

Consultation

Reviewing smart metering costs in the default tariff cap

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Contact: Anna Rossington, Deputy Director

Team: Retail Price Regulation

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Tel: 020 7901 7000

Email: Retailpriceregulation@ofgem.gov.uk

We are consulting on our approach to reviewing the smart metering costs and allowance in the default tariff cap. We would like to receive views from people with an interest in the level of the default tariff cap. We particularly welcome responses from suppliers and consumer groups. We would also welcome responses from other stakeholders and the public.

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

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Executive summary

This consultation sets out how we propose to review the efficient costs of rolling out smart meters, in order to set the smart metering allowances in the default tariff cap (the cap).

Context

We introduced the cap on 1 January 2019, protecting over 11 million customers on standard variable and default tariffs (which we refer to collectively as default tariffs). The cap ensures default tariff customers pay a fair price for the energy they consume, reflecting its underlying costs.

One component of customers' energy bills is the net cost of suppliers providing smart meters. The non-pass-through Smart Metering Net Cost Component (SMNCC) reflects the average change in the net costs of installing smart meters since 2017.¹ As the cost and pace of rolling out smart meters evolves over time, we only set the non-pass-through SMNCC for the first two cap periods (covering 1 January to 30 September 2019).

How we propose to review efficient smart metering costs

We propose to update our non-pass-through SMNCC model based on the new Smart Metering Implementation Programme Cost Benefit Analysis (SMIP CBA). If appropriate, we propose to use different assumptions than those in the SMIP CBA, so that the non-pass-through SMNCC model suits our purpose of setting a cap. This is the same process we carried out when setting the non-pass-through SMNCC originally.

This consultation is the first in a series to give stakeholders the opportunity to provide input on our approach to reviewing efficient smart metering costs. Our consultation for the fourth cap period (and subsequent cap periods) will be in late August or early September 2019. It will set out the issues we have considered, and our proposed approach to estimating efficient costs. We also propose to make the updated non-pass-through SMNCC model available in a confidentiality ring, alongside our final consultation for the fourth cap period in October or November 2019.

How we propose to set the SMNCC allowances

Our understanding is that the new SMIP CBA will not be available in time to set and consult on an approach for the third cap period. Therefore, we propose to update the non-pass-through SMNCC in two stages.

For the third cap period, we propose to set the allowance using our current non-pass-through SMNCC model. We do not propose to adjust it in light of more recent information on rollout and costs, as this cannot be done in time to set and consult on an approach for the third cap period. This proposed allowance is broadly at the same level as the allowances in the first two cap periods. Based on trends in preliminary data, we expect that these allowances calculated using the current non-pass-through SMNCC model could be somewhat above actual efficient costs. In effect, any excess allowance could be viewed as paying suppliers in advance for installations that will occur later.

We propose to set the allowances for the fourth cap period and beyond using the updated non-pass-through SMNCC model based on the new SMIP CBA (which we expect should be available to us from summer 2019). When setting the allowances, we may give regard to the

¹ There is also a pass-through SMNCC for changes since 2017 in industry body charges relating to smart meters.

extent to which the allowances in the first three cap periods provided advance funding, above the actual efficient costs in those periods (or conversely if lagged payments would be needed to cover any shortfall in the allowances) – for instance depending on the materiality and our confidence in estimated costs.

1. Introduction

What are we consulting on?

- 1.1. This consultation sets out how we propose to review the efficient costs of rolling out smart meters. This is in order to set the non-pass-through Smart Metering Net Cost Component (SMNCC) allowances in the default tariff cap (the cap). This is a focussed review for the purpose of setting the cap – it is not an assessment of the total costs and benefits of the Smart Meter Implementation Programme (SMIP), which is the responsibility of the Department for Business, Energy and Industrial Strategy (BEIS).
- 1.2. The consultation is split into three substantive chapters.
 - Chapter 2: We explain the considerations we propose to make to determine what constitutes an appropriate smart metering allowance in the cap.
 - Chapter 3: We propose how we will review the efficient cost of rolling out smart meters.
 - Chapter 4: We propose how we will set the non-pass-through SMNCC allowances for the third cap period, and beyond this.

Context and related publications

The default tariff cap

- 1.3. We introduced the cap on 1 January 2019, protecting over 11 million customers on standard variable and default tariffs (which we refer to collectively as default tariffs). The cap ensures default tariff customers pay a fair price for the energy they consume, reflecting its underlying costs. These underlying costs change over time, so we update the cap every six months to reflect this. We will announce the next cap update by 7 August 2019. This will have effect between 1 October 2019 and 31 March 2020.

Smart metering cost allowances in the cap

- 1.4. One component of customers' energy bills is the net cost of suppliers providing smart meters. Smart meters are an important feature for transforming the retail market. The supply licence requires suppliers to take all reasonable steps to ensure that smart meters are installed by the end of 2020, allowing their customers greater control and choice.
- 1.5. The cap includes allowances for the efficient cost to suppliers of installing smart meters. (Table 1 below summarises this).
 - We include smart metering costs incurred up to (and including) 2017 in the operating cost allowance. We index the operating cost allowance over time with inflation.
 - We include changes in the net cost of introducing smart meters since 2017 in a separate allowance, called the Smart Metering Net Cost Change (SMNCC).

1.6. We calculate the SMNCC in two sub-components.

- **Pass-through costs:** we set an allowance for changes in industry body charges since 2017 (such as those from the Data Communications Company and Smart Energy GB). We estimate the net change in costs using sources including: the latest charging statements, forecasts, and budgets. We do not cover pass-through costs in the remainder of this consultation.²
- **Non-pass-through costs:** we provide an allowance for the increase in net costs relating to installing smart meters since 2017. Our current non-pass-through SMNCC model uses BEIS’s 2016 SMIP Cost Benefit Analysis (CBA) as a starting point but differs in a number of ways, including removing cost and benefit categories not relevant to suppliers.

1.7. There is no non-pass-through SMNCC allowance currently included for the third cap period. As the cost and pace of rolling out smart meters will evolve over time, we only set the non-pass-through SMNCC for the first two cap periods (covering 1 January to 30 September 2019).

1.8. In our decision, we stated that we would review smart metering costs to set the non-pass-through SMNCC for future cap periods. This consultation discusses how we intend to consider costs and ensure that the allowance is appropriate.

Table 1: Smart metering allowances within the cap

Category	Operating costs	SMNCC	
		Pass-through SMNCC	Non-pass-through SMNCC
Data sources	Operating cost benchmarking for 2017; results indexed using the Consumer Prices Index including owner occupiers’ housing costs (CPIH)	Information on industry body charges	SMIP CBA
Where updates calculated	Default tariff cap model	Pass-through SMNCC model (in the document annex 5 referred to in standard licence condition 28AD)	Non-pass-through SMNCC model

² For the third and subsequent cap periods, we propose to amend an error within the current pass-through SMNCC model (which is in the document annex 5 referred to in the cap licence condition). One stakeholder identified a formula error in the calculation of DCC costs. The total DCC costs do not include the total dual band communications hub costs. This applies to both gas and electricity. We estimate that this error reduces the level of the cap (in the second cap period) by £0.37 for a typical dual fuel customer.

Related publications

1.9. The key documents relating to the cap and smart metering costs in particular are:

- Smart metering costs in future Default Tariff Cap periods:
https://www.ofgem.gov.uk/system/files/docs/2019/03/smart_metering_costs_included_in_future_default_tariff_cap_periods.pdf
- Decision overview:
https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document_0.pdf
- Decision Appendix 7 – Smart metering costs:
https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_7_-_smart_metering_costs.pdf
- Statutory notice of reasons for modification of electricity and gas standard licence conditions (which includes the licence condition text):
https://www.ofgem.gov.uk/system/files/docs/2018/11/statutory_notice_of_reasons_for_modification_of_electricity_and_gas_standard_licence_conditions.pdf
- Statutory consultation overview: <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>
- Statutory consultation Appendix 7 – Smart metering costs:
https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_7_-_smart_metering_costs_0.pdf

Consultation stages

This consultation

1.10. This consultation will remain open for four weeks, closing on 30 May 2019.

1.11. This is an initial consultation only. Your responses will help shape how we conduct our review of smart metering costs, and will inform our final policy proposals.

Broader process

1.12. Table 2 shows an indicative timetable for the process and consultations we plan to carry out on this issue.

Table 2: Initial timeline for setting the SMNCC in future cap periods

Time	Milestone	Proposed content
30 April 2019	Initial consultation	This consultation
Mid-June 2019	Final consultation for third cap period	We aim to consult stakeholders on our proposed approach for setting the SMNCC in the third cap period. This would include changes to the models published alongside the licence.
7 August 2019	Decision for third cap period	We will announce our decision on the SMNCC for the third cap period at the same time as the upcoming cap level.
Late August/early September 2019	Further consultation	We aim to consult stakeholders on our potential methodology for setting the SMNCC in the fourth, and subsequent, cap periods.
October/ November 2019	Final consultation for fourth and subsequent cap periods	We aim to consult stakeholders on our proposed approach and associated licence changes, if any, for setting the SMNCC in the fourth, and subsequent, cap periods.
Early December 2019	Decision for fourth and subsequent cap periods	We aim to announce our decision for the SMNCC value in the fourth, and subsequent, cap periods.
7 February 2020	Cap level announced	We will announce the cap level for the fourth cap period (April to September 2020).

How to respond

- 1.13. We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document’s front page.
- 1.14. We’ve asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.
- 1.15. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

- 1.16. You can ask us to keep your response, or parts of your response, confidential. We’ll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.
- 1.17. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you do wish to be kept confidential and those that you do not wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we’ll get in touch with you to discuss which

parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

- 1.18. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.
- 1.19. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback


- 1.20. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:
 1. Do you have any comments about the overall process of this consultation?
 2. Do you have any comments about its tone and content?
 3. Was it easy to read and understand? Or could it have been better written?
 4. Were its conclusions balanced?
 5. Did it make reasoned recommendations for improvement?
 6. Any further comments?

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

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. [Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations).


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



2. How we propose to consider an appropriate SMNCC allowance

Section summary

We explain the considerations we propose to take into account when determining what constitutes an appropriate allowance in the cap. We discuss:

- the objective of the Domestic Gas and Electricity (Tariff Cap) Act 2018
- how we consider efficient costs
- how we consider whether our estimates are sufficiently robust.

Question 2.1: Do you agree with how we propose to consider an appropriate allowance for smart metering costs? Please explain your views.

Summary of our proposals

- 2.1. When setting the smart metering allowance in the cap, we must consider the objective of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act), and give regard to the statutory needs.
- 2.2. In considering how the allowance protects customers on default tariffs, we will ensure customers do not pay more than efficient costs³ justify. As part of protecting future domestic customers, we also propose to consider the potential impact of the allowance on the rollout of smart meters.
- 2.3. In giving regard to the ability of an efficient supplier to finance its activities, we propose to consider efficient costs on average⁴. Different suppliers are likely to have different efficient costs – due to either differences in their customers’ circumstances, or differences in the timing of their rollout. We must set one allowance for all suppliers. It is therefore inevitable that the allowance will differ from some or all suppliers’ costs. **We do not propose to set the allowance at the level of a supplier with high efficient costs.** This would not protect customers sufficiently.
- 2.4. We will use models and forecasts to estimate efficient costs. Our estimates will therefore inevitably include a degree of approximation. We propose to ensure that our assumptions and estimates are sufficiently accurate for our purpose. Where it is impossible, impractical, or disproportionate to make estimates more precise, we will give regard to that uncertainty when setting the allowance.

³ Where we refer to costs in this document, we mean the net costs of smart metering (ie taking benefits to suppliers into account).

⁴ This is the way we propose to assess financeability – it is distinct from the way we propose to set the allowances. In particular, to set the allowance for the third cap period, we propose to use a rollout assumption which takes into account the EU target for installing electricity smart meters – see Chapter 4 for more detail.

Explanation of our proposals

The Act

The objective of the Act, protecting customers on default tariffs

- 2.5. When setting an appropriate allowance, our judgement will be guided by the objective of the Act. The Act provides that we must set the cap with a view to protecting existing and future customers who pay standard variable and default rates.⁵
- 2.6. We propose that, over the life of the cap, the SMNCC should not exceed our estimate of the efficient costs relating to rolling out smart meters. The Act requires us to set the cap to protect default tariff customers. The cap ensures they pay prices that more closely reflect the underlying cost of supplying them with energy – in this case, the efficient cost of providing smart meters.
- 2.7. As part of protecting future domestic customers, we also propose to consider the potential impact of the SMNCC on the efficient and timely rollout of smart meters. In part, this reflects that the Act makes specific reference to smart meters. The Act requires us to consider the rollout of smart meters in our assessment of the conditions for effective competition – our assessment of whether the price cap should be extended or not.⁶
- 2.8. In our decision, we took a more conservative approach in relation to smart metering costs than we did in other areas of the cap. In particular, we benchmarked to average costs, rather than lower quartile costs. Our conservative approach ensures that the smart metering allowance does not impede the rollout of smart meters. We propose to maintain this conservative approach, benchmarking to average costs.
- 2.9. We cannot ring-fence the SMNCC. We set an overall cap level, which suppliers must comply with. This is the sum of individual cost components, including an allowance which is sufficient to allow suppliers to deliver the smart meter rollout. However, we do not require suppliers to spend specific amounts on particular cost components. Some suppliers may face cost pressure if they have inefficient costs in relation to other cost components. Regardless, we expect suppliers to meet their obligations rolling out smart meters. It is not acceptable for suppliers to reduce their rollout plans to avoid addressing inefficient spending elsewhere in their business. In our work on smart metering, we inspect suppliers' smart meter rollout plans and hold them to account.

⁵ Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6).

⁶ Domestic Gas and Electricity (Tariff Cap) Act 2018, section 7(2).

Statutory needs

2.10. The Act requires that, in protecting default tariff customers, we must have regard to the following matters:⁷

- the need to create incentives for holders of supply licences to improve their efficiency
- the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts
- the need to maintain incentives for domestic customers to switch to different domestic supply contracts and
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

2.11. We recognise that the Act identifies the four matters set out in section 1(6) as being “needs” and we have proceeded on the basis that each is in principle desirable. However, we do not consider that the Act requires us to achieve the four statutory needs.⁸ Rather, our duty is to consider each of these important needs when setting the cap. We will seek to do so carefully, rigorously and conscientiously.

Giving regard to efficient costs

The challenge: variation in efficient costs

2.12. To set an appropriate allowance, we must give regard to efficient suppliers’ ability to finance their activities.⁹ The Act also requires that we set one allowance for all suppliers.¹⁰ However, there is no single allowance that will match *each* supplier’s efficient costs. Whatever approach we take to considering efficient costs, it is inevitable that the allowance will differ from some or all individual suppliers’ efficient costs.

2.13. Suppliers’ costs will differ for a variety of reasons. Some of these reasons will reflect inefficiency, but not all of them will do. For instance:

- **Difference in customer bases:** some suppliers may have a higher proportion of customers with properties that incur higher installation costs.
- **Difference in rollout profiles:** suppliers are at different stages of their rollouts. In any specific cap period, different suppliers may therefore incur different costs

⁷ Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6).

⁸ See for example the interpretation of the statutory wording in: R (Brown) v SSWP [2008] EWHC 3158 (Admin); London Borough of Hackney v Haque [2017] EWCA Civ 4; R (Baker & Ors) v Secretary of State for Communities and Local Government [2008] EWCA Civ 141; R (Hurley and Moore) v Secretary of State for Business Innovation & Skills [2012] EWHC 201 (Admin).

⁹ Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6)(d).

¹⁰ Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2)(b).

compared to the average rollout profile. In the long run however, these differences in timing should net out.

Our approach

2.14. Where suppliers have different efficient costs:

- We propose to give regard to suppliers' costs and rollout **on average**. Individual suppliers' costs and rollout numbers will vary around these averages.
- We do **not** propose to set the allowance at the level of suppliers with high efficient costs. This would set the allowance too high for all suppliers with lower efficient costs, allowing them to overcharge their customers. We do not consider this approach would protect customers on default tariffs.

2.15. This matches the approach we adopted for setting the SMNCC for the first two cap periods.

2.16. Our proposed approach also ensures that we have regard to the separate need to create incentives for suppliers to improve their efficiency. Inefficient suppliers will still need to reduce their costs. Setting the benchmark at a higher level (eg at the upper quartile) would not have delivered the same incentives to become more efficient.

2.17. When considering a supplier's ability to finance its activities, we propose to focus on the medium to long-term average, rather than focussing on each cap period in isolation. The timing of revenues allowed under the SMNCC is based on the costs of an average supplier. This will inevitably differ from the timing of costs for individual suppliers, as suppliers will roll out smart meters on different profiles to the average rollout profile. The cap effectively allows suppliers to recover costs in arrears (for smart meters already installed), or charge in advance of costs (for smart meters not yet installed).

Ensuring estimates are sufficiently robust

The challenge: approximation of costs

2.18. In giving regard to the average costs of smart metering, any proportionate and practical estimate of efficient costs will include a degree of approximation. For instance, the allowance is forward looking. There is uncertainty about the actual costs incurred and the number of smart meters installed in any future period. In addition, for some costs or assumptions, exact data may not be available, or may be challenging for suppliers to create and provide. In such circumstances, reasonable simplifications will be preferable.

Our approach

2.19. We propose to ensure that assumptions and estimates are sufficiently accurate for our purpose (of setting the non-pass-through SMNCC allowance within the cap). We do not expect that estimates will exactly match any given supplier's circumstances, costs, and revenues. There will be some variance between estimated averages and actual results.

2.20. To determine whether estimates are appropriate, we propose to (among other things):

- Take account of the modelling and quality assurance processes in place.
- Identify areas that require modification or further assurance to make them appropriate for the purpose of setting the cap. This may include using alternative data sources to set or test assumptions.
- Provide stakeholders with the opportunity to scrutinise and provide their views on key issues.

2.21. Where it is not possible, impractical, or disproportionate to make estimates more precise, we will consider the extent and nature of uncertainty in the estimates, and give regard to that uncertainty when setting the allowance.

3. How we propose to review efficient smart metering costs

Section summary

In this section we propose how we will review smart metering costs to set an appropriate allowance in the cap. We discuss:

- our proposal to use the new SMIP CBA as the basis for our analysis
- how we propose to consider whether any deviations from the CBA assumptions would be appropriate
- our proposed transparency arrangements.

Question 3.1: Do you agree with how we propose to review efficient smart metering costs? Please explain your views.

Summary of our proposals

- 3.1. We propose to review our current non-pass-through SMNCC model. This model takes the 2016 SMIP CBA as its starting point. BEIS is currently reviewing the SMIP CBA. We propose to use the new SMIP CBA, which we expect should be available to us from the summer¹¹, in our updated non-pass-through SMNCC model.
- 3.2. The SMIP CBA is designed for a different purpose. If and where appropriate, we propose to deviate from the assumptions in the new CBA when constructing our updated non-pass-through SMNCC model so that it suits our purpose of setting the cap. Some stakeholders have already raised issues where they consider we might need to make additional or different assumptions, or use alternative data. Our consideration of whether to deviate from the CBA information will include understanding: the assurance processes for the CBA and other data sources, the sensitivity of the final SMNCC to modifications, and the availability of a practical alternative approach.
- 3.3. We will consult stakeholders so that they have the opportunity to provide input on our approach, starting with this consultation. In particular, our further consultation for the fourth cap period in late August or early September 2019 will set out the issues we have considered, and our proposed approach to estimating efficient costs. We also propose to make the updated non-pass-through SMNCC model available in a confidentiality ring, alongside our final consultation for the fourth cap period in October or November 2019.

Explanation of our proposals

Scope of our review of efficient smart metering costs

- 3.4. This chapter covers how we propose to review efficient smart metering net **costs**. Chapter 4 then explains how this will feed into the **allowance** we include in the cap for

¹¹ The availability of the new SMIP CBA may differ from expectations, in which case we would need to consider the implications for our planned timetable.

the fourth cap period and beyond. Chapter 4 also explains how we will separately set the allowance in the third cap period.

- 3.5. We propose to review our current non-pass-through SMNCC model. This model takes the 2016 SMIP CBA as its starting point. When creating our current non-pass-through SMNCC model, we made a number of modifications which deviated from the 2016 SMIP CBA. This included removing cost and benefit categories not relevant to suppliers. We also used more recent information from suppliers to better reflect the incremental net cost of smart metering to suppliers.
- 3.6. We will create an updated non-pass-through SMNCC model, using the new SMIP CBA as its starting point. We expect this will involve updating the inputs and assumptions.
- 3.7. We do **not** propose to change the high-level methodological judgements specified in our original decision. For instance, as discussed in Chapter 2, we will continue to define the efficient level using average costs.

The new SMIP CBA

- 3.8. BEIS is reviewing its SMIP CBA. We consider the CBA to be the most robust and comprehensive assessment of the costs and benefits associated with rolling out smart meters.
- 3.9. The BEIS SMIP CBA has been developed over several years (with Impact Assessments in 2011, 2013 and 2014 and a CBA in 2016).¹² BEIS created it to model the overall economic impact of the introduction of smart meters in Great Britain. This includes the impact on consumers, suppliers, network operators, wholesale markets and the environment. The model has been repeatedly reviewed, improved and updated over that period and represents the most accurate smart metering model available.
- 3.10. BEIS will be publishing a new CBA for the SMIP as part of a commitment made by ministers during the passage through Parliament of the Smart Meters Act 2018. This CBA will be published in 2019 and will reflect the best available evidence in relation to the rollout. This update will include a comprehensive review of the inputs and assumptions, building on the previous version of the model.

Considering modifications

- 3.11. We propose to deviate from the new SMIP CBA, if and where appropriate, in order to use it to create an updated non-pass-through SMNCC model. BEIS designed the CBA for a different purpose. It assesses the overall economic impact of smart meters – it was not intended to estimate the net change in suppliers' smart metering costs in six monthly intervals. In our original decision, we addressed this issue by modifying and updating the analysis.
- 3.12. **We propose to remove costs and benefits that are not relevant to suppliers.** The current SMIP CBA includes costs and benefits that accrue to customers, for

¹² BEIS (2016), Smart meter-rollout cost-benefit analysis.
<https://www.gov.uk/government/publications/smart-meter-roll-out-gb-cost-benefit-analysis>

example the savings customers make from reducing their energy consumption after a smart meter is installed. These savings do not represent a benefit to suppliers.¹³

3.13. **We propose to assess whether other modifications, differing from the approach taken in the new SMIP CBA, may be appropriate.** These are likely to differ from the adjustments we made in our original decision. In that decision, we modified the 2016 SMIP CBA approach to reflect more up to date information on rollout and on certain costs. The new SMIP CBA is likely to reflect the most up to date data. This means there may be fewer adjustments required than previously to ensure the new SMIP CBA is suitable for our purposes. We will consult on our proposed approach, and provide stakeholders with more detail when this becomes available.

3.14. **Some stakeholders have already raised issues which they recommend we include in our review of the CBA's assumptions and supporting data.** Issues raised include, but are not limited to:

- **Premature replacement costs¹⁴**, which are sensitive to assumptions about the actual age of the traditional meters that suppliers replace.
- **The timing and extent of additional operating costs.** For example, some suppliers argue that, due to the smart metering rollout, consumer engagement costs have increased beyond the level of advertising that an efficient supplier would engage in anyway. Some suppliers also argue an efficient supplier would see a temporary increase in calls after installation, not already recognised in the Annual Supplier Reports (ASRs).
- **Changes in the timing and extent of assumed benefits**, such as avoided site visits, reduced debt, and remote disconnections.
- **The sensitivity to, and evidence for, key assumptions.** These include: suppliers' ability to optimise their rollout approach to reduce costs, economic asset lives of meters and IT, productivity assumptions in the ASRs, forecasts for future periods, and the proportion of SMETS1 meters compared to SMETS2 meters.

3.15. To make the judgement on whether a modification is needed we will consider a number of factors. We are currently considering which factors may form the basis of our decision. These may include, but are not limited to:

- **The assurance processes for the CBA and other data:** There is an extensive process to review the CBA. There is also an extensive process to review the ASRs. We will take account of these processes to assess how robust assumptions and data sources are for our purposes, and whether there are refinements we need to consider.

¹³ For more information on costs and benefits which are not relevant to suppliers, see appendix 7 of our original decision. Ofgem (2018), Default tariff cap: decision. Appendix 7 – Smart metering costs. https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_7_-_smart_metering_costs.pdf

¹⁴ Please see our previous publications, especially Appendix 7 to our decision, for explanations of these technical terms.

- **Coherence and consistency between assumptions:** Some assumptions are interrelated, so we will consider where isolated modifications may reduce rather than increase the accuracy of our estimates. In these circumstances, we will consider the overall impact of adjusting all related assumptions, compared with no adjustment.
- **Sensitivity of the SMNCC:** Not all costs, benefits, or assumptions have a significant impact on the SMNCC. We propose to prioritise areas where modifications would have a significant impact on the SMNCC.
- **Availability and practicality of an alternative data source:** Some assumptions have an inherent degree of uncertainty (for instance, forecasting how costs will develop in future). Other assumptions may not have alternative data available, or it might be impractical or disproportionate for suppliers to commit sufficient resources to gather new data. In such circumstances, we propose to consider whether simplified assumptions are more practical. Where this is the case, we will consider what impact that remaining uncertainty has on the SMNCC.
- **The implication of cost variations on efficiency.** Some increases in reported costs may not indicate an increase in efficient costs at all, or increases may be specific to one outlying supplier. We propose to define efficient costs using the average costs we observe.

3.16. We will review the new SMIP CBA once we receive it. However, we are starting to consider the extent to which all the costs, benefits, assumptions and data in the new CBA are likely to be appropriate for our purposes – eg based on our understanding of the information BEIS has collected. We therefore invite stakeholders to provide as much information as possible in response to this consultation about the issues that they would like us to consider, including supporting evidence where possible. This will help us to explore the issues and plan any additional work. We would like to understand what alternative approaches stakeholders suggest to collect any additional data – and particularly which issues they consider we should prioritise.

Scrutiny and transparency

3.17. We will start to assess the new CBA as soon as it is published. Before this, we will prioritise areas for scrutiny, based on responses to this consultation and discussions with BEIS. Where appropriate, we will start to make additional enquiries or request data from suppliers.

Further consultation

3.18. We propose to consult stakeholders on our approach to the review of costs in late August or early September 2019. This consultation will set out the issues we have considered, and our proposed approach to estimating efficient costs. It will specify where we propose to make modifications, deviating from the new SMIP CBA, and where we consider that approach to provide a sufficient approximation of average costs. We intend to explain why this is the case with reference to the approach and sources used for the new SMIP CBA.

- 3.19. Where we consider more data is required, we intend to make enquires before or alongside this consultation. When deciding whether to gather additional data, we will consider the views from responses to our previous consultations.

Transparency

- 3.20. We consider that the proposed approach above should provide stakeholders with sufficient transparency on our approach. In addition, we propose to provide the non-pass-through SMNCC model in a confidentiality ring, so that stakeholders can review the modelling approach. This will be alongside the final consultation for the fourth cap period, which we intend to publish in late October or early November 2019.

4. How we propose to set the SMNCC allowances

Section summary

We propose how we will review smart metering costs for the purpose of setting an appropriate allowance in the cap. We discuss how we propose to set the SMNCC non-pass-through allowance for the third cap period, and for the fourth cap period and beyond.

Question 4.1: Do you agree with how we propose to set the allowance for the third cap period? Please explain your views, and any alternative proposals if applicable.

Question 4.2: Do you agree with how we propose to set the allowance for the fourth cap periods and beyond? Please explain your views, and any alternative proposals if applicable.

Summary of our proposals

- 4.1. We propose to update the non-pass-through SMNCC in two stages: an update for the third cap period, and an update for the fourth cap period and beyond. This two stage process reflects that the new SMIP CBA will not be available in time to define and consult on an approach for the third cap period. We must announce the level of the cap for the third cap period by 7 August 2019.
- 4.2. For the third cap period, we propose to set the allowance using our original non-pass-through SMNCC model. This uses the 2016 SMIP CBA as a starting point, and includes the modifications described in our original decision. This proposed allowance is broadly the same level as the allowances in the first two cap periods. We do not propose to adjust it in light of more recent information on rollout or costs. This means the allowance may be somewhat above actual efficient costs, and that the allowance in the first two cap periods may have exceeded efficient costs also. In effect, any excess in the allowances could be viewed as paying suppliers in advance for installations that will occur later.
- 4.3. We propose to set the allowances for the fourth cap period and beyond using the updated non-pass-through SMNCC model based on the new SMIP CBA (which should be available to us from summer 2019). When setting the allowances, we propose to estimate, and give regard to, the extent to which the allowance in the first three cap periods provided advance funding, above the actual¹⁵ efficient costs in those periods (or conversely if lagged payments would be needed to cover any shortfall in the allowance). However, we would not automatically include any such impact in the calculation of the allowances for the fourth and subsequent cap periods.

¹⁵ By actual, we mean the efficient costs in the first three cap periods as assessed by the updated non-pass-through SMNCC model based on the new SMIP CBA. We do *not* mean the current non-pass-through SMNCC model which used the 2016 CBA as a starting point.

Explanation of our proposals

A two stage update of the allowances

- 4.4. Standard licence condition 28AD.11 of the gas and electricity supply licences includes the arrangements for reviewing the non-pass-through element of the SMNCC.¹⁶ The licence condition states that we will:

"following consultation, re-publish in the format set out in Annex 5 following a review of the Smart Metering Non-Pass-Through Net Cost Change which the Authority will undertake during the course of 2019, such re-publication to take effect for the 28AD Charge Restriction Period starting on 1 October 2019; and;

otherwise, and subject to paragraphs 28AD.15 and 28AD.16 below, re-publish in the format set out in Annex 5 where it appears to the Authority that it is necessary to do so, such re-publication not to take effect before the first day of the 28AD Charge Restriction Period immediately following the date on which it is published."

- 4.5. Currently, the licence condition and associated annexes do not contain a non-pass-through SMNCC value beyond the first two cap periods. To recognise any of suppliers' incremental smart metering costs (above the 2017 level), we need to propose and consult on an allowance for the upcoming cap periods.
- 4.6. We do not have enough time to update and consult on an updated SMNCC non-pass-through allowance based on the new SMIP CBA for the third cap period. We must announce the level of the cap for the third cap period by 7 August 2019.
- 4.7. We do not consider it appropriate to wait to set a non-pass-through SMNCC until after our review of the new SMIP CBA. This would mean there would be no non-pass-through SMNCC in the third cap period. This could constrain the rollout of smart meters. It could still constrain the rollout even if we allowed for the relevant costs in later cap periods (in effect collecting payments in arrears), as there would be a cash flow impact on suppliers. Such an approach would also increase the volatility of the cap level, and therefore the volatility of consumers' bills.
- 4.8. We therefore propose to update the non-pass-through SMNCC in two stages: an update for the third cap period, and an update for the fourth cap period and beyond.

Third cap period

Proposed allowance

- 4.9. We propose to set the allowance for the third cap period using our current non-pass-through model. This uses the 2016 SMIP CBA as a starting point, and includes the modifications described in our original decision.

¹⁶ The licence condition 28AD.11 refers to this as the Smart Metering Non-Pass-Through Net Cost Change.

4.10. We expect that the proposed SMNCC for the third cap period would be broadly the same level as the SMNCC in the first two cap periods. Table 3 below compares the levels for each cap period.

Table 3: SMNCC for a typical dual fuel customer, broken down into its non-pass-through and pass-through cost elements

Cap period	Non-pass-through allowance		Pass-through allowance		Combined SMNCC
	Electricity	Gas	Electricity	Gas	Total
Period 1: January 2019 – March 2019	£9.02	£10.70	£2.47	£1.97	£24.15
Period 2: April 2019 – September 2019	£9.02	£10.70	£4.89	£3.94	£28.55
Period 3: October 2019 – March 2019 (forecast)	£11.24	£9.26	£4.80	£3.74	£29.03

Notes:

- The combined SMNCC is for a dual fuel customer with typical consumption.
- Pass-through costs for the third cap period are estimates only – though we expect the final figure to be broadly similar. We will finalise these estimates in late July 2019, when we have all required inputs for the third cap period update of the pass-through SMNCC model. Outstanding inputs include: the market share of nominated suppliers for gas and electricity, and the Consumer Prices Index including owner occupiers’ housing costs (CPIH) used to calculate the net change in pass-through charges from the operating cost baseline.

Considering the accuracy of underlying assumptions

4.11. **For the third cap period, we propose to maintain the assumptions in the current non-pass-through SMNCC model.** Our detailed approach is set out in our decision (in the overview document and Appendix 7 – smart metering costs). Although we used the 2016 SMIP CBA as a starting point, we modified a number of assumptions to reflect more recent trends in rollout and costs. The key modifications reflect data submitted in early 2018.

- **Rollout assumptions in the model:** Table 4 shows the assumptions contained in the current non-pass-through SMNCC model. In our decision, we considered that the EU target for installing electricity smart meters by the end of 2020 is a prudent minimum end point modelling assumption for the purposes of setting the SMNCC. For 2019, we extrapolated between the level forecast in 2018 and this modelling assumption.
- **Cost assumptions in the model:** As stated above, we modified the 2016 SMIP CBA to update some of the cost assumptions. In particular, we used the average of the six largest energy suppliers’ modelled costs, based on their 2017 ASRs submitted to BEIS in 2018, to modify the unit cost of metering assets, installations, In Home Display and smart-related system changes.

Table 4: Smart metering rollout assumptions underpinning the non-pass-through SMNCC model

Fuel	Supplier actual installations		Rollout allowance (supplier forecast)	Rollout allowance (extrapolated)
	End 2016	End 2017	For end 2018	For end 2019
Electricity	9.9%	19.9%	29.9%	55.0%
Gas	9.5%	18.9%	28.5%	54.3%

Note: This table was originally published in our Decision, Appendix 7 – smart metering costs.

4.12. Suppliers have submitted more recent data on their rollout plans and their costs. This data is still being processed. Broad trends suggest there will be differences between the assumptions in the current non-pass-through SMNCC model and the most recent data which is likely to inform the new SMIP CBA.

- The number of smart meters installed in 2019 is likely to be lower than assumed in the current non-pass-through SMNCC model. All else being equal, this would reduce the estimate of efficient costs.
- Costs in 2018 are reported to have been higher than costs in 2017. All else being equal, this would increase the estimate of efficient costs in 2019, above the level assumed in the current non-pass-through SMNCC model.

No adjustment to underlying assumptions

4.13. We do not propose to adjust assumptions underpinning the current non-pass-through SMNCC model in light of more recent information on rollout or costs. To make an appropriate assessment we would need to update all assumptions. This update would be replicating some of the work BEIS is undertaking for its new SMIP CBA. In any case, the earliest we could complete such an update would be very similar to the time required to update the CBA. This would be too late to consult on the estimate and update the allowance in the third cap period.

4.14. We do not consider that we can modify individual assumptions in isolation. For example, adjusting the rollout assumption, *in isolation*, would reduce the SMNCC. However, adjusting the rollout assumption could have an impact on the assumed costs per installation, and vice versa. We do not consider it appropriate to ignore these interactions, as this would risk reducing the level of accuracy in the SMNCC.

Considering costs over the life of the cap

4.15. Even taking the higher 2018 costs into consideration, preliminary data suggests that the proposed allowance for the third cap period is somewhat higher than the actual efficient costs will be in that period. We expect that is also the same for the allowances in the first two cap periods.

4.16. Any additional amounts (comprising the allowances over the first three periods above the level of actual efficient costs) could be viewed as paying suppliers in advance for installations that will occur later. In principle, we are not concerned that *on average*

the SMNCC allows payment in advance of costs, although in practice we would not want the difference to be large. However, we would ideally want the allowance to align with costs over the life of the cap.

Fourth cap period and beyond

- 4.17. We propose to set the allowances for the fourth cap period and beyond based on our updated non-pass-through SMNCC model.
- 4.18. **We propose to set the allowance for the fourth and fifth cap periods.**¹⁷ We will also consider whether or not it is practical to set the allowance at the same time for potential cap periods up to 2023. As in our original decision, the speed of rollout and the costs of smart meters are uncertain. We propose to monitor rollout and costs, and will consult stakeholders if we consider any adjustments to the SMNCC to be necessary.
- 4.19. **When setting the SMNCC for the fourth cap period and beyond we propose to give regard to any substantial advance payment (or lagged payment) in first three cap periods.** As discussed above, it is possible that the non-pass-through allowances in the first three cap periods are somewhat different from the actual efficient costs (based on the new SMIP CBA). This consideration would ensure that over the life of the cap, the suppliers' efficient costs and revenues more closely align. We propose to assess the actual efficient costs in the first three periods based on our review of the updated CBA.
- 4.20. However, we would not automatically include an adjustment for this in the calculation of the allowances for the fourth and subsequent cap periods. For instance, we would consider the degree of uncertainty around our estimates and whether the impacts were material. This would affect whether we considered it sufficiently likely that there had been a substantial advance payment or lagged payment.

¹⁷ From 2020, the Act requires the Secretary of State to decide each year whether to extend the cap for the following year. We must provide a recommendation to inform this decision. The cap will end in 2023 at the latest. (Domestic Gas and Electricity (Tariff Cap) Act 2018, sections 7 and 8).

Appendices

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Appendix 1 – Privacy notice on consultations

Personal data

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

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

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

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

2. Why we are collecting your personal data

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

3. Our legal basis for processing your personal data

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

3. With whom we will be sharing your personal data

We are not intending to share your personal data with other organisations. We are intending to publish non-confidential consultation responses, including any personal data that may be contained within them

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

Your personal data will be held until six months after we have set the non-pass-through SMNCC for the fourth and subsequent cap periods.

5. Your rights

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

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

6. Your personal data will not be sent overseas.

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

8. Your personal data will be stored in a secure government IT system.

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