

Thursday, February 6, 2025

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Dear Daniel,

Re: Energy price cap operating cost and debt allowances consultation

We welcome Ofgem's efforts to improve the design of the default tariff price cap. The proposed new structure is easier to engage with. Most of Ofgem's current proposals are those which we stated a preference for in our response to the May 2024 Energy Price Cap: Operating cost allowances review. Our preferences and their justification remain valid.

Our feedback is focussed on the consequences of the proposed cap value. The cap was introduced as a temporary measure with the objective of addressing supposed supplier inefficiencies identified by the CMA. Ofgem recognise that those efficiencies have now been captured¹. We are concerned that further reductions to the level of the cap will negatively impact the long-term health of the sector.

Ofgem's minded-to position results in a -0.4%/-0.5% decrease in EBIT² as a proportion of revenue. Ofgem must consider whether this is justifiable, given that almost all Suppliers have been unable to recover against the EBIT allowance in previous cap periods. This is at a time where there are above inflation cost increases (national insurance, living wage) which have not yet been accounted for in operating costs.

The energy retail sector is approaching a period of significant change, with Market wide Half-Hourly Settlement and Net-Zero initiatives likely to significantly change consumption and billing arrangements. For this sectoral transformation to be successful, Suppliers must be able to adequately fund mandatory schemes and invest in associated innovations.

The original aims of the price cap have been achieved. The long-term health of the sector is best served by creating an environment which encourages investment and growth. The concept of a Notional Supplier is now harming the retail market. Ofgem recognise that there is no such thing as a typical Standard Credit or Prepayment Customer. An overly simplistic model can never account for such differences. The needs of customers are best met by allowing Suppliers to tailor their offerings as they see fit, and letting competition run its course. This includes allowing Suppliers to make reasonable profits, as determined by market forces.

¹ "However, the cap is no longer a temporary measure, and we consider the most significant efficiencies have already been captured" [p4. Energy price cap operating cost and debt allowances consultation: overview]

² Table 8, p21. Impact Assessment

Ofgem uses Supplier data submissions as the foundation for all price cap calculations. Ofgem recognises there are inconsistencies in cost allocations between Suppliers. These inconsistencies are consequential when over 50% of the market is shared between three Suppliers³. These inconsistencies lead to allocations across payment methods being inaccurate. These inaccuracies have significant impacts on Suppliers who focus on specific payment methods and customer types.

We make two requests of Ofgem:

1. **Scale the Allowance** - Ofgem recognises that Suppliers have been unable to recover against the EBIT allowance in previous caps⁴. Ofgem is aware of the impact on investability by setting allowances below costs.^{5 6} A further reduction in EBIT is proposed because of these proposals.⁷ Ofgem must increase the proposed EBIT allowance to allow Suppliers to make reasonable profits.
2. **Price Cap Calculation Approach** – A small sample size and difference in cost allocation between Suppliers limits reliance Ofgem can place on Supplier data submissions. Ofgem should instead take reported profitability as stronger indicators of appropriate price cap values.

Scale the Allowance

Our analysis shows that almost all retail energy Suppliers reported negative EBIT in 2019-2022. This mirrors Ofgem's own reporting⁸. Historic data shows that the EBIT allowance must be increased. Negative EBIT is not sustainable, nor is it in the long-term interests of customers.

The Supplier market is in a challenging place if a further 20% reduction in EBIT is proposed. This 20% EBIT reduction will deliver just 1% on customer savings at current price cap level. This short-term saving is at the cost of the long-term health of the industry. Individual success stories are an exception and there has been a significant number of Suppliers leaving the market. Ofgem risk further consolidation of the market and removing the possibility of future competition. This is not in keeping with Ofgem's primary objective. It is worth noting that this lack of competition in the prepayment sector is what the CMA cited as one of their reasons for intervention⁹. The cap now risks creating the exact problem is sought to solve.

We also note that since 2022 supplier costs have continued to rise, and bad debt has increased significantly. All this points to increase in operating cost allowances rather than decreases.

We propose that the EBIT allowance should be increased. Supplier performance against previous cap levels can be analysed and Ofgem can apply an increase to the allowance which allows for Suppliers to make reasonable profits. Ofgem can then assess the reported profitability of the sector and adjust future allowances as necessary.

³ Ofgem Website Data Portal– "Electricity supply market share by company – Domestic"

⁴ *Aside from periods affected by adjustments for previous under recovery, suppliers have generally made profits below the EBIT allowance in the cap* – p27, appendix 1

⁵ *"we do see significant risk to the investability of the sector if we were to set a long-term signal that allowances were to be set significantly below average costs."* 2.21 p 18, main document

⁶ *"do not consider a permanent approach to setting allowances at a level where the majority of the market does not recover their costs would be sustainable"* p5, main document

⁷ Table 8 – p21 – Appendix 5 - Impact Assessment

⁸ Ofgem Website Data Portal– "Domestic supply profits by £ million by Supplier"

⁹ *"Our analysis of the prepayment segments suggests that competition is significantly weaker than in the wider GB domestic retail energy markets"* 164, p 46 <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

Price Cap Calculation Approach

Ofgem recognise that inconsistencies between Supplier data submissions limit the reliance they can place on their data sets. These limitations have correctly led Ofgem to propose to use weighted average calculations in some places.

Ofgem's proposed total operational cost allowances see just a £2 difference between Direct Debit and Prepayment¹⁰. Ofgem cannot reasonably expect the difference in net operational costs for these customers groups to be just £2.

We also challenge the use of the same benchmark consumption value for SC, DD and Prepayment customers. Ofgem assess the recoverability of costs assigned to unit rates against the same consumption profile for every payment method. This approach does not account for the lower consumption levels of prepayment customers. Ofgem's approach here results in relative under-recovery of costs assigned to unit rates for prepayment customers. We request that payment specific consumption benchmarks are used.

SMNCC

Ofgem must assess whether the continued rollout of smart meters is delivering operational cost savings for Suppliers. The SMNCC model may have been appropriate during the start of the smart rollout, where cost and benefits were unclear and the use the DESNZ Impact Assessment was unavoidable. Ofgem now have operational cost data which shows the impact of over 65% rollout completion. Continuing to use an adjustment mechanism set against an impact assessment is no longer necessary.

We have incontrovertible evidence, as an efficient smart prepay specialist, that smart prepay customers are not cheaper to supply. They still need extra support, and with the increasing price cap requirements and restrictions imposed by Ofgem, these operational costs continue to rise. Prepay customer debt is rising, and smart prepay customers are seventeen times more likely to contact us for help and support than a smart credit customer – these calls are also longer and operationally expensive. Technology can provide efficiencies as well as increased value and protection for customers, but the costs are also higher.

George MacGregor
Head of Market Policy

¹⁰ Table 4 - £279 proposed allowance for direct debit, £281 for prepayment

Appendix 1: Core Operating Costs

We are supportive of the case for change. It is time to update the operating case baseline from a 2017 value. The proposed new structure of the core operating cost allowance is easier to engage with and will make it easier to track future changes.

The proposed modelling approach is justified but we are concerned the outcome does not meet Ofgem's stated goals, as we describe in our cover letter. A mathematically justifiable approach can still deliver outcomes which hurt the long-term health of the sector.

We also highlight known increases to operational costs which Ofgem have not yet accounted for.

3. Additional Operational Costs

There are known increases to operational costs which Ofgem have not accounted for. We anticipate increases to staff costs due to increases in the living wage and National Insurance.

We do not believe that Ofgem have fully accounted for the increased costs of additional regulatory burden. Capital adequacy requirements have a particularly large impact on a Supplier's costs. Ofgem must uplift the cost allowances to account for these.

4. Benchmarking Approach

We continue to support the proposal to benchmark at an aggregate level. It is unreasonable to expect Suppliers to disaggregate their costs in a uniform manner. There will be unavoidable inconsistencies which means only total cost figures can be relied upon. Even the approach to calculation of total operational costs will vary between Suppliers.

The basket of costs which form operational costs are made of business elements which cover both fuel types and all payment methods. Disaggregating costs stemming from customer contact or metering will be incredibly challenging to do on a payment method or fuel type basis. Especially when customers frequently move between payment methods and many customers are dual fuel.

As Ofgem recognise that suppliers have increased their efficiency over the span of the price cap, the use of a lower quartile frontier efficiency measurement no longer seems appropriate. We therefore support the use of a weighted average calculation across aggregate supplier operational costs.

It is encouraging that Ofgem agree this and have opted for Option A. We note that this recognition of inaccuracy is not factored into the allocation approach decision.

Sample Size

Here we again draw attention to the issue of the sample size. The removal of 3 suppliers results in the proposed allowance decreasing from £261 to £245¹¹. Whilst we understand the justification for removing these 3 suppliers, it should indicate how small the sample size

¹¹ 3.80 p25 vs table 1.1, appendix 1

Ofgem is now working with and how the removal of three Suppliers can reduce the PPM costs by ~40% of the EBIT allowance¹².

5. Allocating core operating costs across customer groups

Context

Ofgem propose to use cost data from suppliers to calculate the weighted average differences in costs for serving SC and PP compared to DD. However, Ofgem state that *"The RFI data shows significant variation in suppliers' methodologies for allocating their core operating costs between payment methods and fuel types. Several suppliers also stated that they had difficulties in splitting some cost lines between different customer groups."*¹³

It is questionable how reliable Supplier submission can be for calculating the allocation of costs across payment types.

Proposals for payment methods and fuel types

Only including suppliers with over 100k customers does not achieve the goal of *"ensuring payment methods are representative"*. It does not guarantee accurate apportionment methods.

Removing Suppliers with fewer than 100k customers in each payment type has a significant impact on the premium applied to payment methods. (£38 vs £54 for SC, £55 vs £78 for PPM), and with Ofgem's stated goal of setting a less stringent cap, it suggests that these Suppliers should be included in the sample.

Suppliers with fewer than 100k customers in a category are representative of new or growing suppliers. Excluding their costs means that only larger Suppliers can recover their costs. This both prevents new entrants from being profit making and prevents large suppliers from benefitting from economies of scale. These are two factors we should encourage in a healthy market.

It could equally be argued that suppliers with fewer customers are better at allocating costs as the cost centres are relatively new – especially given that Ofgem recognise allocation is poor amongst large suppliers.

Ofgem recognise that there are factors within group that result in a different cost to serve but fail to recognise that certain suppliers capture specific cohorts of customers¹⁴. Some Suppliers can operate under the cap due to capturing a specific cohort of customers (as they focus on capturing those.) Others have customers which are higher cost to serve. Setting a uniform price cap across these two organisations is not valid as the factors which influence cost to serve are not being correctly captured – instead overly simplistic payment method and fuel type categories are used. A price cap can never account for such differences in customer base. Whilst a price cap remains, Ofgem make certain customers unprofitable. This in turn leads to these customers being underserved.

¹² 16/43 = 37.2% (261-245 = 16), £43 EBIT allowance from <https://www.ofgem.gov.uk/energy-price-cap>

¹³ 3.44, main consultation document

¹⁴ 4.22, main consultation document

Proposals for Standing Charge and Unit Rate

These values are calculated at benchmark consumption values, which prepayment customers are likely to fall beneath. Average consumption will be lowest for prepayment customers, making their performance against benchmark values most likely to fall short. Suppliers with a higher weighting of prepayment customers are unfairly penalised through any allocation to unit rate when a blanket¹⁵ consumption approach across payment types is applied. We request that payment method specific consumption profiles are used.

6. Updating the core operating cost allowance over time

Regulatory change is one of the most significant influences on operational costs. Linking the current allowances to CPIH is only appropriate if the market and associated costs are expected to be stable and unchanging. Analysis of the past five years show that this is unlikely to be the case.

Ofgem must commit to an update process which accounts for additional cost pressures and regulatory change.

¹⁵ E.g., 3,100 kWh for single-rate electricity, 12,000 kWh for gas and 4,200 kWh for multi-rate electricity

Appendix 2: Debt Related Costs

Debt related costs continue to rise. We support the proposal to set a distinct allowance for debt-related costs within the operational cost element of the price cap.

Utilita provided £60m in Additional Support Credit to prepayment customers in 2023. We are concerned that insufficient allowance is granted through the price cap to account for the impact of ASCs. We provide full commentary on the prepayment debt burden in our response to Ofgem's Resetting the Energy Debt Landscape consultation.

Levelisation remains the best way to approach the distribution of debt-related costs. Any other approach would result in unfair treatment of specific customer groups.

3. Update Mechanism

Using bill size as an update mechanism is appropriate for minor changes in total energy costs. If Ofgem can see a strong correlation between the two then the mechanism would seem appropriate.

Affordability and debt remain a significant challenge. Any update mechanism must be flexible and Ofgem must be prepared to adjust the cap quickly to account for increased costs.

We would appreciate Ofgem providing a worked example of how such a bill size update mechanism would work. For example, model against the price increases in the energy crisis and demonstrating how a repeatable update mechanism would have resulted in the cap adjusting correctly.

Appendix 3: Smart Metering Costs

It remains our position that the best way to handle the impact of smart meters is to remove SMNCC and for core operational costs to be measured assuming smart meters as the norm.

We do not agree with Ofgem's view of smart prepayment offering such a large difference in savings in comparison to other payments. Whilst there are savings against the 2017/2023 benchmarks delivered through the rollout of smart meters, much of this benefit is passed on to customers. Prepayment suppliers do not capture this benefit – it is undeniable that the level of service and assistance offered to smart-enabled prepayment customers is greater than for those with a traditional meter.

We have incontrovertible evidence, as an efficient smart prepay specialist, that smart prepay customers are not cheaper to supply. They still need extra support, and with the increasing requirements and restrictions imposed by Ofgem, these operational costs continue to rise. Prepay customer debt is rising, and smart prepay customers are seventeen times more likely to contact us for help and support than a smart credit customer – these calls are also longer and operationally expensive. Technology can provide efficiencies as well as increased value and protection for customers, but the costs are also higher. Unfortunately, the Cap is still based on legacy levels of communication and services.

3. Post-2025 Framework

We agree that decisions on SMNCC can be made before the introduction of a post-2025 framework. We welcome Ofgem's statement to consider SMNCC again following publication of any new DESNZ framework.

4. Updating the SMNCC Baseline

We recognise that SMNCC attempts to model for the difference in operating costs against the baseline year due to the rollout of smart meters.

Updating the SMNCC baseline year to a more recent year is also reasonable. Updating the baseline year for core operating costs requires the SMNCC baseline year to be updated to the same year.

5. Costs and Benefits

We agree that the approach for calculating NPT SMNCC allowance is too complex. There are simple assumptions made about decreasing costs to serve. There are no equivalent assumptions made about the greater level of service and regulatory burden which smart meters enable.

We recognise Ofgem's minded-to position to update the SMNCC to cover asset, installation, PRCs for traditional meters, IHDs and non-zero direct operational benefits. We note that a high level of PRCs and device costs are due to land imminently due to the transition to 4G. Ofgem have not accounted for these increased costs – costs which will be comparable to those from the initial smart meter rollout. We request that PRCs should be included for smart meters too, as these will inevitably increase during the 4G transition. The costs of repeat visits to properties to install new generation Communication Hubs (ignoring the cost of the hubs themselves) must be accounted for as these are unavoidable costs. These costs are outside the control of Suppliers and yet appear to be unaccounted for.

Appendix 4: Industry Charges

Industry charges are the simplest cost element to measure and reconcile. Charges are forecast in advance and variations from forecasts are identifiable through individual invoicing. There should be no categorisation or allocation challenges.

These charges should be set against forecast costs from each source. Costs should be reconciled on an annual basis and subsequent cap periods adjusted to account for over or under-recovery.

Some industry charges have been unaccounted for in previous cap periods (e.g., RECCo). An annual review process should be conducted to ensure all costs are accounted for.

Customer advocacy groups expect Suppliers to exert downward pressure on these prices. These prices stem from tightly defined governance process of which Ofgem has sole oversight. Ofgem must do more to decrease these costs. They now present around 10% of the operating cost allowance. Our experience is that Suppliers are frustrated in their efforts to reduce costs, especially those of the DCC which now represent ~90% of total industry charges.

3. Proposed Approach to setting the allowance

We support the proposal to use Option 2 to set the allowance for Industry charges. A six-monthly review window is frequent enough to balance changes with administrative burden.

We note Ofgem's comment on the relatively small materiality of changes to these prices but draw attention to the fact that the proposed £2.81 increase for this cap period represents ~6% of a Suppliers EBIT allowance. Whilst such values are small in the context of the cap, they have significant impact on Supplier profitability.

Recovery Mechanism

Allocating any cost recovery across payment methods is only accurate if done on standing charges. Otherwise, lower consuming groups will suffer under-recovery of new allocation as less of the unit rate allocation can be captured.

Update Mechanism

As the purpose of this review is to set an enduring gap, this is the best opportunity to agree a process to update the allowance against any new code body costs.

We propose that an agreed process should be implemented. This process must include a mechanism to reconcile costs in future years to ensure the element has been entirely balanced. We must isolate individual elements of the cap and aim for accuracy and appropriateness. We cannot dismiss inaccuracies under the assumption they will be made up for elsewhere. This approach is unjustifiable when the proposed EBIT margins are so tight and further reductions are proposed.

DCC Costs

The price control mechanism is not effective in controlling DCC costs. Ofgem must review DCC charges to identify if they are offering value for money and evaluate these against the goals of the SMIP. These costs end up on customer bills and the expectation is on Suppliers to manage them. We wish to make it clear that our ability to do so is limited.