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16 July 2019

Dear Anna,

Default tariff cap: approach to the third cap period

Thank you for the opportunity to comment on Ofgem's proposed approach to the third cap period, specifically on allowances for net costs of the smart meter rollout and costs of the Capacity Market (CM). In general, we agree with the approach and both proposed allowances for the third cap period.

We recognise that this consultation relates solely to the third cap period (1 October to 31 March) and that Ofgem will consult on these allowances for subsequent cap periods later in the year. The majority of our response, set out in two separate sections below, is framed in this context but we include views beyond the calculation of Smart Metering Net Cost Change (SMNCC) for the third period where we consider them to be relevant.

<u>Smart metering cost allowance</u>

Missing allowance in respect pf prepayment meters

The CMA's 7 June provisional decision on the Prepayment Charge Restriction (PCR) has highlighted a serious anomaly resulting from the different approaches adopted by Ofgem and CMA to smart costs. The CMA has proposed that there will be no non-pass through (NPT) SMNCC allowance in the revised PCR with effect from 1 October 2019 (and nor was any such allowance made in the original PCR). As we understand it, Ofgem's methodology for calculating NPT SMNCC is to estimate the overall smart meter net cost change for an efficient supplier (across credit and prepayment meters) and then to divide it by the total number of meters (credit and prepayment) to obtain a per-meter NPT SMNCC value. Assuming circa 15% of meters market-wide are prepayment[1], this means that suppliers will on average be unable to recover circa 15% of NPT SMNCC costs.[2]

[1] According to the CMA's 2016 EMI final report the proportion of customers on prepayment meters was 16%. The number may have reduced slightly since then.
[2] Fully interoperable smart prepayment meters are covered by Ofgem's default tariff cap rather than the CMA's PCR, but the number of such meters to date has been negligible.

Assuming the CMA confirms its decision we think it would be feasible and appropriate for Ofgem to make a corresponding adjustment to the DTC in time for 1 October 2019. The simplest approach would be to uplift the NPT SMNCC allowance by 18% (=1/0.85-1) which would ensure that smart costs are fully recovered. Alternatively, as an interim solution until it is possible to properly reconcile the DTC and PCR inconsistency, Ofgem could focus the adjustment on credit meters only. So for example, if the six largest suppliers' rollout of smart meters comprised on average 95% credit and 5% prepayment meters[3], Ofgem could apply an uplift of 12% (=0.95/0.85-1) to ensure that credit-meter related smart costs are fully recovered.[4] Given that the CMA will need to confirm its provisional decision ahead of 7 August, we see no reason why Ofgem should not make this adjustment in time for the Period 3 cap (1 October 2019 to 31 March 2020).

Postponement of SMNCC review and rollover for Period 3

We agree with that it would be inappropriate to leave the licence condition without a non-pass-through (NPT) SMNCC value for the third period. Ofgem's proposal to set the NPT SMNCC component for the third period using the current NPT SMNCC model is sensible given the new Smart Metering Implementation Programme Cost Benefit Analysis (SMIP CBA) is unlikely to be available from BEIS in time for the 7 August cut-off point. However, as noted above, we think that Ofgem should make an interim adjustment for Period 3 to focus the SMNCC calculation specifically on credit meters rather than meters in general.

Data gathering for SMNCC review

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 additional data if necessary. Our response to the April consultation[5] highlighted a risk that Ofgem will have insufficient time to collect all required additional data following the completion of the updated CBA. Therefore, we repeat our call for Ofgem to collect any additional information it would require to supplement the Annual Supplier Returns, rollout data and BEIS CBA 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.

Energy UK has previously shared views on where there are gaps in the collection of such data[6] and we consider that list to be a useful template for information requests to suppliers. It is consistent with areas such as programme costs, early replacement charges and meter rental charges where we feel the SMNCC model underestimates costs.

Transparency

We would reiterate our previous request that Ofgem provides greater transparency over the breakdown of NPT SMNCC costs and benefits in its forthcoming review. We can see no justification on confidentiality or commercial sensitivity grounds for Ofgem not to

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[3] Based on our market knowledge we would expect the percentages to be of this order, but it should be straightforward for Ofgem to obtain this data.

[4] Ofgem sets the SMNCC based on the average of the six largest energy suppliers' modelled costs (Default Tariff Cap Decision: Appendix 7 – Smart metering costs, para 2.16)

[5] Reviewing smart metering costs in the default tariff cap (April 2019) https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap

[6] Reviewing Smart Metering Costs in the Tariff Cap (May 2019) https://www.energy-uk.org.uk/publication.html?task=file.download&id=7143

disclose how its proposed aggregate NPT SMNCC allowance breaks down into its constituent costs and benefits, together with key assumptions. This would be of considerable assistance to suppliers in reviewing (and challenging where appropriate) Ofgem's assumptions and would be good regulatory process. We recognise that there will be some aspects of the model which are genuinely commercially sensitive, and these will need to be covered by the confidentiality ring – but this should not be used as a substitute for public disclosure.

Ofgem's commitment to set out plans for its confidentiality ring proposals to stakeholders at an appropriate time is welcomed but we encourage Ofgem to be more definitive on timescales and process when it publishes a decision to this consultation.

Lagged/advance payments

Ofgem continues to make reference to its intention to give consideration to any substantial advance payment (or lagged payment) in the first three cap periods when it sets allowances for the fourth and subsequent periods. We note Ofgem's argument that this would be conceptually different from ex post correction mechanisms (which it had previously ruled out), because suppliers would be deemed to have been paid in advance for rollout and therefore need less allowance in future. But we think that in practice such an approach would have similarly adverse effects on suppliers' ability to forecast costs and revenues and manage their businesses and would raise many of the same concerns that Ofgem raised about ex post correction mechanisms, that:

> "using an error correction mechanism would create a further distortion to the market. In particular, a negative adjustment (to correct for the cap being set too high in the previous period) could lead to a cap being set beneath an efficient level of costs. This would distort customers' incentives to engage in the market, suppliers' incentives to offer competitive tariffs, and the incentives of new suppliers considering entering the market"[7].

In any event, as we noted in our response to the April 2019 consultation[8], we believe the current cost model significantly under-estimates net unit costs, but mitigates this somewhat by over-estimating rollout percentages. We would fundamentally disagree with any approach to adjusting for 'advance payment' which looked at rollout percentages in isolation. It would be essential to look at the Period 1-3 allowance in the round, including reviewing ex post the accuracy of unit cost estimates and taking account of non-recovery in respect of prepayment meters (see above).

<u>Capacity Market cost allowance</u>

We agree with Ofgem's proposal to include a full CM allowance in the third cap period. The rationale is consistent with the approach taken in the second cap period and is a sensible approach as suppliers are collecting these costs from customers in the knowledge that deferred payments to capacity providers will need to be paid promptly in the event the standstill period comes to an end.

As Ofgem notes, the Government has encouraged suppliers to make adequate provisions, including through voluntary contributions to the Electricity Settlements

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[7] Default Tariff Cap: Decision, Appendix 3 – Updating the cap methodology (November 2018), para 3.7 https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

[8] Reviewing smart metering costs in the default tariff cap (April 2019) https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap

Company (ESC), to pay these charges in full when they become due. Therefore, the cap in the third period must enable suppliers to make these voluntary contributions or save up money to make back-payments.

Ofgem's approach notes that if the State Aid decision is published before 7 August, it will consider whether these proposals remain appropriate and whether to carry out a consultation, where appropriate. We encourage Ofgem to continue working closely with BEIS in the lead up to the third cap period decision as timescales involved in this process are very short and it is important that Ofgem is able to accommodate any last minute developments in its decision.

We also think it would be a prudent approach, consistent with its statutory objective, for Ofgem to consult on any implications from the State Aid decision on CM allowances in the price cap.

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,

Richard Sweet
Head of Regulatory Policy