# Appendix 1: Core operating costs

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# **1. Executive summary**

#### **Chapter summary**

This chapter sets out the context for the review of the core operating costs allowance as part of our operating cost allowances review, a summary of our proposals, and the structure of the remaining chapters.

# **Purpose of this paper**

- 1.1 In our operating cost allowances review (the "operating costs review"), we define "core operating costs" as a supplier's own costs of retailing energy. It includes the costs of customer contact, billing and payment, metering (some of which would be related to smart metering), sales and marketing, central overhead, third party commissions, depreciation and amortisation, as well as administrative costs related to environmental and social obligations. It does not include debt-related costs and industry charges (see Appendix 2 and Appendix 4 for further details).
- 1.2 In our May 2024 policy consultation, we considered updating the core operating costs baseline by re-benchmarking core operating costs using more recent supplier cost data, including considering options for the benchmark approach.<sup>1</sup> We also explored options for updating the allowance over time and considered how we would allocate costs across customers (eg across payment methods, fuel types, and the standing charge and unit rate).
- 1.3 The aim of this review is to update the core operating cost allowance to reflect the efficient costs of a notional supplier in serving default tariff customers. It considers the changes in the market since the cap was introduced and aims to set an enduring allowance.
- 1.4 The energy crisis has also resulted in increased challenges for suppliers. Many customers, especially vulnerable customers, require greater and better support. Our recent consumer confidence publication outlined our goal that all customers receive not just a good service but one that sets the highest standard for all service sectors.<sup>2</sup> To be clear, we do not believe that good customer service necessarily means higher costs. However, we do think that it is in customers' interest that efficient suppliers are able to recover their costs and attract

 <sup>&</sup>lt;sup>1</sup> Ofgem (2024), Energy price cap operating cost allowances review, Chapter 3. <u>https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review</u>
 <sup>2</sup> Ofgem (2024), Consumer confidence: a step up in standards. <u>https://www.ofgem.gov.uk/publications/consumer-confidence-step-standards</u>

necessary investment. This is all the more critical as we transition towards a net zero future.

- 1.5 This review is being undertaken within the context of a number of wider interrelated reviews of pricing reforms, including standing charges, debt and affordability, and future price protection. Where possible, we seek to align our position with these wider reviews. However, we note there could be potential timing differences between workstreams so we must also consider the option space on its own merits within our operating costs review.<sup>3</sup>
- 1.6 This document sets out our proposals to set an enduring forward-looking core operating cost allowance. For each proposal, it details the context, an explanation of the approach, a summary of stakeholder responses, and relevant considerations and analysis.

# Summary of our proposals

- 1.7 We propose to remove three suppliers from the initial benchmarking sample of12: Bulb (no longer active), Foxglove (data quality) and Utility Warehouse(difficulty in isolating costs from bundled services).
- 1.8 We propose to benchmark core operating costs using suppliers' cost data for calendar year 2023, gathered through a Request for Information (RFI) in May 2024. While we acknowledge that 2023 was a year of high operating pressures, 2023 data reflects the latest market conditions and is less likely to have been impacted by any external events such as supplier failures and high energy prices in comparison to 2022 data.
- 1.9 We propose to benchmark suppliers' core operating costs at an aggregate level (rather than benchmarking each payment method separately), using a weighted average benchmark approach. An aggregate benchmark is the option most resilient to differences in the cost allocation methodologies amongst the suppliers in the sample. Furthermore, a weighted average benchmark approach balances stringency while enabling suppliers to continue to invest in improvements to customer support, quality standards, financial resilience and net zero capabilities.
- 1.10 We propose to allocate core operating costs in a broadly cost-reflective way across payment methods. To achieve this, we plan to use cost data from suppliers

<sup>&</sup>lt;sup>3</sup> Ofgem (2024), Energy price cap operating cost allowances review, paragraph 3.110. <u>https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review</u>

who have at least 100,000 customers on each payment method relevant to a particular differential. This means that we calculate the weighted average difference in costs for serving Standard Credit and Prepayment meter (PPM) customers compared to Direct Debit customers using different samples. We consider this approach will continue to incentivise both customers and suppliers to opt for lower cost-to-serve options, reducing overall costs.

1.11 We propose to use a weighted average of the suppliers' own fuel type allocations to allocate costs across fuel types. This cost reflective approach reflects the slightly higher cost to serve gas customers compared to electricity customers.

Table 1.1 - Estimated proposed cap levels per dual fuel customer at benchmark consumption, for each payment method, in 2024 prices.

Payment method	Proposed allowance	Change vs cap 13a
Direct Debit	£190	-£15
Standard Credit	£228	+£4
PPM	£245	-£13
Weighted average	£206	-£11

Note: table estimates the value of each cost component for the new baseline compared against the core operating cost allowance levels for cap period 13a. Benchmark consumption is equal to 12,000 kWh for gas and 3,100 kWh for electricity.

- 1.12 We propose to set new allocations for the core operating cost allowance across standing charges and unit rates, as described in Table 4.2. This will enable us to fully reflect the weighted average reduction of £11 in the core operating cost baseline onto standing charges and keep unit rates the same (relative to cap period 13a). Although the impact of this will vary by payment method (given the difference in changes in overall allowance levels), it would result in a modest decrease in standing charges for most customers. We consider this approach continues to incentivise both customers and suppliers to opt for lower cost-to-serve options.
- 1.13 We propose to index the core operating cost allowance by CPIH (the Consumer Prices Index, including owner occupiers' housing costs) for future cap periods. This is in line with our existing approach to updating the current operating cost allowance. A CPIH index allows suppliers to make necessary investments to ensure quality improves over time.

# Structure of this paper

- 1.14 The structure of the remaining chapters is set out below:
  - Chapter 2 Context. In this chapter we set out the current approach for the operating cost allowances, the case for change and the structure of new core operating cost allowance.
  - Chapter 3 Benchmarking approach. In this chapter we outline our proposals for the benchmarking approach. We cover the supplier sample, cost adjustments, and the approach to benchmarking at an aggregate level, as well as the baseline year and benchmark metric to use to set the allowance.
  - Chapter 4 Allocating core operating costs across customer groups. In this chapter we set out our proposals for allocating core operating costs across customer groups, including payment methods, fuel types, and standing charges and unit rates.
  - Chapter 5 Updating the core operating cost allowance over time.
    In this chapter we set out our proposals for updating the core operating cost allowance in the future.
  - Chapter 6 General stakeholder comments. In this chapter we outline cross-cutting comments from stakeholders in response to the policy consultation, alongside our responses.

# 2. Background

### **Chapter summary**

This chapter sets out the existing approach for setting the allowances of operating costs, the case for change and the structure of the new core operating cost allowance.

# Previous approach to setting the allowances

- 2.1 When we established the cap, operating costs were spread across three cost components in the cap:
  - Operating cost allowance Which was set at a level reflecting the operational costs associated with serving a typical Direct Debit customer. It includes costs such as metering, billing and payments, central overheads and amortised costs.
  - Payment method uplift This allowance accounted for the additional costs of serving Standard Credit and Prepayment Meter (PPM) customers respectively.<sup>4</sup> Broadly, the Standard Credit uplift has reflected higher debt costs associated with the payment method and the PPM uplift has reflected higher metering costs.
  - Smart Metering Net Cost Change (SMNCC) This allowance is set annually and is intended to capture the change in overall operating costs that have resulted from the rollout of smart meters. Generally smart meters reduce suppliers' operating costs and so over time the SMNCC allowance has tended to reduce overall operating cost allowances.
- 2.2 We break down the operating costs review into four parts: (i) core operating costs, (ii) debt-related costs, (iii) smart metering costs and (iv) pass-through industry charges. This appendix focuses on the core operating costs element of the review.

# **Operating cost allowance**

2.3 The existing operating cost allowance baseline was set using suppliers' 2017 cost data.<sup>5</sup> At the time, we did not collect the data broken down by payment methods. We calculated the cost to serve Direct Debit customers by subtracting the

<sup>&</sup>lt;sup>4</sup> There is also a payment method uplift for Direct Debit, reflecting our decision on how to allocate costs between Direct Debit and Standard Credit customers.

<sup>&</sup>lt;sup>5</sup> Ofgem (2018), Default tariff cap: Appendix 6 - Operating costs, paragraph 2.9. <u>https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview</u>

additional costs to serve PPM and Standard Credit customers from the total operating costs.<sup>6</sup>

- 2.4 We benchmarked the operating cost allowance at the lower quartile cost minus £5 (for Direct Debit customers). This was a conscious choice which required the market as a whole to make considerable efficiency improvements in how they run their businesses, following a Competition and Markets Authority (CMA) report which highlighted considerable market inefficiencies and customer detriment.<sup>7</sup>
- 2.5 We considered that setting a more stringent frontier benchmark would be unlikely to sufficiently cover the costs of an efficient supplier with a typical customer base.<sup>8</sup> We found that compared to frontier suppliers those suppliers closest to the lower quartile had proportions of Priority Services Register (PSR) and single fuel customers that were much closer to the market average.<sup>9</sup> We considered the lower quartile supplier could still achieve efficiency savings, so we reduced the benchmark by £5 to provide an efficiency saving incentive.
- 2.6 In our 2018 methodology, the operating cost allowance includes some elements of industry charges (such as the charges suppliers pay to Elexon, the code administrator of the BSC, and Xoserve, the Central Data Service Provider for the gas market). In this review, we propose to set a distinct pass-through industry charge allowance. This is discussed in Appendix 4.

# **Payment method uplift and SMNCC**

- 2.7 The payment method uplift allowance accounts for the additional costs of serving Standard Credit and PPM customers respectively.
- 2.8 To set the payment method uplift for the additional Standard Credit costs, we compared supplier cost data for Standard Credit and Direct Debit customers.<sup>10</sup> We calculated the difference in cost to serve for each cost element, using data from the benchmark supplier. We then allocated these additional costs across Standard Credit and Direct Debit customers based on the assumed percentage of customers using each payment method.

 <sup>&</sup>lt;sup>6</sup> Ofgem (2018), Default tariff cap: Appendix 6 - Operating costs, paragraph 2.6. <u>https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview</u>
 <sup>7</sup> Ofgem (2018), Default tariff cap: Appendix 6 - Operating costs, paragraph 3.4. <u>https://www.ofgem.gov.uk/decision/default-tariff-cap-decision-overview</u>
 <sup>8</sup> Frontier would use the supplier with the lowest costs.

 <sup>&</sup>lt;sup>9</sup> Ofgem (2018), Default tariff cap: Appendix 6 – Operating costs, paragraph 2.23. <u>https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview</u>
 <sup>10</sup> Ofgem (2018), Default tariff cap: Appendix 8 – Payment method uplift, paragraph 2.11.

<sup>&</sup>lt;sup>10</sup> Ofgem (2018), Default tariff cap: Appendix 8 – Payment method uplift, paragraph 2.11 <u>https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview</u>

- 2.9 To set the payment method uplift for the additional PPM costs, we relied on data from the CMA. We adopted the CMA's PPM uplift designed for its cap. The uplift was set using 2014 supplier data and supplemented with further information. The CMA used a combination of top-down and bottom-up cost assessment to set a central estimate of the additional PPM costs split by gas and electricity.<sup>11</sup>
- 2.10 In our 2020 decision on protecting energy consumers with PPMs, we noted that the CMA had used a stringent benchmarking and calculation approach for the PPM uplift. While we considered this approach to be in line with the rest of the cap methodology, there was uncertainty in these costs so we considered that a range from the CMA value to the weighted average could reasonably reflect these costs. Using the 2014 supplier data, we assessed that an upper bound estimate of the additional costs (based on a weighted average approach) may have been up to £17 higher than the PPM uplift value.<sup>12</sup>
- 2.11 To allow for the £17 uncertainty in cost, we took it into account in the SMNCC allowance.<sup>13</sup> Given the smart meter rollout is a net benefit to suppliers for PPM customers (driven by smart meters being cheaper than traditional PPM meters), we said that any reduction in the SMNCC allowance for PPM customers would be offset against the £17 additional PPM cost under the upper bound estimate.<sup>14</sup>

### Standing charges and unit rates

2.12 When setting the cap in 2018, our analysis suggested that using a bottom-up approach<sup>15</sup> to set the nil consumption level of the cap would yield an increase in standing charges for default tariff customers above market prices at that time. While most operating costs are fixed (with the notable exception of bad debt), we said supplier practice was to split these costs between the unit rate and standing charge.

<sup>&</sup>lt;sup>11</sup> Ofgem (2020), Protecting energy consumers with prepayment meters – August 2020 decision, paragraph 4.7. <u>https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumers-prepayment-meters</u>

<sup>&</sup>lt;sup>12</sup> Ofgem (2020), Protecting energy consumers with prepayment meters – August 2020 decision, paragraph 4.2. <u>https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumers-prepayment-meters</u>

<sup>&</sup>lt;sup>13</sup> Ofgem (2020), Protecting energy consumers with prepayment meters – August 2020 decision, paragraph 4.84. <u>https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumers-prepayment-meters</u>

<sup>&</sup>lt;sup>14</sup> Ofgem (2020), Protecting energy consumers with prepayment meters – August 2020 decision, paragraph 4.85. <u>https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumers-prepayment-meters</u>

<sup>&</sup>lt;sup>15</sup> Where the standing charge of each allowance within the cap is calculated independently and then summed to create a total standing charge across the cap.

- 2.13 We set the initial level of the cap benchmark at nil consumption in line with market prices in 2017, to avoid significantly increasing charges for low consumption default tariff customers.<sup>16</sup>
- 2.14 The current allocation of the operating cost allowance applies 51% of operating costs to the standing charge for electricity, and 73% for gas.

### Updating the allowance

- 2.15 To reflect the changes in efficient operating costs, we updated the operating cost allowance component using inflation. We used the most recent value of CPIH (the Consumer Prices Index, including owner occupiers' housing costs), as observed prior to the level of the cap being set.
- 2.16 The evidence available at the time of setting the cap into 2018 did not suggest that an efficient level of operating costs had in the past increased more quickly than CPIH, nor that it should be expected to do so in the future.<sup>17</sup>

# **Case for change**

- 2.17 Our May 2024 policy consultation sets out a detailed case for review, highlighting the need to update operating cost allowances as the cap has now been in place longer than originally envisaged.<sup>18</sup> Outdated costs data, significant sector changes, such as market consolidations (eg acquisitions and exits), introduction of regulatory changes (eg changes in debt-related rules<sup>19</sup>) and external events (eg the gas price crisis) are the key reasons for undertaking this review.
- 2.18 There have been a number of changes in the market since the cap was introduced which may have impacted on suppliers' core operating costs. These range from the support measures we have introduced to the wider industry changes occurring such as the ongoing smart meter rollout and the planned introduction of market-wide half-hourly settlement (MHHS). We also acknowledge recent and upcoming regulatory changes, such as the October 2023 customer standards decision, the 24/7 enquiry line proposals, the uplift to payments under the Guaranteed Standards of Performance, the involuntary PPM code of practice, and

<sup>17</sup> Ofgem (2018), Default tariff cap: Appendix 6 – Operating costs, paragraph 3.54. <u>https://www.ofgem.gov.uk/decision/default-tariff-cap-decision-overview</u>

<sup>18</sup> Ofgem (2024), Energy Price Cap operating cost allowances review, paragraphs 2.18 - 2.31
 <u>https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review</u>
 <sup>19</sup> Ofgem (2024), Energy price cap: additional debt costs review decision.

<sup>&</sup>lt;sup>16</sup> Ofgem (2018), Default tariff cap: Appendix 1 – Benchmark methodology, paragraph 1.3. <u>https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview</u>

https://www.ofgem.gov.uk/decision/energy-price-cap-additional-debt-costs-review-decision

the financial resilience framework, may place costs pressures on suppliers (see detailed discussion in Chapter 5).

2.19 For these reasons, we believe it is an ideal time to review the operating cost allowances and, if appropriate, consider updating the methodology underpinning the allowances, using more recent cost information.

# Structure of the new core operating cost allowance

- 2.20 The existing allowance structure is complex, making it difficult to precisely map how allowances are changing as a result of our proposals. We have therefore sought to create a like-for-like comparison of allowances based around the new proposed structure. This has required mapping existing allowances to the new structure (see full detail in our overview paper Table 2).
- 2.21 The existing allowances map onto the new core operating cost allowance (CO) in the cap, as follows:
  - Operating costs for a Direct Debit customer (OC) We include Direct Debit operating costs paid by Direct Debit customers (deducting the elements moved to industry charges and debt-related costs).
  - Change in smart metering costs from the 2017 baseline (SMNCC) A new baseline will include non-pass-through smart metering costs in that year, therefore reflecting changes in smart metering costs between 2017 and 2023. For PPM, we currently offset uncertainty over traditional PPM costs against part of the modelled reduction in smart metering costs. This step will not be required with a revised (2023) baseline.
  - Fixed element of payment method uplift (PAAC) For Standard Credit, we include additional non-debt operating costs compared to Direct Debit (eg additional customer contact costs). For PPM, we include additional operating costs compared to Direct Debit, based on a portfolio of largely traditional meters. (Note in 2023 suppliers' actual PPM costs would be based on a mix of traditional and smart PPMs)

# 3. Benchmarking approach

#### **Chapter summary**

This chapter sets out the proposals for the benchmarking approach. It covers the supplier sample, cost adjustments and the approach to benchmarking at an aggregate level, as well as the baseline year and benchmark metric to use to set the allowance.

# Context

- 3.1 The Domestic Gas and Electricity (Tariff Cap) Act 2018 (the act) requires us to set one cap level across the market.<sup>20</sup> Our primary consideration is the protection of existing and future consumers who pay standard variable and default rates. In our 2018 decision, we emphasised the role of the price cap to provide a high level of protection – to prevent unjustified price increases and ensure that default tariffs more closely reflect the underlying costs of supplying energy.<sup>21</sup>
- 3.2 When we first established the cap, we did so in the context of the CMA's report suggesting widespread inefficiency and as a result, we set a very stringent benchmark for suppliers to meet on operating costs. Our data suggests that despite the increased challenges, suppliers have become more efficient since the cap was introduced, in part due to re-platforming and invest-to-save measures.
- 3.3 In our May 2024 consultation, we discussed the case for change in detail, and we highlighted the need to balance various factors to make judgements in the round.
- 3.4 In our overview paper, we outline our duties regarding the act, and the implications of our consumer interest framework for making decisions on setting the cap. The level of the core operating cost allowance will materially and directly impact the prices paid by customers on default tariffs and the revenues received by suppliers. In protecting current and future consumers we need to further consider trade-offs within our Consumer Interests Framework, the principal trade-offs in reaching decisions on the cap here involve balancing fair prices (stringency), standards and resilience. In the context of Net Zero, these trade-offs are crucial for ensuring that our regulatory framework supports the transition to a low-carbon economy. By carefully balancing these factors, we aim to

<sup>&</sup>lt;sup>20</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018.

https://www.legislation.gov.uk/ukpga/2018/21/enacted

<sup>&</sup>lt;sup>21</sup> Ofgem (2018), Default tariff cap: Overview Document, page 6. https://www.ofgem.gov.uk/decision/default-tariff-cap-decision-overview

maintain fair prices for consumers, uphold high standards of service, enable a low carbon transition and enhance the resilience of our energy system.

- 3.5 Therefore, in setting the allowance for core operating costs, we need to establish the right level of overall stringency to set the allowance at, which is influenced by what data sample we use to carry out the benchmarking exercise, what costs we should include in core operating costs, what baseline period we use to assess costs, and the benchmarking methodology chosen.
- 3.6 In this chapter, we discuss each element of our benchmarking approach. We need to consider them in the round when setting the cap level for core operating costs, because these elements are interrelated. For example, we explain the rationale for including sales and marketing costs in the core operating costs baseline. This consideration should be viewed alongside our proposals for the baseline year, given that the switching rate in 2023 was significantly lower than it was before the energy crisis, which will likely have influenced sales and marketing costs.

# **Benchmarking sample**

# Context

- 3.7 We intend to set an enduring allowance that reflects the efficient core operating costs of a notional supplier. To achieve this, we need to update our core operating cost baseline, which was originally calculated using 2017 data.
- 3.8 In our May 2024 consultation, we discussed our proposal to use a top-down approach to calculate the core operating cost baseline. This means that we use suppliers' reported core operating costs to set the allowance by benchmarking across the market. This approach is consistent with our 2018 decision. We do not consider using a bottom-up approach to model a notional supplier's costs as appropriate and accurate for estimating the core operating costs baseline.
- In May 2024 we sent a Request for Information (RFI) to obtain the latest operating costs incurred by suppliers in 2023 (we refer to this as 2023 RFI data).
  We previously collected data for calendar year 2022 in our July 2023 RFI (we refer to this as 2022 RFI data).
- 3.10 For each RFI, we collected data from 12 suppliers with over 100,000 customer accounts.

# Proposals

3.11 In determining which suppliers' costs data should be included in our benchmarking sample, we propose to exclude three of the twelve suppliers from

our RFI sample for the benchmarking exercise: Bulb, Foxglove and Utility Warehouse.

- 3.12 We propose to exclude:
  - Bulb, as they have been acquired by Octopus and are no longer in the market due to going through special administration. We intend to set a forward-looking allowance for core operating costs, so it is reasonable to only include suppliers who are currently operating in the market.
  - Foxglove, as they were unable to provide sufficient justification for the abnormal level of 'other costs' in their submission, which has raised concerns about the reliability of their data.
  - Utility Warehouse, as they operate a multi-utility model which is significantly different from other suppliers. It makes it challenging for them to accurately spilt their retail energy related costs from other costs.
- 3.13 By excluding these suppliers from our benchmarking sample, we ensure that our analysis is based on accurate, reliable, and relevant data from suppliers currently active in the market. This approach enhances the credibility and validity of our proposals. Additionally, it allows us to set a more realistic and forward-looking allowance for core operating costs, better reflecting current market conditions and the operational realities of notionally efficient suppliers.

# Cost lines and adjustments

# Context

- 3.14 Given our proposal to use a top-down approach (using suppliers' costs data), we need to carefully scrutinise which costs are appropriate to include in our benchmarking exercise. Specifically, we reviewed the appropriateness of including sales and marketing costs. We also considered whether any adjustments were required to the baseline costs.
- 3.15 We have collected suppliers' operating costs to calculate the core operating costs baseline, including: administrative costs of environmental and social obligations schemes, depreciation and amortisation, billing and payments (excluding debt-related costs), sales and marketing, central overhead, customer contact, metering, and other costs.

### Proposals

3.16 We propose to include all these costs lines in the core operating costs baseline.

#### Summary of stakeholder responses

- 3.17 One consumer group said that heavy marketing costs were non-essential. In contrast, two suppliers said it is possible that switching levels will return to similar levels as seen prior to the energy crisis. This would cause an increase in switching-related operating costs, including the costs of sales and marketing.
- 3.18 One stakeholder suggested reviewing the comparability of 2023 RFI data, with the aim of ensuring data categories and defined terms that inform the allowance are comparable between suppliers.

#### Considerations

#### Sales and marketing costs

- 3.19 Under the current cap methodology, sales and marketing costs are included in the operating cost allowance. Sales and marketing costs are essential expenses for any business aiming to promote its products or services and drive revenue. For the energy retail sector, sales and marketing activities focus heavily on customer acquisition.
- 3.20 In our operating costs review, we have collected a granular breakdown of these costs and qualitative information on: sponsorship, advertising, customer promotions, commissions and other sales and marketing costs. We found that suppliers have carried out different activities and incurred different levels of costs in sponsorship and advertising, as well as wider marketing activities. Evidence collected suggests that different customer acquisition and retention strategies may be deployed with very different emphasis on expenditure on different activities. In principle, there will be different ways that suppliers attract and retain customers, with individual suppliers possibly having different degrees of success with various methods.
- 3.21 To some extent these approaches net off for example a supplier with higher advertising costs may spend less on third party commissions and vice versa. It is therefore not possible to isolate a specific subset of activities to be considered as heavy marketing. When comparing realised costs, we should also bear in mind that switching was low in 2023, with around 29 million customers staying on standard variable tariffs. This may make acquisition strategies with fixed costs (eg sponsorship) seem more expensive than those with variable costs (eg price comparison websites). This does not necessarily mean that certain strategies were disproportionate ex ante.

- 3.22 It is within our duties under the cap to have regard to the need for suppliers to compete for customers and for customers to have incentive to switch. It is consistent with these duties to include the normal costs of a competitive market. Therefore, we propose to include the reported sales and marketing costs in the baseline costs, as spending money to acquire customers is part of a competitive market.
- 3.23 Switching levels are higher in 2024 than 2023. However, default tariff customers would typically have lower average sales and marketing costs than suppliers' overall customer bases. We are therefore making a judgement in the round that including sales and marketing costs at the 2023 level is sufficient.

### Baseline cost adjustments

3.24 To improve the comparability and completeness of the data, which influence the accuracy and reliability of the benchmarking results, we carefully scrutinised the reported costs to consider whether adjustments are needed. We focused on the costs of market-wide half hour settlement (MHHS) and central overhead costs.

### **MHHS costs**

- 3.25 We need to be mindful of emerging cost pressures, such as those associated with the MHHS programme. Some suppliers provided their incurred costs associated with MHHS in their 2023 RFI submissions, along with additional costs they expect to incur in the near future. These suppliers used different approaches to estimate their MHHS costs.
- 3.26 Seven stakeholders said that the industry is expected to go through changes in the medium-term which will require additional investment, specifically highlighting MHHS as an example. Five suppliers also said they expect costs to increase as a result of implementing and maintaining MHHS.
- 3.27 We propose including the MHHS costs as presented in the RFI data and do not propose making adjustments for MHHS costs at this stage.
- 3.28 First, our analysis of suppliers' estimates of future MHHS costs shows an immaterial increase in cost per customer per year, on average. Although suppliers will incur costs for MHHS, IT and process improvements are a regular cycle. In future years, depreciation and amortisation costs of existing IT and other systems improvements (as recognised in the 2023 data) will start to fall out of suppliers' accounts.
- 3.29 Second, we acknowledge that there are uncertainties regarding MHHS implementation timing and associated costs. For example, one supplier said, due

to their investment in technology, they expect to implement MHHS without incurring additional operating costs. We therefore do not consider that making an explicit adjustment for MHHS would improve the accuracy of the allowance.

3.30 We discuss below how we consider our approach to the baseline year and benchmark metric will account for foreseeable uncertainties in operating costs and provide room for suppliers to recover their efficient costs.

### **Central overhead costs**

- 3.31 One stakeholder said that Ofgem should adjust for any supplier's transition from a legacy IT system to a new system, as the cost per customer will be overstated compared to once the transition is complete.
- 3.32 We consider that transitional costs from improvements to IT systems and other infrastructure are a normal cost for suppliers. We therefore propose to include these costs. This aligns with our proposal not to make an adjustment for MHHS costs, as suppliers routinely encounter transitional costs due to longer-term innovation, which are already present within suppliers' 2023 RFI data. This is distinct from exceptional costs (eg of restructuring), which we asked suppliers to exclude in their RFI responses.
- 3.33 However, we adjusted the central overhead cost for one supplier, in relation to the cost of a service provided by another group company, to better reflect the true economic cost that would have been incurred by an efficient notional supplier. This adjustment was made by using the 2024 rate charged rather than the 2023 rate, as we believe this better reflects the enduring cost of the service.

### **Other considerations**

3.34 In principle, non-compliance also poses a risk to obtaining comparable data across suppliers. Suppliers that are not in compliance with their licence obligations may have core operating costs that are not reflective of an efficient notional supplier. There have been a number of concluded compliance cases which relate (at least in part) to actions in 2023. However, we would be cautious about removing further suppliers, as using a more limited sample could have its own risks of inaccuracy. In the current circumstances, we do not consider that removing further suppliers is likely to improve the accuracy of our benchmark.<sup>22</sup>

<sup>&</sup>lt;sup>22</sup> We have not taken ongoing compliance cases into account in reaching this position, as we do not want to prejudge the conclusions of these investigations.

# Benchmarking at aggregate level

### Context

- 3.35 In determining how we should benchmark suppliers' core operating costs to set a new baseline, we must consider how to allocate costs across different groups of customers. This could be achieved by either benchmarking across different parameters, for example, producing three separate benchmarks for each payment method; or benchmarking at an aggregate cost level, producing a single benchmark. A single aggregate benchmark must then be allocated across customer groups (such as payment methods).
- 3.36 The cap varies by several different parameters such as region, payment method, fuel and electricity meter type. For benchmarking across parameters, we focus on fuel type and payment method as we consider these best capture the variation in core operating costs between groups of customers.<sup>23</sup>
- 3.37 In our May 2024 policy consultation, we set out four options for benchmarking across fuel types and payment methods:<sup>24</sup>
  - Option A: aggregate costs for fuel types and payment methods for this option we would benchmark at total core operating costs level.
  - Option B: split cost by fuel types only for this option, we would rely on suppliers' allocation of costs between fuels but not across payment methods.
  - Option C: split cost by payment method only for this option, we would take the aggregate costs of gas and electricity but benchmark costs at the payment method level (ie split Direct Debit, Standard Credit, and PPM).
  - Option D: split cost by fuel and payment method for this option, we would benchmark costs at the fuel type and payment method level.
- 3.38 The key factors in determining which option to choose are our confidence in the accuracy of suppliers' cost allocations across parameters and the comparability of these cost allocation approaches among different suppliers.

<sup>&</sup>lt;sup>23</sup> Ofgem (2024), Energy price cap operating cost allowance review, paragraph 3.54. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

<sup>&</sup>lt;sup>24</sup> Ofgem (2024), Energy price cap operating cost allowances review, paragraph 3.56 and figure 3.3.

https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review

3.39 We also need to consider the option together with the choice of benchmark metric. The sensitivity of our benchmarking over parameters varies depending on whether we set the allowance at a lower quartile benchmark or a weighted average benchmark.

### Proposals

3.40 We propose to set a benchmark for core operating costs by combining all fuel types and payment methods (option A). This approach eliminates the need to rely directly on suppliers' allocation methodologies to split costs between customer groups for benchmarking. An aggregate benchmark is resilient to differences in allocation methodologies as we can then decide the allocation approach across payment methods and fuel types alongside our benchmarking approach. We discuss the allocation approach in Chapter 4.

### Summary of stakeholder responses

- 3.41 Two suppliers supported benchmarking at aggregate level, citing resilience to cost allocation methodological differences.
- 3.42 Two suppliers supported benchmarking at payment method level only, saying that payment differentials represent a key driver of cost differences. One supplier supported this particularly if we were to opt for a lower quartile benchmark.
- 3.43 Three suppliers supported benchmarking at both fuel types and payment methods.

# Considerations

- 3.44 The RFI data shows significant variation in suppliers' methodologies for allocating their core operating costs between payment methods and fuel types. Several suppliers also stated that they had difficulties in splitting some cost lines between different customer groups.
- 3.45 We found that suppliers have allocated their costs using inconsistent approaches across our sample, such as:
  - Customer account numbers simply splitting the costs using customer numbers, which means allocating some costs equally across customers
  - A cost-reflective approach allocating the actual costs incurred by a particular customer group
  - A mixed of both approaches suppliers have used a mixed costs allocation approach for different costs lines within their RFI submissions.

- 3.46 We are aware that suppliers may take different approaches to allocating across customer groups to best reflect their business practices. However, benchmarking inherently requires a reasonable degree of comparability across suppliers.
- 3.47 There are inconsistent approaches among the suppliers in our sample, as well as within suppliers' own costs lines. This limits the degree of cost reflectivity and hinders our ability to understand variation in suppliers' efficiencies. Allocations that are not cost-reflect may lead to variations in reported costs as a result of suppliers' allocation decisions, rather than actual differences in cost to serve.
- 3.48 In addition, we need to consider the option together with the choice of benchmark metric. The sensitivity of our approach to benchmarking over parameters varies depending on whether we use a lower quartile benchmark or a weighted average benchmark.
- 3.49 Benchmarking each of the three payment methods individually could risk suppliers' ability to recover their efficient costs. In addition to the allocation issues above, this risk arises if suppliers have lower costs in serving customers with certain payment methods due to factors like economy of scale or specialisation, but higher costs for serving customers using other payment methods. If the allowance were set individually for each payment method, especially at a stringent benchmark, we consider most suppliers in the market would not be able to recover their efficient costs through the allowance. The potential outcome for customers could be bearing costs through the Supplier of Last Resort process.
- 3.50 Therefore, we propose to benchmark using aggregate costs across fuel types and payment methods. This approach sets a benchmark at a total core operating costs level, without reliance on suppliers' allocation methodology to split costs between customer groups. We consider an aggregate benchmark is a more resilient option to differences in the cost allocation methodologies amongst the suppliers in the sample.

# **Baseline year**

### Context

3.51 In updating the core operating costs baseline, we consider two options for the baseline year – 2022 or 2023. In our May 2023 call for input,<sup>25</sup> we discussed the trade-off between using data from one calendar year against using data averaging from multiple calendar years to smooth out any external shocks.

### Proposals

3.52 We propose to use 2023 cost data as it reflects the latest market conditions and is less likely to have been impacted by any external events in comparison to 2022 cost data. Moreover, we have confidence in the 2023 cost data after scrutinising it and requesting further clarification on specific cost lines from suppliers.

### Summary of stakeholder responses

- 3.53 When responding to our May 2023 call for input, three stakeholders suggested we should collect 2023 data for any updates to the allowance. They said that 2023 data would be less impacted by some of the external events in 2022 such as the numerous supplier failures.
- 3.54 One supplier said that 2022 cost data coincide with overall customer satisfaction hitting a low of 60 percent according to Ofgem's survey data, and highlighted that the higher standards Ofgem wishes to see may not be embedded within the benchmark cost data.

# Considerations

- 3.55 When comparing 2022 data against 2023 data, we found that costs had risen year-on-year from £187 in 2022, to £206 in 2023 (in 2024 prices).<sup>26</sup> These increases were driven by higher costs for central overheads, sales and marketing, and meter rentals.
- 3.56 While 2022 was impacted by supplier failures and the consequences of high energy bills, 2023 was not a normal year either. In 2023, suppliers were still dealing with the impacts of high energy bills. First, delivery of government support schemes would have impacted their operations. Second, customers are

 <sup>&</sup>lt;sup>25</sup> Ofgem (2023), Price cap - call for input on the operating cost allowances review, page 17.
 <u>https://www.ofgem.gov.uk/call-for-input/price-cap-call-input-operating-cost-allowances-review</u>
 <sup>26</sup> Calculated using a weighted average across the nine suppliers in our proposed sample, per dual

fuel customer per year on benchmark consumption level (3,100 kWh for electricity and 12,000 kWh for gas).

more likely to contact their supplier when facing difficulty paying their bills, which would have affected suppliers' customer contact costs. Third, suppliers who had taken on the customers of failed suppliers would have still been integrating these customers. Fourth, market switching was still low by historical standards meaning less expenditure on customer acquisition than a typical year.

3.57 Therefore, while we consider that 2023 data is preferable because it is more recent and less impacted by external events than 2022, we recognise that there is still a risk that 2023 data is not entirely typical. We consider this further below alongside our choice of benchmarking metric.

# **Benchmarking metric**

### Context

- 3.58 The benchmark metric describes the cost level of the allowance being set. The benchmark metric, alongside the rest of the benchmarking methodology and how we allocate costs across customer groups, is used to establish an appropriate level of stringency to set the allowance at.
- 3.59 In our May 2024 policy consultation, we set out two approaches to setting a benchmark metric:
  - Option 1: a lower quartile benchmark the cost of the supplier that is at the 25th percentile in the sample.
  - Option 2: a weighted average benchmark the average cost across suppliers weighted by the number of customers in their portfolio.

### Proposals

- 3.60 Our data suggests that suppliers have made efficiency improvements in previous years, leading to average costs that are now modestly below existing core operating cost allowances (see Table 3.1 below). In this context, we propose to set the allowance for core operating costs on a weighted average benchmark basis. This approach would both increase current stringency and move away from a "frontier efficiency" benchmark. This approach recognises that some higher costs (eg from serving vulnerable customers) may not be fully in suppliers' control and that the scope for further overall step-changes in efficiency savings may be limited.
- 3.61 Moreover, we aim to set an allowance that does not require frequent adjustment. We consider our proposed approach (a weighted average benchmark, alongside a 2023 baseline and a cost reflective allocation approach) will account for foreseen uncertainties in the operating costs and provide room for suppliers to recover

their efficient costs, so we would not need to revisit the allowance every time a modest additional cost driver occurred. (details are discussed in Chapter 4 and Chapter 5).

3.62 Table 3.1 sets out the proposed new core operating cost baseline value at aggregate level, as well as alternative benchmarking options. Note that these figures are provisional and subject to change (eg following consultation and following any changes to input values such as inflation).

Table 3.1 – Proposed core operating cost allowance at aggregate level for a dual fuel customer (2024 prices), along with alternative benchmark options

Benchmark metric	Allowance baseline	Change vs cap 13a	
Lower quartile	£197	-£20	
Weighted average	£206	-£11	
Median	£212	-£5	
Cap 13a	£217	N/A	

Note: table shows values for a customer with benchmark consumption (3,100 kWh electricity and 12,000 kWh gas). Current allowance refers to cap 13a. Values may not sum due to rounding.

# Summary of stakeholder responses

- 3.63 Eight suppliers and one stakeholder supported the use of a weighted average benchmark. They consider the weighted average benchmark would: balance the short-term price protection with longer term consumer protection goals; reduce the risk of delivering a sustainable and diverse energy retail market; enable investment and innovation to maximise long term consumer protection; better reflect market diversity; offset any modelling and/or data inaccuracies, reducing sensitivity to any outlying data points; and reduce the impact of limited evidence of correlation between benchmarking and efficiency.
- 3.64 One supplier supported the use of a lower quartile benchmark. They said this would encourage greater efficiency and lower prices, and that financial resilience was not enough justification for less stringency. Two stakeholders supported the use of a lower quartile benchmark and said that the reasons for previously adopting a lower quartile benchmark are still valid.
- 3.65 One stakeholder suggested the potential use of a median benchmark could prevent outlying suppliers from driving the benchmark.

### Considerations

- 3.66 A lower quartile benchmark would deliver a lower allowance than a weighted average. This would deliver immediate financial benefits to default tariff customers. We recognise that many customers are facing financial pressures and would value an immediate reduction in bills.
- 3.67 However, another element of protecting consumers is related to ensuring that suppliers provide appropriate customer support and treat consumers fairly. While we do not consider that good quality customer service necessarily costs more to deliver, a weighted average benchmark should provide greater room for suppliers to undertake a range of activities beyond their minimum obligation under the supply licence. This is particularly important for vulnerable customers who require a more sensitive and personal service. We have set out in our consumer confidence strategy our ambition to drive improvements in customer service.
- 3.68 Suppliers must remain compliant with all requirements. However, a lower quartile benchmark may lead suppliers to reduce costs by reducing the quality of their service to align to the minimum requirements.
- 3.69 We recognise that customers may have different preferences over the balance between price and service. We must set a single cap, so we have a limited ability to take this into account. Customers will remain able to select a fixed tariff which may better reflect their individual preferences.
- 3.70 Even if we considered that a lower quartile benchmark was sufficient for an efficient notional supplier, it could potentially create a risk of failure for some suppliers. Regardless of whether this was due to customer base effects or inefficiencies, the potential outcome for customers could be bearing costs through the Supplier of Last Resort process. Market exits, especially as a result of customer base effects, could also reduce competitive pressure in the market.
- 3.71 We consider a weighted average benchmark would enable continued improvement to customer service standards and reduce the risk of supplier failure from an overly stringent benchmark. A weighted average benchmark is also less susceptible to future market changes. To set a more stringent lower quartile benchmark we would need compelling evidence that further step-change cost savings could be realised for most suppliers while further driving up standards.

#### Role of efficiency and non-efficiency factors

- 3.72 When setting the cap, we must have regard to providing incentives for efficiency improvements and enabling efficient notional suppliers to finance the activities authorised by the licence.
- 3.73 The cap itself provides an incentive for suppliers to become more efficient to maximise their rates of return given that the cap is fixed for a period. We consider a stringent benchmark to generally provide a stronger efficiency incentive for suppliers, as they would need to become more efficient to achieve a normal rate of return. However, setting an overly stringent benchmark or continuing to tighten the benchmark to reflect frontier efficiency on an ongoing basis could have the opposite effect. By undermining investability and confidence in reasonable returns on investment, an overly stringent benchmark can therefore act to discourage investment and hence efficiency in the medium to longer-term.
- 3.74 Whilst suppliers can take actions to maximise their efficiency, there may be some factors that are outside the control of suppliers we refer to them as non-efficiency factors. The variation can be due to their customer base, a commercial strategy that is unrelated to efficiency, accounting differences (eg amortisation assumptions), and random noise.
- 3.75 Data for 2022 and 2023 core operating costs show variation that could be driven either by differences in relative efficiency or non-efficiency factors. If the variation in costs is driven by efficiency factors, then we would have more confidence in setting a lower quartile benchmark. We noted in our previous consultation that the hypothesis is that majority of the differences in core operating costs between suppliers are more likely to be related to efficiency rather than customer base differences. However, we acknowledge non-efficiency factors related to customer base differences do exist.
- 3.76 For a lower quartile benchmarking approach, we would need to set an allowance based on a benchmark supplier that is broadly representative of the market, especially if non-efficiency factors were significant drivers of differences in cost between suppliers. Not doing so would increase the risk of a benchmark that is based on a supplier with a cheaper customer base and is unachievable for an efficient notional supplier with a typical customer base.
- 3.77 In our proposed sample, the lower quartile supplier is representative of the market and features a mixed customer base. This would reduce the risk of a

lower quartile benchmark being unattainable for a supplier with a typical customer base.

- 3.78 Alternatively, we could use a weighted average benchmark approach to account for the non-efficiency factors in the sample. However, this would increase the risk of the benchmark capturing differences in efficiency and may provide weaker incentives to become more efficient.
- 3.79 We do not consider non-efficiency factors to be critical drivers of cost differences between our lower quartile supplier and other suppliers in our sample. Despite this, there remains a residual risk. Therefore, while we are primarily proposing a weighted average benchmark for other reasons discussed alongside these considerations, mitigating non-efficiency factors is a supporting reason. We also acknowledge there is a trade-off between mitigating the risk of non-efficiency factors and the strength of an efficiency incentive.

### Cost variations between suppliers

- 3.80 There were material differences in core operating costs between suppliers in 2023. One relevant factor is a supplier's mix of payment methods, given that we observed variation between payment methods. The weighted average core operating cost per dual fuel customer across suppliers in our proposed sample was £183 for Direct Debit, £238 for Standard Credit, and £261 for PPM (in 2024 prices).
- 3.81 The difference in the cost in serving Standard Credit customers relative to Direct Debit customers is largely down to greater volumes of customer contact, as well as increased billing and payments costs.
- 3.82 The difference in the cost in serving PPM customers relative to Direct Debit customers is largely down to increased billing and payments costs, and higher metering costs due to meter rentals and PPM specific charges.
- 3.83 However, we noted that a significant number of suppliers used customer numbers to apportion costs between payment methods across various cost lines. This limits the accuracy of the range of values, along with our ability to infer variation in suppliers' efficiencies. Allocation decisions that are not truly cost-reflective may lead to variations in reported costs being a result of allocation choices, as opposed to differences in costs to serve.
- 3.84 There may be some costs which are the same per customer across payment methods, and where allocation by customer numbers is therefore appropriate (eg central overheads). Our concerns are therefore driven by the extent to which

suppliers have allocated costs by customer numbers, and the variation in approaches between suppliers.

- 3.85 Moreover, we also consider that there may be some variation in suppliers' operating costs that are driven by aspects of the suppliers' operating environments or customer bases which do not relate to efficiency. Some of the factors that we identified but did not account for in the analysis include size, proportion of PSR customers, online and offline customers, and proportion of single fuel customers.
- 3.86 Larger suppliers may be able to incur some economies of scale, eg by spreading central overhead costs over a larger number of customers. However, we expect that most costs will scale with the number of customers served. This is likely to include IT costs. While these may have been fixed costs in the past, suppliers may now see these as a per customer charge due to the move to subscription-based IT systems. We therefore do not consider that scale is likely to be a large driver of variation in suppliers' operating costs between large suppliers. However, it may be significant when comparing small suppliers and large suppliers, which is why we gathered data from suppliers above a certain size threshold.
- 3.87 We consider that PSR customers are more likely to require additional communication and contact with their supplier. Therefore, suppliers with larger numbers of PSR customers may have higher associated customer contact costs.
- 3.88 Similarly, we consider offline customers to be harder to reach, requiring more expensive communication methods such as physical letters.
- 3.89 Central overhead and customer contact costs are unlikely to be materially different for single fuel compared to dual fuel customers. As a result, suppliers with fewer single fuel customers may benefit from slightly reduced core operating costs.
- 3.90 The quantity of these three customer groups (PSR, offline and single fuel) may vary among the suppliers in our sample. However, we consider payment methods and fuel types larger drivers of cost differences between customer groups. Regardless, a lower quartile benchmark would be more susceptible to differences in customer bases across suppliers than a weighted average benchmark.

### In the round assessment

3.91 As discussed above, using a 2023 baseline has a risk of over-stating some notionally efficient costs relative to a normal year. We are also proposing to select a weighted average benchmark, rather than a lower quartile. Taken together, we recognise that, although these proposals end up reducing the core operating cost allowance relative to today, they result in a higher overall set of allowances compared to alternative, more stringent, design choices.

- 3.92 However, in the round, we do not consider that our proposed approach is overly loose. In particular, we highlight three points.
- 3.93 First, we have not seen suppliers make supernormal profits under the existing allowances. Aside from periods affected by adjustments for previous under-recovery, suppliers have generally made profits below the EBIT allowance in the cap. This suggests that we should be cautious about the extent to which we reduce the core operating cost allowance.
- 3.94 Second, the cap is no longer a temporary measure. In this context, setting an unduly stringent allowance would send a negative signal for investment and even market participation. While we expect suppliers to make efficiency improvements over time, a lower quartile benchmark would leave some suppliers making a loss until they were able to improve their efficiency. We do not have sufficient confidence that suppliers have the ability to make rapid efficiency gains to mitigate this.
- 3.95 Third, while the cap includes a headroom allowance to recognise residual costs and uncertainties, we set this taking into account the prevailing relationship between typical consumption (where we set the benchmark) and mean consumption (which determines the revenue suppliers recover). Consumption patterns have been subject to change over time, especially as a result of high energy prices. This could reduce headroom. In this uncertain context, we would be cautious about reducing allowances further through our choice of benchmark.

# 4. Allocating core operating costs across customer groups

#### **Chapter summary**

This chapter sets out the proposals for allocating core operating costs across customer groups, including payment methods, fuel types, standing charges and unit rates, and electricity meter types.

# Context

- 4.1 In setting the allowance for core operating costs, we also need to decide how the overall costs should be allocated across different payment methods, fuel types (electricity and gas), consumption levels (standing charge and unit rate) and electricity meter types (single-rate and multi-register).
- 4.2 In the existing cap methodology, we set the operating costs allowance at a level reflecting the operational costs associated with serving a Direct Debit customer. The payment method uplift allowance accounts for the additional costs of serving Standard Credit and Prepayment Meter (PPM) customers respectively. Broadly, the Standard Credit uplift has reflected higher debt costs associated with the payment method and the PPM uplift has reflected higher metering costs.
- 4.3 We set the individual allowances for gas and electricity using the ratio of costs between fuels of the company closest to the benchmark. In addition, we calculated the allowance at the nil and benchmark consumption levels, which are used to calculate the standing charge and unit rate in an energy bill.
- 4.4 In this chapter, we outline the reasoning behind our proposed approaches for allocating core operating costs across payment methods, fuel types, standing charges and unit rates. While the decision for the allocation approach does not impact the total level of core operating costs, it determines how these costs will be allocated between different customer groups. As a consequence, it also affects the revenue that will be recovered by suppliers with different customer bases.
- 4.5 In our May 2024 policy consultation, we set out options for allocating across payment methods and fuel types:
  - Option 1: Using the allocation methodology of the supplier closest to the benchmark.
  - Option 2: Calculating a weighted average of the percentage split on each parameter (payment method and fuel type) across the sample.

- Option 3: Allocate equally across electricity and gas.<sup>27</sup>
- 4.6 We said we would seek to align our position with the wider reviews the standing charge review, work on debt and affordability and future price protection and seek a coordinated policy outcome. However, we noted that there could be potential timing differences between workstreams, so we would consider the option space on its own merits within our operating costs review.

### **Proposals**

#### Proposals for payment methods and fuel types

- 4.7 We propose to allocate core operating costs in a broadly cost-reflective way across payment methods. To achieve this, we use cost data from suppliers to calculate the weighted average differences in costs for serving Standard Credit and PPM customers compared to Direct Debit customers.
- 4.8 To ensure the cost differences of payment methods are representative, when calculating the costs differences between serving Direct Debit and Standard Credit customers, we only include suppliers who have at least 100,000 customers on both the Direct Debit and Standard Credit payment methods. When calculating the costs difference between serving Direct Debit and PPM customers, we only include suppliers who have at least 100,000 customers on both the Direct Debit and Standard Credit and PPM customers, we only include suppliers who have at least 100,000 customers on both the Direct Debit and PPM payment methods.
- 4.9 This enables us to exclude suppliers who have very small number of customers on certain payment methods from our benchmarking sample. We consider this approach balances the protection of customers' interests while having regard to the need for cost recovery for an efficient notional supplier.
- 4.10 We propose to use option 2 for fuel type allocation. To achieve this, we used suppliers' allocation of fuel types to calculate weighted average core operating costs for electricity and gas customers. These benchmarks were then translated into a split ratio of electricity and gas. This results in an allocation of 48% for electricity and 52% for gas. We consider this approach minimises the risk associated with relying on the benchmark supplier's split (option 1), which can vary due to inconsistent allocation approaches among suppliers. Additionally, it is more cost-reflective than option 3 (equal allocation).

<sup>&</sup>lt;sup>27</sup> Ofgem (2024), Energy price cap operating cost allowances review, paragraph 3.126. <u>https://consult.ofgem.gov.uk/energy-supply/energy-price-cap-operating-cost-allowances-review/</u>

4.11 Table 4.1 sets out the values of the proposed new core operating cost baseline for each payment method and fuel type. Note that these figures are provisional and subject to change (eg following consultation and following any changes to input values such as inflation).

Table 4.1 – Proposed core operating cost allowance baseline by payment method and fuel type, per customer per year (2024 prices)

	Direct Debit	Standard Credit	РРМ
Electricity	£92	£110	£118
Gas	£98	£118	£127
Dual fuel	£190	£228	£245
Change vs cap 13a (Dual fuel)	-£15	+£4	-£13

Note: Table shows values for a customer with benchmark consumption (3,100 kWh electricity and 12,000 kWh gas). Values for dual fuel customers may not sum due to rounding.

### Proposals for standing charge and unit rate

- 4.12 The standing charge review workstream has decided not to implement any immediate shift in operating costs from standing charges to unit rates (details in our overview paper). We therefore consider options for allocation between the standing charge and unit rate within the context of the operating cost review.
- 4.13 We propose to allocate the core operating cost allowance across standing changes and unit rates as set out in Table 4.2. This will enable us to fully reflect the average reduction of £11 in the core operating cost baseline onto the standing charges and keep unit rates broadly the same (compared against cap 13a). This approach will benefit Direct Debit and PPM customers directly no matter what consumption level they use. For Standard Credit customers, this approach will result in a very small increase to the standing charges (around one penny per day), due to the increase in core operating costs baseline for Standard Credit customers. However, we consider this approach continues to incentivise both customers and suppliers to opt for lower cost to serve payment methods.
- 4.14 Although the data indicates significant variations in core operating costs across payment methods, with PPM customers being the most expensive to serve, we consider that PPM customers are largely protected from higher core operating costs. This is due to our levelisation intervention, which ensures that PPM

customers and Direct Debit customers under the cap pay the same standing charge.<sup>28</sup>

Fuel type	Direct Debit	Standard Credit	РРМ
Electricity	49%	57%	63%
Gas	72%	77%	78%

Table 4.2 – Proposed core operating costs standing charge allocations

Note: Allocation percentages have been calculated at the benchmark consumption level (3,100 kWh electricity and 12,000 kWh gas). Note that these figures are provisional and subject to change (eg following consultation, following any changes to input values such as inflation or following updates to debt-related costs).

# Proposal for electricity meter types

4.15 We propose to maintain the status quo approach and allocate the core operating cost allowance equally across single-rate and multi-register electricity meters.

# Summary of stakeholder responses

- 4.16 We received mixed views from stakeholders on how costs should be allocated between payment methods and fuel types. Stakeholders generally supported benchmarking based on methods which do not rely on one supplier's allocation methodology.
- 4.17 Multiple stakeholders also supported benchmarking payment methods and fuel types separately (particularly if we select a lower quartile).
- 4.18 Five stakeholders and three suppliers supported reducing or removing the standing charge, as they considered the standing charge is unfair for customers.

# **Considerations and analysis**

# Allocating costs across payment methods

4.19 While some costs vary across different payment methods, it is often difficult to establish whether this is a result of causation (the payment method is inherently

<sup>&</sup>lt;sup>28</sup> Ofgem (2024), Energy price cap update - Summary of changes to energy price cap 1 April to 30 June 2024 letter

https://www.ofgem.gov.uk/energy-policy-and-regulation/policy-and-regulatory-

programmes/energy-price-cap-default-tariff-policy/energy-price-cap-default-tariff-levels

more costly to serve) or correlation (the payment method has a disproportionately high number of high cost to serve customers on it).

- 4.20 While certain costs are inherently linked to the specific nature of the payment method, the majority are not. Many costs have considerable variation within the payment method. For instance, PPM customers may on average have higher metering costs, but smart PPM meters are generally much less expensive to manage and maintain than traditional PPM meters. Conversely, some traditional PPM customers require minimal customer service.
- 4.21 Similarly, within Standard Credit customers, customers who pay their bills promptly present a vastly different cost profile compared to customers who pay in arrears or do not pay at all. For Direct Debit customers, the cost to serve an engaged vulnerable customer differs significantly from that of a disengaged affluent customer. High costs are frequently driven by atypical cases rather than the "typical" customer within each payment method category.
- 4.22 When evaluating options for allocating costs across different payment methods, we balance the protection of customers' interests while having regard to the need for cost recovery for an efficient notional supplier. We also consider the cost reflectivity of suppliers' allocation approaches in our 2023 RFI data and the effect of customer mix when choosing the sample.
- 4.23 Four suppliers said, if Ofgem takes an aggregate benchmarking approach, the allocation across payment methods should be carried out separately (option 2), especially if a lower quartile benchmark is used.
- 4.24 One supplier agreed with a cost reflective approach, but mentioned there are limitations as it involves many assumptions and there is a significant information asymmetry between suppliers and Ofgem.
- 4.25 Two suppliers supported option 1. They said using the allocation closest to the weighted average benchmark is the simplest approach and avoids unnecessary complications. However, another two suppliers said option 1 would be too reliant on a specific allocation approach that may not be representative and could drive significant under or over recovery depending on the customer base. One supplier told us that option 2 would mitigate this risk, provide a more in-the-round view of cost allocation and be more cost reflective of the market as a whole.
- 4.26 We intend to have an in-the-round view for establishing the right level of overall stringency to set the allowance at and deciding how the overall costs should be allocated across different payment methods. We consider our proposed approach

(a weighted average benchmark on overall costs and a cost reflective way of allocating costs across payment methods) balances the protection of customers' interests while having regard to the need for cost recovery for an efficient notional supplier. We consider that option 2 is a more reliable way of delivering this intent than option 1, because it is less exposed to the allocation approach of any individual supplier.

- 4.27 We propose to allocate core operating costs in a broadly cost-reflective way across payment methods. However, to ensure that we are isolating actual differences in cost to serve, rather than differences in supplier efficiency, we propose to use only data from suppliers who have at least 100,000 customers on each payment method being compared. To achieve this, we use cost data from these suppliers to calculate the weighted average difference in costs for serving Standard Credit and PPM customers compared to Direct Debit customers.
- 4.28 This approach is different from the option 2 set out in our May 2024 consultation, as we only include suppliers who have at least 100,000 customers on each payment method in the benchmark sample. This means we have six suppliers in our sample for calculating the cost differentials between Standard Credit and Direct Debit customers, and five for the differentials between PPM and Direct Debit customers. Suppliers' customer mix and cost allocation approaches influence how they allocate their core operating costs across Standard Credit, PPM and Direct Debit customers. Our proposed approach excludes suppliers where the allocation to a specific payment method may be less reliable because they have few customers on that payment method, which would then affect their differentials between payment methods. Including such suppliers within the benchmark sample could risk inflating the differential.
- 4.29 We consider our proposed approach will continue to incentivise both customers and suppliers to opt for lower cost-to-serve options, reducing overall costs. This will result in a core operating cost allowance premium of approximately £38 per customer per year for Standard Credit customers (relative to Direct Debit customers). This is notably lower than the £54 per customer per year premium that would have resulted from calculating the cost difference using all suppliers' data. For PPM customers, the premium is approximately per £55 per year (compared to Direct Debit customers), which is lower than £78 per year if we use all suppliers' data. Customers will therefore generally be better off paying by Direct Debit, but we have taken care to ensure that this differential is appropriate.

4.30 Option 1 (benchmark supplier's allocation) is the simplest approach. However, it could risk solely relying on one supplier's cost differential between customers who use different payment methods. This may not accurately reflect the average cost variation between payment methods in the market. Consequently, this could risk that suppliers may not be able to recover their efficient core operating costs through the cap.

# Allocating costs across fuel types

- 4.31 In our 2018 approach, we chose our benchmark by comparing suppliers' total operating costs per customer account (counting dual fuel twice), rather than benchmarking gas and electricity separately.<sup>29</sup>
- 4.32 In our May 2024 policy consultation, we mentioned that we consider most core operating costs do not significantly differ by fuel type. If the cost differences between fuels are relatively small, we proposed that we could consider whether it would be proportionate to allocate costs equally between gas and electricity or alternatively in proportionate to the remainder of the cap.
- 4.33 Two suppliers supported equal allocation between fuel types (option 3). One supplier supported using customer numbers or revenue for allocating costs across fuel types (option 2).
- 4.34 We propose to use option 2 for fuel type allocation. To achieve this, we use suppliers' allocation of fuel types to calculate weighted average core operating costs for electricity and gas customers. The weighted average cost to serve a gas customer is £106, which on average is £7 higher than the cost to serve an electricity customer. These benchmarks are then translated into a split ratio of electricity and gas. This results in an allocation of 48% for electricity and 52% for gas.
- 4.35 We consider this approach minimises the risk associated with relying on the benchmark supplier's split (option 1), which can vary due to inconsistent allocation approaches among suppliers. Option 1 could therefore lead to suppliers with a customer base weighted towards one fuel over or under recovering their efficient costs. It could also lead to electricity only customers over or underpaying. (There would be no impact on other customers who receive supply for both fuels under the cap).

<sup>&</sup>lt;sup>29</sup> Ofgem (2018), Default tariff cap: Appendix 6 – Operating costs, paragraph 2.13. <u>https://www.ofgem.gov.uk/decision/default-tariff-cap-decision-overview</u>

4.36 Additionally, option 2 is more cost-reflective than option 3 (equal allocation). Equal allocation would lead to under-recovery for suppliers with a customer base weighted towards gas, and an over-recovery for suppliers with a customer base weighted towards electricity. We do not consider that there would be a reason to justify this inaccuracy.

### Allocating costs across standing charge and unit rate

- 4.37 The current cap methodology allocates 51% of the operating cost allowance to the standing charges for electricity and 73% for gas. We do not allocate costs between the standing charge and unit rate in a bottom-up cost-reflective manner under the current approach. This reflects that we were seeking to set the initial standing charge in line with observed historical market levels.<sup>30</sup>
- 4.38 In our operating costs review, we are proposing to change the current three operating cost allowances into four new allowances (see Table 2 in our overview paper). This means that our proposed core operating cost allowance includes part of the operating cost allowance (OC), the SMNCC allowance, and the payment method adjustment additional cost (PAAC) allowance. Each has a different ratio currently for splitting costs between the standing charge and unit rate. Table 4.3 shows the ratios between the standing charges and unit rates for these allowances under the current cap methodology.

<sup>&</sup>lt;sup>30</sup> Ofgem (2018), Default tariff cap: Appendix 1 – Benchmark methodology, paragraph 2.20. <u>https://www.ofgem.gov.uk/decision/default-tariff-cap-decision-overview</u>

Fuel type	Payment method	Operating costs	SMNCC	РААС
Electricity	Direct Debit	51%	69%	100%
Gas	Direct Debit	73%	69%	100%
Electricity	Standard Credit	51%	69%	100%
Gas	Standard Credit	73%	69%	100%
Electricity	РРМ	51%	69% & 100% <sup>31</sup>	100%
Gas	РРМ	73%	69% & 100% <sup>31</sup>	100%

Table 4.3 – Summary of the percentage of operating cost allowances on standing charges by payment methods and fuel types under the current cap methodology

- 4.39 In our May 2024 consultation, we said we would seek to align our position with the wider reviews – the standing charge review, work on debt and affordability and future price protection – to achieve a coordinated policy outcome. The standing charge review workstream has since decided not to implement any immediate shift in operating costs from standing charges to unit rates. The reasoning for this is that whilst a shift of operating costs as proposed would deliver a net consumer benefit, some vulnerable households could face significant losses and these consumers must be adequately protected before we proceed with this change.
- 4.40 However, we must still consider how to allocate costs across consumption levels for the core operating cost allowance.
- 4.41 Three suppliers supported using the existing standing charge and unit rate ratio, to limit the negative impact of bill shocks for customers.
- 4.42 Two stakeholders suggested consideration of alternative approaches when allocating between the standing charge and unit rate.

<sup>&</sup>lt;sup>31</sup> 69% of smart meter pass-through net cost change is allocated to standing charges, while 100% of the net PPM smart metering non-pass-through net cost change (after the PPM additional cost offset has been applied) is allocated to standing charges.

- 4.43 Our proposed core operating cost allowance would, on average, result in an £11 reduction compared to the current cap 13a allowance for a dual fuel customer.<sup>32</sup> This reduction in the core operating cost baseline allows us to reduce the level of standing charges without affecting unit rates. For example, we could set new allocations across standing charges and unit rates to apply the change in benchmark level entirely to standing charges. This leads to a new percentage of the core operating cost allowance on standing charges for each payment method and fuel type (see Table 4.3).
- 4.44 However, this option would lead to uneven impacts across payment methods. Table 4.4 shows that applying the change in benchmark level to standing charges would result in decreased standing charges for Direct Debit (-£15) and PPM (- $\pounds$ 13) customers, while Standard Credit customers would experience a small increase (+£4) in their standing charges due to the increase in the core operating costs baseline for Standard Credit customers. There would be no change to unit rates for any payment method – it is important to note therefore that the £4 increase to the standing charge for standard credit would result in smaller bill impacts for higher-energy use customers than if we were to apply the increase to the unit rate.

Table 4.4 – Summary of standing charges of the core operating cost allowance for a dual fuel customer by payment method. Note that these figures are provisional and subject to change.

Payment method	Current standing charge	New standing charge	Proposed change
Direct Debit	£130	£116	-£15
Standard Credit	£150	£154	+£4
РРМ	£187	£173	-£13

Note: comparison against standing charges in cap 13a. Values may not sum due to rounding.

4.45 We consider this approach will benefit Direct Debit and PPM customers as a reduction in their bill. However, Standard Credit customers will pay more in their standing charge due to the increase in the core operating costs baseline. We have to take a balanced approach to protecting customers' interests while having

<sup>&</sup>lt;sup>32</sup> The reduction is calculated as the average change across payment methods, weighted by the number of customers within each payment method for cap 13a.

regard to the need for cost recovery for an efficient notional supplier. We consider a cost-reflective approach will continue to incentivise both customers and suppliers to opt for lower cost-to-serve options.

4.46 The underlying point is that our proposed operating cost allowance has increased for Standard Credit customers (relative to the current level). If we then instead held the standing charge constant, this would mean an increase in the unit rate for Standard Credit customers. This would have a further negative impact on Standard Credit customers with above average consumption. It is therefore not feasible to avoid some Standard Credit customers seeing a small negative impact, while delivering a cost-reflective approach to recovering the costs of serving Standard Credit customers.

# Single-rate and multi-register electricity meters

- 4.47 For electricity only, we also consider how to allocate between electricity meter types (single-rate and multi-register meters). The current operating cost allowance was allocated near equally between single-rate and multi-register electricity meters at typical consumption. This a result of the 2018 approach where nil consumption across the entire cap was set in line with 2017 market prices.<sup>33</sup>
- 4.48 We do not consider core operating costs to be materially different between electricity meter types. Therefore, we propose to maintain the status quo approach and allocate the core operating cost allowance equally across singlerate and multi-register electricity meters.
- 4.49 Our operating cost data relates to electricity customers on average. Therefore, even if any stakeholders considered that there were above average operating costs for multi-register electricity meters, this would imply that the costs for single rate meters would be below average. This is a question of allocation, rather than a judgement which would change the total allowances across the market.

<sup>&</sup>lt;sup>33</sup> Ofgem (2018), Default tariff cap: Appendix 1 – Benchmark methodology, paragraph 2.20. <u>https://www.ofgem.gov.uk/decision/default-tariff-cap-decision-overview</u>

# 5. Updating the core operating cost allowance over time

### **Chapter summary**

This chapter sets out our proposals for updating the core operating cost allowance in the future.

# Context

- 5.1 The current operating cost allowance baseline was set using 2017 supplier cost data. We update the allowance by indexing it against the Consumer Prices Index including owner occupiers' housing costs (CPIH). This means that the allowance remains the same in real terms but allows for inflationary pressures. We also include a Smart Metering Net Cost Change (SMNCC) allowance to account for the specific impacts of the smart meter rollout on suppliers' overall operating costs see Appendix 3.
- 5.2 The update approach is an important aspect of designing the core operating cost allowance. Our approach aims to ensure that the allowance remains appropriate over time.
- 5.3 There are a number of reasons efficient costs may change over time (eg inflation, changes in activities, changes in efficiency, regulatory changes etc.). While we cannot fully control for these in the update approach, we aim to set an allowance for core operating costs that does not require frequent adjustment.
- 5.4 In our May 2024 policy consultation, we set out three options for the update approach:<sup>34</sup>
  - Option 1: Indexed by CPIH for this approach, we would retain the status quo approach of indexing by inflation.
  - Option 2: Indexed by CPIH-x (where 'x' could be positive or negative). For this option, we would retain the indexation by inflation, but we may subtract or add an additional amount.
  - Option 3: Indexed by a different external indicator.

<sup>&</sup>lt;sup>34</sup> Ofgem (2024), Energy price cap operating cost allowances review, paragraphs 3.135. <u>https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review</u>

# **Proposals**

- 5.5 We propose to index the core operating cost allowance using the value of CPIH for future cap periods (option 1 status quo approach). This accounts for the main factor that we expect will influence suppliers' operating costs over time.
- 5.6 Given we use 2023 data to set the new baseline for core operating cost allowance, we propose to set the initial index by using the average of the CPIH inflation index across 2023, equal to 128.6.
- 5.7 We propose to use the same months of the CPIH index to update the cap as currently. Specifically, for future cap periods:
  - For a price cap period starting on either 1 April or 1 July, we propose that the level of the allowance is updated using the CPIH for the month of December preceding the start of this cap period.
  - For a price cap period starting on 1 October or 1 January, we propose that the level of the allowance is updated using CPIH for the month of June preceding the start of this cap period.

# Summary of stakeholder responses

- 5.8 Seven suppliers supported the use of CPIH, citing the following reasons:
  - Applying stringency over time (option 2) in a manner similar to network companies is inappropriate as the suppliers in the retail market are not monopolies.
  - A lack of data to infer how sustainable the cost reductions might be.
  - Further tightening of the cap risks suppliers not being able to recover costs and would be detrimental to a well-functioning retail market where suppliers can sustainably compete, obtain fair margins, and innovate.
- 5.9 Two stakeholders agreed with option 2 as improvements in efficiency are directly translated into reductions to the operating cost allowance.

# **Considerations and analysis**

# Main rationale for our proposal

5.10 In determining how to update the core operating cost allowance over time, we aim to set an allowance that does not require frequent adjustment (beyond automatic indexation). There are various factors which may impact on future efficient costs, exerting either upward or downward pressure.

- 5.11 To reflect the changes in efficient operating costs that we expect to take place over time, we propose to update the core operating cost allowance by indexing with CPIH to account for inflation.
- 5.12 Under certain circumstances, such as external market events, a notional supplier's efficient core operating costs may increase above the rate of inflation. On the other hand, new technologies, such as Artificial Intelligence (AI), could improve efficiency and reduce suppliers' operating costs. Also, if we see a significant number of customers moving away from standard variable tariffs (SVT) to fixed term contracts, one supplier said that they expected the lower-cost to serve customers to return to fixed deals. They said that this in turn will leave SVT with a higher cost base.
- 5.13 Given that these cost uncertainties are in both directions, we consider our proposed approach to setting the core operating cost allowance using a 2023 baseline, a weighted average benchmark and cost-reflective allocation across payment methods will account for foreseeable uncertainties in core operating costs. This approach provides room for suppliers to recover their efficient costs, so we would not need to revisit the allowance every time a modest additional cost driver occurred. Consequently, this proposed approach should increase regulatory stability compared to our recent frequency of adjustments.

### Impact of regulatory changes

- 5.14 In our analysis, we considered the potential impacts (both increases and decreases in costs) of upcoming regulatory changes that may not be reflected in the 2023 costs we used for benchmarking. These include enhanced consumer standards rules, market-wide half-hourly settlement (MHHS), and any potential future changes to the retail market as we move towards net zero targets. These regulatory changes could significantly influence the operating costs of suppliers, either by imposing new compliance requirements or by creating opportunities for cost savings through efficiency improvements.
- 5.15 To better understand these impacts, we collected data on how suppliers expect their costs to evolve in the near future. This includes the adoption of AI technologies, which could streamline operations and reduce costs; and other external factors identified by suppliers that could affect their cost structures. However, suppliers submitted limited evidence on either increased costs or cost savings regarding to these regulatory changes. Our analysis shows that, based on the data we have, the impact of these changes on operating costs is immaterial.

We recognise that it is inherently difficult to forecast future cost trends, especially when the sector is changing at pace and impacted by wider trends.

- 5.16 Some suppliers have included their estimates of MHHS costs in their May 2024 RFI submissions. Most suppliers anticipate that MHHS costs will increase over the medium term, extending up to and beyond the MHHS deadline. While there may be initial cost pressures, there could also be long-term benefits from improved efficiency and data accuracy.
- 5.17 We acknowledge recent and upcoming regulatory changes, such as October 2023 customer standards decision,<sup>35</sup> the 24/7 enquiry service for customers who are off supply proposals,<sup>36</sup> the uplift to payments under the Guaranteed Standards of Performance,<sup>37</sup> the involuntary PPM code of practice,<sup>38</sup> and the financial resilience framework,<sup>39</sup> may put costs pressures on suppliers, which would not be reflected in full in the 2023 cost data. In the impact assessment for the customer standards decision, we estimated the ongoing costs to suppliers as between £2 and £4 per customer per year.<sup>40</sup> In the draft impact assessment published alongside the statutory consultation on the 24/7 enquiry line proposals, we estimated the additional ongoing costs at £0.41 to £0.56 per customer per year.<sup>41</sup>
- 5.18 We consider our proposed approach to setting the core operating cost allowance including MHHS costs in the benchmarking costs, using a 2023 baseline, using a weighted average benchmark and allocating costs across payment methods in a cost-reflective way will mitigate the impact of the recent and future regulatory changes.

<sup>&</sup>lt;sup>35</sup> Ofgem (2023), Consumer Standards decision.

https://www.ofgem.gov.uk/decision/consumer-standards-decision

<sup>&</sup>lt;sup>36</sup> Ofgem (2024), Consumer Standards – Supplier 24-7 Metering Support statutory consultation. <u>https://www.ofgem.gov.uk/consultation/consumer-standards-supplier-24-7-metering-support-statutory-consultation</u>

<sup>&</sup>lt;sup>37</sup> Ofgem (2024), Supplier Guaranteed Standards of Performance (GSOP) Payment Uplift. <u>https://www.ofgem.gov.uk/decision/supplier-guaranteed-standards-performance-gsop-payment-uplift</u>

<sup>&</sup>lt;sup>38</sup> Ofgem (2023), Involuntary prepayment meter energy supplier Code of Practice.

https://www.ofgem.gov.uk/publications/involuntary-prepayment-meter-energy-supplier-codepractice

<sup>&</sup>lt;sup>39</sup> Ofgem (2024), Financial resilience in the energy retail market.

https://www.ofgem.gov.uk/energy-policy-and-regulation/policy-and-regulatoryprogrammes/financial-resilience-energy-retail-market

<sup>&</sup>lt;sup>40</sup> Ofgem (2023), Consumer Standards – Impact Assessment, Table 2.

https://www.ofgem.gov.uk/decision/consumer-standards-decision 41 Ofgem (2023), Consumer Standards – Supplier 24-7 Metering Support Draft Impact Assessment, page 6.

https://www.ofgem.gov.uk/consultation/consumer-standards-supplier-24-7-metering-supportstatutory-consultation

5.19 If there are any future regulatory changes which have a material and systematic impact on suppliers' core operating costs, we would be able to review the allowance. However, in light of our approach to setting the benchmark, we would apply a higher bar for treating cost changes as material. This reflects that we are seeking to set a stable allowance. Frequent reviews of core operating costs could undermine the incentives for suppliers to become more efficient.

#### **Alternative options**

- 5.20 A few suppliers disagreed with the option 2 CPIH-x approach. They told us that applying stringency over time, similar to price controls for network companies, is inappropriate because suppliers in the retail market are not monopolies. They also highlighted a lack of data to determine the sustainability of cost reductions. These suppliers said that further tightening of the cap could prevent them from recovering costs and harm a well-functioning retail market where suppliers can compete sustainably, achieve fair margins, and innovate. They thought that using CPIH-x for efficiency can be detrimental if Ofgem aims to promote a more competitive market, with higher financial resilience and increased investments in consumer standards.
- 5.21 One supplier suggested using CPIH-x with x = 0 as a minimum, where adjustments are only made upwards to recover unfunded or unexpected increases.
- 5.22 Two stakeholders agreed with option 2. One supplier said that using 'x' as a glide path to transition from a weighted average allowance to the lower quartile allowance over a period of time may make the cap more resilient to future updates as it is forward looking. One consumer body said that if a looser benchmarking approach is taken, then CPIH-x is appropriate, as it creates a feedback loop that reduces operating costs through efficiency improvements in a competitive market.
- 5.23 We conducted analysis to determine what level of 'x' could be appropriate under option 2. If we define 'x' as a glide path to transition from the weighted average core operating cost allowance (£206) to a lower quartile allowance (£197) over a 5-year period, this would result in an average reduction of £2 per year in nominal terms, or equivalent to a 0.9% efficiency improvement. We compared these values with Ofgem's regulatory framework knows as RIIO-2 (Revenue =

Incentives + Innovation + Outputs). RIIO-2 expects network companies to have an on-going efficiency improvement of 1.05% per year.<sup>42</sup> We considered the similarities in the conditions set for network companies and retail suppliers. The on-going efficiency to reach the lower quartile in five years, 0.9%, is similar to the on-going efficiency expected of network companies. However, network companies can access an innovation fund which supports the development of efficiency improvements.

- 5.24 We expect that suppliers should be able to make efficiency improvements over time, relative to our proposed weighted average benchmark.
- 5.25 First, some existing suppliers already have costs below the weighted average. These include suppliers with broadly typical customer characteristics (eg payment methods). As discussed in the section on benchmarking, there will be a number of factors affecting any alternative benchmark, such as a lower quartile. These factors could affect whether a lower quartile benchmark would be achievable for a notionally efficient supplier. However, at a minimum, we consider it plausible that suppliers could move in the direction of the lower quartile benchmark. This catchup efficiency would not rely on future technological developments.
- 5.26 If stakeholders do not agree that a degree of catch-up efficiency is plausible over time, we would expect them to explain why they consider that the costs of suppliers below the weighted average are unrepresentative.
- 5.27 Second, we would expect some efficiency improvements to become available over time through movements in frontier efficiency. These could result from technological developments, process refinements, or other factors. Expecting some degree of efficiency improvement is a standard feature when setting allowances over time (as in the network example above).
- 5.28 If stakeholders do not agree that a degree of improvement to frontier efficiency is plausible over time, then we would expect them to explain why the energy supply sector would be unable to benefit from general economic trends (eg digitalisation).

<sup>&</sup>lt;sup>42</sup> Ofgem (2020), RIIO-2 Final Determinations: ET Annex REVISED, paragraph 3.58. <u>https://www.ofgem.gov.uk/decision/riio-2-final-determinations-transmission-and-gas-distribution-network-companies-and-electricity-system-operator</u>

- 5.29 We would also expect any supplier claiming a lack of potential for efficiency gains (either catch-up or frontier) to demonstrate that this is coherent with the statements that they have made to their investors.
- 5.30 However, we do not propose to make an explicit downward adjustment for expected efficiency gains. Instead, we consider that this is a factor which may offset the need for upward adjustments to the cap in response to any additional cost pressures.
- 5.31 We aim to set an enduring allowance and do not aim to revisit the allowance every time a modest additional cost driver occurs. As we discussed in setting the benchmark for core operating costs, with the most significant efficiencies already captured (alongside some upside pressures associated with the energy transition), we do not consider it sustainable to continue setting allowances at a level where the majority of the market do not recover their costs. In addition, we consider that it is in customers' interests that efficient suppliers are able to recover their costs and attract necessary investment. Therefore, we are not proposing option 2 for updating the core operating cost allowance over time.
- 5.32 We have not received any responses on option 3 indexing using external indicators. We have also not identified any suitable external indicators. Therefore, we are not proposing to proceed with option 3.

# **Initial CPIH inflation value**

- 5.33 The current operating cost allowance is indexed against CPIH inflation. The CPIH inflation index is updated every six months with the latest available data from the Office for National Statistics.<sup>43</sup> This data is at least four months behind the start of the latest cap period. This is largely due to the inherent lags as we set the cap in advance and can only use the latest CPIH data available at that point. For example, cap 13a covers the period between 1 October to 31 December 2024. The operating cost component within cap 13a was updated to CPIH inflation for June 2024, four months earlier than October.
- 5.34 The current operating cost allowance was calculated using data from April to September 2017. When implementing the allowance, we attributed a starting CPIH index value from December 2016 to this data to account for the four-month delay in inflation data.

<sup>&</sup>lt;sup>43</sup> Office for National Statistics (2024), Inflation and price indices https://www.ons.gov.uk/economy/inflationandpriceindices

- 5.35 To set our proposed core operating cost allowance benchmark, we use suppliers' data from the year 2023. Therefore, we must attribute a new starting CPIH index value to this data to enable it to be inflated by CPIH for the most recent cap period.
- 5.36 Under typical circumstances, applying a starting CPIH index value from four months prior to the data period would lead to a modest increase of the allowance, when compared against prices during the data period. However, the period between mid-2022 and early-2023 was subject to abnormally high levels of CPIH inflation. As shown in figure 5.1, CPIH inflation peaked at 9.6% in October 2022.

Figure 5.1 – Annual rate of CPIH inflation between October 2014 and September 2024



# Accessible format

A chart showing the rapid increase in the annual rate of CPIH inflation, which rose from 2.1% in July 2021, to a peak of 9.6% in October 2022, before falling back to 2.6% in September 2024.

- 5.37 Setting the starting CPIH index value using a figure from within this period would lead to a considerable increase in the allowance. We do not consider this period representative of the levels of inflation suppliers faced throughout the entirety of 2023.
- 5.38 Therefore, we propose to set the starting CPIH value used to index the core operating cost allowance at 128.6, equal to the average index value across 2023. This value is than lower than the index value for the mid-point of 2023, 129.0 (July 2023). However, it is higher than the index value for March 2023, 126.8, four months prior to July 2023. We consider this approach to balance the

inclusion of a delay to match the approach to setting the allowance for any future cap period, while also using appropriate values of inflation that are representative of the cost increases suppliers faced during 2023.

5.39 We propose to maintain our current approach to defining CPIH for future cap updates.

# 6. General stakeholder comments

#### **Chapter summary**

This chapter outline the cross-cutting comments from stakeholders in response to the policy consultation, alongside our responses.

6.1 We have addressed many stakeholder comments through our discussions in the previous chapters. In this chapter, we provide more details on certain stakeholder comments not covered elsewhere, and respond to these comments.

# Efficiency

### **Stakeholder responses**

- 6.2 One supplier said that the price cap is dissimilar to enduring price controls for natural monopolies who are not constrained by competition (such as networks) and may have an incentive to otherwise inflate costs. Another supplier agreed with this sentiment, saying that the use of regulated financial controls has previously been justified in the energy sector to introduce price tension in monopoly markets, such as networks. They said that such organisations receive guaranteed revenues through regulation, unlike in retail.
- 6.3 One supplier said that a reduction in operating costs does not necessarily mean increased efficiency, with another supplier cautioning that reductions in operating costs may be, in part, due to the compliance with stringent cap level and cannot be assumed to be the result of increased efficiency.
- 6.4 One consumer advocacy body said that operational inefficiencies such as billing errors or issues with IT drive up operating costs. They said that the cap should not be providing room for such inefficiencies. This was echoed by a second consumer advocacy body who said consumers should not face unnecessary additional cost for inefficiency.

- 6.5 We recognise that there are differences between networks and retail. However, the existence of the cap reflects that there are limitations on the strength of competition in the domestic retail segment, due to low engagement by a significant proportion of customers. This raises questions on whether competition can be relied on to provide sufficient efficiency incentives.
- 6.6 Improving efficiency involves delivering the same outcomes at a lower cost (or delivering improved outcomes for the same cost). We therefore accept that a

reduction in cost does not automatically mean an improvement in efficiency. However, we still consider that efficiency has improved since the introduction of the cap. There has been a clear cost reduction, and we do not consider that other consumer outcomes have deteriorated to an extent that would offset this effect.

6.7 We agree that reducing errors is a way of reducing operating costs. A weighted average benchmark will reflect the current level of performance across the market. Therefore, to the extent that errors are higher than we would expect, the weighted average benchmark will incorporate these costs. We aim to enable suppliers to continue making improvements to customer standards. We consider that setting a weighted average benchmark going forward is the best way to do this, by enabling suppliers to invest in their IT and billing systems, alongside customer service. Furthermore, we hold suppliers accountable for their compliance with licence conditions.

# Financial resilience and competition

### Stakeholder responses

- 6.8 One trade body said that an overly stringent cap has previously created transitory issues that have resulted in cashflow volatility for suppliers. They said that these issues have contributed to significant market consolidation and routine loss-making across the sector, which has held back investment.
- 6.9 One supplier noted the importance of considering the need for financial resilience to protect the longer-term interests of consumers. They said that minimum capital requirements to ensure that investors, rather than customers, bear the risks of supplier failure are not yet fully in place – but Ofgem must have regard to the need for suppliers to finance their licensed activities. This was echoed by another supplier who said that a stringent cap makes it more challenging for suppliers to achieve the capital adequacy requirements Ofgem has imposed.

- 6.10 The purpose of this review is not to reassess whether we set the operating cost allowance at an appropriate level historically. However, we note that the market has experienced significant external shocks (COVID-19 and high gas prices). This context may limit the extent to which recent years can be used to identify the impacts of a particular operating cost benchmark stringency.
- 6.11 Suppliers are responsible for compliance with their licence obligations, including those in relation to capital adequacy. Our proposals for the core operating cost allowance do not change these obligations. When developing our proposals, we

have had regard to the ability of a notionally efficient supplier to finance its licensed activities, and we have also considered the potential impacts of supplier failures on customers.

# Wider consumer protection goals

### Stakeholder responses

- 6.12 One supplier noted the importance of recognising the impact of the core operating cost allowance decision on the full span of suppliers' activities, mentioning the trade-off between seeking to drive significant improvements in customer service for vulnerable groups and reducing the ability of suppliers to pay for such improvements. This was mentioned in relation to Ofgem's review of its vulnerability strategy. As this review is taking place in the context of other strategic workstreams such as standing charges, debt and affordability, the future of price protection, and the implementation of the financial resilience framework, the supplier said that it is important for Ofgem to recognise the trade-offs between competing objectives.
- 6.13 One supplier said that continuously requiring suppliers to bear down on operational costs is leading to diminishing returns and arguably to poorer consumer outcomes on customer service. The supplier said that this is evidenced by customer satisfaction with the utilities sector falling to its lowest level in eight years.

### **Our response**

- 6.14 We confirm that we have considered this review of the core operating cost allowance in the context of our wider work as an organisation, and consumers' interests in the round.
- 6.15 A range of factors will affect customer satisfaction, including high energy prices. To the extent that customer satisfaction is driven by actions within the control of suppliers, we do not consider that the cap level removes suppliers' responsibility for their own actions. Nevertheless, we want to move towards higher standards of customer service, and we consider that our proposed approach to benchmarking will support this goal.

# **Statutory duties**

# Stakeholder responses

6.16 One supplier noted that it is necessary for Ofgem to consider this review in the context of section 1(6) of the Tariff Cap Act 2018 to ensure that it gives adequate weight to the interests of future as well as existing domestic customers.

Particularly, Ofgem needs to give adequate weight to how the interests of future consumers are served by ensuring that the domestic retail market is an investible proposition, which in turn should drive innovation, improved customer service and competition.

### **Our response**

6.17 We have considered and balanced the considerations set out in section 1(6) of the act throughout our proposals, which can be found throughout the consultation documents. However, we note that the cap has a direct, immediate and certain impact on prices for existing customers, whereas its impact on other consumer interests is harder to predict.

# Smart and traditional meters

# Stakeholder responses

- 6.18 One stakeholder said that Ofgem should consider setting a separate core operating cost allowance for smart meter and traditional meter customers. They said that the lower bills associated with smart meters should be passed on to customers who have adopted them. This would in turn, lead to a price differential which would demonstrate the benefits of smart meters to customers who have not yet had them installed.
- 6.19 One supplier had the opposing view stating that if separate allowances were reflective of suppliers' costs, a traditional meter tariff could be lower than a smart meter tariff, complicating the customer journey and disincentivising smart meter uptake.

# **Our response**

6.20 In our May 2024 policy consultation, we discussed the concept of setting different cap levels for smart and traditional meters.<sup>44</sup> However, there was a lack of substantial support from stakeholders for this option, with some noting the disproportional impact this option could have on customers who are unable to receive a smart meter. Defining separate cap levels would also be challenging. We do not consider that this would be proportionate, given that we have not seen a strong case why separate caps would better protect customers. In addition, a separate smart metering cap level would only reflect the impacts of smart meters on suppliers' costs, rather than the entirety of the costs and benefits.

<sup>&</sup>lt;sup>44</sup> Ofgem (2024), Energy price cap operating cost allowances review, paragraph 5.4. <u>https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowances-review</u>

Consequently, we have decided not to pursue the discussion of separate caps for smart and traditional meters in the ongoing operating cost review.

# Future regulatory changes

### Stakeholder responses

- 6.21 One supplier said that the expected regulatory changes include: financial resilience measures, MHHS, the outcome from the debt and affordability review, and compliance with new Involuntary PPM rules. Increasing regulatory restrictions and requirements on suppliers have a direct impact on operating cost levels and should be considered in the allowance approach.
- 6.22 Taking a different view, one supplier said that the 2022-2023 time period included a large degree of regulatory change during a period of energy crisis. It therefore said that this period provides a good baseline going forward and acts as a proxy for the forward-looking adjustment that Ofgem is considering. The supplier said that regulatory change can be addressed through headroom allowance instead.
- 6.23 One consumer advocate said that if costs to meet expected regulatory changes are higher for a supplier because of previous under-investment or poor performance, these should not be included in any benchmark.

- 6.24 Our proposed 2023 baseline did include a degree of regulatory change. We recognise that there are subsequent changes which have been implemented or are envisaged. We consider that our proposed benchmark recognises regulatory change to an appropriate extent. We agree that the headroom allowance could provide further mitigation for additional costs relating to regulatory change.
- 6.25 We accept that suppliers will have different starting positions, and that these will in part be a consequence of their previous decisions. However, the current market is the realistic starting point for determining future allowances. A weighted average benchmark sets a challenge for suppliers with below average efficiency to improve. Setting a tougher challenge would not necessarily be in customers' interests if it led to risks for customer service or resilience.
- 6.26 If stakeholders have examples of specific historical actions by suppliers which they consider are unjustifiable, they should provide these in response to this consultation. Any such actions would need to be those which were unjustifiable on an ex ante basis, rather than merely suboptimal with the benefit of hindsight.

# **Role of non-efficiency factors**

#### Stakeholder responses

- 6.27 One consumer advocate body said that, whilst suppliers have argued that a price difference is necessary to encourage consumers to move onto Direct Debit, Ofgem's own consumer research shows that only 24% of people on Standard Credit know that it is more expensive than Direct Debit. Therefore, until there is much greater awareness of these price differences, they said that this argument does not work.
- 6.28 Our response
- 6.29 We recognise that there are limits to customers' awareness of the relative costs of different payment methods. However, we do not consider that this means that we should disregard the broad principle of providing a signal for customers that payment methods have different costs. Doing so could lead to an increase in overall costs, which we do not consider would be in customers' interests.

# **Data limitations**

#### Stakeholder responses

- 6.30 One supplier said that due to extraordinary events observed in the market over the course of the past few years, Ofgem does not have a consistent time series of data from which to derive any new benchmark. The supplier said that Ofgem is limited to before and after snapshots from which it is hard to draw clear conclusions as to the sustainable level of efficient costs or trends.
- 6.31 Regarding the sample of suppliers for the analysis, one supplier said that Ofgem needs to consider the extent to which observed cost levels are commercially sustainable for a stand-alone retail supplier as opposed to a vertically integrated operator supported by upstream revenues eg through ownership and licensing of technology platforms.

- 6.32 We recognise that the market has gone through a series of shocks, and that this affects the data available to us. We do not consider that this is a reason to defer our review, but we recognise that it is an additional factor to take into account when interpreting the data available.
- 6.33 We recognise that suppliers have a range of corporate structures and other activities within their groups. We consider that the checks we have carried out, as

well as our proposal for a weighted average benchmark, have mitigated the risk of selecting a benchmark which is unachievable for a notionally efficient supplier.

# Technology

# Stakeholder responses

- 6.34 One supplier said that technology developments are expected in line with changes in consumer expectations and demands. The supplier said that we should be less focused on predicting their efficiency and instead make decisions on an ex post basis. They said that it would not be possible to predict efficiency gains on an ex ante basis. Alternatively, they said that efficiency improvements brought forth as a result of technology improvements should be analysed thereafter on a year-byyear basis.
- 6.35 One supplier said that the cost to innovate and implement new technologies will likely be higher for suppliers with a more varied mix of customers (eg payment methods, meter types, offline/online). The supplier said that new technologies like AI are often most relevant and easily deployable to online and smart-enabled customers with 'standard' needs and preferences, due to the greater scope for enabling process automation and operational optimisation. Another supplier made a similar point.

- 6.36 In principle, we consider that it would be possible to make reasonable judgements about future efficiency gains, even if these would be subject to uncertainty. However, we do not propose to make a downward adjustment to CPIH, for the reasons set out in Chapter 5. We do not consider that annual updates to the core operating cost allowance would be desirable, as this could reduce the incentive on suppliers to become more efficient.
- 6.37 We consider it plausible that the scope for efficiency gains may be different when serving different customer groups. At the least, we recognise that there is uncertainty about whether efficiency gains can be achieved at the same rate for all customers. This is one factor we have taken into account when considering whether a downward adjustment to CPIH is appropriate when updating the core operating cost allowance.

# **Capitalised costs**

### **Stakeholder responses**

6.38 One supplier said that by focusing on 2023 costs, Ofgem does not appear to be giving any consideration to the treatment of capitalised costs and their associated depreciation. This issue is particularly material for the new regulatory requirements for MHHS and associated industry 'pass-through' costs, but it is also relevant to supplier internal capital expenditure, whether for MHHS or other regulatory obligations.

- 6.39 Suppliers have some room to adopt different depreciation and amortisation assumptions, within the constraints of accounting standards. We consider that our proposal to adopt a weighted average benchmark mitigates the risk that our benchmark is driven by any particular supplier's accounting approach.
- 6.40 We recognise that suppliers may have incurred costs in 2023 which they had not started to depreciate or amortise (if the associated assets had not come into use). At any point in time, suppliers will make investments in assets which they will then depreciate or amortise in subsequent years. We have not seen evidence that 2023 is an exceptional year, such that we need to make an adjustment.