Reviewing smart metering costs in the default tariff cap

Thank you for the opportunity to comment on Ofgem's proposals on the SMNCC review. This response reflects the views of both E.ON and npower.

We have commented below on Ofgem's proposals. Our main concern is Ofgem's intention to claw back what it sees as 'advanced payments'. No similar mechanism is provided elsewhere in the price cap methodology for any form of claw back, whether to rectify under- or over-forecasts; we do not believe it is fair for Ofgem to use such a mechanism in the SMNCC and yet deny it for other elements. We ask Ofgem to seriously reconsider its proposals in this regard.

Rollout projections

Installation of smart meters is a key part of E.ON's (and, as part of the E.ON Group, npower's) strategy for the future; we perceive benefits both for consumers and for suppliers and our aim is to complete the smart meter rollout as quickly and efficiently as possible. Applying more resource to the problem is not always the most sensible solution: efficiency requires that decisions must be taken based on realistic expectations of return for the investment made. This is reflected in the fact that Ofgem has chosen to require suppliers to take All Reasonable Steps, rather than a straightforward 'must ensure' requirement.

In paragraph 4.39 of the consultation, Ofgem states that suppliers suggested, in their responses to its October 2019 consultation[1], that they were not committing resources that would improve their performance to the extent required to deliver their smart rollout obligations. This does not reflect E.ON's view. We commit the relevant amount of resource necessary to install meters in customers' homes and businesses to efficiently deliver our strategy. Lack of rollout progress has far more to do with consistent delays to the smart metering programme, of which we talk more of later. We believe that most suppliers have done as much as was feasibly possible, given the circumstances. Ofgem should recognise this.

Given that the Government is still to consult on its new four-year framework to reach market-wide coverage of smart meters, we believe it is pragmatic to assume an installation rate for 2021 and beyond at the same rate achieved between 2017 and 2019. However, there must be allowance made for the difficulties suppliers will experience towards the end of the rollout, when suppliers will be left with customers who are unwilling to have smart meters fitted, or who fail to respond to communications. Many studies have shown that there is a cohort of customers who will resist smart meters being installed in their homes; little, if any, account has been taken of customers who are totally disengaged from the energy market and for whom an opt-out mechanism is the only workable solution.

[1] https://www.ofgem.gov.uk/system/files/docs/2019/10/smart_metering_review_in_the_default_tariff_cap_-_october_consultation.pdf

Benchmarking suppliers' efficient costs and benefits

We agree with Ofgem's proposal to use suppliers' average costs per customer, weighted by the number of customers they have. We do not consider this a relatively generous approach, as Ofgem claims.

Considering future reviews

We agree with Ofgem's proposal to review the SMNCC allowance every 12 months, assuming that the Secretary of State determines that the price cap should remain in place beyond the end of 2020. It is to be hoped that such reviews would recognise the real efficient costs of the smart meter rollout; in particular, as the rollout progresses, the increasing costs of engaging reluctant or disengaged consumers that will become even more difficult unless Government removes consumer choice to have a smart meter installed. The reviews will also be able to take account of any further delays in delivery of some of the remaining technical elements of the project and the consequent, unavoidable, additional costs for suppliers.

We have concerns that Ofgem states it does not *"expect to carry out future reviews with the same level of detail as this consultation."* This pre-supposes that the future for the rollout is predictable, whereas there are still a number of uncertainties about what technical requirements are capable of being delivered and by when. As part of its consultation at each 12-month period, Ofgem should be open to challenges from stakeholders on what elements of the methodology require a more detailed review.

Sufficiency of the cap level and double-counting

Suppliers have taken significant steps to reduce their costs since the introduction of the price cap, which may or may not have improved efficiency but will have reduced their costs; nevertheless, nearly all suppliers continue to make a loss. We continue to assert that the price cap methodology is insufficient to maintain profitability for an efficient supplier.

However, we appreciate that it would be unacceptable to double count smart metering costs and therefore, to the extent that costs are duplicated, under the correction mechanism Ofgem is proposing it is appropriate to make an adjustment. Ofgem claims (paragraph 7.14) that most default tariff customers were supplied at close to maximum cap level and therefore the full amount of the SMNCC (for an efficient supplier) was recovered. However, due to the SMNCC allowance and some other allowances being *in*sufficient, the restraints of the price cap meant that the full cost of smart installations were not recovered, and therefore there has been less double-counting than Ofgem asserts.

We must also point out that a proportion of costs of delayed installations are unavoidably fixed and therefore incurred whether or not a meter is installed. Ofgem states that *"In normal circumstances, suppliers have installed smart meters at a stable rate between 2017 and 2019."* (paragraph 4.18). Installations in those years were less than Government and Ofgem expected, and less than suppliers had planned for due to circumstances outside of their control, e.g. resolution of issues such as RF noise, complex meters, ALT HAN, Dual Bank Communications Hubs and SMETS2 prepayment, and consumer resistance to smart meters. It is disingenuous for Ofgem to claim that because the level of installs was flat, it was as predicted and did not result in sunk costs.

Ofgem considers that *"A supplier should expect a degree of volume risk …, have experience of mitigating the impact of delays and barriers …, and good estimates of the resources it will likely require"* (paragraph 4.18) and *"an efficient supplier should have been able to anticipate and mitigate the impact of delays …"* (paragraph 7.18). We agree that, to an extent, this is possible and a prudent supplier would have built (and, in E.ON's case, did build) as much flexibility into its plans as possible. However, Ofgem and the Government urged suppliers to make their delivery plans in accordance with readiness timetables provided by the industry, which they did. It transpired that those timetables were delayed, often by a considerable amount of time, making it impossible for suppliers to deliver their rollout plans; the amount of delay was such that even the most prudent suppliers will have incurred some degree of unavoidable fixed costs. Ofgem must make allowance for this, and we therefore believe that, instead of adopting its proposal to recognise the advanced payment in full, it should adopt its option to recognise a proportion of advanced payments since 1 October 2019; Ofgem should base its assessment of the relevant proportion on the average unavoidable costs experienced by suppliers.

Considering advanced payments carried forward

In consultations prior to the implementation of the price cap concerning design of the cap methodology, E.ON and other suppliers consistently called for correction mechanisms to deal with inaccuracies in forecasting and Ofgem consistently denied such requests. In terms of the costs of the smart meter rollout and its uncertainties, Ofgem decided that, instead of a correction mechanism, it would carry out a review of costs at a single point in time; this was the closest it came to a correction mechanism prior to implementation of the cap and, given the particular uncertainty of smart meter rollout costs, we were supportive of this.

Due to the Government finally acknowledging that the timescales for delivery of the smart meter rollout were impossible to achieve (due to unrealistic system and technical delivery targets and requiring customers to opt in rather than allowing them to opt out of having a smart meter), the deadline for delivery of the rollout has been extended; we acknowledge, therefore, that it is pragmatic to carry out further reviews of smart meter rollout costs. We are strongly opposed, however, to the use of correction mechanisms to deal with previous forecast inaccuracies unless they are applied to all cost elements in the price cap. Ofgem appears to have taken a 'pick and mix' approach to correction mechanisms, applying them where it believes that the price cap has been overstated, but refusing to consider them where there is a risk that the price cap has been understated (except as, in the case of the High Court's decision in November 2019[2], it is forced to do so – although we believe that Ofgem should merely have sought to reverse its original decision in this case rather than adopt a correction mechanism approach).

In the case of bad debt costs during COVID-19, Ofgem is refusing to make any attempt to forecast at all and intends to correct at a later date; it seems to believe that, despite it already being over-subscribed, suppliers can utilise headroom in the short term to cover the bad debt costs. We have

[2] https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html

always maintained that the headroom allowance is totally inadequate, given the insufficiency of some of the forecasts for some price cap elements and the number of unforeseen mutualisations (which have largely resulted from lax market entry rules and inadequate monitoring of new entrants to the energy market).

We welcome Ofgem's decision not to correct for forecast errors in the first two cap periods, but believe that Ofgem should go further; either it should not correct for forecast errors at all (including in the SMNCC (notwithstanding COVID-19 impacts, which we discuss below) or should correct for errors in all elements of the price cap methodology. Selectivity implies a bias which, on the basis of Ofgem's proposals, would appear to be in favour of corrections to lower the cap. This could result in pricing the cap at a level below that of an efficient supplier and thus prevent suppliers from financing their activities, a matter to which Ofgem is required, under the Domestic Gas and Electricity (Tariff Cap) Act 2018 to have regard to.

We urge Ofgem not to carry forward any 'advanced payments' or, alternatively, to allow for correction mechanisms in all aspects of the price cap and to review the sufficiency or otherwise of headroom to cope with any further unaccounted for costs.

Despite this, if Ofgem continues with its proposals in this respect, we agree with its proposal to spread any advanced (or lagged) payments carried forward over all of the potential cap periods up to the end of 2023. This avoids artificial volatility in prices which could lead to consumer distrust and distorts comparisons with fixed term tariffs.

COVID-19

We welcome Ofgem's proposal to use its 'delayed' rollout profile for 2020, assuming an installation rate of 30% to reflect the impacts of COVID-19, and its Scenario A: assumption that suppliers are exposed to sunk installation costs (during the epidemic) and are unable to mitigate them (except for tools and materials). We recognise that, at this stage, there is insufficient data to assess the COVID-19 impact and that, therefore, it will be necessary to assess the impact in arrears and make a retrospective adjustment in the following cap period. Under the particular circumstances of COVID-19, which were unforeseeable, we accept that such a correction mechanism is reasonable. Ofgem must also recognise that suppliers will incur additional costs as a result of the pandemic, for example from procuring PPE, field staff needing to isolate, additional training for field staff and changes to installation processes, plus risks of late appointment cancellations where customers become infected by, or are at risk of infection from, COVID-19.

At E.ON we have recently restarted our appointment booking and some smart meter installations, and we are pleasantly surprised that there has been less resistance than we anticipated from customers to having a smart meter installed on their premises; however, it is still too early to form a conclusive view of recovery of demand, with sections of the community remaining in self-isolation and differences in relaxation of lockdown rules in the devolved administrations. This is making the recovery complex and slow.

At this stage it is impossible to say what the extent of deviation from our rollout plans will be or for how long the impacts of the pandemic will be felt – on present medical advice, it could be well into 2021, albeit, hopefully, to a lesser extent.

Contingency

We agree with Ofgem's contingency proposal to delay a decision on advanced payments until after the next proposed SMNCC review to allow it to gather more information, but to go ahead with the remainder of its proposals for the fifth cap period (starting 1 October 2020).