



By email:

Anna Rossington
Deputy Director, Retail Price Regulation
Ofgem

13th September 2019

Dear Anna,

RESPONSE PAPER #3: REVIEWING SMART METERING COSTS IN THE DEFAULT TARIFF CAP – HAVING REGARD FOR CARRY FORWARD BALANCES

Thank you for the opportunity to respond.

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 (appended to this letter), 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 ongoing shortfall in the allowance (as we have previously highlighted), increased 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. The net impact of one less smart meter installed is an increase in our net cost.

It is essential to ensure that the 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.

From the outset we have stated to Ofgem the inevitability of reversing the decision on recovery mechanisms, not least because they save Ofgem from being in breach of the Electricity Act 1989 and Gas Act 1986 in terms of setting the cap at lower than actual costs of licensed activities. In the event that recovery is re-opened (and for the avoidance of doubt, we dispute any assertion of over-recovery), there is no rationale for smart being a special case as the principle should apply equally to other areas (such as mutualisation of defaults).

We expand on the issues of funding during cap periods 1-3, impact of the slower roll-out and setting the roll-out profile from April 2020, in Appendix 1.

I trust that you find our comments helpful for ensuring that the price cap facilitates the efficient delivery of the smart programme. If you require any further information, please contact Paul Finch (details below).

Yours sincerely,

Chris Harris
Head of Regulation & Compliance

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npower's response to SMNCC paper #3 (September 2019)

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APPENDIX 1: Funding during price cap periods 1-3 and roll-out profile

Ofgem refers to preliminary data suggesting that the allowance for periods 1-3 may be higher than actual efficient costs. We are unable to comment on undisclosed data.

Ofgem asserts that the allowance for periods 1-3 provides funding for the efficient costs of c7.8 million smart meter installations (31% of the rollout), whether or not suppliers actually install those meters in the same period of time. We disagree. The existing shortfall (c£10+ per meter) and stranded fixed costs erodes any surplus that Ofgem implies will have accumulated, for smart meters assumed to have been installed by the end of March 2020. Such meters, yet to be installed, will therefore need to be funded from price cap period 4 onwards.

Ofgem supposes that suppliers have incurred lesser costs as a result of the rollout being slower than anticipated by Ofgem in the price cap. Should this be the case, it would be manifest in their 2019 accounts, mandatorily published by several suppliers in the Consolidated Segmental Statements. ✕ We can provide more information on request. Ofgem can now ask other suppliers for their full year forecasts. Either there are Recovery mechanisms or there are not. If not, then Ofgem may not apply adjustments. If there are, then they should be done now on the basis of suppliers' financial forecasts, or in 2020 following the receipt of actuals. To depress the cap now, only to correct the error and raise it later would add unjustified volatility to the cap level. In addition to this, to take forward a known error would have the effect of misleading consumers since their anticipation of cap levels, on which they may base decisions, would have an incorrect bias.

It is important that Ofgem has recognised the need to consider the impact of stranded fixed costs. We have also flagged the need to consider the additional costs of increased efforts to engage customers about smart. Suppliers are also taking a hit by keenly pricing specific tariffs to incentivise smart take-up.

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.

Implications of lower rollout profile up to March 2020

The lower rollout profile up to March 2020 compared to that assumed in early 2018 has had significant financial implications for suppliers. We believe that these should be fully taken into account when considering the smart metering allowance. In particular there are four areas we would like to highlight:

- The slower rollout profile, much of which is due to factors outside suppliers' control, will inevitably mean that the rollout period is longer than originally intended, probably lasting until 2023. The logical result of this is that the total cost of the smart programme will increase, as the overheads and fixed costs required to deliver the programme will be required for a longer period. One of the key points in the paper is that the cap should not exceed "efficient costs" over the life of the price cap. Given the delay to the rollout, the estimate of overall "efficient costs" will be higher than originally envisaged, meaning any clawback is inappropriate.
- Related to the above point about the overall cost increases due to the longer rollout period, is the implications in the period up to March 2020. npower, in common with a number of other suppliers, have adopted a business model of largely insourcing the installation of smart meters. This has had the effect of making a large proportion of our smart metering

costs fixed, at least in the short to medium term (i.e. six to twelve months). Consequently, the reduction in the volume of smart installations relative to that anticipated in 2018 has not translated into a like-for-like reduction in operating costs. npower resourced up to a rollout profile anticipated in 2018, and this has not materialised largely due to factors outside our control. This has reduced meter installation productivity (as opposed to the 40% increase assumed in the SMNCC decision of October 2018), whilst the fixed costs relating to back office staff and IT investment has either remained the same or in the case of the latter continued to increase due to ongoing industry issues.

- The uncertainties around the rollout profile, together with industry decisions taken around SMETS 1 meters, has left npower with a significant stock write off from SMETS 1 meters that were purchased in anticipation of a higher rollout profile, but could not be used due to yet more DCC delay. ✂ If this level of write off were to be extrapolated nationally, it would mean a total of £50m of asset write-offs caused by the slower rollout profile, which represents one sixth of the entire SMNCC allowance of £309m for the period up to March 2020.
- Under the standard industry model, we expect the delay to the rollout profile to have incurred substantial interest rate penalties from MAP providers who had taken a financial hedge on the funds required to support an earlier rollout profile. The reduction in interest rates has meant that the unrequired funds have had to be sold back by the MAP at a substantial loss, for which a supplier is liable. ✂
- The delay to the rollout profile has clearly delayed the implementation of supplier benefits assumed in the SMNCC. A clear example of this is the benefit of reduced pedestrian meter readings. The SMNCC assumes a benefit of £6 per meter per year – assuming 22 million meters covered by the price cap, then for every 1% reduction in the rollout profile means an additional 220k pedestrian meter readings, which has an annual cost of £1.3m. The churn of SMETS 1 meters in “dumb” mode has also added to operating costs. As with the SMETS 1 write-offs above, this clearly erodes the £309m allowance in the price cap up to March 2020.

It is essential that the above factors are fully examined to determine the real financial consequences of the lower rollout profile. We believe that these factors mean that any view that the reduced rollout profile has benefitted an efficient supplier is entirely inappropriate.

Rollout profile from April 2020

Ofgem considers various ways for setting the rollout profile from April 2020:

A - Continue using the EU trajectory: we appreciate that this is not aligned with the pace of the roll-out, although it would maintain incentives to expedite the programme to the extent possible;

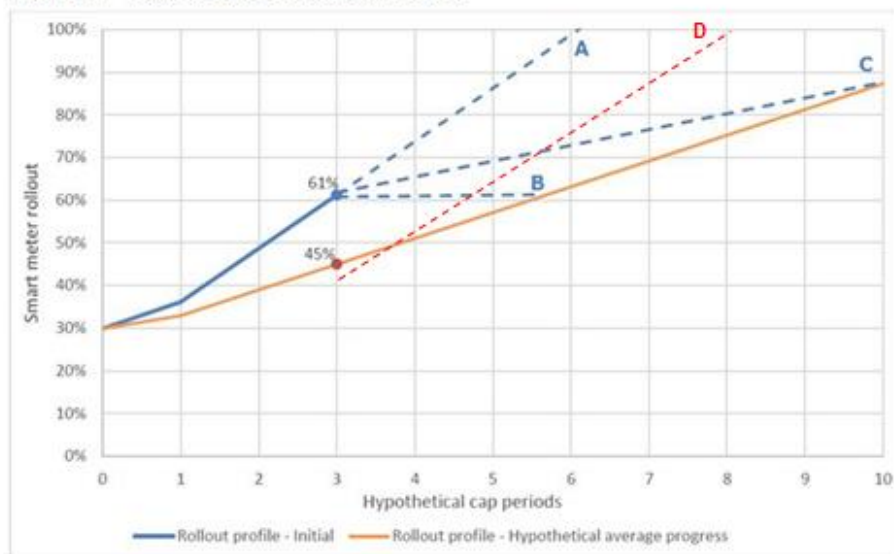
B - Flat line the rollout progress: as explained above, we do not agree that funding has been provided for 61% of the rollout. If the effect is to freeze the SMNCC allowance this would dampen incentives and undermine the roll-out

C - Set a new rollout trajectory: as explained above, we do not agree that funding has been provided for 61% of the rollout. We can see how this might be perceived to be an attractive option for aligning the recovery of costs with an updated estimate of the likely roll-out completion date. However, in the event that the price cap ends before completion of the roll-out, there is a risk that suppliers would not be able to fully recover the balance of smart costs in the competitive market,

jeopardising completion of the programme. It would be prudent to reflect this in any revised trajectory.

Alternative option D - we have outlined our concerns regarding the impact of the lower roll-out on costs, resulting in a lower % of the rollout having been funded than Ofgem states, along with the need for a prudent trajectory to mitigate the risk of under-recovery beyond the price cap. To illustrate how these concerns could be mitigated, we have overlaid onto Figure 3 in your paper, an alternative hypothetical change in rollout (see red line “D”). Further analysis would be required to determine what % of the roll-out has in fact been funded. For illustrative purposes only, we have assumed only 40% has been funded (it is highly likely to be less). If Ofgem persists with assuming that 61% has been funded, a recovery mechanism is required to adjust the SMNCC for the funding shortfall to date.

Figure 3 – Hypothetical change in rollout



Note: The hypothetical rollout progress of 45% is an arbitrary figure chosen for illustrative purposes because it is half ways between 30% (the average at the start of 2019) and 61% (the rollout in April 2020, using the assumption in the current SMNCC model).

Appendix 2: Impact of rollout profile on net costs (extract from npower response (May 2019) to Ofgem's SMNCC Review)

Ofgem indicate that as smart installations are likely to be lower than assumed in the non-pass-through model, allowances in the first two cap periods may be above the level of efficient costs. This is seriously and logically flawed. We are surprised and concerned that such an argument has been put forward when the financial dynamics of the smart metering rollout are well known across the industry.

It was a policy decision that the Smart programme be supplier-led, underpinned by a licence obligation to take all reasonable steps to install smart meters. As external agencies have limited resource, we and other suppliers invested in building the metering capability and expertise required to comply with our obligations. We have taken on fixed costs, including additional field installation engineers and back office staff, in anticipation of a rollout that has not materialised due to factors largely outside our control. We incurred those fixed costs in good faith and on the understanding that they would be externally funded and amortised over the life of the meter, in line with the practice across the industry. We would also highlight that high MAP charges are causing through life cost increases, particularly where acquired under "customer churn" arrangements.

We are being forced to incur inefficiency due to the delayed rollout as we have installation staff that cannot be efficiently utilised, and this manifests itself in the lower productivity rate (i.e. meters installed per day). These costs are not being offset by payments from the MAP where a smart meter has not been installed. The consequences of the delayed rollout is that suppliers received less income from the MAP (due to lower installations) but the cost base does not reduce by the same level due to a significant proportion being fixed. This drives up the net cost of smart during the current year, which is the exact opposite to the impact suggested by Ofgem above. The model of recovering installation costs through MAP charges is essential to avoid npower paying for a smart installation and then not being able to recover the cost from a customer if they leave us.

Ofgem seems to imply that the model assumes that 100% of smart costs are variable. This is not the case for our installation costs, which are a mixture of fixed and variable, and are offset by income from our MAP which is fully variable. The key smart costs and income for npower are:

- Cost of meter – this is a variable cost based on the volume of meters purchased, and the cost is offset by income from the MAP. Therefore, a reduction in the rollout volumes will mean less meters purchased, and less MAP income, which should broadly offset each other. There will be working capital implications as changes to the rollout profile impact the number of meters held in stock;
- Installation cost – whilst in the long term this cost is variable, in practice this is a mixture of fixed and variable costs. The smart rollout model used by the industry assumes that installation costs are offset by MAP Income;
- MAP installation income – this is paid by the MAP to suppliers on completion of a smart meter installation and is fully variable;
- IHD and Comms Costs – these are fully variable costs, so will reduce if there is a reduction to the rollout profile.

Consequently, the net impact of one less smart meter installed in 2019 is an increase in our net cost, and this should be reflected in the SMNCC as the majority of reasons for the delay to the rollout are industry related, not a reflection of supplier inefficiencies. We believe that the movement in the rollout from what was expected in 2018, to what is now planned in 2019, adds an additional £3 per meter to the SMNCC. This should be reflected in the price cap from October 2019.