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Dear Anna,

SSE response to Ofgem Review of Smart Metering Costs in the Default Tariff Cap

We welcome Ofgem's commitment to review the smart metering cost component of the Default Tariff Cap, which we hope will ensure the allowance accurately reflects the costs suppliers incur in delivering this high profile and critical government programme.

We acknowledge that this is the beginning of the engagement process and that a further consultation is expected in August. We also acknowledge that this is a complex area and Ofgem has the difficult task of balancing a range of criteria in setting the cap. However, while the proposals at this stage are very high level, we have serious concerns with some of the plans shared by Ofgem. Annex 1 contains our full response, and a summary is provided below.

Summary of SSE response

- Suppliers should have earlier and direct access to the SMNCC model, so they can engage effectively in the consultation and help ensure cost-reflectivity of the model.
- SSE strongly opposes the introduction of a correction mechanism on the basis that it risks reducing investment in – and damaging the pace of – the rollout; it is a reversal of Ofgem's original policy on correction mechanisms, which brings procedural unfairness; and the risk of a negative adjustment could lead to a cap being set beneath an efficient level of costs.
- We support Ofgem's willingness to consider modifications to the model's assumptions and believe there is a very strong case for the inclusion of the non-SEGBC costs of consumer engagement in the model.

We would be happy to discuss the points made in our submission in more detail if helpful.

Yours sincerely

Patricia Hall



Annex 1: SSE response to Ofgem consultation on Reviewing Smart Metering Costs in the Default Tariff Cap

1 Feedback on Ofgem's consultation process

1.1 Suppliers should have earlier and direct access to the SMNCC model

Ofgem sets out on page 4 and in Table 2 of page 9 that they do not intend to share the SMNCC model with suppliers for consideration until the Final Consultation stage. This timeline will not allow suppliers access to the data with enough time to consider its accuracy and impact. This timeline is even less appropriate in the event that suppliers will need to co-ordinate access to – and dissemination and interpretation of – the data via a third party under a restricted process defined by Ofgem. As such, this introduces a risk that Ofgem will not benefit from the quality of industry input that they have sought to gather through this process.

Suppliers should have access to the SMNCC model as early as possible, and at the latest at the Further Consultation stage in August/September 2019.

Furthermore, by restricting access to the SMNCC model to a confidentiality ring, this means that suppliers are required to use third parties to access and disseminate information. Third parties will not have an operational or specialist knowledge of the data they are viewing which introduces a barrier to suppliers' ability to get value from the process. This minimises our ability to understand the implications of Ofgem's proposals. Ofgem's Consultation Policy¹ stresses the importance of stakeholders being able to access and respond to Ofgem's consultations; we believe that, by removing direct access to the very model upon which Ofgem is consulting, Ofgem erodes their ability to comply with this policy.

We accept – and welcome – Ofgem's efforts to protect the confidentiality of sensitive supplier data, but believe that suppliers should be able to access, interrogate, and provide comment on the SMNCC model. We encourage Ofgem to reconsider their decision to restrict access so that we can contribute effectively to the engagement process.

1.2 SSE strongly opposes Ofgem's proposals to introduce a correction mechanism

As set out in our response to Question 4.2, SSE strongly opposes Ofgem's proposal of introducing a correction mechanism to set allowances for cap period four and beyond. We have outlined the reasons for this in our detailed responses to the consultation questions below.

¹ <https://www.ofgem.gov.uk/consultations/our-consultation-policy>



2 SSE's response to consultation questions

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

SSE supports the notion of reviewing efficient smart meter costs and Ofgem's willingness to consider modifications to the model's assumptions and inputs. We have set out below our views on what we believe should be considered as part of this process, along with supporting evidence. We have also set out our views on the timeline to which Ofgem is working.

Non-SEGGB costs of consumer engagement should be accounted for in the SMNCC

As per SSE's response to the Statutory Consultation in November, there is a strong case for the inclusion of non-SEGGB marketing costs in the SMNCC. We have set out below information and evidence to support this view.

Low levels of customer interest increase the effort required to incentivise customers to get a smart meter

Levels of customer interest in smart metering are low and continue to fall. This is evidenced by external research on customer appetite for smart metering.

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Ofgem will also be aware of the National Audit Office's (NAO) 2019 report into the smart metering programme. This report includes findings in respect of smart marketing costs and provides useful context to support our view that supplier marketing costs are not only substantial but are increasing far beyond initial government expectations due to low levels of customer interest. The NAO's report explains: 'Consumer behaviour has proven to be more of a barrier to mass uptake of smart meters than the Department anticipated. In its 2014 impact assessment, the Department included an initial estimate of £87 million for the potential costs of a national awareness-raising campaign for smart meters. This campaign would be carried out by a central delivery body (now known as Smart Energy GB). This estimate was subsequently increased to £192 million in the 2016 cost–benefit analysis. The Department made no provision in its estimates for the costs that energy suppliers might incur on marketing and consumer engagement.'²

Increasingly sophisticated efforts are expected by Ofgem to engage customers and demonstrate 'all reasonable steps'

As Ofgem's Retail Price Protection team will be fully aware, there is an explicit expectation that suppliers will invest in – and continuously develop – their customer engagement activity, which Ofgem describes as being a critical element in being able to demonstrate 'all

² <https://www.nao.org.uk/wp-content/uploads/2018/11/Rolling-out-smart-meters.pdf>



reasonable steps' at the end of the rollout³. Ofgem's Open Letters from the Smart Metering team make consistent reference to the need for suppliers to engage all customers, develop recontact strategies, use multiple channels of engagement, use customer segmentation, tailored messaging, offer incentives⁴, and, importantly, that Ofgem expects suppliers to ensure their activity complements the broader engagement of SEGB⁵.

The National Audit Office's 2019 report into the smart metering programme also includes relevant commentary in respect of smart marketing costs. When referring to the scope of the BEIS cost-benefit analysis, they explain: 'It does not include the direct marketing and consumer engagement costs energy suppliers are incurring to persuade consumers to accept smart meter installations, which for some suppliers are significant.' 'Some suppliers told us they are having to spend significant amounts on consumer engagement and direct marketing activity. If this expenditure were to be replicated across the energy market, we estimate that suppliers could spend around £200 million to increase consumer demand for installations. The Department did not include these costs in its business case.'⁶

It must be acknowledged that suppliers are expected to invest in marketing and consumer engagement above and beyond what is commissioned to SEGB and what was forecast in the BEIS cost-benefit-analysis. It must also be acknowledged that the cost of this activity has increased to substantial levels against a challenging backdrop of low customer interest. We encourage Ofgem to reconsider the exclusion of these costs.

The smart meter rollout underpins a wider regulatory energy strategy for Great Britain

Finally, the successful and timely completion of the smart meter rollout programme underpins a much wider regulatory energy strategy for Great Britain. This makes it even more important to ensure that suppliers can make sufficient investment in non-SEGB marketing costs. As BEIS explain in their recent consultation on enrolment and adoption of SMETSv1 meters, 'the rollout is not only an investment in our future; it will also support the delivery of tangible and immediate energy-saving benefits for households and small businesses across Great Britain. It is an important foundation for the Government and Ofgem's Smart Systems and Flexibility Plan.'⁷ We believe that given this wider importance of smart across the policy landscape and considering the delays and disruption to which the smart rollout programme has already been subjected, suppliers' ability to invest in engaging customers with smart is a crucial enabler to the transformation of the sector.

It is clear from a variety of sources that engagement on smart is a challenge, and that Ofgem expect suppliers not to rely solely on SEGB activity to incentivise customers to take a smart meter but to invest in taking all reasonable steps to drive demand. Given Ofgem's clear and

3 https://www.ofgem.gov.uk/system/files/docs/2018/05/2018.05_open_letter_-_observations_from_rollout_plans.pdf

4 https://www.ofgem.gov.uk/system/files/docs/2018/05/2018.05_open_letter_-_observations_from_rollout_plans.pdf

5 https://www.ofgem.gov.uk/system/files/docs/2017/12/2017.11_open_letter_on_smart_meter_rollout_-_dcc_user_mandate_tolerance_2019_submissions_and_energy_efficiency_advice.pdf

6 <https://www.nao.org.uk/wp-content/uploads/2018/11/Rolling-out-smart-meters.pdf>

7 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/783149/enrolment-secure-smets1-meters-in-dcc.pdf



consistent direction on this point, it is difficult to understand why no allowance would be made for the associated smart marketing costs in assessing efficient costs under the Default Tariff Cap. We would therefore welcome a modification to the SMNCC that will help ensure the cap reflects the essential costs suppliers incur in engaging and incentivising customers to take a smart meter by 2020.

It is unclear how Ofgem is managing the risks associated with its timeline to revise the SMNCC

We note that Ofgem's timeline is dependent on BEIS completing its updated cost-benefit-analysis (CBA) in time. Ofgem has, however, not articulated (a) what it is doing to expedite this process to ensure it appropriately safeguards the completion of the SMNCC review in time for cap period four; and (b) what contingency plans Ofgem has in place to mitigate this, given that publication of the most recent update to the BEIS CBA was subject to multiple delays. We encourage Ofgem to share these details so that suppliers can input to discussions and manage their own readiness and contingency planning.

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.

SSE is comfortable with Ofgem's proposal of a two-stage process for setting the allowance for the third cap period, but only on the basis that the allowance is unqualified, and that Ofgem removes its proposal for a claw-back mechanism in future periods. See our response to question 4.2 for further details.

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

SSE is comfortable with Ofgem's proposal to set the allowances for the fourth cap period and beyond based upon the updated non-pass-through SMNCC model only if (a) suppliers are given earlier and direct access to the SMNCC model than currently proposed, as explained in Section 1 above; and (b) Ofgem removes its proposal to introduce a correction mechanism when setting allowances for cap periods four and beyond. We have expanded on (b) below.

In its November Decision Document (Appendix 7) Ofgem provided industry with confidence that the approach for cap periods 1 – 3 was robust and conclusive. Ofgem set out with confidence that their approach to calculating the allowances for the smart meter rollout via the SMNCC represented a fair smart metering net costs increment for efficient suppliers, and that this aligned with the requirement in the Act for Ofgem to have regard to the need to provide incentives for suppliers to improve efficiency (Page 8, Appendix 7, Decision Document). There was no indication in this publication that the review Ofgem intended to conduct in 2019 would review costs incurred in cap periods 1 -3 using the new CBA and that this would inform adjustments to cap period four onwards to rebalance any over- or under-payments.



Furthermore, in its previously published material on the Default Tariff Cap, Ofgem strongly opposed the use of a correction mechanism. Ofgem was clear throughout its consultation process that it viewed the use of a correction mechanism for forecast errors as creating further distortions in the market. This view was expressed in Ofgem's May 2018 Policy Consultation (Appendix 5, paragraphs 3.13 – 3.16),⁸ September 2018 Statutory Consultation (Appendix 3, paragraph 3.22)⁹ and its November 2018 Decision Document (Appendix 3, paragraphs 3.18 – 3.21).¹⁰ In particular, in Appendix 3 of the Decision Document, Ofgem explicitly stated that a negative adjustment could lead to a cap being set beneath an efficient level of costs, distorting customers' incentives to engage in the market, suppliers' incentives to offer competitive tariffs, and the incentives of new suppliers considering entering the market. It was also noted that suppliers' default tariff customer base is not static, so any correction mechanism would result in recovery that did not match the benefits or costs in the preceding period. Indeed, Ofgem were explicit in their view that it would not be possible to ensure any correction accurately reflected the level of over- or under-recovery in the previous period.

SSE urges Ofgem to remove this proposal on the following basis:

- The reversal of policy is against the principles of natural justice, brings procedural unfairness and renders the earlier consultations regarding the setting of the price cap unfair as respondents were unable to understand Ofgem's proposals and comment on them. This opens Ofgem up to challenge.
- As Ofgem described in the Decision Document, a negative adjustment resulting from a correction mechanism could lead to a cap being set beneath an efficient level of costs, distorting customers' incentives to engage in the market, suppliers' incentives to offer competitive tariffs, and the incentives of new suppliers considering entering the market. SSE is concerned as to how the introduction of this risk aligns with section 1 (6) of the Act which requires Ofgem to have regard for matters relating to improving efficiency, enabling competition, maintaining incentives to switch, and ensuring suppliers who operate efficiently are able to finance their licenced activities.
- SSE believes that any claw-back in future periods could be detrimental to the success of progressing the smart meter rollout. Investments and commitments for early cap periods have already been made and cannot be used to sustain a strong rollout going forward. A negative adjustment for cap period four onwards would therefore reduce investment available and risk limiting the future pace of the rollout.
- This proposal also goes against the view set out by Ofgem elsewhere in its consultation that any over or under-recovery by individual suppliers relating to their specific roll-out profile is expected to even itself out over time.

8 https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix_5_-_updating_the_cap_over_time.pdf

9 https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_3_-_updating_the_cap_methodology.pdf

10 <https://www.ofgem.gov.uk/ofgem-publications/142161>



- As Ofgem has previously noted, the Act requires it to consider the rollout of smart meters as part of its assessment of the conditions for effective competition; we urge Ofgem to reconsider the potential impact a claw-back mechanism in the SMNCC would have on suppliers' ability to rollout smart meters in an efficient and timely manner.
- Finally, we note that the proposal is inconsistent with all other elements of the cap. In outlining these proposals, Ofgem has not given any explanation as to why this particular element of the cap should be subject to a correction mechanism while other elements are not.