

EXPLANATORY MEMORANDUM TO THE MODIFICATIONS TO THE STANDARD CONDITIONS OF ELECTRICITY AND GAS SUPPLY LICENCES

SMART METERS

2023 NO. 2

1. Introduction

- 1.1 This explanatory memorandum has been prepared by the Department for Energy Security and Net Zero (DESNZ) and is laid before Parliament by Command of His Majesty.

2. Purpose of the instrument

- 2.1 The instrument modifies the standard conditions of gas and electricity supply licences. These modifications further develop the regulatory framework to support Government's policy for the rollout and operation of smart meters in Great Britain.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

- 3.1 None: these are licence modifications under section 88 of the Energy Act 2008 and not a statutory instrument.

4. Extent and Territorial Application

- 4.1 The extent of this instrument (that is, the jurisdiction(s) which the instrument forms part of the law of) is Great Britain.
- 4.2 The territorial application of this instrument (that is, where the instrument produces a practical effect) is Great Britain.

5. European Convention on Human Rights

- 5.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

- 6.1 Section 88 of the Energy Act 2008 gives the Secretary of State the power to modify certain licences under the Gas Act 1986 and the Electricity Act 1989 and related industry codes for specified purposes related to the rollout of smart meters in Great Britain. In 2020 the powers were exercised to insert standard licence condition 33A into the gas supply licences issued under section 7A(1) of the Gas Act 1986 and standard licence condition 39A into the electricity supply licences issued under section 6(1)(d) of the Electricity Act 1989. These licence conditions set a four year framework, which commenced on 1 January 2022, for annual targets for the number of smart meters that a given energy supplier must install each year. This instrument makes modifications for the third year (2024) and fourth year (2025) of that framework.

7. Policy background

What is being done and why?

- 7.1 Smart meters are a vital upgrade to our national energy infrastructure and underpin the cost-effective delivery of the Government's commitment to reduce greenhouse gas emissions to net zero by 2050. They are a critical tool in modernising the way we use energy and support the transformation of the retail energy market, helping the system to work better for energy consumers. As of 31st March 2023, there were 32.4 million smart and advanced meters in homes and small businesses across Great Britain¹.
- 7.2 The instrument makes changes to gas and electricity supply licences for four different smart metering related purposes.

Amendment of the structure of Domestic and Non-Domestic Installation Requirements

- 7.3 The first set of changes amends the structure of the current single annual installation requirement into separate domestic and non-domestic installation requirements. This is intended to ensure that sufficient focus is placed on both the domestic and non-domestic rollout by mixed portfolio energy suppliers (suppliers of both domestic and non-domestic premises), delivering benefits for small business and public sector consumers alongside/as well as benefits for domestic consumers.
- 7.4 Currently, mixed portfolio energy suppliers have a single annual smart metering installation requirement in licence conditions (for electricity and gas separately) that reflects both the domestic and non-domestic components of their portfolio. However, these suppliers currently have the flexibility to meet their total requirement through any combination of domestic and non-domestic installations. This contrasts to domestic only and non-domestic only energy suppliers, who can only meet their targets through domestic or non-domestic installations respectively.
- 7.5 We have growing evidence of slower progress in the non-domestic rollout by mixed portfolio suppliers, which was posing a risk to benefits realisation for small businesses and public sector consumers.
- 7.6 We are therefore removing this flexibility in Year 3 (2024) and Year 4 (2025) of the Framework so that mixed portfolio suppliers will be required to meet both the domestic and non-domestic components of their installation requirements individually.

Targets Framework Churn Adjustment

- 7.7 The second set of changes partially extends the current adjustment to the formula used to derive energy suppliers' annual smart meter installation requirements to ensure that suppliers are not unfairly penalised as a result of losing materially more smart meter customers than they gain through customers switching supplier.
- 7.8 In May 2022, the Government confirmed implementation of a customer switching ("churn") adjustment into the formula used to derive suppliers' annual installation targets². This change was implemented for the second year of the Targets Framework only (2023). This was to mitigate the impact on annual targets of smart meter customers switching energy supplier. The Government has reviewed this adjustment

¹ See: <https://www.gov.uk/government/statistics/smart-meters-in-great-britain-quarterly-update-march-2023>

² See: <https://www.gov.uk/government/consultations/smart-meter-targets-framework-churn-adjustment>

for Year 3 (2024) and Year 4 (2025) as part of the ‘mid-point review’ of the Framework.

- 7.9 The rationale for the adjustment in Year 2 (2023) was to mitigate any potential unfair penalisation of energy suppliers that are furthest ahead in their smart meter rollout. This penalisation may occur because suppliers that have a smart meter installation coverage higher than market average may be more likely to lose smart meter customers and gain traditional meter customers. This would lead them to have higher targets in the subsequent year than they would have had, had they not experienced this churn. Current evidence shows that levels of smart coverage among energy suppliers is increasingly converging to the market average level, reducing the potential for penalisation as a result of customer switching. The level of convergence is different in the domestic vs. the non-domestic sector. Convergence between domestic suppliers is higher and we have, therefore, decided not to extend the churn adjustment for the domestic sector. Convergence between non-domestic suppliers is lower, and we consider this potential for unfairness remains a risk in relation to non-domestic targets in Year 3 (2024) and, therefore, have decided to extend the churn adjustment for the non-domestic target setting formula for a further year. We consider that convergence in the non-domestic sector will continue to increase to the extent that no further adjustment is required in relation to non-domestic targets in Year 4 (2025).
- 7.10 This instrument sets out amendments to the relevant licence conditions to apply an adjustment to the formula used to derive the non-domestic targets for Year 3 of the Targets Framework, which begins on 1 January 2024. The adjustment will mitigate the impact of smart meter customers switching supplier on annual installation targets.

Gas SMETS2³ First Installation Adjustment

- 7.11 The third set of changes adjusts the value of installations where single-fuel gas SMETS2 meters have to be installed before the relevant electricity meter has been upgraded to SMETS2.
- 7.12 Currently all installations of SMETS2 meters count equally towards meeting energy suppliers’ annual installation targets, irrespective of the type of installation, as long as the existing meter being replaced is not a smart or advanced meter. However, we have received feedback from industry noting that installing single-fuel gas smart meters when a SMETS2 electricity meter and associated communications device are not yet present (“gas first” smart meters) is more resource-intensive. This is because before they can install and commission the “gas first” smart meter, the installer has first to separately install and power a free-standing communications hub. This is an additional installation step. For a more standard dual fuel gas and electricity smart meter installation or in a situation where the SMETS2 electricity meter was already in situ, this additional step would not be needed because the communications hub would form part of the SMETS2 electricity meter unit).
- 7.13 The intention of the Targets Framework is to drive the rollout of smart meters across the market, so that as many consumers as possible receive the benefits of the rollout. As such the Government wants to ensure that customers who choose to contract with separate suppliers for each fuel type equally benefit from smart metering. We also

³ SMETS (Smart Metering Equipment Technical Specifications) are split into two categorisations: SMETS1 and SMETS2, relating to the first (SMETS1) and second (SMETS2) generation smart meters respectively.

recognise that certain energy suppliers may be disproportionately impacted by this issue if they have a large proportion of customers requiring gas-first SMETS2 installations in their consumer base.

- 7.14 An additional weighting (Z) will be introduced for installations that require the installation of a SMETS2 gas meter at a premise where the supplier only supplies gas and is not the electricity supplier, and where there is not already a SMETS2 communications hub on site. This weighting is being set at 1.5 based on evidence provided in response to the consultation on the targets for the Third and Fourth years of the Targets Framework. The value of the weighting can be amended by the Secretary of State in the future, following consultation with gas suppliers.

Advanced Meter Adjustment

- 7.15 The fourth set of changes align the Targets Framework rules on Advanced Meters with the New and Replacement Obligation (NRO), to allow advanced meters installed after all reasonable steps have been taken to install SMETS2 to count towards annual non-domestic installation targets.
- 7.16 Currently, under the NRO energy suppliers may be able to install advanced meters in microbusiness premises, or in non-microbusiness premises that initially chose SMETS2 meters, once all reasonable steps were first taken to install SMETS2 meters and this failed. However, at present, such installations would not count towards meeting the smart metering installation targets under the Targets Framework.
- 7.17 We received consultation feedback that the Targets Framework should be aligned with the NRO for consistency. This change will help to ensure a positive customer journey for non-domestic customers (by ensuring they have a successful installation outcome and still receive a meter upgrade if there are technical barriers to installing SMETS meters) and assist suppliers by providing them with additional technical flexibility.

8. European Union Withdrawal and Future Relationship

- 8.1 This instrument does not relate to withdrawal from the European Union / trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

- 9.1 The Government does not intend to consolidate the standard conditions of electricity and gas supply licences. A consolidated version of the standard licence condition will be available on the Office of Gas and Electricity Market's (Ofgem's) website⁴ once these modifications come into force.

10. Consultation outcome

- 10.1 Between 6th February and 21st March 2023, the Government published a public consultation on Gov.Uk in regards to smart meter minimum installation requirements for energy suppliers in 2024 and 2025. The consultation ran for 6 weeks and 3 days⁵.

⁴ See: <https://www.ofgem.gov.uk/licences-codes-and-standards>

⁵ Some respondents expressed concerns about the length of time available to respond during the consultation process. The consultation deadline was set to enable us to publish the government response and make the associated amendments to the licence conditions in good time, to provide energy suppliers and broader industry with sufficient notice of their Year 3 (2024) minimum installation requirements.

These minimum installation requirements are set on a trajectory to 100% smart coverage by end of 2025, subject to an annual allowance or ‘tolerance level’ that applies across industry as a percentage of each supplier’s customer base⁶. The consultation proposed the tolerance levels that would apply in the third and fourth years of the Framework (2024 and 2025). The Government sought views on the draft Licence Condition amendments as part of the consultation. There were 18 respondents in total, including large and small suppliers, domestic and non-domestic suppliers, and metering manufacturers. The Government response was published on 6th July 2023.

Amendment of the structure of Domestic and Non-Domestic Installation Requirements

- 10.2 Stakeholders were asked via the published consultation whether they agreed/disagreed with the proposals and what they perceived to be the main benefits and risks. Out of 18 respondents, a third agreed with the proposal, a third disagreed and a third were neutral or did not respond. Those that agreed with the proposal emphasised the benefits to non-domestic consumers and non-domestic energy suppliers. Those that disagreed tended to be mixed portfolio suppliers who did not want to lose the additional flexibility to meet targets via any combination of domestic and non-domestic installations. The non-domestic rollout is expected to lead to £1.5 billion of energy savings as a result of smaller businesses and public sector organisations engaging with their smart meter energy use data to identify such savings. We therefore agree with those respondents that highlighted the consumer benefits of ensuring that all energy suppliers focus on both their domestic and non-domestic rollouts and are therefore proceeding with the changes.

Targets Framework Churn Adjustment

- 10.3 The consultation sought views on the proposal to partially extend the churn adjustment, so that it applied to non-domestic targets in Year 3 (2024) only. Responses were largely in favour of maintaining the churn adjustment beyond the partial extension proposed. The Government did not accept this suggestion, however, as we considered an extension to cover domestic targets would be a disproportionate intervention given that convergence in suppliers’ domestic smart coverage levels has increased, and the potential for unfairness as a result of customer churn has therefore reduced. While we have maintained a churn adjustment for Year 3 of the Framework in relation to non-domestic targets, we did not consider that any churn adjustment is required, for either domestic or non-domestic installation requirements, by Year 4 of the Framework (2025) given the high levels of convergence in levels of smart coverage that we expect to have seen by the latter stages of the Framework. No concerns were raised to the Government’s proposal to apply the same adjustment to non-domestic targets in Year 3 (2024) as has applied to the whole market in Year 2 (2023). Therefore, this is implemented through changes to the Licence Conditions.

Gas SMETS2 First Installation Adjustment

- 10.4 No question was posed on this issue as part of the consultation. However, feedback was received from respondents which noted the additional resource required to complete these types of gas first installations. The Government accepts that an adjustment to the Targets Framework is needed to account for these more resource-

⁶ See: <https://www.gov.uk/government/consultations/smart-meter-targets-framework-minimum-installation-requirements-for-year-3-2024-and-year-4-2025#>

intensive installations which will be more prevalent in 2023 and 2024, and therefore have introduced the changes outlined above.

Advanced Meter Adjustment

- 10.5 No question was posed on this as part of the consultation. However, feedback was received in consultation responses on the value of aligning licence conditions in this area and regarding complexities relating to gas first installations in the non-domestic sector. Therefore, the final policy position reflects this feedback.

11. Guidance

- 11.1 Regarding all the changes mentioned above, the Government does not intend to publish any guidance in respect of the modifications made by this instrument, beyond the explanation of the licence changes included within the Government Response.

12. Impact

- 12.1 A full Impact Assessment is submitted with this memorandum and published alongside the Government response on the gov.uk website⁷.
- 12.2 There is no significant impact on charities or voluntary bodies.
- 12.3 The costs of the Targets Framework are incurred predominantly by energy suppliers. Energy suppliers are not free to simply pass costs through to energy consumers – their ability to pass on some or all of their costs will depend on the price cap⁸ and the individual cost-competitiveness and commercial position of each supplier. To determine the direct costs and benefits to business, we consider the immediate and unavoidable costs accrued to energy suppliers and other industry operators as a result of this policy; and we consider the immediate and unavoidable benefits that accrue to all businesses as a result of this policy, including energy suppliers and non-domestic premises with a smart meter⁹.
- 12.4 The amendments to the Targets Framework and the tolerance levels set out in the Government Response lead to an overall Net Present Value of £1,039m over the appraisal period to 2034, compared to the status quo counterfactual scenario.
- 12.5 Public sector sites and voluntary bodies in the scope of the smart metering mandate will benefit from the amendment to the structure of minimum installation requirements. Mixed portfolio energy suppliers will be required to meet the non-domestic component of their minimum annual installation requirement in Year 3 and Year 4 of the Framework. This change ensures that all energy suppliers place focus on their non-domestic smart meter rollout, so that non-domestic consumers that want to upgrade to smart meters (including public sector organisations and charities of voluntary bodies) can do so as soon as possible and realise the benefits of smart metering.

⁷ See: <https://www.gov.uk/government/consultations/smart-meter-targets-framework-minimum-installation-requirements-for-year-3-2024-and-year-4-2025>

⁸ Determined by the Smart Metering Net Cost Change (SMNCC) allowances for credit and prepayment meters

⁹ See: <https://www.gov.uk/government/publications/rpc-case-histories-direct-and-indirect-impacts-march-2019>

13. Regulating small business

- 13.1 The legislation applies to activities that are undertaken by small businesses. Most of the non-domestic consumers covered by the smart metering mandate are micro-businesses. We expect 200,000 more metering points in these businesses to have a smart meter by the end of December 2025 than would be the case without policy intervention. The 2019 Smart Metering Cost-Benefit Analysis¹⁰ showed that receiving a smart meter will enable these non-domestic consumers to realise substantial benefits through energy savings (on average 2.8% savings on electricity bills and 4.5% for gas, subject to consumer action). The accelerated rollout under the Targets Framework will allow these savings to be realised earlier, delivering higher benefits to those small and micro-business consumers who receive a smart meter earlier.
- 13.2 17 energy suppliers are small / micro business and 6 are medium sized businesses. We do not consider any need to minimise the impact of the requirements on these small businesses, as this policy will work to equalise impacts across suppliers (whilst remaining in proportion to their number of meters and thus size).

14. Monitoring & review

- 14.1 The changes outlined in these Licence Condition adjustments are the result of the Government commitment to carry out a ‘mid-point review’ in order to set the minimum installation requirements for Year 3 and Year 4 of the Targets Framework.
- 14.2 The smart meter roll-out has an established programme of monitoring and evaluation, delivered by the Programme’s Benefits Realisation team. The Programme will continue to monitor the progress of the smart meter rollout, including (but not limited to):
- Producing quarterly statistical releases;
 - Holding regular bilateral meetings with energy suppliers to identify issues, promote best practice, and monitor developments within the industry;
 - Collect data from energy suppliers on a quarterly and annual basis, and drawn on information and data from third parties; and
 - Reviewing the benefits being delivered by smart meters, as part of ongoing benefits realisation activity within the Smart Meter Implementation Programme.
- 14.3 The approach to monitoring of the supply licence changes is set out in the Impact Assessment. A Post-Implementation Review (PIR) of these policy changes will also be conducted as part of the Programme’s wider benefits monitoring and evaluation activities. The PIR will be published within five years of policy implementation, alongside other monitoring and evaluation work for the Programme.
- 14.4 The instrument does not include a statutory review clause as it is not secondary legislation within the meaning of section 32(6) of the Small Business, Enterprise and Employment Act 2015.

¹⁰ See: <https://www.gov.uk/government/publications/smart-meter-roll-out-cost-benefit-analysis-2019>

15. Contact

- 15.1 Tim Hedgeland at the Department for Energy Security and Net Zero Strategy, email: tim.hedgeland@energysecurity.gov.uk can be contacted with any queries regarding the instrument.
- 15.2 Oliver Sinclair, Deputy Director and Head of Smart Metering Policy and Governance at the Department for Energy Security and Net Zero can confirm that this Explanatory Memorandum meets the required standard.
- 15.3 The Lords Parliamentary Under Secretary of State, Minister for Energy Efficiency and Green Finance at the Department for Energy Security and Net Zero can confirm that this Explanatory Memorandum meets the required standard.