
Energy price cap operating cost review benchmarking working paper

1. Introduction

- 1.1 The default tariff cap (the 'cap') was introduced in 2019 to protect existing and future domestic customers on standard variable and default tariffs (which we refer to collectively as 'default tariffs'), ensuring that customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy. The cap is set out in legislation through the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act').¹
- 1.2 The cap includes several allowances which relate to the operating costs associated with the supply of energy to domestic consumers. These are:
- Core operating costs allowance - a supplier's own costs of retailing energy;
 - Smart Metering Net Cost Change (SMNCC) allowance – the net cost of installing and operating smart meters as part of the transition for the smart meter rollout; and
 - Payment Method Uplift (PMU) - allowances for the additional costs of serving customers who pay by different payment methods.

Purpose of this working paper

- 1.3 We published our call for input (CFI) on the operating cost allowances review (operating cost review) in May 2023.² In the CFI, we stated that we intend to consider whether publishing working papers on specific policy areas to explore the options further would be beneficial, before proceeding with our normal consultation process. This working paper is focused on how we set a single allowance using data across a range of suppliers and what outcome we seek to achieve in doing so – we refer to this as the 'benchmarking' approach.
- 1.4 This paper sets out our initial thinking on developing a framework for choosing between a range of potential benchmarking options. Following our CFI, we outline our initial thinking on the trade-offs of competing considerations. We aim to be

¹ Domestic Gas and Electricity (Tariff Cap) Act 2018.
<https://www.legislation.gov.uk/ukpga/2018/21>

² Ofgem (2023), Price cap: Call for Input on the operating cost allowances review (operating cost review).
<https://www.ofgem.gov.uk/publications/price-cap-call-input-operating-cost-allowances-review>

transparent about how we develop our methodology and are seeking stakeholders' views and evidence regarding our considerations on the benchmarking approach at an early stage to help inform our methodological approach. We will consider further evidence and data collected through the request for information (RFI) and responses to this working paper. Our current views are subject to further analysis and changes in the market conditions.

1.5 This working paper includes the following sections:

- **Section 1: Introduction** – provides an overview of the working paper.
- **Section 2: Background** – provides a summary of case studies of benchmarking approaches within the cap;
- **Section 3: Overarching objectives** – sets out our primary objective under the legislation, potential outcomes we could seek to achieve, and how our benchmarking option could achieve them with possible trade-offs;
- **Section 4: Methodology** – sets out our initial thinking on the considerations for choosing between potential benchmarking options;
- **Section 5: Benchmarking approach for other operating cost allowances** – sets out our initial thinking on the options for the benchmarking approaches across cost components;
- **Section 6: Next steps** – provides details of the consultation closing date;
- **Appendix 1** – contains a list of questions for comments;
- **Appendix 2** – provides a list of cost lines and cost lines breakdown we have requested in our RFI; and
- **Appendix 3** – sets out our privacy notice.

1.6 We are seeking responses to this working paper by 08 November 2023.

Objective of the benchmarking approach

1.7 The objective of the Act is to protect existing and future customers on default tariffs. We currently interpret and achieve this by setting a cap that encourages efficiency while allowing suppliers to recover a reasonable cost. The legislation underpinning the cap does not enable us to set cap levels bespoke to each supplier, so we set one cap that reflects a notional supplier. We consider protecting customers means that prices reflect underlying efficient costs of a notional supplier.

- 1.8 In principle, we seek to set an efficient benchmark, such that an efficient notional supplier with 'typical' characteristics could recover their costs, comply with their obligations, and deliver a good standard of service.³
- 1.9 We are also seeking to develop an enduring methodology for the operating cost allowances. This would provide a certain level of resilience. The cap also includes other mechanisms to address uncertainty such as the headroom allowance. We therefore do not intend to review the operating cost allowances again in the near term unless there are significant developments that we would consider it to be reasonable and appropriate to do so in the circumstances.
- 1.10 We note that how we benchmark suppliers' operating costs will lead to different outcomes being attained, so it is important to consider which of those outcomes we would like to achieve.
- 1.11 Generally, we have the following benchmarking options:
- **Frontier benchmark:** This is the cost of the supplier with the lowest costs;
 - **Lower quartile benchmark:** This is the costs of the supplier that is halfway (in number of suppliers) between the suppliers with the lowest and median (ie midpoint) costs; and
 - **Weighted average benchmark:** This is the weighted average costs of all the suppliers included in the sample. This would, therefore, incorporate each of the suppliers' circumstances into the calculation. If some suppliers have higher costs or lower costs, due to factors outside their control, the weighted average will reflect the average situation across all suppliers.
- 1.12 We note that we also have the option of further adjusting the above benchmarks either upwards or downwards to achieve the desired outcome.

³ We define a notional supplier as a theoretical and efficient supplier that has no direct comparison with existing suppliers but draws from the properties across efficient suppliers in the market .

2. Background- Case study of benchmarking approaches within the cap

- 2.1 We have used different benchmarking approaches for different allowances within the cap. This is because variations in costs can be driven by a number of factors, for example external events, regulatory and cap changes, and non-efficiency differences between suppliers. These factors may impact the cap allowances and any adjustment we make to them differently. When choosing a benchmark approach, we will consider a notional efficient supplier's costs, but we should also consider the impacts of factors that are outside of suppliers' control.
- 2.2 In this section, we provide a summary of case studies of benchmarking approaches within the cap. We compare the benchmark metrics and trade-offs of competing considerations for each case.

Table 1 - Summary of benchmarking approaches of the price cap policies

Policy	Benchmark	Rationale
Setting the allowance for the core operating costs (2018) ⁴	Lower quartile minus £5	We considered that a lower quartile benchmark mitigates the impact of non-efficiency factors (eg customer base factors such as number of customers on PSR and on single fuel) on core operating costs compared to a frontier benchmark. We benchmarked core operating costs £5 lower than the lower quartile to recognise that differences in non-efficiency factors might not account for the total difference in costs between frontier and lower quartile suppliers.
Setting the allowance for the payment method uplift (2018) ⁵	Lower quartile ⁶	We considered the impact of non-efficiency factors. We especially investigated costs linked to customer base differences regarding payment method such as proportion of customers paying by standard credit. We considered that a lower quartile benchmark better mitigated the impact of non-efficiency factors on the payment method differential compared to a frontier benchmark. Considerations for efficiency were aligned to setting the core operating costs given the strong interaction.

⁴ Ofgem (2018), Default Tariff Cap: Decision. Appendix 6 – Operating costs, paragraph 2.25-2.30. https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_6_-_operating_costs.pdf

⁵ Ofgem (2018) Default Tariff Cap: Decision. Appendix 8 – Payment method uplift, paragraph 2.26-2.28 and 2.32-2.37. https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf

⁶ Benchmarking costs to the lower quartile means taking the cost of the supplier which is halfway (in number of suppliers) between the suppliers with the lowest and median (ie midpoint) cost.

Policy	Benchmark	Rationale
Setting the allowance for smart metering costs (2020) ⁷	Weighted average	We acknowledged the uncertainty of smart metering rollout costs and considered that adopting an average efficiency approach should account for any unidentified cost differences between suppliers. We note that the smart meter rollout was a large delivery programme at the time and the government placed an obligation on suppliers to take all reasonable steps to complete the rollout. The rollout was novel which further explains the uncertainty of the programme.
One-off COVID-19 True-Up allowance included in the cap for additional costs incurred in cap periods four to seven (March 2020 – March 2022). ⁸	Weighted average ⁹	We considered the unique and exceptional circumstances of COVID-19, which made it harder than usual to be confident on the link between a supplier's efficiency and its costs. Customer bases was also a contributing factor. A supplier may have developed an efficient process for normal circumstances, but it might not have functioned as well in the unexpected disruption caused by the pandemic on its own customers. This guided our decision towards a looser allowance, i.e. weighted average instead of lower quartile.
12-month allowance for additional support credit (ASC) debt to account for expected increase in ASC demand in Winter 2023/24.	Weighted average	We considered the notable rise in ASC bad debt costs, which has been driven by increased ASC issuance and high energy prices. ¹⁰ Suppliers may have an incentive to limit how much ASC they issue to reduce the risk of ASC bad debt costs being incurred. Also, exact ASC demand in winter 2023/24 is inherently uncertain and the allowance needs to be sufficient for customers to access ASC and for suppliers to recover their costs. Setting a higher benchmark mitigates such risks of moral hazard and unintended consequences. ¹¹

⁷ Ofgem (2020), Decision on reviewing smart metering costs in the default tariff cap. Paragraph 2.29-2.31 and 2.39.

<https://www.ofgem.gov.uk/publications/decision-reviewing-smart-metering-costs-default-tariff-cap>

⁸ Ofgem (2023), Price cap – Decision on the true-up process for COVID-19 costs, paragraph 6.2-6.6; paragraph A1.56, A1.64-A1.71.

<https://www.ofgem.gov.uk/sites/default/files/2023-02/Price%20cap%20-%20Decision%20on%20the%20true-up%20process%20for%20COVID-19%20costs.pdf>

⁹ Benchmarking costs to the weighted average means taking the average operating costs of the suppliers in our sample weighted by the size of each supplier. The weighted average benchmark would be driven by the overall market position rather than individual suppliers' approaches.

¹⁰ Ofgem (2023), Price cap – Decision on allowance for additional support credit bad debt costs; paragraph 4.20. <https://www.ofgem.gov.uk/sites/default/files/2023-08/Allowance%20for%20additional%20support%20credit%20bad%20debt%20costs1692828077507.pdf>

¹¹ Ofgem (2023), Price cap – Statutory consultation on introducing an allowance for bad debt associated with additional support credit; paragraph 4.14- 4.19. <https://www.ofgem.gov.uk/sites/default/files/2023-06/Price%20cap%20%E2%80%93%20Statutory%20consultation%20on%20introducing%20an%20allowance%20for%20bad%20debt%20associated%20with%20Additional%20Support%20Credit.pdf>

Policy	Benchmark	Rationale
Setting the allowance for the unexpected SVT demand costs adjustment for cap periods eight and nine (April 2022 – March 2023) ¹²	Lower quartile	We recognised that unexpected SVT demand might depend on suppliers’ actions and that there was a high risk of uncertainty between non-efficient and efficient costs. The lower quartile better protected default tariff customers by reducing the risk of them paying for inefficient costs compared to an average benchmark.

3. Overarching objectives

3.1 Section 1(6) of the Act sets out the objective and five matters we must have regard to in setting the cap. In setting the cap, our primary consideration is the protection of existing and future consumers who pay standard variable and default rates and in so doing we must have regard to the following matters:

- (a) the need to create incentives for holders of supply licences to improve their efficiency;
- (b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- (c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
- (d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence; and
- (e) the need to set the cap at a level that takes account of the impact of the cap on public spending.

3.2 The requirement to have regard to these five matters does not mean that we must achieve all of these. When setting the cap, our primary consideration is the protection of existing and future consumers who pay standard variable and default rates. In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often, a balance must be struck between competing considerations.

3.3 The cap objective also aligns with Ofgem’s consumer interest and competition frameworks, which Ofgem is currently consulting on.¹³ Ofgem set out four high-

¹² Ofgem (2022), Price Cap – Decision on possible wholesale adjustments, paragraph 3.28-3.31, 3.58 and 3.66-3.69.

<https://www.ofgem.gov.uk/sites/default/files/2022-08/Price%20Cap%20-%20Decision%20on%20possible%20wholesale%20cost%20adjustment.pdf>

¹³ Ofgem (2023), The development of a competition framework for the domestic retail market.

level objectives in the consumer interest framework: (1) Fair prices, (2) Quality & Standards, (3) Low-Cost Transition and (4) Resilience.¹⁴ While the cap cuts across all of these objectives, it is most closely linked with Fair prices.

- 3.4 The proposed competition framework is split into three themes: (1) Consumer engagement & empowerment, (2) Market rivalry and (3) Structural parameters of the market.¹⁵ We intend to use this framework to identify the competition effects of the benchmarking options to ensure that we continue to achieve the cap objectives.
- 3.5 The overarching objectives of the cap, consumer interest and competition frameworks are relevant to our decision making when making changes to the cap methodology. In our operating cost review, we are exploring options for updating the benchmarking approach. We seek to set an efficient benchmark, such that, an efficient notional supplier could recover its costs, comply with its obligations, and deliver a good standard of service.
- 3.6 We note that how we benchmark suppliers' operating costs will lead to different outcomes being attained. It is important to consider which of those outcomes we would like to achieve through the choice of benchmarking approaches. Table 2 sets out a non-exhaustive list of potential outcomes we could achieve through the choice of the benchmarking approach and shows how we could achieve it by choosing different benchmark metrics, samples of suppliers and adjustments to the benchmarks.
- 3.7 It is possible that whilst achieving one outcome we might also be able to achieve other outcomes. For example, and as illustrated in Table 2, implementing a "looser" cap¹⁶ is likely to increase supplier financial resilience, which in turn is likely, but doesn't on its own guarantee, the facilitation of higher consumer standards.

<https://www.ofgem.gov.uk/publications/development-competition-framework-domestic-retail-market>

Ofgem (2023), Consultation on a framework for consumer standards and policy options to address priority customer service issues.

<https://www.ofgem.gov.uk/publications/consultation-framework-consumer-standards-and-policy-options-address-priority-customer-service-issues>

¹⁴ TBC

¹⁵ Ofgem (2023), The development of a competition framework for the domestic retail market. Paragraph 3.2.

<https://www.ofgem.gov.uk/publications/development-competition-framework-domestic-retail-market>

¹⁶ For the purpose of this paper, we define a 'looser' cap as a less stringent benchmark, for example set above the lower quartile cost level.

- 3.8 The current approach to setting the cap reflects the decision we took in 2018 when we decided to introduce a cap with “a high level of protection”.¹⁷ This included an efficiency challenge, by setting the operating cost allowances below suppliers’ historical operating costs (at just below the lower quartile). We also took the desired level of stringency into account when setting the headroom allowance. We included headroom for residual risks and uncertainty, but did not include additional headroom to help suppliers below the cap.
- 3.9 In considering how we could benchmark supplier costs for the operating cost review, we intend to reflect on whether we should maintain a cap with “high efficiency expectation and maximises customer price protection” or whether we should seek alternative primary outcomes (which will still ensure customers are protected¹⁸ but at varying levels), given how the market has changed since 2018.
- 3.10 We acknowledge that there is a debate on what constitutes consumer protection. In particular, the relative weight between price protection and non-price protection, such as good customer services.
- 3.11 We consider the following outcomes. A cap that:
- Sets a high efficiency expectation and maximises customer price protection (the status quo);
 - Promotes sustainable competition¹⁹;
 - Facilitates higher customer service standards; and
 - Increases supplier financial resilience against shocks or detrimental changes in the market.

¹⁷ Ofgem (2018), Default tariff cap: decision - overview, p6.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

¹⁸ Here we refer to ‘protection’ as price protection and/or non-price protection such as improvement in customer services and innovation. We consider it may be possible to enhance customer protection by allowing more innovation under the cap and by leveraging competition by allowing a looser cap.

¹⁹ We define sustainable competition as “where suppliers have incentives to innovate in the pursuit of net zero and receive a reasonable profit as they drive up consumer service standards. At the same time, we recognise that excessive pursuit of resilience above other goals would have costs, stifling entry to the market and constraining competition.

Ofgem (2023) Decision on introducing a minimum capital requirement and ringfencing customer credit balances by direction, page 6

<https://www.ofgem.gov.uk/publications/decision-introducing-minimum-capital-requirement-and-ringfencing-customer-credit-balances-direction>

Table 2. Outcomes and benchmarking options.

Outcomes	Benchmark metrics	Benchmark sample	Adjustments to the benchmark
(1)A strict efficiency driving cap to set a high efficiency expectation and maximise customer price protection.	Between Frontier and Lower quartile	Potentially all suppliers	Potentially including a deduction using an efficiency saving factor if we consider the benchmark supplier could be more efficient.
(2)A cap to promote sustainable competition , so to drive efficient costs down	Weighted average	Potentially all suppliers	Potentially including an upward adjustment to the benchmark to reflect future regulatory changes.
(3)A cap to facilitate higher customer service standards	Weighted average	Potentially exclude suppliers who do not deliver acceptable levels of customer service	Potentially including an upward adjustment to the benchmark to reflect future regulatory changes.
(4)A cap to increase supplier’s resilience to shocks or changes to competitive environment	Weighted average	Potentially all suppliers	Potentially upwards adjust if we consider the cap should be less stringent than implied by the weighted average benchmark.

3.12 Further, in Table 3, we conduct an initial assessment of the effectiveness of each outcome against our primary objective, and the matters that we must have regard to when setting the cap. We measure the effectiveness on a scale of 1 to 5, with 1 being the least effective and 5 being the most effective.

3.13 In our assessment, we have made several assumptions and considerations:

- Assumes an imperfect market (ie suppliers have some market power through product differentiation);
- Assumes the Energy Price Guarantee ('EPG') to not be in place or remain above the cap level. This means that the outcomes considered would not have an impact on public spending, therefore, the matter to have regard to public spending is not considered in our assessment;
- The effectiveness rating is determined by considering the outcome and the means of achieving the outcome (ie loose cap or stringent cap) on each relevant objectives relative to other objectives;
- We only consider the first-order impacts (ie the direct impact of the outcome and the means of achieving the outcome on the relevant objective).

3.14 The following are some notable trade-offs we observed in our assessment in table 3:

- Setting a stringent cap to achieve the outcome of high-efficiency expectations and maximise customer price protection (1) would likely be effective in achieving our primary objective of protecting customers and the matter of incentivising efficiency (a) that we must have regard to when setting the cap. However, this is less likely to be effective in achieving other matters, such as enabling competition (b) and incentivising switching (c). The former is because we could expect the proportion of inactive customers to stay larger with a tight cap, reducing the potential for suppliers to build market share through innovation/services. The latter is because a stringent cap reduced the gains from switching, therefore less incentive for customers to switch.
- Setting a loose cap to achieve the outcome of increasing suppliers' resilience (4) would likely be effective in achieving the matter of financing efficient costs (d) that we must have regard to when setting the cap. However, this is less likely to be effective in achieving our primary objective as this would mean a higher cap level for customers and would disproportionately mitigate the risk of supplier failure, while we have other mechanisms to address some of the supplier failure risks and costs.
- Setting a loose cap to achieve the outcome of facilitating higher customer service standards (3) would somewhat likely be effective in achieving our primary objective. This is because although it would lead to a relatively higher cap, the customer may benefit if suppliers invest in improving customer service. Conversely, this is less likely to achieve the first matter of incentivising efficiency (a). This is because suppliers have less incentive to improve their efficiency.

3.15 It is evident from this assessment that the outcomes we wish to achieve through our benchmarking approach and how we intend to accomplish them, have varying degrees of effectiveness towards achieving our primary objective and the matters we must take into account in setting the cap.

3.16 As noted earlier, whilst achieving one outcome we might also be able to achieve other outcomes; however, the extent may depend on how much the cap changes. It follows that since we are only looking at operating cost allowances, the extent to which we can influence the cap would be limited to the operating costs of suppliers and the differences in costs between our benchmarking approaches.

Questions

1. What is your view on how benchmarking options will lead to different outcomes?
2. In terms of achieving these overarching objectives, what outcomes should we focus on through the operating cost review?
3. Are there any other outcomes that we should consider achieving through the choice of benchmarking options?

Table 3. Outcomes and the effectiveness of achieving primary objectives and the matters to have regard under each outcome

Outcomes	Primary objective	(a) Incentivise efficiency	(b) Enables competition	(c) Incentivise switching	(d) Financing efficient costs	Rationale
(1) A strict efficiency driving cap to set a high efficiency expectation and maximise customer price protection. <i>Achieved by a stringent cap (Status quo)</i>	5	5 ^a	2 ^b	2/(3)	2/(3) ^c	^a Stringent cap incentivises suppliers to improve efficiency to make efficiency gains now or in the long term. ^b Stringent cap is likely to lead to a large proportion of inactive customers, reducing the potential for suppliers to build market share through innovation/service. ^c Ensure cost recovery of an efficient notional supplier, however, depends on how strictly we define efficiency and the variation between the defined level of efficiency and ‘true’ efficiency.
(2) A cap to promote sustainable competition, to drive efficient costs down <i>Achieved by a loose cap</i>	3 ^a	4 ^b	5	5 ^c	4	^a Higher price for customers on the cap. However, theoretically, competition could lead to innovation and potentially drive some prices down, noting that not all suppliers will transfer efficiency gains to customers. ^b Theoretically, competition could drive innovation that could improve efficiency in the long term. ^c Improve competition (innovation and new market entrants) offers greater products, incentivising customers to switch.
(3) A cap to facilitate higher customer service standards²⁰	3/(4) ^a	2	3 ^b	3 ^b	3	^a Higher price for consumers, however, drives higher consumer standards, benefiting customers

²⁰ This outcome would depend on the supplier's choice to invest in consumer standards. Therefore, we consider that setting consumer standards in parallel would facilitate in achieving this outcome.

Ofgem (2023), Consumer Standards - Statutory Consultation

<https://www.ofgem.gov.uk/publications/consumer-standards-statutory-consultation>

Outcomes	Primary objective	(a) Incentivise efficiency	(b) Enables competition	(c) Incentivise switching	(d) Financing efficient costs	Rationale
<i>Achieved by a loose cap plus a premium</i>						(depends on if suppliers invest in improving consumer standards). ^b Loose cap possibly leads to greater innovation and competition, facilitating switching (depends on if suppliers invest in innovation and improved competition).
(4) A loose cap to increase suppliers' resilience to shocks or changes to competitive environment <i>Achieved by a loose cap plus a higher premium</i>	2 ^a	2	3/(4) ^b	3/(4) ^b	5	^a Loose cap means higher prices to customers and might disproportionately mitigate risk of supplier failure while having other means to mitigate supplier failure risk (eg ad-hoc adjustments). ^b Loose cap might lead to greater innovation and improve competition (depends on if suppliers invest in innovation) but concerns that incumbents would have the funds to protect their positions and constrain competition.

Notes: Effectiveness Scale: 1-least effective, and 5-most effective. See paragraph 3.13 for details on assumptions and considerations for this exercise. Where the effectiveness is not clear between the outcome and objective, we have provided some rationale for the rating.

4. Methodology

Overview

- 4.1 In this section we provide our initial thinking on considerations and practicalities for choosing between potential benchmarking options, so we can achieve our objectives. We intend to present our views on how we calculate operating costs and the provisional findings from our data collection exercise in our policy consultation. We are currently working through the data provided by suppliers.
- 4.2 We discuss the following considerations in this section:
- The treatment of cost lines;
 - Approach to benchmarking parameters;
 - Consideration of non-efficiency factors; and
 - Trade-offs for choosing between benchmarking options;

Treatment of cost lines

Benchmarking at total core operating cost level

- 4.3 In our CFI, we stated that our preferred approach when calculating the core operating cost allowances, was to carry out our analysis at the level of total operating costs per customer (ie a top-down approach), rather than breaking this down into allowances for individual components (cost lines) of operating costs. We asked for stakeholders' views on the options (top-down and bottom-up) for treating the cost lines and whether there were alternative approaches for calculating the efficient level of core operating costs across suppliers.²¹
- 4.4 We consider that the approach of benchmarking at the total operating costs level is still proportionate from a time and data perspective, and is less technically complex. For example, it reduces some of the challenges associated with ensuring that operating costs are allocated to individual categories on a consistent basis across suppliers, providing more confidence that the data for each supplier is comparable. The difficulty of ensuring consistent allocation of costs between expenditure categories was a concern raised by a number of stakeholders.
- 4.5 It also takes into account the fact that costs incurred in some categories of the operating costs may be correlated with other cost categories. For example,

²¹ Ofgem (2023), Price cap: Call for Input on the operating cost allowances review (operating cost review). Page 18.
<https://www.ofgem.gov.uk/publications/price-cap-call-input-operating-cost-allowances-review>

suppliers who incur more debt-related administration costs to manage debt collection, may have lower level of bad debt costs in their accounts. This could mean that the sum of individually benchmarked cost lines might not be achievable by a notionally efficient supplier, particularly when using a more stringent benchmark approach.

- 4.6 We consider that some cost components (cost lines) can be grouped into broad cost categories, such as debt and debt-related costs and metering costs. Where we have confidence that such groups are identifiable in isolation and do not correlate with other cost components (for example, bad debt and debt-related costs do not correlate with metering costs), we may consider benchmarking these costs at a broadly defined cost level. Additionally, this does not preclude us from considering different benchmarks over different parameters (eg different benchmarks for different payment methods). We discuss benchmarking across parameters in section 5.

Isolating cost lines

- 4.7 Although we intend to benchmark at the total core operating cost level, we are collecting cost data via the RFI that is broken-down by selected cost lines (refer to Appendix 2 for a list of cost breakdowns we have requested in our July 2023 RFI). This is due to three main reasons.
- 4.8 **Flexibility in how we treat costs:** Suppliers could include various costs in their RFI submission related to their operations. As a result of having these costs at a cost line level, we would be able to isolate any particular cost line in the new baseline and consider how they should be treated.
- 4.9 **Potential adjustment to cost lines due to internal and external shocks:** We consider some reported costs for 2022 might be impacted by supplier-specific exceptional events (eg mergers and acquisitions) and/or external events (eg the energy crisis). Since we intend to set an enduring benchmark, we may consider adjusting these impacted costs to isolate the impact of these one-off events.
- 4.10 **Flexibility to consider an alternative approach to some cost lines:** As explained in the previous section, we may consider an alternative approach to benchmarking some costs, for example, pass-through industry charge costs, smart metering costs, and potentially debt-related costs. In this regard, we consider that cost line breakdowns would allow us to categorise these costs appropriately. We provide a brief description below of why we may treat these components separately and intend to provide further discussion on this in our policy consultation:

- Pass-through industry charges - we intend to consider whether to set a different approach based on charging statements, which we can update separately (eg the approach we take for DCC charges);
- Smart metering costs – we intend to consider how the calculation approach interacts with any set up costs related to the rollout of smart meters. For example, we currently have a separate SMNCC model for setting the transitional cost profile for the smart meter rollout;
- Debt related costs – in light of the ongoing debt-related cost review in the price cap, we consider we are better positioned to isolate these costs from total operating costs.. The following are two key considerations:
 - 1) different approaches and provision assumptions between suppliers may distort the comparability of the total costs when benchmarking, so we could exclude them to better understand the impact.
 - 2) We may want to set a separate benchmark or update the methodology for bad debt costs given the current uncertainty in economic situation (such as uncertainty over the cost of living crisis) and the impact this may have on bad debt costs.

Questions

4. Are there groups of costs captured within the operating cost review that are cross correlated and therefore those costs should be considered and benchmarked together?
5. How should we treat costs (ie debt-related costs) that may be more uncertain than other costs?
6. Are there any other costs that we should isolate from the total core operating costs?

Benchmarking parameters

- 4.11 When benchmarking costs, we make a number of decisions on which parameters to compare costs over (eg the cost to serve different payment methods). We consider whether we should set separate levels for these parameters, and if not, whether we should take these parameters into account as non-efficiency factors. This means that, for the chosen benchmarking parameters, we intend to set separate levels of allowances for customers who are split by these parameters, so the allowances are reflective of the costs to serve them.
- 4.12 Most of the stakeholders who responded to our CFI agreed with our views on including fuel type and payment method as benchmarking parameters. They also

supported our views of not separating operating costs by tariff type, region and electricity meter type for the benchmarking purpose. However, they provided mixed views on whether we should set separate benchmarks for smart and traditional meter customers.

Smart and traditional meters

- 4.13 At present, we set a single blended cap level across smart and traditional meter customers. This means that all standard variable and default tariff customers bear the costs and benefits of the smart meter rollout regardless of their meter type. Using the data we have collected, we could consider setting separate cap levels for smart and traditional meter customers, as mentioned in our CFI.
- 4.14 Setting separate cap levels would more accurately reflect the specific costs of serving the two groups of customers compared to the current approach. This would lead to smart metering costs and benefits being met by / recovered from customers using smart meters.
- 4.15 In considering whether to set separate cap levels, we will take into account any implications on (1) the incentive to take up a smart meter by customers, (2) suppliers meeting the smart meter rollout targets, and (3) both smart and traditional meter customers.
- 4.16 In considering whether to set separate levels for smart meter and traditional meter customers, by definition one group will see an increase and the other a decrease in cost compared to the blended level. We will need to carefully consider the distributional impacts on the two groups and the characteristics of the customers in them.
- 4.17 From a practical perspective, alongside considering whether we should set a separate level for smart metering costs, we are also considering what is a proportionate approach to setting the allowance for smart metering costs. We intend to discuss options in greater detail in our policy consultation. However, it is worth noting the interplay between any decision regarding the setting of a separate cap level and the smart metering costs provided for in the cap.

Questions

7. What are your views on setting separate core operating cost allowances for smart meter and traditional meter customers, given the risks we discussed in this section?
8. What other benchmarking parameters do you think we should consider setting separate allowance for?

Non-efficiency factors

- 4.18 There are a number of potential factors that may drive variation in suppliers' operating costs, which are unrelated to relative efficiency or inefficiency. We refer to these as non-efficiency factors.
- 4.19 In our 2018 decision, we identified a number of non-efficiency factors, which might have had an impact on a supplier's operating costs, such as company size, legacy pension arrangements, the proportion of vulnerable customers (proxied by whether or not a customer was on the Priority Service Register (PSR)), the proportion of single fuel customers and the proportion of offline customers.²²
- 4.20 In response to our May 2023 CFI, stakeholders supported our plan to assess whether the existing non-efficiency factors (and any new ones) are driving cost variations among suppliers, based on new evidence we gather. Suppliers did not propose any new non-efficiency factors.²³
- 4.21 For the existing non-efficiency factors, we consider whether the mechanism²⁴ by which they could affect costs remains appropriate. We intend to review the materiality of the impact of the identified non-efficient factors on suppliers' operating costs, using the information we collect through our RFI from suppliers. We also intend to carry out analysis to identify whether there are additional non-efficiency factors which may materially vary across suppliers' operating costs. We will then consider whether to adjust our data sample of suppliers' operating costs to increase comparability as our analysis continues.
- 4.22 In this section, we highlight some further considerations of non-efficiency factors to what we have set out in the CFI. In our policy consultation, we intend to elaborate on how we may treat these factors.

²² Ofgem (2018), Default tariff cap: Decision Appendix 6 – Operating costs, Paragraph 2.26. https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_6_-_operating_costs.pdf

²³ One supplier mentioned that it was still early stage of this consultation process and further analysis of the relevant data might lead to additional factors being identified.

²⁴ Ofgem (2018), Default tariff cap: Statutory Consultation Appendix 6 – Operating costs, Table A6.5 and Table A6.6. https://www.ofgem.gov.uk/sites/default/files/docs/2018/09/appendix_6_-_operating_costs.pdf

Scope of the non-efficiency factors

- 4.23 In response to question 16 of the CFI (*“What non-efficiency factors linked to customer bases do you think drive cost variation among suppliers?”*), two suppliers commented that Ofgem should consider factors such as costs due to regulatory changes and inflation. Another supplier commented that changes in switching due to market volatility could have an impact on suppliers’ costs.
- 4.24 We consider costs due to regulatory changes (including industry change programmes), market volatility and inflation should not be seen as non-efficiency factors on the basis that they should affect suppliers in a broadly even way. We intend to account for such impacts in other ways within this review (eg considering adjustments to the benchmark for future regulatory changes).

Proxy for vulnerable customers

- 4.25 Customers in vulnerable circumstances (eg low income) may be more costly to serve, for example due to potentially higher customer contact costs from needing more frequent support. In our 2018 decision, we used whether or not a customer was on the PSR as a proxy for the proportion of vulnerable customers per supplier. We also gathered data on the additional costs to serve customers on PSR to investigate whether vulnerable customers contribute to the variation of suppliers’ operating costs.
- 4.26 We acknowledge that there are limitations to using the PSR to represent the proportion of vulnerable customers for suppliers. We discuss the limitations below:
- **PSR captures some customers that may not incur additional costs to serve:** The PSR covers a broad eligibility for the service,²⁵ for example, people who have reached state pension age or have young children, but suppliers may not incur additional costs to serve some of these customers on the PSR. In this case, it is likely to cause us to overstate the impact of differences in customer base in driving variation in suppliers’ efficient costs.
 - **PSR does not reflect the accurate proportion of high-cost-to-serve vulnerable customers:** We could expect suppliers to incur additional costs to support financially vulnerable customers, for example, through providing additional customer contact and debt support. Financial

²⁵ Ofgem, Get help from your supplier- Priority Services Register <https://www.ofgem.gov.uk/information-consumers/energy-advice-households/getting-extra-help-priority-services-register>

vulnerability is not a PSR needs code therefore PSR may not capture all low income customers. Moreover, some vulnerable customers may not be aware of the PSR or may not know how to register, thereby underestimating the proportion of high-cost-to-serve vulnerable customers at each supplier.

- 4.27 We are considering alternative proxies for the proportion of high-cost-to-serve vulnerable customers. The eligibility for Warm Home Discount (WHD)²⁶ might be a suitable alternative option to represent the proportion of high-cost-to-serve vulnerable customers. Those with high energy costs who claim a means-tested benefit are eligible for the WHD, and The Department for Energy Security and Net Zero (DESNZ) may be more likely to capture data on those customers who are in financially vulnerable situations but not on the PSR. However, some vulnerable customers with a disability may not get the WHD rebate and not all those who are eligible for WHD will claim it. Therefore, a proportion of high-cost-to-serve vulnerable customers may not be captured by this measure.
- 4.28 We also consider the proportion of customers who identify as the 'do not install' (DNI) category for involuntary prepayment meters (PPM) to be another proxy for vulnerability. In order to protect vulnerable customers from the detriment of involuntary PPM and subsequent self-disconnection, in 2023, we made a decision to classify those customers with children under two, and persons over the age of 75 as DNI for involuntary PPMs.²⁷ We consider suppliers may incur additional costs to serve these customer groups, for instance through incurring additional bad debt or debt related costs. However, we also acknowledge that not all customers classified under this group will incur additional costs. For example, not all households with children are likely to incur additional costs. As this is a new category, we should also consider whether suppliers will have historical data on this group of customers over the period we have gathered data for. This will allow us to assess the impact of this customer group on suppliers' operating costs.
- 4.29 We note there is no perfect proxy for a supplier's proportion of high-cost-to-serve vulnerable customers. In our RFI, we have asked suppliers to provide the additional cost of serving vulnerable customers compared to non-vulnerable customers. Ideally, we would like to collect data on how many vulnerable customers suppliers serve, and the additional cost-to-serve these customers. In responding to our RFI, some suppliers mentioned they did not record a

²⁶ Ofgem, Eligibility for WHD, <https://www.gov.uk/the-warm-home-discount-scheme>

²⁷ Ofgem (2023) Involuntary prepayment meter decision
<https://www.ofgem.gov.uk/publications/involuntary-prepayment-meter-decision>

breakdown of data for this group of customers; instead they would make a significant degree of judgement and assumptions to divide the data in this way.

4.30 We consider there are few options to account for the impact of this non-efficiency factor. For example, we could:

- Choose the benchmark as suppliers whose customer base is reflective of the wider market;
- Make an additional adjustment to the benchmark (eg similar to the £5 efficiency saving adjustment in our 2018 decision); or
- Consider how to achieve this outcome when choosing the benchmark metric.

Questions

9. What analysis do you think we should carry out in assessing the materiality of non-efficiency factors using the RFI data?
10. What other approach do you think we should take in how we account for non-efficiency factors?
11. What is your view on the proxy for suppliers' proportion of high-cost-to-serve vulnerable customers? Would you suggest an alternative approach?

The stringency level of the cap

Overview

4.31 In section 3, we discussed the link between high level outcomes we may seek to facilitate through the cap and our considerations on benchmarking. There are a number of other considerations that also feed into the stringency of benchmarking, which we discuss below. When setting the benchmark, we will consider the outcome and other considerations in the round. For example, we may wish to retain the status quo in setting a cap that drives efficiency and protects customers and therefore benchmark to the lower quartile. However, our view of uncertainty may suggest a weighted average approach is preferable in the round and should still facilitate our desired outcome.

Regulatory changes

4.32 In the CFI, we said that we intend to consider whether the evolution of regulatory obligations has resulted in or could lead to changes in a notional supplier's efficient operating costs.

- 4.33 For the regulatory changes that are already in place (eg updating the cap on a quarterly basis), we expect the efficient costs associated with these changes to be reflected in the RFI 2022 data, so we can consider the treatment of these costs in the new baseline. For the pass-through industry charge costs associated with industry change programmes since the cap was introduced, we are considering options for setting a separate cost component for them. We intend to discuss this in our policy consultation.
- 4.34 There may be future regulatory changes that are not captured by the data we have currently collected. This is because we gathered 2019 and 2022 data through the RFI to build the new baseline for calculating suppliers' efficient costs, but suppliers could potentially see changes in costs driven by regulatory changes from 2023 onwards. We intend to set a suitable benchmark on an enduring and forward-looking basis, which means we need to consider the options for accounting for the changes when setting the benchmark, for example:
- Option 1 - issuing another RFI to gather 2023 data. This would enable us to include the costs due to these expected regulatory changes, into the new baseline. However, it would depend on the data availability and may significantly delay our implementation of the operating cost review decisions. Some impacts may not be realised until 2024 and will therefore still require a different approach.
 - Option 2 - consider including a forward-looking adjustment to the benchmark. This would account for the net costs associated with these regulatory changes²⁸ and make the cap more resilient to future updates. However, this involves making assumptions on future enduring costs, which may be somewhat uncertain at the time we set the new operating cost allowances.
 - Option 3 - setting a looser cap (eg weighted average benchmark) to account for these uncertainties on additional efficient costs due to these regulatory changes. This would address the direction of the impact, but the magnitude may not be reflected accurately.

²⁸ Here we are considering the net costs of these regulatory changes, to offset the potential benefit/savings suppliers would gain from improved customer services or improved efficiency, for example reduced bad debt costs.

Limitations and uncertainty

- 4.35 We consider that there are likely to be some limitations in our methodology and the data we use, which could impact the accuracy of the baseline in terms of reflecting the efficient level of suppliers' operating costs.
- 4.36 We also consider that there may be uncertainty in suppliers' costs (ie bad debt costs), which could be affected by, for example, customer base characteristics, or the shock from external events.
- 4.37 Whilst the cap includes other mechanisms to address uncertainty, we will need to consider that when setting the operating cost allowance, we aren't being over-generous across the cap holistically and reduce any risk of double-counting costs.

Questions

- 12. What level of stringency of the cap do you think we should consider?
- 13. How should we account for the impact of the expected regulatory changes mentioned above?
- 14. Which option of accounting for the uncertainties in costs driven by upcoming regulatory changes do you agree with? What other options do you think we should use to account for these costs?
- 15. How should we account for the limitations in our methodology and the associated uncertainty?

5. Benchmarking approach across operating cost allowances

- 5.1 In this section, we set out our initial thinking on the options for the benchmarking approaches across operating cost components. As discussed in section 3, the combination of benchmarking metrics, sample of suppliers and adjustment to the benchmark would have an impact on the outcome we would achieve through the cap. Therefore, we need to consider whether it's best to have the same level of stringency for each cost component and what benchmark approach would enable us to achieve that.
- 5.2 We outlined our initial thinking on the benchmarking objective and methodology above. These initial considerations of the core operating cost allowance also largely apply to setting the benchmark for the payment method differential and smart metering costs allowances.
- 5.3 One approach for considering the benchmarking approach across different operating cost allowances is to consider this as a two-step approach.

- 5.4 In step 1, we would consider whether to use the same benchmark metric across components. For example, whether we use a lower quartile approach for both the core operating costs and payment method uplift.
- 5.5 As listed in Table 1, under the current cap methodology, we are using different benchmarking approaches to calculate the allowances for the core operating costs, payment method differential and smart metering costs. This is because, at the time of making the decisions related to each of these allowances, we considered there were different drivers for the variation in these cost components and we reached different conclusions on the trade-offs between competing considerations. Therefore, it isn't a given that we would use the same metric across components.
- 5.6 In step 2, If we use the same metric that produces a benchmark supplier (eg using a lower quartile approach), we will then consider whether it's appropriate to use different benchmark suppliers between components or whether we should use the same supplier.. Using two separate benchmarks could help to set a more efficient benchmark where suppliers are better at particular aspects of serving customers and in some circumstances, it may be helpful to use different samples for different components (eg if some suppliers have anomalous characteristics for particular components or costs). However, there is a risk this captures differences in how suppliers have allocated costs between components (eg allocation of costs across payment methods) and therefore the benchmark may capture a level below efficient costs.
- 5.7 There are a number of different options and combinations, which will yield different trade-offs and risks. For example, we could mitigate allocation differences by adjusting the benchmark supplier's cost allocation to reflect the industry average allocation.
- 5.8 We may also consider the need for including an adjustment to the benchmark separately for each cost component. This links to our consideration on the level of stringency of the cap and the outcome we want to achieve through the cap.

Questions

16. What approach do you think we should take to set the benchmarks for different operating cost allowances?

6. Next steps

- 6.1 We have collected suppliers' operating costs data through our RFI and are currently in the process of analysing the data.²⁹
- 6.2 We are seeking responses to this working paper by 08 November 2023 which should be sent to priceprotectionpolicy@ofgem.gov.uk. We will use the responses to our CFI, this working paper and the data we collect through our RFI to analyse the impact of different benchmarking options. This will feed into our policy consultation early next year.

²⁹ We issued our RFI to suppliers with 100,000 customers on July 19, and they are required to submit their data to us by September 13.

Appendix 1:

Overarching objective

1. What is your view on how benchmarking options will lead to different outcomes?
2. In terms of achieving these overarching objectives, what outcomes should we focus on through the operating cost review?
3. Are there any other outcomes that we should consider achieving through the choice of benchmarking options?

Methodology

Treatment of cost lines

4. Are there groups of costs captured within the operating cost review that are cross correlated and therefore those costs should be considered and benchmarked together?
5. How should we treat costs (ie debt-related costs) that may be more uncertain than other costs?
6. Are there any other costs that we should isolate from the total core operating costs?

Benchmarking Parameters

7. What are your views on setting separate core operating cost allowances for smart meter and traditional meter customers, given the risks we discussed in this section?
8. What other benchmarking parameters do you think we should consider setting separate allowance for?

Non-efficiency factors

9. What analysis do you think we should carry out in assessing the materiality of non-efficiency factors using the RFI data?
10. What other approach do you think we should take in how we account for non-efficiency factors?
11. What is your view on the proxy for suppliers' proportion of high-cost-to-serve vulnerable customers? Would you suggest an alternative approach?

The stringency level of the cap

12. What level of stringency of the cap do you think we should consider?
13. How should we account for the impact of the expected regulatory changes mentioned above?

14. Which option of accounting for the uncertainties in costs driven by upcoming regulatory changes do you agree with? What other options do you think we should use to account for these costs?

15. How should we account for the limitations in our methodology and the associated uncertainty ?

Benchmarking approach across operating cost allowances

16. What approach do you think we should take to set the benchmarks for different operating cost allowances?

Appendix 2:

Table A1: List of cost lines and cost lines breakdown we have requested in our July 2023 Operating costs review RFI

High-level cost line	Sub-group	Sub subgroup
Environmental and social obligation	Warm Home Discount (WHD) Administrative costs only	Not applicable
	Renewable Obligation (RO) Administrative costs only	Not applicable
	UK Capacity Market (CM) Administrative costs only	Not applicable
Other direct costs	Industry charges	Not applicable
	3rd party commissions	Not applicable
Indirect costs	Customer contact	Call centre
		Customer relations
	Billing and payment collections	Billing/ statements
		Payment services (PPM)
		Internal collections
		External collections
		Bad debt charge
		Warrant costs
		Active charge
		Bank charges/Transaction costs.
	Metering	Rental
		Net cost of installation/removal
		Maintenance
		Meter reading/Data Collection/Data aggregation
PPMIP charge		
Sales and marketing	Not applicable	
Central overhead (where not allocated above)	Not applicable	
Depreciation	Not applicable	Not applicable
Amortisation	Not applicable	Not applicable

Appendix 3:

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

3. With whom we will be sharing your personal data

(Include here all organisations outside Ofgem who will be given all or some of the data. There is no need to include organisations that will only receive anonymised data. If different organisations see different set of data then make this clear. Be as specific as possible.)

4. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for *(be as clear as possible but allow room for changes to programmes or policy. It is acceptable to give a relative time e.g. 'six months after the project is closed')*

5. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

6. Your personal data will not be sent overseas (Note that this cannot be claimed if using Survey Monkey for the consultation as their servers are in the US. In that case use “the Data you provide directly will be stored by Survey Monkey on their servers in the United States. We have taken all necessary precautions to ensure that your rights in term of data protection will not be compromised by this”.

7. Your personal data will not be used for any automated decision making.

8. Your personal data will be stored in a secure government IT system. (If using a third party system such as Survey Monkey to gather the data, you will need to state clearly at which point the data will be moved from there to our internal systems.)

9. More information For more information on how Ofgem processes your data, click on the link to our “[Ofgem privacy promise](#)”.