Consultation

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Price cap – November 2022 consultation on approach to reviewing the SMNCC allowances

Subject	Details
Publication date:	25 November 2022
Response deadline:	23 December 2022
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This is a statutory consultation on the approach taken to reviewing and updating the non-pass-through Smart Metering Net Cost Change (SMNCC) allowances. It also covers proposed modelling changes required to reflect the removal of a known end date to the price cap. We welcome views from all stakeholders with an interest in the domestic retail energy supply market. We particularly welcome responses from energy suppliers, consumer groups and charities. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at Ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

Contents

Executive summary

The default tariff cap ('cap') protects domestic customers on default tariffs. We currently conduct annual reviews of the Smart Metering Net Cost Change (SMNCC) allowances in the cap for credit and prepayment meters (PPM). These reviews focus on the 'non-pass-through' elements which reflect the change in costs to suppliers of meeting their smart meter roll out obligations compared to a 2017 baseline. These non-pass-through values are then combined with pass-through values and a cost offset for PPM customers to generate the final SMNCC allowances which form part of the cap.

In our August 2022 SMNCC decision, "Price Cap – August 2022 decision on credit and PPM SMNCC allowances", we provided final non-pass-through SMNCC values for cap periods 9a and 9b (October 2022 - March 2023) and cap periods 10a and 10b (April 2023 – September 2023).[1] We also updated the provisional non-pass-through values for cap period 11a (October 2023 – December 2023). Under the current approach we would usually seek to conduct a 2023 annual review in order to set final non-pass-through values for cap periods 11a to 12b (ie October 2023 – September 2024) and to set provisional values for all remaining periods.

This consultation proposes an alternative to annual reviews as a way of updating non-pass-through SMNCC values. We propose to indefinitely pause annual reviews of the SMNCC methodology but keep the values reflective of current data by making annual updates to a pre-defined list of inputs used in the modelling of smart metering costs. This will include all the inputs derived from Annual Supplier Return (ASR) data, an updated rollout profile to reflect the latest actual installation numbers and any new or updated target or tolerance values and the latest actual and forecasted inflation values. We propose to publish 12 months' worth of final non-pass-through SMNCC values in August each year, in line with current practice, but to not publish any provisional values for cap periods beyond this 12-month period (ie October to September) reflecting the recent removal of a fixed end date to the cap. Finally, we propose to consider and consult on a longer-term approach for SMNCC as part of a future review of the operating cost allowance.

The case for these proposed changes rests on the observation that our approach to modelling the change in smart metering costs is mature, following repeated and extensive engagement with the industry since we first set out our SMNCC allowances in 2018. Given this maturity,

[1] Ofgem (2022), Price Cap – August decision https://www.ofgem.gov.uk/publications/price-cap-august-2022-decision-credit-and-ppm-smncc-allowances

changes to our methodology are likely to generate increasingly smaller gains in accuracy at the expense of increased complexity.

Therefore, the benefits of detailed annual reviews have consequently diminished, and no longer address systematic errors which were unforeseen, clear, and material referred to in our August 2020 decision.[2] Pausing these reviews will reduce burdens on stakeholders, freeing up resources to be prioritised on more consequential allowances. The maintenance of data updates will reduce any negative impact on accuracy. Should unforeseen issues arise that generate clear and material systematic errors in our approach to SMNCC allowances then temporarily returning to an annual review style process would remain an option.

We considered other proposals, including maintaining annual reviews and rolling forward already published values into future cap periods. We are minded against these options as they either do not reflect the diminished benefit of detailed regular reviews, or they potentially have too large a negative impact on accuracy.

Finally, we propose to extend the functionality of the current non-pass-through SMNCC model to 2030, reflecting the new enduring nature of the price cap. We also propose spreading advanced payments across a rolling 12-month period, matching our proposal to only publish 12-months' worth of non-pass-through values.

[2] Ofgem (2020), Decision on reviewing smart metering costs in the default tariff cap, para 5.1 https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap

1. Consultation process

What are we consulting on?

1.1. This statutory consultation is seeking views on our proposed change to the way non-pass-through Smart Metering Net Cost Change (SMNCC) allowances are reviewed and updated. We are also seeking views on our proposed approach to extending the functionality of the non-pass-through SMNCC model and adjusting the period over which advanced payments are applied to reflect the removal of a known end date to the price cap.

1.2. This document is split into four chapters:

- Chapter 1: Consultation process;
- Chapter 2: Introduction;
- Chapter 3: Case for change;
- Chapter 4: Options for change; and
- Chapter 5: Model extension

1.3. We invite stakeholders to submit comments on any aspect of this policy consultation on, or before, 23 December 2022.

1.4. We intend on publishing a decision document in February 2023. Under the proposal set out in this consultation and depending on the response received, we would then intend to publish updated non-pass-through SMNCC values in August 2023 covering the period October 2023 to September 2024. We will continue to publish the full SMNCC allowances through updates to the Annex 5 model.

Related publications

1.5. The main documents related to reviewing on approach to the SMNCC allowances are:

- May 2020 consultation on reviewing smart metering cost in the default tariff cap: https://www.ofgem.gov.uk/publications/reviewing-smart-metering-costs-default-tariff-cap-may-2020-statutory-consultation

- August 2020 decision on reviewing smart metering cost in the default tariff cap: https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap

- May 2022 consultation on credit and PPM SMNCC allowances: https://www.ofgem.gov.uk/publications/price-cap-may-2022-consultation-credit-and-ppm-smncc-allowances

- August 2022 decision on credit and PPM SMNCC allowances: https://www.ofgem.gov.uk/publications/price-cap-august-2022-decision-credit-and-ppm-smncc-allowances

How to respond

1.6. We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

1.7. We have asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

1.8. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

1.9. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.10. If you wish us to keep parts of your response confidential, please clearly mark those parts of your response that you do wish to be kept confidential and those that you do not wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.11. If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

1.12 If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

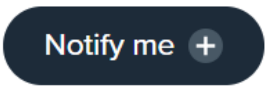
1.13. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

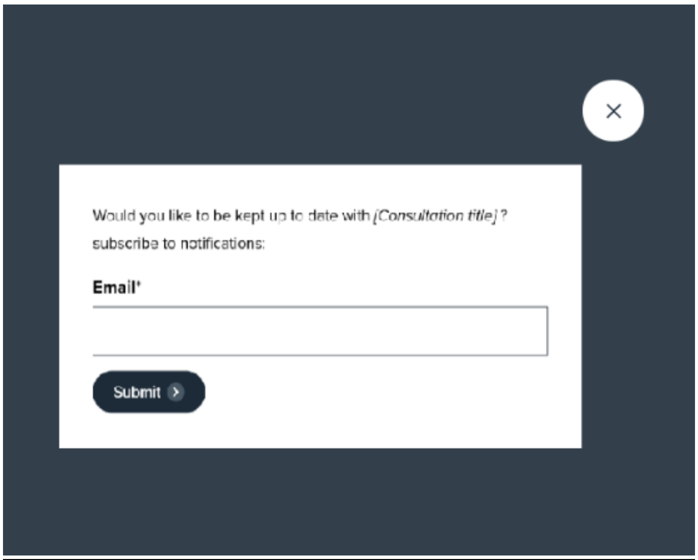
1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

1.14. Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

1.15. You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. Ofgem.gov.uk/consultations.





1.16. Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

Upcoming	►	Open	►	Closed (awaiting decision)	►	Closed (with decision)

2. Introduction

2.1. The default tariff cap ('cap') protects approximately 26 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. Following amendments made through the Energy Prices Act 2022, the cap is no longer subject to a sunset clause– although the Secretary of State may give notice at any time that the cap ceases to have effect. The cap is one of the key activities which falls within the 'Future of Retail' strategic change programme set out in our Forward Work Programme for 2022-23.[3] 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.

2.2. 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).[4] The Smart Metering Net Cost Change (SMNCC) allowances reflects the change in smart metering costs since 2017.

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

- We update the pass-through element every six-months, as part of the April and October price cap updates, via changes to the Annex 5 model. Pass-through values are set to cover two quarterly cap periods. These SMNCC elements are not the focus of this consultation.

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

[3] Ofgem (2022), Forward work programme 2022/23. https://www.ofgem.gov.uk/publications/202223-ofgem-forward-work-programme
[4] We update this allowance in line with CPIH inflation

Consultation scope

2.4. In our August 2022 decision we announced our intention to consider alternative approaches to updating the SMNCC allowances for future cap periods.[5] This consultation sets out our preferred alternative approach to reviewing and updating these allowances.

2.5. In response to the removal of a known end date to the price cap, we also set out our intention to extend the functionality of the SMNCC model, and supplementary models, to 2030 and to spread advanced payments over a rolling 12-month period.

Current approach to annual reviews

2.6. Our current approach is to review the SMNCC methodology annually and update all future values of the cap when we conclude an Annual Review.[6] For example in our August 2022 decision we published the final SMNCC allowances for cap period 9a and 9b (October 2022 - March 2023) and cap period 10a and 10b (April 2023 – September 2023). We also updated the allowances for cap period 11a (October 2023 – December 2023), stating that these allowances could be subject to revision through a potential 2023 Annual Review.[7]

2.7. We have not yet published SMNCC allowances for any cap periods beyond the end of 2023, reflecting the sunset clause within the original Domestic Gas and Electricity (Tariff Cap) Act 2018. However, following amendments to the Act, the price cap no longer has a pre-defined end date. We would therefore expect a 2023 SMNCC review, conducted under the current approach, to set final values for cap period 11a to 12b (October 2023 – September 2024) and to provide provisional allowances for cap periods up to some date in the future.

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

[5] Ofgem (2022), Price Cap – August decision, paragraphs 1.12, 1.13 and 1.14 https://www.ofgem.gov.uk/publications/price-cap-august-2022-decision-credit-and-ppm-smncc-allowances

[6] 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.

[7] 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>Quarterly cap period</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="4">Annual review sets final SMNCC values for these quarterly cap periods</td><td rowspan="4">N/A (historical cap period)</td><td rowspan="8">N/A (historical cap period)</td></tr>
<tr><td>Cap period X+1</td></tr>
<tr><td>Cap period X+2</td></tr>
<tr><td>Cap period X+3</td></tr>
<tr><td>Cap period X+4</td><td rowspan="8">Annual review updates SMNCC for these cap periods (but subject to later Annual Review)</td><td rowspan="4">Annual review sets final SMNCC values for these quarterly cap periods</td></tr>
<tr><td>Cap period X+5</td></tr>
<tr><td>Cap period X+6</td></tr>
<tr><td>Cap period X+7</td></tr>
<tr><td>Cap period X+8</td><td rowspan="4">Annual review updates SMNCC for these cap periods (but subject to later Annual Review)</td><td rowspan="4">Annual review sets final SMNCC values for these quarterly cap periods</td></tr>
<tr><td>Cap period X+9</td></tr>
<tr><td>Cap period X+10</td></tr>
<tr><td>Cap period X+11</td></tr>
</table>

Statutory framework

2.9. We set the cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act'). The Act requires us to put in place and maintain the licence conditions which give effect to the cap.[8] The objective of the Act is to protect current and future default tariff customers. We consider protecting customers to mean that prices reflect underlying efficient costs. We must have regard to five matters when setting the cap:[9]

- the need to create incentives for holders of supply licences to improve their efficiency;
- the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- the need to maintain incentives for domestic customers to switch to different domestic supply contracts;

[8] Domestic Gas and Electricity (Tariff Cap) Act 2018, sections 1(1) and 1(2). https://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[9] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6). https://www.legislation.gov.uk/ukpga/2018/21/section/1

- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence; and
- the need to set the cap at a level that takes account of the impact of the cap on public spending.[10]

2.10. We are required to exercise our functions under the Act with a primary focus on protecting consumers on default rates, while having regard to specified considerations listed above. Following the coming into force of the Energy Prices Act 2022, those specified considerations to be taken into account include 'the need to set the cap at a level that takes account of the impact of the cap on public spending'. That new consideration reflects the fact that, while the Government's Energy Price Guarantee is in force, the cap level affects the levels of payments by Government to energy suppliers.

2.11. The requirement to have regard to the five matters identified in section 1(6) of the Act does not mean that we must achieve all of these. In setting the cap, our primary consideration is the protection of existing and future consumers who pay standard variable and default rates. In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often, a balance must be struck between competing considerations.

2.12. Before we make a final decision on the proposals contained in this consultation, we shall review the issues to be decided with a view to the full set of statutory considerations, to ensure that our approach and conclusions are appropriate. We would invite any views from stakeholders on whether there are any further particular factors or information which we should consider in making our decision.

2.13. In setting the cap, we may not make different provisions for different holders of supply licences.[11] This means that we must set one cap level for all suppliers.

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[10] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6)(e) as inserted by Schedule 3 to the Energy Prices Act 2022. In performing the duty under section 1(6)(e) we must have regard to any information provided by the Secretary of State, or any guidance given by the Secretary of State on this matter (section 1(6A)).

[11] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted

3. The case for change

Section summary

Lower levels of uncertainty regarding the rollout of smart meters, a lack of clear and material systematic errors to correct and the relative decline in the contribution of SMNCC allowances to the overall accuracy of the cap suggest the current resource intensive detailed annual methodological reviews may no longer be justified.

Background

3.1. In our May 2020 consultation, we proposed to review the SMNCC allowances every 12 months.[12] We proposed this in recognition of the fact that the progress of the smart meter rollout and its impact on a notional suppliers' efficient operating costs was highly uncertain. This uncertainty increased the chance that the SMNCC allowances could be clearly, materially, and systematically misstated. Regular reviews could therefore help prevent the cap itself from becoming misstated and help ensure that we have sufficient regard to the statutory needs set out in the Act as circumstances change, including the need for an efficient supplier to finance the costs of its licensed activities.[13]

3.2. In response to our May 2020 consultation, stakeholders generally supported reviewing the SMNCC allowances. Some stakeholders supported our proposal for annual reviews. However, some stakeholders felt that the allowances should be reviewed only in response to one-off changes such as COVID-19 and/or BEIS' new Framework. This was primarily because they considered that annual reviews would create budget uncertainty for operational planning.[14]

[12] Ofgem (2020), Reviewing smart metering costs in the default tariff cap: May 2020 statutory consultation, paragraph 3.1 https://www.ofgem.gov.uk/publications/reviewing-smart-metering-costs-default-tariff-cap-may-2020-statutory-consultation
[13] Domestic Gas and electricity (Tariff Cap) Act 2018, section 1(6) https://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[14] Ofgem (2020), August 2020 decision on credit and PPM SMNCC allowances https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap

3.3. After consideration of stakeholder views, we decided, in our August 2020 decision document, to proceed with annual reviews.[15] We set out that we intended reviews to be subject to consultation and to take effect in the winter cap update.

3.4. Our August 2020 decision also set out the expected scope of annual reviews. Reviews were to consider (i) the latest data, (ii) the latest policy announcements, and (iii) changes to our rollout methodology. Only the first of these set an expectation for all future reviews, with the other two being dependent on events.

3.5. We stated that we did not consider in-depth annual reviews to be necessary or desirable and that we would consider input from stakeholders on the items we should consider within the scope of future reviews. The bar we set for inclusion in an annual review was that items should relate to clear and material systematic errors rather than issues with a limited prospect of materially impacting the final allowance values.

3.6. Following the completion of the 2021 and 2022 annual reviews, we now believe that the case for automatically consulting on SMNCC allowances each year has diminished. The main drivers of this are:

- Lower levels of uncertainty
- Fewer clear and material systematic errors
- A growing opportunity cost for both suppliers and Ofgem

Lower levels of uncertainty

3.7. Following the introduction of the post-2020 Smart Meter Policy Framework in July 2021 the level of uncertainty surrounding the pace of the smart meter rollout has reduced. The framework introduced minimum installation requirements by setting tolerance values around a trajectory to 100% coverage. In so doing we now have greater certainty about the pace of rollout compared to the previous "All Reasonable Steps" obligation. These tolerances now form the basis of our rollout profile within the SMNCC calculations.

[15] Ofgem (2020), August 2020 decision on credit and PPM SMNCC allowances, paragraph 5.2 https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap

3.8. We do not yet know the 2024 and 2025 tolerance levels; these are expected to be confirmed in a BEIS review in 2023. However, having already set out our approach to reflecting tolerance values in our rollout assumptions, incorporating the values for 2024 and 2025 does not pose any new methodological questions. Once these values are known the model can be updated mechanistically without having to make further choices about how we model the smart meter rollout.

3.9. Another key source of uncertainty, that was subject to a substantial portion of the methodological discussion in both the 2021 and 2022 annual reviews, was the impact of COVID-19. The pandemic impacted suppliers' ability to carry out installations, generating costs that could not be recovered as spending couldn't be scaled down as quickly as installations. In our August 2022 decision we decided to not include these sunk installation costs beyond 2021, reflecting the impact of removed restrictions. We do not currently expect COVID-19 to generate sufficient uncertainty about the smart meter rollout to prompt similar methodological reviews going forward.

3.10. For these reasons the level of uncertainty that made frequent reviews of the underlying SMNCC calculations valuable has diminished. In the absence of a change in approach, we would expect future reviews to focus primarily on a simple update of the data behind model inputs and potentially a discussion of whether certain changes represented clear and material systematic errors rather than elements of detail.

3.11. To some extent this can be seen in our 2022 annual review, which beyond some discussion of the impact of COVID-19 almost exclusively focused on updating certain inputs to reflect newer data. In several cases, such as when considering newer data behind assumptions related to the operation and rollout of SMETS1 meters, we decided not to make any change reflecting that such changes did not relate to a clear and material systematic error.

A lack of clear and material systematic errors

3.12. Since March 2019, our approach to non-pass-through SMNCC modelling has been tested and refined through seven consultations, eight decision documents, and ten working papers and letters. As a result, and in the absence of a significant change to the external environment, the most consequential methodological decisions and assumptions are now unlikely to change fundamentally. Further changes to our modelling approach will, therefore, likely deliver increasingly smaller improvements in accuracy and do so at the expense of higher complexity.

3.13. For example, in our 2022 annual review, we considered whether and how we could account for the impact of the Supplier of Last Resort (SoLR) process on the market leader rollout profile. After gathering information from suppliers, we noted that the impact of SoLR on rollout was less than one percentage point, and that adjusting for this change would add significant complexity to the SMNCC model. We would have needed to develop a specific rollout profile for the advanced payments calculation, calculated the SMNCC allowance using this profile, and then fed this back into the model as an additional input. As a result of the trade-off between a small accuracy improvement and increased model complexity, we decided against making the change.

3.14. This example highlights the marginal nature of the methodological questions that now arise as we update the SMNCC model. Most of the changes we consulted on in our 2022 annual review did not require a change to SMNCC calculations or new assumptions, just an updating of existing assumptions or inputs using newer data. This reflects that the prevalence of any clear and material systematic errors has diminished over time as our modelling approach has matured.

3.15. Ultimately what matters for consumers, suppliers and taxpayers is the overall level of the cap and whether it meets the statutory needs as defined in the Act. As a result of declining SMNCC allowances and increased allowances elsewhere, notably those relating to wholesale costs, SMNCC now represents less than 1% of the overall cap value. Consequentially, even if there were to be large accuracy gains to be found in our approach to SMNCC, which we do not believe there are, these would have a minimal impact on the accuracy of the overall cap.

Growing opportunity costs

3.16. We do not consider detailed annual reviews of SMNCC are necessary to meet our obligations under the Act. The case for this judgement is now even greater considering the lower levels of uncertainty, the reduced prevalence of clear and material systematic modelling errors, and reduced contribution of SMNCC to the overall cap level. The judgement is also in line with our approach to other allowances, most of which are not subject to consultation and detailed review every year.

3.17. We will of course maintain awareness of any changes in circumstance that may generate clear and material systematic errors and consider any evidence stakeholders may wish to present on such issues. Should any such errors be identified a detailed methodological review, along the lines of previous Annual Reviews, would remain an option.

3.18. Continuing annual reviews is therefore a judgement on whether the benefits outweigh the costs. The resource costs of conducting SMNCC reviews only partially scale with the complexity of the issues being considered (ie there are high fixed costs). Therefore, we expect the costs of conducting future SMNCC annual reviews to remain high. This includes for suppliers, some of whom have raised concerns related to the complexity of the SMNCC model and the need to employ specialist advisors to engage in the disclosure process.[16]

3.19. The direct resources costs are not the only costs we need to consider. We also need to consider the other uses those resources could be put to in the absence of annual SMNCC methodology reviews (ie the opportunity costs). As previously noted, the SMNCC allowances make up a relatively small proportion of the cap and have been subject to regular review when compared to other allowances. It therefore seems likely that those resources would generate higher returns, in terms of improved accuracy, when allocated to other larger allowances which have been subject to less frequent review.

3.20. The combination of high fixed resource costs, the existence of larger and less mature allowances and the low expected return from further SMNCC methodology reviews points towards the current approach likely being an inefficient use of supplier and Ofgem resources.

[16] For example, see the response from Utilita to the 2022 SMNCC consultation https://www.ofgem.gov.uk/publications/price-cap-may-2022-consultation-credit-and-ppm-smncc-allowances

4. Options for change

Section summary

This chapter sets out our preferred proposal to pause the annual reviews of the non-pass-through (NPT) element of the Smart Metering Net Cost Change (SMNCC) allowances in the Default Tariff Cap (DTC). We also briefly outline other options we have considered but are minded against.

Pausing annual SMNCC methodology reviews

The proposal

4.1. Our proposal for an alternative approach to updating and reviewing the SMNCC allowances consists of four elements:

i. An indefinite pause of annual SMNCC methodology reviews.

ii. The updating of model input data each year.

iii. The publishing of 12 months of final SMNCC values in August each year.

iv. A commitment to consider SMNCC as part of a wider review of the operating cost allowance.

Pausing annual methodology reviews

4.2. We propose to no longer automatically undertake a review of the underlying SMNCC methodology and model calculations each year. In practice, this would mean we would no longer publish an SMNCC consultation document or any working papers in a normal year. Stakeholders will of course still be able to contact Ofgem about any concerns they have regarding SMNCC. We would retain the right to undertake a full review informed by a consultation should we feel this necessary for any reason.

Updating model inputs

4.3. We propose to continue to update the inputs into the SMNCC model on an annual basis. This will include all the inputs which are based on the Annual Supplier Returns (ASR) data collected by BEIS. We will also update rollout input using the latest outturn figures and reflect any changed or new rollout tolerance values as set by BEIS. We will update the SMNCC model's measure of inflation, the GDP deflator, using the latest outturn values from the Office for National Statistics (ONS) GDP quarterly national accounts publication and the latest forecasted values from the Office for Budget Responsibility's (OBR) economic and fiscal outlook publications as available by the 30th of June each year. The GDP deflator will be updated for all relevant supplementary models as well, with their new outputs being fed into the SMNCC model. Finally, we will complete all necessary model updates to ensure the impact of new input values are fully reflected in the final allowances. This will include an update of the advanced payments calculation.

4.4. Table 4.1 below sets out in detail the inputs we propose to update each year.

Table 4.1 – Proposed annual data/input updates to the SMNCC model

Area	Components	Sources of Data
Costs	• the costs of smart meters • the costs of communication hubs • the costs of In-Home Displays (IHDs).	ASR data
Benefits	• the number and cost of avoided site visits • change of supplier benefits (credit only) • benefits of reduced inbound enquires (credit only) • improved debt management (credit only) • benefits of a remote change of tariff (credit only)	ASR data
Rollout	• data on actual customer numbers by metering type to update smart meter roll out percentages for upcoming years • new or changed rollout target or tolerance values	ASR data; BEIS Smart meter policy framework publications
Other inputs	• GDP deflator	ONS and OBR

Publishing final SMNCC values

4.5. As set out in Table 1.1, under the current annual review approach we set 12 months' worth of SMNCC values which are not subject to further review. We also set initial SMNCC values for all future cap periods beyond those 12 months, subject to change through future reviews.

4.6. Under this proposal we would publish a short decision paper setting out the final SMNCC allowances for the relevant October to September period only and would not publish provisional values beyond this 12-month period. This reflects the removal of a known end date to the cap, which we discuss in chapter five of this consultation. Additionally, in contrast to our previously long and detailed decision documents, under this new approach decision documents would simply state the new values and give a brief description of the data updates conducted.

Operating cost allowance review

4.7. As set out in our Programme of Work, published at the same time as this consultation, we currently intend to review the operating cost allowance by Winter 2024/25.[17] Smart metering costs are embedded within the operating cost allowance. SMNCC allowances are there to reflect the fact that those embedded allowances may change over time. SMNCC and the operating cost allowances are therefore intrinsically linked.

4.8. As a result, any review of the operating cost allowance would represent an opportunity for us to review our approach to SMNCC as well. This could include a more fundamental look at our approach to SMNCC rather than just a refinement of our current methodology, as existing annual reviews have become. This could include giving consideration as to how we might significantly simplify our approach to SMNCC, reflecting anecdotal comments that the current approach is complex and difficult to engage with. **We welcome any early views stakeholders may have on the how we could best use an operating cost allowance future review to improve our approach to SMNCC.**

[17] https://www.ofgem.gov.uk/publications/price-cap-programme-work

Considerations

Impact on accuracy

4.9. Reducing the frequency and detail of our reviews of SMNCC reduces our ability to regularly check the model against new developments and make relevant adjustments. However, as previously set out, the methodology behind the SMNCC values is mature. There is therefore limited scope to improve the accuracy of the model without significantly increasing its complexity.

4.10. In addition, should significant changes in circumstance or policy arise which impact the smart meter rollout, we retain the ability to consult on methodology changes. The impact of our proposal is that this would be by exception rather than as part of an annual requirement.

4.11. Furthermore, under our proposal the data behind the SMNCC calculation will continue to be updated, ensuring the allowances reflect the most up to date information. Newer data is one of the main drivers of revisions to our SMNCC estimates, maintaining this will help mitigate any negative impact of pausing reviews on accuracy.

4.11. As a result, we expect that the impact of pausing annual reviews on the accuracy of SMNCC values is likely to be minimal.

Impact on transparency

4.12. Under the current annual review approach stakeholders often have multiple opportunities, through responses to working papers and a consultation, to express their views on any changes we propose to make to the SMNCC model. Under this new approach there will be no formal opportunities for stakeholders to express a view, although they can do so unprompted.

4.13. However, at the same time the nature of the changes we consider each year will fundamentally change. We will no longer be considering changes beyond updating inputs to reflect recent data, as outlined in this consultation (see Table 4.1). As such the removal of the consultations will not reduce the transparency of the changes to the SMNCC allowances.

4.14. In addition to consultations, under the current approach, we run a disclosure exercise where interested parties can access and examine the models used to calculate the

SMNCC values. As the changes to these models will only reflect mechanistic updates and updates to input values, the utility of a disclosure exercise is diminished.

4.15. Under our new proposed approach this disclosure process would no longer happen, with stakeholders no longer being able to examine the models themselves for errors or discrepancies between what we claim to have updated and what has been updated.

4.16. Given the change in the nature of updates we do not believe that this represents a material negative impact on transparency. The purpose of the disclosure exercise is to allow stakeholders to examine the model changes detailed in a consultation. As there would no longer be a consultation and the changes to the model would be limited to a set of pre-determined updates, this rationale no longer applies.

Impact on statutory duties

4.17. As set out earlier, in setting the cap we must have regard to five matters (see paragraph 2.9). We do not believe that our proposal to indefinitely pause annual methodological reviews has material implications for any of these five matters or on existing or future default tariff customers.

4.18. The precise impact of pausing reviews on the final SMNCC allowances in any given cap period cannot be known ahead of time and cannot be known without conducting the reviews for comparison. However, for the reasons we have set out above and in Chapter 3, we believe we are justified in our expectation that any impact is likely to be small. In addition, we do not see any reason to believe there is likely to be any systematic bias in impact along consumer or supplier characteristics. More generally, and in line with our public sector equality duty, we do not consider that our proposal disproportionately affects people protected under the Equality Act.

Alternative options considered

Alternative 1: Continue with annual reviews

4.19. An obvious alternative to our preferred option would be to continue with the current approach to annual reviews. This would mean consulting on a range of potential changes and updates to the SMNCC calculations. In line with previous annual reviews, we would aim to publish this consultation in May and a decision in August.

4.20. We would expect a 2023 annual review to set the final SMNCC allowances for the cap periods between October 2023 and September 2024 and establish values for cap periods beyond this, which could be subsequently revised through future annual reviews.

4.21. Should we decide at the end of this consultation to proceed with a full 2023 annual review, it is unlikely that there would be sufficient time to publish a working paper setting out the scope of that review and inviting stakeholder views - as we have done for previous reviews.

4.22. We have considered the elements of the SMNCC methodology we could review if we were to conduct a 2023 annual review. Table 4.2 below sets out some of the options and considers their likely materiality. We assess that the likely materiality of these are quite limited and do not, in our judgement, rise to the bar of being related to clear and material systematic errors.

4.23. The one area where a new approach is considered to be required is advanced payments. The removal of a fixed end date to the price cap means our current approach of spreading advanced payments up to the end of 2023 is no longer appropriate. Instead of carrying out a 2023 annual review on this issue alone, we are seeking views on our proposed change on approach in this consultation (see Chapter 5).

Table 4.2: Potential issues to be consulted on as part of a 2023 Annual Review

Potential update	Description
Reflect the impact of the introduction of a churn adjustment for 2023 supplier installation targets on rollout assumptions	An adjustment has been introduced to the Year 2 (2023) smart meter installation targets to reflect the impact of customer switching. This is most likely to impact the rollout assumption used to calculate the credit SMNCC allowances, potentially lowering it. However, it currently only applies to one year (2023) and given the low levels of customer switching we do not expect the adjustment to have a significant impact.

Review of the approach to applying customer switching benefits	SMNCC calculations include a benefit to suppliers of smart meters reducing the cost of processing customer switching. This benefit is applied via a static £/meter/year estimate and is not profiled over time. However there has been a notable decline in customers switching energy suppliers recently, reflecting current market conditions. Updating this benefit estimate with newer data may therefore retrospectively reduce the size of the benefit in previous periods. There is therefore a case to profile the benefit over time. However, as customer switching benefits only currently reduce the final credit NPT value by around £1.50, a move to profiling is unlikely to generate a material change.
Review the pace of SMETS1 enrolment	Following the BEIS consultation on amending the replacement obligation for SMETS1 meters not enrolled with the DCC issued in July 2022, there is the possibility that the date for full SMETS1 enrolment will be pushed back. This may have implications for the rollout assumptions used in the SMNCC model, and therefore supplier costs.

4.24. Overall, for the reasons we've set out in Chapter 3, we do not believe a 2023 annual review would be necessary to meet our obligations under the Act nor would it deliver meaningful improvements in accuracy compared to our preferred alternative, as detailed earlier in this consultation. **We therefore do not recommend that we continue with annual reviews.**

Alternative 2: Roll forward already published values

4.25. As an alternative to any kind of review, we could make use of the SMNCC values we have already published for the October to December 2023 period (cap period 11a). Under the current approach, a 2023 annual review would revise this published value, applying it over cap period 11a and 11b (ie up to March 2024) and would set a new value for the subsequent cap period (April – September 2024).

4.26. As an alternative to the current approach, we could not review the already published cap period 11a values and then roll them forward into future cap periods. If we were to do that, we would face a choice about how far those values are rolled forward. Table 4.4 below shows two indicative options. Under option A, the cap period 11a values are rolled forward only as far as cap period 11b with a review then used to establish new values for cap periods 12a (April – June 2024) onwards. Under option B, the cap period

11a values are rolled forward up to cap period 12b (July – September 2024), in effect removing the need for a 2023 annual review entirely but still necessitating a review in 2024 to set new values for cap period 13a (October – December 2024) onwards.

Table 4.4: Timing options for the roll forwards approach– sub-options A and B

Sub-option	Cap periods				Consultation	Decision
	11a	11b	12a	12b		
A	11a	11a	**12**	**12**	Oct 23	Feb 24
B	11a	11a	11a	11a	May 24	Aug 24

Notes: **Bold black represents new values**/Light grey represents existing published values. We do not consider an option which includes producing a new value for 11b as doing so would alter the April/October timing for SMNCC updates as set out in the August 2022 Wholesale methodology publication.

4.27. One practical issue with rolling forward the cap period 11a values is our approach to advanced payments. Advanced payments account for the over or under recovery of net costs from previous periods through adjustments to values in future periods. As the SMNCC model currently ends in 2023 these adjustments are designed to have been fully recovered by the final cap period of the model (11a). Rolling forward this number unmodified would therefore result in those advanced payments being recovered on a repeated basis.

4.28. Table 4.5 below sets out the SMNCC values for cap period 11a as published in August 2022 and adjusted to remove the impact of advanced payments.

Table 4.5: SMNCC allowance values to roll forward

Fuel	Published SMNCC cap period 11a values		SMNCC cap period 11a values with advanced payments removed	
	Credit	PPM	Credit	PPM
Electricity	£10.55	-£6.25	£9.83	-£6.25
Gas	-£0.88	-£26.33	£1.97	-£23.36

Notes: All values are £/customer, nominal.

4.29. Rolling forward existing values has the short-term benefit of requiring no further reviews or model updates. It does however have the largest negative impact on accuracy of the three options we have considered. As a result of these accuracy concerns it is also necessarily a temporary measure, as at some point using the values for cap period 11a in cap periods far beyond 2023 will lack credibility and will undermine our ability to meet our obligations under the Act.

4.30. For these reasons we do not propose the option of rolling forward already published values.

5. Model extension

Section summary

In this chapter we set out our proposed approach to extending the functionality of the SMNCC non-pass-through model to reflect the fact that there is no longer a known end date to the price cap. In particular we set out a proposed change to the period over which we apply advanced payments.

Extending the non-pass-through SMNCC model and supplementary models

Context

5.1. As previously described, amendments made by the Energy Prices Act 2022 to the Domestic Gas and Electricity (Tariff Cap) Act 2018 mean that there is now no known end date to the price cap. Prior to these amendments the cap was due to cease operating no later than the end of 2023. Following these amendments, the Secretary of State may at any time give notice that tariff cap conditions cease to have effect.

5.2. The non-pass-through SMNCC model we use to set the non-pass-through values reflects the previous fixed end-date, producing values only up to a final cap period of October to December 2023. Given the changes in legislation we need to modify the model, and any relevant supplementary models, so that we can produce SMNCC allowances for 2024 onwards.[18]

Proposal

5.3. We propose to extend the functionality of the non-pass-through model and any relevant supplementary models to the end of 2030. We will do so without changing the existing modelling approach, simply extending the calculations into future years.

[18] Supplementary models are models used to generate inputs to the primary non-pass-through SMNCC model.

5.4. We do not propose to subject the extended model, or relevant supplementary models, to a disclosure process.

Considerations

5.5. The choice to extend the model to cover potential cap periods up to 2030 reduces the possibility that we will need to extend the model again. In reality we would expect the smart metering rollout to have completed before then. Once the rollout is complete, the need for an SMNCC allowance is reduced, or potentially removed, as the costs associated with smart metering become more stable and would resemble more standard on-going operating costs.

5.6. Extending the functionality of the model up to 2030 does not mean we will publish provisional values up to that date, only that the option is there should that ever be required. As set out in our proposed new approach to updating the SMNCC model, we currently intend to only publish 12-months' worth of SMNCC allowances each year (see paragraph 4.6).

5.7. We expect the process of updating the model to be mechanical in nature, and to not require any methodological judgements. If we encounter any areas where there are options in how we can approach extending the model, we will default to maintaining the current approach as closely as possible. This will ensure the workings of the extended model continue to reflect the public decisions we have made following previous consultations.

5.8. In practice we do not expect to need to make such choices, reflecting that extending the model should only require us to apply the current methodology to future periods and not require adjustments to the current methodology. As a result, disclosing the extended model would only serve the purpose of allowing participants to engage in error checking. This is not the role of stakeholders. The extended model will be subject to internal Ofgem quality assurances processes.

Approach to advanced payments

Context

5.9. Advanced payments reflect when suppliers have received payment in advance for smart metering costs they have not yet incurred. The opposite case could also occur, where suppliers have incurred costs prior to receipt of payment through the allowance.[19,20]

5.10. We calculate the SMNCC allowance in a given historical cap period using the latest version of the SMNCC model and compare it against the SMNCC allowance we provided in the historical cap period. The difference between the two forms the basis of advanced payments.

5.11. To date we have spread the balance of advanced payments over the maximum number of remaining cap periods.[21] However as there is no longer a defined number of remaining cap periods this approach is no longer suitable.

Options

5.12. We have considered two approaches to recovering advanced payments when there is no fixed cap end-date:

i. on a rolling basis (ie over a set number of cap periods after each model update); and

ii. by a certain fixed date.

[19] Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraph 2.18. https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap
[20] The opposite case would technically involve lagged payments (rather than advanced payments). However, for simplicity, we use the term advanced payments throughout this section. This is regardless of whether we are referring to suppliers receiving payments in advance or in arrears.
[21] Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraph 5.52. https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap

Proposal

5.13. We propose to recover any outstanding advanced payments on a 12-month rolling basis. In steady state (ie from October 2024) each 12 months of SMNCC allowances would reflect the totality of any positive or negative advanced payments balance built up over the previous 12 months.

5.14. If the cap is brought to an end prior to the end of the 12 months period, then advanced payments will be partially unrecovered. We acknowledge this risk but note that a 12-month recovery period lowers the likely materiality of this issue compared to a fixed-date approach with longer recovery window.

Considerations

Applying advanced payments on a 12-month rolling basis

5.15. The cap was due to expire at the end of 2023 and we have already published final SMNCC allowances up to September 2023. As a result, there is only one outstanding cap period containing a portion of the existing advanced payments balance (Oct-Dec 23).

5.16. This means, to transition to a 12-month rolling approach, we would evenly spread the value of this existing one-quarter (Oct-Dec 23) of advanced payments, plus any additional balance built up between October 2022 and September 2023, over the four quarterly allowances between October 2023 and September 2024.

5.17. This would ensure that all outstanding advanced payments are recovered by September 2024. From October 2024 onwards each 12 months' worth of SMNCC allowances would then only reflect advanced payments built up over the previous 12 months, as calculated using the latest version of the SMNCC model. The choice to align the rolling 12-month period with the first winter cap period (ie October to December) reflects our intention, and current practice to date, to publish the final SMNCC allowances each year in August for the period between October and September.

5.18. The advantage of this approach is that customers or suppliers (depending on whether the advanced payments balance is positive or negative) would benefit from the allowances reflecting costs more quickly. Also, by having a 12-month recovery period, if the cap ends prior to the advanced payments balance being fully recovered any outstanding balance is likely to be smaller compared to a longer recovery period.

5.19. The primary disadvantage of this approach is that it could generate higher levels of volatility in the SMNCC allowances and therefore the cap. When the advanced payments balance is reset at the end of each 12-month period it could result in a larger adjustment to SMNCC allowance compared to spreading the payments out over the longer period, where positive and negative balances could potentially offset each other for example.

5.20. We do not expect any increase in volatility to be significant. Current advanced payments are equal to -£2.09 for credit customers and -£2.92 for PPM customers (prior to the application of the PPM offset). In the context of current overall price cap levels, even large proportional movements in advanced payments at these levels would not generate undue volatility in the overall price cap.

Applying advanced payments on a six-month rolling basis

5.21. We could shorten this recovery period even further by aligning it with other price cap decisions, such as the decision to recover backwardation costs over a six-month period.[22]

5.22. This would build on the advantage of 12-month approach by ensuring customers or suppliers receive the benefits of advanced payments more quickly. However, in combination with setting 12 months' worth of allowances each year in August, it would also result in arbitrary seasonality in SMNCC allowances. Advanced payments would only be applied to the winter cap periods (between October and March), or possibly the summer cap periods (between April to September) if spread over the second six-months. This would result in changes to either winter or summer period allowances which were unrelated to changes in supplier's net costs, and likely to generate volatility in the allowances.

5.23. We view this feature as undesirable and unnecessary. Advanced payment values are likely to continue to be relatively small in absolute terms. Therefore, a 12-month recovery period compared to a six-month period is unlikely to result in a material difference for customers or suppliers.

[22] Ofgem (2022), Price cap - Decision on changes to the wholesale methodology, paragraph 5.9 https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology

Setting a fixed date by which advanced payments are recovered

5.24. An alternative to recovering advanced payments on a rolling basis would be to select an end date at which all advanced payments will have been recovered.

5.25. One option would be to align this assumed end date with the end date of the smart meter policy framework. The current framework ends in 2025. Suppliers are expected to have reached 100% smart meter rollout by this date, minus a tolerance level which has not yet been set.

5.26. The advantage of spreading advanced payments over a period ending in 2025 is that it generates a smaller adjustment to SMNCC allowances in each cap period compared to recovery over a shorter period. It is also more aligned with our current approach.

5.27. One key disadvantage is that the end date will have to be revisited if the cap and SMNCC allowances continue past 2025. Additionally, the potential for material unrecovered advanced payments when the cap ends is greater compared to a shorter recovery period. It might prove possible to mitigate this risk if the final cap period is known sufficiently well in advance, but there is no guarantee this will be the case.

5.28. Overall, as a fixed-date approach is potentially not an enduring solution, we are minded against this option.

Impact of a 12-month recovery period on statutory duties

5.29. The choice of recovery period for advanced payments only changes the timing of costs and benefits, not the absolute size. Compared to a longer recovery period, a 12-month recovery period is likely to have larger advanced payments in nearer periods but smaller adjustments further in the future. The precise impact will depend on the size and direction of the advanced payments balance, as calculated by the non-pass-through model each year.

5.30. The impact on the profile of allowances will have consequences for consumers, suppliers and public spending as a result of the time value of money (ie money now is worth more than money in the future). If the advanced payments balance remains positive, meaning suppliers have overall received payments in advanced of costs, a front loading of advanced payments could be seen, looking from todays' perspective, as advantageous to consumers and for public spending and disadvantageous for suppliers. However, as discussed in earlier sections, we do not expect advanced payment adjustments to be large and therefore do not consider changes in timings of these adjustments to be a material consideration.

5.31. It is also important to remember this judgement is being made in relation to a theoretical alternative option of a longer recovery period and not in relation to the status quo (a fixed recovery date of 2023), as the status quo is no longer applicable.

Appendices

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Appendix 1 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

3. With whom we will be sharing your personal data

(Include here all organisations outside Ofgem who will be given all or some of the data. There is no need to include organisations that will only receive anonymised data. If different organisations see different set of data then make this clear. Be a specific as possible.)

4. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for ***(be as clear as possible but allow room for changes to programmes or policy. It is acceptable to give a relative time e.g. 'six months after the project is closed')***

5. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 0303 123 1113.

6. Your personal data will not be sent overseas (Note that this cannot be claimed if using Survey Monkey for the consultation as their servers are in the US. In that case use "the Data you provide directly will be stored by Survey Monkey on their servers in the United States. We have taken all necessary precautions to ensure that your rights in term of data protection will not be compromised by this".

7. Your personal data will not be used for any automated decision making.

8. Your personal data will be stored in a secure government IT system. (If using a third party system such as Survey Monkey to gather the data, you will need to state clearly at which point the data will be moved from there to our internal systems.)

9. More information For more information on how Ofgem processes your data, click on the link to our "Ofgem privacy promise".