Decision

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Price Cap – August 2022 decision on credit and PPM SMNCC allowances

Subject	Details
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This document sets out our decisions for updating the smart metering allowances (the Smart Metering Net Cost Change or SMNCC allowances) for credit meters and prepayment meters (PPM) in the default tariff cap in time for winter 2022.

We have carefully considered all responses to our consultation. We have published non-confidential responses alongside this decision.

Contents

Executive summary

The default tariff cap ('cap') protects domestic customers on default tariffs. We conduct annual reviews of the Smart Metering Net Cost Change (SMNCC) allowances in the cap for credit meters and prepayment meters (PPM). These allowances reflect the change in smart metering costs since 2017. In the current cap period (April 2022 – September 2022) the SMNCC allowances accounted for around 1 percent of the overall default tariff cap value for standard credit customers.

We update all future values of the cap when we conclude an annual review (except when we adopt a contingency allowance). These are the final SMNCC allowances for cap period nine (October 2022 – March 2023) and cap period ten (April 2023 – September 2023). Quarterly updates to the price cap would not affect the update frequency of SMNCC allowances. Only certain price cap components, such as wholesale costs, will be updated via additional interim updates in July and January.

We proposed a relatively modest set of changes and updates as part of this 2022 Annual Review. This reflects that our approach to modelling the change in smart metering costs is mature, following extensive engagement with industry since we first set out our SMNCC allowance. Given this maturity, changes to our methodology are likely to generate increasingly smaller gains in accuracy at the expense of increased complexity. As a result, in a few instances where changes would be disproportionately complex to make and would result in relatively minor effects on the end result, we did not propose that they were made. Summaries of the updates and changes we have decided to make are given in the sections below.

Changed positions from May 2022 consultation

The Gross Domestic Product (GDP) deflator is the measure of price inflation used in the SMNCC model to convert real to nominal values (and vice versa). A significant focus of responses to the May 2022 consultation concerned our proposal to continue using the GDP deflator. Respondents advocated a change in inflation measures, towards a measure based on consumer prices, such as CPIH, reflecting concerns that the GDP deflator was too wide a measure of inflation and was impacted by pandemic related measurement issues.

We have decided to continue using the GDP deflator. This reflects our judgement that any pandemic related measurement issues in 2020 and 2021 are at least partially offsetting, that the gains in accuracy from moving to a narrower consumer prices measure are

uncertain and that the GDP deflator remains a quality assured and widely used measure of inflation.

Respondents also advocated that, if we were to continue using the GDP deflator, we should use more up-to-date estimates and forecasts. To date, estimates and forecasts of the GDP deflator have been sourced from the HM Treasury (HMT) Green Book supplementary guidance. This is a secondary source drawing on Office for National Statistics (ONS) and Office for Budget Responsibility (OBR) publications. It is updated irregularly and will not always contain the most recent estimates and forecasts.

In line with stakeholder feedback, we have decided to change our approach to updating the GDP deflator series. We will now ensure that the GDP deflator values used are taken from the most recent ONS estimates and OBR forecasts.

Unchanged positions from May 2022 consultation

With the exception of the change to the source of GDP deflator values, we have decided to maintain all other May 2022 consultation proposals.

COVID-19 and installation costs

COVID-19 affected suppliers' ability to install smart meters which resulted in them incurring costs which did not result in installations (sunk installation costs). We included an estimate of sunk installation costs for 2020 and 2021 in our August 2021 decisions. We have now been able to gather data on installation costs in 2021, including sunk installation costs.

We have decided to update our 2021 estimates of sunk installation costs using an average of values from two methods, in line with our approach to 2020. We have also decided not to include sunk installation costs for the years beyond 2021, reflecting our expectations that the impact of COVID-19 on sunk installation costs beyond 2021 is likely to be small.

Setting the rollout profile

In our May 2022 consultation, we considered the impact of the Supplier of Last Resort (SoLR) process on the smart meter rollout for those suppliers who took on SoLR customers. We concluded from relevant supplier data, related to the market leader rollout profile we use for credit, that the SoLR process reduced their smart meter rollout by less than one percentage point at the end of 2021. We have therefore decided not to make an

adjustment for SoLR impacts at this stage as doing so would be disproportionate given the low impact on rollout and complexity of implementing the adjustment.

We also considered whether to update the fuel-specific rollout adjustments from our August 2021 decisions. These adjustments, based on historical data from large suppliers, are used to generate separate rollout profiles for each fuel type. Calculating the impact of updating these adjustments with 2021 data showed it had an immaterial impact. We have therefore decided to maintain the existing fuel-specific rollout adjustments.

Updating general economic inputs

We propose to update several inputs into the SMNCC model so that they are more reflective of recent data. Beyond using the GDP deflator, we have also decided to update the headline rate of corporation tax used as part of the cost of capital estimate to reflect a planned increase. While there is now some uncertainty about the level of corporation tax going forward, on the day of this document's publication the rise remains legislated for. Given this, we have decided to use a corporation tax rate of 20%. This has been calculated as the average rate of corporation tax weighted by the modelled profile of smart meter installations between 2012 (the start of the smart meter rollout) and 2023. We have also decided to update the Long-Run Variable Cost (LRVC) of energy estimates using the latest 'central' estimates. The LRVC estimates are used in the calculation of debt management benefits.

Other areas

We have decided to introduce a 35% positive uplift adjustment to the modelled costs of traditional PPM electricity meters, so they better align with measured costs. We have also decided to maintain our qualitative assessment of model uncertainty and will not be making any numerical uncertainty adjustment.

SMNCC values

For cap period nine, we propose to set the non-pass-through (NPT) credit SMNCC at £9.37 per typical dual fuel customer and the NPT PPM SMNCC at -£28.69 per typical dual fuel customer (before PPM offset). For cap period ten, we propose to set the NPT credit SMNCC at £9.67 per typical dual fuel customer and the NPT PPM SMNCC at -£32.58 per typical dual fuel customer (before PPM offset). Appendices 1 and 2 show the values we will use when calculating the cap for individual fuels as well as the values for cap period eleven.

Compared with the equivalent values published in February 2022 this represents a £1.35 increase in the dual fuel NPT credit SMNCC allowance for cap period nine and a £1.65 increase for cap period ten. For the dual fuel NPT PPM SMNCC allowance (before PPM offset) these decisions represent a £6.69 reduction for cap period nine and a £7.34 reduction for cap period ten.

After applying the expected PPM offset value the dual fuel NPT PPM SMNCC allowance is -£12.85 in cap period nine, a reduction of £3.29 compared to if there had been no change to the cap nine NPT values published in February 2022.

1. Introduction

Subject of this decision

1.1. The default tariff cap ('cap') protects approximately 24 million domestic customers on standard variable and default tariffs (which we refer to collectively as 'default tariffs'), ensuring that they pay a fair price for their energy, reflecting its underlying costs. The cap is one of the key activities which falls within the 'Future of Retail' strategic change programme as set out in our Forward Work Programme for 2022-23.[1] We set the cap by considering the different costs suppliers face. The cap is made up of a number of allowances which reflect these different costs.

1.2. One cost to suppliers is the net cost of installing and operating smart meters. We reflect this in the cap through two allowances. The operating cost allowance includes the cost of smart metering in the 2017 baseline year (alongside other operating costs).[2] The Smart Metering Net Cost Change (SMNCC) allowance reflects the change in smart metering costs since 2017.

1.3. The SMNCC allowance comprises a 'pass-through' element covering industry charges relating to smart metering and a 'non-pass-through' element covering suppliers' smart metering costs.

- We currently update the pass-through element as part of the six-monthly cap updates in October and April. Updates to this element will not form part of the newly introduced interim (quarterly) cap updates in July and January. This pass-through element is not the focus of this consultation.

- We use a forward-looking modelled approach to set the non-pass-through element for future cap periods. **This decision focuses on the non-pass-through SMNCC allowances** (which we refer to as 'the SMNCC' for the remainder of this document).

[1] Ofgem (2022), Forward work programme 2022/23. https://www.ofgem.gov.uk/publications/202223-ofgem-forward-work-programme
[2] We index this allowance with inflation as part of the six-monthly cap update.

1.4. Changes to the SMNCC affect the amount suppliers can charge their default tariff customers under the cap, and therefore are highly likely to affect the amount these customers pay through their energy bills. However, while the value of the SMNCC contributes to the level of the cap, other cost changes (especially to wholesale costs) are significantly larger than changes to the SMNCC and have a greater impact on the cap level.

Scope of this decision and our decision-making process

Annual Reviews

1.5. We set the SMNCC allowances in the cap for the duration of the cap.

1.6. To date we have reviewed the SMNCC annually and updated all future values of the cap when we conclude an Annual Review.[3,4] This decision document provides the final SMNCC allowances for cap periods nine and ten. The SMNCC allowances for the remaining cap period (ie cap period eleven) could be subject to revision through a subsequent Annual Review.

1.7. Table 1.1 below provides a simplified illustration of the current Annual Review process.

[3] When we are unable to conclude our Annual Review and have to set a contingency allowance, we only update the SMNCC for the next cap period.
[4] We normally announce the conclusions of our review ahead of our August cap announcement.

Table 1.1: Simplified illustration of Annual Review process

<table>
<tr><th></th><th>Annual review Y</th><th>Annual review Y+1</th><th>Annual review Y+2</th></tr>
<tr><td>Cap period X</td><td rowspan="2">Annual review sets final SMNCC for these cap periods</td><td rowspan="2">N/A (historical cap period)</td><td rowspan="3">N/A (historical cap period)</td></tr>
<tr><td>Cap period X+1</td></tr>
<tr><td>Cap period X+2</td><td rowspan="4">Annual review updates SMNCC for these cap periods (but subject to later Annual Review)</td><td rowspan="2">Annual review sets final SMNCC for these cap periods</td></tr>
<tr><td>Cap period X+3</td></tr>
<tr><td>Cap period X+4</td><td rowspan="2">Annual review updates SMNCC for these cap periods (but subject to later Annual Review)</td><td rowspan="2">Annual review sets final SMNCC for these cap periods</td></tr>
<tr><td>Cap period X+5</td></tr>
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1.8. As the consultation on changes to wholesale methodology made clear, only some components of the price cap would be updated more regularly under a quarterly approach with SMNCC not being one of those components.[5] As such, the move to quarterly cap updates does not impact our ability to maintain the same Annual Review process should we chose to do so.

Consultation stages and process to date

1.9. In October 2021, we published a working paper ('SMNCC WP5') setting out the intended scope of the 2022 Annual Review. In that document we emphasised our intention to not carry out future Annual Reviews (including the 2022 Annual Review) with the same level of detail as our May 2020 credit consultation, as we considered that this would be disproportionate.[6,7]

[5] Ofgem (2022), "Price cap - Statutory consultation on changes to the wholesale methodology", table 3.2 page 25: https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology
[6] Ofgem (2022), Working paper on 2022 annual review of SMNCC allowances, paragraph 27: https://www.ofgem.gov.uk/publications/price-cap-working-paper-2022-annual-review-smncc-allowances
[7] Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraph 5.39: https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-

1.10. In May 2022 we published a consultation on the SMNCC allowances, covering both credit and prepayment meters (PPM). The consultation was part of our 2022 Annual Review, and it closed on the 2nd of June 2022. The consultation set out a relatively modest set of changes and updates to the SMNCC model. Four suppliers and one individual submitted feedback in response to the consultation.

Scope of the decision

1.11. This is our decision for the May 2022 consultation (the final consultation of the 2022 Annual Review). [8] It sets the SMNCC allowance for cap periods nine and ten. We have also set SMNCC allowances for cap period eleven. However, we retain the ability to update the allowance for cap period eleven as part of a possible future annual review.

Future decisions

1.12. We consider our approach to calculating the SMNCC allowances to be mature, having been subject to consistent refinement since we first set the SMNCC allowances. Given this maturity, changes to our methodology are likely to generate increasingly smaller gains in accuracy at the expense of increased complexity.

1.13. The scope for annual reviews, of the kind carried out to date, to improve the accuracy of SMNCC calculations has diminished. Therefore, we will be considering alternative approaches to updating the SMNCC allowances for future cap periods (ie cap period eleven and beyond).

1.14. Any changes to our review processes will be subject to an open consultation.

default-tariff-cap

[6] Ofgem (2022), Consultation on credit and PPM SMNCC allowances: https://www.ofgem.gov.uk/publications/price-cap-may-2022-consultation-credit-and-ppm-smncc-allowances

Approach to considering impacts

1.15. Although not specifically required to by the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act'), as part of our 2018 decision we conducted an extensive Impact Assessment (IA). This included an equalities assessment.[9] We have since continued to consider the impact of our decisions on customers and suppliers. When considering the impact on customers, we have paid particular attention to the impact on customers in vulnerable situations. By doing so, we have taken into account the impact on protected groups where customers are more likely than average to be in vulnerable situations.

1.16. The value of the SMNCC contributes to the level of the cap and differs between energy and payment types, and therefore could have equalities impacts. The change in the SMNCC allowance is small in comparison to other components of the cap and beneficial to some customers (see below). Changes in other components, like wholesale prices, will therefore dominate the overall impact on both suppliers and customers.

1.17. It is currently the case that the SMNCC allowance for PPM customers is lower than for credit or direct debit customers. On a dual fuel basis the overall PPM SMNCC allowance for the upcoming cap period is in fact negative, reducing customer bills. As there can often be a correlation between PPM and vulnerable customers, our approach to calculating changes in smart metering costs currently helps protect a potentially more vulnerable customer group.

What are our decisions?

COVID-19 and installation costs summary

1.18. We have decided to update the 2021 sunk and productive installation costs estimates using an average of two methods. We will also not include any sunk costs estimates in years beyond 2021, reflecting the easing of pandemic restrictions. These decisions are unchanged from our consultation proposals.

[9] Ofgem (2018), Default Tariff Cap: Decision. Appendix 11 – Final Impact Assessment. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview

Rollout

1.19. We have decided not to account for the impact of the Supplier of Last Resort (SoLR) on the smart meter rollout due to limited materiality and a disproportionate increase in complexity that would arise from trying to do so.

1.20. We have decided not to update the fuel-specific rollout adjustments from our August 2021 decisions, again due to an immaterial impact.

1.21. Both decisions are unchanged from the consultation.

Updating general economic inputs

1.22. Despite stakeholder feedback advocating for a move to CPIH, we have decided to maintain the GDP deflator as the measure of price inflation in the SMNCC models. This reflects our assessment that any accuracy gains from moving to an inflation measure based on consumer prices are uncertain and that the GDP deflator remains a widely used and quality assured measure of changes in prices.

1.23. However, reflecting stakeholder responses, we have decided to depart from the consultation proposal to update the GDP deflator values using a secondary source. We will now, and going forwards, source GDP deflator values from the most recent Office for National Statistics (ONS) estimates and Office for Budget Responsibility (OBR) forecasts.

1.24. In line with our consultation proposals, we have decided to update the headline rate of corporation tax used in the SMNCC model to a weighted average value of 20%, reflecting planned rises. While there is now some uncertainty about the level of corporation tax going forward, on the day of this document's publication the rise remains legislated for. We have also decided to update the Long-Run Variable Cost (LRVC) of energy estimates using the latest available "central" values.

Other areas

1.25. In line with our consultation proposal, we have decided to introduce a 35% uplift adjustment to the modelled costs of traditional PPM electricity meters, so they better align with measured costs.

1.26. We have decided to maintain our qualitative assessment of model uncertainty provided in the May 2022 consultation document and will not make any numerical uncertainty adjustment.

2. Changed positions: May 2022 consultation

Section summary

This chapter sets out our decisions where, following a review of stakeholder responses, we have decided to alter our initial proposal as set out in our May 2022 consultation.

Summary

2.1. The overwhelming majority of comments received from stakeholders in response to the May 2022 consultation focused on our proposal to continuing using the GDP deflator as our measure of price inflation and the proposed approach to updating the series to reflect more recent data.

GDP deflator

Context

2.2. The GDP deflator is the measure of price inflation used in the SMNCC model to convert real to nominal figures (and vice versa). The GDP deflator values currently used in the SMNCC model are taken from the HM Treasury (HMT) Green Book supplementary guidance as published on 11 April 2019.[10]

2.3. On 15 July 2021 the HMT Green Book supplementary guidance was updated, including the GDP deflator values included in the associated data tables.[11] This newer data reflects the Office for National Statistics (ONS) estimates of the GDP deflator up to 2020 as published alongside the first estimate of Q4 2020 GDP and

[10] Green Book supplementary guidance: valuation of energy use and greenhouse gas emissions for appraisal. Table 19 of: https://web.archive.org/web/20200522003020/https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/793632/data-tables-1-19.xlsx

[11] Green Book supplementary guidance: valuation of energy use and greenhouse gas emissions for appraisal. Table 19 of: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1024043/data-tables-1-19.xlsx

the Office for Budget responsibility (OBR) forecasts of the GDP deflator published in its March 2021 Economic and fiscal outlook.[12,13]

2.4. In the May 2022 consultation, we proposed to maintain the GDP deflator as our measure of price inflation but to update the values to those published in the latest version of the HMT Green Book supplementary guidance.[14]

Decision

2.5. We have decided to keep the GDP deflator as our measure of inflation within the SMNCC model.

2.6. We have decided to change our approach to updating the GDP deflator. We have decided to use the most recent quarterly national account data published by the ONS[15] and most recent forecasts published by the OBR[16] to update the GDP deflator rather than use the latest version of the HMT Green Book supplementary guidance. This is a change in our proposal following stakeholder responses.

Overview of responses

2.7. We received responses from two suppliers, one supported by economic advisers, and one industry body which disagreed with both our use of the GDP deflator and our approach to updating the GDP deflator values. Their responses focused on three areas:

[12]ONS GDP first quarterly estimate Q4 2020: https://www.ons.gov.uk/file?uri=%2feconomy%2fgrossdomesticproductgdp%2fdatasets%2fuksecondestimateofgdpdatatables%2fquarter4octtodec2020firstestimate/firstquarterlyestimateofgdpdatatables.xls
[13] OBR March 2021 Economic and Fiscal Outlook: Economy supplementary tables. Table 1.7: https://obr.uk/download/march-2021-economic-and-fiscal-outlook-supplementary-economy-tables/
[14] Ofgem (2022), May 2022 consultation on credit and PPM SMNCC allowances, paragraph 5.4: https://www.ofgem.gov.uk/publications/price-cap-may-2022-consultation-credit-and-ppm-smncc-allowances
[15] ONS, "Gross Domestic Product at market prices: Implied deflator", "GDP quarterly national accounts time series (QNA)" dataset, Series ID MNF2: https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/mnf2/qna
[16] We will make use of the most recent OBR Economic and fiscal outlook publication that is available in the month prior to the publication of an SMNCC decision.

- the reliability of the GDP deflator as an accurate measure of inflation in recent years.

- the preferability of using a consumer prices inflation measure such as CPIH, when adjusting prices within the SMNCC model.

- the timeliness of the publication we proposed to source GDP deflator values from.

Considerations

Reliability

2.8. Stakeholders highlighted issues regarding the impact of the pandemic on the reliability of the ONS measurement of government output and therefore the GDP deflator, particularly in 2020 and 2021.

2.9. A supplier and their economic advisers described the reduced reliability of the GDP deflator as meaning it was "no longer fit for purpose as a measure of inflation within the SMNCC model".

2.10. In addition, one economic adviser noted that during the pandemic period the difference between the initial and first final quarterly GDP deflator estimates have been more extensive compared to differences in estimates from previous periods and that the 2020 and 2021 deflator values would likely be subject to "significant ongoing revisions". In comparison it was noted that consumer price inflation measures like CPIH, are much less likely to be revised due to the way they are calculated.

2.11. In the May 2022 consultation document, we acknowledged and discussed the measurement difficulties the pandemic had caused. We noted that the measurement errors in 2020 and 2021 were likely to be at least partially offsetting.

2.12. Furthermore, we do not expect the GDP deflator estimates used in the SMNCC model to be subject to the same level of revisions as those identified in the economic adviser's response. Firstly, the SMNCC model uses annual measures of the price level, not quarterly measures, and annual estimates tend to be subject to smaller revisions than quarterly estimates. Secondly, we have decided to use the

latest quarterly national account GDP deflator estimates which tend to be subject to smaller revisions than the initial estimates used for comparison in the adviser's report.

2.13. While it is still the case that by their construction consumer price measures, such as CPIH, are revised less often and less significantly they nonetheless also contain uncertainty and are also subject to measurement issues, such a substitution effects and product quality changes. For these reasons we do not consider that any reliability advantages of measures based only on market prices over the GDP deflator are sufficiently clear cut or obviously large enough to motivate a change in the inflation measure used in the SMNCC model.

Market-based price inflation measures

2.14. In addition to reliability concerns, the suppliers who responded also argued that the GDP deflator is an inappropriate measure to adjust the prices of the goods and services which appear in the SMNCC model. One economic adviser highlighted that the GDP deflator is a very broad measure of inflation which tracks the prices of all domestically produced goods and services (as well as other actual and implied prices), a significant proportion of which may not be relevant to the smart meter rollout.

2.15. The same economic adviser also argued that the choice of the GDP deflator was not motivated by its relevance or suitability but that it is instead an artefact of the SMNCC model's origins in a cost-benefit analysis for the smart meter rollout. The adviser argues that, while the GDP deflator may be appropriate for cost-benefit style analyses, where the focus is on whole economy net impacts, it is less suitable when the model is more narrowly concerned with cost of the smart meter rollout to suppliers.

2.16. The responding suppliers, the industry body and the economic advisrs all conclude that, given these issues, a measure of inflation such as CPIH would be preferable. Such measures estimate inflation by surveying the prices of goods and services sold in markets and, in contrast to the GDP deflator, do not include elements such as the implied change in price of government outputs or the price of UK exports, etc. For these reasons respondents argued that such a solely market-based measure may more closely correspond to the prices faced by suppliers and households and that

such a measure would not be subject to the same pandemic induced reliability issues the GDP deflator faces.

2.17. On top of arguing that a solely market-based measure of inflation would be preferrable, respondents also argued that CPIH specifically would be the preferred choice amongst such measures. This is because CPIH is already used within the Price Cap methodology, for example in adjusting operating costs. Ofgem also uses CPIH in the RIIO-2 price controls.

2.18. Ultimately, as noted by one respondent, in an ideal world we would be able to construct a bespoke price index that accurately tracks the prices of only the set of goods and services we are adjusting for in the SMNCC model. Given this, we consider the appropriate question to be whether the GDP deflator is likely to be significantly further away from that benchmark than a market-based measure like CPIH.

2.19. The GDP deflator does include changes in the price of things like government output and imports and exports, which are unlikely to be relevant in helping measure the inflation energy suppliers are facing. However, measures like CPIH will track price changes in many consumer goods that are similarly irrelevant to the cost base of suppliers. It is therefore not obvious which measure would better align with the theoretical bespoke index. In particular, it is not clear how the effect of movements in irrelevant price items causes the CPIH to diverge from that notional index. As such, any gains in accuracy from moving away from the GDP deflator are uncertain.

2.20. Estimates provided by one of the respondents to the May 2022 consultation, advocating for a switch to CPIH, suggest that moving to CPIH would likely somewhat increase the SMNCC non-pass-through allowance for credit customers and somewhat decrease it for PPM customers. However, the magnitude of change would be in single £'s per customer and so would be small in the context of the wider default tariff cap.

2.21. Given the uncertain gain in accuracy, the relative immateriality of the choice and our stated intention to not carry out Annual Reviews to the same level of detail as our May 2020 credit consultation, we have decided to maintain the GDP deflator as the inflation measure used in the SMNCC model.

2.22. This reaffirms our proposed approach in May 2020 as well as our August 2020 decision, when we last considered this question.[17,18]

Timely estimates and forecasts

2.23. Regardless of the choice of inflation measure, the two suppliers, the industry body and the economic adviser all argued that we should be using the latest estimates available, and they disagreed with our proposal to continue relying on a secondary source for GDP deflator estimates (the HMT Green Book supplementary guidance).

2.24. Using the latest available forecasts was highlighted as particularly important in the context of rising inflation, where the difference between older and newer forecasts can be significant.

2.25. One economic adviser disagreed with the suggestion in the May 2022 consultation that the combination of future annual reviews and the advanced payments calculation meant that newer GDP deflator estimates would still ultimately be reflected in the SMNCC allowance, just with a lag. They note that there is no certainty around when or if the HMT Green Book supplementary guidance will be updated and that the SMNCC model currently only accommodates advanced payments up to the October to December 2023 cap period.

2.26. With relatively stable inflation we have until now been comfortable using a convenient secondary source of precompiled GDP deflator estimates and forecasts; even when they were not always taken from the most recent publications by the ONS and OBR.

2.27. However, we agree with stakeholder comments that with recent rises in inflation the difference between older and newer estimates, and particularly older and newer forecasts, are likely to be larger than has been the case in the recent past. Relying

[17] Ofgem (2020), Technical annex to reviewing smart metering costs in the default tariff cap: May 2020 statutory consultation: https://www.ofgem.gov.uk/publications/reviewing-smart-metering-costs-default-tariff-cap-may-2020-statutory-consultation
[18] Ofgem (2020), Technical annex to reviewing smart metering costs in the default tariff cap: August 2020 decision: https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap

on an out of date secondary source therefore risks us entering material underestimates of inflation in recent and future years.

2.28. For this reason, we have decided to use GDP deflator estimates and forecasts taken directly from the most recent ONS and OBR publications available ahead of publishing our decision.

3. Unchanged positions: May 2022 Consultation

Section summary

This chapter sets out the decisions which are unchanged from the proposals laid out in the May 2022 consultation. We did not receive any stakeholder feedback regarding these proposals in response to the consultation.

Summary

3.1. In this section we summarise the proposals from the May 2022 consultation that we have decided to take forward unchanged. For more detail on these decisions please refer to the relevant section of the May 2022 consultation document.[19]

3.2. We received no stakeholder responses that referred to the changes discussed in this section, reflecting the relatively modest nature of the changes proposed. This in turn reflects the maturity of our modelling approach.

Updating sunk installation costs for 2021

Context

3.3. In our August 2021 decisions, we decided to calculate sunk installation costs in 2020 and 2021, reflecting that COVID-19 had impacted smart meter installations up to that point.

3.4. Our estimates of sunk installation costs for 2020 were based on our 2021 Request for Information (RFI). They were calculated by using an average of the values from two methods:[20]

[19] Ofgem (2022), Consultation on credit and PPM SMNCC allowances: https://www.ofgem.gov.uk/publications/price-cap-may-2022-consultation-credit-and-ppm-smncc-allowances
[20] Ofgem (2021), Price Cap - Decision on credit SMNCC allowance, paragraph 3.15: https://www.ofgem.gov.uk/publications/price-cap-decision-credit-smncc-allowance

- **method one** - by gathering information directly on sunk costs.

- **method two** - estimating sunk costs as a residual, starting with the total installation costs and subtracting the estimated cost for the meters which were installed.

3.5. We collected data on sunk installation costs for 2021 through our 2022 RFI. This was to replace previous bottom-up estimates of sunk installation costs for 2021 during our August 2021 decisions. The bottom-up methodology involved selecting values for three parameters: the proportion of normal rollout, which is not achieved, the proportion of costs which are sunk when an installation does not occur, and the cost per installation in a normal year.[21]

3.6. Our May 2022 consultation proposed to update our estimates of sunk installation costs in 2021 by using an average of the values calculated from 2022 RFI data using methods one and two.

Decision

3.7. We have decided to update our estimates of sunk installation costs in 2021 using 2022 RFI data for credit and PPM, by using an average of the values calculated using methods one and two.[22] We consider that the average will be a better reflection of suppliers' aggregate costs than either of the two methods. This is in line with our approach to estimating sunk installation costs in 2020.

3.8. This maintains the proposals from our May 2022 consultation.

Overview of responses

3.9. We received no stakeholder responses related to our May 2022 proposals to update 2021 sunk installation costs.

[21] Ofgem (2021), Price Cap - Decision on credit SMNCC allowance, paragraph 3.48: https://www.ofgem.gov.uk/publications/price-cap-decision-credit-smncc-allowance
[22] Ofgem (2021), Price Cap - Decision on credit SMNCC allowance, paragraph 3.15: https://www.ofgem.gov.uk/publications/price-cap-decision-credit-smncc-allowance

Considerations

Results

Table 3.1 - Sunk installation costs by payment method in 2021 and 2020.[23]

Payment method	2021	2020
Credit (£m, 2021 prices)	41.9	95.8
PPM (£m, 2021 prices)	11.7	7.0
Total (£m, 2021 prices)	53.6	102.8

Notes: *All values are totals across single and dual fuel and averages between methods one and two. The figures for methods one and two include an adjustment to scale up the data from the suppliers included in the analysis to a representation of the full market. This adjustment assumes that the suppliers outside our data had the same per customer sunk installation costs as those included. The 2021 and 2020 figures use an updated GDP deflator in line with C*
2. The 2020 figures have also been expressed in 2021 prices. They therefore will not match figures previously published in our May 2022 consultation

3.10. Table 3.1 shows that in 2021 total sunk installation costs across payment methods have fallen. This matches our expectations that COVID-19 would have a lesser impact on smart meter rollout in 2021 than in 2020. This is because societal restrictions in response to the pandemic were reduced. Suppliers may also have been able to include more flexibility in their plans over time to reduce the risk of sunk installation costs.

3.11. Table 3.1 also shows that PPM sunk installation costs have increased in 2021 compared to 2020. However, the share that PPM sunk installation costs accounted for in the total PPM installation costs in 2021 decreased by approximately 1 percentage point relative to 2020.[24] Whilst this matches our expectations for COVID-19, the decrease in the proportion of PPM installation costs that were sunk was smaller than we would have expected, when considering that COVID-19 may have impacted roll out in 2021 to a much lesser extent than in 2020.

3.12. In our May 2022 consultation, we invited stakeholders to comment on potential explanations for why the decrease in the proportion of PPM installation costs that are

[23] The data used for 2020 reflects an update to our estimates of 2020 sunk installation costs due to revised data from one supplier, see Appendix 6 of May 2022 consultation document for more detail.
[24] We define total PPM installation costs as both sunk installation costs due to COVID-19 and productive installation costs in cases where suppliers were able to install smart meters. We gathered data on this in our February 2022 RFI.

sunk may have been small in 2021 and whether we should cap the absolute level of sunk costs at their 2020 value. We received no further stakeholder comments on this.

3.13. We consider that using more recent sunk cost data may be a better reflection of suppliers' aggregate costs than an option of capping PPM sunk costs at their 2020 value. The impact on the PPM SMNCC allowance of this latter approach is also small. We therefore consider that using an average of the values calculated using methods one and two for PPM 2021 sunk installation costs remains appropriate. This maintains our proposals from the May 2020 consultation.

GDP deflator

3.14. Our sunk installation cost estimates are impacted by our decision in Chapter 2 to change our approach to updating the GDP deflator to reflect newer data. Sunk installation costs for 2020 and 2021 have therefore been updated in line with the new GDP deflator series.

Sunk installation costs beyond 2021

Context

3.15. In principle, there could also be sunk installation costs due to COVID-19 in 2022 (or 2023).

3.16. In our August 2021 decisions, we decided that we would not include sunk installation costs beyond 2021. However, given the uncertainty around COVID-19, we stated that we could not rule out the possibility that we may need to revisit this position as part of a future review.[25]

3.17. In our May 2022 consultation, we proposed not to include sunk installation costs for the years beyond 2021.

[25] Ofgem (2021), Price Cap – Decision on credit SMNCC allowance, paragraphs 3.55, 3.62. https://www.ofgem.gov.uk/publications/price-cap-decision-credit-smncc-allowance

Decision

3.18. We have decided to maintain our May 2022 consultation proposal to not include sunk installation costs beyond 2021.

3.19. This reflects that, while the impacts of COVID-19 were uncertain in 2020 and 2021, in 2022 almost all of the UK's COVID-19 rules have ended. The societal restrictions in response to the pandemic have substantially decreased. Changing circumstances have enabled suppliers to include more flexibility in their plans over time to reduce the risk of sunk installation costs.

Overview of responses

3.20. We received no stakeholder responses related to our May 2022 proposal to not include sunk installation costs beyond 2021.

Considerations

3.21. In our May 2022 consultation, we stated that the impacts of COVID-19 were uncertain, meaning that we would have no confidence that making a sunk installation cost adjustment for 2022 would increase the accuracy of our SMNCC allowance.

3.22. At the time of publishing our consultation document on 3 May 2022, the majority of UK societal restrictions in response to COVID-19 had been removed and the rollout of vaccines had progressed. Furthermore, to the extent that suppliers were able to include more flexibility in their plans when they had more time to do so, this would apply to a greater extent by 2022. This is supported by the fact that the overall share (across credit and PPM) that sunk installation costs accounted for of total installation costs fell in 2021 relative to 2020.

3.23. Nothing has changed that makes us consider there is a significantly increased risk of sunk costs in 2022 since we published our consultation document. We continue to judge that sunk installation costs are currently unlikely in 2022 and 2023 for the reasons set out above.

Updating cost per installation for 2021

Context

3.24. Our earlier considerations of accounting for sunk installation costs in 2021 discuss the cases where suppliers were unable to install smart meters in 2021 due to COVID-19. However, there were many cases where suppliers were able to install smart meters in 2021, and where installation costs were therefore productive. We need to consider what cost per installation to use for 2021 for where installation costs are productive.

3.25. In our August 2021 decisions, we decided to use the same bottom-up approach for estimating cost per installation in 2021 as we previously used for estimating sunk installation costs for 2021.

3.26. Our May 2022 consultation proposed to estimate the cost per installation achieved (ie where suppliers were able to install smart meters) for 2021 using an average of the costs per installation associated with the two methods that we also proposed (and have now decided) to use for calculating sunk installation costs in 2021.

Decision

3.27. We have decided to proceed with our May 2022 consultation proposal as summarised above. This decision ensures that our approach to estimating productive installation costs is coherent, by using the same data source as for sunk installation costs.

Overview of responses

3.28. We received no stakeholder responses on our May 2022 proposals for updating cost per installation in 2021.

Considerations

Data source

3.29. Our previous considerations in the April 2021 consultation were to estimate the cost per installation achieved in 2020 using the same data source as for sunk installation

costs. This is to ensure that our approach is coherent to these related items, which together make up installation costs. We consider this approach should apply to the cost per installation in 2021 as well.[26] To reflect this, we consider we should use an average of the costs per installation achieved with method one and two. For method one, this is based on data gathered from suppliers.[27] For method two, this is the cost per installation from 2019 (adjusted for inflation), which we use to estimate sunk installation costs. This uses the same approach to estimate sunk installation costs in 2021.

3.30. The updated 2021 cost per productive installation values are lower than the 2020 cost per productive installation values.[28] This may be reflecting our expectations of COVID-19 generally having less of an impact on rollout in 2021, particularly in relation to lower direct costs for personal protective equipment or additional pre-installation contact centre costs. Part of the decrease may also reflect natural variation in costs between years for other (non-COVID-19) reasons.

GDP deflator

3.31. Our cost per installation estimates is impacted by our decision in Chapter 2 to change our approach to updating the GDP deflator to reflect newer data. Cost per installation values for 2020 and 2021 have therefore been updated in line with the new GDP deflator series.

[26] Ofgem (2021), Price Cap – Decision on credit SMNCC allowance, paragraphs 3.55, 3.62: https://www.ofgem.gov.uk/publications/price-cap-decision-credit-smncc-allowance
[27] The cost per installation achieved is the productive installation cost divided by the number of actual installations.
[28] Despite a fall in the cost per productive installation, total productive installation costs as reported by suppliers in response to our RFIs rose between 2020 and 2021. This partly reflects an increase in the number of productive installations offsetting any fall in per install costs. This is why despite sunk installation costs rising for PPM (see table 3.1), as a proportion of total installation costs they fell by approximately 1ppt (see para 3.11).

SoLR impact on the market leader rollout profile

Context

3.32. We decided to use different rollout profiles for credit and PPM in our August 2021 PPM SMNCC decision.[29] We decided to use the market leader rollout profile for credit and the market average rollout profile for PPM.[30]

3.33. The rollout profiles are used to set the SMNCC allowances in future cap periods and calculate the discrepancies between historical SMNCC allowances and suppliers' actual costs. These discrepancies are then corrected through the advanced payments adjustment.

3.34. Following the recent increase in wholesale prices, there have been numerous suppliers exits from the market in a short period of time. This has meant that some of the suppliers remaining in the market have taken on customers from the suppliers who exited the market through the SoLR process.

3.35. As some suppliers exiting the market are likely to be further behind in their smart meter rollout when compared to suppliers who are the market leaders, and as such they would have been historically overfunded for their rollout of credit meters. That historic overfunding would not transfer to the receiving suppliers as part of the SoLR process.

3.36. In addition, given the likely lower rollout of some suppliers exiting the market, we would expect the impact of SoLR on receiving suppliers' rollout to be negative. If the market leader suppliers used to set the credit rollout profile in the SMNCC model received customers through the SoLR process it could reduce their historic rollout profile, which would translate into a reduced advanced payments for credit meters.

3.37. Firms receiving credit customers from exiting suppliers would therefore not gain from the overfunding those suppliers historically received but would face an

[29] Ofgem (2021), Price Cap - Decision on PPM SMNCC allowance, paragraph 4.8: https://www.ofgem.gov.uk/publications/price-cap-decision-ppm-smncc-allowance
[30] Ofgem (2021), Price Cap - Decision on credit SMNCC allowance, paragraph 2.21: https://www.ofgem.gov.uk/publications/price-cap-decision-credit-smncc-allowance

increased clawback through a higher advanced payment value for credit meters.

3.38. This issue is not relevant for the SMNCC PPM allowance because PPM rollout is calculated on the basis of a market average rollout profile which will be unaffected by the relocation of customers between suppliers.

3.39. In our May 2022 consultation, we proposed to not make an adjustment for the impact of SoLR reflecting an assessment that the impact was small and therefore making an adjustment would be disproportionate.

Decision

3.40. We have decided to proceed with the approach laid out in the May 2022 consultation and will not be making any adjustment to account for any SoLR impacts on the receiving supplier rollout.

Overview of responses

3.41. We received no stakeholder responses disagreeing with our May 2022 proposal to not making an adjustment for SoLR impacts at this stage.

Considerations

3.42. In order to consider how the SoLR process impacted market leaders' rollout profiles, we asked the suppliers who could potentially be the market leader for data on their rollout at the end of 2021. We asked for this to be split between their existing customer base and customers gained through the SoLR process.

3.43. In each case, the rollout percentage for the credit customers gained through the SoLR process was lower than for their existing customer base. However, as the customers gained represented a small proportion of their customer bases, the overall impact of taking on customers through the SoLR process on their overall smart meter rollout for credit customers was to reduce it by less than 1 percentage point (ppt).

3.44. Making an adjustment to remove the impact of SoLRs processes would increase the complexity of calculating the SMNCC. We would need to develop a specific rollout profile for advanced payments (for both the market leading suppliers). We would

then need to calculate the SMNCC with this rollout profile, and feed this back into the SMNCC model as an additional input to help us calculate advanced payments.

3.45. We do not consider that making this adjustment would be proportionate at this stage, given the low impact of SoLR customers on these suppliers' rollouts and the complexity of implementing an adjustment when calculating the SMNCC.

Updating fuel specific rollout with 2021 values

Context

3.46. In our August 2020 decision, our Annual Supplier Return (ASR) main rollout data was not split by fuel, so we did not calculate separate rollout profiles for each fuel. We maintained the same approach in our April 2021 consultation.

3.47. For our August 2021 decision we included adjustments from a separate data source to create separate rollout profiles for each fuel.[31] This was in response to a stakeholder comment from the April 2021 consultation that said we should return to our approach of separate rollout profiles for gas and electricity.

3.48. We estimated these by looking at historical data for rollout up to 2020 across large energy suppliers. We used this data to calculate the ratio between the rollout achieved for a given fuel and the combined dual fuel rollout. We then applied this ratio to the rollout profiles in the SMNCC model.

Decision

3.49. We have decided to maintain the existing fuel-specific rollout adjustments from August 2021 decisions, which uses historical rollout data up to 2020 across large energy suppliers.

3.50. This maintains our proposal in the May 2022 consultation.

[31] Ofgem (2021), Price Cap - Decision on credit SMNCC allowance, paragraph 2.23: https://www.ofgem.gov.uk/publications/price-cap-decision-credit-smncc-allowance

Overview of responses

3.51. We received no stakeholder responses on our May 2022 proposals for updating fuel specific rollout with 2021 values.

Considerations

3.52. We calculated the impact of updating the fuel-specific rollout adjustments with 2021 data. This would affect the values for 2021 and beyond. Given there was an immaterial impact from this, we are deciding to not update the existing fuel-specific rollout adjustment with 2021 data.

3.53. We do not consider it necessary to make all possible minor updates as part of this Annual Review. As set out in SMNCC WP5, "we do not expect to carry out future Annual Reviews (including this one) with the same level of detail as our May 2020 credit consultation, as we consider this would be disproportionate".[32]

Long-Run Variable Cost of energy

Context

3.54. The Long-Run Variable Costs of energy supply estimates (LRVC) are a set of figures published as part of HMT's Green Book supplementary guidance.[33] They attempt to isolate the parts of the retail price that vary according to the level of consumption. They are used as an input when estimating the value to suppliers of being able to better manage customer debt because of smart metering. Given the reduced ability of PPM customers to build up debt, these benefits apply to credit customers only.

3.55. The SMNCC model uses the change in LRVC values, compared to the equivalent 2021 values, to adjust the portion of the average 2021 retail bill which is related to

[32] Ofgem (2021), Price Cap - Working paper on 2022 Annual Review of SMNCC allowances, paragraph: https://www.ofgem.gov.uk/publications/price-cap-working-paper-2022-annual-review-smncc-allowances

[33] Green Book supplementary guidance: valuation of energy use and greenhouse gas emissions for appraisal. Table 9 and 10 of: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1024043/data-tables-1-19.xlsx

variable costs, in order to produce a modelled time series of average retail bills. This series of average retails bills is then used to scale the estimated debt management benefits to suppliers.

3.56. The LRVC values currently used in the SMNCC model are taken from the HMT Green Book supplementary guidance as published on 11 April 2019.[34] On 15 July 2021 the HMT Green Book supplementary guidance was updated, including new LRVC estimates.[35] However subsequently we have seen significant price increases in wholesale energy markets, which are not reflected in the latest published LRVC values.

Decision

3.57. We have decided to update the LRVC values used in the SMNCC model to the "central" estimates published in the latest HMT Green Book supplementary guidance.

3.58. This is in line with our May 2022 consultation proposal.

Overview of responses

3.59. We received no stakeholder responses on our May 2022 proposals for updating the LRVC values used in the SMNCC model.

Considerations

3.60. We considered whether to make changes to the LRVC estimates so they better reflect current wholesale prices. However, we do not consider this proportionate because of the low materiality of the issue and the additional complexity that it would entail.

[34] Green Book supplementary guidance: valuation of energy use and greenhouse gas emissions for appraisal. Table 9 and 10 of: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1024043/data-tables-1-19.xlsx

[35] Green Book supplementary guidance: valuation of energy use and greenhouse gas emissions for appraisal. Table 9 and 10 of: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1024043/data-tables-1-19.xlsx

3.61. We explored two potential ways to better reflect changes in wholesale energy prices. The first was to use the "high" LRVC estimates for 2021 to 2023 and the second was to uprate the 2021 and 2022 "central" LRVC estimates by the change in the wholesale component of the price cap. In both cases this adds complexity and reduces the transparency of our modelling.

3.62. The impact of both approaches was a small increase in the estimated debt management benefits to suppliers, as these scale in proportion to average bills, but an immaterial impact on the final credit SMNCC values.[36] This is because debt management benefits are only a small component of the final credit SMNCC value. For example, estimated debt management benefits in 2022 contributed only around -£0.29 to the cap period eight non-pass-through SMNCC credit value published in February 2022.

3.63. When weighing this additional complexity against the low materiality, we consider our proposed approach proportionate. Furthermore, any impact revised LRVC estimates have on historical cap periods will be accounted for through the advanced payments calculation.

Corporation tax

Context

3.64. The headline rate of corporation tax is used in the SMNCC model to convert the 2019 cost benefit analysis (CBA) post-tax cost of capital estimate into a pre-tax figure. This is done as the SMNCC allowance ultimately needs to provide suppliers with pre-tax revenue.

3.65. The pre-tax cost of capital figure is primarily used in the SMNCC model to amortise the cost of buying and installing smart metering equipment.

[36] Only credit SMNCC values are impacted by changes in debt management benefits as it is assumed that there are no such benefits from switching PPM customers to smart meters given the reduced ability of PPM customers to build up debt.

3.66. Currently the same rate of corporation tax (19%) is used for every year of the model, reflecting the current headline rate. From 1 April 2023 the main rate is scheduled to rise to 25%.[37,38]

Decision

3.67. We have decided to use a corporation tax rate of 20%.

3.68. This reflects the average rate of corporation tax weighted by the modelled profile of smart meter installations between the start of smart meter rollout in 2012 and the end of the SMNCC modelling cap period in 2023.

3.69. This is in line with our May 2022 consultation proposal.

Overview of responses

3.70. We received no stakeholder responses related to the rate of corporation tax used in the SMNCC model.

Considerations

3.71. Maintaining a 19% value or moving straight to using a 25% value would, respectively, underestimate or overestimate the impact of corporation tax on the pre-tax cost of capital that suppliers face.

3.72. Our proposal means we are able to reflect the average rate of corporation tax suppliers have faced over the period they have been installing smart meters. Using the number of smart meter installations in each year to weight the importance of each year's corporation tax rate ensures the average reflects the profile of supplier

[37] HM Revenue & Customers (2021), Corporation Tax charge and rates from 1 April 2022 and Small Profits Rate and Marginal Relief from 1 April 2023: https://www.gov.uk/government/publications/corporation-tax-charge-and-rates-from-1-april-2022-and-small-profits-rate-and-marginal-relief-from-1-april-2023

[38] As of the date of publication, 4th August 2022, corporation tax remains scheduled to rise to 25% in the financial year 2023.

activity over time. This approach offers accuracy benefits compared to choosing one of the headline rates while avoiding the proportionality concerns of other methods.[39]

2021 Annual Supplier Return data

Context

3.73. Suppliers submit Annual Supplier Return (ASR) data to the Department for Business, Energy, and Industrial Strategy (BEIS) each year. This data provides information on costs related to smart and traditional metering that they have incurred in the previous year.

3.74. In our May 2022 consultation, we listed the areas of the SMNCC model we intended to update using the 2021 ASR data. The language in the consultation document suggested that this list was of a subset of inputs that relied on ASR data. Following a supplier query requesting clarity on which ASR based inputs were not being updated we were able to clarify that the reference in the consultation document to ASR data outside of the areas listed having "limited (or zero) role in the SMNCC model" was imprecise and should have more clearly said that it played no role. Therefore, on review we were able to confirm that the list provided in the consultation was an exhaustive list of all inputs into the SMNCC model that are based on ASR data.

[39] See paragraph 5.19 of the May 2022 SMNCC consultation for a detailed description of the alternative methods considered. https://www.ofgem.gov.uk/publications/price-cap-may-2022-consultation-credit-and-ppm-smncc-allowances

Decision

3.75. We have decided to update all SMNCC inputs based on ASR data using 2021 returns.

3.76. Consequentially we have also made the relevant edits to reflect the use of 2021 ASR data. These are: removing optimism bias from the 2021 values, starting any assumed cost erosion[40] from after the last actual data, and updating the baseline adjustment for payment methods.

3.77. This is in line with our clarified May 2022 consultation proposal.

Overview of responses

3.78. We received no stakeholder responses to our May 2022 proposals on the use of ASR data.

Considerations

3.79. As much as possible we want to use the latest data available to us. However, we must also balance this against the proportionality of conducting updates if they make an immaterial difference to the accuracy of the model's outputs. In this case as ASR data is used widely in the model and is central to a number of calculations, ensuring it is updated is easily justified.

SMETS1 assumptions

Context

3.80. For our August 2021 decision we decided to update the following inputs to the SMNCC model:[41,42]

[40] The SMNCC model assumes that the costs of smart meter assets and SMETS1 communications hubs decline slightly over time, for years where data is forecast. The SMNCC model refers to this as cost erosion.
[41] Ofgem (2021), Decision on credit SMNCC allowance, Appendix 10 paragraph 1.29: https://www.ofgem.gov.uk/publications/price-cap-decision-credit-smncc-allowance
[42] Ofgem (2021), Decision on PPM SMNCC allowance, paragraph 2.171: https://www.ofgem.gov.uk/publications/price-cap-decision-ppm-smncc-allowance

- the profile for the proportion of SMETS1 meters enrolled with the DCC
- the date at which SMETS1 meters are treated as enrolled
- the proportion of SMETS1 meters expiring earlier
- the scaling factors for the proportion of SMETS1 meters losing smart functionality
- the proportion of installations which are SMETS1 or SMETS2 for 2020 and 2021.

Decision

3.81. We have decided to not update these elements again as part of the 2022 Annual Review.

3.82. This is in line with our May 2022 consultation proposal.

Overview of responses

3.83. We did not receive any stakeholder responses to relation to these assumptions.

Considerations

3.84. Not updating these assumptions is consistent with our approach to other metrics in the model, where we focus on making changes where there is likely to be a significant improvement in accuracy from doing so. In a number of cases the choice to not update one of these assumptions implies a choice not to update another as they are directly linked (eg the profile of SMETS1 enrolment and the date SMETS1 meters are treated as enrolled).

3.85. A more detail description of the considerations given to each of the listed assumptions can be found in Appendix 4 of the May 2022 consultation document.[43]

[43] Ofgem (2022), "Price Cap – May 2022 consultation on credit and PPM SMNCC allowances", Appendix 4, paragraphs 1.14-1.29: https://www.ofgem.gov.uk/publications/price-cap-may-2022-consultation-credit-and-ppm-smncc-allowances

Traditional electricity PPM rental uplift

Context

3.86. We use the meter rental uplift to adjust our modelled approach to metering costs, taking into account data on suppliers' meter rental charges.[44]

3.87. In our October 2021 consultation model (and previous versions), we applied a meter rental uplift for traditional gas PPMs but set this to zero for traditional electricity PPMs.

3.88. In our February 2022 decision we increased the amortisation period for PPM, which reduced annual metering costs in the modelled approach, as asset and installation costs are spread over more years. This in turn increased the difference between the modelled approach and the meter rental charge data.

3.89. After recalculating the implied uplift values following the change in modelled PPM costs, it became apparent that there was now a greater case to include a non-zero meter rental uplift for traditional electricity PPMs. We decided not to make this consequential change as part of the February 2022 decision because stakeholders had not had the opportunity to comment on it. We stated it was our intention to consult on applying a non-zero meter rental uplift for electricity PPM as part of our next Annual Review.

3.90. We proposed introducing a non-zero meter rental uplift for traditional electricity PPMs as part of our May 2022 consultation.

[44] For an explanation of our approach to the meter rental uplift (in the context of the credit SMNCC, but also applicable to the PPM SMNCC), see: Ofgem (2020), Technical annex to reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraphs 3.50 to 3.53: https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap

Decision

3.91. We have decided to introduce a meter rental uplift for traditional electricity PPMs of 35%. This reflects the proportional difference between the average modelled rental payment and the actual meter rental payment as given by supplier data in 2019.

3.92. This is in line with our May 2022 consultation proposal.

Overview of responses

3.93. We did not receive any stakeholder responses related to the introduction of a non-zero meter rental uplift for traditional electricity PPMs.

Considerations

3.94. Setting a non-zero meter rental uplift for traditional electricity PPMs will increase the modelled installation and asset costs of traditional electricity PPMs. This will increase the modelled benefit of fewer traditional meters being bought and installed under a given smart metering rollout scenario, when compared to the counterfactual of no smart metering.

3.95. As a result, this will reduce the modelled electricity PPM increment. The impact of introducing a 35% uplift on the electricity PPM allowance for cap period nine is to reduce it by £2.24 compared to no uplift. This impact is insufficient to change the final non-pass-through PPM electricity SMNCC allowance. This is because the PPM cost offset, which is added onto the non-pass-through value, is large enough the final value remains £0.00.

Review of uncertainty

Context

3.96. In our May consultation, we set out our intention to continue to assess the uncertainty around our calculated SMNCC value qualitatively. We concluded that the net effect of uncertainty is roughly neutral and therefore did not propose making any numerical uncertainty adjustment.

Decision

3.97. We maintain our position from the May 2022 consultation paper that a qualitative assessment of uncertainty is appropriate and that the net effect of uncertainty is roughly neutral.

3.98. In line with this we have decided not to make any numerical uncertainty adjustment.

Overview of responses

3.99. We did not receive any stakeholder feedback on our approach to the review of uncertainty or the qualitative assessment present in the May 2022 consultation document.

Considerations

3.100. We consider that the qualitative review of uncertainty provided in the May 2022 consultation document remains appropriate.[45]

[45] Ofgem (2022), "Price Cap – May 2022 consultation on credit and PPM SMNCC allowances", Appendix 7: https://www.ofgem.gov.uk/publications/price-cap-may-2022-consultation-credit-and-ppm-smncc-allowances

4. Unchanged positions: February 2022 decision

Section summary

In addition to comments relating to the proposals in the May 2022 consultation we also received feedback on methodology changes made in the February 2022 SMNCC decision. In this section we outline the feedback related to the February decision, provide a response, and justify why we have chosen to maintain those positions.

Summary

4.1. In its consultation response, one supplier raised questions about several changes to PPM assumptions made as part of our February 2022 decision.

4.2. These changes were made in response to stakeholder feedback gathered via the October 2021 consultation and were first described in the February 2022 decision paper. The May 2022 consultation therefore represents the first opportunity stakeholders have had to respond to those decisions.

4.3. We have decided to maintain the decisions set out in February 2022.

Traditional gas PPM asset life assumption

Context

4.4. The traditional meter asset life determines the rate at which traditional meters expire and should be replaced. Within the SMNCC model, the assumed asset life primarily affects the benefits arising from the avoided costs of replacing expiring traditional meters with new traditional meters (as a smart meter is being installed instead).

4.5. In our February 2022 decision we decided to increase the traditional PPM asset life from 10 years to 12 years for gas and from 12 years to 15 years for electricity.[46] This reflected a reassessment of our methodology for determining the traditional PPM asset life following feedback from stakeholders in response to our August 2021 decision.

Decision

4.6. We will maintain the assumed asset life of traditional PPMs at 12 years for gas and 15 years for electricity.

Overview of responses

4.7. One supplier considers that the increase in the traditional gas PPM asset life from 10 years to 12 years is still too low and that the assumed asset life should be 15 years for gas, as it is for electricity.

Considerations

4.8. The supplier raises potential issues with the implied expiry approach used to estimate the meter asset life. It states that the implied expiry approach assumes that the only driver of the difference in the number of meters of different ages is meter expiry when in fact other factors, such as difference in the number of meters installed per year, are also relevant. It points out that for some ages the implied expiry approach results in a negative number, suggesting old and expired meters are being brought back into operation.

4.9. Finding this assumption implausible, the supplier suggests switching to the approach it and its economic consultants first set out in its response to our April 2021 credit SMNCC consultation, which we will call the 'comparing distributions' approach. This approach seeks to find the meter asset life value that generates a distribution of meters by age that best resembles the distribution observed in the data collected

[46] Ofgem (2022), "Price Cap - February 2022 decision on credit and PPM SMNCC allowances", paragraph 2.11 https://www.ofgem.gov.uk/publications/price-cap-february-2022-decision-credit-and-ppm-smncc-allowances

from suppliers. This approach leads the supplier to conclude that a meter asset life of 15 years would be appropriate for traditional gas PPMs.

4.10. We considered the comparing distributions approach in detail in our February 2022 decision document. We still consider the issues we highlighted with this approach in that document to be relevant today. It is still the case that this approach is likely to overestimate the typical expiry date of meters.[47]

4.11. We acknowledge that in our preferred approach of implied expiry there is an inbuilt assumption that meters were installed at a broadly consistent rate up the selected starting point for the calculation. This is something we explicitly mentioned in our February 2022 decision.[48]

4.12. However, as this approach involves looking at the cumulative expiry of meters over time, year to year variation is less of a concern. In addition, our approach to identifying the starting age for the analysis, to mitigate any upward bias from the impact of the smart meter rollout, uses a three-year rolling average. This helps mitigate the impact of variation in installation numbers impacting the choice of starting point.

4.13. Finally, once we've calculated the implied cumulative distribution of meters expiring after the designated starting point, we use the median age of the distribution in order to set the typical meter asset life. The use of the median, rather than mean, ensures that the degree of sensitivity to any particular year of data being too high or low is minimised.

4.14. For these reasons we still consider the implied expiry approach reasonable and therefore have decided to maintain the assumed typical meter asset life for gas PPMs at 12 years.

[47] Ofgem (2022), "Price Cap - February 2022 decision on credit and PPM SMNCC allowances", paragraphs 2.18-2.20 https://www.ofgem.gov.uk/publications/price-cap-february-2022-decision-credit-and-ppm-smncc-allowances
[48] Ofgem (2022), "Price Cap - February 2022 decision on credit and PPM SMNCC allowances", paragraph 2.21 https://www.ofgem.gov.uk/publications/price-cap-february-2022-decision-credit-and-ppm-smncc-allowances

PPM Premature Replacement Charge (PRC) assumptions

Context

4.15. Suppliers incur a charge for replacing a meter before the cost of that meter has been paid off – a PRC. In the SMNCC model, we calculate PRCs using a bottom-up modelled approach. This involves using asset and installation cost inputs to calculate a weighted average PRC across years, an assumption to capture PRCs will generally decrease as the meter ages and the distribution of meters ages form RFI data.[49,50]

4.16. In the SMNCC model, the age after which PRCs no longer apply affects what proportion of replaced meters incur PRCs due to being replaced early. In our February 2022 decision we increased this PRC age for traditional PPMs to 14 years for electricity and 12 years for gas, up from a previous value of 10 years for both fuel types.

4.17. These increases were the result of a refinement of our bottom-up modelled approach. The output of the revised approach indicated a PRC age of 13 years for gas. However, given the decision, discussed earlier, to set the gas PPM asset life assumption at 12 years it was considered incoherent that PRCs could be incurred beyond the life of the asset itself. For this reason, the gas PPM PRC age was capped at 12 years.

Decision

4.18. We will maintain the assumed age after which PRCs no longer apply for traditional PPMs at 14 years for electricity and 12 years for gas.

Overview of responses

4.19. One supplier, supported by economic advisers, set out its belief that the assumed PRC age for traditional gas meters was too low at 12 years. This reflects a

[49] We refer to this assumption as the age after which PRCs no longer apply or PRC age.
[50] This is explained further in the Technical Annex of the August 2020 credit decision: Ofgem (2020), Technical annex to reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraph 3.178: https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap

disagreement around whether the PRC age should be capped at the assumed meter asset life.

Considerations

4.20. The supplier repeats concerns that our bottom-up modelled approach is not reflective of the 2019 RFI data on gas PPM PRCs per meter. This view was originally raised to us in response to our April 2021 consultation.

4.21. We have previously responded to the supplier's concerns about our bottom-up approach. Most recently in our February 2022 decision we stated that it was not the aim of the bottom-up modelling approach to replicate with the PRC values per meter taken directly from supplier data.

4.22. Actual PRC data may not be a reliable guide because some suppliers are also traditional meter owners and do not charge an internal PRC even though there is still an economic cost involved to a section of the business. Furthermore, as we need to consider future cap periods, we would have to make some assumptions to extrapolate the 2019 RFI data forward, leading to a modelled approach in any case.[51]

4.23. The supplier further argues that even under Ofgem's own analysis of supplier data the traditional gas PPM PRC age is 13 years and that the decision to cap this in order to align with the assumption of a 12 year meter asset life is flawed.

4.24. The supplier argues that there are two options when considering the relationship between the PRC age and meter asset life. In the first option the supplier suggests the PRC age and asset lives could vary, reflecting a potential commercial choice by Meter Asset Providers (MAPs) to recover some costs through PRCs beyond a meter's average life. Under this option there is no justification for capping the traditional gas PPM PRC age at 12 years. In the second option the supplier suggests that the PRC age and asset lives do align, reflecting that commercial parties would not pay

[51] Ofgem (2022), "Price Cap - February 2022 decision on credit and PPM SMNCC allowances", page 19, para. 2.49: https://www.ofgem.gov.uk/publications/price-cap-february-2022-decision-credit-and-ppm-smncc-allowances

penalties for the removal of meters beyond the average life span. The supplier argues under this scenario Ofgem's 13 year PRC age estimate is evidence of the estimated meter asset life of 12 years being too low.

4.25. In our choice to align PRC age and asset life assumptions we reflect this latter option. However, we do not see a strong justification for the supplier's suggestion that under this scenario the meter asset life assumption should be aligned with the PRC age, rather than the other way round. As discussed in an earlier section we consider the implied expiry approach to be a robust methodology for setting an assumed meter asset life. As such we consider it a reasonable judgement to allow this approach to take priority over the PRC age data. No explanation was provided by the supplier setting out why relying on the PRC age data alone would be more reliable.

4.26. Finally, the supplier's economic advisers question the exclusion of two sets of meter age data from the calculations which, if included, they state would have generated a PRC age for traditional gas PPMs of 15 years.

4.27. The exclusion of two suppliers' meter age data from the PRC age calculations reflects the fact that those data were supplied on a supply start date basis, which is typically gives results lower than actual meter age. As such that data was considered not to be comparable with other supplier's data on the age of their meters.

PPM amortisation period assumption

Context

4.28. The amortisation period assumption determines the length of time that meter asset and installation costs are spread over. Our February 2022 decision increased the amortisation period assumption for traditional PPMs to 15 years for electricity and 12 years for gas from an earlier 10-year assumption for both fuel types.[52]

[52] Ofgem (2022), "Price Cap - February 2022 decision on credit and PPM SMNCC allowances", paragraph 2.60: https://www.ofgem.gov.uk/publications/price-cap-february-2022-decision-credit-and-ppm-smncc-allowances

4.29. This change was made as a consequence of the decision to increase the assumed age after which premature replacement charges (PRCs) no longer apply for traditional PPMs, as discussed in the section above.

4.30. For traditional gas PPMs the PRC age and meter asset life are both assumed to be 12 years and so the amortisation period is also assumed to be 12 years. However, for traditional electricity PPMs the PRC age is set at 14 years and the meter asset life is assumed to be 15 years. In our February 2022 decision, we decided to align the amortisation period for traditional electricity PPMs with the meter asset life (ie 15 years) to be consistent with the approach taken for credit meters.

Decision

4.31. We have decided to maintain our February 2022 decision to increase the amortisation period for traditional electricity PPMs to 15 years.

4.32. We will continue to align the amortisation period with the assumed meter asset life, rather than the PRC age assumption.

Overview of responses

4.33. One supplier argues that the amortisation period should be aligned with the age after which PRCs no longer apply, the PRC age, and not with the meter asset life. They therefore argue that the amortisation period for traditional electricity PPMs should be 14 years instead of 15.

Considerations

4.34. The supplier states that if the PRC age was shorter than the amortisation period then MAPs would not have the certainty of cost recovery, as meters could be replaced without charge before they are fully paid off. This would raise the cost of capital for MAPs and therefore is unlikely to be reflective of real-world business practice.

4.35. The supplier states that the justification provided for aligning the amortisation period of traditional PPMs with their assumed meter asset life, that it is consistent with how credit meters are treated in the model, is insufficient. It states that the treatment of credit meters is incorrect for the same reasons and therefore repeating this mistake is not justified.

4.36. Our aim is to choose assumptions for PRC age, amortisation period and meter asset life that reflect the typical metering arrangement. Suppliers may negotiate a variety of different meter rental agreements with MAPs where the arrangement for the payment of PRCs can differ. While the scenario provided by the supplier, where PRCs are faced by a supplier throughout the rental period, is one plausible example of a metering rental agreement, other differently structured agreements are also possible.

4.37. We stated in our February 2022 decision that the amortisation period could plausibly be linked to either the PRC age or the meter asset life.[53] Our choice to align the amortisation period with the meter asset life is therefore a judgement, but one based on a plausible scenario given the possible range of metering agreements suppliers and MAPs may come to.

4.38. For these reasons and given the low materiality of reducing the amortisation period for traditional PPM electricity meters from 15 to 14 years, we consider it reasonable to maintain the decision from February 2022.

[53] Ofgem (2022), "Price Cap - February 2022 decision on credit and PPM SMNCC allowances", paragraph 2.67: https://www.ofgem.gov.uk/publications/price-cap-february-2022-decision-credit-and-ppm-smncc-allowances

Appendices

Index

Appendix 1 – Credit SMNCC values

1.1. We have decided to make the changes to the credit SMNCC (as set out in this decision) in the document 'Annex 5 – Methodology for determining the Smart Metering Net Cost Change' referred to in standard condition 28AD of the electricity and gas supply licences.

1.2. Within that document we have decided to make changes to sheet '2a Non pass-through costs', cells Q7:S8.

1.3. The values we have decided to insert are set out in the table below. These are the output values from the SMNCC model we have disclosed, including revisions.

Table A1.1: Values to insert into Annex 5 of SLC28AD

Fuel	Cap period nine	Cap period ten	Cap period eleven
Electricity	£10.17	£10.55	£10.55
Gas	-£0.80	-£0.88	-£0.88

Notes: All values are £/customer, nominal.

Appendix 2 – PPM SMNCC values

1.1. We have decided to make the changes to the PPM SMNCC (as set out in this decision) in the document 'Annex 5 – Methodology for determining the Smart Metering Net Cost Change' referred to in standard condition 28AD of the electricity and gas supply licences.

1.2. Within that document we have decided to make changes to sheet '2a Non pass-through costs', cells Q9:S10.

1.3. The values we have decided to insert are set out in the table below. These are the output values from the SMNCC model we have disclosed, including revisions.

1.4. The values in the table are before the PPM cost offset has been applied. The PPM cost offset is only applied to these values once they have been inserted into Annex 5.

Table A2.1: Values to insert into Annex 5 of SLC28AD

Fuel	Cap period nine	Cap period ten	Cap period eleven
Electricity	-£5.26	-£6.25	-£6.25
Gas	-£23.43	-£26.33	-£26.33

Notes: All values are £/customer, nominal. These SMNCC values are before the PPM cost offset has been applied.

Appendix 3 – Process feedback

1.1. One supplier expressed its view that the requirement to employ specialist economic and/or legal advisers to participate in the disclosure of the underlying SMNCC model and supplementary models makes engagement with the price cap process costly and precludes suppliers from engaging unless they can meet those costs.

1.2. While we acknowledge that participation in the SMNCC disclosure process does involve costs the requirement to make use of external advisers is well justified. A number of the supplementary models used to calculate inputs used in the SMNCC model contain data collected from suppliers. For reasons of commercial sensitivity, we cannot share these models with other suppliers as they may contain highly confidential information about their competitors. The use of a third party is therefore a necessity. We do not consider that the incremental cost to a supplier which wishes to analyse disclosed materials is such as to unfairly restrict its participation, or that the cost consideration overrides the essential importance of maintaining confidentiality.

Appendix 4 – Responding to stakeholder comments on previous decisions

1.1. One supplier highlighted several instances of what it sees as errors in the SMNCC model. These concerns were first raised in response to our April 2021 PPM SMNCC consultation.[54] The supplier does not feel that they have been sufficiently addressed and so has repeated them in response to this latest consultation.

Estimate of Smart Metering Net Costs embedded in the 2017 Default Tariff Cap

1.2. The supplier and its economic adviser state that we have overestimated the smart metering costs included in the operating cost allowance. This would result in a smaller positive (if costs have gone up) or larger negative (if costs have gone down) SMNCC allowance being set than is necessary to achieve alignment with the current estimate of smart metering costs.

1.3. The supplier states the error occurs because of the choice to use a notional lower quartile supplier rather than the values of the actual lower quartile supplier to estimate the smart metering cost element of the 2017 operating cost allowance. It is argued that the smart metering costs of the actual lower quartile firm from the original 2017 operating cost benchmarking analysis would have been lower than the notional supplier with an average rollout profile used.

1.4. We previously considered these different approaches in detail as part of our August 2020 decision on the credit SMNCC.[55] Comparing the supplier's proposed approach, which we called the 'benchmark supplier method', with the notional supplier method, which we referred to as the 'stricter' assessment of efficient net costs, we concluded that they were not equally reliable.

1.5. The 'benchmark supplier method' uses a particular supplier's own reported smart metering costs. However, it is hard to identify which costs are new (incurred as a result of the smart meter rollout) and which are categorised as related to smart metering but would

[54] Ofgem (2021), "Price Cap - final consultation on updating the PPM SMNCC allowance": https://www.ofgem.gov.uk/publications/price-cap-final-consultation-updating-ppm-smncc-allowance
[55] Ofgem (2020), "Technical annex to reviewing smart metering costs in the default tariff cap: August 2020 decision", paragraphs 5.21-5.51: https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap

have been incurred anyway. Any inconsistencies between suppliers in how they reported smart metering costs could have biased that 'benchmark supplier' method. For these reasons we only used the 'benchmark supplier method' to sense-check the results of the 'stricter' assessment of efficient net costs.

1.6. We consider that this prior discussion adequately explains and justifies the approach taken in respect of the SMNCC credit allowance. The subsequent application of this approach to the SMNCC PPM allowance follows from the fact there is one operating cost allowance across credit and PPM. Using different approaches would increase the risk of mis-estimating the size of the smart metering costs in the operating cost allowance. For these reasons we do not see a justification for selecting an alternative approach for PPM in isolation.

1.7. Furthermore, given the credit customer segment is much larger than the PPM segment, any issues with the selected approach for PPM would have to be large in order to affect over overall choice of approach.

PPM cost offset

1.8. The purpose of the PPM cost offset is to reflect the potential that the PPM-specific payment method uplift (PMU) included in the SMNCC model is insufficient to allow efficient suppliers to fully recover the higher costs of serving PPM customers.[56] These potential additional PPM costs were, and continue to be, reflected in the operating cost allowance and therefore can be recovered over all default tariff customers.[57] However, this meant suppliers with higher-than-average proportions of PPM customers may under-recover their efficient costs as they miss out on the over recovery from credit customers. For this reason, the PPM cost offset was introduced.

1.9. However, it was decided that the cost offset would only be applied if the PPM allowance is negative and would only be applied up until the SMNCC PPM allowance equalled £0. One supplier responding to the consultation argued that the choice to limit the application of the

[56] We used the CMA's PPM cost differential for our PPM PMU but acknowledged that it could be up to £17 higher if we used a different judgement of efficiency, it is this differential the PPM cost offset seeks to address.
[57] This is because we used the CMA's original PPM differential when setting the operating cost allowance, as part of moving from data on suppliers' total operating costs to a benchmark specific to direct debit customers. Therefore, any costs above the CMA's PPM differential have not been removed from the direct debt operating cost allowance and are included in the cap level for all payment types.

offset is not justified because it forces credit customers to cross-subsidise prepayment customers and only works for suppliers who have substantially more credit than prepayment customers.

1.10. The choice to apply the PPM offset only up until the PPM SMNCC equals £0 reflects the fact that the additional PPM costs it is attempting to compensate for are uncertain. In our May 2020 PPM consultation, we concluded that the efficient PPM cost differential could likely be between the CMA's and our own estimate and therefore the appropriate offset somewhere between £0 and £17.[58] We therefore do not consider it necessary to always offset the full £17 differential between the two estimates. The application of the offset up to the point the PPM allowance equals £0 allows for a balancing of price protection for PPM customers and enabling suppliers to recover an uncertain level of cost.

1.11. Given the uncertainty in the efficient PPM cost differential, we do not consider the way we have decided to apply the PPM offset is inappropriate as the supplier suggests.

1.12. The supplier further states that the advanced payments mechanism should be used to compensate suppliers for the historic under application of the PPM offset. For the reasons given above we do not agree that there has been a historic under application of the PPM offset and therefore do not agree any compensation through advanced payments is necessary.

[58] Ofgem (2020), "Statutory consultation for protecting energy consumers with prepayment meters", paragraph 4.29 https://www.ofgem.gov.uk/publications/statutory-consultation-protecting-energy-consumers-prepayment-meters