion concludes that Ofgem is not in a position to lawfully depart from the commitments in the November 2018 Decision in this respect.

Ofgem's defence for applying clawback from 1 October 2019 is untenable

In the present consultation for credit SMNCC, Ofgem has modified its previous stance in relation to cap periods 1 and 2, acknowledging suppliers' legitimate expectation that such allowances were fixed and would not be subject to retrospective review.[8] We welcome the movement on periods 1 and 2 but reject Ofgem's suggestion that the issue falls away from 1 October 2019. This issue is addressed further in the accompanying legal opinion, but we note that – in overturning suppliers' legitimate expectations - Ofgem is required to act fairly and this includes in relation to transitional arrangements. Beginning clawback from 1 October 2019 is conspicuously unfair – Ofgem did not provide any unambiguous statement that parts of the smart allowance in any cap period would be treated as 'advanced' payments for the future until 22 October 2019 and Ofgem knows that suppliers' rollout programmes are expensive and complex undertakings, which require many months to adjust to such fundamental changes.

We have consistently emphasised the long planning lead times associated with scaling activity up or down. Uncertain indications as to what Ofgem 'might' do are of limited practical assistance, especially when there is no quantification provided – as was the case when Ofgem first mooted the concept of 'advance' (or 'lagged') payments. Moreover, Ofgem did not provide any reliable quantification even in the last substantive consultation – Ofgem's present proposals are materially different as regards both profile and unit cost. In these circumstances Ofgem cannot lawfully proceed with historic clawback.

Ofgem should recognise all relevant 'sunk' costs, and not just during lockdown

We welcome Ofgem's recognition that the current exceptional circumstances of Covid lockdown and social distancing restrictions need to be addressed since it is plainly not realistic to assume that deferred installations mean all associated costs are avoided

[8] SMNCC consultation at 3.20

We recognise that considerable uncertainty surrounds the exact timing and pace of restart and resultant 2020 outturn will be. Ofgem's working assumption that only 30% of average 2017-2019 installations will be achieved may be conservative, and we have wider concerns about Ofgem's use of an average profile. However, since an overly aggressive assumption may itself serve to frustrate restart by exacerbating short term funding constraints, it may be reasonable to err on the side of caution for the purpose of this exceptional adjustment.

Our principal concern with Ofgem's current proposals to adjust for Covid is that while they assume the majority of installation costs are 'sunk' they also assume that asset costs are entirely avoidable. This is not the case for BG due to the nature of our commercial arrangements with meter asset providers as set out further at Annex A.

Lack of procedural fairness

Finally, we note that the consultation is subject to a failure to meet the requirements of procedural fairness. Our consultants have been denied access to key input data that they require to properly understand and comment on Ofgem's approach. Our consultants have written to Ofgem to specifically request this data and explain why it is necessary to properly understand Ofgem's approach.[9]

The relevant data is (in large part) the information which Ofgem used to make assumptions about the underlying benefits to suppliers of installing smart meters. These assumptions are material – they form a very significant part of the total 'net cost' of a credit meter; and in relation to prepayment meters, Ofgem in fact considers that the benefits are so large that they outweigh the costs of migrating to smart meters.

Ofgem is already aware that making an assumption which does not reflect reality will render its decision unlawful.[10] Procedural fairness therefore requires that suppliers have a fair opportunity to understand the basis of these assumptions, including how they have been derived from supplier data, not simply glib assurances that they reflect suppliers' collective data.

Ofgem's explanation for failing to provide the data is that it only needs to disclose information necessary for suppliers '*to compare their own situation against these set values [i.e. the values in the model], and to provide representations as part of their consultation response where they consider that the values do not reflect their own experience*'. In particular, Ofgem refuses to disclose the requested information on the basis that:

> '*The purpose of providing information is not to allow all the figures used in the model to be subject to … QA audit, but to allow consultees generally to understand the approach we have taken and to allow relevant consultees to compare the input values to their own relevant figures.*'

This explanation is deeply concerning and Centrica rejects it:

- No positive reason has been advanced for why the material requested cannot be disclosed to consultants – all Ofgem states is that disclosure is not 'necessary' for the type of exercise it wants consultees to undertake. However, it is not for Ofgem to decide what feedback consultees offer. It is disturbing that Ofgem has decided that it is only willing to disclose information sufficient for a certain type of consultation response.

[9] Letter from Towerhouse LLP to Ofgem, 10 June 2020.
[10] R (British Gas Trading Limited) v Gas and Electricity Markets Authority [2019] EWHC 3048 (Admin).

- It is not sufficient for each supplier to individually compare their own observed benefits against the benefit assumed in the model but only Ofgem will determine how supplier data collectively is reflected in the model. As a matter of principle, we consider it is wrong for Ofgem to 'decide' for consultees' consultants that they can have nothing useful to say about any other supplier's data. And as a matter of reality, Ofgem is wrong. Having access to the full data set is necessary to identify, for example:

    - Calculation errors in how suppliers' data has been processed.
    - The identification of outliers that may be skewing the results, or indeed any other reasons to believe that the data is unreliable (for example, if it suggests that benefit data across different suppliers might be being reported by suppliers on an inconsistent basis). Ofgem's answer is that outliers should be included and that each supplier can report issues with its own data. But Ofgem knows this is not the reality. Not all suppliers will view or comment on their own underlying data – Ofgem's confidentiality restrictions mean there is a high barrier to engagement with the underlying data, including the need to engage third party consultants – yet all suppliers will be affected by errors. In any event, Ofgem has rejected representations made by a single supplier about a cost/benefit unless the point has been made more broadly.[11] Furthermore, many forms of unreliability or error (for example, supplier data not being directly comparable) may only be ascertainable by seeing the whole data set.
    - Whether the calculations undertaken are the ones expected based on the description in the consultation document. Ofgem states that consultees can point to any lack of clarity in their consultation responses. We assume that Ofgem is suggesting it will then provide the required clarity in its decision. This is an unacceptable answer because, at that stage when Ofgem finally provides clarification, it will be too late for consultees to provide feedback. Ofgem's responsibility is to provide a clear explanation of its proposals *now*, by disclosing its actual use of data. The consultation materials (including the parts Ofgem refers to) rarely explain in any detail its approach to combining supplier data. The underlying data is necessary to understand what Ofgem has done.
    - Whether the Lower Quartile estimation of attributed cost savings for each of the benefit calculations is appropriate, given the inconsistency between the basis of the calculation of the 2017 opex baseline (where Lower Quartile cost estimates have been used) and the benefit calculations (where averages have been used). While we can make arguments about Ofgem's policy position in the abstract, it is only with access to the underlying data that we can make specific submissions about any errors or concerns with Ofgem's proposals.
    - Ofgem's approach is self-contradictory. Ofgem has accepted that 'In order for stakeholders to understand our proposals in detail, we must disclose the models and data that underpin our proposals' and that this 'includes underlying data that we have used to calculate inputs in the SMNCC model'.[12] Pursuant to this, Ofgem has disclosed the data Ofgem used to make assumptions about the underlying *costs* to suppliers. There is no rational basis on which Ofgem can recognise the need to disclose data about underlying *costs* but refuse to disclose data about underlying

[11] As just one example, in the technical annex to the SMNCC consultation paper, para 3.79, Ofgem disregards one supplier's observation that its meter purchase costs were higher than assumed, without referring to having undertaken any other assessment: '*One supplier said that its meter purchase costs were higher than the meter costs assumed in the October 2019 consultation model. Meter asset costs vary to some extent between suppliers. A particular supplier will not know its competitors' costs. There will be some degree of variation around the average – this does not indicate a problem*.'

[12] Ofgem, Disclosure Arrangements for May 2020 consultations on the default tariff cap (21 April 2020).

benefits. This error is especially egregious and indefensible in relation to prepayment meters, since the benefits Ofgem assumes (where data has not been disclosed) significantly outweigh the costs Ofgem assumes (where data has been more comprehensively disclosed).

- Ofgem is aware – and has acknowledged – that it corrected errors in Ofgem's October 2019 SMNCC model previously. Those errors were identified by suppliers' consultants and could only have been identified with the type of input data we have requested to review.[13] Therefore, Ofgem knows the submissions Centrica could make may result in correcting serious defects in Ofgem's modelling and proposals. Ofgem's only answer to this is that *the current* calculations are 'less likely to be subject to error'[14] (and we are therefore to 'trust' that its approach is without error). This seems to suggest Ofgem considers consultation in this respect to have little value, which cannot be correct.

Scrutinising the inputs and assumptions into the model is important and valuable to minimise the scope for errors whose impact could be significant in terms of future funding for the programme. This is not an academic exercise: even small errors may have an outsized impact on the amount of the allowance, which in turn will have a profound impact on the workforce that the smart rollout supports, and the ability of suppliers to deliver the benefits of smart metering to consumers. The legislation directs Ofgem to treat smart metering as important for delivering an effectively competitive market. Any error could undermine achievement of this outcome.

There is extensive case law demonstrating that a failure to disclose information on which assumptions are based is a failure of procedural fairness.[15]

We wrote to Ofgem ahead of the consultation deadline in order that this deficiency could be addressed. It is therefore disappointing that Ofgem is frustrating the opportunity for stakeholders to engage and improve the quality of Ofgem's final proposals. We maintain our position that Ofgem has failed to comply with the requirements for a lawful consultation. We therefore reserve our rights and are reviewing our legal options.

If Ofgem is prepared to change course, we would of course welcome the opportunity for our consultants to review and comment on the requested data, and would be prepared to do everything reasonable to facilitate this review without adversely impacting Ofgem's intended timeframe for a decision.

[13] Specifically: (i) Ofgem's attempt to calculate a previous 'carry forward' adjustment was compromised by mathematical flaws which seriously misstated the result; and (ii) Ofgem made adjustments to the BEIS CBA model to detail what SMETS1 PRC costs suppliers actually incur but not all of those adjustments actually fed into the final result – SMETS1 PRC asset costs were ignored.

[14] Ofgem letter to Towerhouse LLP, 23 June 2020, para 6.

[15] See, eg, *BDC v GDC* [2014] EWHC 4311 (Admin) (in relation to dentists retention fees increasing due to a higher number of fitness to practice hearings, the court found that 'it was difficult to see how consultees could express an intelligent view on the proposed increases in the … fee unless they had some idea of what information the very substantial projected increase in fitness to practise hearings was based on').