By email:
Anna Rossington
Deputy Director, Retail Price Regulation
Ofgem

6th September 2019

Dear Anna,

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

Thank you for the opportunity to respond. The importance of this review cannot be understated.

It is essential to ensure that the efficient costs of the smart programme are fully included within the cap, to enable the sustainable delivery of the programme and related benefits to customers. As suppliers are obliged to take all reasonable steps to install smart meters to domestic premises by the end of 2020, this requires (under the Electricity and Gas Acts) that the necessary investment and activities are financed, otherwise the roll-out is compromised.

We continue to have significant concerns in this regard.

Our headline comments:

- We continue to support Ofgem's central plan to use the updated SMIP CBA as the basis for the SMNCC. We welcome Ofgem's commitment to using resources such as the National Audit Office report (2018), which highlighted the escalation of costs above the 2016 CBA;

- If the SMIP CBA is unavailable before October or, after consultation, the new SMNCC model requires substantial revision, Ofgem's contingency plan is to use the current SMNCC model for the fourth cap period. We maintain that this should be adjusted, for the reasons detailed in our response to your April consultation. The current model could and should be adjusted for existing, known errors and shortfall in the SMNCC (at least £10 per meter). We reiterate these issues in the appendix to this letter.

- We remain concerned about a potential retrospective adjustment for perceived advanced payments in price cap periods 1-3. As we explained in our response to the April consultation, the notion that a lower than forecast roll-out profile means that the current SMNCC is above the efficient level of costs incurred, is seriously flawed. This is due to the shortfall we highlight above, increased costs and stranded fixed costs incurred to comply with smart obligations, arising as a result of a delayed roll-out due to factors largely outside our control. We will respond separately to the detail in your third paper. Notwithstanding, it should also not be overlooked that the divergence of the prepayment cap and policy/smart costs has meant a significant under-recovery by suppliers since 2017. As explained in our response to the CMA (copied to you), we estimate this to be at least £300m.

- Process – we note Ofgem's plan to present proposals in an implementable form, by way of statutory consultation. If there is a need for substantive revision, this may then require a further consultation in the New Year, which would mean the methodology not being updated until October 2020. The priority must be to update the model from April 2020, although any consultation must be open-minded. We note Ofgem's view, articulated in response paper 3, that its general opposition to error correction does not apply to Smart. It follows that an adjustment would be appropriate for any shortfall in cap period four (and indeed, cap periods 1-3).

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Yours sincerely,

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Cc: Chris Harris, Head of Regulation & Compliance

Appendix: adjustments required to the current SMNCC model

We previously raised concerns that all significant costs of the smart programme are not included within the cap methodology. This remains the case. Fundamentally, it seemed perverse to us to base the costs on the lower cost 2017 Foundation period in which DCC problems delayed mass roll out, rather than fully recognise the true costs of SMART in a 2019 mass deployment period including the cost consequences of those delays.

We remain particularly concerned about three issues which should be addressed in the price cap by inclusion and adding to the current SMNCC. These are:

1. The failure to adequately address SMETS 1 costs; in particular the shorter asset life of 10 years (which increases current MAP charges) rather than Ofgem's incorrect assumption of 15 years and the additional communications costs. We estimated that these issues combined equate to around £5 per meter in 2019 (annualised). There are potentially further costs in 2020 (c£2 per meter) of SMETS 1 PRC charges resulting from the Enrolment & Adoption process;

2. The impact of the delay in the rollout, and the resulting inefficiency that is imposing on our business through stranded fixed costs, including labour costs, resulting in a net cost increase per meter (estimated at £3). Further details on this were provided in our response to your April consultation;

3. IT investment costs – it was not possible to quantify what Ofgem included in the price cap due to the lack of transparency, required in law, in the consultation process, but we do not believe they adequately reflect the increasing costs to the industry. Ofgem should clarify, both publicly and via the proposed dataroom. In particular, the use of a 15 year asset life for IT investment is clearly inappropriate, and we were surprised and disappointed that Ofgem chose to continue using this assumption in the modelling despite its obvious flaw. Since the consultation in 2018, IT costs have continued to increase due to industry delays, particularly around the prepayment solution and the rollout of dual band comms hubs (DBCH).

Accordingly, the SMNCC for the first three cap periods (January 2019 to March 2020) remains well below the actual costs incurred by efficient suppliers, and by a value that is broadly similar to the £10 per meter (minimum) that we stated in our 2018 consultation response. Much of this shortfall can and indeed, should have been addressed. If the current SMNCC is used for the fourth cap period, it should be adjusted to address this shortfall.