

# **Decision Appendix**

# **Appendix 3: Smart metering costs**

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# 1.Introduction

#### Section 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 decisions, and the structure of the remaining chapters.

## **Purpose of this paper**

- 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 Change (SMNCC) allowance.
- 1.2 The operating cost allowance reflects the efficient costs of a notional supplier in serving customers. 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 allowance is made up of two parts, the 'Non-Pass-Through' (NPT) and 'pass-through' (industry charge) costs. This Appendix focuses on the NPT SMNCC costs. Please refer to 'Appendix 4: industry charges' for our decisions and considerations for the pass-through costs.
- 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.<sup>1</sup>
- 1.5 DESNZ's four-year smart metering rollout framework sets out the minimum installation requirements (subject to tolerance levels) for suppliers up until the end of 2025.<sup>2</sup> These supplier targets and tolerance levels are input into the SMNCC model and, alongside annual data inputs and updates, are used to set the SMNCC allowance for the forthcoming year.

 <sup>&</sup>lt;sup>1</sup> BEIS (2019), Smart meter rollout: cost-benefit analysis 2019. <u>https://www.gov.uk/government/publications/smart-meter-roll-out-cost-benefit-analysis-2019</u>
 <sup>2</sup> DESNZ (2023), Smart Meter Targets Framework: government response to a consultation on minimum installation requirements for Year 3 and Year 4. <u>https://www.gov.uk/government/consultations/smart-meter-targets-framework-minimum-installation-requirements-for-year-3-2024-and-year-4-2025#full-publication-update-history</u>

- 1.6 In our May 2024 policy consultation 'Energy price cap operating cost allowances review' ('May 2024 policy consultation'), our 'Energy Price Cap operating costs review: smart metering costs working paper' ('August 2024 working paper'), and our December 2024 statutory consultation 'Energy price cap operating cost and debt allowance consultation' ('December 2024 statutory consultation'), we consulted on our approach to setting the future SMNCC allowance for the remainder of the smart meter rollout.<sup>3, 4, 5</sup> This included:
  - how we update the SMNCC allowance to ensure it aligns with the new core operating cost allowance;
  - reviewing the costs, benefits and other model inputs used to calculate the allowance; and
  - our approach to updating and reviewing the SMNCC allowance in the context of the existing Smart Meter Targets Framework and any future post-2025 framework.
- 1.7 This document sets out our decisions, having considered the feedback received in response to our December 2024 statutory consultation.

### Summary of our decisions

- 1.8 Our approach to calculating and setting the NPT SMNCC allowances remains broadly the same as our current method. Our new core operating costs baseline, as detailed in 'Appendix 1: core operating costs', necessitates an update to the SMNCC baseline and we have updated our SMNCC and Annex 5 models to reflect this.
- 1.9 We have made several consequential changes to the calculations in the SMNCC (eg calculating the cost change using a 2023 baseline compared to a 2017 baseline). These are the minimal changes needed to align to the new core operating cost baseline. However, they do not reflect a change in policy intent for how we calculate the SMNCC.

<sup>&</sup>lt;sup>3</sup> Ofgem (2024), Energy price cap operating cost allowances review, Chapter 5. <u>https://consult.ofgem.gov.uk/energy-supply/energy-price-cap-operating-cost-allowances-review/</u>

<sup>&</sup>lt;sup>4</sup> Ofgem (2024), Energy price cap operating cost review: smart metering working paper. <u>https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-costs-review-smart-metering-costs-working-paper</u>

<sup>&</sup>lt;sup>5</sup> Ofgem (2024), Energy price cap operating cost and debt allowances consultation, Appendix 3 Smart metering costs.

https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-and-debtallowances-consultation

1.10 We are broadly keeping within the current approach for SMNCC now, however considerations on future rollout and the future of wider price protection may see us revisit this approach in the near future.

# Decisions that are the same as our December 2024 statutory consultation

- 1.11 We have decided to update the SMNCC baseline year from 2017 to 2023, in line with our decision to use 2023 cost data to set the new baseline for the core operating costs allowance (as detailed in 'Appendix 1: core operating costs'). We have decided to calculate the 2023 SMNCC baseline using the SMNCC model, which is necessary given the new operating costs baseline. We detail the SMNCC model updates undertaken in Chapter 3 of this appendix.
- 1.12 We have decided to maintain our existing approach for setting future rollout profiles, benchmarking, annual reviews, and advanced payments. These decisions are detailed in Chapter 5.

# Decisions that have changed from our December 2024 statutory consultation

- 1.13 On consideration of responses received, we have decided to set the SMNCC allowance using the status quo approach, using the same cost and benefit components as the current model (used to calculate the October 2024 June 2025 SMNCC allowance). This is a change from our December 2024 statutory consultation position where we proposed an alternative cost and benefit option that sought to exclude a number of costs and benefits which feed into the SMNCC allowance on the basis that they were low materiality. This change was due to consideration of the increasing materiality of exclusion over time.
- 1.14 In response to comments received, and following additional analysis, we have also decided to update the PPM cost to serve (PPM CTS) benefit in the model to make use of the latest available data. This update reduces the PPM CTS benefit which, with all else being equal, leads to a slight increase in the PPM allowance. The update also means that there will be smaller reductions in the PPM SMNCC allowance over time. We detail our considerations and decisions regarding the cost and benefit components of the SMNCC model in Chapter 4.

### **Consideration of DESNZ's post-2025 framework**

1.15 We intend to adopt a temporary approach to set rollout in the model until DESNZ reach a framework decision. We will make a decision on and implement, the temporary approach after this operating costs review is concluded.

1.16 We intend to review our approach to rollout following DESNZ's decision on a post-2025 framework. We set out our considerations of this in Chapter 6.

#### **SMNCC** allowance values

- 1.17 Given that we are broadly adopting the same methodology as the current allowance, we consider that any impact on overall allowance values is driven by the baseline change in supplier's underlying metering costs, as measured through supplier data. This makes it difficult to meaningfully compare the decision allowance (reflecting a net cost change on 2023 operating costs) to the current approach (reflecting a net cost change on 2017 operating costs).
- 1.18 For SMNCC, the exception to this is where we have updated the PPM CTS benefit. The PPM CTS benefit update means that the NPT PPM SMNCC allowance will increase, and that it will also reduce more slowly over time than would have been the case without this update. This is shown by a net increase to the PPM level of the allowance relative to the current approach.
- 1.19 Based on the decisions outlined in this document, the allowance for a dual fuel Direct Debit and Standard Credit customer (at benchmark consumption) will be £4.69 lower that the current equivalent allowance at cap period 14a (April 2025 – June 2025). This largely reflects that the allowance is a change relative to our new operating cost benchmark (rather than to cap period 14a) rather than a change in policy intent.
- 1.20 For a PPM dual fuel customer, the allowance will be £1.20 higher than the current equivalent allowance at cap period 14a (April 2025 June 2025) reflecting the changes to the PPM CTS benefit, though partially offset by the same baseline updates highlighted for credit meters.
- 1.21 A breakdown of the allowance values is shown in Table 1 below. For the avoidance of doubt, the NPT SMNCC allowances for cap period 14b (July 2025 September 2025) will be the same as the cap period 14a allowances shown.

Payment method	Fuel type	Decision allowance, Nil	Decision allowance, Benchmark	Change vs Cap period 14a, Nil	Change vs Cap period 14a, Benchmark
Direct Debit	Electricity	1.15	1.67	-1.24	-1.80
Direct Debit	Gas	-3.76	-5.44	-2.00	-2.90
Direct Debit	Dual fuel	-2.61	-3.78	-3.24	-4.69
Standard Credit	Electricity	1.15	1.67	-1.24	-1.80
Standard Credit	Gas	-3.76	-5.44	-2.00	-2.90
Standard Credit	Dual fuel	-2.61	-3.78	-3.24	-4.69
РРМ	Electricity	0.10	0.10	+1.08	+1.08
РРМ	Gas	-18.43	-18.43	+0.13	+0.13
РРМ	Dual fuel	-18.33	-18.33	+1.20	+1.20

Table 1: NPT SMNCC allowance (nominal prices) (£ per customer), for nil consumption and benchmark consumption, at cap period 14a (April 2025 – June 2025)

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 electricity. Values may not sum due to rounding.

- 1.22 We are maintaining our previous SMNCC decisions on the standing charge and unit rate allocation. This means that 100% of the PPM SMNCC is applied to the standing charge, and 69% of the credit SMNCC is applied to the standing charge. We note this is different from the allocation ratio we used for the new core operating cost allowance, where we have moved to a new allocation between the standing charge and unit rate. See 'Appendix 1: Core operating costs' for further details.
- 1.23 The numbers presented above are pre-levelisation, so the change to PPM nil rate's effect on customers will be mitigated by levelisation.

# Structure of this paper

- 1.24 The structure of the remaining document is set out below:
  - **Chapter 2 Background.** In this chapter, we set out our current approach to calculating the NPT SMNCC allowance, and the case for change.
  - Chapter 3 Setting the SMNCC baseline. In this chapter, we set out our decisions to update the NPT SMNCC baseline in alignment with the core operating cost allowance.

- Chapter 4 Costs and benefits. In this chapter, we set out our decision to maintain the cost and benefit components in the SMNCC model that are included in the previous model. We also detail our decision to update the PPM CTS benefit in the SMNCC model.
- Chapter 5 Other areas. In this chapter, we set out our decisions regarding the calculation of future rollout profiles, the benchmarking of net costs, our model review and update process, and the advanced payment adjustment.
- Chapter 6 Post-2025 framework. In this chapter, we set out our intentions for setting the NPT SMNCC allowance following the conclusion of this operating costs review, and in the context of any future post-2025 framework.

# 2.Background

#### Section summary

In this chapter, we set out the current approach to calculating the non-pass-through (NPT) smart metering net cost change (SMNCC) allowance and how it relates to the operating cost allowance. We also outline the case for change.

# Current approach to setting the allowances

- 2.1 The current operating cost allowance reflects all metering costs in the 2017 baseline year (alongside other operating costs) and is set using suppliers' 2017 cost data. At the time, we did not collect the data broken down by payment methods. We benchmarked the operating cost allowance at the lower quartile cost. This allowance is indexed to CPIH when the cap is updated.
- 2.2 The SMNCC baseline is calculated in our SMNCC model. The model is based on DESNZ's CBA model with several modifications, as well as more recent supplier data inputs including Annual Supplier Return (ASR) data.
- 2.3 We calculate the annual SMNCC allowance in the SMNCC model which takes a forward-looking modelled approach. The NPT SMNCC allowance reflects the net change in operating costs, compared to the baseline, that has resulted from the rollout of smart meters.
- 2.4 The SMNCC model uses ASR data to reflect supplier costs. The ASR data are input to the SMNCC model annually to update cost, benefit and rollout data inputs.
- 2.5 We benchmark smart metering costs at the weighted average cost. The NPT SMNCC allowance uses a weighted average baseline because:<sup>6, 7</sup>
  - we had expected the market would converge on an efficient way of procuring assets, thereby minimising variation in suppliers' reported asset costs; and
  - we considered that a stricter benchmark could hinder rollout progress and reduce suppliers' willingness to participate in the smart meter rollout programme.

<sup>&</sup>lt;sup>6</sup> Ofgem (2018), Default tariff cap: overview document.

https://www.ofgem.gov.uk/consultation/default-tariff-cap-overview-document <sup>7</sup> Ofgem (2020), Decision on reviewing smart metering costs in the default tariff cap. <u>https://www.ofgem.gov.uk/decision/decision-reviewing-smart-metering-costs-default-tariff-cap</u>

- 2.6 As the operating cost allowance has, to date, been benchmarked differently (at the lower quartile) to the smart metering costs benchmark, we calculate uplift adjustments within the SMNCC model to ensure the NPT SMNCC allowance reflects the difference between a lower quartile and weighted average benchmark.
- 2.7 We model the profile of smart meter installations over time and refer to this as the rollout profile. The rollout profile is based on the level of smart meter rollout achieved, with future rollout based on DESNZ's smart metering targets framework. We use different rollout profiles for credit and PPM smart meters and describe these in more detail in Chapter 5.
- 2.8 In the SMNCC model, we use an 'advanced payments adjustment' which reflects that we set the SMNCC allowances based on estimates of future rollout and costs. We use the advanced payment adjustment once actual rollout data becomes available and calculate it by comparing the difference between the allowance that was set, and the allowance that would have been set had we used actual rollout and cost data at the time. Advanced payments are then recovered over a 12month period, from each October.

## **Case for change**

- 2.9 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. In particular, the core operating cost allowance baseline year will change from 2017 to 2023, and will change from a lower quartile benchmark to a weighted average benchmark.
- 2.10 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.
- 2.11 Since the cap was introduced in 2019, and smart meter rollout has progressed, we consider that some costs and benefits have become more stable while others may still change. We have therefore considered our approach to setting the NPT SMNCC allowance through this review.

# 3. Updating the SMNCC baseline

#### Section summary

This chapter sets out our decision to update the SMNCC baseline, from 2017 to 2023, in line with our decisions for updating the core operating cost allowance baseline. We summarise and consider stakeholder comments made in response to our statutory consultation and detail the SMNCC baseline updates we have made.

# Context

- 3.1 We use the core operating cost allowance to reflect the efficient costs of a notional supplier in serving default tariff customers, including metering costs. 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 core operating cost allowance baseline year.
- 3.2 We consider it is appropriate to update the NPT SMNCC allowance as the future costs and benefits resulting from the smart meter rollout may still change over time. For example, future net costs may not align with a simple inflation index update. Updating the NPT SMNCC allowance therefore helps an efficient notional supplier to recover its costs and allows customers to benefit from the smart meter programme.
- 3.3 In our December 2024 statutory consultation, we discussed updating the SMNCC baseline in line with our proposals for updating the operating cost allowance. We proposed to proceed with updating the SMNCC baseline, from 2017 to 2023, in line with our proposal to set the core operating cost allowance using 2023 RFI data. We also outlined other SMNCC model updates that would be required to reflect a change in how we benchmark the operating cost allowance, from a lower quartile to a weighted average benchmark.
- 3.4 In our December 2024 statutory consultation, we also identified two options to update the SMNCC baseline:<sup>8</sup>
  - 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

<sup>&</sup>lt;sup>8</sup> Ofgem (2024), Energy price cap operating cost and debt allowance consultation, Appendix 3 Smart metering costs, paragraph 3.14. <u>https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-and-debt-allowances-consultation</u>

- 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 allowance. This option was our proposed approach in the December 2024 statutory consultation.
- 3.5 As detailed in 'Appendix 1: core operating costs', we have decided to set the core operating cost allowance using a 2023 baseline year and weighted average benchmark. We therefore need to update the SMNCC model to ensure the allowances calculated align with the new core operating costs allowance.
- 3.6 In 'Appendix 1: core operating costs' we have also decided to change how we reflect the additional costs of serving PPM customers in the core operating cost allowance. We therefore need to update how we calculate the PPM allowance, in our Annex 5 model, to ensure consistency with the new core operating cost allowance.

# Decision

- 3.7 We have decided to implement all the SMNCC baseline updates that we proposed in our December 2024 statutory consultation.<sup>9</sup> We have:
  - updated the SMNCC baseline year from 2017 to 2023, in line with our decision to use 2023 cost data to set the new baseline for the core operating cost allowance; and,
  - calculated the 2023 SMNCC baseline by updating the SMNCC model which is based on 2023 Annual Supplier Return (ASR) data. The ASR data includes supplier cost and benefit smart meter data, reported annually to DESNZ.
- 3.8 We consider that it is necessary to update the baseline given the new operating cost baseline and have accordingly made a few technical adjustments to account for this, which are described below.
- 3.9 As part of updating the SMNCC model baseline, we have decided 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;
  - set the 'percentage cost reduction' for avoided costs to zero;

<sup>&</sup>lt;sup>9</sup> Ofgem (2024), Energy price cap operating cost and debt allowance consultation, Appendix 3 Smart metering costs, paragraphs 3.4 – 3.8. <u>https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-and-debt-allowances-consultation</u>

- 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.
- 3.10 All baseline updates have been applied to the SMNCC model, the outputs of which are input to the updated Annex 5 model.
- 3.11 We have decided to remove the 'PPM cost offset', that was applied to the PPM NPT SMNCC allowance. This update is applied in the updated Annex 5 model.

## Rationale

- 3.12 We have decided to set a new core operating allowance baseline, as detailed in 'Appendix 1: core operating costs'. To ensure coherence with this, we have decided to align the baseline year in the SMNCC model with the core operating cost allowance baseline year (2023). This alignment will provide consistency and clarity in our allowance.
- 3.13 We calculated the new SMNCC baseline using the SMNCC model. This method is consistent with our approach to calculating the current baseline, as described in Chapter 2. Calculating the new baseline in the SMNCC model will ensure consistency with future annual model updates, as we will be calculating the change in costs using the same data source used to calculate the SMNCC baseline. We considered using the 2023 RFI data to calculate the new baseline however the data showed allocation inconsistencies between suppliers, and also do not report cost and benefit data to the same level of detail.
- 3.14 As detailed in 'Appendix 1: core operating costs', we have decided to change how we benchmark the core operating cost allowance, moving from a lower quartile to a weighted average approach. As detailed in Chapter 2, we incorporate adjustments within the SMNCC model to ensure the NPT SMNCC allowance reflects the difference between a lower quartile and weighted average benchmark. To ensure the SMNCC model is consistent with the new 2023 core operating cost allowance benchmarking approach, we have decided to update the model by:
  - removing all steps that calculated the lower quartile SMNCC net cost; and
  - removing all steps that calculated the difference between the lower quartile baseline cost and the weighted average cost.
- 3.15 We have decided to change, in the core operating cost allowance, how we reflect the difference in cost to serve PPM customers compared to Direct Debit

customers. We have therefore decided to remove the PPM cost offset from the NPT SMNCC allowance which is applied because of the uncertainty with our current approach to allocating costs between PPM and Direct Debit customers in the operating cost allowance. The same uncertainty no longer exists in the new core operating cost allowance.

## **Stakeholder responses**

- 3.16 Three suppliers agreed with our proposal to update the 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. One of these suppliers also said that the model was currently difficult to interpret and that they had previously informed us about an error relating to calculating COVID parameters.
- 3.17 One supplier re-iterated its view that the SMNCC allowance should be removed, saying the allowance is no longer necessary.
- 3.18 Another supplier said it was concerned we were using different data to calculate the SMNCC baseline (compared to the operating costs baseline), and by our intent to remove the PPM cost offset (applied in Annex 5).

## Considerations

#### The need for an SMNCC allowance

- 3.19 In response to our December 2024 statutory consultation, one supplier said that while the SMNCC model may have been appropriate during the start of rollout, when using DESNZ's impact assessment was unavoidable, this approach is no longer necessary. It said that Ofgem hold operational cost data which show the impact of over 65% of rollout, and that we should measure operating costs assuming smart meters are the norm. It also said that savings against the baseline are not captured by suppliers.
- 3.20 As smart meter rollout is ongoing, we recognise that while some costs are enduring and stable, others may still vary as the rollout progresses. In Chapter 4, we consider supplier comments that refer ongoing costs and benefits associated with smart meter rollout. The analysis we describe in Chapter 4 evidence future changes in costs and benefits as smart meter rollout progress.
- 3.21 We therefore consider that the SMNCC allowance remains appropriate to account for any changes in supplier' 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.

#### Our approach to setting the SMNCC allowance

- 3.22 In our December 2024 statutory consultation, we proposed to update the SMNCC baseline using the SMNCC model, rather than using the 2023 RFI data used to calculate the core operating cost baseline.<sup>10</sup> In response, one supplier said it was concerned that our proposed source of supplier costs data for the SMNCC baseline is different to the data used to set the core operating cost baseline
- 3.23 The RFI data shows significant variation in suppliers' methodologies for allocating their core operating costs, between payment methods, fuel types, and smart and traditional meter types. Several suppliers also stated that they had difficulties in splitting some cost lines between different customer groups.
- 3.24 We are also aware that suppliers may take different approaches to allocating costs across customer groups to best reflect business practices (such as smart and traditional meter types).
- 3.25 Further to this, the 2023 RFI data takes a top-down view, and does not provide detailed information on specific cost or benefit inputs relevant to the SMNCC allowance. Costs and benefits associated with smart rollout are provided by the ASR data, which we use to update the SMNCC allowance on an annual basis. If we were to calculate the new SMNCC baseline using the 2023 RFI data, there would be inconsistency between how the SMNCC baseline was calculated and how we update the allowance as part of our annual review process.
- 3.26 We have therefore decided to calculate the SMNCC baseline using the SMNCC model, consistent with our current approach. Using the SMNCC model to set the SMNCC baseline also ensures consistency between the SMNCC baseline and our annual update process (outlined in Chapter 5) which uses ASR data to update cost and benefit inputs in the SMNCC model. As such, we updated the baseline calculations within the SMNCC model from 2017 to 2023.
- 3.27 One supplier and their adviser informed us that there was missing data on COVID parameters, as the input stopped at 2023. We agree that there was missing data and have amended the COVID parameters to reflect years up to 2030.

<sup>&</sup>lt;sup>10</sup> Ofgem (2024), Energy price cap operating cost and debt allowances consultation, Appendix 3 Smart metering costs, paragraph 3.14. <u>https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-and-debt-allowances-consultation</u>

#### **Removing the PPM cost offset**

- 3.28 In our 2020 decision on protecting energy consumers with PPMs, we introduced a PPM level to the cap. We did this by applying a payment method uplift (PMU) to the operating cost allowance which reflected the additional cost to serve PPM customers relative to direct debit customers. To set the PPM PMU, we used the allowance designed by the Competition and Markets Authority (CMA) for their PPM cap which was previously in place. However, we recognised a £17 upperbound uncertainty in the PPM uplift reflecting that the CMA had set a stringent allowance. We took this uncertainty into account in the SMNCC allowance via the 'PPM cost offset'.<sup>11</sup> The PPM offset was based on less stringent benchmark of historic data the CMA used to set its PPM uplift.
- 3.29 We applied the PPM cost offset if the PPM SMNCC allowance was negative, and then only applied it until the PPM SMNCC allowance equalled £0. In this way, the PPM cost offset was designed to mitigate the risk that the PPM PMU could lead to under-recovery for an efficient notional supplier with a higher-than-average proportion of PPM customers.
- 3.30 As further detailed in 'Appendix 1: core operating costs', we have set a new PPM operating cost level based on the 2023 RFI data, which no longer applies the historic PPM PMU. Removing the PPM PMU, and the historic data used to set it, removes the previous uncertainty around the allowance, thus removing the purpose of the PPM cost offset. The PPM cost offset is therefore no longer applied to our updated NPT PPM SMNCC allowance, and we have removed it from Annex 5.

<sup>11</sup> Ofgem (2022), Price Cap – August 2022 decision on credit and PPM SMNCC allowances, paragraph 1.8. <u>https://www.ofgem.gov.uk/decision/price-cap-august-2022-decision-credit-and-ppm-smncc-allowances</u>

# 4. Costs and benefits

#### Section summary

In this chapter we set out the cost and benefit component options for the SMNCC allowance and consider our overall approach to defining which costs and benefits to include. We summarise and consider stakeholder comments on our December 2024 statutory consultation relating to this and update our considerations accordingly.

# Context

- 4.1 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. We considered robustness, proportionality and simplicity over time when choosing which cost components to include within the SMNCC allowance.
- 4.2 We considered changes to various cost components of the SMNCC allowance within our December 2024 statutory consultation and following on from supplier comments. We considered various options including different combinations of cost and benefit components within our December 2024 statutory consultation (outlined below).

Table 2: Overview of cost components and allowance values for different options, cap period 14a (April 2025 – June 2025)

Option	Key components	Credit allowance, £/customer (dual fuel, cap period 14a)	PPM allowance, £/customer (dual fuel, cap period 14a)
1	Cost of smart meter assets installed during rollout, benefit of not replacing old traditional meters with a new traditional meter, installation costs of installing smart meters during rollout, benefit of not replacing old traditional meters with a new traditional meter and PPM CTS.	2.06	-13.31

Option	Key components	Credit allowance, £/customer (dual fuel, cap period 14a)	PPM allowance, £/customer (dual fuel, cap period 14a)
2	Option 1 plus asset costs of installing traditional meters during rollout, cost of prematurely replacing traditional meters, benefit of avoided rental charges for prematurely replaced traditional meters, installation costs of installing traditional meters during rollout, cost of prematurely replacing traditional meters and benefit of avoided rental charges for prematurely replaced traditional meters.	0.19	-20.78
3	Option 2 plus In-Home Display (IHD) costs, supplier IT (including DCC adaptor services), debt handling, customer enquiry benefits, change of tariff benefit, customer switching benefits and avoided site visits.	-4.77	-23.44
4 (Status quo)	Option 3 plus cost of prematurely replacing SMETS1, benefit of avoided rental charges for prematurely replaced SMETS1 meters, operation and maintenance costs, organisational costs, net reduction in energy theft, advertising costs and other costs.	-3.78	-23.31
5a	Cost of smart meter assets installed during rollout, cost of prematurely replacing SMETS1, installation costs of installing smart meters during rollout, cost of prematurely replacing SMETS1, benefit of avoided rental charges for prematurely replaced SMETS1 meters, operation and maintenance costs and PPM CTS.	5.93	-6.42
5b	Option 3 plus cost of prematurely replacing SMETS1, benefit of avoided rental charges for prematurely replaced SMETS1 meters, cost of prematurely replacing SMETS1, benefit of avoided rental charges for prematurely replaced SMETS1 meters and operation and maintenance costs.	-3.66	-23.18

(see annex for table further summarising what components are included within each option)

4.3 Within our December 2024 statutory consultation, we proposed option 3 cost component option as we said it simplified the model without disadvantaging customers compared to other options. We concluded that option 3 was our preferred option. We considered that it was a proportionate approach as it best

reflects the key costs and benefits that suppliers face as a result of the smart meter rollout.

### Decision

- 4.4 We have now decided to implement option 4 to set the SMNCC allowance for reasons outlined below. This option sets the SMNCC allowance using the status quo approach which consists of the cost components in the current model.
- 4.5 We have also decided to update the PPM CTS benefit using 2023 ASR data as a proxy. This reduces the PPM CTS benefit and in turn increases the allowance by £2.38 per customer for electricity and £2.60 for gas in cap period 14a (April 2025 June 2025).

#### Rationale

- 4.6 While operation and maintenance (O&M) costs have low materiality in the current cap period (cap period 14a, April 2025 June 2025), when analysed on a longer timeframe they become material as a greater number of smart meters are rolled out. As such, we consider it appropriate to continue including O&M costs in the SMNCC allowance.
- 4.7 We consider retaining the current approach (option 4) is beneficial compared to option 3 with O&M costs because there are other costs excluded in option 3 that impact the SMNCC level over time as rollout increases. Including O&M but excluding these other costs would risk overstating the credit SMNCC allowance. We discuss this in greater detail below.
- 4.8 Overall, we consider that option 4 provides a more reliable allowance, while maintaining a wider range of costs and benefits will be more robust than making a single change to option 3.
- 4.9 Our analysis of ASR data suggests that the PPM CTS benefit has reduced since we set the allowance. We have decided to update the PPM CTS benefit input to reduce the risk the allowance had departed from efficient costs. In adjusting this benefit, we have decided to retain the original data source but to use the ASR data as a proxy to scale the costs. We consider this best accounts for the reduction in benefit while reducing the risk of double counting costs and benefits captured across the rest of the SMNCC. This change will ensure that we are using the latest available data and lead to less steep reductions in the CTS benefit over time.
- 4.10 The overall effect of these changes to the SMNCC allowance is shown in the table below. The effect of the changes we are making from our December 2024

statutory consultation is that allowance levels for all fuel and payment type combinations become less negative (ie providing a higher allowance), with PPM electricity allowances moving from negative to positive.

Table 3: Changes in overall SMNCC allowance, £ per customer, cap period 14a (April 2025 – June 2025)

	Fuel	Proposed December 2024 statutory consultation allowance	Decision allowance
Credit	Electricity	1.09	1.67
Credit	Gas	-5.86	-5.44
Credit	Dual fuel	-4.77	-3.78
РРМ	Electricity	-3.28	0.10
РРМ	Gas	-20.16	-18.43
РРМ	Dual fuel	-23.44	-18.33

# **Stakeholder responses**

- In response to our December 2024 statutory consultation stakeholders raised various points relating to the inclusion of different cost and benefit components. They also suggested further reviews of various cost components. The specific components raised include:
  - operation and maintenance costs,
  - premature replacement charges,
  - PPM CTS benefit,
  - avoided meter reading and inspection visits,
  - traditional meter asset lifetime; and
  - replacement of comms hub costs.

# Considerations

# Retaining the status quo (option 4)

4.12 In our December 2024 statutory consultation, we considered that option 3 was the most robust approach and would reduce the number of individual components modelled within the allowance compared to the status quo approach. We considered 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.

- 4.13 In response to our December 2024 statutory consultation, suppliers raised a number of points relating to which option should be used going forward. In general, there were concerns relating to cost and benefit components which were not included within option 3, specifically O&M costs and premature replacement charges.
- 4.14 One supplier said that components excluded from option 3 do materially change year on year, contrary to assumptions we made in our December 2024 statutory consultation. It stated that the difference between options 3 and 4 is therefore not immaterial. The same supplier said this would lead to under-recovery of costs. Another supplier stated some costs excluded in the interest of simplification should be included and some of the cost benefit analysis is out of date. The same supplier said that costs such as marketing and advertising increase as customers who have not yet switched will be less willing. Another supplier said option 3 overstated PPM benefits whilst understating credit costs. One supplier broadly supported this option as it balances simplicity and accuracy.

#### Operation and maintenance costs

- 4.15 In our December 2024 statutory consultation, we proposed to adopt a reduced version of the SMNCC that excluded several cost and benefit components. We considered they were not material and excluding them would simplify the approach in setting the allowance. The option we proposed (option 3) 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 (option 4). We stated this would not disadvantage customers. One such cost we proposed to exclude was O&M costs. O&M costs comprise of post-installation costs to suppliers for issues such as replacing faulty equipment.
- 4.16 One supplier stated option 3 should be amended to include O&M costs. It said that O&M costs should be included within the SMNCC allowance as they are material and will become more material as smart meter installations increase. They said that not capturing these costs would fail to fund future efficiently incurred costs.
- 4.17 We tested the materiality of including O&M costs by adding back O&M to option 3 and determining what impact this had on the final SMNCC allowance numbers. We then compared option 3 with O&M to the original SMNCC allowance numbers to SMNCC allowance numbers using option 4. To understand the impact of rollout over time on these costs, we forecasted the number of meters installed (ie the rollout profile) to cap period 17 (October 2026-March 2027). To forecast the

rollout, we calculated average year on year rollout increases from 2021 to 2023 and extrapolated this out for later years. The findings of this analysis are shown in Figures 1 and 2 below.

- 4.18 The graphs show that adding O&M costs increases the SMNCC allowance. This difference is small for cap period 14a (April 2025 June 2025) allowances, approximately £2.01 for credit and £0.57 for PPM, and aligns with our December 2024 statutory consultation. However, the materiality of the difference increases as rollout rises for both credit and PPM and is therefore larger for later cap periods. As there are more smart meters installed with increased rollout the cost to operate and maintain smart meters will also increase. By cap period 17 (October 2026 March 2027), the difference between option 3 with and without O&M costs will increase to £5.30 for credit and £1.71 for PPM based on our projected rollout.
- 4.19 Given stakeholder feedback and our conclusion that O&M costs are material as rollout increases, we have decided to deviate from our December 2024 statutory consultation position and include them in the allowance. We have achieved this by reverting to the status quo approach (option 4) rather than an amended option 3 that includes O&M. We set out our considerations for this in the next section.

Figure 1: credit SMNCC allowances for considered options, increased rollout forecast, dual fuel



	Cap period 13	Cap period 14	Cap period 15	Cap period 16	Cap period 17
Option 3	-0.25	-0.37	0.83	1.51	1.86
Option 3 with O&M	1.13	1.64	3.81	5.45	7.16
Option 4	0.79	1.12	2.82	4.00	5.15

Figure 2: PPM SMNCC allowances for considered options, increased rollout forecast, dual fuel



	Cap period 13	Cap period 14	Cap period 15	Cap period 16	Cap period 17
Option 3	-16.68	-20.45	-12.15	-13.60	-19.31
Option 3 with O&M	-16.34	-19.88	-11.12	-12.11	-17.60
Option 4	-16.50	-20.08	-11.31	-12.29	-18.02

Change in consulted option

- 4.20 There are two methods we considered for reinstating O&M costs in the allowance: 1) retain option 3 but including O&M; 2) revert to the status quo (option 4). We have decided to use the latter of these and maintain the status quo. In our December 2024 statutory consultation, we considered that option 3 was the most robust approach and would reduce the number of individual components modelled within the allowance compared to the status quo approach. We considered 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.
- 4.21 We have decided to maintain the status quo (option 4). We still consider that option 3 is simpler and takes less time to update because of the need for material costs to be accounted for within the SMNCC allowance, especially as rollout

increases. However, components not included within option 3 are now shown to be material. This is highlighted in Figures 1 and 2 above.

- 4.22 The deviation between credit and PPM SMNCC allowance values over time for option 3 and option 4 becomes greater as rollout increases. This is mainly because of the increased O&M costs associated with higher rollout. However, the impact of excluded benefits in option 3 offset some of this increase in cost, shown by the difference between the option 3 including O&M and the option 4 lines, particularly for credit.
- 4.23 On balance, we consider that retaining option 4 is preferable as it provides a more reliable allowance, and considers a wider range of costs and benefits. It will be more robust than making a single change to option 3 (inputting O&M costs). We are placing a greater weight on having a robust allowance over the simplicity of update. This enables an efficient notional supplier to recover its costs, while also ensuring that customers continue to see the benefits of the smart meter rollout. Using option 3 with O&M costs could risk overstating the allowance by up to approximately £2 for credit (ie the cap period 17, October 2026 March 2027, difference).
- 4.24 Premature replacement charges and advertising costs are included in the allowance. This addresses suppliers' concerns that we were excluding these costs under option 3.

#### Other options

- 4.25 We rejected options 1, 2 and 5a in our December 2024 statutory consultation because they had the fewest benefit components, and subsequently higher costs. The potential benefits customers would incur as a result of the smart meter rollout would also be limited with these options. We rejected option 5b as being too close to the status quo option (option 4) and only offering a modest reduction in cost components, without sufficient simplification.
- 4.26 One supplier stated that we gave no sufficient reasoning for why options 1, 2 and
  5a were rejected and our statement that costs outweighed benefits for these
  options was not sufficiently justified. No suppliers directly commented on option
  5b.
- 4.27 We still consider that these (1, 2 and 5a) options are not in the best interest of consumers, as they limit the benefits customers would gain from the smart meter rollout. We consider that these options have upward bias by focusing on including the key costs in the absence of benefit components which would unduly lead to a non-cost reflective allowance.

#### PPM cost to serve benefit

- 4.28 One supplier stated that it was unable to reconcile the PPM CTS benefit with its own reported data. It asked us to review this data point. Another supplier said PPM smart customers are not cheaper to serve than PPM traditional customers.
- 4.29 The PPM CTS benefit reflects the operational cost savings of replacing a traditional PPM with a smart meter operating in PPM mode. These benefits include reduced customer calls, easier customer switching, changing tariffs remotely and reduced cost of meter readings. In the SMNCC model, this is currently calculated using 2019 RFI data using a weighted average of five suppliers' data. This is also updated annually using updated GDP deflator numbers.
- 4.30 We used 2019 RFI data to set the PPM CTS benefit in the current allowance as this included more granular data (showing relevant cost items) from a wider supplier pool, relative to the ASR data.<sup>12</sup> Using the RFI data minimised the risk of double counting costs and benefits captured elsewhere in the SMNCC allowance.
- 4.31 To assess whether the PPM CTS benefit has changed since our 2019 RFI data we have compared how PPM CTS data collected through the ASR differs between 2019 to 2023.
- 4.32 As shown in Table 3 below, our analysis of the ASR data shows the PPM CTS benefit allowance for electricity went down by £5.68 per customer and for gas went down by £4.31 per customer. The reduction in the PPM CTS benefit is consistent across fuel types. We do not have clarity on the cause of this reduction, although we note that the PPM rollout was at a relatively early stage in 2019 for many suppliers.
- 4.33 The ASR data still shows that there is a PPM CTS benefit. This means that we should still retain this element with the SMNCC model. Individual suppliers may see different impacts. However, under the Act, we cannot set allowances specific to each supplier, so we consider the average impact across the market.

<sup>&</sup>lt;sup>12</sup> Ofgem (2021), Price Cap - Decision on PPM SMNCC allowance <u>https://www.ofgem.gov.uk/decision/price-cap-decision-ppm-smncc-allowance</u>

Year	Electricity PPM CTS benefit £ per customer (2011 prices), ASR data	Gas PPM CTS benefit, £ per customer (2011 prices), ASR data	Dual fuel PPM CTS benefit, £ per customer (2011 prices), ASR data
2019	10.06	6.96	17.02
2023	4.38	2.65	7.03

Table 4: Change in PPM CTS benefit (£ per customer, 2011 prices), ASR data

- 4.34 Given the downwards trend shown in the ASR data, we have decided to adjust the PPM CTS benefit. Retaining the current approach would increase the risk of a notional supplier under-recovering its efficient costs. This could increase the risk of failure for a notional efficient supplier with an above average proportion of PPM customers, the costs of which would be recovered through customers' bills.
- 4.35 To adjust the PPM CTS benefit, we considered two options: 1) scale the existing benefit by the change observed in the ASR data; and 2) use the ASR data directly to set the benefit.
- 4.36 We have decided to use the first option. This methodology uses the proportional decrease in ASR data over time (until 2023) as a proxy for the changes in the CTS benefit, which is then applied to the PPM CTS allowance calculations. The approach maintains our original rationale for using RFI data and reduces the risk of double counting costs and benefits captured elsewhere in the SMNCC allowance.
- 4.37 Updating the PPM CTS benefit using the ASR data as a proxy increases the PPM allowance in cap period 14 (April 2025 September 2025) by approximately £5 (£2.38 for electricity and £2.60 for gas). It will then yield a smaller reduction in the PPM allowance over time compared to continuing to use the 2019 RFI data, as more meters are installed. Relative to this, using the ASR data directly would yield a slightly higher increase, though the two approaches are comparable with only approximately £1.50 separating them. We still consider our approach of using the proxy to be more robust given our considerations outlined above. The allowance levels relating to all considered options are shown in Table 4.

Table 5: PPM SMNCC allowance levels for current approach and ASR data,  $\pounds$  per customer, cap period 14a (April 2025 – June 2025)

	PPM SMNCC allowance, dual fuel	Difference
Do nothing	-23.31	N/A
Use ASR data	-16.89	+6.42
Use 2023 ASR data as a proxy	-18.33	+4.98

4.38 We have decided to not update the PPM CTS benefit annually, other than to account for inflation. Continually updating the CTS benefit on an annual basis may reduce efficiency improvement incentives.

# Premature Replacement Charges (PRCs)

- 4.39 One supplier said it was concerned SMETS1 meter PRCs were excluded and it considered that PRCs were not adequately accounted for in either option 3 or option 4, however said it preferred option 4. They stated that despite PRCs not being accounted for properly in this option they would support this option with review of some components. Three suppliers expressed their concerns relating to costs associated with failed or non-communicating meters, particularly for SMETS2 meter PRCs, which they said were higher than SMETS1 PRCs and should be kept under review.
- 4.40 PRCs are a charge incurred by suppliers when a meter is replaced before the cost of the meter has been paid off. If a SMETS meter is replaced early and it is not faulty, or the SMETS meter is replaced at the same time as a comms hub, then PRCs are incurred for the meter and the comms hub.
- 4.41 We have decided to include SMETS1 meter PRCs in line with the decision to move to option 4 (which includes SMETS1 meter PRCs) as mentioned in relation to O&M costs above.
- 4.42 Given the most recent review of PRCs was carried out in 2022<sup>13</sup> we do not consider it necessary to carry out further reviews into this at this stage.
- 4.43 Modelling PRCs, we include a meter rental uplift for SMETS1 meters within the current allowance to account for a difference between the underlying cost of the asset and the amount suppliers may be charged by Meter Asset Providers (MAPs). The asset and installation costs data is also updated annually using ASR data to

<sup>&</sup>lt;sup>13</sup> Ofgem (2022) Price Cap- August 2022 decision on credit and PPM SMNCC allowances <u>https://www.ofgem.gov.uk/decision/price-cap-august-2022-decision-credit-and-ppm-smncc-allowances</u>

account for changes and we consider the advanced payment adjustment provides for any difference in costs.

- 4.44 We are aware that DESNZ are considering the issue of failed / noncommunicating meters, including how this may be incorporated into the post '25 framework and the outcome of this may lead to a further review of PRCs.
- 4.45 We have decided to not include SMETS2 meter PRCs but will monitor any change in policy relating to the replacement of non-communicating meters. These costs will be included within the new baseline at the level incurred across the industry in 2023.
- 4.46 One supplier said that its additional costs are not recognised and that its costs for non-communicating meters are significantly above the weighted average. In setting the cap, we may not make different provisions for different holders of supply licences so we must set one cap for all suppliers.

#### AMRIVs (Avoided Meter Reading and Inspection Visits)

- 4.47 One supplier said that the benefit from AMRIVs has been reducing over time because of industry developments over recent years, with fewer meter reads for traditional meters being carried now than have been historically.
- 4.48 AMRIVs (or avoided site visits) is a component of the SMNCC allowance which take into account the cost saved when smart meters remove the need for a site visit. These were included within option 3. The AMRIV cost line is set using a weighted average approach which naturally means some suppliers' costs will be above or below this value. The data was last updated using 2023 ASR data in August 2024. As such, we consider that the current input appropriately accounts for this cost.
- 4.49 We expect to update the inputs for AMRIVs as part of the annual update this year using the latest ASR data.

#### Meter lifetime

- 4.50 One supplier also raised that we should update the meter asset lifetime assumption, as it stated that the average age of currently installed credit meters is close to or above the maximum age we assume in our model.
- 4.51 We do not consider it necessary to change the assumption on meter asset lifetime. This is because it will not materially affect the allowance, and any changes to the asset lifetime will impact the amortisation assumption in the model which would require us to recalculate historical allowances.

4.52 The lifetime assumption is set through the CBA input for credit and our own data for PPM but the amortisation assumption should mean that disparities relating to this are limited. Changing this assumption would also create a risk of double counting between amounts already amortised through previous allowances and amounts in future allowances.

### **4G Comms Hub Only Replacements**

- 4.53 Two suppliers stated that exclusion of 4G comms hub replacement costs will lead to an under-recovery of costs. They stated that they expect to incur costs ahead of DESNZ's decision on the cost recovery arrangements for 4G comms hub only exchange site visits, and said that this would be in part due to high PRCs associated with the comms hubs.<sup>14</sup> Another stakeholder said 4G costs should be included as they are outside of suppliers' control.
- 4.54 By way of background, mobile network operators do not intend to offer 2G/3G networks past 2033 at the latest, and after this date any communication hubs using these networks will lose smart connectivity and the meter will revert to analogy mode. Suppliers will therefore need to replace impacted communication hubs in advance of the 2G/3G switch off. DESNZ has concluded that DCC will provide centralised funding for all energy suppliers undertaking 4G comms hub only exchange site visits, meaning that suppliers incurring these costs will be reimbursed.<sup>15</sup>
- 4.55 In our December 2024 statutory consultation<sup>16</sup> we proposed not to include costs associated with 4G comms hub only exchange site visits as a separate component in the SMNCC allowance. This is because these are already covered via DCC costs which flow through into the price cap. On this basis, we still consider that costs associated with 4G comms hub only exchange site visits will be covered, so we have not changed our decision in this respect. We have included considerations of these cost types below:

<sup>&</sup>lt;sup>14</sup> We have assumed that these suppliers are referring to the DCC's communications hub returned and not redeployed charge.

<sup>&</sup>lt;sup>15</sup> DESNZ (2024), Smart Metering Implementation Programme: Conclusions on 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-proposalon-the-dcc-charging-mechanism-and-legal-changes/

<sup>&</sup>lt;sup>16</sup> Ofgem (2024), Energy price cap operating cost and debt allowances consultation, paragraphs 4.37-4.38, Appendix 3.

https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-and-debtallowances-consultation

- site visit costs: DESNZ has required the DCC to provide centralised funding for all energy suppliers undertaking 4G comms hub only exchange activity for SMETS2 meters in the Central and South regions of Great Britain (where meters are not being replaced). In addition, as part of their February 2024 consultation on the associated legal changes, DESNZ are minded to allow recovery of these costs via DCC fixed charges, which will be included in the DCC allowance in Annex 5
- comms hub PRCs (also known as DCC's communications hub returned and not redeployed charge): this is where a comms hub user returns (or notifies as lost or destroyed) a comms hub that cannot be redeployed. The amount, is calculated based on the remaining finance left on the comms hub assets at the time of the return. These costs are currently recovered by the DCC via an Explicit Charge for each HAN Variant in accordance with Section K7.5(p) of the SEC, and the explicit charges revenue element already feeds into the allowance in Annex 5.<sup>17</sup> The amount included in Annex 5 is a forecast of explicit charges for a given charging year, meaning that costs incurred in a given year may differ from this amount. However, we consider that this should be sufficiently accurate given that DCC will be able to update its forecasts from year to year in light of previous experience. We note there is an amount of uncertainty associated with this
- SMETS1 meter PRCs: in the context of the transition to 4G communications, there is currently no technical way to swap out the comms hub of SMETS1 meters, so suppliers have no other option but to carry out a full meter replacement with a SMETS2 meter. Depending on when suppliers choose to replace their SMETS1 meters, they may incur various levels of meter PRCs depending on the remaining commercial life of the asset at the point of replacement. In addition, SMETS1 meter PRCs are currently included in the SMNCC allowance based on the current level of replacements. The future level of premature replacements is currently unknown. Even if there were a future increase in the number of SMETS1 replacements, the cost per replacement will decline over time as the SMETS1 meter population becomes older. This would reduce the impact of any increase in the volume of replacements. We will keep the issue of

<sup>&</sup>lt;sup>17</sup> Row '2c DCC' AA28, Smart metering net cost change methodology (Annex 5). <u>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</u>

SMETS1 meter PRCs under review in future and would consider whether the impact was material and systematic

4.56 Based on the above considerations, we consider that the legitimate costs associated with the 4G comms hub only exchange programme will be largely covered by price cap funding, and as such do not see justification for adding a new specific allowance for them in the price cap. Doing so would lead to the double counting of costs. If appropriate we may revisit how the cost of 4G comms hub only replacements are captured once DESNZ make their decision on the cost recovery arrangements.

# 5. Other areas

#### Section summary

In this section we consider other areas not covered in the previous sections of this appendix. We summarise and consider stakeholder comments on our December 2024 statutory consultation relating to this.

## Context

5.1 Beyond updates to the baseline and costs and benefits, we looked at various other areas of SMNCC allowance within our December 2024 statutory consultation. These included the rollout methodology for 2024 onwards, benchmarking choice, the continuation of annual reviews and the advanced payments methodology. We considered these within the context of supplier comments.

#### Decision

- 5.2 For rollout methodology, benchmark choice, annual review and advanced payments methodology we decided to proceed with the proposals set out during our December 2024 statutory consultation. These are outlined below:
  - rollout methodology: we have decided to calculate credit rollout using a market leader approach
  - benchmark choice: we have decided to continue benchmarking the net change in costs using a weighted average
  - annual reviews: we have decided to maintain the current approach of regular annual reviews and updates of the SMNCC model
  - current advanced payment methodology: we have decided to roll over the advanced payment adjustment used in the current SMNCC model, which will maintain the current advanced payment cash values for the July-September 2025 cap period
  - future advanced payment methodology: From October 2025, we will calculate advanced payments within our revised SMNCC model. We will carry out this calculation in relation to the period from April 2024 (ie the first cap period after the new baseline). For each relevant cap period, we will compare the SMNCC value generated through the new model (after taking into account updated data) and the best view of the actual allowances suppliers received

before July 2025. We will use different inputs for the actual allowance depending on the time period, as set out below:

- (1) April 2024 March 2025: to account for the introduction of the new baseline, we will calculate the difference between the actual SMNCC allowance in the relevant cap periods (cap periods 12a-13b, April 2024 March 2025) and the actual SMNCC allowance in the middle of the 2023 baseline year (cap periods 10a-10b, April-September 2023). This will represent an equivalent allowance for what suppliers received before the new model was introduced, while avoiding capturing the re-baselining within the advance payment calculation. If we did not do this, the advanced payments calculation would not be a like-for-like comparison, as we would be comparing an actual SMNCC relative to a 2017 operating cost baseline and a modelled SMNCC relative to a 2023 operating cost baseline.
- (2) April September 2025: we will take a simple average between the calculation approach set out above (for the relevant cap period 14a) and the new SMNCC value applied through this decision (for cap period 14b, July-September 2025). We need to take an average as the SMNCC model works on 6 month cap periods (eg April-September 2025), so for the April to June period suppliers would have received an allowance via the current model, and for the July to September period suppliers will receive an allowance from the new model.
- (3) Beyond September 2025: we will use the new SMNCC values as an input to calculate advanced payments.

# Rationale

- 5.3 We considered that for rollout methodology, benchmark choice, annual reviews and the advanced payments methodology, the proposals set out in our December 2024 statutory consultation were sufficient and there were no comments from stakeholders relating to these which influenced our decision making beyond this. The rationale for these decisions is set out below:
  - rollout methodology: we consider expanding the pool of suppliers to all suppliers with a market share above 5% will better reflect the market overall. Calculating the cumulative SMNCC allowance to the end of the framework means we can continue to use the rollout profiles set by DESNZ, to calculate the market leader. This market leader approach is applicable for credit allowances for 2024 onward. For credit allowances from 2023 and earlier and all PPM allowances, a weighted average approach is used

- benchmark choice: we consider that a weighted average is still an appropriate approach as individual suppliers are at different stages of their smart meter rollout. We consider that our allowance allows for recovery of the efficient cost of the smart meter rollout programme
- annual reviews: we consider that continuing to do the current annual review process will enable the SMNCC allowance to best reflect the costs suppliers face
- advanced payments: we consider using the new SMNCC model to calculate advanced payments from the first annual review period after the operating costs review is implemented will be a proportionate approach

# **Stakeholder responses**

- 5.4 Two suppliers commented on rollout methodology. One specifically highlighted disparities with DCC data and achieving rollout targets which we have addressed in 'Appendix 4: industry charges'.
- 5.5 One supplier agreed with our proposals set out in our December 2024 statutory consultation on benchmark choice.
- 5.6 No suppliers directly commented on annual reviews or the advanced payments methodology.

# Considerations

# **Rollout methodology**

- 5.7 One supplier agreed with the approach we set out in our December 2024 statutory consultation in principle, although stated that the current rollout target would be difficult to meet.
- 5.8 The rollout of smart meters across the industry is calculated in different ways for credit and PPM customers. In our December 2024 statutory consultation, we proposed that credit rollout would be set using a market leader approach and PPM rollout would be set using a weighted average approach.
- 5.9 We consider credit rollout should continue to be updated using a market leader approach, with an updated pool of suppliers to better reflect the current market. The pool of six suppliers from which the market leader is selected from comprises of all suppliers with at least 5% market share for both fuel types in 2023. We intend to select the market leader based on the supplier with the largest forecast cumulative SMNCC between 2023 (the new baseline year) and the end of any DESNZ framework.

5.10 We will set the rollout profile for PPM for 2024 onwards using the weighted average methodology. Our decision relating to credit rollout is unchanged to what was proposed in our December 2024 statutory consultation. PPM rollout will remain using a weighted average profile. We discuss how future rollout may be set in light of a post-2025 framework in Chapter 6.

#### **Benchmark choice**

- 5.11 One supplier agreed with our approach set out in our December 2024 statutory consultation to continue benchmarking the net change in costs using a weighted average benchmark.
- 5.12 The legislation underpinning the cap does not enable us to set separate allowance levels for each supplier, so we set one allowance that reflects a notional supplier. We seek to set an efficient benchmark, such that an efficient notional supplier could recover their costs, comply with their obligations, and deliver a good standard of service.
- 5.13 We have decided to maintain the current weighted average approach to updating the benchmark. This was chosen as the approach in 2018 to minimise variation in suppliers' reported asset costs and this reasoning has not subsequently changed.

#### **Annual reviews**

- 5.14 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.
- 5.15 We have decided to maintain the current approach of regular annual reviews and updates of the SMNCC model. This involves a mechanistic annual update of the ASR data in August each year.
- 5.16 We consider that annual reviews of costs should be maintained. Smart meter rollout increases lead to changes in suppliers' operating costs. Regular reviews will therefore best reflect costs. The ASR data is collected on an annual basis, so we consider an annual update to be an appropriate frequency.

### Advanced payment methodology

- 5.17 The advanced payment adjustment is an element of the SMNCC model 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.
- 5.18 In our December 2024 statutory consultation we proposed to roll over the advanced payment adjustment used in the current SMNCC model to our future

modelling approach until October 2025. This was set out to prevent adding unnecessary complexity to the next SMNCC model update.

- 5.19 As discussed elsewhere in this document, we have decided to change our modelling approach compared to our statutory consultation proposal. Given we have decided to make fewer changes to the SMNCC model than were proposed in the December 2024 statutory consultation, we consider that our new SMNCC model will still be able to calculate a reasonable estimate of advanced payments for the period between the new baseline and the implementation of the operating cost review. We consider that including this advanced payments value will therefore increase the accuracy of the SMNCC (relative to not including it), making it more likely that cumulative cap allowances will reflect the cumulative costs of the rollout.
- 5.20 We acknowledge that there is not a perfect or exact method we could use to calculate the advanced payments adjustment as we move between SMNCC models, due to the update of the baseline. There is a risk that the advanced payments adjustment may capture some of the impacts of updating the baseline and the reduction in PPM CTS benefit. However, given the approach we have set out to calculate advanced payments and that the changes to our modelling approach are modest, we consider that the impact will be minimal. Any impact will only apply to the meters rolled out between the baseline year and the implementation of the operating cost review.

# 6.Post-2025 framework

#### Section summary

In this chapter we outline our considerations of the timing of DESNZ's post-2025 consultation and clarify our approach to completing our annual SMNCC model update.

# Context

- 6.1 We use DESNZ's four-year smart metering rollout framework to set the future rollout profile in our SMNCC model. Under this framework, the government set out supplier targets and tolerance levels to the end of 2025.
- 6.2 The NPT SMNCC allowance for cap period 15 (October 2025 March 2026) will be based on a combination of the 2025 and 2026 rollout profile that is set in our SMNCC model.
- 6.3 Currently, the rollout profile in our SMNCC model shows no increase in smart meter rollout beyond 2025, ie no additional meters are installed after 2025. We therefore need to consider how we set the rollout profile beyond 2025 to ensure the allowance remains appropriate, and complete our annual SMNCC model update.
- 6.4 As part of each annual update, we inform suppliers what the NPT SMNCC allowances are for the forthcoming year (from October to September). 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 annual update (to set the cap for cap period 15).

# Decision

- 6.5 We intend to adopt a temporary approach to setting future credit and PPM rollout profiles in the SMNCC model. We will decide on, and implement, the temporary approach as part of our annual update to set the cap period 15 (October 2025 March 2026) allowance and subsequent allowances.
- 6.6 We intend to apply our temporary approach to the SMNCC model, to set a rollout profile beyond 2025. To set a temporary rollout profile, we will consider what information is available at the time of our annual review, including rollout to date and any published DESNZ consultation information.
- 6.7 We will confirm what our temporary approach is at the same time as informing suppliers what the SMNCC allowances will be for cap period 15 (October 2025 – March 2026), following our annual ASR update.

- 6.8 For the avoidance of doubt, the 2024 rollout profile in the SMNCC model will reflect actual rollout, as reported in supplier ASR data.
- 6.9 Our temporary approach to setting rollout will remain in place until DESNZ publish their post-2025 framework decision and we have had time to assess the implications for the cap. We intend to review our approach to rollout following DESNZ's decision and will consult with stakeholders as part of our review. To note, the advanced payment adjustment will account for differences between our temporary rollout profile and either the updated profile against the new framework or actual rollout data, whichever is available sooner.

# Rationale

- 6.10 Our 2024 annual SMNCC update, to be applied in October 2025, requires us to have calculated the SMNCC allowances in time for the August price cap announcement.
- 6.11 We consider that it is in customers' interests to set a rollout profile which continues to increase (as opposed to assuming that the stock of smart meters remains constant). As well as ensuring the allowance more accurately reflects supplier costs, DESNZ analysis indicates that the smart meter rollout is expected to deliver significant net benefits.<sup>18</sup> In assuming an increase in smart meter rollout beyond 2025, which we consider to be realistic, the SMNCC allowance continues to support the delivery of smart metering, to the benefit of customers.
- 6.12 We also consider that setting a temporary rollout profile, to show an increase in rollout beyond 2025, avoids potential volatility in the allowances. The number of smart meter installations in any year is an important factor in calculating the allowance. By implementing a temporary rollout profile, we seek to minimise the difference between no rollout and actual rollout, thus minimising variation in allowance values between cap periods. We also consider this approach will reduce the scale of the advanced payments adjustment which accounts for the difference between modelled and actual rollout.
- 6.13 We recognise that DESNZ's consideration of future rollout obligations is ongoing. We expect any new proposals by DESNZ will require time for consultation and consideration of responses. We are uncertain when DESNZ will publish their post-2025 consultation or decision. At this stage, we do not think there is enough time

<sup>&</sup>lt;sup>18</sup> DESNZ (2019), Smart meter rollout cost-benefit analysis. <u>https://www.gov.uk/government/publications/smart-meter-roll-out-cost-benefit-analysis-2019</u>

for us to adequately review or consult on any post-2025 framework prior to our August price cap announcement.

6.14 We therefore intend to define a temporary 2026 and 2027 rollout profile, for the purpose of setting the SMNCC allowance. We intend to use this temporary profile until DESNZ has reached a decision on a new framework, and we have had time to consult on any consequential amendments to our SMNCC approach.

## **Stakeholder responses**

- 6.15 Four suppliers supported our proposal to consider future changes to the SMNCC model once a post 2025 framework is published.
- 6.16 One supplier highlighted two areas where we should continue to review the SMNCC model. It said the model should reflect actual rollout progress, and the cost of replacing non-communicating meters.

## Considerations

- 6.17 When we calculate a temporary rollout profile, we intend to use rollout data that is available at the time of our annual review. At this stage, we consider that the data we could use to extrapolate a temporary rollout profile will include existing ASR rollout data, and the content of any available DESNZ post-2025 publication. We consider there are two broad, sensible options for setting a temporary rollout profile. We will determine which of these we use to set the allowance as part of the ASR update.
- 6.18 Option 1: we could use 2024 ASR data to set a temporary rollout profile. We would calculate the percentage point increase in rollout over 2024 (ie the difference between the start of 2024 and end of 2024). We would then apply this percentage point increase to the 2025 rollout profile to set the rollout profile for 2026 and 2027. We could also consider taking an average change in rollout over multiple years then applying that forward.
- 6.19 Option 2: If available, we could set a temporary rollout profile using consultation publications from DESNZ. This option is dependent on the content of any publication. If available, we would calculate a straight-line trajectory from the 2025 tolerance value to any new published tolerance level, in a similar way to how we use DESNZ's existing tolerance values.
- 6.20 To clarify, we will announce our temporary approach at the same time as we announce the SMNCC allowances following our annual update process.
- 6.21 In response to our December 2024 statutory consultation, one supplier said it would be important to update the model to reflect actual rollout progress in 2024-

25. It said this is particularly important if the advanced payments adjustment is reinstated. To clarify, as part of our annual model update (to set the SMNCC allowances for cap period 15, October 2025 – March 2026) the rollout profile in the SMNCC model will be updated with 2024 rollout data. There has been no pause to the advanced payments adjustment therefore, as in previous years, any difference in allowance values will be reflected in the updated SMNCC allowances.

- 6.22 As outlined in Chapter 5, we use an advanced payments adjustment to reflect that we set the SMNCC allowances based on estimates of future rollout and costs. We use the advanced payment adjustment once actual data become available. In the same way, the advanced payment mechanism will address any differences between the allowances calculated using our temporary rollout profile and the actual rollout achieved by suppliers under any new obligations or the future rollout framework once decided. Our temporary rollout profile therefore does not affect the ultimate amount of revenue that suppliers in aggregate will receive under the SMNCC.
- 6.23 One supplier said that we should review the SMNCC model to reflect the additional costs of replacing non-communicating meters, even though meter replacements are not included in mandatory installation targets. We will review our modelling approach following any DESNZ decision. This will primarily involve reflecting any new rollout requirements in the model. We will also consider whether there are any consequential changes to costs and benefits as a result of changes to rollout.
- 6.24 For the avoidance of doubt, our temporary rollout profile is solely intended to generate a temporary SMNCC allowance. It should not be misinterpreted as a rollout policy or a forecast of what such a policy could be. We will review and consult on our approach following a DESNZ decision.

# Annex 1 – Cost and benefit 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

Table A1: Cost and benefits components included in different options

Component	Sub-component	Option 1	Option 2	Option 3	Option 4	Option 5a	Option 5b
Traditional meter asset cost	Cost of prematurely replacing traditional meters	Not captured	Captured	Captured	Captured	Not captured	Captured
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

Component	Sub-component	Option 1	Option 2	Option 3	Option 4	Option 5a	Option 5b
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
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 <sup>19</sup>	Other costs	Not captured	Not captured	Not captured	Captured	Not captured	Not captured

<sup>&</sup>lt;sup>19</sup> Other costs categories include organisation costs, net reduction in energy theft, advertising costs, legal and organisational, and other costs.