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Domestic suppliers, consumer
groups, other interested parties

Email: retailpriceregulation@ofgem.gov.uk

Date: 18 June 2019

Dear stakeholder,

Default tariff cap: approach to the third cap period

We update the level of the default tariff cap ('the cap') every six months. The third cap period will run between 1 October 2019 and 31 March 2020. We must publish the level for the third cap period by 7 August 2019.[1]

The licence describes the methodology we use for updating the cap. However, there are two elements where we need to determine our approach for this cap period. These are the allowance for the net costs of the smart meter rollout, and the allowance for the costs of the Capacity Market (CM).

This consultation sets out our proposals for these specific allowances, and provides stakeholders with an opportunity to comment. We are not consulting on other allowances within the cap, as there is a settled approach to take in those areas.

This consultation relates solely to the third cap period. We will publish consultations relating to these allowances for subsequent cap periods later in the year.

Smart metering

Proposed approach

We propose to set the non-pass-through Smart Metering Net Cost Change (SMNCC) component for the third cap period using our current non-pass-through model. This is the same model that we used to set the non-pass-through SMNCC for the first two cap periods.

Background

The licence condition and associated annexes currently do not contain a non-pass-through SMNCC value beyond the first two cap periods. We explained the issue in our April consultation on reviewing smart metering costs in the default tariff cap.[2] To recognise any of suppliers' incremental smart metering costs (above the 2017 level included in our operating cost baseline), we need to include an allowance for the third cap period.

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[1] Standard licence conditions 28AD.19 of the electricity supply licence and 28AD.18 of the gas supply licence.
[2] Ofgem (2019), Reviewing smart metering costs in the default tariff cap.
https://www.ofgem.gov.uk/system/files/docs/2019/04/review_of_smart_metering_costs_in_the_default_tariff_cap.pdf

We intend to update our non-pass-through SMNCC model based on the new Smart Metering Implementation Programme Cost Benefit Analysis (SMIP CBA) developed by the Department for Business and Industrial Strategy (BEIS), which we expect to be available later in the summer. As set out in our April consultation, we propose to use the new SMIP CBA as the starting point for our analysis. We consider the SMIP CBA to be the most robust and comprehensive assessment of the costs and benefits associated with rolling out smart meters. The new SMIP CBA will reflect the best available evidence in relation to the rollout.[3] We consider it is particularly important to consider the evidence in the round, rather than updating isolated assumptions, as this could make the allowance less reflective of actual efficient costs (see the rationale section below).

We therefore need the new SMIP CBA to update our SMNCC model. However, we do not have enough time to update and consult on an updated non-pass-through SMNCC allowance based on the new SMIP CBA for the third cap period. This is because we must publish the level for the third cap period by 7 August 2019.

Stakeholder feedback on calculating the allowance for the third cap period

The majority of consultation respondents broadly agreed with our proposal of using the current non-pass-through SMNCC model to set the allowance for the third cap period. Several stakeholders said that their agreement was subject to Ofgem not giving regard to this allowance when calculating the allowance for later cap periods.

However, one large supplier said that we should make an adjustment from October 2019 to address three issues, in advance of the updated SMIP CBA. These issues were: SMETS1 costs (especially the asset life assumption), IT investment costs (especially the asset life assumption), and inefficiency resulting from delays to the rollout (as fixed costs do not fall when fewer meters are installed). It said that there was a shortfall of around £10 per meter.

One large supplier queried the split between the proposed gas and electricity SMNCC allowances – specifically why the allowance for electricity had increased while the allowance for gas had decreased, given Ofgem's intention not to refresh any input data for the third cap period and lack of any overt justification.

Rationale for our proposed approach

We do not consider it appropriate to wait to set a non-pass-through SMNCC until after our review of the new SMIP CBA. This would mean there would be no non-pass-through SMNCC in the third cap period. This could constrain the rollout of smart meters, as the cap would include an allowance to provide suppliers with revenues to cover the incremental costs of installing smart meters. It could still constrain the rollout even if we allowed for the relevant costs in later cap periods (in effect collecting payments in arrears), as there would be a cash flow impact on suppliers. Such an approach would also increase the volatility of the cap level, and therefore the volatility of consumers' bills.

We therefore propose to use the information currently available to us (ie the current non-pass through SMNCC model) to set the non-pass-through SMNCC for the third cap period.

As we explained in our April consultation, broad trends suggest that there will be differences between some of the assumptions in the current non-pass-through SMNCC model and the most recent data which is likely to inform the new SMIP CBA.

[3] Ofgem (2019), Reviewing smart metering costs in the default tariff cap, paragraphs 3.6 and 3.8-3.10. https://www.ofgem.gov.uk/system/files/docs/2019/04/review_of_smart_metering_costs_in_the_default_tariff_cap.pdf

We do not agree with the suggestion that we should update individual assumptions in advance of the new SMIP CBA.

We do not consider it appropriate to update isolated parts of the current non-pass through SMNCC model (through adjusting assumptions or using more recent data). Such an approach would likely make the allowance less reflective of actual efficient costs, for the following reasons.

- Taken together, some updated assumptions would have opposing effects on the SMNCC. For instance, the number of smart meters installed is likely to be lower than assumed in the current non-pass-through SMNCC model, but costs in 2018 are reported to have been higher than costs in 2017. Updating one of these assumptions in isolation would therefore not be likely to improve the accuracy of the SMNCC.
- Furthermore, the assumptions may interact. For example, adjusting the rollout assumption could have an impact on the assumed costs per installation. We do not consider it appropriate to ignore these interactions, as this would also risk reducing the level of accuracy in the SMNCC.
- Suppliers will have a mixture of fixed and variable costs relating to smart metering. Where costs are fixed (at least in the short-run), then these costs will not depend on the number of meters installed. However, suppliers who install fewer meters will avoid variable costs for those installations. The number of meters installed is therefore likely to have an impact on a supplier's total costs relating to smart metering in a given period.

Although we consider that using the unadjusted current non-pass-through SMNCC model is the most robust approach, it is possible that the overall allowance differs from the actual expenditure an efficient supplier (with an average rollout profile) will incur. As a result the allowance may be partially ahead of, or lagging behind, the actual costs of rolling out smart meters.

In our April consultation, when discussing setting the SMNCC for the fourth cap period and beyond, we proposed to give regard to any substantial advance payment (or lagged payment) in the first three cap periods.[4] We will continue to consider our approach in this area, including through taking into account feedback from stakeholders about not giving regard to previous allowances. We will respond on this, and other issues relating to the fourth cap period, at a later date. For the avoidance of doubt, our proposal for the third cap period does not fetter our discretion to adopt any particular approach for the fourth and subsequent cap periods.

The gas and electricity non-pass-through allowances for the third cap period in table 3 of our April consultation were transposed due to a typographical error. This only affected the order of the values for gas and electricity – it did not affect the estimated combined SMNCC. We have addressed this in our proposals below.

Model implications

To implement our proposed policy, we need to include non-pass-through SMNCC values for the third cap period in the document Annex 5 referred to in the cap licence conditions.[5] We therefore propose to insert values in cells J7 and J8 of sheet '2a Non pass-through costs'. These values would be £9.26 for electricity and £11.24 for gas. (For the avoidance of doubt, these are the same numbers we published in April, but in reverse order. This was due to a typographical error). We have calculated these values using our current non-pass-through SMNCC model.

[4] Ofgem (2019), Reviewing smart metering costs in the default tariff cap, paragraphs 4.19 and 4.20. https://www.ofgem.gov.uk/system/files/docs/2019/04/review_of_smart_metering_costs_in_the_default_tariff_cap.pdf
[5] Standard licence condition 28AD of the gas and electricity supply licences.

As set out in our April consultation, for the third and subsequent cap periods, we also propose to amend an error within the current pass-through SMNCC model. One stakeholder identified a formula error in the calculation of DCC costs. The total DCC costs do not include the total dual band communications hub costs. This applies to both gas and electricity.

We would address this by editing the formulas for 'Total Explicit Costs' in rows 52 and 53 of sheet '2c DCC' of Annex 5. When correcting this error, we will only edit the values for the upcoming cap periods (ie the third cap period and onwards), which are in columns M to U. We will not edit the formulas for past cap periods, so that the model continues to reflect the actual levels in previous cap periods. For electricity, we would add to the sum the relevant cell in row 48 ('Total DB Comms Hub Costs – Electricity'). For gas, we would do the same in relation to row 49 ('Total DB Comms Hub Costs – Gas').

After making the proposed changes above, we currently estimate that the total dual fuel SMNCC would be £29.03 for a typical customer, as set out in our April consultation. This is a provisional figure because the pass-through costs are estimates only. We will finalise these estimates in late July 2019, when we have all required inputs to update the pass-through SMNCC model for the third cap period.

Stakeholder comments beyond calculating the SMNCC for the third cap period

In response to our April consultation, stakeholders raised a number of points which went beyond the calculation of the SMNCC for the third cap period. Below we address issues raised that affect this June consultation. We will respond to the remaining issues in our future publications.

Several stakeholders said that we should consult on our proposed confidentiality ring arrangements in June.

One large supplier requested that we publish the current non-pass-through model in June, making it available as far as possible on a non-confidential basis, but where not possible, within a confidentiality ring.

One large supplier said that we should consult in June on how we could update the current SMNCC model, including on what additional information is required.

<u>Our responses</u>

We have not yet developed the details of our confidentiality ring proposals, and so we are not currently in a position to consult on them. We will run a suitable confidentiality ring process to inform our approach, and will set out our plans to stakeholders at an appropriate time.

As set out above, we propose to use the new SMIP CBA, which we expect will be available this summer, to create an updated non-pass-through SMNCC model from the fourth cap period onwards. We therefore do not see sufficient value in publishing the current SMNCC model for review. (We are proposing to calculate the SMNCC for the third cap period using the current non-pass-through SMNCC model. However, we have already disclosed and consulted on this model during its development, and we are not proposing any changes to this model since our November 2018 decision).

We have already received suggestions from stakeholders on what additional information they consider we should collect. We will consider these as part of our ongoing work, and provide our response as part of a later consultation. We would be happy to receive any further suggestions from stakeholders (separately from this consultation on the third cap period).

Capacity Market

Proposed approach

We propose to include a full CM allowance in the third cap period. This allowance covers the costs associated with the CM Supplier Charge, as well as the administrative costs of the CM scheme.

Background

On 7 February 2019, we published a decision on the CM allowance in the second cap period.[6] This followed the November 2018 judgment of the General Court of the Court of Justice of the European Union which had the effect of removing the European Commission's State Aid approval for the GB CM scheme.[7] We decided to include a full CM allowance in the second cap period.

Since this decision, there have been several relevant developments.

On 21 February 2019, the European Commission sent the government a letter communicating its decision to initiate the formal State Aid investigation procedure.[8] The European Commission assessed the measure and set out the areas where it particularly sought comments. However, this does not yet allow us to reach a firm view on whether it will or will not eventually approve the CM scheme.

On 28 February 2019, the government published its response to its consultation on technical amendments to the CM.[9] The government decided "to mandate that supplier charges are collected and paid in full shortly after the standstill period ends" and "to encourage suppliers to make prudent provision in the interim, including through making voluntary payments to the ESC [Electricity Settlements Company], to ensure that they are in a position to pay the full amount of supplier charges promptly when they become due".[10] This aligned with the government's letter to us ahead of our February decision. In that letter, it set out its intention that, subject to State Aid approval of the CM that would permit this, suspended payments would be made to capacity providers, and suppliers would make contributions to the scheme based on the current charging methodology.
On 9 May 2019, the Secretary of State for Business, Energy and Industrial Strategy set out auction parameters for the replacement T-1 auction.[11] This reduced the target capacity for the T-1 auction to 2.7GW. The previous target capacity was 4.6GW – we used this as an input when calculating the level for the second cap period.

Rationale for our proposal

Our proposal and rationale are the same as for the second cap period. We consider that we should set the cap to enable suppliers to collect CM costs from their customers. This will

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[6] Ofgem (2019), Decision: capacity market allowance in the default tariff cap. https://www.ofgem.gov.uk/system/files/docs/2019/02/decision_-_capacity_market_allowance_in_the_default_tariff_cap.pdf
[7] Ofgem (2019), Capacity market allowance in the default tariff cap. https://www.ofgem.gov.uk/system/files/docs/2019/01/capacity_market_default_tariff_cap_letter_final_0.pdf
[8] European Commission (2019), State Aid SA.35980 (2018/NN) – United Kingdom Electricity Market Reform: Capacity Mechanism. C(2019) 1296. http://ec.europa.eu/competition/state_aid/cases/277359/277359_2054365_76_2.pdf
[9] BEIS (2019), Technical amendments to the Capacity Market: Government response to consultation. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/782657/capacity-market-technical-amendments-consultation-government-response.pdf
[10] BEIS (2019), Technical amendments to the Capacity Market: Government response to consultation, p33. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/782657/capacity-market-technical-amendments-consultation-government-response.pdf
[11] Letter from the Secretary of State for Business, Energy and Industrial Strategy to National Grid Electricity System Operator, 9 May 2019. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/800952/SoS_BEIS_to_Duncan_Burt_T-1_Parameters_.pdf

enable suppliers to ultimately pay for deferred payments to capacity providers, should there be State Aid approval for this. As noted previously, in the event that State Aid approval for deferred payments is not granted, we expect suppliers to reimburse consumers.

We do not consider that the developments since our February decision change this position.

- As noted above, the government's response did not change the position it had already communicated to us by letter ahead of the February decision. Regardless of whether suppliers are currently making voluntary payments, or are saving up money to pay future supplier charges, in either case they should be collecting money now from their consumers. The cap should therefore allow them to do this.

- The outcome of the State Aid investigation remains uncertain. We do not consider that the decision to initiate a formal investigation gives us new information which materially affects our ability to reach a firm view on whether State Aid approval is likely or not.

We do not know whether there will be a State Aid decision before 7 August 2019 (the date when we need to publish the level for the third cap period). Our proposal above is based on the assumption (for the purpose of this consultation) that there will not be a State Aid decision at this point. If the State Aid decision is published before 7 August 2019, we will consider any implications for the cap, and whether our proposal remains appropriate. We will also consider whether to carry out a consultation, where appropriate. If the State Aid decision is published after 7 August 2019, it will not affect the level for the third cap period, as we would have already set this.

Model implications

Given our proposed position above, we would not need to make changes to the model in the document Annex 2 referred to in the cap licence conditions. We will update the inputs as set out in the licence, and the model will calculate the CM allowance.

We estimate that the CM allowance would be £14.71 for a typical domestic customer. This estimate is a GB average, for a single rate electricity customer with a typical level of consumption. It is a provisional figure because it does not use the final input values for other parameters (losses and demand).

This estimate includes the outcome of the replacement T-1 auction, which was held on 11 and 12 June 2019. The calculations for the second cap period used placeholder values, given this auction had not taken place at that point. We are now able to use the actual clearing price and obligated capacity to calculate the allowance for the third cap period. These values are available in the provisional auction results.[12]

- For obligated capacity, we entered 3,626.196MW in cell S48 of sheet '6b Obligated capacity'.

- For the clearing price, we entered £0.77/kW/year in cell C23 of sheet '6c Clearing prices and CPI'. Given the auction is held in the same year as delivery, there is no need to index this clearing price for inflation. We have therefore entered "N/A" as the CPI base period in cell E23.[13]

[12] National Grid Electricity System Operator (2019), Provisional Auction Report – 2018 year ahead Capacity Auction (T-1), 12 June 2019. https://www.emrdeliverybody.com/Capacity%20Markets%20Document%20Library/Provisional%20Results%20Report%20T-1%202018%20(DY%2019-20).pdf

[13] The proposed changes to the clearing price overwrite the value we used when calculating the level for the second cap period. (The same clearing price input cells are used for all cap periods where a given T-1 auction is relevant). We want Annex 2 to continue to reflect the actual CM allowance that applied in each cap period. We would therefore hard-code the actual value for the indexed clearing price for the second cap period in cell Q49 of sheet '5c Uplift clearing prices'. It would therefore be unaffected by our proposed changes to the clearing price. This is purely a cosmetic change – it would not affect how we calculate the level of the cap.

Given the small amount of capacity procured through the T-1 auction, this auction only has a small impact on the CM allowance for the third cap period.

CM costs in the prepayment meter cap

We are aware that the current version of the prepayment meter (PPM) cap model uses a different source for the costs of the CM. The PPM cap model uses forecasts from the Office for Budget Responsibility (OBR). The latest OBR forecasts do not include CM costs, given the standstill period for the CM scheme. The PPM cap, using its current methodology, would therefore not include CM costs when indexing policy costs for the cap period starting in October 2019.

The CMA is currently consulting on changes to the PPM cap.[14] It proposes to adopt the default tariff cap methodology in relation to the CM. The design of the PPM cap is a matter for the CMA. Our role is to update the level of the PPM cap using the methodology in force and in accordance with standard condition 28A of the gas and electricity supply licences.

Next steps

We welcome any comments from stakeholders on the proposals in this consultation. Please provide any responses to retailpriceregulation@ofgem.gov.uk by close of business on **16 July 2019**.

After considering responses, we will set out our decisions at the same time as publishing the level of the cap (ie by 7 August 2019).

Yours faithfully,

Anna Rossington
Deputy Director, Retail Price Protection

[14] CMA (2019), Review of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016 – Provisional Decision.
https://assets.publishing.service.gov.uk/media/5cf7cd9b40f0b663f62506af/Finalised_Provisional_Decision.pdf