

Anna Rossington
Deputy Director
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

19 November 2019

Dear Anna,

Reviewing smart metering costs in the default tariff cap

We are pleased to respond to your consultation of 22 October 2019 on 'reviewing smart metering costs in the default tariff cap'. This letter is accompanied by a confidential annex containing information derived from the disclosed model and subject to Ofgem's confidentiality conditions.

Ofgem's consultation and the disclosed model set out Ofgem's proposals and rationale for the level of the non pass-through smart metering net cost change (NPT SMNCC) allowance in future price cap periods. For the reasons given below, we consider that aspects of Ofgem's proposals are based on incorrect and uncertain assumptions, and cannot form the basis for a robust price cap from 1 April 2020 ('Period 4'). We believe Ofgem must therefore adopt its proposed contingency approach, which is to set the NPT SMNCC allowance for Period 4 based on its previous methodology, and delay introduction of the revised NPT SMNCC allowance until 1 October 2020 ('Period 5'). We note that if Ofgem adopts this approach, it says it would seek to adjust the allowance in subsequent price cap periods in respect of any resulting over-allowance in Period 4.

We believe it is necessary for Ofgem to adopt the contingency approach for the following reasons:

1. Incorrect assumptions in calculation of NPT SMNCC allowance

We have provided in Annex 1 details of three areas, listed below, where we believe the model relies on incorrect or inadequately evidenced assumptions. As noted below (section 4) we have been constrained by the very limited time allowed for us to respond to this consultation, and we will provide details of any other issues identified as soon as we are able.

- a) smart meter rental costs are based on an idealised and unrealistic methodology and are substantially below the actual market prices faced by suppliers;
- b) SMETS1 premature replacement charges (PRCs) are based on an assumed rate of replacement which is at variance with implied market expectations and unduly optimistic;

- c) switching benefits post 2022 make no (or inadequate) allowance for the costs that suppliers will incur to realise the benefits and are therefore over-stated.

In aggregate these result in a very material under-estimate of the NPT SMNCC allowance and we are doubtful that Ofgem can resolve them satisfactorily in time to consult on and publish amended Period 4 price cap levels by 7 February 2020.

2. Interaction with BEIS post-2020 rollout obligation has not been considered

Ofgem's model for the NPT SMNCC allowance uses a smart meter rollout profile between 2021 and 2024 based on BEIS' September 2019 consultation on smart rollout obligations beyond 2020¹. The proposed rollout target of 85% by end 2024 is considered by most suppliers to be unachievable, and a report by Frontier has been submitted to BEIS showing that a more realistic position at 2024 is around 68%, making it uncertain whether the 85% target will be retained by BEIS in its final decision.

Furthermore, by moving the basis for the obligation from 'all reasonable steps' to an absolute target, BEIS is in effect implying that suppliers may be required to take unreasonable (and costly) steps, for which no allowance is made in Ofgem's proposals. Whether or not 'unreasonable' steps are required, it seems likely that suppliers who face the prospect of severe financial penalties may be induced to offer aggressive acquisition tariffs for customer with smart meters, no allowance for the costs of which has been made in the default tariff cap.

We understand that the decision on future rollout obligations is a matter for BEIS not Ofgem, but given the significant interaction between the obligations and the NPT SMNCC allowance, we think it would be imprudent for Ofgem to confirm the level of the allowance until there is more visibility on BEIS' decision (and any appeal thereof) – particularly when Ofgem intends to lock down allowances for almost 4 years (see below).

3. There is too much uncertainty to lock down the allowance for 3.75 years

Ofgem is proposing to fix the NPT SMNCC allowance from 1 April 2020 to 31 December 2023 (should the cap be extended to this date), a period of 3.75 years with a 'very high bar on reviewing the allowances'². There is currently too much uncertainty to safely lock down the allowance for a period of this length, but if Ofgem was to wait until Period 5, some of the key uncertainties may be resolved, for example:

- the regulatory framework for smart meter rollout post 2020: we would hope that a decision from BEIS could be expected within the next 6 months;
- the proportion of SMETS1 meters that need to be replaced with SMETS2 meters in the course of enrolment and adoption: early data to test the validity of Ofgem's assumption may become available over the next 6 months.

Indeed, given that BEIS is suggesting a mid-period review of the smart meter rollout obligations, we think Ofgem might be better advised to schedule its own mid-period review (timed to take account of any decision from BEIS' review) instead of its 'very high bar' position.

¹ <https://www.gov.uk/government/consultations/smart-meter-policy-framework-post-2020>

² Condoc para 2.5

4. Suppliers have been given too little time to comment on the model

EnergyUK wrote to Ofgem on 5 November (and ScottishPower wrote in similar terms on 12 November) to express our concerns that suppliers were being given too little time to comment properly on the model, and requesting a two week extension to the response deadline, a request that Ofgem rejected.

The SMNCC model runs to over 40 separate worksheets, many of significant complexity, and there is no written user guide.³ The model is entirely new and suppliers have no prior familiarity with it⁴. In order to engage meaningfully with the consultation, suppliers need to get to grips with the workings of the model, map relevant cost and benefit lines between internal accounting views and the BEIS/Ofgem view, identify the source of any divergence, and then document and evidence any concerns within their consultation response. After allowing for internal start-up and review processes (including unnecessarily burdensome confidentiality restrictions), four weeks is far too short a period to do this. Based on Ofgem's own consultation policy, we consider a period of at least eight weeks should have been allowed.

If Ofgem adopts the contingency approach, it could then allow suppliers more time to review and comment on the model and reduce the risk that the consultation is held to have been unfair. This is all the more important when Ofgem is seeking to place the onus on suppliers to scrutinise the model and identify any omissions: "*Stakeholders should consider their own activities rolling out smart meters and the CBA document to check we have not excluded relevant costs and benefits*".⁵

Conclusion

In conclusion, for the reasons given above, we believe Ofgem should adopt the contingency approach proposed in its consultation. This will extend the deadline for finalising the NPT SMNCC allowance by 6 months. This time should be used to:

- allow suppliers further time to consider the detail of Ofgem's model and raise further issues in response to the current consultation;
- issue information requests to suppliers to gather data in areas where assumptions have been shown to be incorrect or insufficiently substantiated (notably smart meter rental rates);
- re-consult on a revised model and allowance, taking into account the wide range of material issues identified in response to this consultation, and any developments in BEIS' policy on post 2020 obligations.

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.

³ Our request for Ofgem to give us a verbal walk through of the model was rejected.

⁴ Although, as Ofgem notes, BEIS published its new CBA in mid-September, it was of limited value in preparing to review Ofgem's model. For example, costs and benefits were presented as NPVs over the modelling period, with no ability to identify the corresponding values for the price cap period.

⁵ Condoc para 3.14

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive, slightly slanted style.

Richard Sweet
Head of Regulatory Policy