

Centrica's response to Ofgem's statutory consultation on the Default Tariff Cap: response on smart metering costs (and Appendix 7)

Overview

1. Sufficient provision for the smart meter rollout is vital, firstly to ensure that the smart programme progresses to conclusion and is not inadvertently slowed down, and secondly because the Act requires that the cap is temporary, and its removal is linked to the progress of smart rollout. If insufficient provision is made for smart costs, then it would have a negative impact on the rollout and the rate of installation would slow. This is an outcome that the Act specifically seeks to avoid. In these circumstances, there is also a real risk that the duration of the cap is extended. Such an outcome would be particularly damaging for consumers, given the benefits that smart meters (and the technological advances they enable) deliver in terms of opportunities for increased engagement.
2. By setting this cap, Ofgem will be determining the level of the smart meter costs of an efficient operator as they relate to customers covered by this cap. Given the "All Reasonable Steps" (ARS) framework, suppliers will be constrained necessarily by the allowance embedded within the price cap in terms of the scale of activities that can be undertaken¹.
3. We recognise the challenge that Ofgem faces in this regard given that it is required to set one cap, and therefore one allowance, for all suppliers, regardless of the progress they have made in the smart meter rollout. The only way that this can be achieved is to set the allowance at a level that is sufficient to cover both the costs of suppliers that have a greater number of installations left to do, as well as those suppliers that already have a high smart meter stock in place and have ambitions to continue to progress completion faster the average pace of the industry.
4. Ofgem's current proposals do not do this: Ofgem's proposals provide insufficient allowance for the costs of the rollout while simultaneously over-estimating the benefits. Inclusion of a profile that shows an ambitious 2019 rollout target is not sufficient to address these deficiencies; stating that Ofgem is being ambitious in terms of its expectation is irrelevant (Ofgem's assumed rollout profile would only be "conservative" if Ofgem's relevant cost and benefit assumptions were also "conservative"). ✂
5. We estimate that, absent any uplift in smart funding, the level of British Gas investment in the rollout of smart meters would be constrained to between £43 – £47 per dual fuel customer.² ✂. It is also insufficient to deliver the rollout profile being assumed by Ofgem. ✂.

¹ The analysis quoted in this response for the allowance assumed for smart rollout in 2019 does not rely on information from the Disclosure Room

² The range is driven by alternative assumptions about the supplier benefits that will be realised, with the upper limit being set using assumptions that we believe that Ofgem is making that we currently do not consider will be realised.

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6. Our response covers the following issues:
 - a) The legal framework and the limitations in the process of consultation;
 - b) The calculation of the smart meter allowance;
 - c) Implications for British Gas' smart meter rollout and the "All Reasonable Steps" obligation; and
 - d) Review of net costs of smart metering in 2019.
7. We focus our response on the treatment of smart meter costs up to September 2019, given that future values will be subject to review.

Legal framework and consultation process

8. Ofgem's approach to allowing smart meter costs under the cap needs to be considered in the context of two important legal points:
 - a) First: suppliers are under licence obligations to take all reasonable steps to rollout smart meters. This means that – to a greater or lesser extent – they have no choice but to incur the costs of doing so. It is particularly important Ofgem recognises that the steps that are 'reasonable' are those for which the efficient costs can be recovered under the tariff cap. Clearly if Ofgem demanded that suppliers took steps which it considered were consistent with smart meter rollout licence conditions but suppliers were not reasonably able to recover the full costs of doing so, Ofgem would be contravening the financeability requirements of the Electricity Act 1989 and the Gas Act 1986.
 - b) Second: the smart programme forms an important part of achieving the policy objectives behind the Tariff Cap Act, because smart meters will enable customers to better engage in the competitive market place. The Act's success is to be measured, in part, by the smart meter rollout: the cap is designed to be temporary, and smart meter rollout is a key part in its removal. A price cap which hampers the smart meter rollout will therefore not meet the objectives of the Act. The smart meter roll-out is, effectively a mandatory consideration in the Act alongside the requirements of clause 1(6).
9. These two reasons make it critically important that smart meters are dealt with appropriately and transparently in the price cap.
10. Given its importance, our primary concern in this consultation period has been to validate the costs and benefits that underlie Ofgem's assumptions. However, Ofgem's approach to the consultation process, and specifically the operation of the Disclosure Room, has prevented us from being able to participate effectively and to provide well-informed responses to Ofgem's proposals. This has included restrictions that have nothing to do with the commercial confidentiality of data. These issues are addressed in more detail in the legal annex on procedural issues written by Towerhouse LLP.
11. For example, we have only had access to the aggregate SMNCC value, rather than being provided with the underlying input assumptions. Given that the overall allowance appears to be inadequate, we are often left to speculate where many of the individual errors may be. As a further example, despite a secure Disclosure Room being set-up, our Advisors were not provided with access to other suppliers' data, which Ofgem has used to determine the level of the allowance.

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12. In these circumstances, there has simply been no adequate consultation. This serves to undermine stakeholders' confidence in what Ofgem has done, and means Ofgem has missed an important opportunity to gather feedback and input on its proposals when it comes to make its final decision. Ofgem can currently have no confidence that its cap protects customers in the way it intends. For example, there is a material risk that an unrepresentative forecast of costs or benefits is baked into the price cap, putting the rollout at risk.
13. As a practical matter, Ofgem's approach has required us to make assumptions to interpret Ofgem's proposals. We make these explicit in our response, and we expect Ofgem to notify us in the event that any of these are incorrect, advise us of the correct position, and provide us with a fresh opportunity to be consulted before proceeding.

The calculation of the smart meter allowance

14. Ofgem's determination of the allowance to cover the costs of the smart meter rollout comes from two main building blocks:
 - a) 2017 opex baseline: There is an amount contained within the 2017 operating cost benchmark that relates to ScottishPower's net smart metering costs in 2017.
 - b) SMNCC: This provides an increment in each cap period to reflect that the costs of the smart meter rollout will change in a way that differs substantially from CPIH. It is determined on the basis of a set of assumptions about the costs, benefits and profile of the rollout.
15. Within each of these building blocks, there are two types of cost: those classified as "pass-through costs" (such as those relating to DCC) and those determined to be "non-pass-through costs" (such as the costs incurred by suppliers to install a smart meter).
16. Based on our understanding of what is proposed, the "pass-through costs" for credit customers appear appropriately accounted for in Ofgem's methodology, and we do not comment further on them in this response.³
17. Therefore the shortfall in allowance seems to come from the estimation of the "non-pass-through costs": both from the opex baseline and the calculation of SMNCC. Our understanding of what Ofgem has done is only partial given the approach to consultation, as described above. However, we set out in the following sections where we believe the main shortfalls are likely to be, ✕. This response draws on an Annex provided by our Advisors, which was prepared based on access to Ofgem's Disclosure Room.

The SMNCC model

18. A large part of the allowance for smart has been determined using Ofgem's SMNCC model. It is therefore vital that the results produced by this model appropriately reflect the net costs that will be faced by an efficient supplier. ✕

³ This is in contrast to the PPM cap, which takes no account of the escalation associated with these costs. This is one of the reasons why there is a significant shortfall in allowance for the rollout across both caps.

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19. Given these issues, we would suggest that Ofgem should look to build a bespoke model for use in the 2019 review that does not have these issues. In addition, such a model would have no issues of confidentiality and could be shared with the industry.

The 2017 baseline

20. The 2017 baseline for the net smart metering costs is set as part of the calculation of the operating cost baseline. This means that the starting point for the calculation of the allowance is ScottishPower's 2017 net smart metering costs.
21. As part of a completely separate calculation, the SMNCC values are calculated using an estimation of 2017 net costs that is taken from the SMNCC model. The values for 2017 depend on a set of costs, benefits and rollout profile from this model.
22. If these two 2017 starting points are different, the values created for SMNCC will be incorrect. In particular, if ScottishPower's rollout differed from the industry average (in terms of stock of smart meters and installations in 2017, as well as any particular cost variations associated with its actual rollout in that year) then an adjustment would need to be made to SMNCC to address this. This is because the SMNCC allowance is calculated as an increment against 2017 costs, on the assumption that 2017 costs are already captured within the operating cost baseline.
23. From the consultation, Ofgem is equivocal about whether this is the case, referring to the fact that the lower quartile company has "*approximately* lower quartile smart metering costs" and a profile that is "*broadly* representative" (emphasis added).⁴ ✂
24. However, based on information contained in Iberdrola's published accounts, our estimate of ScottishPower's rollout penetration is that it was 5.7% in 2016 and 15.5% in 2017. ✂

Traditional meter rental termination charges

25. We welcome Ofgem's acknowledgment that the tariff cap will need to be set to cover traditional meter rental termination charges. However, we have concerns that the methodology that Ofgem has set out will not cover the costs of an efficient supplier. ✂
26. ✂
27. ✂
28. ✂
29. ✂ or accept that the way that suppliers will change their approach to targeting out of life meters to match the implicit assumption that Ofgem is making.
30. ✂ we are also concerned that the assumed costs associated with early termination are not representative of commercial reality. Given the restrictions imposed by Ofgem, we have not been able to review these assumptions. We assume that Ofgem has made sufficient enquiries to ensure that they reflect the costs that efficient suppliers are experiencing. For example, we forecast that our average meter rental termination costs per smart meter installed in 2019 would be £✂ for a gas credit meter and £✂ for an electricity credit meter⁵.

⁴ Ofgem (September 2018) para 4.17 Appendix 7.

⁵ Note that these costs are an underestimate of rental termination costs for credit meters because they will exclude the costs of some traditional PPM meters that are replaced with smart meters operating in credit mode. ✂

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31. As part of the review that Ofgem is planning to undertake in 2019, it must also take account of any additional charges that may be associated with the treatment of non-enrolled SMETS1 meters.

Efficiency assumptions

32. We support Ofgem's use of an average, rather than lower quartile, approach to estimating the input costs to be used to calculate SMNCC. However, there are three reasons why this approach is not as generous as Ofgem implies.
33. First, Ofgem's assumed 40% productivity improvement between 2017 and 2018 results in an updated estimate of single fuel insourced installation cost to be ✂ The application of Ofgem's productivity assumption essentially has the effect of taking an average value and transforming it into one more akin to a lower quartile.
34. ✂ Given that supplier data was not included within the Disclosure Room, it has not been possible for our Advisors to understand the effect that this approach is having on the outcome.
35. Third, Ofgem ✂ has not taken account of factors that will cause them to rise. As we highlighted in our June response, ✂⁶.

Engagement costs and cost evolution

36. Given the supplier-led and "opt-in" framework of the smart meter roll out, spending on engagement with customers is crucial to deliver material smart meter deployment in the timescales desired by government and Ofgem.
37. Ofgem provides four reasons why no additional allowance is required for these additional costs (which it terms "marketing", although "engagement costs" would be a more accurate description), none of which withstand scrutiny.
 - a) *The costs are covered by SEGB:* Whilst SEGB plays a part in this activity, British Gas currently spends around twice as much on marketing and engagement as we do through SEGB.
 - b) *They are included within the baseline:* Given the way that the baseline has been set, it is extremely unlikely that they have been included sufficiently given that (i) these costs are not fixed costs and will instead be driven by the number of installations attempted in each year and (ii) the costs will increase over time as the challenge becomes more difficult, as acknowledged by Ofgem.
 - c) *They are included in the ASR responses, which include appointment setting costs within its estimate of installation costs:* Ofgem itself notes later in the document that "there is significant variation on how suppliers report installation costs in the ASR which we do not believe is solely the result of differing cost assumptions"⁷. This is driven by two factors. First, suppliers have almost certainly not been consistent in how they have included the costs of marketing within the estimation of installation costs. Indeed, while some of our marketing costs are included within this line item, there are many costs that are not. Second, costs will increase over time. Because there is a mix between these two factors, it is not surprising that Ofgem has failed to

⁶✂.

⁷ Ofgem (September 2018) A7, para 4.9.

discern a clear trend. In addition, Ofgem chose not to disclose the data necessary to allow our Advisors to investigate this further within the Disclosure Room.

- d) It isn't possible to split out marketing costs into smart and non-smart related categories: We have identified the costs of additional engagement that we are referring to.
38. As we discuss in response to bullet 3 above, not only do we have a concern that these costs are largely missing from the benchmark value, we are concerned that they do not increase sufficiently with rollout maturity. In addition, there should be an explicit provision for the possibility that additional marketing spend is needed to counteract a reduction in demand for smart meters that occurs as a result of the cap itself depressing engagement. We note that the issue of customer engagement will only be made more difficult following the imposition of the tariff cap and the reduction in engagement that we expect to follow. Indeed, the need for such an allowance is particularly compelling given that Ofgem recognises explicitly that its proposed cap is expected to result in a drop-off in customer engagement. Any failure to reflect changing costs over time will affect the effort that can be put into creating install opportunities in future.
39. While we are pleased that Ofgem recognises that suppliers are likely to be targeting the most difficult customers with the most technically demanding installations towards the later part of their rollout,⁸ Ofgem's proposals do not then take this into account. Ofgem does not seem to have given due weight to the evidence provided by stakeholders on this effect, particularly from those companies that are further through the rollout than the industry average (such as British Gas and First Utility).
40. In our response to the policy consultation we presented a forecast showing that engagement costs per install are expected to increase from £✂ in 2017 to £✂ in 2019 and £✂ in 2020⁹. This increase in costs reflects the requirement to target customers that are progressively less inclined to take a smart meter and may have ignored previous engagement activities.
41. ✂
42. Ofgem says that "the model itself includes assumptions about how installation costs are likely to grow over time, particularly in years of high rollout" (para 3.62) via "bottleneck cost uplifts" which scale upwards for each percentage of rollout in any given year which is above a threshold level. ✂
43. Ofgem also states that "suppliers that are further along in their rollout have fewer meters to install than suppliers who are less advanced in their rollout. On a per installation basis this may mean that a supplier which is further along in its rollout has relatively more smart metering increment on a per installation-to-be-completed basis."¹⁰ ✂

Benefits

44. We are particularly concerned about the way in which Ofgem has treated supplier benefits within its modelling of SMNCC. ✂. Ofgem has ✂ had the opportunity to collect

⁸ Ofgem (September 2018) A7, para 4.25.

⁹ ✂.

¹⁰ Ofgem (September 2018) A7, para 4.26.

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additional information from suppliers if further evidence was required. We notified Ofgem of the need to undertake such enquiries on a number of occasions¹¹.

45. ✂ We also have concerns that, by tying itself to the BEIS model and its classification of supplier benefits, it is making it unnecessarily difficult to undertake a proper evaluation of what benefits are being realised in practice.
46. Within the constraints of using the BEIS model, we have identified at least three changes that Ofgem should make to get a more realistic view of supplier benefits:
 - a) Avoided site visits: The largest of the supplier benefits relates to avoided site visits, with the biggest driver of this benefit being the assumed cost of traditional meter reads. If Ofgem is continuing to use the latest BEIS Impact Assessment value for an avoided meter read, then this is £6 and dates back to an assumption made in 2011.¹² The equivalent cost for British Gas is £✂.¹³ ✂
 - b) The impact of lagged benefits: ✂ For example, we experience an increased contact volume in the months following a smart install, over and above the costs incurred for equivalent customers that do not have a smart meter. We submitted this evidence to Ofgem in our June consultation response.¹⁴ ✂
 - c) Some of the benefit categories do not align with experience: ✂ Unless Ofgem provides the underlying assumptions and model we cannot help identify where the shortfalls arise, and ensure that more appropriate assumptions are made. ✂
47. It is incumbent on Ofgem to undertake due enquiry and not just rely on out of date material. This is true particularly in a context such as this where the material on which Ofgem is relying is clearly out of date.
48. Given it is critical that the smart meter rollout allowance in the cap is calibrated correctly, and ✂, this is clearly an area where Ofgem will need to undertake significant additional work and revision of its proposals ahead of final decision, and in the context of the broader review in Q1 2019.

Summary of SMNCC corrections

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Rollout profile

50. The final driver of the allowance is the rollout profile assumed by Ofgem. As we have discussed in the overview, the decision on the appropriate profile to use is made more

¹¹ Indexation of Smart Meter Cost Methodology, (Frontier Economics 2018) submitted 23 February 2018; Centrica Working Paper 4 consultation response, pages 10-20; Centrica (June 2018) para 289.

¹² £6 in 2011 prices

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/48806/2550-smip-rollout-small-and-med-non-dom.pdf

¹³ ✂, adjusted to be reported on a per credit meter per year basis rather than a per customer basis. It is in 2017 prices.

¹⁴ See Centrica (June 2018) paras 316-319.

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difficult by the fact that Ofgem is required to set a single cap across all suppliers, even though progress in the rollout has been very different.

51. Ofgem claims to have set an optimistic rollout profile so as not “to disadvantage energy suppliers who are making progress above the industry average or to disincentivise them from rolling out smart meters”.¹⁵
52. At the beginning of the price cap period, British Gas will have a higher stock of smart meters already on the wall than the industry average on which the price cap is based. Indeed, by the end of 2018 we expect our smart meter penetration rate to be at ✂% for gas and ✂% for electricity, significantly higher than the profile that Ofgem is assuming of 28.5% for gas and 29.9% for electricity. ✂
53. ✂

Implications for All Reasonable Steps

54. In spite of our requests, Ofgem has failed to disclose the information to allow suppliers to understand precisely how the 2019 smart meter allowance has been set. However, we have been able to estimate this allowance by making a number of assumptions from publicly available data.
55. To the extent that Ofgem has an alternative view of the assumptions and the forecast we have derived, we would welcome a clear exposition of Ofgem’s view together with full disclosure of the reasoning and the data that underpins that position.
56. As set out above, the lack of transparency in Ofgem’s description of how it has determined the smart meter allowance in the cap, the lack of relevant data in the Disclosure Room, and the highly restrictive undertaking relating to its operation have materially hampered our ability to determine precisely what allowance has been made for smart metering rollout activity in 2019. Given we need certainty to formalise our plans for 2019, we have endeavoured to estimate this critical value based on information available from *outside* of the Disclosure Room. We have done this using the following steps:
 - a) We have estimated the 2017 baseline net cost based on British Gas’ smart meter costs and benefits which we then adjusted to reflect those that we believe that ScottishPower would have incurred in 2017 (given its lower rollout profile). We assume that this is inflated at CPIH.
 - b) We add on the estimate of SMNCC that Ofgem has published.
 - c) We include a range regarding the level of benefits that could be achieved in 2019.
57. We assume that this level of smart meter spend applies to all of our credit customers (whether covered by the default tariff cap or not).
58. To this we also include the nominal allowance for smart meter costs that is included in the PPM price cap (which, given the limited information in the public domain, we assume to be £1.50 (plus indexation)) together with the associated supplier benefits¹⁶.

¹⁵ Ofgem (September 2018) A7, para 3.13.

¹⁶ We have assumed that there were no supplier benefits included within the 2015 PPM smart baseline. This is a conservative approach and will increase the implied budget for a given rollout profile.

59. We add each of these elements together to generate our estimated total smart meter budget for 2019 and divide by our customer base to get a range between £43 - £47¹⁷ per dual fuel customer in 2019. In contrast, Centrica's spend on smart meter rollout was planned to be £✂ in 2019.
60. ✂
61. Ofgem has failed to take adequate account of this risk of delay to the smart meter rollout in its Impact Assessment. Indeed, it justifies not undertaking an assessment of the risk on the basis that it considers that the cost provisions are "conservative"¹⁸ and it would be undertaking a review of these costs in 2019. Our assessment is that the provision is insufficient and, unless addressed, the impact will be felt ahead of the planned review.

Review of smart metering costs in 2019

62. We support the fact that Ofgem is planning to undertake a review of the allowance for smart metering costs in 2019. This should start in January, given its importance, and the number of areas requiring further attention. We would welcome confirmation that the review will take account of the following.
- a) We expect Ofgem to revisit the assumptions about costs and benefits that underlie the cap, and not just the profile of rollout. Ofgem must use this review to properly engage with stakeholders to understand the rollout costs and benefits, and to use the data gathered as part of the National Audit Office's (NAO) ongoing Value for Money assessment.
 - b) We expect the review to be undertaken with a far greater level of transparency than has been the case for this default tariff cap. In particular, if Ofgem is not able to share the current SMNCC model with suppliers, it should start again and build a model that can be shared.
 - c) ✂
 - d) We refer to Appendix 3 which emphasises the need for Ofgem to undertake reviews diligently, transparently and promptly. All this is particularly true for the case of smart meters where it is apparent that a number of material assumptions are outdated and clearly in need of updating (e.g. the benefits estimates).
 - e) We note that Ofgem has written the need for a review, effective from 1 October 2019, into the conditions definition of SMNCC. We strongly support this intention (and, indeed, are relying on that review to correct the deficiencies in the current approach).
 - f) The following points are particularly important for this review:
 - o First, there should be no conditions precedent for this review. This means that the words "subject to paragraphs 28AD.15 and 28AD.16 below" should be deleted from the chapeau to the second bullet point of that definition.
 - o We would also recommend that the drafting be amended to show that the review will be effective from "1 October 2019" rather than stipulating that it is

¹⁷The bottom of this range assumes that the supplier benefits will be limited to those we are currently realising (related to savings in meter read costs). The top of this range also includes the additional benefits that Ofgem is assuming related to inbound enquiries; debt handling; remote (dis)connection; and reduced theft. These are not benefits that British Gas is currently realising and therefore this upper limit is unlikely to be attained. ✂.

¹⁸ Ofgem (September 2018) A11 para 6.74.

“not to take effect before” that date. The current drafting gives suppliers no certainty at all.

- g) Finally, while we welcome the review provision in the licence, it is very important that Ofgem still consults diligently, thoroughly and in good time. The issues here are significant and complex and, as we have shown above, there is plenty of room for improvement. We urge Ofgem to start work on the review as soon as the Default Tariff Cap is in force.

Standing charge

- 63. We note that Ofgem is proposing that 73% of SMNCC goes into the standing charge. Since the customers that are anticipated to benefit most from smart meters, by helping them to reduce consumption, are those with higher levels of consumption, there is a case for allocating a greater portion of smart meter costs specifically on to the unit rate in the default tariff.