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Smart metering allowance in the default tariff cap – Update and summary of responses to the October 2019 consultation

Summary

1. This paper updates stakeholders on our plans for updating the non-pass through Smart Metering Net Cost Change (SMNCC) allowance in the default tariff cap ("the Cap").
2. In October 2019 we consulted on an updated methodology for calculating the SMNCC in future cap periods.[1] In December 2019, we announced that we would use a contingency allowance for cap period four (1 April 2020 to 1 October 2020), while we continued to consider suppliers' representations on our proposed methodology. We said that we would either publish a decision in the New Year, or consult on updated proposals.
3. We plan to update our proposals and provide a statutory consultation on that methodology in **mid-May 2020**. We intend to publish a decision on the proposed modification by **the end of July 2020**, with effect from cap period five (1 October 2020 to 31 March 2021) onwards.[2]
4. In this document, we:
    a. set out the background to this update (section 1)
    b. set out the key stages and timetable for consulting on an updated methodology (section 2)

[1] Ofgem (2019), Reviewing smart metering costs in the default tariff cap: October consultation. https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-october-consultation

[2] This timetable is based on our proposal to align the licence conditions with the minimum 56 day period in section 5 of the Domestic Gas and Electricity (Tariff Cap) Act 2018. If we decide not to implement those proposals we will update stakeholders in mid-March with a new timetable for this consultation. See Ofgem (2020), Statutory Consultation on the process for modifying the Default Tariff Cap. https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-process-modifying-default-tariff-cap

c. explain how we have considered suppliers' responses to our October 2019 consultation (section 3).

5. Table 1 summarises the timetable for the proposed consultation.

Table 1: Draft timeline for the SMNCC consultation

Step	Period	Overview
Data gathering	February and March	We are sending an RFI to suppliers to make further enquiries about specific cost categories.
Publish disclosure arrangements	Mid-March	We will publish disclosure arrangements in order for suppliers to comment and prepare.
Consultation and disclosure period	May to mid-June	We will publish a statutory consultation on the updated methodology and disclose the SMNCC model according to the specifications we will make in March. The consultation period will likely last up to 6 weeks.
Decision	End of July	Publication of decision, rationale, and modification to the licence.

Next steps and interaction with other work

6. If you wish to respond to this paper, please send representations to retailpriceprotection@ofgem.gov.uk on or before **2 March 2020**.

7. We also intend to consult on two other modifications to the Cap, with effect from cap period five. These are:

   a. reassessing the wholesale allowance in the first cap period. We have published an initial consultation on our approach alongside this update.[3]

   b. introducing a payment method uplift for prepayment customers on default tariffs, to ensure appropriate protection for these customers when the PPM Cap expires at the end of 2020. We will publish an initial consultation on this issue shortly.

8. If you have any questions please contact retailpriceprotection@ofgem.gov.uk.

[3] Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation. https://www.ofgem.gov.uk/publications-and-updates/initial-consultation-on-reassessing-the-wholesale-allowance-in-the-first-cap-period

1. Background

The default tariff cap ("the Cap")

1.1. We introduced the Cap on 1 January 2019, protecting over 11 million customers on standard variable and default tariffs (which we refer to collectively as "default tariffs").[4] The Cap ensures default tariff customers pay a fair price for the energy they consume, reflecting its underlying costs.

1.2. We set separate caps for default gas tariffs and default electricity tariffs, as the underlying costs for each fuel differ. The underlying costs of supplying energy change over time, so we update the cap every six months to reflect cost changes. We will announce the fifth cap update on 7 August 2020. That cap will apply to tariffs charged in the fifth cap period – between 1 October 2020 and 31 March 2021.

1.3. The Cap is temporary. In 2020, we must review whether the conditions are in place for effective competition, and publish a report, including a recommendation on whether the cap should be extended or not. The Secretary of State will then decide whether to extend the Cap. If the Cap is extended, we will repeat our review in 2021 and (if necessary) also in 2022. In line with Domestic Gas and Electricity (Tariff Cap) Act 2018 ("the Act"), the Cap cannot be extended beyond the end of 2023.

The smart meter rollout

1.4. Smart meters are replacing traditional gas and electricity meters across Great Britain as part of a national infrastructure upgrade that will enable technologies such as electric vehicles, smart tariffs and microgeneration to be efficiently and cost-effectively integrated with renewable energy sources.

1.5. The half-hourly consumption and price data recorded by smart meters brings an end to estimated billing and manual meter reads, while the In-Home Display provides households with accurate information about their energy consumption which they can use make changes to the way they use energy and save money on their bills.

1.6. Once installed, smart meters will bring net benefits to consumers, businesses and the nation as a whole – estimated to be worth £6bn up to 2034.[5] They are an important feature for modernising the retail energy market. They help decarbonise the energy sector, enable energy suppliers to offer new products and services to customers, and allow consumers to take control of their energy consumption.

[4] Ofgem (2018), Default tariff cap: decision – overview. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview
[5] BEIS (2019), Smart meter roll-out: cost-benefit analysis 2019. https://www.gov.uk/government/publications/smart-meter-roll-out-cost-benefit-analysis-2019

1.7. However, in the initial years during the smart meter rollout, energy suppliers incur net costs to install smart meters in their customers' homes. We need to consider these costs when we set the Cap.

Smart metering cost allowances in the Cap

1.8. We include allowances in the Cap to recognise the underlying efficient cost to suppliers (taken as a group) of installing and operating smart meters. This allows suppliers to recover the efficient cost of installing smart meters, and ensures customers with default tariffs are protected in terms of paying a fair price.

1.9. In each cap period, for each fuel, we split the net cost of the smart meter rollout between two allowances in the Cap:

- **the operating cost allowance**: this allowance covers (in real terms) the efficient level of a supplier's total operating costs in 2017, which include the net cost of rolling out smart meters *at that point in time*. We index the allowance over time with inflation.

- **the non-pass-through SMNCC**: in this allowance we include the *change in the efficient net cost of introducing smart meters since 2017* (ie the incremental costs since 2017, not already provided for in the operating cost allowance). We update this allowance using the values calculated in the SMNCC model and discussed in this consultation.

  Note that we defined our 'efficient' benchmark differently in our assessment for operating costs and our assessment of smart metering costs. In effect, our assessment of operating costs uses a less generous (or "stricter") definition of 'efficient'.

1.10. The Cap includes a **pass-through SMNCC** allowance. This is an allowance for changes in industry body charges since 2017 (such as those from the Data Communications Company – DCC – and Smart Energy GB). We estimate the net change in costs using sources including: the latest charging statements, forecasts, and budgets.[6] In the operating cost allowance we include industry body charges at the level incurred in 2017. Together, that proportion of the operating cost allowance and the pass-through SMNCC equals the total industry body charges. The pass-through SMNCC is outside the scope of this review.

[6] We carry out this calculation in the document Annex 5 referred to in the cap licence conditions (standard licence condition 28AD of the gas and electricity supply licences).

Our October 2019 Consultation

1.11. When we introduced the Cap in 2018, we recognised that the costs, benefits, and pace of the smart meter rollout were uncertain. At the time of our decision, the assessment of costs and benefits of the programme had not been updated since 2016, and suppliers were obliged to take all reasonable steps to complete the smart meter rollout by the end of 2020.

1.12. Due to that uncertainty, we decided to set the SMNCC for the first two price cap periods only. We decided to review (in 2019) the latest data on costs and rollout, update the approach and set the SMNCC for cap periods from October 2019 onwards.[7]

1.13. In September 2019, the Department for Business, Energy and Industrial Strategy ("BEIS")published its latest view on the rollout and its expected costs. It published:

- **the new cost-benefit analysis of smart meter rollout ("new CBA")**.[8] This document is the latest independent assessment of the costs and benefits of the smart meter rollout based on the most up-to-date evidence from the programme.
- **its consultation on the smart meter policy framework post 2020**.[9] This document consults on a number of proposals to help inform the policy framework for energy suppliers to continue installing smart meters after 31 December 2020, when the current rollout duty ends.

1.14. In October 2019, we published a consultation proposing an updated SMNCC methodology. We acknowledged that we may not be able to publish a decision on the proposed methodology before 13 December 2019 (the last point at which publication of a modification to the methodology could have effect from 1 April 2020). In that event we proposed using a contingency allowance to set the SMNCC in cap period four (1 April 2020 to 30 September 2020).

Contingency allowance for cap period four

1.15. On 13 December 2019 we published our decision to implement the contingency allowance for cap period four.[10] We set the contingency allowance using the current

[7] Ofgem (2019), Decision – Default tariff cap – Overview document; para 2.50, para 2.65. https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document_0.pdf
[8] BEIS (2019), Smart meter roll-out: cost-benefit analysis 2019. https://www.gov.uk/government/publications/smart-meter-roll-out-cost-benefit-analysis-2019
[9] BEIS (2019), Smart meter policy framework post 2020. https://www.gov.uk/government/consultations/smart-meter-policy-framework-post-2020
[10] Ofgem (2019), Reviewing smart metering costs in the default tariff cap: Decision for cap period four. https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-decision-cap-period-four

SMNCC model, which has not been updated for changes in rollout progress or installations costs.

1.16. In our decision on the contingency allowance, we stated that we may reach a decision on the updated methodology in the New Year, or consult on further updates to the methodology.

2. Timetable and plans

Summary

2.1. This year we intend to consult on an updated SMNCC methodology.

2.2. We aim to consult on our updated proposals in **May 2020** and publish a decision to modify the allowance at the **end of July 2020**.

2.3. In this section we explain the key stages of the consultation: additional data gathering; further analysis; disclosure arrangements; statutory consultation and decision; interaction with other consultations; contingency allowance for cap period five (if required); and future consultations.

2.4. This timetable is informed by suppliers' representations, which we discuss in section 3.

Additional data gathering

Requests for information from suppliers

2.5. Based on suppliers' representations on our consultation we have decided to make further enquiries into aspects of suppliers' smart metering costs.

2.6. In January 2020 we shared a draft Request for Information (RFI) with the suppliers defined as large suppliers for smart metering purposes. Based on their feedback we will refine our enquiries and issue an RFI in early February 2020.

2.7. We have selected cost and benefit categories for further enquiry based on suppliers' representations. We considered each issue against the following criteria:

- materiality: the likely impact on the SMNCC of additional data (taking account of relevant data we already have, in particular from the new CBA)
- practicality: the ability of suppliers to provide additional data (within an appropriate timescale);
- applicability of available data: whether additional data and analysis would lead to more robust decision (for example, for forward-looking issues, data on current trends may be unavailable or inclusive), again taking account of relevant data we already have;
- robustness of current position: the extent to which there is robust data and a clear rationale supporting the current assumptions, and the extent to which that is challenged by the data and rationale of suppliers' representations on those costs.

2.8. We have not limited our enquiries to areas where representations demonstrate that our approach is inappropriate. We include issues where we consider that suppliers'

evidence is inconclusive – their costs could be consistent with the model, or their variances may indicate that the model is unrepresentative. For instance, many suppliers discussed high rental charges on meters with deemed rates. These meters are a specific subcategory which we would expect to be more expensive than average. The model makes no attempt to subdivide costs into different subcategories of rental contract, so the fact that there is a variance is not surprising. However, suppliers' representations indicate that the variance in this area could be significant enough to affect the suitability of our allowance for costs in general (meters on average). As this is a highly material area of costs and enquiries can practicably be made, we wish to make further enquiries to understand the issue better.

2.9. Requests for additional data do not necessarily indicate a change in approach using that data. We have requested data to help us assess whether our current approach is appropriate. Based on that data we may propose to maintain our current approach regarding particular cost items, propose to update the approach using the data requested, or update the approach using some other method (for instance, a simple uplift to recognise the additional uncertainty that new data may have illustrated). In all respects, we shall seek to take account of the statutory principles governing the Cap.

2.10. We intend to consider whether to make modifications to our current approach using the same criteria set out in our April and October 2019 consultations.[11]

Annual Supplier Returns (ASRs)

2.11. We expect suppliers' quality-assured ASR data relating to 2019 to be available in **April 2020**. This data is the most recent and reliable source of smart metering costs and will set out suppliers' costs and benefits for 2019.

2.12. We propose to include the 2019 ASR data in our updated proposals. Including this data would allow us to use an additional year of actual costs. It should also directly address some of the issues raised by stakeholders such as stranded costs, as the data should show actual costs incurred, regardless of whether they were stranded or not.

2.13. While it is always the case that we could delay a decision in order to acquire new data, in this case an earlier decision would not lead to earlier implementation. Any decisions made between now and 6 August 2020 would not have effect until 1 October 2020. We consider it preferable to include suppliers' ASR data on their

[11] Ofgem (2019), Reviewing smart metering costs in the default tariff cap: October consultation. https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-october-consultation

2019 costs, which could be done before a consultation on the SMNCC in May 2020 and modification in July 2020.

2.14. However, we would consider excluding the ASRs if we would otherwise need to delay a decision on the updated methodology until cap period six (1 April 2021 to 30 September 2021).

Further analysis

2.15. We intend to update our analysis, maintaining our general approach, which takes the new CBA as a starting point, and modifies certain costs and benefits assumptions as appropriate.

2.16. Suppliers made representations about the suitability of this approach. They argued that, in practice, our approach to validating the CBA and our judgements on when to modify the approach were inadequate. We consider these representations in section 3, concluding that our approach is suitable, but we will, of course, seek to make refinements where required.

2.17. Suppliers made representations about specific cost and benefit categories. We will discuss these issues with detailed comments on our methodology in the forthcoming statutory consultation.

Disclosure arrangements

2.18. We intend to disclose the SMNCC model during the statutory consultation period. This will be the full model that underpins our proposals, allowing suppliers to understand them, compare their own circumstances to the assessed costs (in aggregate, and isolated cost or benefit and categories), and make representations on their variances.

2.19. We also intend to disclose a number of underlying data sources, which support key inputs to the model.

2.20. We intend to publish the disclosure arrangements in **mid-March 2020**, around two months before the disclosure and consultation period is foreseen to start.

2.21. Suppliers made representations about the adequacy of the disclosure arrangements for the October 2019 consultation. We respond to these in section 3. We consider that the disclosure arrangements were sufficient, but we will nonetheless consider where improvements can be made.

Statutory consultation and decision

2.22. We intend to present an updated methodology for statutory consultation in **May 2020**. We intend to consult for a period up to six weeks. We have considered the complexity of the update and modelling, the stage of this consultation, and

interactions with other consultations on the Cap that we will publish at the same time.

2.23. In response to the October consultation, suppliers argued that the consultation process had been inadequate and they raised various concerns about procedural fairness. We have considered these arguments and concluded that the process was fair and adequate. Nonetheless, we will reassess the requirements for the statutory consultation in May 2020 to ensure they are appropriate, if for example, circumstances for that consultation differ from the October 2019 consultation.

2.24. We intend to publish a decision on the modification at or before **the end of July 2020**. The modifications would have effect from cap period five (1 October 2020).

Interaction with other consultations

2.25. On 23 January 2020 we published a statutory consultation on changing the process for modifying the Cap's licence conditions. That consultation seeks to align the licence conditions with the 56 day period set out in section 5 of Act.[12] This proposal should allow us to modify the Cap conditions in the manner that most stakeholders had already assumed was the case.

2.26. The timetable set out in this document is based on the proposed process changes in 2.25. However, if we decide to maintain the current licence conditions then, in **mid-March 2020,** we will publish updated plans taking that into account. In that circumstance, we would need to publish a decision by **12 June 2020** in order to have effect by cap period five (1 October 2020), which could require us to change other dates in the timetable set out in this document.

2.27. We also intend to publish a statutory consultation this year to prepare the Cap for prepayment customers, and a statutory consultation to reassess of the wholesale allowance in the first cap period. Those consultations will follow a similar timetable for disclosure and consultation to the one set out in this paper.[13]

Contingency allowance for cap period five

2.28. For Cap period four we used a contingency allowance benchmarked to the current SMNCC model, which had not been updated.

2.29. In the event that we are unable to make a decision on the new SMNCC methodology in July 2020, we would still need to set an SMNCC for cap period five. There is no SMNCC for cap period five in the licence.

[12] Ofgem (2020), Statutory Consultation on the process for modifying the Default Tariff Cap. https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-process-modifying-default-tariff-cap
[13] Ofgem (2020), Default tariff cap: January 2020 update letter. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-january-2020-update-letter

2.30. We would expect to take the same approach as we did in the October consultation, benchmarking the allowance to the current SMNCC model. The current model has relatively consistent values in the first four cap periods, but it will reduce to around £15 for a typical dual fuel customer in cap period five (£8.46 for a gas customer and £6.44 for an electricity customer). We would consider whether this is appropriate and present any proposed contingency in the statutory consultation.

Future consultations and reviews

2.31. In our October 2019 consultation we said that we intended to set the SMNCC for all potential cap periods, and that although we could not rule out future reviews due to the uncertain pace and costs of the rollout, it was not our intention to review those allowances.

2.32. Having considered suppliers' representations we consider that on balance future review, or reviews, are inevitable and to be welcomed, as the most practical way of dealing with uncertainty.

2.33. We envisage that review(s) will be appropriate to assess the impact of standard uncertainty, and to respond to significant policy decisions (such as, but not limited to BEIS's decision on the post 2020 policy framework for the rollout of smart meters).

2.34. As we cannot guarantee when reviews would occur, and we seek to avoid a situation where there is no SMNCC at all, we still propose to estimate the SMNCC for all potential cap periods. However, these would be subject to later review(s).

3. **Suppliers' representations**

Overview

3.1. Suppliers made extensive representations regarding the proposals we set out in our October consultation. Suppliers' main themes included:

- the significance of on-going uncertainty, in particular the Cap's interaction with the post-2020 policy framework for the rollout of smart meters
- our methodology and assessment of specific cost or benefit categories
- dissatisfaction with aspects of the disclosure and consultation arrangements and
- opposition to our consideration of carry forward balances.

3.2. In this section, we consider the issues above that have a direct impact on our proposed timetable. We do not discuss detailed aspects of the methodology. We will discuss these issues in the forthcoming consultation, in the light of additional data we collect.

Ongoing uncertainty

Representations

3.3. We acknowledge that the pace and costs of the rollout are uncertain. This is generally the case, as programme developments, consumer appetite for a smart meter, and rollout productivity can be difficult to anticipate. There is also a specific variable in that BEIS is yet to finalise the post-2020 policy framework, which suppliers stated could significantly affect the pace and cost of installations. In its consultation BEIS proposed to replace the supplier obligation in the licence to use "all reasonable steps" ("ARS") to roll out smart meters with one where annual targets would be set for energy suppliers for the years 2021 to 2024. By the end of 2024, energy suppliers would be required to have installed smart meters in the premises of at least 85% of their customers. Some suppliers were concerned that this could lead them to incurring "unreasonable" costs to meet the targets.

3.4. Some suppliers stated that we could not, or in any case should not, take a decision on the SMNCC allowance in circumstances where the underlying rollout obligations are uncertain. They felt we must, or should, wait for a decision by BEIS on the post-2020 rollout obligation. Alternatively, most suppliers considered that subsequent reviews would be necessary, as circumstances change.

Our consideration

3.5. We have considered these views carefully. We have a continuing obligation to set the Cap, and in doing so, protect default tariff customers as well as having regard to the matters in section 1(6) of the Act. In previous representations, suppliers agreed

that it would be inappropriate not to set an SMNCC. It would also be inappropriate to set an SMNCC at a level that substantially differed from suppliers' efficient costs, to the detriment of consumers. The relevant question is therefore at what level we should decide to set the allowance, acknowledging that suppliers' future costs are uncertain (in the medium to long term).

3.6. In the near term, uncertainty is manageable. There is a known existing regime and we have a more recent assessment of progress and costs than what was available to us in 2018. Therefore the pace and cost of the rollout in the next year or two is much clearer than it was in 2018.

3.7. In the longer term, uncertainty is more significant and will continue, even after BEIS finalises the post-2020 framework. For instance, BEIS sought suppliers' views on further policy interventions that it might introduce to assist the rollout. The nature, timing, and impact of any new policy interventions are currently unknown as these will very much depend on the progress of the rollout, external factors and specific factors in the market that need to be addressed. Therefore, in reality, it is difficult to foresee when long-term costs will become more certain. Regardless, we should set the SMNCC at an appropriate level for each Cap period so far as practicable, taking account of our ability to make appropriate adjustments in later Cap periods.

3.8. On that basis, we agree with suppliers that further review(s) of the SMNCC are inevitable and that they offer a preferable and practical approach to dealing with ongoing uncertainty. Such reviews may be necessary at times when we could consider the impact of major policy decisions (including, but not limited to the post-2020 policy framework for rolling our smart meters). Periodic reviews may also be necessary to consider the inherent uncertainty of the cost and pace of the rollout in the medium to long term.

Our analytic approach and methodology

Representations

3.9. Several suppliers provided representations questioning the appropriateness of our methodology. This included our overall analytic approach – which takes BEIS' new CBA as a starting point and modifies certain aspects of it as we consider appropriate. Suppliers also made representations about the accuracy of specific cost and benefit categories. We have considered these representations to inform our plans for this year's consultation.

Our approach

3.10. We have considered those representations. We consider it appropriate to use the new CBA as a starting point, and we propose to maintain that approach. The CBA

has been prepared to a high standard. It is a major research project which has been developed over several years. The latest CBA was developed over two years by a qualified team. BEIS increased the quantity and quality of data it holds on the roll-out as compared with the position in 2016. Its analysis largely relies on historical data and evidence provided by energy suppliers and collected from other sources available to BEIS. The CBA was prepared in line with the latest best practice as set out in HM Treasury's Green Book and is believed to represent the most accurate smart metering model available. The CBA was the subject of sensitivity tests, responding to recommendations by the National Audit Office, after its review of the previous CBA. The new CBA's quality assurance score exceeded the requirement for business-critical models.

3.11. As stated in our April and October 2019 consultations we do not uncritically assume that the new CBA is in all respects appropriate for *our* purposes when developing the new SMNCC model. BEIS designed the CBA for a different purpose (i.e. assessing the overall economic impact of the smart meter rollout. The CBA was not intended to estimate the net change in suppliers' smart metering costs in six monthly intervals. On that basis, we reviewed the CBA and, in constructing the SMNCC model, we made modifications in line with the considerations set out in our April and October consultations.[14] We set out and explained those modifications in our October consultations. We intend to take the same broad approach in the forthcoming consultation (although, as set out above, we may make further and different modifications).

Considering our approach in principle

3.12. One supplier considered that, as a matter of process, we could not have lawfully and diligently formed a conclusion on whether the CBA was appropriate to be used in the way we proposed, as we had not verified and disclosed all inputs to the new CBA and their underlying assumptions.

3.13. We have considered these points, and we do not consider that it is necessary or realistic to verify each and every input in the CBA, nor are we required to so. As explained above, we consider the CBA had been constructed to a high standard. We reviewed the CBA's assumptions, bearing in mind the considerations we set out, including suitability to our purposes, materiality, and the feasibility of developing alternative approaches.

3.14. Comprehensive validation, including minor values, is unrealistic. In the context of formulating a Cap which is required by legislation to be subject to six-monthly

[14] Ofgem (2019), Reviewing smart metering costs in the default tariff cap: October consultation. https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-october-consultation

reviews and which is intended to protect consumers from paying inflated prices, we do not consider it reasonable to extend timelines to validate all minor values. Such an approach would be impracticable within the context and timescales of this exercise. It would negate the value of using the CBA as a starting point in the first place. .

3.15. Comprehensive validation is also unnecessary. Suppliers were able to identify each input and value in the SMNCC model we disclosed in October 2019 and compare this to their own experience. Considering their knowledge of the market and their operations they could explain if they considered the model values to be unrepresentative and we can take account of the totality of responses as well as our understanding of the market. Suppliers' responses to the October consultation demonstrate they were able to do this. Naturally, we have considered suppliers' specific representations carefully, and where they indicate that the model may be unrepresentative of the market's efficient costs, we are considering changes, or will make further enquiries to determine whether a change in approach is required.

Considering our approach in practice

3.16. Most suppliers agreed with our approach (to start with the CBA and modify it as necessary) in principle. However, in practice a number disagreed with individual judgements on when it was appropriate to modify the CBA assumptions (or not modify them).

3.17. Firstly, some suppliers disagreed with our judgement on the level of precision that is required and the level of approximation that is acceptable. As one supplier illustratively put it, some circumstances require an egg-timer, whereas others require the additional precision of a stopwatch. In general, suppliers favoured a more precise approach than we judged to be practical or necessary.

3.18. We shall keep our judgements about precision and approximation under consideration in the forthcoming consultation to ensure they are appropriate. However, we note that it may not be possible (or necessary) to reach a consensus on the level of precision and additional work that is required or realistic.

3.19. Secondly, suppliers raised several concerns about specific cost and benefit categories, either noting errors and points of principle, or noting variances with their own costs.

3.20. Where we consider that there may be errors we will reconsider our approach and describe it in the May 2020 consultation. Variances are expected and not necessarily a concern. The SMNCC model is not intended to reflect the costs of model any specific supplier; we seek to reflect the aggregate net efficient cost for the market

as a whole, whereas each individual supplier will have different circumstances and costs.

3.21. Nonetheless, we consider carefully each representation made by suppliers, and we have observed that there are some marked variances that, at least, indicate that we would benefit from further enquiry to determine whether or not the SMNCC model materially represents the market's efficient costs. In light of suppliers' representations we have started making further enquiries about some cost and benefit categories, either to make adjustments, or to help us assess whether or not the our current approach is adequate.

Disclosure arrangements

Representations

3.22. A number of suppliers raised concerns about consultation process or procedural fairness. There were three principal concerns:

- suggestions of insufficient detail disclosed
- suggestions of unreasonable restrictions on information that was disclosed
- suggestions of insufficient consultation time to consider what was disclosed.

3.23. We have considered these views carefully in developing plans for further consultation. While we do not agree with suppliers' arguments about the consultation process to date (for the reasons set out below), we will, of course, consider where we could adjust our approach to the next consultation and where changes are necessary due to changing circumstances (for instance, relating to new data sources). We will consult stakeholders on the specific disclosure arrangements in March 2020.

Considering the detail disclosed

3.24. Several suppliers stated that they required more detailed disclosure. In particular, some argued that their ability to validate the model was hampered by a lack of transparency regarding underlying assumptions and how each value in the model had been verified.

3.25. We have considered these representations, and we consider that our judgement on what data to disclose (or not disclose) was carefully made and reasonable. We provided access to a fully executable version of the model, permitting consultees to check its functionality and its sensitivity to particular inputs. We also provided access to underlying data for key material inputs, allowing greater understanding. We did not judge it necessary, nor were we required, to acquire or provide further detail on each and every input or variable, particularly in circumstances where the

purpose of consulting was to allow suppliers to compare data to their own experiences, costs and knowledge of the market, rather than to require every piece of data to be independently auditable by every supplier.

Considering restrictions on disclosure

3.26. Some suppliers argued that we should have made the SMNCC model public, and not disclosed subject to restrictions. By our not making the model public, some suppliers argued that they were not able to understand the proposals properly.

3.27. We have considered these views, and we do not consider that the restrictions on suppliers were unreasonable, or that they undermined suppliers' ability to respond. We provided the SMNCC model to suppliers directly. This allowed suppliers to inspect the model underpinning our proposals using their own staff and operational expertise, as they had requested. We provided commercially sensitive underlying data to suppliers' advisers, so that they could check the data and calculations for error, as requested. Some suppliers felt that not all underlying data was sensitive, so we will review this for future disclosure.

3.28. Some suppliers felt that they were unfairly prevented from discussing key themes with their trade representative, Energy UK. As we explained in the October 2019 consultation, we cannot publish the SMNCC model.[15] We made the model available in full to the stakeholders that requested access and those stakeholders were free to discuss key issues and themes. Energy UK's own consultation response demonstrates that it was aware of the principal issues raised by the consultation.

Considering time for consultation

3.29. Some suppliers considered that the SMNCC model (and potentially the October 2019 consultation) was too complex for them to understand our proposals and respond appropriately in 28 days (the minimum period allowed for consultation under the Act).

3.30. It is clear to us from suppliers' responses to the October 2019 consultation, that a sophisticated supplier did have sufficient information and time to understand our proposals and provide sufficiently informed and detailed responsive commentary. This is as we would expect, especially given that in 2018 suppliers had responded to the consultation on the entire Cap methodology, which included the SMNCC, in such a manner and in a similar time period.

3.31. Ofgem's guidelines state that consultations will be 12, 8, or 4 weeks in duration depending on their circumstances. We reserve four week consultations for urgent

[15] Ofgem (2019), Reviewing smart metering costs in the default tariff cap: October consultation. https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-october-consultation

issues. Suppliers argued that we did not face time constraints and so, in their view, a four week consultation was inappropriate in the circumstances of the October 2019 consultation.

3.32. Firstly, they argued that we had eight weeks to reach a decision. In fact, in order to have effect in cap period four, we had to publish a decision by 13 December 2019 (less than four weeks after the consultation closed). In response to suppliers' views, we have published a consultation to amend the licence so it aligns with the period of 56 days as required by the Act.

3.33. Secondly, suppliers argued the contingency allowance provided a fall back option, meaning we could consult for longer and should not target making a decision in time for cap period four. This is not correct. As we explained, the contingency allowance is not an accurate assessment of costs, and is likely higher than actual efficient costs. This adversely affects customers (including those of limited means) in the short to medium term and, even if adjusted for in future allowances (as we proposed), this may cause disruption to suppliers and customers in future.

3.34. For the forthcoming consultation we will consider the time available for consultation afresh, not least as circumstances change. One new factor is that suppliers will have consultations on each of the three issues discussed in this note. On the other hand, for the SMNCC consultation, many of the issues and the model will now be familiar to suppliers that participated in the October 2019 consultation.

Carry forward

Representations

3.35. In our October 2019 consultation, we proposed to take into account the difference between the level of the SMNCC in previous cap periods (i.e. the amount of money suppliers recovered from customers) and our updated estimate of suppliers' efficient costs for those periods as a market-wide group (i.e. the amount of money that needed to be recovered from customers). When we mentioned this proposal in March 2019, and further explained it our April 2019 consultation and in Working Paper 3, it was possible that suppliers' costs (on average) may have exceeded the allowances, or the allowances may have exceeded their costs.[16, 17, 18] Each case might be true of two different suppliers.

[16] Ofgem (2019), Smart metering costs in future Default Tariff Cap periods, paragraph 13. https://www.ofgem.gov.uk/publications-and-updates/smart-metering-costs-future-default-tariff-cap-periods
[17] Ofgem (2019), Reviewing smart metering costs in the default tariff cap: April consultation, paragraph 4.19. https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap
[18] Ofgem (2019), Reviewing smart metering costs in the default tariff cap: Response Paper 3. https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-response-paper-3

3.36. In either case it would require consideration to ensure that, over the life of the Cap, combined allowances reflected costs. To maintain parity, we proposed to adjust future cap periods to offset earlier cap periods if we concluded there were significant deviations between the allowance and costs.

3.37. Suppliers strongly opposed this proposal. In principle, some suppliers considered that we should not make any adjustment for previous deviations. In practice, some suppliers considered that their costs (or more relevantly, the costs for the market as a whole) had not deviated from the allowances, so no adjustment would be necessary.

3.38. Specifically suppliers argued that

- our assessment of costs may not account for stranded costs accurately, so suppliers would not have over-recovered their costs even though the allowances provided for higher installation rates
- some suppliers had higher than average costs, due to early progress with the rollout, and would be unfairly affected compared to the average supplier
- we had not corrected other allowances in the Cap and so we should either correct all of the allowances in the Cap or none of them.

Ongoing considerations

3.39. We are considering suppliers' views carefully and will take these into account in formulating our forthcoming proposals. We agree that the SMNCC model should account for efficiently stranded costs appropriately. Additionally, although our general approach is to consider costs *on average,* we will consider the impact of this proposal on suppliers with higher than average costs. We will also reconsider and consult on the principle of adjustments in general and in this specific context.

3.40. Some suppliers considered that they had a legitimate expectation that we would not attempt to adjust allowances (i.e. we would consider costs and cost recovery in each cap period in isolation, rather than attempt to ensure cost recovery reflected costs over the life of the Cap). Without having formed a view on that issue yet, we intend to consider the difference between suppliers' costs and the first cap periods separately from any difference between their costs and the contingency allowances. No supplier has argued that our intention to consider this issue in relation to the contingency allowances was unclear.