

# Reviewing Smart Metering Costs in the Tariff Cap

19 November 2019

## 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 response to Ofgem's October substantial consultation as part of its 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.

## Process and Timing

Energy UK does not consider the 4 weeks that were made available for responding to the consultation to be a fair balance between the time available to suppliers to respond.

Energy UK considers that Ofgem's approach to this consultation is inconsistent with its own consultation policy, which states that 'major issues of wide interest' will be subject to 12 weeks' consultation, and 'issues of more specific interest' to 8 weeks' consultation. Only urgent issues, "minor changes to existing policy", or instances of Ofgem following another organisation's timetable would be subject to the short 4 weeks' consultation period.<sup>1</sup> It is clear that the matter being consulted upon does not represent a minor change, nor is Ofgem following another organisation's timetable. Furthermore, we also do not see that any immediate urgency mandates the current approach, as Ofgem has the option to roll over the previous non pass through Smart Meter Net Cost Change (NPT SMNCC) model.

Given the complexity and significance of the subject matter, we think that Ofgem's policy dictates that a period a more substantial response period should be afforded. In this context we would note that:

- Ofgem is proposing to make a very material reduction the level of the SMNCC allowance (to £11.30 in Period 4 compared to £20.50 in Period 3), and is seeking to place the onus on suppliers to scrutinise the model and identify any omissions: "*Stakeholders should consider their own activities rolling out smart meters and the CBA document to check we have not excluded relevant costs and benefits*".<sup>2</sup>
- In the consultation, Ofgem suggests that there will be a 'high bar' for re-opening its decision on NPT SMNCC values to the end of 2023. If the values are to be fixed for a further four

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<sup>1</sup> Our Consultation Policy, Ofgem, <https://www.ofgem.gov.uk/consultations/our-consultation-policy>

<sup>2</sup> Consultation document, para 3.14

years with minimal opportunity for review, it is particularly important that they are subject to full and detailed scrutiny at this stage.

- The SMNCC model is new to suppliers who have no prior familiarity with it. In order to properly understand the model and how the outputs relate to suppliers' own experience, suppliers will need to get to grips with the workings of the model, map relevant cost and benefit lines between internal accounting views and the BEIS/Ofgem view, identify the source of any divergence, and document any concerns within a consultation response. After allowing for internal start-up and review processes, 20 working days is far too short a period.

These concerns on overly-strict timelines are not singular to Ofgem's SMNCC review, but are also pertinent to other workstreams it is undertaking in which it is placing unrealistically short deadlines for responses to consultations and RFIs that undermines suppliers' abilities to robustly scrutinise and respond.

We are, therefore, disappointed that Ofgem has refused Energy UK's request for a two-week extension to the consultation timeline on behalf of our members, and believe that the ability for suppliers to respond to the complexities of Ofgem's proposals will now be restricted.

In addition, Energy UK is disappointed that Ofgem's chosen disclosure arrangements have been disproportionately obstructive to scrutiny from industry. In previous representations to Ofgem throughout the review of smart metering costs under the default tariff cap, Energy UK had urged Ofgem to make its SMNCC model public and disputed its assertion that to do so would be distortive to competition. While we welcome Ofgem's late decision to also include some supplier-specific data within the data room exercise, we believe that its refusal to make the SMNCC model publicly available has undermined a meaningful public consultation.

### **Linkages with BEIS post-2020 Proposals**

Energy UK is concerned that Ofgem has not properly appreciated the linkages and dependencies with BEIS' current policy development on post-2020 proposals. We note that Ofgem has based its proposals on the provisional roll-out targets of the BEIS post-2020 consultation, but these proposals are yet to be decided upon. We would question the robustness and appropriateness of definitively deciding upon smart meter costs and an SMNCC allowance from 2020 to 2023 based upon a policy proposal that has yet to be decided by BEIS or put into law and is subject to change following the recent consultation.

This is particularly concerning as Ofgem considers this to be a one-time review of smart metering costs under the default tariff cap, and places a very high bar in the consultation on undertaking any further review into the SMNCC at a future date. We also note that this reluctance re-examine smart costs does not align with BEIS' own concerns around setting post-2020 thresholds:

*"We acknowledge that some uncertainty remains regarding the external factors and market conditions that could influence the path towards the delivery of a market-wide rollout. We therefore propose to undertake a mid-point review during the early stages of the new regulatory framework."<sup>3</sup>*

We would, therefore, urge Ofgem to delay any decision on an updated SMNCC model until BEIS has delivered its conclusion. It would not be sensible to implement a new SMNCC model based upon provisional proposals for the post-2020 obligation, which are subject to challenge and change. It would be reasonable for Ofgem to implement its contingency arrangements in the meantime until BEIS has addressed the numerous issues with its proposals.

Fundamentally, any post-2020 obligation placed on suppliers for delivering the Government's smart meter rollout must be realistically achievable and fundable. While we recognise that Ofgem must act within the confines of the Tariff Cap Act 2018, we would urge it to ensure that it appreciates the

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<sup>3</sup> [Smart meter policy framework post-2020](#), BEIS, 53, page 21

linkages between the two programmes and liaise with BEIS to ensure that it is realistically achievable and fundable under the default tariff cap.

We specifically highlight these points as Energy UK has numerous concerns about the proposals put forward by BEIS for a post-2020 obligation, which underpins Ofgem's proposed plans for its SMNCC allowance out until the end of 2023. We have attached Energy UK's response to the BEIS consultation in Annex 1 for Ofgem's information.

The proposed imposition of hard targets (with no reasonableness test), while retaining customers' rights to refuse a smart meter, means that if a supplier honours the preference of its customers it could be in breach of the obligation. The absolute target also takes no recognition of reasonable costs whilst energy suppliers continue to operate under the default tariff cap, and would be an obligation in contradiction of Ofgem's efficiency-driving SMNCC allowance. We would also reiterate that Ofgem's disproportionately obstructive disclosure arrangements have hindered stakeholders' ability to robustly scrutinise the cost and financeability of BEIS' proposal under the default tariff cap, with learnings from examining the SMNCC model strictly reserved for the purpose of responding to Ofgem's consultation and therefore unavailable for helping to provide fully evidential representations to BEIS.

To assist in Energy UK's response to the BEIS post-2020 proposals, Energy UK commissioned Frontier Economics to carry out independent analysis to test the assumptions that have resulted in Government's minded-to position set out in the consultation. This analysis uses the very latest information from energy suppliers on their latest performance against their 2019 smart meter forecast submissions to Ofgem (noting that these are just 10-11 months old at the time of writing). We have attached this analysis in Annex 2 to highlight some of the deficiencies of BEIS' provisional proposals and CBA in greater detail, such as its overly ambitious installation rates and understatement of the impact of increasing customer resistance.

### **Reviewing Efficient Net Costs**

The unjustified restrictions that Ofgem placed around the disclosure of its updated model made detailed discussion of its wider proposals difficult. As a result, Energy UK's response cannot discuss costs and benefits in great detail. A lack of detailed comment does not signify agreement with Ofgem's proposals, and we expect suppliers to respond in detail individually.

With regards to the reliance upon BEIS's updated SMIP CBA, Ofgem seeks to describe extensive quality assurance checks that the CBA has undergone and been subject to. However, Energy UK notes that this CBA was not put to consultation and has therefore not received external, robust and transparent scrutiny from stakeholders as to its accuracy, assumptions and underlying data.

### **Setting the Allowance**

Overall, Energy UK agrees and welcomes Ofgem's general approach to set allowances through to 2023 to smooth costs and allowances of the potential full length of the default tariff cap, rather than making drastic alterations within a single period.

However, while we understand Ofgem's desire to implement a recovery mechanism in the cap, Energy UK retains its position, previously outlined in response to Ofgem's initial SMNCC review consultation in May and its consultation on the third cap period in July, that any claw-back in future cap periods would be detrimental upon the success of the continuing smart meter rollout and cannot be justified on costs grounds. Having explicitly set SMNCC for the first and second periods to ensure no reduction in the pace of planned rollouts, Ofgem risks undermining the effectiveness of any obligation and inhibiting the ability of suppliers to invest by introducing unforecastable regulatory risk and setting future allowances below efficiently incurred cost levels.

Moreover, in its November 2018 decision, Ofgem made no mention or gave any consideration to the allowance it was putting in place for the first three cap periods to be subject to a potential claw-back mechanism in future periods, following the 2019 review.

It is manifestly inappropriate to now take a tactical approach to recovery by choosing one cost element of perceived but unproven over-recovery in one cap period. If Ofgem is to impose recovery mechanisms, then all cost elements in all cap periods should be taken into account and there have been several incidents of significant under recovery to date, including pass through costs and Unidentified Gas (UIG).

### **Contingency Allowance**

Energy UK believes that Ofgem should fully consider the points raised in relation to the BEIS post-2020 proposals. Fundamentally, at this stage, Ofgem should not be locking-in an SMNCC allowance through to 2023 until the deficiencies raised with the BEIS CBA and post-2020 obligations have been fully addressed. It is perfectly correct that an SMNCC allowance is needed to continue in the meantime, and Ofgem's proposed contingency allowance is the only realistic short-term option.

We note Ofgem's position that should such a contingency allowance be used then any future, newly modelled allowance would also include the proposed claw-back mechanism. While we retain the position that recovery is not justified for cap periods 1-3, we believe that any future decision by Ofgem on this issue should not be made until after an appropriate consultation exercise.

**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](mailto:steve.kirkwood@energy-uk.org.uk).**