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## **Plans for reviewing the Smart Metering Net Cost Component in future default tariff cap periods**

1. On 6 November 2018 we published our decision on the Default Tariff Cap. The cap came into force on 1 January. On 7 February, we announced the cap level for the second cap period (April to September 2019).
2. Our published methodology includes a Smart Metering Net Cost Component (SMNCC). This allowance reflects the change in smart costs from the 2017 baseline (part of operating costs) to subsequent cap periods. The SMNCC has two components: industry body charges for smart metering (SMNCC pass-through), and suppliers' net efficient costs rolling out smart meters (SMNCC non-pass-through).
3. In November we only set SMNCC values for the first two cap periods. There are currently no allowances or methodology for the third cap period (October 2019 to March 2020) and beyond. This was a deliberate decision, recognising the cost and pace of rolling out smart meters was particularly uncertain. We said we would review developments to inform allowances in the third cap period (October 2019 to March 2020) and beyond.
4. This letter sets out a timeline and our initial thinking on how we propose to conduct this review for setting the SMNCCs for the forthcoming cap periods. We propose to conduct the review in two stages – one to set the SMNCC for the third cap period, using mainly the same methodology and sources used for the first two cap periods; and one to set the SMNCC in the fourth and subsequent cap periods, drawing on analysis from the updated Smart Metering Implementation Programme (SMIP) Cost Benefit Analysis (CBA).

### **Taking a two-staged approach to setting the SMNCC**

5. In setting the methodology for the cap and the SMNCC specifically, we concluded that it should be set with reference to the SMIP CBA, as the most comprehensive available source for examining the costs and benefits of the rollout.<sup>1</sup>
6. We continue to believe that the SMIP CBA is the best basis on which to calculate the SMNCC. It provides the most accurate and comprehensive way to assess the change of smart metering costs from the baseline in 2017 to the periods of the default tariff cap.

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<sup>1</sup> We made a number of modifications to the CBA, including removing cost and benefit categories not relevant to suppliers as well as using more recent information from suppliers to better reflect the incremental net cost of smart metering on suppliers, please see "[Default Tariff Cap: Decision, Appendix 7 – Smart metering costs](#)"

7. BEIS intends, this year, to update its cost benefit analysis. However, the updated CBA will not be available before July 2019. On that basis, Ofgem:
  - a. would **not** be able to use the updated CBA to set the SMNCC for the third cap period (1 October 2019 to 31 March 2020). This is because, consistent with the requirements of the licence conditions, we are required to set the cap level for the third cap period on 7 August 2019, and on that basis there would not be enough time to consider the updated business case and consult on our proposed methodology in time for the third period cap update.
  - b. would be able to update the SMNCC, including consulting stakeholders in an appropriate manner in time to include the update in the announcement made on 7 February 2020 so as to apply **from 1 April 2020**.
8. A two-stage approach to setting the future level of the SMNCC is necessary, as the SMNCC is currently set to zero for the third cap period which we do not consider to be appropriate as it would risk the deployment of smart meters.

### **Our initial thinking on the approach**

#### *Setting the SMNCC for cap period three*

9. Our proposed approach is likely to be that we would set the SMNCC for cap period three using the same methodology we used to set the allowance in the first two cap periods (i.e. the 2016 CBA with same modifications), unless there is a strong justification for not doing so. We would look at suppliers' annual submissions on costs, rollout projections and other appropriate data to assess this estimate's suitability. We would also consider whether we could reliably adjust it.
10. The bar for adjusting the original estimate would be high. Our focus is on whether the SMNCC provides an appropriate allowance in total, not simply the accuracy of individual assumptions in isolation. Considering and updating individual assumptions (for instance, adjusting costs but not roll out figures, or vice versa) might lead to a greater mismatch between the overall funding allowed by the SMNCC and the underlying costs an efficient supplier might incur. We would be unlikely to rely on cost data that had not (yet) been approved by the assurance processes involved in updating the BEIS cost benefit analysis, or provided an incomplete picture of the cost associated with smart meters.

#### *Proposed approach to setting the SMNCC for cap period four and subsequent periods*

11. Our proposed approach is likely to be that we would set the SMNCC for cap period four, and subsequent cap periods as appropriate, using the updated CBA. Subject to changes in the updated CBA, we would expect to maintain the same modifications to the CBA that we used for the first two cap periods. This approach assumes that the CBA will be available from July 2019, allowing us to present a proposed methodology in a final consultation in October or November 2019.
12. We will consult stakeholders on our approach and on the transparency arrangements required to ensure that the analysis is appropriate for its intended purpose – a sufficient allowance for inclusion in the default tariff cap.

#### *A challenge when updating assumptions*

13. Finally, in considering the appropriate SMNCC to include in future cap periods, we would consider whether updating assumptions has unintended consequences. The SMNCC in the first two cap periods allows suppliers to recover costs of installing a large number of smart meters to customers on default tariffs (around 20% of all SVT customers). In that regard, as part of our review of smart costs from cap period four onwards, we would consider the significance of rollout and cost assumptions in previous cap periods, to

consider how to limit the risk of incorrectly funding suppliers for the smart meter roll-out.

### Initial timeline

14. We will consult stakeholders on these issues. We intend to publish the first consultation in **late April**. It will focus on the options and proposed approach for the SMNCC for cap period three, and consult stakeholders on the potential high-level methodology and transparency arrangements for the SMNCCs in subsequent cap periods.
15. Subsequent consultations will cover our proposed approach, changes to the models published alongside the licence conditions and licence conditions (if any) for cap three (June), the methodology options for cap period four and beyond (August or September), and a final consultation on the proposed methodology (October or November). **Table 1** sets out our proposed timetable for setting and consulting on appropriate SMNCC allowances.

Yours faithfully,  
 Rob Salter-Church  
 Director, Consumers & Markets: Retail Systems Transformation

*Table 1: initial timeline for setting the SMNCC in future cap periods.*

Time	Milestone	Proposed content
<i>Late April 2019</i>	<i>Initial consultation</i>	We aim to consult stakeholders on: <ul style="list-style-type: none"> <li>the options and proposed approach for setting the SMNCC in the third cap period.</li> <li>the approach for subsequent cap periods.</li> </ul>
<i>Mid-June</i>	<i>Final consultation for cap three</i>	We aim to consult stakeholders on our proposed approach, changes to the models published alongside the licence as well as any associated licence changes, if necessary, for setting the SMNCC in the third cap period
<i>7 August</i>	<i>Decision</i>	We will announce our decision on the SMNCC for cap period three at the same time as the upcoming cap level
<i>Late August/early September</i>	<i>Further Consultation</i>	We aim to consult stakeholders on our potential methodology for setting the SMNCC in the fourth, and subsequent, cap periods
<i>October – November</i>	<i>Final consultation for cap four</i>	We aim to consult stakeholders on our proposed approach and associated licence changes, if any, for setting the SMNCC in the fourth, and subsequent, cap periods.
<i>Early December</i>	<i>Decision</i>	We aim to announce our decision for the SMNCC value in future cap periods
<i>7 February 2020</i>	<i>Cap level announced</i>	We will announce the cap level for cap period four (April-September 2020)