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Dear Anna,

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

Thank you for the opportunity to respond to this first working paper on updating the allowance for smart metering costs in the default tariff cap. We set out our key points below and have provided more detail on them in Annex 1.

We note that Ofgem proposes to update the SMNCC model using the latest Annual Supplier Returns (ASR) in time to update the SMNCC allowance for Period 7 and is not minded to carry out further data gathering. We understand that the ASR draft template for 2020 requires suppliers to provide information on costs incurred specifically to support COVID-19 interactions. In our view, Ofgem should utilise actual data where it is available. To mitigate the risk of gaps or data quality issues in the ASR, we think it would be prudent for Ofgem to issue an RFI to suppliers to gather actual data on sunk installation costs in 2020.

Ofgem intends to limit the use of ASR data to a review of certain costs. We believe that Ofgem should also review the level of benefits assumed in its modelling as the smart meter programme has been significantly disrupted by COVID-19 and benefits may not be realised in the same timescales as previously anticipated.

In terms of Ofgem's review of uncertainty, we are opposed to the introduction of a numerical uncertainty adjustment in Period 7 because it introduces subjectivity and risk (for both consumers and suppliers) and reduces transparency in how Ofgem sets the level of the cap. We believe Ofgem should instead be consulting on the adequacy of the headroom allowance.

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.

Yours sincerely

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive style with a large initial 'R'.

Richard Sweet
Head of Regulatory Policy

**UPDATING ALLOWANCE FOR SMART METERING COSTS IN THE DEFAULT TARIFF
CAP: WORKING PAPER – SCOTTISHPOWER RESPONSE**

1. Introduction

We comment below on the following aspects of Ofgem’s proposals:

- Installation costs
- Cost and benefit input data
- Review of uncertainty

2. Installation costs

Sunk installation costs in 2020

Ofgem intends to update 2020 installation costs with actual data and correctly assumes that some of these installation costs are sunk (ie should be recognised as a cost in 2020 and not be amortised). We agree that accurately quantifying sunk costs in 2020 is important to avoid understating costs suppliers faced in 2020, overstating costs in future years and consequently miscalculating advanced payments.

The working paper outlines three options for updating sunk installation costs in 2020:

1. Gathering data from suppliers on actual sunk costs
2. Estimating the sunk installation cost as a residual¹
3. Estimating it as a proportion of total installation costs²

Ofgem’s view is that the second option (residual method) would be simplest but welcomes feedback on whether gathering data from suppliers would be practical and more accurate than the second option.

We believe that gathering actual data from suppliers would be practicable and more accurate. Our understanding is that the ASR draft template for 2020 requires suppliers to provide information on costs incurred specifically to support COVID-19 interactions. In our view, Ofgem should utilise actual data where it is available. To mitigate the risk of gaps in the ASR, we think it would be prudent for Ofgem to issue an RFI to gather actual data on sunk installation costs in 2020 from suppliers.

The second (‘residual’) option, as Ofgem notes, will not take into account additional COVID-19 related costs (eg PPE) as the assumed cost per installation is based on the installation cost from 2019 and the installer productivity based on the average over 2017-2019.

In our view, Ofgem should prioritise accuracy over simplicity and issue an RFI to gather actual data on sunk installation costs from suppliers. This approach would minimise the risks of

¹ Starting with total installation costs from the latest ASR, Ofgem would then subtract an estimate of cost of meters installed (ie number of meters installed from ASR data x estimated cost per installation absent COVID-19)

² (Total installation costs / expected number of meters to be installed in 2020 absent COVID-19) x (expected number of meters installed in 2020 – actual number of installations)

cumulative errors arising from estimating sunk installation costs in 2020 and basing the calculation of advanced payments on that estimate.

Projecting sunk installation costs in 2021

Ofgem invites views on whether suppliers may incur sunk installation costs in 2021. We believe it is possible that there will be 'sunk' costs in 2021 but agree that suppliers should be able to take action to avoid some of these sunk costs.

We believe Ofgem's proposed approach of estimating sunk installation costs for 2021 (in the same way it has done for 2020) and making adjustments based on information that will be available during the 2021 consultation in late Spring is a reasonable way forward.

Sunk installation costs beyond 2021

We agree that it would be premature to include sunk installation costs for 2022 as part of this review and that it should be part of a future review.

3. Cost and benefit input data

Ofgem notes (paragraph 2.2) that it intends to use ASR data to update the SMNCC model for the following input costs:

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

The working paper also states that Ofgem does not consider other areas included in the ASR to be significant or to have changed materially. We disagree and believe Ofgem should review the level of benefits assumed in its modelling as the smart meter rollout has been significantly disrupted due to COVID and benefits may not be realised in the same timescales as previously anticipated.

4. Review of uncertainty

Ofgem is seeking views on its assessment of uncertainty in its August 2020 decision and how it could determine the value of an uncertainty adjustment, if one was considered necessary.

We consider the assessment of uncertainty, which Ofgem has been evolving since its consultation in October 2019, is subjective and not sufficiently transparent. To date, the review of uncertainty has predominantly been a qualitative assessment of areas where Ofgem's approach has been deemed to be conservative and less-conservative.

Ofgem's assessment of uncertainty has rightly concluded in two successive consultations³ that:

'Considering that assessment of uncertainty can never be precise (or there would be no uncertainty in the first place) and that some otherwise efficient suppliers will have high costs due to their rollout profiles, we propose to not make an adjustment for uncertainty'.

³ Reviewing smart metering costs in the default tariff cap (October 2019) – Paragraph 4.29 and Reviewing smart metering costs in the default tariff cap: May 2020 statutory consultation – Paragraph 6.39

Furthermore, Ofgem's decision in August 2020 considers that the net effect of where it believes its approach to be conservative and less-conservative is more or less neutral⁴. Therefore, there has been limited indication prior to this working paper that Ofgem would be exploring the possibility of introducing an uncertainty adjustment in the seventh price cap period.

We are opposed to the introduction of any numerical uncertainty adjustment that, as Ofgem acknowledges in paragraph 4.7 of the working paper, would be derived from an assessment which would be largely qualitative.

As Ofgem noted in October 2019, uncertainty works in both directions and introduces risks for both consumers and suppliers. It does not strengthen the modelling of the price cap for Ofgem to introduce a subjective component such as this adjustment.

One of the functions of the headroom allowance is to allow for uncertainty in Ofgem's assumptions. However, headroom has gradually been eroded by a number of factors and we believe Ofgem should be consulting on the adequacy of the headroom allowance instead of how it might quantify an uncertainty adjustment.

ScottishPower

December 2020

⁴ Technical annex to reviewing smart metering costs in the default tariff cap: August 2020 decision - Paragraph 6.3