
Appendix 3: Smart metering costs

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1. Introduction

Chapter summary

This chapter sets out the context for the review of the SMNCC allowance as part of our operating cost allowances review, a summary of our proposals, and the structure of the remaining chapters.

Context

- 1.1 The impact of the smart meter rollout on suppliers' costs is reflected in the default tariff cap (the 'cap') through two allowances: the operating cost allowance and the Smart Metering Net Cost of Change (SMNCC) allowance.
- 1.2 The operating cost allowance reflects all metering costs in the baseline year (alongside other operating costs). The SMNCC allowance is set annually and reflects the net change in operating costs, compared to the operating cost allowance baseline, that has resulted from the rollout of smart meters.
- 1.3 The SMNCC is made up of two parts, the 'non-pass-through' (NPT) and 'pass-through' (industry charge) costs. Generally, smart meters reduce suppliers' NPT operating costs and so over time the SMNCC allowance has tended to reduce overall operating cost allowances.
- 1.4 We calculate the NPT net change in costs using the SMNCC model, which is based on the 2019 Department for Energy Security and Net Zero (DESNZ, formerly referred to as the Department for Business, Energy & Industrial Strategy (BEIS)) Cost Benefit Analysis (CBA) model.¹
- 1.5 This Appendix focuses on the NPT SMNCC costs. Please refer to 'Appendix 4: industry charges' for our proposals and considerations for the pass-through costs.

Purpose of the review

- 1.6 Implementation of the operating costs review will set a new core operating costs baseline (as considered and proposed in 'Appendix 1: core operating costs'). As such, we need to update the SMNCC allowance to ensure it aligns with the updated core operating cost allowance. As part of this review, we also consider it appropriate to revisit our approach to setting the NPT SMNCC allowance.

¹ BEIS (2019), Smart meter roll-out: cost-benefit analysis 2019.
<https://www.gov.uk/government/publications/smart-meter-roll-out-cost-benefit-analysis-2019>

- 1.7 In our May 2024 policy consultation, we considered options for setting the future NPT SMNCC allowance for the remainder of the smart meter rollout.² We considered updating the current SMNCC model or whether to adopt a simpler modelled approach, and options for our review and approach for updating the allowance over time.
- 1.8 In our August 2024 working paper, we further considered options for a simpler modelled approach to setting the future NPT SMNCC allowance.³ We also considered options around how to proceed beyond the current rollout framework which is due to expire at the end of 2025.
- 1.9 This document sets out our proposals, having considered the comments received to our policy consultation and working paper.

Summary of our proposals

- 1.10 We propose to progress with the NPT SMNCC review as part of the operating costs review and consider the post-2025 framework following a decision on the revised rollout framework. We will consider whether further consultation with stakeholders is necessary following DESNZ's framework decision. This will likely depend on the nature of decisions taken by DESNZ on the smart meter rollout framework post-2025.
- 1.11 We propose to update the SMNCC model baseline year to 2023, in alignment with the core operating cost allowance.
- 1.12 We propose to simplify the SMNCC model, by reducing the number of individual components modelled within the allowance. Depending on which option we decide to proceed with, some supplementary models may become redundant. In this document, we propose to select option 3 to simplify the SMNCC model.⁴ We consider that this is the most appropriate option and reject the other options which exclude key benefits that we consider to be material.

² Ofgem (2024), Energy price cap operating cost allowances review, Chapter 5.

<https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review>

³ Ofgem (2024), Energy price cap operating cost review: smart metering working paper.

<https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-costs-review-smart-metering-costs-working-paper>

⁴ This option includes asset costs, installation costs, Premature Replacement Charges (PRCs) for traditional meters and avoided rental costs for meters where a PRC was previously incurred, asset and installation cost of installing traditional meters during rollout, in home displays, non-zero direct operational benefits and supplier IT.

- 1.13 We propose to maintain our existing approach to setting future rollout profiles, using a market leader tolerance approach for the credit allowance, and a weighted average tolerance for the prepayment meter (PPM) allowance.
- 1.14 We propose to continue benchmarking the key cost and benefit inputs by using a weighted average benchmark.
- 1.15 We propose to maintain our existing approach of annual review and updates of the SMNCC model.
- 1.16 We propose to maintain our existing approach to calculating the advanced payment adjustment (reflecting the difference between the forward-calculated NPT SMNCC allowance provided, and the allowance that would have been set had we used actual data), and to roll over the current advanced payment adjustment.
- 1.17 Based on the proposals outlined in this document, the allowance for a dual fuel Direct Debit and Standard Credit customer (with benchmark consumption) will be £3.27 lower than the current cap period 13a allowance. For a PPM dual fuel customer, the allowance will be £2.45 lower than the current cap period 13a allowance. A breakdown of the allowance values is shown in Table 1 below. We have also included indicative allowance for cap period 14a (April - June 2025).

Table 1: Proposed SMNCC allowance (nominal prices) (£ per customer)

	Cap period 13a, Nil (current allowance)	Cap period 13a, Benchmark (current allowance)	Cap period 13a, Nil (proposed allowance)	Cap period 13a, Benchmark (proposed allowance)	Cap period 14a, Nil (proposed allowance)	Cap period 14a, Benchmark (proposed allowance)
Direct Debit, elec	2.41	3.49	1.46	2.12	0.75	1.09
Direct Debit, gas	-1.40	-2.03	-2.70	-3.92	-4.04	-5.86
Direct Debit, dual fuel	1.01	1.47	-1.24	-1.80	-3.29	-4.77
Standard Credit, elec	2.41	3.49	1.46	2.12	0.75	1.09
Standard Credit, gas	-1.40	-2.03	-2.70	-3.92	-4.04	-5.86
Standard Credit, dual fuel	1.01	1.47	-1.24	-1.80	-3.29	-4.77
PPM, elec	-0.14	-0.14	-1.74	-1.74	-3.28	-3.28
PPM, gas	-15.41	-15.41	-16.26	-16.26	-20.16	-20.16
PPM, dual fuel	-15.56	-15.56	-18.01⁵	-18.01	-23.44	-23.44

Note: Benchmark consumption is equal to 3,100 kWh for single-rate electricity, 12,000 kWh for gas and 4,200 kWh for multi-rate electricity. Values displayed are shown for single-rate metering arrangement.

⁵ We are maintaining our previous SMNCC decisions on the standing charge/unit rate allocation, which means that 100% of the PPM SMNCC is applied to the standing charge, while 69% of the credit SMNCC is applied to the standing charge.

- 1.18 We consider the proposed negative credit and PPM allowances are both appropriate at capturing the key costs and benefits which are materially changing beyond the 2023 baseline year. As rollout is progressing, suppliers gain from operational benefits so the negative numbers in part reflect the benefit against the new baseline.

Structure of the paper

- 1.19 The structure of the remaining document is set out below:
- **Chapter 2 – Post-2025 framework.** In this chapter we set out our approach to updating and reviewing the NPT SMNCC allowance in the context of the existing Smart Meter Targets Framework and any future post-2025 framework.
 - **Chapter 3 – Updating the SMNCC baseline.** In this chapter we set out our proposals to update the NPT SMNCC allowance in alignment with the core operating cost allowance.
 - **Chapter 4 – Costs and benefits.** In this chapter we set out our proposal to simplify our modelled approach, and consider the allowances calculated against those calculated using alternative options.
 - **Chapter 5 – Other areas.** In this chapter we set out our proposals, largely unchanged from our current approach, to calculating future rollout profiles, benchmarking net costs, our model review and update process, and the advanced payment adjustment.

2. Post-2025 framework

Chapter summary

This chapter sets out our consideration of the interaction between this review and the next smart meter rollout framework.

Context

- 2.1 DESNZ's four-year smart metering rollout framework sets out minimum smart meter installation requirements (subject to tolerance levels) for suppliers, to the end of 2025.⁶ Under this framework, the government set out individual energy supplier targets and tolerance levels on a trajectory to 100% coverage.⁷
- 2.2 The supplier targets and tolerance levels are input into the SMNCC model and, alongside annual rollout profile data inputs / updates, are used to set the NPT SMNCC allowance for the forthcoming year.
- 2.3 In our August 2024 working paper we considered three options for how we consider a post-2025 framework,⁸ with a preference for option 2:
- Option 1: Delay the SMNCC review until a decision on a post-2025 framework has been made.
 - Option 2: Progress with the SMNCC review and consider the post-2025 framework following a decision on the revised rollout framework.
 - Option 3: Set the SMNCC to £0 until a decision on a post-2025 framework has been made.
- 2.4 We expect DESNZ to publish information on a new post-2025 framework, before the current framework ends.

⁶ DESNZ (2023), Smart Meter Targets Framework: government response to a consultation on minimum installation requirements for Year 3 and Year 4.

<https://www.gov.uk/government/consultations/smart-meter-targets-framework-minimum-installation-requirements-for-year-3-2024-and-year-4-2025>

⁷ These targets are designed to ensure that suppliers have installed a specific number of smart meters by a certain deadline, aiming for 100% coverage. The "tolerance levels" refer to the allowable margin of error or flexibility given to suppliers each year.

⁸ Ofgem (2024), Energy price cap operating cost review: smart metering working paper, paragraph 3.14.

<https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-costs-review-smart-metering-costs-working-paper>

Proposals

- 2.5 We propose to proceed with option 2. This involves updating the SMNCC model baseline (see Chapter 3) and simplifying the existing SMNCC model to set the allowance (see Chapter 4).
- 2.6 In proposing option 2, we will consider whether further consultation with stakeholders is necessary following DESNZ's framework decision.

Summary of responses

- 2.7 Three suppliers and one stakeholder supported option 2, particularly the SMNCC model updates required to ensure compatibility with implementation of the new core operating costs baseline.
- 2.8 Comments on how we should consider the post-2025 framework, once decided, related to: the revised rollout framework, the potential need to address Smart Metering Equipment Technical Specifications (SMETS) 1⁹ meter replacements as a result of the decision by Mobile Network Operators to switch off 2G / 3G mobile network,¹⁰ and that we should undertake a full post-2025 review of how smart meter costs are reflected in the cap.

Considerations

Option 1

- 2.9 One supplier supported option 1, if decisions on the post-2025 framework are made quickly. Although we expect a new framework to be published before the current framework ends, we are uncertain how and when this could align with the timings required for our consultation process.
- 2.10 Under option 1 we could, as intimated by the supplier, update the SMNCC model as required for implementation of the operating costs review (namely updating the model to align with the new core operating costs baseline) and delay wider review until a post-2025 framework decision. However, we consider that delaying

⁹ SMETS1 are first-generation smart meters. SMETS2 are second-generation smart meters and are the current industry standard.

¹⁰ In December 2021, Mobile Network Operators operating in the UK confirmed that they do not intend to offer 2G and 3G mobile networks past 2033 at the latest. Department for Digital, Culture, Media & Sport (2023), A joint statement on the sunsetting of 2G and 3G networks and public ambition for Open RAN rollout as part of the Telecoms Supply Chain Diversification Strategy.

<https://www.gov.uk/government/news/a-joint-statement-on-the-sunsetting-of-2g-and-3g-networks-and-public-ambition-for-open-ran-rollout-as-part-of-the-telecoms-supply-chain-diversification>

our review of how we set the NPT SMNCC allowance presents uncertainty in how we will set the allowance in the context of our wider operating costs review.

- 2.11 We therefore propose to not proceed with option 1. We consider it introduces uncertainty on when we would review the SMNCC model and would not allow for consideration of wider changes associated with our review.

Option 2

- 2.12 We consider that, as a minimum, implementing the operating costs review implies that we need to update the baseline in the SMNCC model. Changing the core operating costs baseline year to 2023, but then using an SMNCC baseline period from 2017 would produce an inconsistent allowance.
- 2.13 Three suppliers and one stakeholder generally supported our view that by considering model simplification options (and implementation if that is what is decided), we can assess how a simplified modelling approach fits with the wider operating cost changes. The stakeholder provided no detailed comment on this option.
- 2.14 All three suppliers supported considering how to reflect the post-2025 framework following a decision on the revised rollout framework. One of these suppliers said that a full and separate review of smart meter costs should take place alongside the new framework. It said rollout costs far exceed those which are encapsulated in the cap methodology, and that a full resetting of the impact assessment and how costs are captured in the operating cost allowance is required. Another stakeholder also said that a complete re-baselining of smart costs is needed once there is greater clarity on a future policy framework.
- 2.15 One stakeholder, with reference to the post-2025 framework, and two suppliers, said there is a potential need to address SMETS1 meter replacements because of the 2G / 3G switch off. We discuss this further in Chapter 4.
- 2.16 Another supplier, while acknowledging it as a DESNZ matter, said that the post-2025 framework should strengthen regulatory signals for suppliers to improve outcomes for consumers, specifically: non-communicating meters and improving customers' experience, and that higher costs at the end of rollout should be dealt with via a levelisation mechanism. It also said that suppliers should be incentivised, not discouraged, from progressing beyond 70% coverage (as the costs and complexity of installs increases as rollout progresses).

- 2.17 We still consider that this option is our preferred approach. Updating the baseline is key to ensuring consistency between the SMNCC and operating cost allowance. Following an expected decision by DESNZ on a post-2025 framework, we will consider whether further consultation with stakeholders is necessary. This will depend on whether there are material structural changes to the smart meter rollout framework.
- 2.18 Together with our proposals in core operating costs, we consider that our proposed combination of benchmark approach, selection of baseline periods and our proposed allocations across payment methods should ensure customers only pay for efficient and fair costs, while enabling good customer service. Overall, this will enable efficient notional suppliers to recover their costs (noting that ensuring this is always the case in all periods is not within Ofgem's powers or duties). It should also enable suppliers to invest in key innovations (such as Market-wide Half Hourly Settlement (MHHS) and associated services) to enable a low carbon transition.

Option 3

- 2.19 One stakeholder and two suppliers did not support option 3. The stakeholder provided no detailed comment on this option. One supplier said this option would not reflect the notionally efficient costs of rolling out smart meters and therefore would not be in customers' or suppliers' interests. Another supplier said setting the allowance to zero, until a post-2025 framework decision, would not be a responsible approach.
- 2.20 We consider this option would not reflect the efficient costs of a notional supplier and could have a negative impact on the smart meter rollout. We therefore consider this option is not in suppliers' or customers' interests and have not considered it further.

3. Updating the SMNCC baseline

Chapter summary

In this chapter, we set out the current approach of how the SMNCC baseline is calculated and explain our proposals of updating it from 2017 to 2023.

Context

- 3.1 Currently, we use the operating cost allowance to reflect the efficient costs of a notional supplier in serving customers. We calculate the NPT SMNCC allowance as the net change in costs to serve customers due to the rollout of smart meters, relative to the operating cost allowance baseline year.
- 3.2 As outlined in 'Appendix 1: core operating costs', the operating costs review considers several updates to the core operating cost allowance, with some directly interacting with how we calculate the NPT SMNCC allowance.
- 3.3 Implementation of the operating costs review therefore requires consideration of how we update the NPT SMNCC model to align with the core operating cost allowance.

Proposals

- 3.4 We propose to update the SMNCC baseline year from 2017 to 2023, in line with our proposal to use 2023 cost data to set the new baseline for the core operating costs.
- 3.5 We propose to calculate the 2023 SMNCC baseline by updating the SMNCC model.
- 3.6 In updating the SMNCC model baseline, we propose to:
 - remove all steps that calculate the lower quartile net cost and all steps that calculate the difference between the lower quartile baseline operating cost allowance and the weighted average SMNCC costs;
 - remove (or set to zero) the 'percentage cost reduction' for avoided costs;¹¹
 - remove the 'PPM cost offset' that is currently applied to the PPM NPT SMNCC allowance in Annex 5;

¹¹ The percentage cost reduction is applied all avoided traditional meter costs so that cost and benefit components were consistent to the baseline when the benchmark method of the operating cost and SMNCC allowances were different.

- use weighted average rollout profiles to set the Credit and PPM rollout profiles for the new baseline year; and
 - update the DESNZ data inputs that we use to calculate the fuel-specific rollout profiles.
- 3.7 We intend all proposals to be applied to the most recent version of the SMNCC model, which was last updated in August 2024.¹²
- 3.8 The proposals considered in this chapter are applicable to all cost and benefit options considered in Chapter 4.

Summary of responses

- 3.9 In response to our May 2024 policy consultation, one supplier asked why the SMNCC allowance would be required at all if the model is updated to set a 2023 baseline.
- 3.10 One supplier said that it was not possible to isolate the smart metering costs from within the total operating costs baseline in 2017; and it said that this should no longer be a factor given the greater insight now available.
- 3.11 Two suppliers agreed that there is an ongoing need to account for cost changes beyond the baseline year even if the absolute change in costs is less, relative to the new baseline (as rollout has progressed).

Considerations

- 3.12 As the smart meter rollout is ongoing, we recognise that while some costs are enduring and stable, others may still vary as the rollout progresses. We therefore consider that the SMNCC allowance remains necessary to account for any changes in suppliers' operating costs resulting from the smart meter rollout programme beyond the baseline year. This will help an efficient notional supplier recover their costs and allow customers to benefit from the smart meter programme.
- 3.13 Our operating costs review is updating the core operating cost baseline. To ensure coherence, we propose aligning the baseline year in the SMNCC model with the new core operating cost allowance baseline year (2023). This alignment will provide consistency and clarity in our allowance.

¹² Ofgem (2024), Annual update of non-pass through Smart Meter Net Cost Change Allowances. <https://www.ofgem.gov.uk/energy-policy-and-regulation/policy-and-regulatory-programmes/energy-price-cap-default-tariff-policy/energy-price-cap-default-tariff-levels>

- 3.14 In determining how to update the baseline year from 2017 to 2023, we identified two options:
- calculate the baseline using the operating costs data we collected through the May 2024 Request for Information (we refer to this as '2023 RFI data'); or
 - calculate the baseline using the NPT SMNCC model, which was used to calculate the 2017 baseline, and which we update annually to calculate the NPT SMNCC allowance.
- 3.15 As noted in 'Appendix 1: core operating costs', the 2023 RFI data shows significant variation in suppliers' methodologies for allocating their core operating costs between payment methods, fuel types, smart and traditional meter types. Several suppliers also stated that they had difficulties in splitting some cost lines between different customer groups.
- 3.16 We are aware that suppliers may take different approaches to allocating across customer groups to best reflect their business practices (such as smart and traditional meter types). There are inconsistent approaches among suppliers in our data. This limits the degree of cost reflectivity and hinders our ability to understand variation in suppliers' efficiencies. Non-cost-reflective allocations may cause reported cost variations to result from suppliers' allocation decisions rather than actual differences in costs to serve.
- 3.17 Therefore, we do not consider that it would be viable or accurate to use the 2023 RFI data to calculate the smart metering costs baseline and as such, we propose to calculate the 2023 SMNCC baseline using the SMNCC model.

Updating the SMNCC model for the new baseline

Changing the benchmark year from 2017 to 2023

- 3.18 The SMNCC model uses Annual Supplier Return (ASR)¹³ data to reflect supplier costs. The ASR data are input to the SMNCC model annually and we propose to use the 2023 ASR data inputs to calculate the SMNCC baseline year.
- 3.19 In our current SMNCC model we apply the Gross Domestic Product (GDP) deflator so that costs and benefits are inflated to 2017 prices (as the current baseline

¹³ Suppliers submit Annual Supplier Return (ASR) data to DESNZ each year, which provides their smart meter annual information requested by DESNZ. Previously known as Smart Meters Annual Information Request (SMAIR) data.

year).¹⁴ As part of updating the SMNCC model for the new baseline year we will apply the GDP deflator so that costs and benefits are inflated to 2023 prices.

Adjusting for the differences in benchmarking approaches between the core operating cost allowance and the NPT SMNCC allowance

- 3.20 In our current SMNCC model we calculate the lower quartile net cost of smart rollout for the 2017 baseline year, in line with the benchmarking approach of the existing operating cost allowance (set by using 2017 cost data).
- 3.21 Currently, when we update the annual NPT SMNCC allowance we calculate the weighted average net cost of smart rollout, and compare this to the 2017 baseline year to calculate the net change in costs.¹⁵ We used a weighted average baseline because we had expected the market would converge on an efficient way of procuring assets, thereby minimizing variation in suppliers' reported asset costs. Additionally, we considered that a stricter benchmark could hinder rollout progress and reduce suppliers' willingness to participate in the smart meter rollout programme.
- 3.22 Given we propose to change the core operating cost allowance benchmark approach (from a lower quartile approach to a weighted average approach), we will need to remove all steps that calculate the lower quartile net costs, and remove all steps that calculate the difference between the lower quartile baseline cost and the weighted average cost. All weighted average calculations would be unchanged and used to calculate the allowances by comparing to the new (2023) baseline year.
- 3.23 We also currently apply an 'avoided costs percentage cost reduction' in the SMNCC model. This is to account for the difference in benchmarking approaches between the lower quartile baseline operating costs in 2017 and the weighted average SMNCC allowance ie we allow for operating costs in 2017 at a the lower quartile however, as suppliers install smart meters, we removed the same costs at the weighted average level, substituting one efficiency measure for another.¹⁶ However, as the new core operating costs baseline changes the benchmark from

¹⁴ Ofgem (2022), Price Cap – August 2022 decision on credit and PPM SMNCC allowances, paragraph 2.5. <https://www.ofgem.gov.uk/decision/price-cap-august-2022-decision-credit-and-ppm-smncc-allowances>

¹⁵ Ofgem (2020), Reviewing smart metering costs in the default tariff cap – August 2020 decision, paragraph 4.2. <https://www.ofgem.gov.uk/decision/decision-reviewing-smart-metering-costs-default-tariff-cap>

¹⁶ Ofgem (2020), Reviewing smart metering costs in the default tariff cap – Technical Annex, paragraph 4.14. <https://www.ofgem.gov.uk/decision/decision-reviewing-smart-metering-costs-default-tariff-cap>

the lower quartile to the weighted average we will remove the percentage cost reduction from the SMNCC model as part of our baseline updates.

Adjusting for a change in how costs are allocated between payment methods in the operating cost benchmark

- 3.24 As outlined in 'Appendix 1: core operating costs', we currently apply a Payment Method Uplift (PMU). The PMU reflects the difference in cost to serve PPM customers with traditional meters compared to Direct Debit customers with traditional meters. Due to uncertainty with the PMU,¹⁷ we currently apply a 'PPM cost offset' within the NPT SMNCC allowance. The offset is applied to mitigate the risk that the PMU is insufficient for an efficient notional supplier with a higher-than-average proportion of PPM customers.¹⁸
- 3.25 However, our operating costs review intends to replace the current three operating costs allowances (operating cost allowance, PMU, SMNCC allowance) with four allowances (core operating cost allowance, debt-related cost allowance, SMNCC allowance¹⁹ and industry charge allowance). We are replacing the PMU allowance with costs components within the four new allowances (details see Table 2 in the overview paper). We therefore need to remove the 'PPM cost offset' from the NPT SMNCC allowance, in line with the changes proposed in our operating costs review.
- 3.26 We acknowledge there is still some uncertainty in the cost-to-serve between payment methods, however we consider that the 'PPM cost offset' is no longer required. First, we consider that our proposed approach to setting a new core operating allowance (benchmarking at an aggregated level, using a weighted average benchmark and a relatively cost-reflective allocation approach for allocating costs among payment methods) have regard to the need for cost recovery for an efficient notional supplier. Our proposed PPM benchmark is based on suppliers' best estimates of the cost to serve PPM customers. Second, we consider that, as rollout has significantly progressed, uncertainty about the cost of traditional PPM meters has less impact on the new core operating cost

¹⁷ The PMU is currently used as part of setting the PPM level of the default tariff cap. We used the Competition and Markets Authority's (CMA) PPM cost differential for our PPM PMU but acknowledged the uncertainty that it could be up to £17 higher if we used a different judgement of efficiency.

¹⁸ Ofgem (2022), Price Cap – August 2022 decision on credit and PPM SMNCC allowances, Appendix 4, paragraph 1.8.

<https://www.ofgem.gov.uk/decision/price-cap-august-2022-decision-credit-and-ppm-smncc-allowances>

¹⁹ For non-pass-through SMNCC only.

allowance than the current PMU. This is due to the reduction in the proportion of traditional PPM meters.

Setting the credit and PPM rollout profiles for the new 2023 baseline year

- 3.27 We currently set the credit and PPM rollout profiles for the 2017 baseline year (and all previous years) using the weighted average. We calculate the weighted average separately for credit²⁰ and PPM²¹ rollout profiles.
- 3.28 We propose to set the credit and PPM rollout profiles for the new 2023 baseline year (and all previous years), using the same weighted average calculation used in the current model to set the 2023 weighted average rollout profiles. This update reflects that we are calculating the net change in costs relative to a fixed 2023 core operating cost baseline.

Setting fuel-specific rollout profiles

- 3.29 We currently apply a scaling factor to account for the difference between electricity and gas rollout.²²
- 3.30 We currently calculate the scaling factor based on the ratio between a fuel-specific rollout profile and the combined dual-fuel rollout profile using published DESNZ data on the number of smart meters. We apply the scaling factor to the credit and PPM rollout profiles in the SMNCC model which, in most years, means slightly increasing the electricity rollout and slightly decreasing the gas rollout.
- 3.31 We propose applying the same methodology to calculate the scaling factor, updated with 2023 data for the new baseline year.

²⁰ Ofgem (2021), Price Cap Decision on credit SMNCC allowance, Appendix 8, paragraph 1.2. <https://www.ofgem.gov.uk/decision/price-cap-decision-credit-smncc-allowance>

²¹ Ofgem (2021), Price Cap – Decision on PPM SMNCC allowance, Chapter 4. <https://www.ofgem.gov.uk/decision/price-cap-decision-ppm-smncc-allowance>

²² Ofgem (2021), Price Cap – Decision on credit SMNCC allowance, paragraph 2.23. <https://www.ofgem.gov.uk/decision/price-cap-decision-credit-smncc-allowance>

4. Costs and benefits

Chapter summary

This chapter outlines the six options we considered in calculating the SMNCC allowance. We set out our considerations on which cost components should be included within our proposed approach.

Context

- 4.1 Since the cap was introduced in 2019, several stakeholders have said that our model for calculating the NPT SMNCC allowance is too complex. As the smart meter rollout has progressed, we consider that some costs and benefits have become more stable while others may still change. We can now identify which costs and benefits are material / immaterial. This might change how much analysis we need in the SMNCC model to set the SMNCC allowance for the rest of the rollout. Therefore, we consider the operating costs review provides an opportunity to review our approach to setting the NPT SMNCC allowance.
- 4.2 In our May 2024 policy consultation, we set out two options for setting the smart metering allowance in the cap:²³
- Option 1: updating the current SMNCC approach (the status quo).
 - Option 2: a simpler SMNCC type model.
- 4.3 In our August 2024 working paper, we considered how we could take a simpler modelled approach and proposed three options to achieving this.²⁴ Each option represents a refinement of cost and benefit components, and each option builds on the previous option (with option 1 being the most simplified option):
- Option 1: includes asset and installation costs.
 - Option 2: option 1, plus in-year Premature Replacement Charges (PRCs) for traditional meters and avoided rental costs for meters where a PRC was previously incurred, and asset and installation costs of installing traditional meters during the rollout.

²³ Ofgem (2024), Energy price cap operating cost allowances review, paragraph 5.32.

<https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review>

²⁴ Ofgem (2024), Energy price cap operating cost review: smart metering working paper, Section 4.

<https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-costs-review-smart-metering-costs-working-paper>

- Option 3: option 2, plus In-Home Displays (IHDs) and non-zero direct operational benefits.
- Option 4: The status quo approach, included to provide a comparison with the components included in the current SMNCC model (Smart meter asset and installation costs, traditional meter asset and installation costs, IHDs, non-zero direct operational benefits and other costs).

4.4 A summary of the cost and benefit components included in each of the options considered is shown in Tables 2 and 3, and a comparison of the allowances each option would provide is shown in Figures 1 and 2. The relevant model will also form a part of our disclosure process for stakeholders and advisors.²⁵

Proposals

- 4.5 We propose to proceed with option 3 to set the SMNCC allowance from July 2025 onwards. We consider that this is the most robust approach and would reduce the number of individual components modelled within the allowance compared to the status quo approach. We consider that a less complex model would reduce the time taken to update each year and would be able to deliver a sufficient level of robustness in the context of a revised core operating costs baseline.
- 4.6 As the smart meter rollout has progressed further, we consider that some costs will not materially change year-on-year. Costs that are not included should have immaterial impacts on the allowance individually. We consider that non-material costs which have been excluded could add spurious noise, rather than increased accuracy.

Summary of responses

- 4.7 One stakeholder disagreed with simplifying our approach, and said that a full review of our approach should be undertaken once a new framework is decided. There was support for simplification from four suppliers. Three other stakeholders did not provide a preference for either option. Two of these suppliers said that further information was required prior to expressing any view on our modelling options and one said it had no preference but that all costs are captured in either the SMNCC model or the operating cost allowance.

²⁵ Ofgem 2024, Disclosure arrangements for 2024 consultation on default tariff cap.
<https://www.ofgem.gov.uk/call-for-input/energy-price-cap-disclosure-arrangements-autumn-2024-consultation>

- 4.8 One other stakeholder did not provide a preference for any option but had concerns about the removal of SMETS PRC costs. We respond to this in our consideration of option 2.

Considerations

- 4.9 We have assessed each option by considering its suitability based on whether costs are likely to materially change over time when compared to the baseline period, as well as its robustness and proportionality. We concluded that option 3 is our preferred option and we consider that it is a proportionate approach as it best reflects the key costs and benefits that suppliers face as a result of the smart meter rollout.

Options

- 4.10 In Table 2, we provide a summary of the options which we consulted on (options 1-4) along with two additional options raised by suppliers (options 5a-5b).

Table 2: Simplified model options

Option	Key components
1	Asset and installation costs
2	Option 1 plus in-year Premature Replacement Charges (PRC) for traditional meters and avoided rental costs for meters where a PRC was previously incurred; asset and installation cost of installing traditional meters during rollout
3	Option 2 plus In-Home Displays (IHDs), non-zero direct operational benefits and supplier IT
4	Status quo approach: Smart meter asset and installation costs, traditional meter asset and installation costs, IHDs, non-zero direct operational benefits and other costs
5a	Asset and installation costs, PRCs of SMETS1, prepayment cost to serve
5b	Option 4 excluding other costs.

Option 1: Asset and installation costs

- 4.11 Option 1 contains the fewest components, focusing on the high-level cost of smart meter asset and installation costs, with the benefit of not replacing

traditional meters. Tables 2 and 3 explain which components are included in this option and alternative options are included at the end of this section.

- 4.12 One stakeholder said this approach would be the best option if the costs absolutely need to be captured in the allowance, and that other costs could be covered by the headroom allowance. However, as shown in Figures 1 and 2, we consider option 1 provides a high Credit and PPM SMNCC allowances as it removes more benefits than cost components.

Option 2: Option 1 plus in-year costs of Premature Replacement Charges (PRCs) for traditional meters

- 4.13 Option 2 adds the cost of premature replacement in two forms, the PRC for traditional meters, alongside the benefit of avoided rental charges for prematurely replaced traditional meters for both meter asset and installation costs.
- 4.14 One supplier in response to our August 2024 working paper supported this option although it wanted us to also include the PRCs for SMETS2 meters. Alongside PRCs for SMETS1 meters, we consider these costs to be immaterial compared to other cost components, and therefore, we do not see a justification for including them in this or any other option. We encourage stakeholders to provide evidence of materiality if they believe these charges should be included in the model.
- 4.15 We consider that these costs were reported in suppliers' 2023 RFI data and will be included in the new core operating costs baseline. As such, we are only interested in costs that will have a material change relative to the 2023 core operating costs baseline.
- 4.16 In response to our August 2024 working paper, one stakeholder said that PRCs and IHDs should not be captured in the SMNCC allowance if they are included in the new baseline, to avoid double counting costs. The SMNCC allowance measures the net cost of change in suppliers' overall operating costs due to the smart meter rollout, ie the difference between costs in a given year and the baseline period. Therefore, only the change in cost components is included within the allowance. As such, we do not consider that cost components will be double counted.

Option 3: Option 2 plus In-Home Displays (IHDs), non-zero direct operational benefits and supplier IT

- 4.17 Option 3 includes the cost of IHDs, non-zero direct operational benefits, and supplier IT. Non-zero direct operational benefits include components such as

debt-handling, customer enquiry benefits, customer switching benefits, avoided site visits and the prepayment cost to serve (for PPM only).

- 4.18 However, option 3 significantly reduces the number of modelled costs and benefits compared to the status quo. For example, it excludes minor cost components such as the PRCs and benefit of avoided rental charges for smart meter asset and installation costs, which we consider are stable and included in the core operating costs baseline. We consider that the exclusion of these costs and benefits will reduce the risk of unnecessary components in allowances and make the model more robust.
- 4.19 We consider that the smart meter rollout benefits customers and suppliers. These benefits should be included in the SMNCC allowance so that customers benefit from the reduced operational costs of having a smart meter. This will be in customers' interests.
- 4.20 Two suppliers supported this option. Support from one of these was subject to the addition of SMETS PRCs and 4G costs beyond 2024, and another requested additional transparency to include the cost of IHDs, debt handling, customer enquiry, customer switching, avoided site visits and the PPM cost to serve.

Option 4: Status quo

- 4.21 This option sets the status quo approach, ie uses all components in the current version of the SMNCC model. Proceeding with this option would involve updating the baseline year in the SMNCC model, as proposed in Chapter 3, and retaining the same components as the current SMNCC model approach. Tables 1 and 2 provide further clarity on the list of components in this option.
- 4.22 No stakeholders commented on this option of our working paper.

Option 5a & 5b: Alternative options

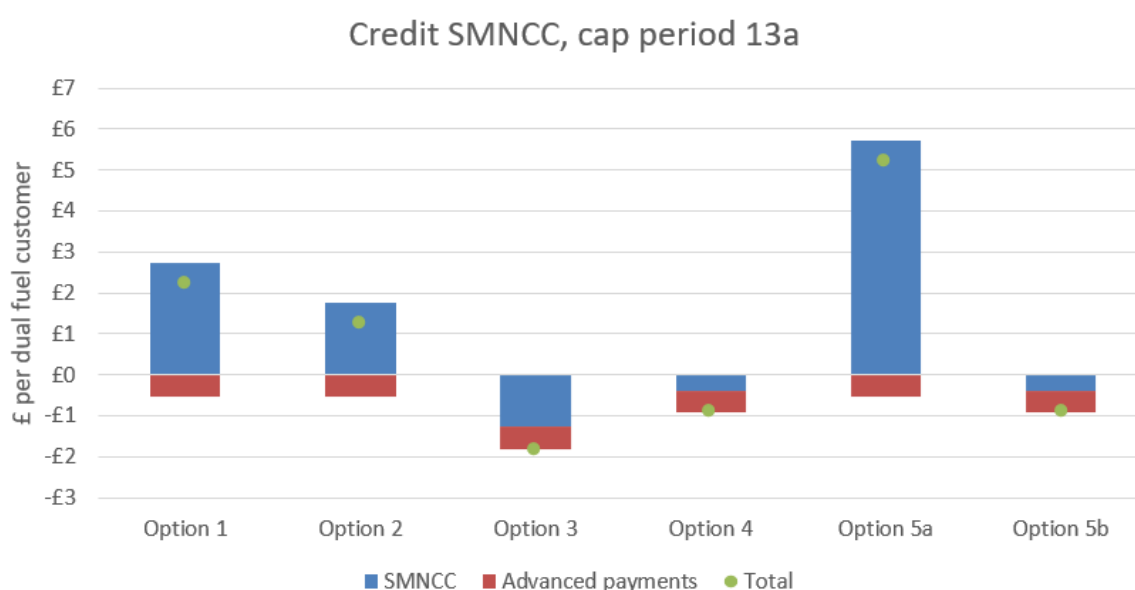
- 4.23 Two suppliers proposed alternative options.
- 4.24 One supplier proposed including the cost of smart meter assets installed during rollout, PRCs of SMETS1 meters, all smart installation costs, cost to serve PPM customers, operating and maintenance costs, and regular review of IHD costs. It said it is important for any revised approach to reflect the ongoing costs of replacing and upgrading meters as technology evolves and older technology become redundant. This proposal is subsequently referred to as option 5a. A different supplier also suggested that we consider removing traditional meter components from the model, as they will be included within the baseline.

- 4.25 One supplier proposed option 4 excluding other costs. This proposal is subsequently referred to as option 5b.
- 4.26 We consider that option 5a is biased in considering a higher proportion of the cost components (rather than benefits). We consider that option 5b does not offer sufficient simplification in components.

Assessing options

- 4.27 This section provides a description of the Credit and PPM SMNCC allowances values for each described option for stakeholders comparisons.

Figure 1: Proposed credit SMNCC allowance, cap period 13a



This figure shows the allowances, in 2024 prices, for a dual fuel Credit customer for cap period 13a for all options considered (1 – 5b). The total allowance for each option (shown by the green dot) is made up of the NPT SMNCC allowance (shown in blue) and the advanced payment adjustment (shown in red).

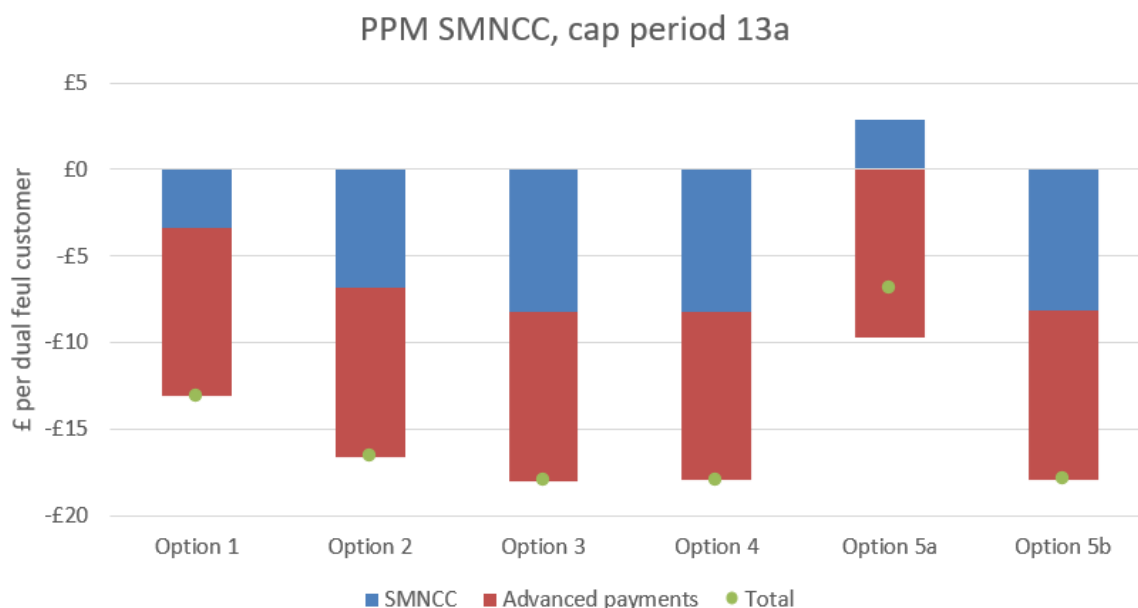
Figure 2: Proposed credit SMNCC allowance, cap period 13a

Figure 2 shows the allowances, in 2024 prices, as calculated for a dual fuel PPM customer for cap period 13a for all options considered (1 – 5b). The total allowance for each option (shown by the green dot) is made up of the NPT SMNCC allowance (shown in blue) and the advanced payment adjustment (shown in red).

- 4.28 Figures 1 and 2 show the cap period 13a Credit and PPM SMNCC allowances for the options under consideration. Options 1, 2 and 5a include the fewest benefit components, resulting in higher costs compared to the status quo approach. Those options largely exclude direct operational benefits, which likely overstates the total cost of rolling out smart meters. Consequently, we consider that these options are not in the best interest of consumers, as they limit the potential benefits customers would gain from the smart meter rollout.
- 4.29 We consider that option 5a underestimates the benefits of smart meter rollout by relying too heavily on individual cost components. We would be concerned on not including the direct benefits which alternative supplier options suggested as this would overstate the SMNCC allowance. We consider that option 5b provides a modest reduction in the cost components and is very similar to the status quo approach (option 4).
- 4.30 In these figures, we have included advanced payments to show stakeholders what the total SMNCC allowance would be in annual terms for cap period 13a. The advanced payment was brought forward from the current model (which is explained in further detail in Chapter 5 of this document), and reflects the update

which we made to 2023 rollout input data to ensure that the allowance was based on the most accurate and up-to-date estimates.²⁶ This element of the allowance is fixed until October 2025, and will be recalculated when we do the next SMNCC allowance update in August 2025. Given it will be recalculated with new ASR and rollout data, the allowance could either increase or decrease.

- 4.31 We consider that option 3 is our preferred SMNCC modelling option. This option simplifies the calculation of both the Credit and PPM SMNCC by reducing the number of modelled costs and benefits included in the status quo approach, without disadvantaging customers compared to other options. The inputs for option 3 are broadly similar to those in the status quo approach (option 4), ensuring that no material costs or benefits are omitted. The residual difference does not necessarily indicate a loss of accuracy, as a more complex model could introduce variability in either direction.
- 4.32 When comparing option 3 to the status quo, we consider that the key costs and benefits are accounted for in the calculation. Other costs remain relatively stable at the current stage of rollout and will be included within the core operating costs baseline. However, year-on-year changes may not necessarily increase the precision of the allowance.
- 4.33 Similarly, the PRC of SMETS1 meters and the benefit of avoided rental charges have been removed from option 3. These costs roughly net off and are, taken together, immaterial.
- 4.34 One supplier evidenced increasing communications hub replacement, and indicated it expects these costs to significantly change over time, and said these costs should be reflected in the price. Communication hub capital and operational expenditure are included in operation and maintenance costs, and other costs; which are not included in option 3 as we do not currently consider their year-on-year changes to be as material as other cost components.
- 4.35 A couple of suppliers raised the cost of remedial visits for non-communication smart meters and meter reading costs. We consider that this cost will be included in the new core operating costs baseline going forward, and as such does not need to be updated each year.

²⁶ Ofgem (2024), Annual update of non-pass through Smart Meter Net Cost Change (SMNCC) allowances.

<https://www.ofgem.gov.uk/energy-policy-and-regulation/policy-and-regulatory-programmes/energy-price-cap-default-tariff-policy/energy-price-cap-default-tariff-levels>

- 4.36 One supplier raised the geographical differences between regions in smart meter installations. We recognise that geography may be a factor in the different costs suppliers face for their smart meter rollout, however we need to set a suitable allowance. We consider that it in the round of other decisions in this appendix, such as rollout profile and benchmarking the allowance should ensure customers pay an efficient cost.

Other considerations - 4G communications hubs exchange costs

- 4.37 In response to our August 2024 working paper, five stakeholders stated the need to include 4G communications hub exchange related costs, due to the 2G and 3G switch-off, which are not currently modelled or benchmarked in the operating costs allowance.
- 4.38 We do not consider that the costs associated with 4G communications hub exchanges for SMETS2 meters are in scope of the operating costs review. This is because DESNZ stated in their further consultation on 4G Communications Hub only exchange site visit arrangements, that their minded to position is for Data Communications Company (DCC) to recover the costs of this activity via DCC Fixed Charges.²⁷ We expect to hear more on their decision soon, but at this stage, we consider that including costs associated with 4G communications hub exchanges for SMETS2 meters in the SMNCC allowance would lead to customers paying twice, given the current proposals for them to be recovered via DCC Fixed Charges, which already flows through into the cap via the DCC component of the Smart Metering Pass-Through Net Cost Change and will be included in the industry charge allowance (details see Appendix 4).

²⁷ Smart Energy Code Company (2024), Smart Metering Implementation Programme: 4G Communications Hub only exchange site visits arrangements, and further proposal on the DCC charging mechanism and legal changes.
<https://smartenergycodecompany.co.uk/smart-metering-implementation-programme-4g-communications-hub-only-exchange-site-visits-arrangements-and-further-proposal-on-the-dcc-charging-mechanism-and-legal-changes/>

Table 3: Simplified model option components

Component	Sub-component	Option 1	Option 2	Option 3	Option 4	Option 5a	Option 5b
Smart meter asset costs	Cost of smart meter assets installed during rollout	Captured	Captured	Captured	Captured	Captured	Captured
Smart meter asset costs	Cost of prematurely replacing SMETS1	Not captured	Not captured	Not captured	Captured	Captured	Captured
Smart meter asset costs	Benefit of avoided rental charges for prematurely replaced SMETS1 meters	Not captured	Not captured	Not captured	Captured	Not captured	Captured
Smart meter installation costs	Installation costs of installing smart meters during rollout	Captured	Captured	Captured	Captured	Captured	Captured
Smart meter installation costs	Cost of prematurely replacing SMETS1	Not captured	Not captured	Not captured	Captured	Captured	Captured
Smart meter installation costs	Benefit of avoided rental charges for prematurely replaced SMETS1 meters	Not captured	Not captured	Not captured	Captured	Captured	Captured
In-home display (IHD) costs	No sub-component	Not captured	Not captured	Captured	Captured	Not captured	Captured
Traditional meter asset cost	Asset costs of installing traditional meters during rollout	Not captured	Captured	Captured	Captured	Not captured	Captured
Traditional meter asset cost	Cost of prematurely replacing traditional meters	Not captured	Captured	Captured	Captured	Not captured	Captured

Appendix 3: Smart metering costs

Component	Sub-component	Option 1	Option 2	Option 3	Option 4	Option 5a	Option 5b
Traditional meter asset cost	Benefit of avoided rental charges for prematurely replaced traditional meters	Not captured	Captured	Captured	Captured	Not captured	Captured
Traditional meter asset cost	Benefit of not replacing old traditional meters with a new traditional meter	Captured	Captured	Captured	Captured	Not captured	Captured
Traditional meter installation costs	Installation costs of installing traditional meters during rollout	Not captured	Captured	Captured	Captured	Not captured	Captured
Traditional meter installation costs	Cost of prematurely replacing traditional meters	Not captured	Captured	Captured	Captured	Not captured	Captured
Traditional meter installation costs	Benefit of avoided rental charges for prematurely replaced traditional meters	Not captured	Captured	Captured	Captured	Not captured	Captured
Traditional meter installation costs	Benefit of not replacing old traditional meters with a new traditional meter	Captured	Captured	Captured	Captured	Not captured	Captured
Non-zero operational benefits	Debt handling	Not captured	Not captured	Captured	Captured	Not captured	Captured
Non-zero operational benefits	Customer enquiry benefits	Not captured	Not captured	Captured	Captured	Not captured	Captured
Non-zero operational benefits	Change of tariff benefit	Not captured	Not captured	Captured	Captured	Not captured	Captured

Appendix 3: Smart metering costs

Component	Sub-component	Option 1	Option 2	Option 3	Option 4	Option 5a	Option 5b
Non-zero operational benefits	Customer switching benefits	Not captured	Not captured	Captured	Captured	Not captured	Captured
Non-zero operational benefits	Avoided site visits	Not captured	Not captured	Captured	Captured	Not captured	Captured
Non-zero operational benefits	Prepayment cost to serve (PPM only)	Captured	Captured	Captured	Captured	Captured	Captured
Operation and maintenance costs	No sub-component	Not captured	Not captured	Not captured	Captured	Captured	Captured
Supplier IT	No sub-component	Not captured	Not captured	Captured	Captured	Not captured	Captured
Other costs ²⁸	Other costs	Not captured	Not captured	Not captured	Captured	Not captured	Not captured

²⁸ Other costs categories include organisation costs, net reduction in energy theft, advertising costs, legal and organisational, and other costs.

5. Other areas

Chapter summary

This chapter sets out our proposals of four other policy area: rollout methodology, benchmark choice, annual reviews and advanced payment adjustments.

Rollout methodology

Context

- 5.1 In our August 2024 working paper we said that we do not consider it necessary to change how the rollout profiles work in the SMNCC model. Here, we set out our proposals to continue to use a market leader tolerance approach for Credit SMNCC and a weighted average rollout tolerance for PPM SMNCC.
- 5.2 For clarity, the rollout proposals considered here refer to setting the rollout profiles for 2024 onwards (subject to our proposals outlined in Chapter 2, Post-2025 framework) and are applicable to all model options considered in Chapter 4.

Proposals

- 5.3 We propose to select the market leader using the current methodology to calculate the credit SMNCC,²⁹ with two updates:
- We propose to update the pool of suppliers that the market leader is selected from. The update would ensure that the pool of suppliers reflects all suppliers that held a market share of at least 5% in both fuel types in 2023. This means the market leader supplier would be selected from a pool of six suppliers (currently a pool of five suppliers).³⁰
 - We propose to select the market leader based on the supplier with the largest forecast cumulative SMNCC between 2023 (as the new baseline year) and the end of the current framework. This is a change to our current approach where we identify the market leader supplier as the supplier with the largest forecast cumulative SMNCC over the full potential life of the cap.³¹ Calculating the

²⁹ Ofgem (2021), Smart meter rollout and the default tariff cap: working paper, paragraph 2.6. <https://www.ofgem.gov.uk/consultation/smart-meter-rollout-and-default-tariff-cap-working-paper>

³⁰ Ofgem (2024), Data Portal. <https://www.ofgem.gov.uk/energy-data-and-research/data-portal>

³¹ When originally legislated for, the Tariff Cap Act set out the cap approach until December 2023. Under the Energy Price Guarantee (EPG), legislated for as part of the Energy Prices Act 2022, the cap end date was removed.

cumulative SMNCC to the end of the framework means we can continue to use the tolerance rollout profiles published by DESNZ.³²

- 5.4 For PPM, we propose to set the rollout profile for 2024 onwards using the current methodology (weighted average rollout).³³

Summary of responses

- 5.5 One stakeholder supported our proposal to continue using our current rollout methodology.

Considerations

- 5.6 We do not consider it necessary to amend the way rollout currently works within the SMNCC model, and consider that there is no compelling evidence to move away from using the market leader tolerance approach for credit, and a weighted average rollout tolerance for PPM.

Benchmark choice

Context

- 5.7 In 2018, we benchmarked the SMNCC model cost and benefit inputs using a weighted average. This was because we had expected the market would converge on an efficient way of procuring assets, thereby minimizing variation in suppliers' reported asset costs. Additionally, we considered that a stricter benchmark could hinder rollout progress and reduce suppliers' willingness to participate in the smart meter rollout programme.³⁴

Proposals

- 5.8 We propose to continue benchmarking the net change in costs using a weighted average. This is the proposed approach regardless of the benchmark selected for the core operating cost allowance.

³² DEZNZ (2023), Smart Meter Targets Framework: government response to a consultation on minimum installation requirements for Year 3 and Year 4.

<https://www.gov.uk/government/consultations/smart-meter-targets-framework-minimum-installation-requirements-for-year-3-2024-and-year-4-2025>

³³ Ofgem (2021), Price Cap – Decision on PPM SMNCC allowance, Chapter 4.

<https://www.ofgem.gov.uk/decision/price-cap-decision-ppm-smncc-allowance>

³⁴ Ofgem (2018), Default tariff cap, Appendix 7 – Smart metering costs, paragraph 4.1.

<https://www.ofgem.gov.uk/consultation/default-tariff-cap-overview-document>

Summary of responses

- 5.9 In response to our May 2024 Policy Consultation and August 2024 working paper, three suppliers supported our proposed benchmarking approach. Both agreed that we should continue to maintain the weighted average benchmark approach.
- 5.10 One supplier said that a looser approach would provide greater assurances that costs will be reflected. A different supplier said that incumbent suppliers will face costs which other suppliers may not face.
- 5.11 Two of these suppliers said that suppliers are at different stages of rollout and consequently the cost per additional smart meter may vary, which is unlikely to be related to efficiency.

Considerations

- 5.12 Our view on the benchmarking of SMNCC remains consistent. We currently do not find sufficient justification and evidence to shift from the weighted average benchmark.
- 5.13 We consider that a weighted average is still an appropriate approach as individual suppliers are at different stages of their smart meter rollout. Consequently, the cost per additional smart meter may vary, which is unlikely to be a result of individual efficiency. We consider that our allowance allows for recovery of the efficient cost of the smart meter rollout programme.
- 5.14 We expect that suppliers at different stages of rollout will, on average, recover the notionally efficient costs over time. Any discrepancies in payments and costs will likely be due to their timing of their rollout activities.

Annual review

Context

- 5.15 We currently update the SMNCC model annually, to set the allowance for the following October to September. This update involves including new ASR, rollout numbers and GDP deflator data to produce next year's NPT SMNCC values.

- 5.16 In our May 2024 policy consultation, we set out that we would consider rollout progress and whether it would be proportionate to continue a review and update process. We considered two options:³⁵
- Option A: Maintaining the current approach of regular reviews and updates. The regular review process is mechanical. This option would not be creating a new consultation process for each update.
 - Option B: Set the profile of allowances with no further updates. We would set the forward profile of the allowances for the coming years when setting the initial operating cost allowance and we would not update the model with new cost or rollout data.

Proposals

- 5.17 We propose to maintain the current approach of regular annual reviews and updates of the SMNCC model (option A).

Summary of responses

- 5.18 Two suppliers agreed with our proposal to maintain the current annual approach and review cycle. One stakeholder also agreed with our proposal, subject to it being done quickly and efficiently.
- 5.19 Three suppliers said that the cost of encouraging customers to accept smart meters and installing these meters increases as rollout progresses, and that Ofgem must have regard for this trend. One of these suppliers said that the current pool included customers who are harder to convert and installs which are more technically complex. Another supplier said that there are still cost uncertainties associated with rollout and the allowance must be flexible to ensure it aligns with costs and benefits experienced by suppliers.

Considerations

- 5.20 We consider that there is a potential for changes in suppliers' operating costs due to the smart meter rollout over time. Given the current smart meter rollout is not complete,³⁶ we further consider that continuing to do the current annual review process will enable the SMNCC allowance to best reflect the costs suppliers face.

³⁵ Ofgem (2024), Energy price cap operating cost allowances review, paragraph 5.52.

<https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review>

³⁶ DESNZ (2024), Smart meters in Great Britain, quarterly update June 2024: statistical bulletin. <https://www.gov.uk/government/statistics/smart-meters-in-great-britain-quarterly-update-june-2024>

We consider that this will be in customers' and suppliers' interests in ensuring the model reflects a notional supplier's efficient costs. We also consider that simplifying our modelling approach enables a more efficient update process.

- 5.21 If we did not proceed with annual reviews, then any unexpected changes in costs or smart meter rollout would not be incorporated into the final allowance unless we reconsulted.

Advanced payment adjustment

Context

- 5.22 The current SMNCC model contains an element called an 'advanced payments adjustment' which intends to reflect when suppliers have received payment in advance for costs they have not yet incurred, or lagged payments for costs they have already incurred. The adjustment is calculated by considering the difference between the set allowance, and the allowance that would have been set had we used actual data.
- 5.23 The advanced payments adjustment reflects that we set the SMNCC allowances based on estimates of future rollout and costs. We use the advanced payment adjustment once actual data becomes available, to align the cumulative allowances and costs for the rollout. Advanced payments are recovered over a 12-month period, from each October.

Proposals

- 5.24 We propose to rollover the advanced payment adjustment used in the current SMNCC model to our future modelling approach until October 2025.
- 5.25 We propose to use the simplified model to calculate advanced payments from October 2025 onwards.

Summary of responses

- 5.26 One stakeholder agreed with including the advanced payment adjustment in the revised SMNCC model. It stated that it is vital suppliers can recover the difference between the allowance and costs incurred.

Considerations

- 5.27 We note that due to our forward-looking modelled approach, allowances may not always be equal to the costs suppliers face in rolling out smart meters. We

consider that an advanced payment adjustment ensures that, over time, a notional supplier can fund the efficient costs of their smart meter rollout programme and their efficient operating costs. The advanced payment adjustment supports the accuracy of the allowances over time, mitigating the risk of over- or under-funding.

5.28 Incorporating advanced payments into a revised model will need to be structured to prevent a gap in how the adjustment is calculated over time. This presents us with two options for how to calculate advanced payments beyond October 2025:

- Option 1: Update the current SMNCC model to calculate advanced payments until the end of 2024 and then use the new SMNCC model to calculate advanced payments beyond that period.
- Option 2: Only use the new SMNCC model to calculate advanced payments from the first annual review period after the operating costs review is implemented.

5.29 On the basis of ease and smoothly transferring SMNCC allowances to the simplified model, we consider that option 2 would be a more proportionate approach. Until we receive 2024 ASR data, we are unable to calculate the materiality of each option presented here, however consider that option 2 will prevent adding unnecessary complexity to the next SMNCC model update. Differences between forecast and actual costs for 2024 and the first nine months of 2025 will not be reflected in advanced payments.

5.30 At this stage we are not aware of the impact of each option, and will not be until we receive new ASR and rollout data. However, we consider that we need to create a proportionate approach, which prevents unnecessary complexity.