

# **Decision Appendix**

# **Appendix 1: Core operating costs**

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# **1.Introduction**

#### Section summary

This section 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 decisions, 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).
- In our May 2024 policy consultation 'Energy Price Cap: Operating cost allowances review' ('May 2024 policy consultation') and our December 2024 consultation 'Energy price cap operating cost and debt allowances consultation' ('December 2024 statutory consultation'), we consulted on our approach to update the core operating cost baseline.<sup>1, 2</sup> This included:
  - re-benchmarking core operating costs using more recent supplier cost data, including considering options for the benchmark approach
  - how we would allocate costs across customers (eg across payment methods, fuel types, and the standing charge and unit rate) and
  - how we would update the core operating cost allowance over time.
- 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.

<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>&</sup>lt;sup>2</sup> Ofgem (2024), Energy price cap operating cost and debt allowances consultation – Appendix 1 Core operating costs.

https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-and-debtallowances-consultation

- 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>3</sup> To be clear, we do not believe that good customer service necessarily means higher costs. However, we do consider it to be in customers' interest that efficient suppliers are able to recover their costs and attract necessary investment. This is even more critical as we transition towards a net zero future.
- 1.5 This review is being undertaken within the context of several 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, and therefore must also consider the option space on its own merits within our operating costs review.<sup>4</sup>
- 1.6 This document outlines our decision to set an enduring forward-looking core operating cost allowance, having considered the feedback received in response to our December 2024 statutory consultation.

## Summary of our decisions

1.7 In reaching our decision for the core operating cost allowance, we have sought to achieve the objective set out in the Act to protect existing and future customers who pay by default tariffs. Through our regulatory judgement, we have balanced the various considerations set out in the Act (including having regards to the need to ensure suppliers who operate efficiently are able to finance their licensed activities and the need to create incentives to improve efficiency). Price protection, quality of service and supplier financial resilience are key parts of protecting default tariff customers. These factors also align with our Consumer Interests Framework.<sup>5</sup>

<sup>&</sup>lt;sup>3</sup> Ofgem (2024), Consumer confidence: a step up in standards.

https://www.ofgem.gov.uk/publications/consumer-confidence-step-standards <sup>4</sup> Ofgem (2024), Energy price cap operating cost allowances review, paragraph 3.110. https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-allowancesreview

<sup>&</sup>lt;sup>5</sup> Ofgem (2023), Consultation on Ofgem's draft Forward Work Programme for 2024 and 2025, page 7.

https://www.ofgem.gov.uk/consultation/consultation-ofgems-draft-forward-workprogramme-2024-and-2025

- 1.8 We have largely adopted the proposals set out within our December 2024 statutory consultation. This includes using 2023 cost data, alongside a weighted average benchmark approach, to set the core operating cost baseline.
- 1.9 We have made two changes to our approach within our December 2024 statutory consultation to address uncertainties in costs. Firstly, we have included an upward adjustment to account for the increase to employer's National Insurance Contributions (NICs). Secondly, we have made an adjustment to our cost differential payment method allocation approach to reduce the risk of understating PPM costs.
- 1.10 We recognise suppliers' concerns regarding the reduction in energy consumption during the energy crisis, as well as the differences in average consumption between payment methods. We continue to monitor consumption levels and will review our approach to consumption within the cap in the future.
- 1.11 We provide a detailed summary of our decisions regarding the core operating cost allowance below.

## **Benchmarking approach**

- 1.12 We have decided to use a weighted average benchmarking metric as it enables suppliers to recover efficient costs related to the support provided to customers (relative to a more stringent benchmark metric), whilst also providing greater mitigation for uncertainties and potential future cost changes. We have benchmarked costs at an aggregate level using 2023 data. This means the data is less influenced by supplier's allocation choices. Using 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.
- 1.13 Given the increase in employer's National Insurance Contributions, we have decided to include an upward adjustment in the core operating cost baseline equal to £1.24 per dual fuel customer (cap 14a prices). This reflects that staff costs have increased faster than expected since 2023 as a result of economic policy changes. It also reflects our expectation that increases to employer's NICs will impact suppliers in a predominately uniform manner. This decision is a one-off adjustment as part of our ongoing review and does not imply we would automatically feed through future changes in taxation to the core operating cost allowance.

#### Allocating across customer groups

1.14 We have decided to allocate core operating costs in a broadly cost-reflective way across payment methods. To achieve this, 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.

- 1.15 Furthermore, we have chosen to reduce the 100,000 customer sampling threshold proposed in our December 2024 statutory consultation to 50,000 customers. We consider this appropriate to address uncertainties in PPM costs and reduce the risk of under-recovery on a notional efficient supplier with an above average proportion of PPM customers.
- 1.16 Alongside this, we have decided 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.
- 1.17 Regarding allocation across standing charges and unit rates, we have decided to fully reflect the reduction in the core operating cost baseline onto standing charges and keep unit rates the same (relative to cap period 14a). This results in a small reduction in standing charges for Direct Debit and PPM customers, and a small increase for Standard Credit customers. We consider this approach continues to incentivise both customers and suppliers to opt for lower cost to serve options.
- 1.18 The long-term trend of energy consumption is uncertain. We intend to monitor trends in energy consumption and review our approach to consumption within the cap, noting that this would ultimately lead to an increase in bills for Standard Credit and PPM customers.

## Updating the allowance

- 1.19 We have decided 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
- 1.20 Table 1.1 below sets out the decision core operating cost allowance at cap 14a (April 2025 June 2025) and compares it to the existing equivalent allowance at cap 14a. We note that, in comparison to our December 2024 statutory consultation position, the decision approach has increased the value of the PPM allowance by £6 per dual fuel customer. Direct Debit and Standard Credit remains unchanged.

	Decision allowance, Nil	Decision allowance, Benchmark	Change vs existing allowance, Nil and Benchmark
Direct Debit, elec	46	93	-8
Direct Debit, gas	72	100	-7
Direct Debit, dual fuel	118	194	-14
Standard Credit, elec	65	112	+1
Standard Credit, gas	92	120	+4
Standard Credit, dual fuel	157	233	+4
PPM, elec	78	123	0
PPM, gas	104	132	-8
PPM, dual fuel	182	254	-8

Table 1.1: Decision core operating cost allowance at cap 14a (nominal prices,  $\pounds$  per customer)

Note: Benchmark consumption is equal to 3,100kWh for single-rate electricity, 12,000 kWh for gas and 4,200 kWh for multi-rate electricity. Values displayed are shown for single-rate metering arrangement. Values may not sum due to rounding.

## Structure of this paper

1.21 The structure of the remaining chapters is set out below:

- Section 2 Background. In this section we set out the current approach for the operating cost allowances, the case for change and the structure of new core operating cost allowance.
- Section 3 Benchmarking approach. In this we outline our decision for the benchmarking approach. We discuss the supplier sample, the baseline year alongside the inclusion of any cost adjustments, and the benchmark metric to use to set the allowance.
- Section 4 Allocating core operating costs across customer groups. In this chapter we set out our decision for allocating core operating costs across customer groups, including payment methods, fuel types, and standing charges and unit rates.

- Section 5 Updating the core operating cost allowance over time. In this chapter we set out our decision for updating the core operating cost allowance in the future.
- Section 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

#### Section summary

This section 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.

## Current 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. 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>6</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>6</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>7</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 on how they run their businesses, following a Competition and Markets Authority (CMA) report which highlighted considerable market inefficiencies and customer detriment.<sup>8</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>9</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>10</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>11</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>7</sup> Ofgem (2018), Default tariff cap: Appendix 6 – Operating costs, paragraph 2.6. <u>https://www.ofgem.gov.uk/decision/default-tariff-cap-decision-overview</u>

 <sup>&</sup>lt;sup>8</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>9</sup> 8 Frontier would use the supplier with the lowest costs.

<sup>&</sup>lt;sup>10</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>&</sup>lt;sup>11</sup> Ofgem (2018), Default tariff cap: Appendix 8 – Payment method uplift, paragraph 2.11.

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

- 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>12</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>13</sup>
- 2.11 To allow for the £17 uncertainty in cost, we took it into account in the SMNCC allowance.<sup>14</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>15</sup>

## Standing charges and unit rates

2.12 When setting the cap in 2018, our analysis suggested that using a bottom-up approach 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.<sup>16</sup> A bottom-up approach would result in the standing charge of each allowance

https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumersprepayment-meters

<sup>&</sup>lt;sup>12</sup> Ofgem (2020), Protecting energy consumers with prepayment meters – August 2020 decision, paragraph 4.7.

https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumersprepayment-meters

<sup>&</sup>lt;sup>13</sup> Ofgem (2020), Protecting energy consumers with prepayment meters – August 2020 decision, paragraph 4.2.

https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumersprepayment-meters

<sup>&</sup>lt;sup>14</sup> Ofgem (2020), Protecting energy consumers with prepayment meters – August 2020 decision, paragraph 4.84.

<sup>&</sup>lt;sup>15</sup> Ofgem (2020), Protecting energy consumers with prepayment meters – August 2020 decision, paragraph 4.85.

https://www.ofgem.gov.uk/publications/decision-protecting-energy-consumersprepayment-meters

<sup>&</sup>lt;sup>16</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.

within the cap being calculated independently and then summed to create a total standing charge across the cap. 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.

- 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>17</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 in 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>18</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>19</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>20</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

https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview <sup>18</sup> Ofgem (2018), Default tariff cap: Appendix 6 – Operating costs, paragraph 3.54. https://www.ofgem.gov.uk/decision/default-tariff-cap-decision-overview

<sup>19</sup> Ofgem (2024), Energy Price Cap operating cost allowances review, paragraphs 2.18 - 2.31.

 $<sup>^{17}</sup>$  Ofgem (2018), Default tariff cap: Appendix 1 – Benchmark methodology, paragraph 1.3.

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

<sup>&</sup>lt;sup>20</sup> Ofgem (2024), Energy price cap: additional debt costs review decision. <u>https://www.ofgem.gov.uk/decision/energy-price-cap-additional-debt-costs-review-decision</u>

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 for example, may place costs pressures on suppliers.

2.19 For these reasons, we maintain our belief that now is an ideal time to review the operating cost allowances and update the methodology underpinning the allowances with 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.
- 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

#### Section summary

This section sets out our decision for the benchmarking approach. We discuss the supplier sample, the baseline year alongside the inclusion of any cost adjustments, and the 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>21</sup> Therefore, to set the core operating cost allowance, we benchmark suppliers' costs to reflect the average cost across the market. 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>22</sup>
- 3.2 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 maintain fair prices for consumers, uphold high standards of service, enable a low carbon transition and enhance the resilience of our energy system.
- 3.3 Therefore, in setting the allowance for core operating costs, we need to establish the right level of overall stringency to set the allowance at. This is influenced by:
  - what data sample we use to carry out the benchmarking exercise
  - the baseline period we use to assess costs;

 <sup>&</sup>lt;sup>21</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018.
 <u>https://www.legislation.gov.uk/ukpga/2018/21/enacted</u>
 <sup>22</sup> Ofgem (2018), Default tariff cap: Overview Document, page 6.
 <u>https://www.ofgem.gov.uk/decision/default-tariff-cap-decision-overview</u>

- what costs we should include in core operating costs
- our approach to including recent or future cost changes and,
- the benchmarking metric chosen.

## **Benchmarking sample**

#### Context

- 3.4 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.
- 3.5 In our December 2024 statutory 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.
- 3.6 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). For each RFI, we collected data from twelve suppliers with over hundred thousand customer accounts.
- 3.7 In our December 2024 statutory consultation, we proposed to exclude three suppliers from our sample for the benchmarking exercise: Bulb, Foxglove and Utility Warehouse.

#### Decision

3.8 We have decided to proceed with our proposal and exclude Bulb, Foxglove and Utility Warehouse from our benchmarking sample.

## Rationale

3.9 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.

## Stakeholder response summary

- 3.10 Three suppliers raised concerns on the exclusions to our benchmarking sample.
- 3.11 Two suppliers and one stakeholder agreed with the proposal to exclude Bulb, Foxglove and Utility Warehouse from our benchmarking sample.

## Considerations

- 3.12 Two suppliers said they did not understand the rationale for excluding Bulb from the benchmarking sample. Another supplier told us that excluding Utility Warehouse from our benchmarking sample would leave a material gap in the data.
- 3.13 We have decided to exclude:
  - Bulb, as the migration of customers from Bulb's legacy IT system to the Kraken system was ongoing at the start of 2023. This ongoing migration impacted the 2023 RFI cost data. Furthermore, 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. We do not consider that data from a supplier who had recently been through special administration and was under transition to new ownership would be a reliable reflection of ongoing costs.
  - 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, increasing the risk of capturing non-energy costs within the cap. We recognise that excluding a supplier from the benchmarking sample means that we do not incorporate information on that supplier's customer base and business model. Nevertheless, we consider that excluding this supplier increases the reliability of our benchmark, as it mitigates the risk from inaccurate data.
- 3.14 Two suppliers said that operating costs could be set too low for smaller suppliers who cannot benefit from economies of scale if the RFI sample is restricted to suppliers with over 100,000 customer accounts.
- 3.15 The July 2023 RFI was issued to suppliers with greater than 100,000 customer accounts, which captured 98% of the market at the time. To maintain consistency, we kept this 100,000 customer account threshold for our May 2024 RFI. We consider the RFI data reflective of the majority of customers within the market and particularly those who are on the cap.
- 3.16 In addition, including more data within the benchmarking process does not guarantee an increase in reliability. For example, additional supplier data may not

reflect the costs of the wider market, reducing the comparability of the entire dataset. Furthermore, given our decision to use a weighted average benchmarking metric, cost differences between smaller suppliers and the chosen sample would not result in large changes to the benchmark.

- 3.17 One supplier told us about its concerns of a cost data point of another supplier, stating it was too low to be credible.
- 3.18 We have scrutinised the 2023 RFI data, engaging with suppliers for clarification and adjusting cost data where necessary. For example, as discussed in our December 2024 statutory consultation, we adjusted the central overhead costs of one supplier to better reflect the true economic cost that would have been incurred by an efficient notional supplier. This has improved the comparability of business activities and costs between suppliers.
- 3.19 Allocations of particular cost lines may vary across suppliers. By benchmarking at a total core operating cost level, we mitigate the risk of these differing allocations. Moreover, we have reconciled suppliers' 2023 RFI data against their Consolidated Segmental Statements (CSS) or statutory accounts.
- 3.20 Several stakeholders also told us about the importance of considering the potential impact of the core operating cost allowance on all market players, including those excluded from the sample.
- 3.21 Throughout the operating cost review, we have engaged with suppliers and other stakeholders to enhance our understanding of the allowance's impact. During these conversations, suppliers and their third-party advisers have shared data with us regarding key specific concerns. We have considered these, alongside our own analysis which explores the market-wide impact, to conclude key decisions regarding the core operating cost allowance.

## **Baseline and future costs**

## Context

- 3.22 We considered two options for updating the core operating costs baseline, 2022 cost data or 2023 cost data. In our December 2024 statutory consultation, we proposed to use 2023 cost data, as collected in the May 2024 RFI.
- 3.23 Within the RFI, we collected suppliers' operating costs, 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.

3.24 In our December 2024 statutory consultation, after carefully scrutinising which costs were appropriate, we proposed to include all these cost lines in the core operating costs baseline. Alongside this, we also considered whether adjustments were required to the baseline costs, but ultimately proposed not to make any adjustments for recent or future cost changes.

## Decision

- 3.25 In line with our proposals, we have decided to use 2023 cost data and include all cost lines to update the core operating costs baseline.
- 3.26 With regards to recent or future cost changes, we have decided to:
  - not include an adjustment in the baseline for future MMHS costs
  - not include an adjustment in the baseline for future sales and marketing costs
  - include an upward adjustment in the baseline of £1.24 per dual fuel customer (cap 14a prices) for changes to employer's National Insurance Contributions (NICs) and,
  - not include an adjustment in the baseline for changes to the National Living Wage (NLW).

## Rationale

- 3.27 We consider 2023 cost data to reflect the latest market conditions and is less likely to have been impacted by any external events, such as COVID-19 and high gas prices, in comparison to 2022 cost data. We also have confidence in the 2023 cost data after scrutinising it and requesting further clarification on specific cost lines from suppliers.
- 3.28 We acknowledge that some costs might have increased since the 2023 RFI data. This includes the impact of recent and upcoming regulatory changes, such as the October 2023 customer standards decision,<sup>23</sup> or April 2025 supplier 24 by 7 metering support decision.<sup>24</sup> However, some cost lines may have also decreased (eg the administrative costs for the 'Energy Bill Support Scheme'). Adjusting for upward cost pressures in isolation risks setting a benchmark that is above the level of efficient costs. Furthermore, the magnitude of some increased costs remains uncertain.

<sup>&</sup>lt;sup>23</sup> Ofgem (2023), Consumer Standards decision.

https://www.ofgem.gov.uk/decision/consumer-standards-decision <sup>24</sup> Ofgem (2025), Consumer Standards: Supplier 24-7 Metering Support Decision https://www.ofgem.gov.uk/decision/consumer-standards-supplier-24-7-meteringsupport

- 3.29 We consider the rise in employer's NIC to be an economic policy change which will affect all suppliers, and its gross impact on suppliers is clear. While there is some uncertainty about the net impact on suppliers after pass-through, we take this uncertainty into account in the round as part of our decision. We therefore have sufficient confidence that making an upward adjustment will increase the accuracy of the core operating cost baseline. This adjustment is equal to £1.24 per dual fuel customer (cap 14a prices). This decision is a one-off adjustment as part of this ongoing review and does not imply we would automatically feed through future changes in taxation to the core operating cost allowance.
- 3.30 We considered collecting 2024 cost data as an update to 2023. It is not guaranteed that the 2024 data would address concerns raised about future cost changes. For example, changes to employer's NICs were enacted in April 2025, while costs due to the implementation of MHHS will continue into the future. In addition, collecting 2024 cost data would delay the operating cost review further which we do not consider would benefit consumers or industry. Prolonging the review would increase regulatory uncertainty, which could impede suppliers' ability to deliver improvements for customers.
- 3.31 We may consider adjustments to the core operating cost allowance in the future if costs depart from the allowance in a material and systemic manner.
- 3.32 Finally, our decision to include all cost lines within the 2023 baseline results in a benchmark set at the total core operating cost level. This removes the risk that the benchmark is affected by suppliers allocating costs across cost lines using different methodologies.

#### Stakeholder response summary

- 3.33 One stakeholder agreed with the proposal to use 2023 cost data to set an updated core operating cost baseline.
- 3.34 Two suppliers agreed with the proposal to include all cost lines within the baseline.
- 3.35 Six suppliers said they expect individual costs, such as sales and marketing, MHHS, and staffing costs to have increased since 2023.

### Considerations

#### Sales and marketing

3.36 Several suppliers said 2023 sales and marketing costs were likely to be lower than future expected costs as a result of lower than historical levels of customer switching between suppliers.

- 3.37 We consider several costs within 2023 to not be entirely typical. In 2023, suppliers were still dealing with the impacts of high energy bills. Delivery of government support schemes, such as the Energy Bill Support Scheme, would have impacted their operations. Suppliers would have incurred additional administrative costs to implement and run these schemes for their customers.
- 3.38 Furthermore, the high energy costs increased the number of customers facing difficulty paying their bills. As a result, the number of customers likely to contact their supplier would be expected to have risen, leading to higher customer contact costs. For example, between 2022 and 2023 we observed an increase in the average customer contact costs across our sampled suppliers.
- 3.39 The energy crisis caused several suppliers to fail. The customers of these failed suppliers were absorbed by other operating suppliers. Throughout 2023, some suppliers would still have been integrating these customers, leading to increased IT system costs.
- 3.40 We acknowledge that market switching was still low in 2023 by historical standards, meaning less expenditure on customer acquisition than a typical year. Since 2023, switching levels have increased. 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 the core operating cost baseline, including sales and marketing costs at the 2023 level, is sufficient.
- 3.41 One supplier asked us to confirm whether its capitalised sales and marketing costs were included within the core operating cost baseline.
- 3.42 All capitalised costs, including those related to sales and marketing, are included within the core operating cost baseline. This is reflected in our decision to include all cost lines within the baseline.

#### <u>MHHS</u>

- 3.43 Several suppliers said they expect future MHHS costs to increase, while others highlighted that they had little, or no spending related to the rollout of MHHS within their 2023 RFI data. One supplier told us that its future MHHS costs had not yet been capitalised and would only begin to be depreciated over the next few years.
- 3.44 Several suppliers also said it was unclear to what extent future MHHS costs were reflected in the core operating cost baseline.

- 3.45 We asked suppliers to provide their incurred costs associated with MHHS in their 2023 RFI data submissions, along with additional costs they expect to incur in the near future. We recognise that several suppliers incurred some MHHS costs in 2023, while others had not. Suppliers also used different approaches to estimate their future MHHS costs.
- 3.46 We recognise that MHHS costs are expected to increase in the future. However, our analysis of suppliers' estimates of future MHHS costs shows an immaterial increase in cost per customer per year, on average. The analysis also highlighted that these costs varied heavily between suppliers. 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.
- 3.47 Therefore, we have decided not to include any adjustment to the core operating cost baseline for future MHHS costs. However, the baseline does include the MHHS costs that were present within suppliers' 2023 RFI data. This aligns with our decision to include all costs lines to update the core operating costs baseline. Where future costs materially and systematically diverge from the core operating cost allowance, we will consider whether an adjustment is appropriate.

#### Staffing costs

- 3.48 Several suppliers said that they anticipate higher staff costs as a result of the increases to employer's National Insurance Contributions and the National Living Wage. One supplier also told us that the impact of higher costs will vary among suppliers depending on their proportion of onshore (ie UK-based) staff.
- 3.49 We acknowledge that staff costs have increased faster than expected as a result of economic policy changes. Ordinarily we would expect changes in underlying cost drivers to be captured in official inflation statistics which we use to uprate allowances into today's prices (using CPIH). Wage inflation and labour costs will normally appear in inflation statistics as increased input costs are transmitted through consumer prices. These costs have been a major driver of inflation during the period in question. However, this relationship is often lagged and is not sector specific – meaning sectors which have a high proportion of costs driven by labour costs may be more affected than the general measure of CPIH.
- 3.50 On balance, we have decided to make an adjustment to account for increased wage costs, resulting from the economic policy change, over and above those captured by CPIH. This is inherently a judgement call as we cannot know the level

of these costs captured by CPIH. We have therefore taken an in-the-round judgement to make an adjustment for the full direct cost of the employer's NICs increase and no adjustment for the NLW. We recognise that this likely reflects an over-estimate and under-estimate of costs respectively, which we consider balance out.

- 3.51 The Office for Budget Responsibility (OBR) estimates that the change to employer's NICs will increase staff costs by just under 2%.<sup>25</sup> As a result of this, we have decided to include an upward adjustment to the core operating cost baseline, equal to £1.24 per dual fuel customer (cap 14a prices). Given the requirement to set one benchmark across suppliers, this adjustment reflects the typical situation within the market. It also assumes suppliers will absorb the entire cost of increases to employer's NICs. We consider this to be an overstated adjustment as some of the cost increase will be captured within future CPIH inflation.
- 3.52 While the NLW change is also economic policy, in comparison to the NICs change, the outcome of the NLW change is less certain. This reflects that the impact of NLW changes will depend on the proportion of a supplier's staff paid the NLW, whereas the change to NICs will affect a supplier's entire UK-based workforce. Furthermore, the NLW is regularly updated on 1 April every year. Given this, and our in-the-round judgement, we have decided not to implement an adjustment for changes to the NLW.
- 3.53 To calculate the £1.24 employer's NICs adjustment, we have collected 2023 salary data through the financial resilience quarterly RFI for the nine suppliers within our benchmarking sample. These salary data were then inflated by 8.1% from 2023 prices to January 2025 prices using the latest available data from the whole economy average weekly earnings wage growth index from the Office for National Statistics (ONS).<sup>26</sup> This reflects changes in staff costs between 2023 and April 2025.
- 3.54 The 8.1% increase is higher than the 4% wage growth reported by the ONS for the electricity, gas, steam and air conditioning supply industry under which

<sup>&</sup>lt;sup>25</sup> Office for Budget Responsibility (2024), Economic and fiscal outlook October 2024, page 21.

https://obr.uk/efo/economic-and-fiscal-outlook-october-2024/

<sup>&</sup>lt;sup>26</sup> Office for National Statistics (2025), Average weekly earnings dataset - March 2025 release

https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkin ghours/datasets/averageweeklyearningsearn01/current

energy suppliers are classified.<sup>27</sup> We consider the 8.1% increase to be more likely and better to reflect changes in wages for energy suppliers, compared to a category which includes activities which relate to energy but are different in nature. We also note that the 4% increase is below the level of CPIH inflation over the same period.

- 3.55 The use of wage growth within the employer's NICs adjustment does not imply that we will make future adjustments to the core operating cost baseline when wage growth outpaces CPIH inflation. We consider the combination of our benchmarking approach and the use of CPIH inflation index enables an efficient notional supplier to recover future staff costs. We have used wage growth within the context of this one-off adjustment.
- 3.56 To assess the impact of the change to employer's NICs, we multiplied the inflated salary costs by the OBR's estimate of 2%.<sup>28</sup> Alongside this impact, the OBR estimated that firms will pass on 60% of the higher costs to workers and consumers within the first year, via lower wages and higher prices.<sup>29</sup> This figure is estimated to rise to 100% over the long-term.<sup>30</sup> Despite this, we have assumed that suppliers will absorb (ie not pass on) 100% of the cost. We consider that this choice will offset some of the additional cost increases due to the NLW and therefore reflects a decision in the round. We also recognise that the cap itself will restrict energy suppliers' ability to pass through costs via the route of higher prices, compared to firms in other sectors which do not have a price cap.
- 3.57 Finally, to arrive at the £1.24 figure, we have calculated the weighted average of the salary cost increase per customer, across the suppliers within our benchmarking sample, weighted by suppliers' total customer numbers. This methodology mirrors our benchmarking metric decision.

https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkin ghours/datasets/averageweeklyearningsbyindustryearn03/current

https://obr.uk/efo/economic-and-fiscal-outlook-october-2024/

 $<sup>^{\</sup>rm 27}$  Office for National Statistics (2025), Average weekly earnings by industry dataset - March 2025 release

<sup>&</sup>lt;sup>28</sup> Office for Budget Responsibility (2024), Economic and fiscal outlook October 2024, page 21.

https://obr.uk/efo/economic-and-fiscal-outlook-october-2024/

<sup>&</sup>lt;sup>29</sup> Office for Budget Responsibility (2024), Economic and fiscal outlook October 2024, page 28.

<sup>&</sup>lt;sup>30</sup> Office for Budget Responsibility (2024), Economic and fiscal outlook October 2024, page 54.

https://obr.uk/efo/economic-and-fiscal-outlook-october-2024/

3.58 This decision is a one-off adjustment as part of our ongoing review and does not imply we would automatically feed through future changes in taxation. Furthermore, any other deviations of costs from CPIH inflation would be treated in line with other cost pressures in the future, ie we would consider reopening the allowance where there is evidence of material and systematic cost pressures.

#### Regulatory changes

- 3.59 One supplier said that our ambition to set high levels of customer service standards may require additional resource that has not yet been reflected in the updated core operating cost baseline.
- 3.60 We do not consider good customer service to necessarily mean higher costs for suppliers. However, it is in customers' interest that efficient suppliers are able to recover their costs and attract necessary investment. Therefore, within our decisions for the benchmarking approach, we have considered the costs of known improvements to consumer standards, such as October 2023 customer standards decision,<sup>31</sup> or April 2025 supplier 24 by 7 metering support decision.<sup>32</sup> We have also taken into account the overarching strategy set out in our September 2024 publication on consumer standards.<sup>33</sup>
- 3.61 One supplier also said the increase in the Guaranteed Standards of Performance (GSOP) payments from £30 to £40, which resulted from our November 2024 decision.<sup>34</sup> Suppliers have considerable ability to control the level of GSOP payments by improving their service reliability. Service standards are a fundamental element of a supplier's business. We do not consider it is appropriate to provide an ex-ante allowance where standards are not met, and a supplier incurs a penalty. To that extent, we asked suppliers to exclude fines for non-compliance or redress payments, or both from the RFI. GSOP payments fall into this same category of costs a supplier faces. Therefore, we do not consider an adjustment for GSOP is appropriate.

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

<sup>&</sup>lt;sup>31</sup> Ofgem (2023), Consumer Standards decision.

<sup>&</sup>lt;sup>32</sup> Ofgem (2025), Consumer Standards: Supplier 24-7 Metering Support Decision <u>https://www.ofgem.gov.uk/decision/consumer-standards-supplier-24-7-metering-support</u>

<sup>&</sup>lt;sup>33</sup> Ofgem (2024), Consumer confidence: a step up in standards.

https://www.ofgem.gov.uk/publications/consumer-confidence-step-standards <sup>34</sup> Ofgem (2024), Supplier Guaranteed Standards of Performance (GSOP) Payment Uplift. https://www.ofgem.gov.uk/decision/supplier-guaranteed-standards-performance-gsoppayment-uplift

- 3.62 Overall, there are risks to considering upward adjustments in isolation, as these may ignore cost reductions in other areas. For example, the adoption of Artificial Intelligence (AI) could streamline operations and reduce costs for suppliers.
- 3.63 Given this, we consider our 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.
- 3.64 We will continue to consider whether an adjustment to the core operating cost baseline is appropriate where the costs materially and systematically diverge from the allowance. This includes consideration of future policy and regulatory changes. However, as part of any assessment, we will account for the looser stringency at which we have set the benchmark (by opting for a weighted average approach) to ensure we do not make adjustments which are unnecessary in the round.

#### Other cost pressures

- 3.65 One supplier said that it would incur significant costs to replace Radio Teleswitch (RTS) meters in 2025-26, and that this would not be included in the 2023 baseline.
- 3.66 We have not made an adjustment to our baseline for RTS. This reflects that this is a temporary issue rather than an enduring programme. It also takes into account that suppliers have varying numbers of RTS meters, and so an individual supplier's cost estimates will not necessarily reflect the average situation across suppliers.

## **Benchmarking metric**

## Context

- 3.67 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 at which to set the allowance.
- 3.68 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 twenty-fifth percentile in the sample

- option 2: a weighted average benchmark the average cost across suppliers weighted by the number of customers in their portfolio
- 3.69 In our December 2024 statutory consultation, we proposed to set the benchmark metric using option 2 a weighted average benchmark.

## Decision

3.70 We have decided to maintain our proposal and set the core operating cost allowance using a weighted average benchmark.

## Rationale

- 3.71 Our data suggests that suppliers have made efficiency improvements in previous years, leading to average costs that are now modestly below existing operating cost allowances. A weighted average benchmark approach reduces the core operating cost allowance, increasing the current stringency compared to the existing operating cost allowances, while also moving away from a "frontier efficiency" benchmark. We also recognise 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.
- 3.72 We also consider a weighted average benchmark to better enable continued improvement to customer service standards and reduce the risk of costly supplier failure compared to an overly stringent benchmark. To set a more stringent lower quartile benchmark we would have needed compelling evidence that further stepchange cost savings could be realised for most suppliers whilst further driving up standards.
- 3.73 Moreover, we aim to set an allowance that does not require frequent adjustment. We consider our combined decisions (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. Further details of these decisions are discussed in Section 4 and Section 5.

## Stakeholder response summary

- 3.74 Six suppliers and two stakeholders agreed with the proposal to set the core operating cost allowance using a weighted average benchmark.
- 3.75 Three suppliers disagreed with the proposal and suggested alternative benchmark metrics.

#### Considerations

- 3.76 One supplier said we should adopt a median average benchmark to reduce the impact of outlying data points, allow for increased diversity of business models and improve support for non-price competition. Another supplier told us to implement a flat or simple average to reduce the impact of several large retail suppliers on the benchmark, which it said could occur through factors such as customer mix or scale advantages.
- 3.77 Median and flat averages would not reflect the true costs of the market, as consumers would pay more than suppliers' aggregate costs. This would reduce consumer protection relative to a weighted average benchmark. We consider that the incremental impact of reducing protection would not be in customers' interests, especially given that any positive impacts on business model diversity or non-price competition would be uncertain, as suppliers are not required to spend an additional allowance in any particular way.
- 3.78 Furthermore, these averages place equal weight on all suppliers' costs within a sample, leading to the efficiencies from economies of scale being reflected to a lesser extent than with a weighted average benchmark. This would negatively impact consumers through higher bills. We also disagree that customer mix effects would be a reason to use a flat average. A weighted average reflects the customer mix across the sample, whereas a flat average would not do so.
- 3.79 We do not consider that a median or flat average is required to control for outliers. Following our data checks, we have sufficient confidence in the data included in our benchmark sample, particularly when we are averaging across suppliers.
- 3.80 One supplier said that the result of using a weighted average rather than a median benchmark was that smaller suppliers and those with different business models would need to make significant changes to their operations, to meet the benchmark. It said that this would harm competition.
- 3.81 Under section 1(6)(b) of the Act, we must have regard to the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts. We consider that a weighted average benchmark enables competition, as some suppliers will have average operating costs below this level. Other suppliers may still be able to offer fixed tariffs at a discount to the cap, for example to the extent that the costs of supply are lower in that segment. Further competition may be enabled over time to the extent that suppliers are able to make efficiency improvements and reduce their average

operating costs. We recognise that some suppliers may make operational decisions in light of the cap allowances, but suppliers could still make such operational decisions if we set a median benchmark.

- 3.82 Alternatively, one supplier told us we should take a more stringent approach to benchmarking, such a lower quartile, to maintain efficiency incentives as savings could still be found. First, it said that investments made it possible to reduce the number of staff needed to serve a customer base without a reduction in service quality. Second, it said that the wide range in operating costs between suppliers showed that efficiencies to date had not been evenly distributed, leaving some suppliers with room for further efficiencies. Third, it said that technology investments had already led to cost reductions and that further improvements should be available through use of AI.
- 3.83 We expect suppliers to continue to strive for efficiency gains. As in any market, we anticipate that suppliers will be able to make some efficiency improvements over time and in this context, we note the evidence the supplier provided. While cost variation between suppliers is not a proof of inefficiency, we also note that the lower quartile supplier is representative of the market and features a mixed customer base. This provides some confidence that other suppliers should be able to catch up with this level. We have taken this point into account when considering the update approach (see Section 5).
- 3.84 However, while a stringent benchmark can generally provide stronger efficiency incentives for suppliers, an overly stringent benchmark could have the opposite effect. By undermining investability and confidence in reasonable returns on investment, an overly stringent benchmark can discourage investment and hence efficiency in the medium to longer-term. Additionally, 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. These efficiency improvements can then be passed on to consumers in the form of bill reductions.
- 3.85 We consider a weighted average benchmark to promote supplier investability. This includes enabling suppliers to invest in improvements to customer support, quality standards, financial resilience and net zero capabilities. Furthermore, a weighted average benchmark supports our aim to set an enduring allowance as it is less susceptible to future market changes.

# 4.Allocating core operating costs across customer groups

## Section summary

This section sets out the decision 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 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.

## Benchmarking at an aggregate level

## Context

- 4.3 Allocating costs across different groups of customers can 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).
- 4.4 In our May 2024 policy consultation, we set out four options for benchmarking across fuel types and payment methods:<sup>35</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.

<sup>&</sup>lt;sup>35</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-allowancesreview

- 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.
- 4.5 In our December 2024 statutory consultation, we proposed to set the benchmark for core operating costs using option A aggregating costs across fuel types and payment methods.

## Decision

4.6 We have decided to proceed with our proposal and benchmark using an aggregate of costs across fuel types and payment methods (option A).

## Rationale

4.7 Benchmarking inherently requires a reasonable degree of comparability across suppliers. An aggregate benchmark eliminates the need to rely directly on suppliers' allocation methodologies to split costs between customer groups for benchmarking. This makes the approach resilient to differences in allocation methodologies, as we can then decide the allocation approach across payment methods and fuel types alongside our benchmarking approach. This assures us we are setting the overarching allowance (ie weighted across parameters such as payment method) at the intended level.

## Stakeholder response summary

- 4.8 Four suppliers agreed with the proposal to benchmark at an aggregate level.
- 4.9 One supplier disagreed with the proposal and supported benchmarking across individual fuel types and payment methods (option D).

#### Considerations

- 4.10 One supplier said it had limited concerns in relation to a benchmark at an aggregate level. This is because it considered the combination of benchmarking at an aggregate level and a weighted average benchmark metric leads to limited variation in costs between the four options set out in our May 2024 policy consultation.
- 4.11 The combination of a weighted average benchmarking metric, alongside weighted average allocations between fuel types and payment methods, leads to limited variation between the four options set out in our May 2024 policy consultation. This is because an aggregate costs benchmark (option A) would be allocated

across fuel types and payment methods using the result of a benchmark split cost by fuel types and payment methods (option D).

4.12 However, our decision to use the suppliers' cost differentials to allocate across payment methods, as opposed to relying directly on suppliers cost level for individual payment methods, leads to a systemically different allocation compared to a weighted average. Furthermore, the cost differential approach uses different weights to calculate the average across suppliers compared to a weighted average approach, generating additional differences. The methodology and rationale behind the cost differentials payment method allocation approach is explained within the following sub-section.

## **Payment methods**

## Context

- 4.13 In our December 2024 statutory consultation, we considered two options for using a weighted average to allocate core operating costs across payment methods:
  - Calculate a weighted average of the percentage split across the sample.
  - Calculate a weighted average of suppliers' differences in cost to serve between payment methods.
- 4.14 We ultimately proposed to 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. This approach (which we refer to as the supplier differential approach) allocates core operating costs in a broadly cost-reflective way across payment methods.
- 4.15 To ensure the cost differences of payment methods are representative, when calculating the costs differences between serving Direct Debit and Standard Credit customers, we proposed to include suppliers who have at least 100,000 customers on both the Direct Debit and Standard Credit payment methods. We proposed the same 100,000 customer threshold for calculating the costs difference between serving Direct Debit and PPM customers.

## Decision

4.16 We have decided to proceed with our proposal to allocate costs across payment methods using the supplier differential approach. However, we have decided to reduce the 100,000 customer sampling threshold to 50,000 customers. Reducing the threshold increases the payment method allocation for a PPM dual fuel

customer by  $\pounds$ 5, with corresponding small reductions to the allocation for Direct Debit and Standard Credit customers.

- 4.17 Furthermore, the change increases the sample for calculating the cost differentials between Standard Credit and Direct Debit customers to seven suppliers, and six suppliers for the differentials between PPM and Direct Debit customers.
- 4.18 The full impact of the customer sampling threshold reduction is described in Table 4.1.

Table 4.1: Core operating cost allowance payment method allocation for cap 14a, April 2025 – June 2025 (nominal prices, £ per dual fuel customer)

Payment method	Decision (50,000 customer threshold)	Statutory consultation proposal (100,000 customer threshold)	Change
Direct Debit	194	194	-1
Standard Credit	233	233	-1
РРМ	254	250	+5

Notes: Includes only the change associated with allocation (eg excludes other changes between December 2024 statutory consultation and decision). Benchmark consumption is equal to 3,100 kWh for single-rate electricity, 12,000 kWh for gas and 4,200 kWh for multi-rate electricity. Values displayed are shown for single-rate metering arrangement. Values may not sum due to rounding.

## Rationale

- 4.19 The supplier differential approach allocates core operating costs in a broadly costreflective way across payment methods. Using supplier differentials means that we are directly making use of how suppliers consider that costs vary between payment methods. This is different to a weighted average approach, where the cost to serve of each payment method is averaged across suppliers, leading to a mixture of allocation approaches between payment methods.
- 4.20 Furthermore, we improve the representativeness of the cost differences between payment methods by restricting the allocation sample. This enables us to exclude suppliers who have a very small number of customers on certain payment methods, where differences may be less reliable and not reflective of the costs of an efficient notional supplier. We consider this approach balances the protection of customers' interests by having regard to the need for cost recovery for an efficient notional supplier.

#### Stakeholder response summary

- 4.21 Two suppliers and one stakeholder agreed with the proposal to use the supplier differential approach to allocate costs across payment methods.
- 4.22 Two suppliers and one stakeholder disagreed with the proposal and supported the use of a weighted average payment method allocation.
- 4.23 Three suppliers disagreed with the proposal to restrict the sample of suppliers used to allocate costs across payment methods.
- 4.24 One supplier said the difference in the proposed allowance between Standard Credit and Direct Debit customers was too high.

## Considerations

#### Allocation approach

- 4.25 Several stakeholders said a weighted average automatically applies less weight to suppliers with small customer numbers, removing the need to restrict the sample for the payment method allocation.
- 4.26 The supplier differential approach differs from allocating across payment methods using a weighted average of the percentage split across the sample. Despite both approaches using a weighted average of suppliers' costs (or cost differentials), the weights given to suppliers is different.
- 4.27 A weighted average is distributed using the proportion of customers for each supplier, relative to the total, for each specific payment method. The supplier differential approach is distributed by determining the proportion of each suppliers' combined customer numbers, relative to the combined total of the sample, of the two payment methods being compared. For example, the sum of each supplier's Direct Debit and Standard Credit customers, divided by the total combined number of Direct Debit and Standard Credit customers across all suppliers.
- 4.28 Therefore, the weighted average component of the supplier differential approach would only apply less weight for suppliers with very small customer numbers on both payment methods being compared. Without a restricted sample, suppliers with very small numbers of customers on one particular payment method, and very large numbers of customers on another, would contribute significantly towards the allocation methodology. We explain the risks associated with this in the sub-section below.
- 4.29 Furthermore, removing the customer threshold does not result in the supplier differential approach matching the allocation of the weighted average approach.

The supplier differential approach uses the difference in costs between payment methods to allocate, as opposed to the weighted average approach of taking the absolute cost of payment methods. This, combined with differences in weighting, result in two distinctly different approaches even with matching samples.

- 4.30 One supplier said that we have not demonstrated why a weighted average allocation would overstate the differentials between payment methods, compared to the supplier differential approach.
- 4.31 As part of our review, we assessed the outcome of the weighted average approach relative to suppliers' own differences in cost to serve between payment methods.
- 4.32 We consider the weighted average approach to be more easily skewed by low or high-cost suppliers than the supplier differential approach. This can amplify the differentials between payment methods, particularly between Direct Debit and PPM, the lowest and highest cost to serve options. We acknowledge that Standard Credit and PPM customers are more expensive to serve than Direct Debit customers. However, we do not consider the weighted average allocation approach reflects suppliers' own allocated differences in cost to serve between payment methods.

## Sample restriction

- 4.33 Several stakeholders shared their concern with restricting the sample of suppliers used to allocate costs across payment methods. They said that a supplier with lower numbers of customers on a particular payment type is not less likely to be able to allocate costs in a reflective manner.
- 4.34 Another stakeholder told us that the 100,000 customer threshold removes new, or growing suppliers from the allocation sample, resulting in only larger suppliers being able to recover their costs. It added that it could be argued that suppliers with fewer customers are better at allocating costs as the cost centres are relatively new.
- 4.35 We maintain the principle from our December 2024 statutory consultation that the reliability of a supplier's payment method allocation could be affected by the number of customers it has on each payment method. A differential inherently depends on a supplier's costs on each compared payment method (eg Direct Debit and Standard Credit), and so having a small number of customers on one payment method could affect the reliability of its costs for that payment method, and therefore its differential.

- 4.36 Furthermore, reliability could also be undermined if costs are subject to natural variation (which would be more likely to average out over a larger customer base) or if a small customer base is less likely to be typical of customers across the market for that payment method. The allocation sample restriction reduces these risks.
- 4.37 We do not consider the supplier differential approach to remove smaller suppliers from the sample. The May 2024 RFI collected data from suppliers with over 100,000 customer accounts. This sampling approach first restricted the sample to exclude smaller suppliers, of which we outlined the rationale within Section 3.
- 4.38 In addition to this, suppliers with smaller numbers of customers on some payment methods may not benefit from the efficiencies of economies of scale, compared to other payment methods. This risks inflating the differential of the benchmark, as only one side of the differential equation benefits from reductions due to economies of scale. Therefore, reducing price protection for Standard Credit and PPM customers.
- 4.39 Finally, the supplier differential approach impacts how costs are allocated between payment methods, not the overall level of costs. Restricting the supplier differential sample has no impact on the overall level of the benchmark and is therefore unlikely to drastically change the recoverable costs of a supplier with a typical customer base.
- 4.40 Another supplier added that a weighted average allocation has a larger sample size than the supplier differential approach, therefore making it more robust.
- 4.41 An increased sample size does not necessarily mean increased reliability. First, the potential benefit from including an additional supplier's data may be limited if their market share is small and therefore has a small impact on an average. Second, any potential benefits from an additional data point could be offset by the risk of the supplier's differential being unreliable.

## Customer number threshold

4.42 Several stakeholders said that the supplier differential approach favours suppliers with large Direct Debit customer bases, and that choosing the wrong allocation can distort competition. One supplier also told us that the proposed approach fails to recognise that certain suppliers serve specific cohorts of customers, some of which are higher cost to serve.

- 4.43 The outcome of the supplier differential approach is primarily driven by the differences in cost to serve between suppliers. However, through setting a customer number threshold, we have the ability to adjust this outcome.
- 4.44 The choice of a customer number threshold is a judgement. In principle we consider that we could maintain the 100,000 threshold we proposed. However, we recognise that the difference between a 50,000 and 100,000 customer threshold has a particular impact on the allocation to PPM, and therefore on PPM specialist suppliers.
- 4.45 On balance, and with regards to customer protection through supplier resilience, we have decided to reduce the customer threshold to 50,000 customers. We consider this approach provides an appropriate balance of protecting PPM customers through a decrease to the overall allowance, whilst reducing the risk of cost under-recovery for PPM suppliers.
- 4.46 The change from a 100,000 to 50,000 customer threshold results in an increase of £5 to the core operating cost allowance for dual fuel PPM customers, and a decrease of £1 for dual fuel Direct Debit and Standard Credit customers. However, the impact on PPM customers will be limited due to levelisation.
- 4.47 We consider that lowering the customer threshold below 50,000 would include suppliers' differentials that are not reflective of the wider market. As outlined previously, a lower threshold can undermine reliability if costs are subject to natural variation, where variation is averaged out over a smaller number of customers.
- 4.48 Lowering or removing the threshold would result in bill increases for Direct Debit and Standard Credit customers, and bill reductions for PPM customers. We consider this to reduce the incentive for both customers and suppliers to opt for lower cost to serve options and increase the risk of cost under-recovery for PPM suppliers.
- 4.49 We recognise that the choice of differential will affect suppliers with different customer bases. However, given that we consider that our allocation uses appropriate estimates of cost-reflective differentials, we do not consider that there would be an undue benefit to any particular type of supplier or a distortion of competition.
- 4.50 Under the Act, we cannot set different cap levels between suppliers. This constrains our ability to recognise supplier-specific circumstances. Our decision to change the customer threshold expands the number of suppliers in the sample

and may therefore take into account a wider range of supplier-specific circumstances.

#### Cost reflectivity

- 4.51 One supplier said it considered the supplier differential allocation to be a move away from a cost-reflective approach, which should be achieved through a levelisation scheme, not through the choice of payment method allocation. This implied that the cost to serve difference between payment methods was wider than our proposal.
- 4.52 Another supplier conversely told us that there are limited differences in the cost to serve Direct Debit and Standard Credit customers, after excluding debt-related costs. It also added that it was opposed to phase 2 of levelisation, as socialising costs between payment methods reduces incentives for suppliers to innovate.
- 4.53 We disagree that we have moved away from a cost-reflective approach. The supplier differential approach uses the weighted average of the differentials across suppliers to calculate the allocation between payment methods. While this approach reflects differences in cost to serve across the market, it may not reflect the differential of any one supplier.
- 4.54 The difference in the cost in serving Standard Credit customers relative to Direct Debit customers is largely driven by greater volumes of customer contact, as well as increased billing and payments costs. We consider the average of these additional costs to be reflected within the payment method allocation.
- 4.55 One supplier told us it was concerned that the proposal to use the supplier differential approach was driven by a desire to minimise the differentials between payment methods.
- 4.56 The supplier differential approach was not chosen due to a desire to reduce the differentials between payment methods. Rather, the approach retains suppliers' own allocation choices between payment methods, which increases the comparability of allocation methodologies across payment methods. Therefore, we consider this approach to better reflect the differences in cost to serve between payment methods seen within suppliers' 2023 RFI data.

## Fuel types and electricity meter types

## Context

- 4.57 In our May 2024 policy consultation, we set out options for allocating across 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 across the sample.
  - Option 3: Allocating equally across electricity and gas.<sup>36</sup>
- 4.58 In our December 2024 statutory consultation, we proposed to allocate the core operating cost allowance across fuel types using option 2 a weighted average approach. We also proposed to allocate costs equally across single-rate and multi-register electricity meters.

## Decision

- 4.59 We have decided to proceed with our proposal and use a weighted average fuel type allocation. To achieve this, we use suppliers' allocation of fuel types to calculate the weighted average core operating costs for electricity and gas customers. These benchmarks are then translated into a split ratio, 48% for electricity and 52% for gas.
- 4.60 We have also decided to maintain our proposal to allocate the core operating cost allowance equally across single-rate and multi-register electricity meters.

## Rationale

- 4.61 A weighted average fuel type allocation minimises the risk associated with relying on the benchmark supplier's split, which can vary due to inconsistent allocation approaches among suppliers. Additionally, it is more cost-reflective than an equal allocation approach. This therefore reduces the likelihood of under or overrecovery for suppliers with a customer base weighted more towards one fuel type.
- 4.62 We do not consider core operating costs to be materially different between electricity meter types. Therefore, even if any stakeholders considered that there were above average operating costs for multi-register electricity meters, this

<sup>&</sup>lt;sup>36</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>

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.

#### Stakeholder response summary

- 4.63 One supplier supported the proposal to use a weighted average fuel type allocation.
- 4.64 One supplier raised concerns regarding the cost of a single fuel customer.
- 4.65 We did not receive any comments on the proposal to allocate the core operating cost allowance equally across single-rate and multi-register electricity meters.

## Considerations

- 4.66 One supplier said that single fuel customers have higher per account costs to serve than dual fuel customers. It also highlighted that decarbonisation policy goals are likely to increase the share of single fuel customers, as more customers become electricity-only through the installation of heat pumps.
- 4.67 We acknowledge that single fuel customers may be slightly more expensive to serve than dual fuel customers. However, these differences in cost to serve have been captured within the core operating cost baseline. A notional supplier with a market average customer base will under-recover from their single fuel customers and over-recover from their dual fuel customers. Therefore, when considered alongside the weighted average benchmarking metric, we expect the net impact on suppliers to be marginal.
- 4.68 Furthermore, as more customers transition to electricity-only, as a result of the increased rollout of heat pumps and electric vehicles, we expect average consumption levels to rise. This would partially offset any under-recovery suppliers may face. Given this transition, we will continue to monitor trends in the number of single fuel households and their associated cost.

## Standing charge and unit rate

## Context

- 4.69 Allowances within the cap are set at nil and benchmark consumption levels, which are used to calculate the standing charge and unit rate in an energy bill. Given this, we must consider how to allocate costs across consumption levels for the core operating cost allowance.
- 4.70 In our December 2024 statutory consultation, we proposed to fully reflect the proposed reduction in the core operating cost baseline onto standing charges and keep unit rates broadly the same (compared against cap 13a, October 2024 –

December 2024). The proposal led to a new allocation to the standing charge for each combination of payment method and fuel type.

4.71 As part of a holistic assessment of the proposed core operating cost allowance, in our December 2024 statutory consultation we considered the prevailing relationship between typical consumption (where we set the benchmark) and mean consumption (which determines the revenue suppliers recover). We acknowledged that changing consumption patterns could impact headroom, increasing the risk that suppliers under-recover from the core operating cost allowance.

## Decision

- 4.72 We have decided to proceed with our proposal to reflect the reduction in the core operating cost baseline onto the standing charge. This approach results in a reduction in standing charges for Direct Debit and PPM customers, and a small increase for Standard Credit customers, as described in Table 4.2.
- 4.73 To enable this decision, we have calculated six new standing charge allocations for each combination of payment method and fuel types. These allocations are outlined in Table 4.3.
- 4.74 This differs from the decision to maintain the existing standing charge allocation for SMNCC and use the previous operating cost standing charge allocation for industry charges. These approaches are explained further within 'Appendix 3: Smart metering costs' and 'Appendix 4: Industry charges', respectively.
- 4.75 We have also decided to maintain our proposal to allocate between standing charges and unit rates at benchmark consumption.

Table 4.2: Core operating cost allowance standing charge allocation for cap 14a, April 2025 – June 2025 (nominal prices, £ per dual fuel customer)

Payment method	Decision	Existing cap 14a	Change
Direct Debit	118	132	-14
Standard Credit	157	153	+4
РРМ	182	190	-8

Notes: Values have been calculated at the benchmark consumption level (3,100 kWh electricity and 12,000 kWh gas). Values may not sum due to rounding.

Payment method	Electricity	Gas
Direct Debit	49%	72%
Standard Credit	58%	77%
РРМ	64%	79%

 Table 4.3: Core operating cost allowance standing charge allocation percentages

Note: Allocation percentages have been calculated at the benchmark consumption level (3,100 kWh electricity and 12,000 kWh gas).

## Rationale

- 4.76 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 by having 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.
- 4.77 The long-term trend of energy consumption is uncertain. Consumption decreased during the energy crisis as a result of high energy prices. While consumption of both electricity and gas increased marginally recently, both remain below preenergy crisis levels. As of 2023, mean electricity consumption was approximately equal to benchmark consumption, while gas remained slightly below.
- 4.78 Given the uncertainty in consumption trends, committing to a new level of consumption for the operating cost review may lead to under or over recovery in the future. Therefore, we have decided to continue to allocate between standing charges and unit rates at benchmark consumption. However, we continue to monitor consumption and will review the level of benchmark consumption in the cap in the coming year.

## Stakeholder response summary

- 4.79 Two suppliers and one stakeholder agreed with our proposal not to move additional costs from standing charges to unit rates.
- 4.80 Two suppliers and one stakeholder said that the standing charge allocation should not be set at benchmark consumption, as mean consumption is lower than benchmark, which would lead to under-recovery.

### Considerations

- 4.81 Two stakeholders said that the proposed standing charge and unit rate allocations will lead to under-recovery as they have been calculated at benchmark consumption, rather than the lower Typical Domestic Consumption Values (TDCVs) levels. This is because full recovery of the core operating cost allowance on the unit rate occurs at benchmark consumption. Therefore, as median consumption of the average consumer is below this figure, suppliers would recover less from the unit rate. Suppliers said that we should set allocations between standing charges and unit rates using TDCVs to correct for this.
- 4.82 We acknowledge that average consumption for both electricity and gas declined since the energy crisis. As of 2023, mean average consumption levels have begun to increase, but remain below pre-energy crisis levels.<sup>37, 38</sup> Given this, we consider the long-term trend of energy consumption to be uncertain. Committing to a new level of consumption for the operating cost review, without considering consumption across the entire cap, may lead to under or over recovery in the future. Furthermore, we do not consider there to be evidence of a persistent shortfall that will extend into the future.
- 4.83 Another supplier highlighted that PPM customers consume less energy on average, resulting in suppliers with high proportions of PPM customers recovering less from the unit rate. It said that payment method specific consumption profiles should be used to set allocations between standing charges and unit rates.
- 4.84 We recognise that on average PPM customers consume less energy than the average across payment methods. A notional supplier may under-recover its efficient operating costs over its PPM customers, all else being equal. However, Direct Debit customers consume more energy on average, therefore a notional supplier would over-recover costs on their direct debit customer base, offsetting their PPM under-recovery.
- 4.85 For suppliers with a payment method mix similar to the market average, we expect the net impact to be marginal. However, a notional supplier with an above

 <sup>&</sup>lt;sup>37</sup> Department for Energy Security and Net Zero (2024), Regional and local authority gas consumption statistics, Mean consumption Domestic
 <u>https://www.gov.uk/government/statistics/regional-and-local-authority-gas-consumption-statistics</u>
 <sup>38</sup> Department for Energy Security and Net Zero (2024), Regional and local authority electricity consumption statistics, Mean consumption Domestic

https://www.gov.uk/government/statistics/regional-and-local-authority-electricityconsumption-statistics

average proportion of PPM customers may on average under-recover its efficient operating costs, all else being equal.

- 4.86 Overall, as part of our decisions in concluding the operating cost review, we have sought to address PPM cost uncertainties faced by suppliers. We have provided adjustments on our payment method allocation approach in the core operating allowance and the PPM cost to serve benefit in the SMNCC allowance. These changes have increased the combined core operating cost and SMNCC PPM allowance level by approximately £10. On balance, we consider these changes provide further financial resilience for suppliers with a high proportion of PPM customers, whilst the overall decrease in the operating cost allowances continues to protect PPM customers.
- 4.87 While our decisions in the round provide additional support for PPM suppliers, we are mindful of the ongoing uncertainty regarding PPM specific consumption. Implementing consumption profiles for each payment method at this stage would be a significant change to the cap and would therefore require further consideration and consultation. We do not consider it appropriate to extend the scope and duration of this project to carry out a further review. A delay to implementation of the operating cost review would not be in customers' interest as core operating costs would remain higher, above the level of an efficient notional supplier.
- 4.88 We continue to monitor trends in energy consumption and will review our approach to consumption within the cap, noting that, if we made an adjustment, this would ultimately lead to an increase in bills for PPM customers and potentially Standard Credit customers.
- 4.89 Two suppliers also said that the expected proposal to require a zero standing charge variant of the cap may increase risks around cost recovery.
- 4.90 The additional uncertainty of future standing charge proposals cannot be incorporated into the core operating cost decision at this time. However, the impact of any future policy changes on consumption may be considered as part of any review of benchmark consumption.

# 5.Updating the core operating cost allowance over time

### Section summary

This section sets out our decision for updating the core operating cost allowance in the future.

## Context

- 5.1 The update approach is an important aspect of designing the core operating cost allowance. 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 and remains appropriate over time.
- 5.2 In our May 2024 policy consultation, we set out three options for the update approach:<sup>39</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
- 5.3 In our December 2024 statutory consultation, we proposed to:
  - index the core operating cost allowance using the value of CPIH for future cap periods (option 1);
  - set the initial index value of CPIH as the average inflation index across 2023, equal to 128.6; and,
  - use the same months of the CPIH index to update the cap as we do currently; the preceding December for cap periods starting 1 April or 1 July, and the preceding June for cap periods starting 1 October or 1 January.

<sup>&</sup>lt;sup>39</sup> Ofgem (2024), Energy price cap operating cost allowances review, paragraphs 3.135. <u>https://consult.ofgem.gov.uk/energy-supply/energy-price-cap-operating-cost-allowances-review/</u>

## Decision

- 5.4 We have decided to proceed with our proposal and:
  - index the core operating allowance using the value of CPIH for future cap periods;
  - set the initial index value of CPIH as the average inflation index across 2023, equal to 128.6; and,
  - use the same months of the CPIH index to update the cap as we do currently, ie the preceding December for cap periods starting 1 April or 1 July, and the preceding June for cap periods starting 1 October or 1 January.

## Rationale

- 5.5 We consider the CPIH inflation index will reflect the changes in efficient operating costs that we expect to take place over time. We acknowledge that 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, could improve efficiency and reduce suppliers' core operating costs.
- 5.6 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.
- 5.7 We also consider that our approach to setting an initial index of CPIH balances 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.

#### **Stakeholder response summary**

- 5.8 Three suppliers and one stakeholder agreed with the approach to use CPIH to index the core operating cost allowance by inflation.
- 5.9 Three suppliers and one stakeholder consider it unlikely that CPIH will account for future cost pressures, including known pressures that are not adjusted for within the core operating cost baseline.

- 5.10 One supplier agreed with the aim to not revisit the core operating cost allowance every time a modest additional cost driver occurs.
- 5.11 Two suppliers disagreed with the approach to not update the core operating cost allowance frequently, while one stakeholder said the allowance should be kept under regular review.

## Considerations

- 5.12 Several stakeholders said that updating the core operating cost allowance with a CPIH inflation index does not remove the need to account for future additional upward cost pressures. They added that CPIH is unlikely to offset the known cost pressures not included within the core operating cost baseline, risking under-recovery.
- 5.13 One supplier also told us that the upward cost pressures associated with the energy transition will likely offset any future efficiency gains, and that we should take a cautious approach to making assumptions about future efficiencies. The supplier also said that, as it was critical that suppliers could recover efficiently incurred costs, there was an asymmetry between upward and downward adjustments.
- 5.14 Two suppliers also disagreed that the core operating cost allowance would not need to be updated regularly. Three stakeholders said that we should consider an update approach that accounts for additional cost pressures and regulatory change. Two stakeholders told us that we should conduct an annual or biennial review of suppliers' costs to ensure the core operating cost allowance remains appropriate. Another stakeholder said that we should adopt a CPIH-x mechanism, where the 'x' adjustment is used as a true-up mechanism to protect against regulatory uncertainty.
- 5.15 We consider our decisions regarding the core operating baseline, as described in Section 3, alongside a CPIH inflation index, will mitigate the impact of future cost pressures. We acknowledge that, in comparison to when we established the cap, significant efficiencies have already been captured in the core operating cost baseline.
- 5.16 Despite this, we do not consider our approach to rely on large unrealised efficiency gains to enable future cost recovery for an efficient notional supplier. First, external factors influencing operating costs could be upward or downward, which may limit the net impact. Second, even if external factors do apply net upward pressure on operating costs, catch-up efficiency gains may provide a mitigation. The lower quartile supplier was already able to achieve core operating

costs below the weighted average, and this supplier was representative of the market with a mixed customer base.

- 5.17 In our December 2024 consultation, we explained why we expected that suppliers should be able to make efficiency improvements over time. We highlighted specific areas which stakeholders would need to explain if they did not agree that a degree of efficiency improvement was plausible.<sup>40</sup> We do not consider that stakeholders have provided convincing explanations as to why a degree of efficiency improvement is not plausible.
- 5.18 However, it is important to continue to incentivise suppliers to make efficiency improvements over time, leading to long term reductions in core operating costs. Suppliers benefit when they are able to recover more from the allowance than their incurred core operating costs. These efficiencies can then be passed on to consumers over the medium to longer-term in the form of bill reductions.
- 5.19 Frequent reviews would undermine those incentives as we would seek to recover any benefits from efficiency savings more regularly. Suppliers would therefore be less able to recover a surplus from efficiency gains, reducing the incentive to make such efficiency gains. Similarly, a CPIH-x approach, where 'x' is used as a true-up mechanism, would also disincentivise efficiency improvements. The average supplier would be able to recover the exact costs they have incurred, drastically reducing the incentive to make efficiency improvements.
- 5.20 Furthermore, regular reviews would also be resource intensive for the industry as a whole. The operating cost review has taken two years to complete. During this time, suppliers have been asked to provide data through numerous RFIs, and many stakeholders have responded in detail to each review phase. We do not consider it to be preferable to repeat this in-depth process on a frequent basis.
- 5.21 We do not agree with the suggestion that there is a relevant asymmetry between upward and downward cost pressures. Under the Act, we must protect default tariff customers and have generally done so through an "efficient notional supplier" approach to setting the cap. While we recognise that supplier failures can lead to costs for customers, we do not consider that customers would be protected if there was a presumption that they had to bear upward cost pressures while not benefitting from downward cost pressures.

<sup>&</sup>lt;sup>40</sup> Ofgem (2024), Energy price cap operating cost and debt allowances consultation. Appendix 1, paragraphs 5.26, 5.28-5.29.

https://www.ofgem.gov.uk/consultation/energy-price-cap-operating-cost-and-debtallowances-consultation

- 5.22 In our Future Price Protection discussion paper in March 2024, we raised the challenge of maintaining a flat, stringent, universal cap, particularly as we move to Market-Wide Half Hourly Settlement.<sup>41</sup> We plan to work with stakeholders over 2025/26 to further this analysis and explore options for longer-term cap reform. We regard this a more appropriate place to consider whether any changes are required to our general approach to price protection.
- 5.23 We may consider an overarching review if the core operating cost allowance is in place for a longer period, for example 5 years. This approach is similar in time to the difference between the introduction of the cap and this operating cost review.
- 5.24 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 our aim to set a stable and enduring allowance.
- 5.25 We consider this approach, alongside the remainder of our approach to setting the core operating cost allowance, to account for foreseeable uncertainties, promote efficiency improvements over time, and increase regulatory stability.

<sup>&</sup>lt;sup>41</sup> Ofgem (2024), Future Price Protection Discussion Paper, paragraphs 4.4-4.18. <u>https://www.ofgem.gov.uk/call-for-input/future-price-protection-discussion-paper</u>

## 6.General stakeholder comments

#### Section summary

This section outlines the cross-cutting comments from stakeholders in response to the December 2024 statutory consultation, alongside our responses.

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

## **Consumer protection**

- 6.2 One stakeholder said that, given the proposal to reduce the core operating cost allowance in comparison to the existing allowances, customers have been overpaying operating costs by approximately £350 million per year. They told us that the core operating cost allowance should be reduced further to true-up the overpayments made by customers over the last five years.
- 6.3 Suppliers have made efficiency gains between when we first set the cap and this operating cost review. However, it is likely that these efficiency improvements have been introduced incrementally over time. Therefore, it is inaccurate to assume the average supplier has over-recovered from the allowance as early as five years ago. Furthermore, ex post reviews for factors within suppliers' control can create additional regulatory uncertainty and reduce the incentives for efficiency. We do not consider this to be in customers' long-term interest. This rationale is explained further within Section 5. However, we may take suppliers' recent over-recovery into account when considering future decisions or allowances, such as a further debt true-up.

#### **Consultation process**

- 6.4 Two suppliers raised their concerns with the level of data transparency throughout the consultation process. They said that there was a lack of detail provided within the confidential data and published documents, making it challenging for suppliers or their third-party advising firms to replicate key steps within the methodology.
- 6.5 One supplier told us that some of the disclosed models were unnecessarily labelled as confidential, specifically those where suppliers' data had been replaced with dummy values. While another supplier said our approach to redactions between third-party advising firms and suppliers was excessive, which made the disclosure exercise largely futile.

- 6.6 The information we collected within our May 2024 RFI is commercially sensitive and, if negligently disclosed, would provide suppliers with detailed views of their competitors finances, which potentially could have competition consequences. We therefore had to carefully consider what data was necessary to disclose and the restrictions required to maintain the safeguarding of sensitive information.
- 6.7 Despite these constraints, we were able to provide a significant amount of information to suppliers' third-party advising firms, enabling stakeholders to respond to the consultation. Redactions on material shared between third-party advising firms and suppliers were required during this process to protect commercially sensitive information. We consider our approach appropriately balanced the trade-off between safeguarding the data and enabling suppliers to respond to the consultation.
- 6.8 One supplier said the supplier differential payment method allocation approach was introduced at a late stage in the consultation process, reducing the opportunity for suppliers to assess and comment on it. It also added that we did not provide enough data to assess the impact of this approach.
- 6.9 We consider our consultation process provided stakeholders with a meaningful opportunity to understand and comment on the supplier differential payment method allocation proposal. It therefore complied with the provisions of the Act in relation to consultation.
- 6.10 Within the December 2024 statutory consultation, we provided estimates of the core operating cost allowance across payment methods for both the supplier differential and weighted average approaches. This enabled suppliers to compare and assess the two methods. Alongside this, the methodology of the supplier differential approach could be scrutinised within the disclosure process, by both suppliers' Authorised Attendees (in a version of the model without supplier-specific data) and their appointed third-party advising firms.

## Implementation

- 6.11 One supplier said it was essential that suppliers be given 12 months to adapt to the new methodology given the impact on business models and existing investment plans. It added that implementation should take place no earlier than April 2026, which would give suppliers more opportunity to phase in revenue adjustment actions rather than detrimentally applying them urgently.
- 6.12 We do not consider it to be beneficial to consumers or the wider industry to delay the operating cost review further. Consumers would not receive the financial benefits of our new allowances during the delay. We consider that this would be

negative from the perspective of the Act's customer protection objective. We do not consider that delaying implementation would generate sufficient countervailing benefits for consumers. Suppliers remain bound by their licence obligations. Beyond this, they would retain flexibility over the speed of any adjustment actions, meaning that we could have no guarantee that consumers would see benefits from the additional revenue.

6.13 Furthermore, we do not consider it appropriate to give suppliers more time to adapt to the methodological changes. Firstly, despite the overall decrease in the allowance, the new core operating cost allowance is set using a less stringent benchmark than the existing allowances. Secondly, suppliers have had less time to implement more material changes in the past, including when we first introduced the operating cost allowances in January 2019.

## **Baseline costs**

- 6.14 One supplier told us that the current headroom allowance is not fit for purpose and should be significantly higher. It added that despite this, we continue to rely on the headroom allowance to offset uncertainties.
- 6.15 We have set the core operating cost baseline with regards to known uncertainties. This is reflected within our use of a weighted average baseline, cost-reflective allocations, and a CPIH update approach. Furthermore, we do not consider a review of the headroom allowance to be within the scope of the operating cost review. Given this, we have not formed a view on whether the headroom allowance will definitely provide a mitigation for future uncertainties. We simply note that the cap does include a headroom allowance, which could potentially provide an additional mitigation for uncertainties. For the avoidance of doubt, headroom does not form a key part of our rationale for our core operating cost benchmarking decision.
- 6.16 One supplier said that an allowance for revenue leakage (ie money which is not billed to customers for consumption which has occurred) should be included within the core operating cost allowance, or the headroom allowance. While it considers excessive revenue leakage to be within suppliers' control, it said that revenue leakage will never be zero. Therefore, it proposed a revenue leakage allowance of between 0.75% to 1% which it said would provide a stretching target for suppliers, while retaining an incentive reduce overall revenue leakage.
- 6.17 We do not consider revenue leakage to be within the scope of the operating cost review, as this does not relate to suppliers' operating costs.