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Consumers & Competition
Ofgem
10 South Colonnade
Canary Wharf
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E14 4PU

30 May 2019

Dear Anna,

Reviewing smart metering costs in the default tariff cap

Thank you for the opportunity to respond to this initial consultation on Ofgem's proposed two-stage approach to reviewing smart metering costs and allowances. We set out our key points below and have provided responses to the consultation questions in Annex 1.

Ofgem proposes to set allowances for Period 3 (October 2019 to March 2020) using its current non-pass-through (NPT) SMNCC model, and allowances for Period 4 (April 2020 to September 2020) and beyond using an updated NPT SMNCC model based on the new BEIS SMIP CBA.

Ofgem explains (paragraph 4.6) that it does not have enough time to do anything other than extend the current model to Period 3 - meaning that it needs to abandon its previous clear commitment to complete the review in time for October 2019. In view of this disappointing delay, and the importance of completing the review ahead of Period 4, it is vital that Ofgem takes steps now to ensure that the risks of any further delay are minimised, including developing contingency plans for updating the NPT SMNCC model without the updated CBA, should that be necessary.

In our response to Ofgem's October 2018 statutory consultation on the default tariff cap, we outlined areas where we believe the current SMNCC model over-estimates benefits and under-estimates costs, resulting in allowances for NPT SMNCC being substantially too low in Periods 1 and 2. It is therefore disappointing that Ofgem now proposes to extend the use of the existing model to Period 3 without any attempt to address the model's weaknesses.

We would urge Ofgem to commence work and consult in mid-June on options for updating the current NPT SMNCC model (with or without a new CBA) in preparation for Period 4, rather than waiting until the proposed consultation for Period 4 and beyond in August or September. Ofgem and BEIS are already in possession of the latest Annual Supplier Returns (ASRs) and rollout data but, as was previously highlighted in analysis provided to Ofgem by Energy UK, there are gaps in this dataset which make it impossible for Ofgem to formulate a complete picture of net costs incurred by suppliers. Consulting in mid-June on the data required to supplement information from ASRs, rollout data and the BEIS SMIP CBA is the minimum Ofgem should be doing to ensure it is able to set accurate allowances for Period 4 and beyond.

Commencing the consultation on the process for Period 4 and beyond earlier will help ensure that suppliers are adequately prepared for potential information requests and that Ofgem is able to update the existing model quickly should there be unforeseen delays to the new SMIP CBA that might otherwise impact its use for Period 4.

We also repeat our request for Ofgem to publish a fuller version (with mathematical formulae) of the NPT SMNCC model as soon as possible, to enable stakeholders to meaningfully comment on any deviations Ofgem proposes to make from the new BEIS SMIP CBA. We have not, to date, seen an explanation from Ofgem to clarify why it is unable to find a way to make the model available without divulging commercially sensitive information. We would strongly urge Ofgem to make the model available in the mid-June consultation, as far as possible on a non-confidential basis, but where not possible, within a confidentiality ring.

Ofgem proposes that, *over the life of the cap*, the SMNCC should not exceed Ofgem's estimate of efficient costs relating to the rolling out of smart meters. If this means that Ofgem is contemplating an ex post correction or 'claw-back' mechanism we would be extremely concerned. Ofgem's November 2018 decision was clear that such correction mechanisms would not be included in the price cap, given the potential risk of distortions, and we see no reason why this position should be changed. In any event, if Ofgem were to proceed with this approach, it would be necessary to reconsider the appropriateness of the Period 1-3 allowance in the round, giving suppliers the opportunity to make further representations on unit cost assumptions which we believe were significantly understated.

In summary, we reiterate our request for Ofgem to commence its review of the current NPT SMNCC model in mid-June, and to provide fuller disclosure of the model on a non-confidential basis.

Should you have any questions on this response, please do not hesitate to contact James Soundraraju (Tel: 0141 614 2421, jsoundraraju@scottishpower.com) in the first instance.

Yours sincerely,



Richard Sweet
Head of Regulatory Policy

**CONSULTATION ON REVIEWING SMART METERING COSTS IN THE DEFAULT
TARIFF CAP – SCOTTISHPOWER RESPONSE**

Question 2.1: Do you agree with how we propose to consider an appropriate allowance for smart metering costs? Please explain your views.

Lifetime test and correction mechanism

Ofgem proposes that, *over the life of the cap*, the SMNCC should not exceed Ofgem's estimate of efficient costs relating to the rolling out of smart meters. If this means that Ofgem is contemplating an ex post correction or 'claw-back' mechanism we would be extremely concerned. Ofgem's November 2018 decision was clear that such correction mechanisms would not be included in the price cap, given the potential risk of distortions, and we see no reason why this position should be changed.¹ Any reversal of that stance undermines regulatory certainty and risks setting an unwelcome precedent.

Impact of SMNCC on rollout

Ofgem proposes to consider the potential impact of the SMNCC on the efficient and timely rollout of smart meters. We agree with this approach.

Benchmarking

Ofgem says it intends to benchmark efficient costs to average costs, rather than lower quartile costs or suppliers with high efficient costs. We agree that this is appropriate.

Statutory needs in the act

Ofgem does not consider that the Act requires it to achieve all four statutory 'needs' and believes its duty is to consider each of the needs when setting the cap. Ofgem states that it will seek to do so carefully, rigorously and conscientiously. We agree with this approach provided it is based on robust analysis and representations from stakeholders.

Question 3.1: Do you agree with how we propose to review efficient smart metering costs? Please explain your views.

Ofgem intends to create an updated NPT SMNCC model using the new SMIP CBA as a starting point. Ofgem expects that this will involve updating inputs and assumptions but does not propose changing the high-level methodological judgements specified in its original decision. The updated NPT SMNCC model will then be made available in a confidentiality ring (CR). Ofgem also proposes to deviate from the new SMIP CBA, if and where appropriate.

We are pleased that Ofgem is starting to consider the extent to which the data collected by BEIS will be appropriate for the purposes of its updated model, and that it is willing to collect

¹ Default tariff cap: decision – overview (6 November 2018). Excerpt of paragraph 3.17 – *We will not include a mechanism in the cap for correcting previous forecast errors – whether or not they benefit suppliers. In our statutory consultation, we stated that we were concerned that an adjustment mechanism to correct for error in forecasts in the previous period would create a further distortion to the market.*

additional data if necessary. However, depending on the timing of BEIS's process, there is a risk that Ofgem will have insufficient time to collect all required additional data following the completion of the updated CBA. We would, therefore, urge Ofgem to coordinate with BEIS so that either BEIS or Ofgem collects any additional data needed from suppliers in a consistent and timely manner, to ensure that any assumptions within the updated SMIP CBA and SMNCC model are based upon consistent and comprehensive evidence.

Ofgem should also consult at an early stage on where it proposes to differ (and not to differ) from the approach taken in the new SMIP CBA, and provide stakeholders with more detail when this becomes available.

Although we welcome Ofgem's commitment to make details of the updated model available in a CR, it is vital that Ofgem discloses as much as possible of the model through the normal public consultation process, outside of the CR. The CR should be used only for genuinely commercially sensitive data, which in general should not include aggregated or averaged data. If a model contains a mix of commercially sensitive and non-sensitive data, Ofgem should create a non-confidential version in the interests of transparency. To the extent that it is necessary to restrict information to the CR, key considerations for us include the level of model information that will be disclosed (eg full model with formulae and source data versus a partial model with hard coded inputs), access arrangements and avoiding unnecessary restrictions on the ability of suppliers to communicate with their professional advisers.

We believe the full model should be made available in the CR and that lessons should be learned from the compressed timescales involved in the Disclosure Room exercise undertaken in 2018. We encourage Ofgem to consult on arrangements for the CR and its contents in the mid-June final consultation for the third cap period.

Question 4.1: Do you agree with how we propose to set the allowance for the third cap period? Please explain your views, and any alternative proposals if applicable.

For Period 3, Ofgem proposes to set the allowance using the current NPT SMNCC model. Ofgem does not intend to adjust the model in light of more recent information on rollout or costs.

We believe the current model is flawed and generates an underestimate of allowances caused mainly (but not exclusively) by the following factors:

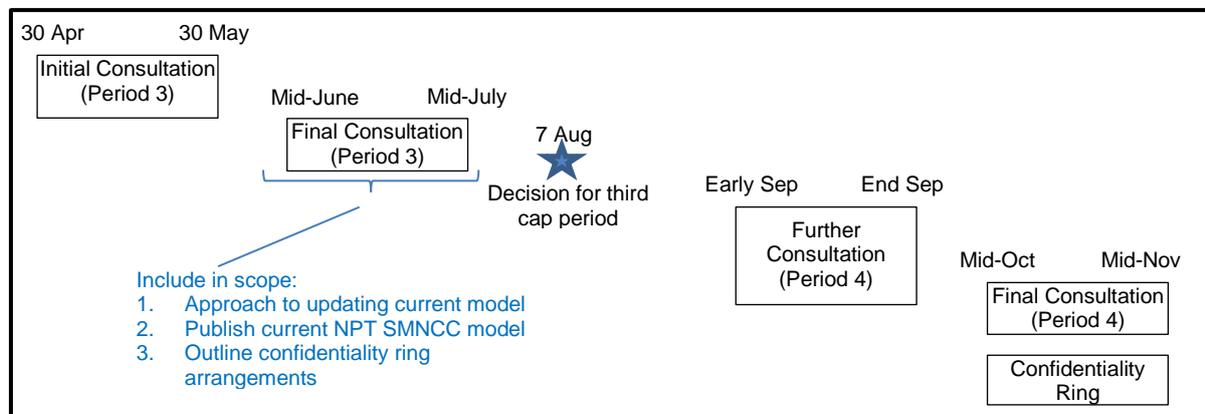
- over-estimated benefits from avoided meter reads
- over-estimated installation productivity gains between 2017 and 2018
- under-estimated costs of early termination of legacy meters
- under-estimated NPT costs of supporting SMETS1 meters during 2019

To avoid finding itself in a similar position for Period 4, we encourage Ofgem to widen the scope of the Final Consultation for Period 3 (mid-June) to include consulting on how it could update the current model (eg what additional information it would require to supplement the ASR, rollout data and BEIS CBA) and to publish a fuller version (with formulae) of the current SMNCC model.

Doing so will ensure industry is adequately prepared for potential information requests and that Ofgem is able to update the existing model quickly should there be unforeseen delays to the new SMIP CBA that might otherwise impact its use for Period 4.

Given the lead times associated with preparing for a confidentiality ring, Ofgem should not delay in sharing its thinking on how the confidentiality ring is intended to work. Once again, we would encourage Ofgem to set out its plans in mid-June.

We illustrate our suggestion in the diagram below.



Question 4.2: Do you agree with how we propose to set the allowance for the fourth cap periods and beyond? Please explain your views, and any alternative proposals if applicable.

We agree in principle with the concept of calculating allowances using an updated NPT SMNCC model which draws on the new SMIP CBA. However, there are aspects of Ofgem’s proposals which could significantly alter the direction of these proposals and we call on Ofgem to clarify its approach.

Ofgem implicitly assumes that the new SMIP CBA will be available in time to set and consult on an approach for Period 4 and beyond, and that it will provide Ofgem with all the information it needs. Ofgem does not elaborate on contingency plans² if the CBA is late and there is limited transparency as to whether Ofgem and BEIS are joined up in ensuring the new CBA satisfies the input requirements of the NPT SMNCC model.

We think the assertion that the SMIP CBA has been repeatedly reviewed, improved and updated between 2011 to 2016 and represents the most accurate smart metering model available materially over-states the position. None of the CBA models has been consulted on and as far as we are aware, none of them has been released to suppliers (or their advisers) for external scrutiny and challenge. There is limited transparency surrounding the manner in which costs and benefits have been calculated and profiled. This may not have been important when the CBA’s main purpose was to justify the SMIP, but it becomes vitally important when the CBA is to be used as a key input to a price cap.

Ofgem proposes to deviate from the new SMIP CBA where it deems appropriate. This includes removing costs and benefits that are not relevant to suppliers and to assess whether other modifications, differing from the approach taken in the new SMIP CBA, may be appropriate. We think this is a sensible approach provided Ofgem does not make modifications in isolation and consults in a way that enables stakeholders to meaningfully comment on areas where Ofgem proposes to deviate (or not to deviate). For the avoidance of doubt, we would interpret such a consultation to include full disclosure of the NPT SMNCC model.

² Except to say that it would need to consider the implications for its planned timetable.

Ofgem says it also intends to estimate and give regard to the extent to which allowances in the first three cap periods provided advanced funding above actual, efficient costs (or conversely if lagged payments would be needed to cover any shortfall in the allowances) – for instance depending on the materiality and Ofgem’s confidence in estimated costs. Notwithstanding the inconsistency of this approach with the stance Ofgem took in its original decision document (which ruled out the use of any ex post correction mechanism), we would be extremely concerned if Ofgem were to undertake such an exercise on the basis that the cost model used in Periods 1 to 3 was correct. As noted above, we believe the current cost model significantly under-estimates net unit costs, but mitigates this somewhat by over-estimating rollout percentages. We fundamentally disagree with the principle of clawing back allowances in this way, but if Ofgem does decide to do so, it is important that it looks at the appropriateness of the Period 1-3 allowance in the round, giving suppliers the opportunity to make further representations on unit cost assumptions.

ScottishPower
May 2019