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26 June 2020

Dear Anna

We are writing in response to your statutory consultations on reassessing the wholesale allowance in the first default cap period, on reviewing smart meter costs in the default tariff cap, and on protecting consumers with prepayment meters.

We provide a bundled response to reduce duplication as some of the content of the consultations, and our views on those matters, overlap (for example, in relation to the annual review of smart meter costs).

This submission is entirely non-confidential and may be published on your website.

Statutory consultation on reassessing the wholesale allowance in the first default cap period

We recognise that you are left with no choice but to reassess the wholesale allowance for the first default cap period given the result of the judicial review, but think that there are several areas where your proposals would merit amendment.

Netting off for overpayment in the second default cap period

You highlight that you are not constrained to considering the impact of the transition problem to the first price cap period and that its impact on subsequent price cap periods are relevant.[1] Your analysis suggests that while the wholesale allowance was too small in the first price cap period, it was too large in the second:

> *'For the second cap period [...] On average the impact is about £2 per dual fuel customer... We are prepared to exclude suppliers' benefits in the second cap period, on the grounds that the impact is minor.'*

While smaller than the underpayment in the first cap period, it is of the same order of magnitude. We think it would be perverse not to net the two figures off against each other. Failure to do so would appear likely to simply replace a windfall loss with a windfall gain and would not be in consumers' best interests.

Rationale for only considering the wholesale strategies of the Big 6

[1] Eg paragraphs 3.46, 3.51 of the consultation document.

We find the arguments for excluding Bulb from the calculation of the wholesale allowance unconvincing. You note that:

> ‘unlike the other large suppliers, it did not attempt to align its hedging strategy with the observation window in the wholesale allowance. Nor did it attempt to manage its hedging strategy in a similar way to the six large suppliers before we introduced the cap. On that basis, we do not need to consider how much the transition problem (its historical hedging strategies before May 2018) constrained Bulb’s ability to align with the observation windows. Bulb chooses not to align.’

In our view this does not demonstrate the need to exclude Bulb so much as it undermines the case for making any correction whatsoever. The key point it illustrates is that the price cap is not prescriptive of how suppliers hedge. They may choose to try and match the hedge implied by the cap to minimise risk, but that is their commercial choice - they are not obligated to do so. Alternative hedging strategies may be more or less profitable. While Bulb may have a different commercial strategy than the other large suppliers this does not make its costs any less relevant. There is a risk that its exclusion will result in an inappropriate ‘cherry-picking’ of reference suppliers, though the materiality of this remains unclear. The Act requires you to set a single cap for all suppliers.

We are more comfortable with the exclusion of smaller suppliers on proportionality grounds. The small number of default tariff accounts elsewhere is unlikely to materially shift any calculation of the wholesale allowance and we recognise there may be a significant burden associated with data collection and analysis.

Correcting based on current customers, not historic ones

Suppliers will have lost and gained customers since the first cap period and we agree that it would not be possible to apply the correction to exactly the same consumers. We further agree that the correction should be applied on a per customer basis, not on a collective basis. This may mean that suppliers recover a smaller amount than the shortfall in the first cap period, as there are now fewer customers on default tariffs. But we agree with you that it would not be appropriate to charge those customers more as an uplift in period 5 than the amount they were considered to have been undercharged in period 1. To do so would mean that default tariff customers were effectively penalised as the result of the correction, which would (in our view) be incompatible with your statutory duties to protect them.

Patron HRH The Princess Royal **Chief Executive Gillian Guy**
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Statutory consultation on reviewing smart meter costs in the default tariff cap

We broadly support your proposals.

It is appropriate to update the non-pass-through Smart Metering Net Cost Change ('SMNCC') allowance to reflect the improvement in understanding of smart metering rollout costs allowed for by the updated cost benefit analysis produced by BEIS in 2019. An expectation that you would do so was clearly established by your November 2018 decision and your April and October 2019 consultations.

It is also entirely appropriate for Ofgem to make adjustments in future price cap periods to reflect where the actual level of smart meters installed deviates materially from that forecast. Because of this we support your moves both to adjust future price caps to reflect the current and future impact of the pandemic, of any continued shortfall of smart meter rollout against its forecast trajectory, and to clawback past monies allowed for the installation of smart meters that have not been delivered.

Adjustment for current and possible future under-delivery

As the consultation highlights, the number of smart meters installed has consistently lagged the assumptions underlying the national rollout. This has created an asymmetric risk to consumers in that aspect of how the price cap is set, in that it has allowed for suppliers to recover costs based on an assumption that far more smart meters have been installed than is actually the case.

Your proposal to annually review and update the SMNCC allowance to reflect actual rollout figures rather than long term forecasts should mitigate this risk that consumers overpay due to forecasting error. These risks are particularly acute at the present moment in time due to the uncertainty caused by the pandemic. While its impacts on smart rollout may most obviously be seen in the suspension of or disruption to smart installation work by some suppliers, there may also be significant impacts we are yet to understand the scale of, for example the potential for impacts on site access (for example, whether consumers may be more reluctant to allow installers access due to health fears).

Your proposal to assume that the number of smart meters installed in 2020 will be 30% of the average annual number installed in 2017-19 appears a reasonable one to us in view of the current uncertainties, with the annual reviews you propose providing a means to adjust in a future price cap period if that estimate should prove to be a material under or over estimate.

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Your proposal to treat 93% of the installation costs that would have been incurred had the number of smart meters installed in 2020 accorded with the 2017-19 average as sunk costs appears extremely generous to us. Most of these costs appear to relate to labour in one form or another, and, as you acknowledge, in many cases these staff may have been furloughed (in which case, the bulk of their wages during the furlough period will have been paid by the state, not by the supplier). You note in paragraph 4.56 that you may consider making a retrospective adjustment in future cap periods to account for any inaccuracy in your sunk cost assumptions. We note that these costs are material - £14.18 for the notionally average dual fuel consumer - and we consider that there is likely to be a strong case for your needing to do so.

Adjustment for historic under-delivery

We agree that you should adjust the allowance in future periods to clawback monies that suppliers were allowed in earlier periods for the installation of smart meters that were not delivered. This is clearly appropriate in order to prevent consumers paying for a service they did not receive.

In principle, we see no reason why this should not extend back to the introduction of the price cap in January 2019. We note that you are only proposing to do so for the period since October 2019, reflecting that you first clearly signalled the prospect of clawback in your April 2019 consultation. The implication is that suppliers had a reasonable expectation of an adjustment along the lines you are proposing from that date, but not before. We think it is regrettable that overpayment in the first 9 months of the cap cannot be clawed back, but recognise that your hands may be tied given that lack of reasonable expectation and the legal risks that acting without it may present. We think that suppliers should be mindful that they have received a windfall in funding for that period when considering the overall balance of this package of proposals.

ECO funding

You highlight that suppliers being funded for work they have not delivered is not constrained to the rollout of smart metering but also impacts the Energy Company Obligation ('ECO'), but the materiality of this is unclear. We would welcome Ofgem publishing further information to allow this issue to be better understood.

Statutory consultation on protecting energy consumers with prepayment meters

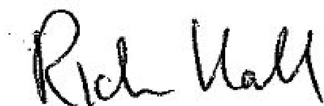
We strongly support your proposal to introduce a Smart Metering Net Cost Change ('SMNCC') allowance for prepay consumers, reflecting the reductions in the cost to serve those consumers that are driven by the rollout of smart metering. It is right that consumers should see these efficiency improvements reflected in their bills.

Because of those benefits, and because of the significant operational inefficiencies that appear likely were there to be two separate three month price caps this winter (one for October to December, and the other for January for March), we support transitioning to this new methodology with effect from the start of the next price cap period, on 1 October. While the motivation for the change is driven by cost reflectivity, there are significant social benefits in trying to get this change in place for the winter months. Energy consumption will be higher in that period and affordability is likely to be particularly challenging for many households given the probability that the pandemic will result in a recession and significant job losses.

We note that if you are unable to introduce your proposals in time for the next price cap period you would seek to claw back any detriment experienced by consumers because of the delay in a subsequent price cap period. We would support such action, though we think it is clearly preferable to avoid a delay in passing through these benefits to consumers.

We also strongly support your proposal to review the smart allowance on an annual basis going forward. There are significant uncertainties on the shape and pace of the ongoing rollout of smart metering, considerably aggravated by the ongoing pandemic. We set out our reasons for supporting an annual review of smart costs in more detail in the preceding section of this letter ('Statutory consultation on reviewing smart meter costs in the default tariff cap'), so do not comment further here in order to avoid unnecessary duplication.

Yours sincerely



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