

Reviewing smart metering costs in the default tariff cap: May 2020 statutory consultation

26 June 2020

Introduction

Energy UK is the trade association for the energy industry with over 100 members spanning every aspect of the energy sector – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

We represent the diverse nature of the UK's energy industry with our members delivering almost all (90%) of both the UK's power generation and energy supply for over 27 million UK homes as well as businesses. The energy industry invests over £13.1bn annually, delivers around £85.6bn in economic activity through its supply chain and interaction with other sectors, and supports over 764,000 jobs in every corner of the country.

This is a high-level industry response to Ofgem's review of smart metering costs in the default tariff cap. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

Energy UK welcomes Ofgem's recognition that the exceptional COVID-19 circumstances that suppliers are currently experiencing will require a further review in 2021 to ensure that any additional efficient costs incurred by suppliers are appropriately accounted for under the cap. While this will have an impact upon suppliers' short and long-term smart meter rollout operations, it will also impact upon many other areas of their operations, and these should be fully accounted for in any review.

We have severe concerns with Ofgem's proposal to instigate ongoing annual reviews of the SMNCC, which we believe would fundamentally change the nature of the cap from prospective to retrospective. Such a drastic change would introduce intolerable levels of uncertainty for suppliers planning and implementing rollouts.

Energy UK also has severe concerns with Ofgem's proposal to use an average rollout profile, and the impacts that this will have on suppliers' ability to fund the successful achievement of the Government rollout programme. In addition to the specific issues with the proposed average profile, its use is unreasonable and risks undermining the rollout programme at a time when suppliers are seeking to deliver a recovery from the immediate COVID-19 circumstances, as well as the economy-wide recession. In combination with the introduction of a new four-year regime (with annual targets for each supplier) for the smart meter rollout from July 2021, there is also a clear and present risk that suppliers' rollouts will be underfunded by the allowance proposed in the cap.

Chapter 3: Future Reviews

Energy UK agrees that a future review of SMNCC will be necessary in order to properly account for the exceptional impacts of COVID-19 and to ensure that the future policy framework of the smart meter

rollout is sufficiently reflected within the methodology following BEIS' decision on the post-June 2021 smart framework and specific tolerances. We would also encourage Ofgem to consider the exceptional impacts of COVID-19 on other areas of the cap (such as bad debt) at the earliest possible opportunity so as to ensure that it remains reflective of the costs incurred by an efficient supplier. We would encourage Ofgem to consult on the areas of impact that should be included in the COVID-19 review at the earliest opportunity.

However, while we support this one-off review to ensure that the cap addresses the exceptional and unforeseeable circumstances of the COVID-19 pandemic, we continue to oppose the introduction of a general claw-back mechanism into the SMNCC as highlighted in our previous consultation responses. We are, therefore, concerned that the proposal to hold ongoing annual reviews will fundamentally change the nature of the default tariff cap from a prospective cap, to a wholly reactive cap. In that scenario, there will be a severe risk of undermining suppliers' ability to effectively forecast and reducing reliability and certainty when budgeting. Suppliers will only have some certainty for two cap periods at a time, and even that certainty will be at risk of retrospective changes at the next review. This would introduce intolerable uncertainty whereby allowances would change retrospectively, but operational decisions cannot be rolled back. Uncertainty is also created by Ofgem identifying more smart meter rollout costs within the Opex than previously signalled, but with no compensating Opex uplift.

We also note Ofgem's intention to rely on suppliers' ASR data to inform the yearly reviews. We do not believe ASR data is currently best formatted to achieve this aim and Ofgem should transparently outline and seek feedback via consultation on its proposed evidence base should it seek to proceed with the proposals.

Chapter 4: Average Rollout Profile

Energy UK welcomes Ofgem's aim to reflect the current exceptional circumstances caused by COVID-19 and acknowledges that there will be sunk costs that should be reflected in the cap. Individual suppliers will be best placed to provide detail on the accuracy of the assumptions on costs that Ofgem has put forward in its proposals.

However, Energy UK has serious concerns with Ofgem's proposed usage of average rollout profiles, and the potentially detrimental impact that this will have on the success of the Government's smart meter rollout programme post-June 2021. Ofgem must take account of the financial reality facing the sector, particularly the state of the Government's smart meter rollout programme during the immediate COVID-19 recovery, and economy-wide recession.

Ofgem's proposal would see the SMNCC only allow for the efficient costs of installing smart meters at the average level, disincentivising suppliers from going above and beyond the average during the lifetime of the default tariff cap. In addition, those suppliers that are not achieving a sufficient rollout will drag the average down, with extreme underperformers having a disproportionate impact on the allowance with the costs of more successful rollouts being compensated even less. We also do not believe that it would necessarily be reasonable to assume the same rollout profiles for credit and PPM customers. Ofgem has not sufficiently shown that this assumption is robust.

BEIS's 18 June 2020 decision on smart meter rollout^[1] envisages a continuation of all reasonable steps until the end of June 2021 followed by introduction of a new four-year regime with annual targets for each supplier. The annual targets will be driven by annual tolerance levels that BEIS will consult on in Autumn 2020. There is no suggestion in BEIS's decision that the targets will be relaxed relative to those previously proposed. This, combined with Ofgem's proposed 12-month review of SMNCC, creates a significant risk to suppliers that the NPT SMNCC allowance in the period July to September 2021 will still be based on the old All Reasonable Steps (ARS) regime, whilst suppliers will in practice be subject to the more stringent new targets. The impending imposition of the new regime could also have impacts upon suppliers' rollouts during the continued ARS period, which would not be reflected in Ofgem's NPT SMNCC. Indeed, it is a feature of the regime proposed by BEIS that any early shortfall in rollout becomes increasingly difficult to catch up on. Further strains on suppliers' funding position will likely be

^[1]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/893124/delivering-smart-system-post-2020-govt-response-consultation.pdf

introduced by increases in costs due to the long-term impact of COVID-19, such as on installer productivity.

Given that Ofgem is proposing a further review to account for the impacts of COVID-19 in 2021, and the importance of restarting the smart meter rollout with maximum momentum, Ofgem should ensure that its allowance for cap periods 5 and 6 does not unnecessarily stifle suppliers' ability to fund their remobilisation programmes, e.g. by increasing rollout assumptions. The impact on consumers of COVID-19 has further highlighted the benefits of smart meters, for example by protecting self-isolating prepayment customers from the risk of going off supply if they cannot physically top-up or if there is a shortage of keys or cards in the country of production. Once the full impacts become clearer through 2021, Ofgem will have the ability in its later review to correct for any advanced payments for these exceptional circumstances without undermining suppliers' ability to finance the efficient costs of their remobilisations.

There is an overwhelming imperative for basing our recovery from this pandemic around the net-zero target, decarbonising our economy and creating a cleaner, resilient and more sustainable future out of the shock of this enforced interruption to our daily lives. The energy sector will be central to powering that recovery and a successful restart of the Government's smart metering programme will of utmost importance to achieve this green recovery. Energy UK and suppliers are currently working in partnership with BEIS as part of its smart metering remobilisation workstream, and we would urge Ofgem to engage with BEIS to ensure that its SMNCC allowance reflects the policy ambition of the immediate-to-middle-term trajectory of the programme.

Chapter 5: Reviewing Efficient Net Costs

Energy UK welcomes that Ofgem has reassessed efficient net costs based upon previous submissions made by Energy UK and suppliers. Individual suppliers will be best placed to provide detailed comments on the changes made, their suitability and impact on the ability to efficiently fund the smart meter rollout.

Chapter 7: Considering Advanced Payments

Energy UK has previously raised concerns with Ofgem's intention to introduce a claw-back mechanism into the SMNCC. As mentioned in response to Ofgem's proposal in Chapter 3, we are also concerned with Ofgem's change in stance on the underlying objective of the cap, moving from a prospective cap to a reactive allowance that undermines certainty and reliability for suppliers' budgeting and forecasting.

We welcome Ofgem's stance that the claw-back mechanism would not be reasonable for cap periods 1 and 2. However, we challenge its view that suppliers had enough advance clarity for such a mechanism to be applied to cap period 3 as there were no indicative figures suggested at the time, which meant that suppliers were unable to adequately forecast any impact and adjust accordingly, similar to the principle that Ofgem has accepted in its rejection of a claw-back mechanism for periods 1 and 2. In addition, a claw-back mechanism based upon the average industry performance penalises suppliers who have done the most, undermining the 'all reasonable steps' requirement with its own smart rollout compliance and enforcement regime.

We would urge Ofgem to consider the impacts of retrospective action at this time whilst the industry is still recovering from the immediate impacts of the COVID-19 pandemic. As Ofgem has already indicated that it will be holding a review in 2021 to take full account of these exceptional circumstances once the data becomes clear, Energy UK would suggest put any work in this area on hold until that further review can fully take into account the full impacts of COVID-19 on 2020's rollouts and efficient costs.

Chapter 8: Contingency Arrangements for 5th & 6th Cap Periods

We note that Ofgem's proposed contingency arrangements are a marked change from those previously put forward in the October consultation.

As highlighted above, we agree that the Ofgem should not be taking advanced payment into account at this time, particularly to guard against the risk that the true efficient costs are higher than Ofgem has

assessed. However, we believe that the current proposal for contingency arrangements would still not be sufficient to mitigate against the risks of undermining the remobilisation of suppliers' rollouts that we have highlighted elsewhere in this response.

Given the serious impacts of the use of the proposed rollout profile, we do not believe it would be reasonable for this to form the basis of a contingency arrangement. We are also concerned that Ofgem has not provided a robust evidence base for its costs and benefits assumptions. The alternative contingency arrangements suggested by Ofgem should be reconsidered and we do not believe should have been ruled out conclusively as the best way forward.

If you would like to discuss the above or any other related matters, please contact me directly on 020 7747 2931 or at steve.kirkwood@energy-uk.org.uk.