Making a positive difference
for energy consumers

Email: retailpriceregulation@ofgem.gov.uk

Date: 16 August 2019

Dear stakeholders,

RESPONSE PAPER #2: RESPONSE TO APRIL CONSULTATION ON REVIEWING SMART METERING COSTS IN THE DEFAULT TARIFF CAP – DATA GATHERING

Background

1. On 30 April 2019, we published a consultation on reviewing smart metering costs in the default tariff cap (the 'April consultation').[1] This open letter forms part of our response to that consultation, focussing on the areas where stakeholders suggested we should gather additional data.
2. We are responding to this consultation through a number of documents.
   - We have already responded on the points specific to the third cap period, through our consultation of 18 June 2019.[2] On 7 August 2019, we confirmed our approach and announced the cap level for winter 2019-20.[3]
   - We are responding on the areas where stakeholders suggested we should gather additional data through this document. We have prioritised this element because of the lead times to get data from suppliers. Stakeholders will be able to review our positions – should they provide compelling reasons why these are incorrect, we would still have sufficient time to gather additional data.
   - We have published today a response paper on points specific to our general approach and the timetable for our review (Response paper #1). The cover letter explains our other planned response papers.

Our general approach

The April consultation

3. In our April Consultation, we proposed to use the new Smart Metering Implementation Programme Cost-Benefit Analysis (SMIP CBA) as the starting point for our updated non-pass-through Smart Metering Net Cost Change (SMNCC) model. We proposed to assess if there were any areas where modifications to the approach taken in the new SMIP CBA might be more appropriate for our purposes.

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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
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

4. 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. Nonetheless they emphasised that it may not provide an appropriate estimate on which to base the allowance, and would require external scrutiny to ensure that our general approach led to a sufficiently robust estimate of costs. See response paper 1 for detail.

Gathering supplementary data

The April consultation

5. We expect to use the new SMIP CBA as the starting point for our non-pass through SMNCC model. However, we considered that there might be areas where we would benefit from considering additional data, for instance where:

    a. we must estimate costs which are not included in the SMIP CBA (eg because they are not relevant to the purpose of the SMIP CBA, but they are relevant to the SMNCC model); or

    b. we require more information in order to form a judgement on whether the position in the new SMIP CBA is suitable for our purposes.

6. In response to the April consultation, four stakeholders emphasised that we should liaise with BEIS to ensure we have the necessary evidence base (either collected by BEIS or Ofgem in a consistent and timely manner). Some suppliers indicated specific issues where they considered we should collect additional data and/or consider modifying the approach taken in the previous SMIP CBA.

Our approach

7. We have considered each of the areas suggested by stakeholders and assessed whether we or BEIS already have sufficient data, or whether we need to collect more information.
8. We do not consider that we need to collect additional data on each area suggested. To develop the new SMIP CBA, BEIS gathered and analysed updated information – for example, through the latest Annual Supplier Returns (ASRs). Where BEIS already has gathered information and taken it through its comprehensive quality assurance process, it would be unnecessary for us to also request the data ourselves. On that basis, in most cases we do not expect that further data gathering will be required for the purpose of our review.
9. Where we are collecting additional data, this does not mean that our SMNCC model will deviate from the approach taken in the new SMIP CBA. While we could use the supplementary data to develop new estimates (ie replacing existing inputs in the SMIP CBA), this will not necessarily be the case and is not our presumption. Requests for information do not indicate that we consider the new SMIP CBA to be inaccurate, or unsupported, in specific areas. The primary aim of requesting supplementary information is to help validate whether the position in the new SMIP CBA is suitable for our purposes.
10. Below we set out the areas where we are collecting additional data, and provide an explanation on why we are not collecting data for other areas.

Areas where we are gathering additional data: Premature Replacement Charges

Background

11. Suppliers incur Premature Replacement Charges (PRCs) when they install a smart meter and this means replacing a traditional meter ahead of schedule. The cost of PRCs

depends on, among other factors, the age of the meters replaced – newer meters have higher PRCs than those which are close to replacement.

12. PRCs are not relevant for the purpose of the SMIP CBA because they would have been incurred under the counterfactual as rental charges, albeit spread over a longer time period. However, they are relevant for our SMNCC model, which focuses on the costs to suppliers within the life of the cap.
13. In the current non-pass-through SMNCC model, we modelled PRCs using a simple assumption about the ages of the traditional meters replaced prematurely. We did not have detailed data on the actual age profile of traditional meters.
14. Several stakeholders told us that we should gather data on PRCs. For example, two stakeholders said that we should gather data on average PRCs and the age profile of suppliers' meter stocks.

Our approach

15. We are gathering data on meter ages and PRCs.
16. We will use this information to assess whether we should maintain our current approach (which assumes that traditional meters are uniformly distributed over a 20-year life at the start of the rollout), or whether a more detailed approach is more appropriate. Information about actual PRCs might also help us to check the results of our modelling.
17. Any decision to make changes to our previous assumptions will also be dependent on our view of the reliability of any information collected. For example, if there was a risk that data unavailability could bias the results in one direction, it might be more robust to maintain our current approach.
18. We have issued a request for information to the suppliers classified as "large energy suppliers" within the smart meter reporting framework.[4] We consider that this is a proportionate approach to gathering data across the majority of the market. However, if you are a smaller supplier or Meter Asset Provider (MAP) and have information that you would like to provide, then please contact us to discuss this.

Areas where we are gathering additional data: additional net advertising costs

Background

19. Smart Energy GB (SEGB) is the body running the nationwide marketing campaign for smart meters, and is funded by suppliers. The cap includes the costs to suppliers of funding SEGB through the pass-through element of the SMNCC.
20. The current non-pass-through SMNCC element assumes that suppliers do not incur other advertising costs (apart from the costs of funding SEGB) as a result of the smart meter rollout.
21. Several stakeholders referred to additional marketing costs which they consider that suppliers are incurring to encourage consumers to install a smart meter. Two stakeholders said that we should gather data on the average marketing costs incurred by suppliers per smart meter installed.
22. We are aware that suppliers have raised this issue with BEIS. The National Audit Office stated that BEIS considers that any amount suppliers spend on marketing (beyond SEGB) represents a diversion of existing marketing activity, rather than additional spending and therefore does not capture it within its CBA.

Our approach

23. In judging whether suppliers incur additional net spending, we need to consider:

[4] Suppliers that in 2018 had more than 250,000 domestic gas customers, or more than 250,000 domestic electricity customers. We have selected 2018 for consistency with the latest ASRs available.

a. What are suppliers' advertising costs, excluding activities undertaken by SEGB, and excluding activities to book appointments (which already feed into the calculation of installation costs)?

b. What proportion of those advertising costs is attributable to the smart meter rollout? (In other words, what costs are **additional** to the advertising costs that would have been incurred without the smart meter rollout?)

c. What is the **net** impact, taking into account the benefits (beyond the smart meter rollout) of additional advertising activities?

24. We are gathering data on each of these three issues to better understand whether the current approach is appropriate. Our view is that we are likely to consider that the current judgement is reasonable, but we recognise that this is a complex area.

25. We anticipate that the information we gather will not be definitive, and that this will remain an uncertain area. Suppliers should be able to provide reliable data on costs. However, they will only be able to estimate, rather than measure, their counterfactual costs (without the smart meter programme) and the scale of benefits from advertising. We do not consider that the different *kind* of information that is available on these issues indicates any difference in the *relevance* of these issues. Even if suppliers can only provide reliable data on costs, we would not consider costs in isolation.

26. In considering this data we will take into account the following factors:

a. Suppliers would have incurred marketing costs in the absence of smart metering (ie in the counterfactual). Any money that suppliers spend on marketing that is related to smart metering may represent a reallocation of marketing spending that suppliers would have undertaken in any case. Any robust estimate would need to demonstrate that smart metering costs were genuinely additional costs.

b. We are seeking to estimate the net costs relating to smart metering (the SMNCC). However, suppliers may well receive spillover private benefits from any marketing related to smart metering. For example, an advert encouraging customers to take up a smart meter may also deliver increased brand awareness for the supplier, helping it to acquire customers. Any robust estimate would need to isolate the costs relating to smart metering, net of any spillover benefits which the supplier receives.

c. Furthermore, some potential smart meter marketing costs will already be included in the cap. To the extent that suppliers were incurring any marketing costs related to smart metering in 2017, these would already be included in our operating cost baseline. Any appointment-setting costs are also already included in the SMNCC, as these are included in the estimate of installation costs, based on ASR data. As noted above, we already include SEGB costs in the cap as part of the pass-through element. The debate is about whether there are any additional marketing costs, beyond these elements.

27. As with PRCs, we have issued a request for information to the suppliers classified as "large energy suppliers" within the smart meter reporting framework.[5] We consider that this is a proportionate approach to gathering data across the majority of the market. However, if you are a smaller supplier and have information that you would like to provide, then please contact us to discuss this.

Areas where we do not intend to gather data because information is available

Our approach

28. There are a number of areas where we do not propose to gather data ourselves because we understand that BEIS already has information available to it. BEIS has been able to consider whether or not to incorporate this information when developing its new SMIP

[5] Suppliers that in 2018 had more than 250,000 domestic gas customers, or more than 250,000 domestic electricity customers. We have selected 2018 for consistency with the latest ASRs available.

CBA. Where the data is sufficient for us to form a robust judgement, we do not consider it necessary to gather supplementary data.

29. For the avoidance of doubt, when considering whether we need to gather additional data we have only considered whether sufficient data is available or not. We have not considered how or whether that data has been used in the development of the new SMIP CBA.

Operating and maintenance costs

30. As well as upfront costs, smart meters also have operating and maintenance (O&M) costs.

31. Two stakeholders said that we should gather data on O&M costs for smart and traditional meters. They said that BEIS's current assumption "does not appear to be informed by recent industry data".

32. We understand that BEIS has recently had discussions with MAPs to validate its assumption in this area. Having reviewed the process BEIS followed, we are satisfied that this approach was sufficient to check that the assumption is sufficiently robust. We therefore do not consider it necessary to gather information ourselves to duplicate validation.

Debt management

33. Smart meters should help suppliers to reduce the costs of customers building up debt, including due to more frequent and accurate billing. However, smart meters will not remove the underlying risk that customers are unable to pay their bills and build up debt.

34. Two stakeholders said that we should gather data on the debt management savings from installing smart meters, rather than just using the ASR data on the cost per traditional meter of recovering debt.

35. BEIS has information on the debt management costs for customers with traditional meters from the ASRs. We understand that BEIS also has information from a variety of sources (including BEIS energy statistics on bills, debt book information in suppliers' annual reports, and debt management costs for traditional meters from the ASRs) which would allow it to estimate the debt management savings from installing a smart meter. This range of sources is available to us, and we consider that it is sufficient for us to judge whether the estimated debt management costs are appropriate.

36. We therefore do not intend to gather further data.

Supplier IT costs

37. Several stakeholders raised issues about supplier IT costs, particularly the assumed amortisation period. For example, two stakeholders said that we should gather data on the annual additional IT costs suppliers incur to deliver the smart meter rollout. One supplier said that IT costs had continued to increase since 2018 (when we set the level of the cap) "due to industry delays, particularly around the prepayment solution and the rollout of dual band comms hubs".

38. We do not need further data in order to consider the amortisation period since we have received suppliers' representations on the amortisation periods they consider appropriate for IT costs.

39. BEIS has information on suppliers' upfront IT costs through an RFI from 2010. This led to BEIS assuming that suppliers would incur the majority of their IT costs upfront in the 2016 SMIP CBA. We therefore do not consider it necessary to duplicate BEIS's work in this area.

40. We consider BEIS' approach to modelling IT costs reasonable (predominantly upfront costs with limited increments in subsequent years). In the context of the SMNCC, smart metering costs up to and including 2017 are already included in the operating costs allowance, so the majority of costs should already be provided for.

41. There is a risk that any new data could be subject to double counting. We would need to be able to distinguish between recent expenditure that is additional to upfront costs and recent expenditure that is deferred upfront expenditure (as the timing of each supplier's investments will differ) The latter category would already have been accounted for in the new SMIP CBA. We would also need to be able to identify recent expenditure that is related to smart meters and additional to the IT costs that would have been incurred without the smart metering programme. (For example, billing system development may be affected by the smart meter rollout, but billing systems would still be developed even without smart meters).

42. We consider the additional data and analysis required to establish these estimates is unnecessary. This is given the high degree of uncertainty that an alternative approach would contain and given that we consider the current approach is reasonable. Additional data is not likely to substantially improve the accuracy of the analysis, or help validate the new SMIP CBA given its methodology.

Inbound enquiries

43. Suppliers incur costs from handling customer contacts (eg phone calls). Smart meters are expected to reduce these costs, as there should be fewer contacts about inaccurate bills. However, suppliers have suggested that there is an increase in calls immediately after they install a smart meter.

44. Two stakeholders said that we should gather data (on costs or call contact rates) separating out the period immediately following smart meter installation and the long term. They also said that suppliers should control for differences in characteristics between customers with smart meters and customers with traditional meters when providing data on the inbound enquiries savings.

45. BEIS already has data through the ASRs on the costs of call handling and the number of inbound contacts for both traditional and smart metered customers. Suppliers have also made BEIS aware of their concerns about an initial increase in contacts.

46. We consider that the information already available to BEIS is sufficient to allow it (or us) to consider the impact on calls at different periods after installation, and make an adjustment to the previous approach if required. We do not consider that additional data would materially improve that consideration. Given this, we do not consider that additional data gathering is necessary.

47. We also do not intend to gather data to control for differences in characteristics between customers with smart meters and traditional meters (as suggested by certain stakeholders).

48. We understand the issue, which is that customers who already have had smart meters installed might have characteristics that make them less likely to contact their supplier than customers who have not yet received a smart meter. This means the apparent savings observed currently from installing smart meters might not be replicable later in the rollout.

49. To gain a broad understanding, we will be able to consider existing information (eg survey data) showing the characteristics of customers with smart meters (including those which might plausibly affect contact frequency), and how these differ from the population as a whole. However, it is unlikely to be feasible to carry out precise analysis in this area. For example, there are a large number of potential characteristics which could affect contact frequency, relative to the number of suppliers operating at scale. In addition, the installation of a smart meter could affect certain customer characteristics (eg if smart meters lead customers to become more engaged). Even if we carried out analysis, it would only be indicative. We therefore do not currently consider that it is necessary to prioritise gathering additional data and carrying out significant analysis to take this into account.

Avoided site visits

50. Smart meters will allow suppliers to take meter readings remotely, rather than through site visits. However, suppliers will still need to visit premises for safety inspections.

51. Two stakeholders said that we should gather data on the average cost of regular safety inspections.

52. Through the ASRs, BEIS has information on the costs of meter readings and of special safety inspections. BEIS therefore has data which it could apply as a way of estimating the cost of regular safety inspections. Given BEIS already has these sources available, which are based on recent information, we do not consider it necessary to gather further data to form a judgement on these costs.

Areas where we do not intend to gather data because we do not consider this would be robust

53. There are a number of other areas where we do not intend to gather data primarily because we do not consider that this would provide robust information to allow us to update the non-pass-through SMNCC model.

Meter rental

54. The 2016 SMIP CBA estimates the asset and installation costs for smart meters. The SMIP CBA annuitises these costs, creating annual figures. This is an alternative to collecting information on the meter rental charges that suppliers incur. The 2016 SMIP CBA approach requires an assumption for the lifespan of meters, as this is the period over which costs are annuitised.

55. Several stakeholders referred to the assumed lifespan for SMETS1 meters. Two stakeholders said that we should gather data on the average asset life used to determine meter rentals for a SMETS1 meter (for each fuel). They also said that we should gather data on meter rental costs to check that the methodology is giving reasonable results.

56. We do not intend to gather data on the lifespan of SMETS1 meters. The SMETS set a clear standard for the lifespan of these meters (15 years). Given the short length of time that SMETS1 meters have been in place, we do not consider that actual data collected now would be sufficiently informative on how long these meters will last in practice.

57. We do not intend to gather data on meter rental costs. We consider BEIS's bottom-up methodology to be a reasonable approach for estimating the typical efficient costs of metering assets and installations.

Pavement reading inefficiency

58. Meter reading costs for traditional meters may increase once there are fewer of them (for example if staff need to travel longer distances between the remaining sites to take readings).

59. Two stakeholders said that we should gather data on the trend in meter reading costs.

60. We do not intend to gather data in this area. The smart meter rollout is at a relatively early stage. The trend in inefficiency should change as the rollout progresses (as traditional meters get further apart). We do not consider data on recent trends to be a good indicator of trends in future periods.

Legal and organisational costs

61. Two stakeholders said that we should gather data on the annual legal and organisational costs of delivering the smart meter rollout.

62. Suppliers' legal and organisational costs related to smart metering in 2017 will already be included in our operating costs allowance. We are interested in any change in these costs *since* 2017 only. Changes in these costs over that short period would not have a substantial impact on the SMNCC.

63. Furthermore, any information on legal and operational costs related to the smart meter rollout would need to demonstrate it avoids double counting costs. Information would have to robustly: (a) distinguish legal and organisational costs related to the smart

meter rollout from those related to a supplier's overall activities, (b) allocate costs to activities in a way that can be consistently compared across suppliers, and (c) demonstrate that any costs are in addition to costs that would have been incurred without the smart meter rollout. This would be a detailed piece of analysis for a relatively minor proportion of incremental costs.

64. On that basis, we do not consider a detailed process to gather additional data on these costs to be necessary.

Area where we do not intend to gather data because it is irrelevant to our review

65. Two stakeholders said that we should gather additional data in relation to the cost to serve customers with prepayment meters. Specifically, the separate costs of prepayment meter exchanges for each fuel, the number of prepayment meter exchanges per year, and to understand which cost to serve differences between customers with smart meters and traditional meters are due to the smart meter installation itself, as opposed to differences in customer characteristics.

66. We do not intend to gather data in relation to specific issues for prepayment meters. Our current review is to update the default tariff cap. This does not apply to most prepayment customers, and does not currently include a specific cap level for prepayment customers.

67. Given the small number of prepayment customers with interoperable smart meters (the only meter relevant to the default tariff cap), there is no robust information available to request. We will continue to monitor the situation for prepayment meters in scope as this evolves.

Next steps

68. If 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 **30 August 2019**.

69. Please provide any comments to retailpriceregulation@ofgem.gov.uk. For any area where you recommend we reconsider the position set out above, please provide as much detail as possible to justify your views. This includes how you recommend that we gather any data in practice to ensure that this is robust, taking account of all the issues we discuss above. In addition, if you have existing 'off the shelf' data, to substantiate your position, and demonstrate what data is available, then please provide this with your response. This would help us to reconsider the issues, and develop any requests if necessary.

70. We will continue to consider whether additional data gathering is required (for example if new issues emerge), and we will gather new information if it is needed to inform our approach. However, within our timescales, it will become less feasible to gather large amounts of data at a later stage of our review. We therefore encourage you to raise any issues which you consider require additional data gathering as early as possible, and with as much detail as possible.

Yours faithfully,

Anna Rossington

Deputy Director – Retail Price Protection