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RESPONSE PAPER #1: REVIEWING SMART METERING COSTS IN THE DEFAULT TARIFF CAP – OUR APPROACH AND TIMELINE

1. On 30 April 2019, we published an initial consultation (“the April consultation”) on how we proposed to review the efficient costs of rolling out smart meters and how we proposed to set the non-pass-through Smart Meter Net Cost Change (SMNCC) allowance (“the allowance”) in the default tariff cap (“the cap”).¹
2. We are responding to stakeholders’ major themes through a suite of papers (“the August Response Papers”). This paper responds to points specific to our general approach and the timetable for our review, including contingency arrangements in the event that we cannot use our updated methodology in cap period four.

The April consultation

3. In the April consultation, we set out our general approach for reviewing the efficient cost of the smart meter rollout. We proposed to:
 - Use the new Smart Metering Implementation Programme Cost Benefit Analysis (“SMIP CBA”) as a starting point;
 - remove costs and benefits that are not relevant to suppliers; and
 - assess if there are any areas where modifications to the approach taken in the new SMIP CBA might be more appropriate for our purposes.
4. We proposed, on publication of the new SMIP CBA, to consult on our methodology in August or September, and provide our modelling alongside a final substantive consultation in October or November. In the April consultation, we set out an initial timetable, as shown in Table 1.
5. Stakeholders responded to our April consultation. In this paper, we discuss three themes that relate to our general approach and timeline for the review. These are:
 - Our general approach to the review;
 - Our contingency plans; and
 - The timing of substantive consultation and disclosure of our modelling.
6. We have updated our plans on these issues to take account of recent developments.

¹ Ofgem (2019), Reviewing smart metering costs in the default tariff cap. (<https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap>)

Table 1: Initial timeline for setting the SMNCC in future cap periods, as set out in the April consultation

Time	Milestone	Content
30 April 2019	Initial consultation	The April consultation
Mid-June 2019	Final consultation for third cap period	Published 18 June ²
7 August 2019	Decision for third cap period	Published 7 August ³
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).

Developments

7. The new SMIP CBA and government consultation on the post 2020 framework have not yet been published. On that basis, we are unable to substantively consult with stakeholders in late August or early September on our proposed methodology for setting the SMNCC in the fourth, and subsequent, cap periods.
8. Below we set out how this affects our timetable. Specifically, we respond to stakeholders' questions on how we might conduct our review (with or without the new SMIP CBA). Specifically, we consider:
 - **Our central plan:** If the new SMIP CBA is published before our final consultation for the fourth and subsequent cap periods, initially planned for October or early November 2019; and
 - **Our contingency options:** If the new SMIP CBA is not published before our final consultation, or we consider that our October proposals (based on the new SMIP CBA) require significant revision and a second consultation.

Our general approach to the review

Suppliers' responses

9. Stakeholders broadly supported our proposal to use the new SMIP CBA as the starting point for our review of efficient costs and the SMNCC model.
10. In addition, suppliers stated that, although they do not disagree that the new CBA is likely the 'best available source' and may serve as a starting point, it may not provide an appropriate estimate of efficient costs on which to base the allowance. Suppliers raised the following points.
 - **The new SMIP CBA and new SMNCC model serve different purposes.** Some suppliers noted that the purpose of the new SMIP CBA is not the same as

² Ofgem (2019), Default tariff cap: approach to the third cap period. (<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-approach-third-cap-period>)

³ Ofgem (2019), Decision: approach to the third cap period for the default tariff cap. (<https://www.ofgem.gov.uk/publications-and-updates/decision-approach-third-cap-period-default-tariff-cap>)

the SMNCC model. It is possible that estimates in the SMIP CBA are appropriate for its purpose, but not appropriate for setting the allowance in the cap.

- **We should assess changes made to the new SMIP CBA:** One supplier specified that we should cross check the new SMIP CBA with the National Audit Office's (NAO's) 2018 report findings⁴ relating to the 2016 SMIP CBA (which the current SMNCC model takes as a starting point).
 - **We should ensure we have a sufficient evidence base to assess costs:** Stakeholders emphasised that we should liaise with BEIS to ensure we (Ofgem) have the necessary evidence base for our review collected in a consistent and timely manner (either using evidence already collected by BEIS or by collecting data ourselves).
11. Some suppliers stated that, ultimately, the suitability of our general approach would depend on the specifics of the new SMIP CBA and our modifications. Some suppliers emphasised that whatever the quality of BEIS's internal development and its quality assurance processes the new SMIP CBA (or previous SMIP CBAs) had not been externally validated. They stated that our SMNCC model would require external scrutiny to ensure that our general approach led to a sufficiently robust estimate of net costs.
12. Most suppliers commented on specific judgements in our methodological approach. For instance, most commented on how we should consider 'efficient' costs (i.e. whether we should consider frontier, lower quartile, average, or higher cost levels) and its significance. Most suppliers agreed with our proposal to use average costs, which we considered conservative. Some specified that this assessment would have to be made on a case by case basis taking into account the specific circumstances. Some suppliers also stated that the approach should not be considered 'conservative', even though we would normally consider 'frontier', or 'lower quartile' costs when analysing efficient costs.

Our consideration

13. We maintain our proposal to use the new SMIP CBA as a starting point for our review of the efficient cost to suppliers of rolling out smart meters, and for our development of the new SMNCC model. We consider the new SMIP CBA to be the best available source. This is consistent with most suppliers' views, which indicate no compelling alternatives. The quality of the internal development and validation processes will provide assurance that the model is robust. We acknowledge some suppliers' observation that the quality of BEIS' internal processes are not the only relevant factor. We will not uncritically assume that the new SMIP CBA will be appropriate for our purposes when developing the new SMNCC model.
14. We maintain our proposal to modify our approach when developing the new SMNCC model, so that it differs from the new SMIP CBA, if and where we consider that to be appropriate.
- We recognise suppliers' observation that the new SMIP CBA and our new SMNCC model serve different purposes. We consider it possible that some assumptions or estimates may be appropriate for the new SMIP CBA, but inappropriate for the new SMNCC model. We expect the suitability of each assumption to depend on specific circumstances, and will consider what is appropriate for the SMNCC model on a case by case basis.
 - We recognise that external reviews of the 2016 SMIP CBA are available to us. These include the NAO report and suppliers' assessment of issues and potential data gaps. We will use these resources to consider the issues affecting the assessment of smart metering costs and ensure we understand how those issues are treated in the new CBA.

⁴ National Audit Office (2018), Rolling out smart meters.
(<https://www.nao.org.uk/report/rolling-out-smart-meters>)

- We recognise the need to ensure a sufficient evidence base. We have taken into account external views and suppliers' representations on potential data gaps. As some suppliers suggested, we have assessed what data BEIS has collected and whether this is sufficient for our purposes. Where sufficient data is already available, we will not replicate BEIS's work. In some cases, we have requested additional data from stakeholders. Please see Response Paper #2, where we discuss these issues, and our reasoning, in detail.⁵
15. We recognise that the new SMNCC model will require external scrutiny. We maintain our proposals to:
- provide the non-pass-through SMNCC model (which will be fully executable), so that stakeholders can understand our modelling approach; and
 - set out the specific issues and methodological judgements we have considered, and consult with stakeholders on our proposed approach to estimating efficient costs.
16. Below we discuss the *timing* of disclosing our modelling. In Response Paper #4 we will set out plans for the content and nature of that disclosure of our modelling.⁶
17. We have taken note of stakeholders' views on specific aspects of our methodological approach. These will be taken into account and will inform our development of the new SMNCC model, and we will respond in detail in our substantive consultation. Below we discuss the proposed timing of the substantive consultation on our methodology, which will allow stakeholders to understand and comment on the proposed methodology.

Our contingency plans

Suppliers' responses

18. Most suppliers noted that our general approach was dependent on the new SMIP CBA, which would affect our approach or timetable if it was not available.
- **Changing circumstances:** Some suppliers noted that when the Government clarifies the post-2020 policy landscape, it may affect our plans, and necessitate another consultation.
 - **Availability:** Many suppliers noted we may not be able to consult on our methodology if the new SMIP CBA is not finalised and published before the substantive consultation.
19. Suppliers encouraged us to develop and share contingency plans at the earliest opportunity, in the event that the new SMIP CBA is not available in time for our SMNCC model update.
20. One supplier suggested that we use the current SMNCC model as a contingency plan for cap period four (as we did for cap period three), but they suggested that we updated some of the assumptions. In its view, the supplier considered that the allowance would increase even though fewer smart meters were being installed, because efficient costs per meter would increase to a greater extent.

Our consideration

21. We agree with stakeholders that our proposals, substantive methodology, and timetable are dependent on the new SMIP CBA. We consider this appropriate and necessary. The new CBA is the most comprehensive and robust assessment of smart meter costs available.

⁵ Ofgem (2019), Response Paper #1: Reviewing smart metering costs in the default tariff cap – our approach and timeline (https://www.ofgem.gov.uk/system/files/docs/2019/08/response_paper_1_-_our_approach_and_timeline.pdf).

⁶ Ofgem (2019), Response Paper #4: Reviewing smart metering costs in the default tariff cap – Disclosure (forthcoming).

22. As the new SMIP CBA has not been finalised and published yet, we were not able to provide the new SMNCC model in June. Nor are we able to substantively consult on specific issues and how we propose to address these in our methodology, which we initially planned to do in August or early September.
23. We recognise that our proposals are also dependent on Government clarifying the policy landscape beyond the end of 2020. As one supplier suggested, this may be important context when considering whether our proposed methodology would be appropriate.

Central plan

24. We maintain our proposal to use the new SMIP CBA as a starting point, and if it is available before October, we propose to have a substantive consultation on our methodology and modelling on that basis in October. This is the earliest opportunity for the new SMNCC model to be used to calculate the allowance for cap period four. Below we discuss the timing of this substantive consultation on our methodology, and how we plan to make changes to the proposed methodology if the consultation shows that this is necessary.

Contingency arrangements

25. There are two circumstances where we would set the allowance in cap period four without the new SMNCC (based on the new SMIP CBA).
- The new CBA is not published before October 2019, which would mean that we could not consult on a substantive methodology based on the new SMIP CBA; or
 - The new CBA is published before October 2019, but after our substantive consultation on our methodology, we consider that, as a result of the substantive consultation, we should make significant revisions to the methodology to the extent that we would consult on the revised methodology in the new year.
26. In either event, we would still need to set an SMNCC allowance for cap period four. The default position in the licence is that cap period four would contain no allowance for the smart meter rollout, which we consider inappropriate.
27. The various options for cap period four include:
- **No allowance.** We do not consider this appropriate, as the smart meter rollout will continue between April and September 2020.
 - **Use the current SMNCC model.** This is the same interim approach we consulted on and adopted for cap period three. The suitability of this approach depends on whether or not we reassess (using the new SMNCC methodology) the cash amount allowed for by the current methodology. The current methodology provides funding at a specific rate of installation (12.5% of suppliers' rollout obligation in each six month period) regardless of suppliers' actual rollout profiles, which inevitably differ. The allowance is the product of that notional rollout rate and specific efficient costs assumptions. Suppliers are concerned those cost assumptions might be too low. On that basis, the current allowance *over the life of the rollout* (where differences between suppliers' rollout profiles and the allowance rollout profile even out) could be too low, unless we correct the unit cost assumptions. However, on average, suppliers are currently installing smart meters at a slower rate than we provide for, so *within a single cap period* the total cash amount allowed for is unlikely to be lower than *reassessed* efficient costs (using an average rollout rate and reassessed costs). Using the current SMNCC model would provide a cash allowance that did not restrict an efficient rollout in short term (such as cap period four) and, if reassessed using the new methodology, would not risk underproviding for the rollout over its life (all cap periods).⁷

⁷ We discuss our proposal to have regard to the extent to which the first three (or, in this case four) cap periods provide advanced payments or lagged payments *as assessed by the new SMNCC model* in Response Paper #3. This includes a detailed exploration of the issue and suppliers' views. Ofgem (2019), Response Paper #3: Reviewing smart metering costs in the default tariff cap – Carry forward balances (forthcoming).

- **Build a new SMNCC model independently of the new SMIP CBA.** We do not consider this option practical or robust. We would in effect be duplicating much of the analytical work done to develop the new SMIP CBA, which has been done over a substantial period of time. There is no suggestion that the new SMIP CBA will be unavailable indefinitely.
- **Adjust the current SMNCC model.** In our April consultation, we stated that we were disinclined to update the current SMNCC model. There are two potential approaches. We could review all assumptions in the current SMNCC model, and adjust them where appropriate. In practice, this approach duplicates much of the work undertaken to update the new SMIP CBA, so it is not a distinct option from using the new SMIP CBA or building an independent model. We do not propose to adopt this approach for the reasons above. Alternatively, we could update individual assumptions in the current model. In the April consultation, we stated that we did not propose to do this (for cap period three) as the individual assumptions interact; by adjusting isolated assumptions, but not others, we may inadvertently make the allowance less accurate. Nonetheless, some suppliers suggested we update specific assumptions in the current model. They did not suggest which assumptions or how we adjust them. The same suppliers considered that an update would increase the total allowance, as they believed increases in the efficient cost per meter would offset reductions in the number of meters installed. Our preliminary assessment suggests this is not the case and the total allowance would reduce, which highlights the difficulty of making an assessment before the new SMIP CBA is published. We may be prudent not to reduce the allowance and assess the appropriate costs when the new SMIP CBA is finalised.

28. We propose to use the current SMNCC model to set cap period four in the event that we cannot use a new SMNCC model based on the new SMIP CBA. This may occur if the new CBA is not published before October 2019, or if we consider that our new SMNCC methodology requires significant revisions after substantive consultation and scrutiny, and therefore we need to consult on the revised methodology in the new year.

29. Note that the appropriateness of this proposal is affected by whether or not we adopt our April consultation proposal to have regard for advanced or lagged payments in the first three (or in this case, four) cap periods as assessed using the new SMNCC when it is available. If we do not use the new SMIP CBA to reassess the efficient costs in the first three cap periods, then it may be inappropriate to use the current SMNCC in cap period four, as *over the life of the cap* it may undervalue a significant proportion of the rollout.⁸ If we cannot adopt this approach, which we currently consider the most robust and proportionate option, then we will explore interim adjustments to the current SMNCC before the new SMIP CBA is available. We will consider the feasibility of this approach in more detail, and present our conclusions on the substantive consultation on our methodology. We have set out the limitations of this approach above.

The timing of substantive consultation and disclosure of our modelling

Suppliers' views

30. Most suppliers commented on our proposed timetable for ensuring stakeholders could scrutinise our methodology and modelling.
- Suppliers encouraged Ofgem to share its modelling at the earliest opportunity, to enable stakeholders to meaningfully scrutinise our approach and modification to the new SMIP CBA.
 - One supplier suggested that we disclose the *current* SMNCC model (not the new SMNCC model) in June.

⁸ In Response Paper #3, we discuss this issue, suppliers' views, and our considerations in detail. Ofgem (2019), Response Paper #3: Reviewing smart metering costs in the default tariff cap – Carry forward balances (forthcoming).

- Several suppliers were concerned that our proposal to share our modelling alongside our final consultation would not allow sufficient time for scrutiny and revision, if required. One supplier noted that stakeholders must be able to engage meaningfully while policy is still at a formative stage. Some specified that, in their view, we should share our SMNCC model in August or earlier, before the final consultation.

31. Suppliers also commented on the form and content of that disclosure. Comments related to three themes:

- What information we would make available on a confidential basis;
- What arrangements we would put in place to share confidential information; and
- What information we would make available to suppliers on a non-confidential basis.

Our considerations

32. Here we discuss the *timing* of our substantive consultation and disclosure of our modelling. We have taken into account suppliers' views on other aspects of our disclosure (including what information is disclosed, to whom, and under what arrangements) and will set out our approach in Response Paper #4. We will address specific points on our methodology in the substantive consultation.

33. In April, we proposed to provide:

- An initial substantive consultation on our methodology in August or September; and
- Detailed modelling in October, with a final substantive consultation on our methodology.

34. At this stage, we are not able to provide the new SMNCC model, or consult on our methodology, without the new SMIP CBA.

35. We propose to provide both the substantive consultation on our methodology and disclose our modelling in October, as initially planned.

36. We will present our proposals in an implementable form (a statutory consultation with draft licence conditions, if required). We are aware that the consultation may show that the proposed methodology should not be implemented without revisions. If significant revisions are required as a result of consulting on our proposal, we will not implement the proposals and will revise and consult on the revised methodology in the New Year. In that event, we would implement a methodology using a contingency arrangement as discussed above. If the results of the consultation show that there are no revisions necessary that require us to re-consult, we would implement the new methodology in time for the announcement of cap period four.

37. Our proposals will be informed by the new SMIP CBA and the development of the cap in 2018. Although not guaranteed, this makes it possible or likely that the methodology presented may not require significant revisions that require re-consultation and could be implemented in time for cap period four to the benefit of suppliers and consumers. If we consider, after consultation, that the methodology requires significant revisions, then we will consult in the New Year on a revised methodology, in time to update cap period five.

38. Alternatively, we could present our substantive methodology twice, once in an initial substantive consultation (in October) and once in a final statutory consultation (in the New Year) after potential revisions. Using this approach, we would implement changes in time for cap period five, but not cap period four, even if the methodology required no revisions after the first substantive consultation in October. On that basis, we consider it efficient to present our proposals in October (or early November) on an implementable basis and nonetheless we will consider the need for revisions and consult on a revised methodology if another consultation is required.

39. We do not propose to disclose the current SMNCC model, as our review of efficient smart meter costs will not be based on it. We will develop a new SMNCC model with updated data and we may use different methodologies if appropriate.

40. Table 2 summarises our revised timetable.

Table 2: Timeline for setting the SMNCC in future cap periods

Time	Milestone	Content
30 April 2019	Initial consultation	The April consultation - COMPLETE
Mid-June 2019	Final consultation for third cap period	Published 18 June ⁹ - COMPLETE
7 August 2019	Decision for third cap period	Published 7 August ¹⁰ - COMPLETE
August	August Response papers	We respond to stakeholders on four major themes of the review and set out our approach: <ul style="list-style-type: none"> • gathering additional data; • our timelines; • considering timing differences between the allowance and costs; and • transparency arrangements.
October/ November 2019	Substantive consultation for fourth and subsequent cap periods	We aim to consult stakeholders on our proposed methodology, contingency arrangements, and associated licence changes, if any, for setting the SMNCC in the fourth, and subsequent, cap periods. Alongside the consultation, we will present our modelling for external scrutiny, under confidentiality arrangements presented in Response Paper #4'
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).
February or March 2020	Contingency: Potential consultation for the fifth and subsequent cap periods	If we have not been able update the SMNCC for cap period four using the new SMNCC model (either because the new SMIP CBA was not available, or we decide major revisions are required), then we will consult stakeholders on our proposals in the new year.

Next steps

41. Should you wish to submit views on any of the positions in this response, we encourage you to get in touch with us as soon as possible, and in any event no later than close of business on **06 September 2019**. Please provide any comments to retailpriceregulation@ofgem.gov.uk.

Yours faithfully,

Anna Rossington

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⁹ Ofgem (2019), Default tariff cap: approach to the third cap period. (<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-approach-third-cap-period>)

¹⁰ Ofgem (2019), Decision: approach to the third cap period for the default tariff cap. (<https://www.ofgem.gov.uk/publications-and-updates/decision-approach-third-cap-period-default-tariff-cap>)