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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 comment on Ofgem’s third ‘response paper’ (RP3) on ‘carry forward balances’, described in the paper as the difference between allowances in the first three price caps as assessed using Ofgem’s new SMNCC model and efficient costs incurred by suppliers in that period.

Extent of over/under-recovery

Ofgem acknowledges that, although the SMNCC allowance in Periods 1 to 3 was based on a rollout profile significantly above average actual rollout, this may well have been offset by unit net costs being too low. We believe this is definitely the case. Our internal analysis suggests that if Ofgem’s revised modelling exercise captures the previously missing costs, it will find that the extent of any under or over-recovery, on an industry average basis, has not been material. We therefore do not expect there to be any need to deal with a ‘carry forward’ balance.

Other impacts of proposed approach

We think Ofgem’s proposed approach to clawing back the ‘carry forward’ balance (should one exist) puts too much weight on the theoretical ideal of ensuring perfect cost recovery and too little weight on the practical consequences. These consequences include increased business planning uncertainty for suppliers (which will ultimately cost the consumer) and potentially weakened incentives to press ahead with smart rollout. Even if Ofgem finds there is a material carry forward balance, there should be a strong presumption in favour of not carrying it forward, unless the case for doing so is compelling.

Smart prepayment meters

Ofgem says (paragraph 4.17) that ‘The adequacy of smart funding for customers that are not on default credit tariffs is outside the scope of the default tariff cap review’. We disagree that it should be outside the scope of the current review. The CMA’s recent

review has shown there is currently a significant shortfall in the prepayment cap cost allowances.<sup>1</sup> This shortfall is likely to have been present in January 2019 when the DTC came into effect, and it would have been reasonable to expect that in a competitive market (before the DTC came into effect) efficient suppliers would have been able to recover this shortfall from DTC customers. If Ofgem intends to look at smart costs on a retrospective basis, it would be appropriate to consider this 'cross-subsidy' of smart costs as part of an efficient suppliers legitimate cost base, particularly as regards the 'fixed' element of smart costs which suppliers would have incurred with or without prepayment customers.

Even if Ofgem does not include the prepayment shortfall in the current review, we would note that Ofgem has said it intends to consider the case for a specific prepayment payment method uplift in the DTC.<sup>2</sup> When Ofgem comes to undertake this latter review (which we believe it should start as soon as possible), we would expect Ofgem to take full account of historic under-recovery of smart costs relating to prepayment customers. To adopt a retrospective approach (as Ofgem is proposing to do) for customers on credit meters, where Ofgem suspects suppliers may have over-recovered<sup>3</sup>, but not to do so for customers on prepayment meters, where there is clear evidence that suppliers have under-recovered, would be untenable. The fact that the prepayment cap is a separate legal instrument from the DTC would not be a valid justification.

#### Unit costs constant over time?

Ofgem argues that it does not matter whether a supplier's actual rollout profile leads or lags the assumed profile because they will be neutral over the period. This relies on the assumption that unit net costs are more or less uniform over the period: if unit net costs were falling over time, a supplier who lagged the assumed rollout profile would be better off (and vice versa).

There are many reasons why unit costs may change over time, both upwards and downwards, for example, later models of smart meters may be cheaper to rent and operate than earlier models (eg SMETS 2 vs SMETS1). If Ofgem intends to rely on this assumption we think it should consider the evidence to support it, and consider to what extent any deviation from the assumption may lead to distorted outcomes or incentives.

#### Stranded fixed costs

Ofgem notes (para 4.18) that it may be necessary to consider stranded fixed costs (costs incurred in anticipation of a rollout level that was not achieved) and that it might not be appropriate to assume that suppliers have not used the allowance when they have not met the corresponding level of rollout. We agree that Ofgem should consider this.

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<sup>1</sup> Final Decision – Market Investigation (Prepayment Charge Restriction) Order 2016:

*“As a result of the change of circumstance relating to policy and pass-through smart metering costs, our conclusion is that the PCR is no longer effective in meeting all of its aims, due to underestimating the costs incurred by efficient suppliers”.*

<sup>2</sup> Ofgem 'Decision – Default tariff cap decision – Overview document' 6 November 2018, para 5.23

<sup>3</sup> Eg see comment in paragraph 1.5 of PR3 regarding 'preliminary data'

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

Yours sincerely,



**Richard Sweet**  
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