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Dear Anna,

Response paper #2: Response to April consultation on reviewing smart metering costs in the default tariff cap – data gathering

Thank you for the opportunity to comment on Ofgem's second 'response paper' (RP2) on data gathering.

We are pleased that Ofgem has decided to gather additional data on premature meter replacement charges and on smart meter rollout-related marketing costs. We are working on our response to the associated RFI and will include any comments on those aspects of RP2 in our RFI response.

We have set out in Annex 1 our response to each of the nine areas where Ofgem does not intend to gather additional data. Our main points in this regard are:

- Ofgem appears to be rejecting a number of the categories on the basis that it would be too difficult/complex to gather the relevant data. This is not an appropriate ground for taking no action. If the potential inaccuracy in cost allowance is (or has the potential to be) sufficiently material, Ofgem should be taking whatever steps are necessary to get a more robust estimate, even if the time required to gather and analyse the data would extend beyond the timescales it has set itself for the SMNCC review. This is particularly important in light of Ofgem's proposals (set out in RP3) to conduct a retrospective assessment of whether SMNCC allowances since January 2019 have over- or under-compensated the costs of efficient smart rollout.
- In a number of the cost and benefit categories our ability to comment on Ofgem's stance is hamstrung by the inadequate transparency to date around the breakdown of the NPT SMNCC allowance, and the key assumptions lying behind different components. Without knowing how much cost or benefit Ofgem has estimated for a category, it is difficult to comment on the importance of obtaining more robust information. And without knowing what assumptions have been made it is difficult to suggest what data gathering could best validate those assumptions. We urge Ofgem to use the SMNCC review to provide much stronger public disclosure (not via confidentiality rings) of this key information.

- As set out in Annex 1, we are not persuaded by Ofgem’s explanation in many of the nine categories, and in others we would reserve judgement until Ofgem has implemented the changes it says it intends to make. However, we would draw particular attention to two categories where we disagree with Ofgem’s stance, and where we are uniquely well qualified to comment by virtue of being the reference supplier used as the basis of the 2017 operational costs (‘opex’) baseline. These categories are IT costs and Legal and Organisational costs. In each case, Ofgem suggests that there is no reason to gather additional data because these costs would have been more or less fully captured in the 2017 baseline and would not be expected to have increased significantly since then. Contrary to Ofgem’s assumptions:
 - Our 2017 opex baseline (on which the DTC opex allowance is based) included minimal smart-related IT costs, because our accounting policy is to start depreciating when the assets come into use (in most cases linked to DCC going live). So, if our understanding of Ofgem’s paper is correct, depreciation costs associated with virtually all our £[X]m of smart-related IT capex will have been omitted from the DTC allowance, together with an additional £[X]m of IT costs not foreseen in 2017 (mainly to cover the Alternative Home Area Network (‘Althan’) solution and costs associated with enrolment and adoption of SMETS1 meters by the DCC).
 - Our Legal & Organisational costs have increased from circa £[X]m in 2017 to circa £[X]m pa today reflecting the increased technical, engagement and procurement challenges which we now face and ScottishPower’s commitment to take all reasonable steps.

Both of these are material increases, on which we would be happy to provide Ofgem further detail and evidence, either informally or in response to a formal RFI. We do not disagree with the methodological difficulties highlighted by Ofgem in RP2, but as noted above, the correct approach is for Ofgem to address these difficulties as best it can, not to consider them grounds for taking no action.

Please do not hesitate to contact me or James Soundraraju (tel 0141 614 2421, jsoundraraju@scottishpower.com) if you have any questions arising from this response.

Yours sincerely,



Richard Sweet
Head of Regulatory Policy

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

1. Operating and maintenance (O&M) costs

Ofgem does not intend to gather information on O&M costs for smart and traditional meters because it understands BEIS has recently held discussions with Meter Asset Providers (MAPs) which are sufficient to validate its assumptions.

We are unable to comment at this stage on whether this is reasonable, but would urge Ofgem to disclose the O&M costs assumed in the revised SMNCC model so that suppliers can also have confidence in the robustness. We see no reason why such costs assumptions should be subject to confidentiality restrictions.

2. Debt management

Ofgem says it does not intend to gather information on debt management costs savings from smart meters because it considers the information which is available to BEIS is sufficient for this purpose, including:

- BEIS energy statistics on bills;
- debt book information in suppliers' annual reports;
- debt management costs for traditional meters from the Annual Supplier Returns (ASRs).

BEIS's 2016 CBA¹ identifies three mechanisms by which debt management costs might be reduced which do not seem unreasonable:

- avoiding the situation where a succession of under-estimated bills is followed by an unexpectedly large actual bill, and the associated risk of debt arising
- earlier identification of customers at risk of building up debt and earlier preventative measures such as debt repayment plans;
- the ability to remotely and promptly switch a customer onto a pre-payment arrangement (subject to regulatory safeguards).

We agree that these features of smart meters are all potentially relevant, and that smart meters could potentially affect bad debt write-off, bad debt management costs (eg costs of obtaining warrants) and working capital associated with debt. However, without any disclosure of how Ofgem/BEIS is setting about estimating these different impacts, it is impossible to comment on whether it has sufficient information. We would strongly encourage Ofgem to provide sufficient transparency around the estimation of debt savings, so that suppliers can meaningfully comment on possible information gaps.

¹BEIS Smart Meter Roll-Out Cost-Benefit Analysis, Part II – Technical annex, August 2016, section 1.4.2.4

3. Supplier IT costs

Ofgem says it does not intend to gather information on supplier IT costs related to smart meters because:

- It considers BEIS’s approach to modelling IT costs (predominantly upfront costs with limited increments in subsequent years) to be reasonable².
- 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.

We disagree with Ofgem’s stance on this point. As ScottishPower’s opex costs were used as the basis for the 2017 opex baseline we are particularly well placed to comment. In contrast to what Ofgem appears to have assumed:

- Under our accounting policy we start to depreciate an asset when it first comes into use. The bulk of our £[redacted]m investment in IT for smart meters only began to be depreciated from 1 April 2019, once our IT project was complete to the point where our interface to the DCC was working. Based on our initial analysis it appears that only circa £[redacted]m of the £[redacted]m was depreciated in 2017, resulting in a depreciation charge of circa £[redacted]m in 2017 (as the asset in question was deemed to have a useful life of [redacted] years).
- The frequently changing DCC requirements have necessitated additional IT capex expenditure, unforeseen in 2017. The original capex approval was for circa £[redacted]m of smart related IT but we have recently had to obtain internal approval for another ~£[redacted]m, taking the total to circa £[redacted]m, mainly to cover internal system developments relating to the Alternative Home Area Network (‘Althan’) solution and costs associated with enrolment and adoption of SMETS1 meters by the DCC. The approximate phasing is shown in Table below.

Table 1 – Phasing of ScottishPower smart-related IT spend 2014 to 2021

	2014	2015	2016	2017	2018	2019-21	Total
Smart IT spend (£m)	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

We understand from the comments in RP2 that Ofgem/BEIS has assumed that the majority of IT costs were incurred up-front (ie prior to 2017), and that these IT costs are depreciated over 15 years,³ presumably on a straight-line basis. It also appears Ofgem has assumed that this depreciation line is included in the 2017 ‘opex baseline’, with the result that there is no need for any further IT allowance in the NPT SMNCC, other than in respect of subsequent additional IT development, which it assumes to be small enough to disregard.

If our understanding is correct, these assumptions (in combination with ScottishPower’s accounting policy) may have led to a significant shortfall in the DTC allowance. £[redacted]m depreciated over 15 years is equivalent to £[redacted]m pa, a shortfall of £[redacted]m pa relative to the £[redacted]m pa allowed for in the 2017 baseline.

² Ofgem notes that this assumption by BEIS is informed by supplier responses to a RFI from 2010.

³ Default Tariff Cap: Decision, Appendix 7 – Smart metering costs, para 3.87

We would also note in passing that we consider the 15 year IT system amortisation period assumed by Ofgem (for consistency with the 2016 BEIS CBA) to be significantly too long in both economic and accountancy terms. This could be an area where it is appropriate for Ofgem and BEIS to use different values, reflecting the different purposes for which their models have been developed.

We would urge Ofgem to respond to these concerns with sufficient detail to give suppliers confidence that initial IT costs have been appropriately allowed for in the DTC calculations, or if not, take steps to remedy this omission. Furthermore, neither Ofgem nor BEIS (so far as we are aware) has access to information about supplier internal IT costs since 2017 and we would strongly encourage Ofgem to design and issue an appropriate information request so that the case for increasing the SMNCC allowance in this respect can be properly assessed.

4. Inbound enquiries

Ofgem acknowledges that there is an initial increase in the volume of calls following installation of a smart meter, before any long term reduction in call volumes takes effect. However, it says it does not intend to gather information on this because 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.

This is clearly an important oversight in previous modelling of smart costs and we are pleased that Ofgem intends to address it (if BEIS does not). We cannot comment at this stage on whether the data available to BEIS is sufficient for this purpose, but would urge Ofgem to publish sufficient detail of its modelling assumptions so that suppliers can validate them against their own experience.

5. Avoided site visits

Ofgem says it does not intend to gather data on the average cost of regular safety inspections since data is already available to BEIS which it could use to estimate this.

We do not disagree that this is the case. However, we would note that we have consistently called on Ofgem to provide greater transparency as to how it has estimated the overall cost savings from avoided site visits, and in the absence of such detail we cannot be sure that Ofgem/BEIS has sufficient up to date information at its disposal or has used it correctly.

6. Meter rental

Ofgem says it does not intend to gather data on meter rental costs since it considers BEIS's bottom-up methodology to be a reasonable approach for estimating the typical efficient costs of metering assets and installations. The BEIS bottom-up methodology annuitises asset and installation costs to derive an annual rental figure based on the meter lifespan (15 years) set in the SMETS standard.

Given that smart meter rental costs are one of the most significant costs of smart meter rollout, it is extremely important that Ofgem's figures are as robust as possible. There are many reasons why the actual costs of meter rental might deviate from the theoretical bottom-up estimates derived by BEIS, and such deviations would not necessarily be indicative of any inefficiency on the part of suppliers.

Given the materiality of meter rental costs and the substantial volume of market data which is now available, we are disappointed that Ofgem is declining to carry out what would be a relatively straightforward validation exercise. We recognise that careful thought will need to be given to the treatment of deemed and Meter Rental Agreement (MRA) rental prices, but such difficulties should not be used as grounds for taking no action.

(We note that Ofgem appears to be conflating two distinct questions: what lifetime has effectively been assumed by MAPs for determining meter rental, and what is the actual lifetime of a SMETS meter. We agree that it is too early to answer the latter question with any robustness, but there is no reason why it should not answer the former.)

In the context of meter rental, we would also highlight the importance of Ofgem obtaining and using up-to-date information on the mix of SMETS1 and SMETS2 meters.

7. Pavement reading inefficiency

Ofgem says it does not intend to gather data on pavement reading inefficiency as the smart meter rollout is at a relatively early stage. The trend of inefficiency should change as the rollout progresses (as traditional meters get further apart) and it does not consider data on recent trends to be a good indicator of trends in future periods.

Given that Ofgem's SMNCC model is forward looking and will, of necessity, cover periods in which inefficiency is material, we would encourage Ofgem to provide a full explanation in due course of how it has modelled this inefficiency.

8. Legal and organisational costs

Ofgem says it does not intend to gather data on Legal and Organisational (L&O) costs (specifically the increase in such costs since the 2017 baseline) because the information would need to robustly:

- distinguish Legal and Organisational costs related to smart meter rollout from those related to a supplier's overall activities;
- allocate costs to activities in a way that can be consistently compared across suppliers;
- demonstrate that any such costs are in addition to costs that would have been incurred without the smart meter rollout.

Ofgem believes this would be a detailed piece of analysis for a relatively minor proportion of incremental costs.

We disagree with Ofgem's stance on this point. As noted above, we feel well placed to comment as the benchmark for the 2017 opex baseline. Our 2017 baseline opex included circa £[~~3~~]m of L&O costs which have increased to circa £[~~3~~]m in the current year, reflecting the increased technical, engagement and procurement challenges which we now face and ScottishPower's commitment to take all reasonable steps. We consider this is a material amount and believe that other efficient suppliers are likely to have seen similar increases.

Neither Ofgem nor BEIS (so far as we are aware) has access to information about supplier internal L&O since 2017 and we would strongly encourage Ofgem to design and issue an appropriate information request so that the case for increasing the SMNCC allowance in this respect can be properly assessed.

9. Prepayment cost to serve

Ofgem says it does not intend to gather data on prepayment meter costs to serve (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.)

It justifies this on the basis that:

- the current review is to update the default tariff cap (DTC), and the DTC does not currently include a specific cap level for prepayment customers;
- the number of prepayment customers with interoperable smart meters is too small to be able to derive robust estimates.

We disagree with Ofgem's stance on this point as we believe that Ofgem should now be embarking on the exercise which it has previously committed to doing, of setting a separate cap level for the smart prepayment cap. This raises a number of complex methodological issues and we intend to write to Ofgem separately on this point.

ScottishPower
September 2019