

Consultation

Updating allowance for smart metering costs in the default tariff cap: working paper

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This working paper is the start of the consultation process for updating the smart metering allowance in the default tariff cap in time for winter 2021-22. It is the first in a series of three consultations leading up to the decision next summer. We would like views from people with an interest in the level of the default tariff cap. We particularly welcome responses from domestic energy suppliers and consumer groups. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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Executive summary

This working paper is the first step towards updating the Smart Metering Net Cost Change (SMNCC) allowance in the default tariff cap in time for winter 2021-22 cap level.

Following multiple consultations, we updated the SMNCC in August 2020. At this stage, we do not consider that many changes are required to what we set out in our August 2020 decision.

We will publish two working papers. This first working paper focusses on areas where we might need to collect more data, and areas where we seek early feedback. The second working paper will focus on issues relating to rollout. We will publish this early next year, after the Department for Business, Energy and Industrial Strategy (BEIS) publishes its consultation on setting the tolerances which will apply as part of its smart meter policy framework post-2020.

Data

We propose to update the SMNCC model using suppliers' Annual Supplier Returns to BEIS. Except as set out in the next paragraph, we are not currently considering carrying out further data gathering.

For sunk installation costs, we can collect actual data on installation costs for 2020, which we can use to update our estimates of sunk installation costs. We discuss options for doing this in this working paper. We also explain how we might estimate sunk installation costs for 2021, if necessary.

Other areas

We also discuss key areas where the approach may differ (from the approach in previous cap periods) when we implement the results of this review. We are reviewing our approach to considering the impact of uncertainty in our modelling, particularly how we could calculate a numerical uncertainty adjustment if required. We note that – in line with our August 2020 decision – advanced payments would start to take effect from this review. We set out our initial view that the SMNCC values calculated in our August 2020 decision for future cap periods could be a suitable fallback position which could apply if we cannot reach a conclusion on our current review.

We are requesting responses by **21 December 2020**. Following our two working papers, we intend to issue a consultation in late spring 2021. This would be followed by a decision in the summer, setting the SMNCC from 1 October 2021.

1. Introduction

What are we consulting on?

1.1. The default tariff cap protects domestic customers on default tariffs, ensuring that they pay a fair price for their energy, reflecting its underlying costs. This is part of the “Protecting customers” strategic objective mentioned in our Forward Work Programme.¹

1.2. One cost to suppliers is the net cost of installing and operating smart meters. We reflect the costs of smart metering in the default tariff cap through two allowances. The operating cost allowance includes the cost of smart metering in the 2017 baseline year (alongside other operating costs). The Smart Metering Net Cost Change (SMNCC) allowance reflects the change in smart metering costs since 2017. The SMNCC allowance comprises a ‘pass through’ element covering industry charges relating to smart metering and a ‘non pass through’ element covering suppliers’ own smart metering costs. This working paper focuses on the non pass through SMNCC (which we refer to as the SMNCC for the remainder of this document).

1.3. The purpose of this working paper is to give stakeholders the opportunity to comment on any changes we might make to our current approach to setting the SMNCC allowance. Specifically to:

- allow stakeholders to suggest any areas where they consider we should gather more data;
- understand how we should take into account the impact of COVID-19 on suppliers’ smart meter installation costs, once we have actual data on suppliers’ installation costs in 2020;
- give stakeholders the opportunity to comment on other areas where the context may be different when setting an allowance for future periods, compared to when

¹ Ofgem (2019), Forward Work Programme consultation 2020-22, p4 and p12.
https://www.ofgem.gov.uk/system/files/docs/2019/12/fwp_programme_2020_22_web.pdf
(Given the effects of COVID-19, we did not publish a finalised Forward Work Programme for 2020 – see: <https://www.ofgem.gov.uk/publications-and-updates/forward-work-programme-202021>).

we were setting an allowance for previous periods (e.g. our approach to setting an uncertainty adjustment); and

- allow suppliers to provide any other feedback on our approach.

Chapter 1: Introduction

1.4. This chapter explains the purpose of this working paper, and outlines our consultation process.

Chapter 2: Cost and benefit input data

1.5. This chapter discusses where we propose to update the SMNCC model with new data, and where we do not propose to do so.

Chapter 3: COVID-19 and installation costs

1.6. This chapter discusses how we may update our approach to measuring the effect of COVID-19 on suppliers' smart meter installation costs, given the availability of more data.

Chapter 4: Other areas

1.7. This chapter discusses our approach to considering the impact of uncertainty in our modelling, the implementation of advanced payments, and the fallback values that we may use if we cannot reach a conclusion on our current review.

Context and related publications

1.8. This is a short working paper. We have already consulted on the SMNCC allowance multiple times, and published a decision in August 2020. Rather than discuss the full set of issues from scratch, this working paper is the first step in reviewing whether there are any changes we need to make when setting the SMNCC allowance from October 2021. Otherwise, our intention is to follow the same approach as set out in our August 2020 decision.

1.9. A key element of this working paper is to consider the impact of COVID-19 on suppliers' smart meter installation costs. In our August 2020 decision, we recognised that suppliers would have fixed costs which they could not avoid, despite installing fewer smart meters than expected, and that these costs would therefore be unproductive ('sunk'). We made an initial adjustment for sunk installation costs. We set this on a conservative (i.e.

high) basis. We said that we would reflect the actual costs when we had data available through the Annual Supplier Returns (ASRs).² We will get this data next year – but in advance, we want to consider how to do this true-up.

1.10. Another issue which we will consider in this review is the impact of the Department for Business, Energy and Industrial Strategy's (BEIS) new smart metering rollout framework. BEIS has already set out its decision on this new framework, including that suppliers will be set installation targets subject to an annual tolerance level.³ BEIS has indicated that it will consult on annual tolerances associated with this framework. BEIS's policy has interactions with our SMNCC allowance, as it affects the rollout profile within our SMNCC model.

1.11. Given BEIS has not yet published its consultation, we do not discuss the issues which relate to rollout in this first working paper. Rather, we will publish a separate working paper on the rollout-related issues, after BEIS publishes its consultation. We expect this to cover: the rollout profile we use, whether the rollout profile should be for an average or a market-leading supplier, and installer productivity. It may also cover any potential knock-on implications of BEIS's policy – e.g. on suppliers' marketing costs.

1.12. Key related publications:

- August 2020 decision: <https://www.ofgem.gov.uk/publications-and-updates/decision-reviewing-smart-metering-costs-default-tariff-cap>
- BEIS 2020 decision on the smart metering framework: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/893124/delivering-smart-system-post-2020-govt-response-consultation.pdf

² This refers to data collected by BEIS.

³ BEIS (2020), Delivering a Smart System Response to a Consultation on Smart Meter Policy Framework Post-2020. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/893124/delivering-smart-system-post-2020-govt-response-consultation.pdf

Consultation stages

1.13. This is the first of two working papers. As discussed above, we will publish a second working paper focussing on issues related to rollout. We will do this after BEIS has published its consultation on the tolerances for its smart metering policy framework post-2020. This is scheduled in autumn 2020. This will enable us to take into account BEIS's consultation position in our second working paper.⁴

1.14. We intend to issue a consultation in late spring 2021. This will allow us to take into account feedback on the two working papers, any subsequent data gathering (if required), and the updated ASR input data.

1.15. Alongside our 2021 consultation, we expect to carry out a similar disclosure process as for our May 2020 consultation. This would enable stakeholders to inspect the SMNCC model and for their advisers to inspect certain other pieces of analysis, in each case subject to confidentiality restrictions.

1.16. Subject to the 2021 consultation, we intend to announce our updated SMNCC allowance values at the start of August 2021. This aligns with our six-monthly updates to the cap. These updated SMNCC allowance values would take effect from cap period seven (beginning in October 2021).

How to respond

1.17. We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

1.18. As a matter of style, we do not ask specific questions in this document. Rather, we welcome views on any of the matters discussed in this working paper.

1.19. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

⁴ The reason for publishing a first working paper now is so that we have time to carry out any further data gathering following supplier feedback, if required.

Your response, data and confidentiality

1.20. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.21. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.22. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 1.

1.23. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

1.24. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?

5. Did it make reasoned recommendations for improvement?
6. Any further comments?

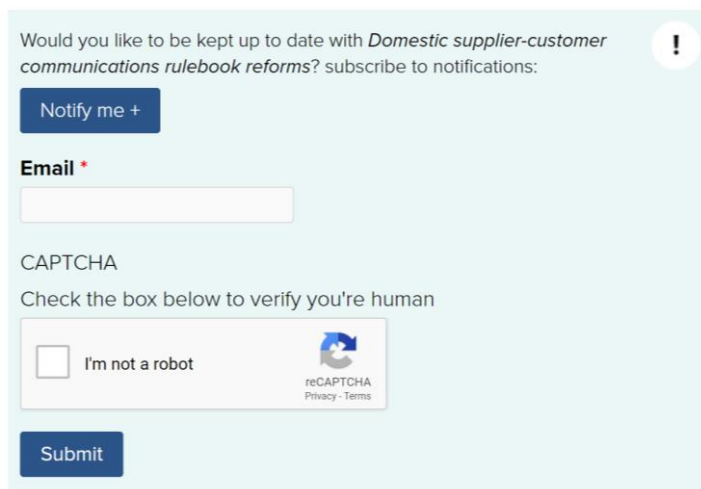
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How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website.

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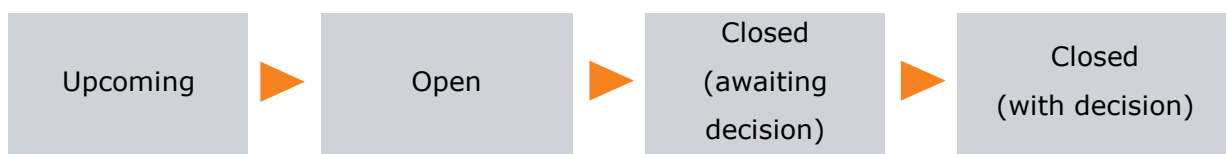
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Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:



2. Cost and benefit input data

As set out in our August 2020 decision, we intend to update the SMNCC model using ASR data in certain main areas. We describe this data, and repeat our position that we do not intend to gather additional data. If stakeholders disagree, they should provide suggestions for data gathering in response to this working paper.

We seek stakeholders' views on any of the areas covered in this chapter.

Annual Supplier Return data

2.1. Suppliers⁵ submit ASR data to BEIS each year. This data provides information on costs related to smart and traditional metering that they have incurred in the previous year.

2.2. As set out in our August 2020 decision,⁶ we intend to update the SMNCC model using ASR data in certain areas. This will ensure that the significant inputs are updated. Aside from rollout (which we will cover in our second working paper), the areas which we said in August that we would update were:

- the costs of smart meters, communications hubs and IHDs;
- smart meter installation costs; and
- the number and cost of avoided site visits.

2.3. This is not all the data included in the ASRs. We do not consider that the other areas included in the ASRs are as significant, or likely to have changed materially. As set out in our

⁵ Those defined as Large Energy Suppliers for the purpose of smart meter reporting.

⁶ Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraph 5.41.

https://www.ofgem.gov.uk/system/files/docs/2020/08/reviewing_smart_metering_costs_in_the_default_tariff_cap_-_august_2020_decision.pdf

August 2020 decision, we do not expect to carry out future reviews with the same level of detail as our May 2020 consultation, as we consider this would be disproportionate.⁷

2.4. Where we update input data, we will also make any consequential mechanistic changes to the SMNCC model⁸ to reflect the fact that this data is now actual rather than forecast. For example, we would no longer apply optimism bias to the 2020 values, and we would start any assumed cost erosion from after the last actual data.

2.5. We expect the cleaned ASR data to be available to us in spring 2021, ahead of our 2021 consultation.

Other data gathering

2.6. At this stage, we do not consider that we require any further data for this review. We have already gathered significant amounts of information through several RFIs in the run-up to our August 2020 decision. Further data gathering is not likely to increase the accuracy of the SMNCC model significantly (for example when this would involve gathering data in areas which have low absolute costs), and is not a proportionate use of resources.

2.7. Given that we carried out a full review of the SMNCC model very recently, we also do not consider it necessary to update the data we gathered previously. We are not aware of significant changes to the underlying technological or commercial features of the smart meter rollout since our last review which would make our previous data materially inaccurate. Any data for 2020 could also be distorted by the temporary impacts of COVID-19, reducing its usefulness for projecting costs in future years.

2.8. Should any stakeholders disagree with this proposal, they should explain why in response to this working paper. Stakeholders should explain – in as much detail as possible – what data they consider we should gather, and the reasons for this. When explaining the reasons for further data gathering, stakeholders should explain why this would be proportionate and likely to significantly increase the accuracy of the SMNCC model.

⁷ Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraph 5.39.
https://www.ofgem.gov.uk/system/files/docs/2020/08/reviewing_smart_metering_costs_in_the_default_tariff_cap_-_august_2020_decision.pdf

⁸ The SMNCC model is the spreadsheet we use to calculate the SMNCC allowance.

2.9. To gather data in time for a decision in early August 2021, we would need to issue any request for information in January 2021, so that we can review and analyse the data in advance of the 2021 consultation.

2.10. We therefore encourage stakeholders to take this opportunity to provide any additional feedback on our proposed approach.

3. COVID-19 and installation costs

In our August 2020 decision, we included an estimated adjustment for sunk installation costs (i.e. where there is an immediate cost to the supplier rather than being able to spread costs over several years) in 2020 due to COVID-19. We now discuss the options for including a true-up to reflect actual data on installation costs in 2020. We also note the possibility of sunk installation costs in 2021, and invite any initial views from stakeholders on this.

We seek stakeholders' views on any of the areas covered in this chapter.

Background on installation costs and sunk installation costs

Normal approach to installation costs

3.1. Data on installation costs is available in arrears through the ASRs. For the years where we have actual data, our normal approach is to calculate the average cost per smart meter installation using this data. We divide the total installation costs by the total number of installations. We then amortise the average cost (to spread it over a number of years) and apply the meter rental uplift. (The meter rental uplift reflects that the rental payments suppliers pay to Meter Asset Providers (MAPs) may not correspond to the way we model the costs of smart meter assets and installations).⁹ We use this uplifted cost per installation in the SMNCC model. The total installation costs then depend on rollout in that year.

3.2. For future periods, we estimate the installation cost by taking the latest historical average installation cost and adjusting it based on expected future changes in productivity. We then amortise this value and apply the meter rental uplift. The total installation costs are the uplifted average cost multiplied by the number of smart meters that we expect will be rolled out in that year (according to the rollout profile used).

⁹ We discussed the meter rental uplift in our previous documents. See for example Ofgem (2020), Technical annex to reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraphs 3.29 to 3.42. https://www.ofgem.gov.uk/system/files/docs/2020/08/technical_annex_to_reviewing_smart_metering_costs_in_the_default_tariff_cap_-_august_2020_decision.pdf

Installation costs under COVID-19

3.3. Restrictions due to COVID-19 limited suppliers' ability to install smart meters for a period in 2020. This was likely to reduce the total number of smart meters suppliers could install in the year. However, many of suppliers' installation costs are fixed costs (rather than scaling with the number of installations) and it is possible that suppliers would not be able to redeploy all of these costs.

3.4. Taken together, these factors created the possibility that the average cost per smart meter installation was higher in 2020 than in previous years. However, suppliers would only be able to include in meter rental charges the costs which related to the meters that were actually installed. The remaining costs would be an immediate (sunk) cost to suppliers.

3.5. We therefore made provision for sunk installation costs in the 2020 SMNCC allowance in our August 2020 decision using the methodology below.

- We developed a COVID-19 rollout scenario, which assumed that installation numbers in 2020 were 30% of the level previously expected (absent COVID-19). (This was a conservative assumption). This scenario gave us an estimate for the number of smart meters which would be installed in 2020.
- To estimate the number of smart meters whose installation costs were sunk, we took the difference between the rollout profile absent COVID-19 and the COVID-19 scenario.
- We estimated the expected cost per installation by starting with the installation cost from 2019. We then assumed that, absent COVID-19, installer productivity in 2020 would have been in line with the average over 2017-2019, and adjusted the 2019 installation cost accordingly.
- For the assumed installed meters, we calculated installation costs in the normal way described above, by amortising the cost per installation and applying the meter rental uplift.
- For the meters which were not installed, we assumed that nearly all installation costs were sunk. (This was again a conservative assumption). We multiplied the proportion of costs which were sunk by the expected cost per installation, in order to give the sunk installation costs per meter.

- To get the total sunk installation costs, we multiplied the number of meters which were not installed by the sunk installation costs per meter. As these costs are sunk, we included these as an immediate cost to suppliers in 2020, rather than amortising them. We did not apply the meter rental uplift, given that these costs would not be reflected in meter rental charges as the meters were not installed.

Updating 2020 installation costs with actual data

Why is there an issue?

3.6. If we updated our 2020 installation costs using our normal approach (i.e. without sunk installation costs), we would use the actual installation costs and actual installation numbers to calculate an average cost. This would likely be higher than previous years, given that we expect costs would largely be the same but there would be fewer installations.

3.7. Our normal approach would then amortise all these costs. To the extent that some costs were sunk (i.e. should not be amortised), this would understate the costs that suppliers faced in 2020 and overstate the costs they faced in subsequent years.

3.8. Our normal approach would also apply a meter rental uplift to the amortised costs. This would exacerbate the problem of overstating costs in subsequent years.

3.9. The misstatements of costs would affect the accuracy of our SMNCC allowances in three ways.

- 2020 will be a historical year by the time we implement the results of this review. However, our assessment of smart metering costs in 2020 is still relevant for the calculation of advanced payments. If we understated the costs that suppliers faced in 2020 (by failing to recognise sunk installation costs), then we would overstate the value of advanced payments, and therefore the amount we recover in future cap periods.
- We include the amortised costs of 2020 installations in future years. By overstating these costs, we would be overstating the SMNCC allowances in future cap periods.
- Our normal approach also uses the previous year's average installation costs as the starting point for projecting installation costs in future years. If we overstated

the average installation cost in 2020, this would lead us to overstate installation costs in future years. We would therefore overstate the SMNCC allowances in future cap periods.

3.10. The reason we included sunk installation costs in our current SMNCC model is because we expect that suppliers cannot amortise more installation costs than can be included in MAP charges. This logic does not disappear when the average installation costs are based on actual data rather than forecasts. We therefore need to find a way to take the new installation cost data into account, while still allowing for sunk installation costs.

Data on installation costs

3.11. The ASR data will provide us with each large supplier's average installation cost and number of smart meter installations. This will allow us to calculate the total installation costs incurred in 2020 by large suppliers.¹⁰

3.12. This depends on the ASR data reflecting the costs that suppliers actually incurred, taking into account as much as possible the effects of COVID-19 – though we note that the full costs may not yet be clear and this single timepoint data collection is unlikely to be a comprehensive view. Suppliers may have incurred some new installation costs due to COVID-19, such as the costs of Personal Protective Equipment (PPE) for meter installers. Suppliers may also have avoided some costs within their smart metering operations, for example by making use of the furlough scheme, or by redeploying staff to other activities.

3.13. BEIS is consulting with suppliers over the content of the cost information collected and how best to capture the impact of specific COVID-19 related costs. We encourage suppliers to flag as soon as possible (to ourselves and BEIS) if they consider that there are changes in total installation costs due to COVID-19 which would not be properly isolated by the current template.

3.14. Our normal approach is to assess smart metering costs using an average efficiency standard. Individual suppliers will have costs which are above or below the average – for example depending on the extent to which suppliers made use of the furlough scheme. Even though COVID-19 is an unexpected event, we do not consider that there is a reason to move

¹⁰ Although the suppliers who provide ASR data do not cover the whole market, they do supply most default tariff customers.

away from the average efficiency standard for smart metering. Using a less stringent efficiency standard (i.e. lower efficiency, with higher costs) would reduce protection for customers, which is against the objective of the Domestic Gas and Electricity (Tariff Cap) Act 2018.

3.15. The ASR template would not provide us with data about the split of costs between those that can be amortised and those which are sunk. We consider the implications of this in the next section.

Considering sunk installation costs

3.16. We have identified three options for estimating actual sunk installation costs in 2020. We welcome any views from stakeholders on these options.

3.17. The first option is to gather data from suppliers on the split of total installation costs between the costs which related to meters which were installed and the costs which were sunk. This would be a direct way of estimating the sunk installation costs.

3.18. The issue is whether suppliers would be able to provide this data with any degree of precision. Although suppliers would have data on total installation costs (as provided through their ASR returns), they may not have a business need to work out what proportion of these costs were sunk. This could affect the accuracy of any estimates provided. Although suppliers will have commercial arrangements in place with MAPs for meters that are installed, installation payments from a MAP to a supplier may reflect commercial negotiations rather than the actual costs incurred in relation to those meters.

3.19. We particularly welcome any comments from suppliers on whether this option is practical – and if so, how we should structure any data gathering.

3.20. The second option is to estimate the sunk installation cost as a residual. We would start with the total installation costs, based on ASR data. We would subtract an estimate of the costs for the meters that were installed. This would be the number of meters installed (from the ASR data), multiplied by an estimated cost per installation. The latter could be the current projected average cost per installation in the SMNCC model for 2020.

3.21. The advantages of this option are that it would be straightforward, and would not require further data gathering. It would however be relying on an assumption that the cost

per meter for meters which were installed was unchanged¹¹ from the value we modelled absent COVID-19. It would therefore not take into account any additional costs that suppliers had incurred (e.g. PPE). It would also not capture any trends in installation costs for other (non-COVID-related) reasons – e.g. technological developments affecting the number of failed installations, and therefore installer productivity.

3.22. The third option would be to estimate sunk installation costs as a proportion of total installation costs. We would divide total installation costs by the number of meters that we expected to be installed in 2020, based on our rollout profile absent COVID-19. Sunk installation costs would therefore be this revised average cost figure, multiplied by the difference between the number of expected installations and the number of actual installations.

3.23. This approach would not require an input for the expected cost per installation absent COVID-19 – we would only be using actual cost data. This actual cost data might pick up any general trends in installation costs. However, it would rely on the assumption that COVID-19 has not affected the total installation cost. This might be unlikely, as there are factors which could have affected total installation costs, e.g. the furlough scheme. Given the unprecedented nature of COVID-19, it seems likely that any COVID-related effects would be larger than any general trends in installation costs.

3.24. Our initial view is that the second option could be a simple way of estimating sunk installation costs. However, we await any feedback from stakeholders on whether the first option is likely to be practical and more accurate than the second option. At this stage, we do not consider that the third option is likely to be best, given that it requires a very strong assumption.

3.25. In each case, we apply the meter rental uplift to the installation costs for the meters that were installed. In effect, this assumes the relationship between costs and meter rental charges is unchanged. This may or may not be true. For example, meter rental charges may have been fixed on long-term contracts with MAPs, meaning that they would not adjust in response to changes in installation costs. In this case the actual meter rental uplift would

¹¹ In real terms.

shrink as installation costs grew – so by applying a fixed meter rental uplift we would overstate costs.

3.26. We recognise that our meter rental uplift was calculated based on a snapshot year, and that there may be some fluctuations over time. However, our initial view is that any changes to the size of the meter rental uplift are relatively unimportant, compared to the issue of estimating the proportion of total installation costs which are sunk.

Projecting sunk installation costs in 2021

Whether suppliers will incur sunk installation costs

3.27. We currently only include sunk installation costs in 2020. Suppliers have restarted smart meter installations, but it is possible that there may be some restrictions linked to COVID-19 in 2021. This could lead to sunk installation costs. However, this is subject to uncertainties.

3.28. First, the COVID-19 situation is very uncertain. At this stage, we do not know what restrictions may be in place over 2021.

3.29. By the time of our 2021 consultation, we will know what has happened over the first months of 2021. We may also have more developed expectations than at present about what may happen in relation to COVID-19 over the remainder of 2021. This will remain uncertain though – especially what restrictions may be required for winter 2021-22.

3.30. Second, the extent to which suppliers incur sunk installation costs will depend on their ability to adjust their cost base. Suppliers only incur sunk installation costs where their cost base is unable to respond to changes in the number of meters installed.

3.31. Unlike when planning for 2020, suppliers will now be aware of the uncertainty caused by COVID-19, and may try to take this into account when planning their smart metering operations for 2021. We expect that an efficient supplier would make significant efforts to try to avoid incurring unproductive costs, by increasing the flexibility of its cost base. This would allow it to adjust its cost base depending on how COVID-19 is affecting its ability to roll out smart meters. We also expect that an efficient supplier would be able to take additional steps as more time becomes available.

3.32. However, there may be limitations on the extent to which suppliers are able to change their rollout programmes to a significant extent in the middle of the rollout. In particular, renegotiations may be difficult as counterparties (e.g. MAPs and third party installers) would not want to take on COVID-related risks themselves.

3.33. We welcome any initial views from stakeholders on whether suppliers may incur sunk installation costs in 2021. In particular, we welcome any comments from stakeholders on the extent to which suppliers could take action to avoid sunk installation costs, especially where these are accompanied by evidence.

How to take sunk installation costs into account

3.34. If we conclude that we need to allow for sunk installation costs in 2021, we expect that we would follow a similar approach to the way we estimated sunk installation costs in 2020.

3.35. This requires us to estimate three values:

- the number of meters whose costs would be sunk;
- the proportion of costs which are sunk when an installation cannot be carried out; and
- the cost per installation absent COVID-19.

3.36. To calculate the number of meters whose costs would be sunk, we would take the difference between our modelled rollout profile for 2021 and an expectation of the number of meters which would be installed in practice (taking into account COVID-19). At the point of the 2021 consultation, we would be able to look at rollout in the first few months of 2021, and compare this against the peak rollout achieved historically. Beyond this, estimating rollout for the remainder of the year would require judgement – e.g. based on expectations about the progress of COVID-19 and associated restrictions. We would also be able to sense check our assumption against the rollout achieved in 2020. Unless there was a clear expectation that restrictions would be more severe in 2021 than in 2020, the proportion of expected rollout achieved in 2020 could be a lower bound for what might be achieved in 2021.

3.37. For the proportion of costs which are sunk where an installation does not occur, our starting expectation would be that we would need to maintain the assumption from our

August 2020 consultation that costs are almost all sunk. Data from 2020 would not be useful as an indication for the proportion of costs which are sunk in 2021, given that the support available to suppliers (e.g. through the furlough scheme) is unlikely to be the same in each year.

3.38. Estimating what installation costs would have been in 2021, absent COVID-19, is complicated by the fact that the previous year's costs are also affected by COVID-19. We therefore cannot use installation costs or productivity in 2020 as a baseline. Our initial view is therefore that we would use the same projected cost¹² as for 2020 (i.e. what we expected installation costs to be in 2020 absent COVID-19).

Sunk installation costs beyond 2021

3.39. The cap periods covered by this review extend into 2022.¹³ In principle, there could also be sunk installation costs in that year. In practice, the COVID-19 situation is sufficiently uncertain that we have no confidence that making a sunk installation cost adjustment for 2022 would increase the accuracy of our SMNCC allowance (rather than reducing it).

3.40. Furthermore, to the extent that suppliers are able to include more flexibility in their plans when they have more time to do so, this would apply to a greater extent by 2022. This could also reduce the likelihood of suppliers incurring sunk installation costs.

3.41. Our initial view is therefore that we would not include sunk installation costs for 2022 as part of this review. We would instead consider 2022 as part of any future review.

¹² In real terms.

¹³ Whether the cap is extended into 2022 is subject to a decision by the Secretary of State. Each summer, we must review whether the conditions are in place for effective competition, and publish a report, including a recommendation on whether the cap should be extended or not. The Secretary of State will then decide whether to extend the cap.

Domestic Gas and Electricity (Tariff Cap) Act 2018, Sections 7 and 8.
<https://www.legislation.gov.uk/ukpga/2018/21/contents/enacted>

4. Other areas

We discuss three other areas which we will consider as part of this review - uncertainty, fallback ('contingency') approach and carry forward.

We seek stakeholders' views on any of the areas covered in this chapter.

4.1. In most areas, we consider that the approach from our August 2020 decision remains appropriate, and can be continued in future. In this chapter, we discuss a couple of areas that may need further consideration in the context of this review. These are the review of uncertainty and the contingency allowance for future periods.

4.2. We also provide an opportunity for stakeholders to comment on the advanced payment approach that we set out in the August 2020 decision, and which we do not propose to change.

Review of uncertainty

4.3. In our previous consultations and our August 2020 decision, we set out our assessment of the uncertainty around our calculated SMNCC values. This took into account both the areas where our approach was conservative and less-conservative.

4.4. We can use the assessment of uncertainty to consider the cumulative effect. We can then consider whether we need to adjust for the net impact.

4.5. In our August 2020 decision, we did not include such an adjustment. We noted the significant conservative effect of our decisions to include sunk installation costs for 2020 and to freeze the SMNCC allowance for the sixth cap period. However, we said that we would consider whether to include an uncertainty adjustment from the seventh cap period.¹⁴

¹⁴ Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraphs 4.88 and 4.89.
https://www.ofgem.gov.uk/system/files/docs/2020/08/reviewing_smart_metering_costs_in_the_default_tariff_cap_-_august_2020_decision.pdf

4.6. We will therefore consider uncertainty further as part of this review. At this point, we welcome comments from stakeholders on the assessment of uncertainty in our August 2020 decision. This includes both comments on whether we included the correct uncertainties, and on how we assessed the uncertainties we recorded. We will use these comments to inform our uncertainty assessment in this review.

4.7. We also welcome any views on how we could determine the value of an uncertainty adjustment, if we considered one was required. By their nature, uncertainties are hard (or impossible) to quantify in a precise way. Any numerical uncertainty adjustment would therefore be derived from an assessment which would be largely qualitative. At best, we might be able to reflect the direction and rough scale of uncertainty. Our current expectation is therefore that this would require a considerable degree of judgement. Any views from stakeholders at this stage will help us consider whether there are proportionate and useful ways of evidencing and presenting these judgements when we come to the 2021 consultation.

Advanced payments

4.8. We did not include advanced payments in our August 2020 decision. We said that this would reduce the benefit of providing for potential sunk installation costs due to COVID-19 and freezing the allowance in the sixth cap period.¹⁵

4.9. We said that we would include advanced payments as part of our next review. We said that we would not include advanced payments from the first two cap periods in this calculation. For the third, fourth and fifth cap periods, we said that we would consider advanced payments based on a market-leading rollout profile only.¹⁶

4.10. In line with our August 2020 decision, we will therefore include advanced payments from the third cap period onwards in the seventh cap period (which starts in October 2021).

¹⁵ Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraph 2.49.
https://www.ofgem.gov.uk/system/files/docs/2020/08/reviewing_smart_metering_costs_in_the_default_tariff_cap_-_august_2020_decision.pdf

¹⁶ Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraphs 2.47 and 2.48.
https://www.ofgem.gov.uk/system/files/docs/2020/08/reviewing_smart_metering_costs_in_the_default_tariff_cap_-_august_2020_decision.pdf

4.11. The value of these advanced payments is likely to be influenced significantly by the size of sunk installation costs. These will affect the degree to which the SMNCC allowances provided in previous cap periods were too high or too low. There is therefore an interaction between the implementation of advanced payments and the sunk installation costs issue discussed in the previous chapter.

4.12. We have consulted several times on the issue of advanced payments. However, if stakeholders have any further comments that they would like to provide (including on the material regarding advanced payments in our August 2020 decision), they should provide these in response to this working paper. This will allow us to consider any additional issues ahead of our 2021 consultation.

Contingency allowance

4.13. Through this review, we intend to develop revised values to update the SMNCC allowances which will apply from October 2021 onwards. However, we need to consider what the contingency SMNCC allowances should be, in the event that we cannot complete this review in time.

4.14. In our August 2020 decision, we defined SMNCC allowances for all remaining cap periods. We included these in the relevant model used to set the cap (Annex 5 of standard condition 28AD of the electricity and gas supply licences), although we said that we would carry out reviews every 12 months.¹⁷

4.15. This means that we have default values which would still apply if we took no further action. This is different to the situation in our previous consultations, where the SMNCC allowance values in the Annex 5 model were blank (i.e. zero) for future cap periods, and therefore unlikely to be a reasonable reflection of what the SMNCC allowance should be. An SMNCC allowance defined using the current model is likely to remain reasonably accurate, and therefore could be a suitable fallback.

¹⁷ Ofgem (2020), Reviewing smart metering costs in the default tariff cap: August 2020 decision, paragraph 2.44.
https://www.ofgem.gov.uk/system/files/docs/2020/08/reviewing_smart_metering_costs_in_the_default_tariff_cap_-_august_2020_decision.pdf

4.16. However, the appropriateness of these default values will depend on our revised assessment of net costs. Even if we were unable to use this revised assessment to update the SMNCC allowance, it might still provide a broad indication of the likely scale of costs. We could compare the implied SMNCC allowances from our revised assessment against the default SMNCC allowance values. Based on our understanding of the strengths and weaknesses of the revised assessment, we could consider whether it was likely that the plausible degree of error in our revised assessment was sufficient to explain this difference, or whether instead the default values might be a poor reflection of our best view of costs, taking into account new information.

4.17. For example, if we considered that suppliers were likely to incur significant sunk installation costs in 2021 (which are not currently included in the SMNCC model), then a higher contingency value might be required. Conversely, if our revised evaluation based on new ASR data suggested that installation costs had fallen significantly, then the current default values might be too high as a suitable contingency.

4.18. We therefore intend to set out further thinking on the contingency values in our 2021 consultation, in light of our revised assessment of net costs. However, we welcome views from stakeholders on whether they agree that the default values in Annex 5 could be a suitable fallback.

Other areas

4.19. We have kept this working paper focussed on a limited number of areas. However, this is also an opportunity for stakeholders to provide views on any other changes they think we should make to our existing approach to calculating smart metering costs in the cap. If we receive comments at this stage, we will have time to consider whether any changes are necessary.

4.20. As discussed in Chapter 2, early feedback is particularly important to help us carry out any data gathering that might be required.

Appendices

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Appendix 1 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, “Ofgem”). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

4. With whom we will be sharing your personal data

N/A

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for 1 year.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data

- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas

8. Your personal data will not be used for any automated decision making.

9. Your personal data will be stored in a secure government IT system.

10. More information For more information on how Ofgem processes your data, click on the link to our "[Ofgem privacy promise](#)".