

Non-confidential

6 February 2025

Dear Danny,

Response to Energy price cap operating cost and debt allowances consultation

Thanks for the opportunity to respond. As there are no specific questions in the consultation, we have structured our response in line with the appendices (core operating costs, debt-related costs, smart metering costs and industry charges). We have limited our response to areas where we have substantive comments. We also attach a data report provided by our advisers, Charles River Associates,¹ who had enhanced data room access and, where relevant, reference this in our response.

In summary:

- We support the simplification of the operating and debt cost allowances and agree these do not need frequent reviews.
- We retain our original positions that operating and debt cost allowances could be benchmarked at a more stringent level than the weighted average. We don't agree that there are no more substantial efficiency savings to be found.
- We would like to see Ofgem continue to drive down the payment method differential between standard credit (SC) and direct debit (DD) customers, which in our view is still too large. We would like to see this done by ensuring suppliers become better at managing SC customers, not by levelisation. Ofgem could potentially use the planned billing MCR to review industry practice.
- Ofgem should look to other policy areas beyond the price cap to make the energy retail market more investable.

Overall, we welcome the progress that Ofgem has made in this long-running review of supplier operating costs and the direction to make the cap less complex. In particular, we support Ofgem moving towards fewer benchmarking parameters, a top-down aggregated approach to measurement and an approach that does not require frequent reviews. We also support Ofgem putting all 'pass through' industry costs together. These will help to support a proper, informed decision about the adequacy of the cap. We urge Ofgem not to move backwards from these positions.

¹ We appointed Charles River Associates to act as our Advisers to access Ofgem's data room and models on our behalf. To inform our response, they provided us with data which was agreed with Ofgem prior to sharing with us and advice on how Ofgem's models worked.

We support Ofgem's concerns about maintaining investability in energy suppliers, but believe there is still a role for the price cap in driving efficiencies. Our position in the market suggests there are efficiencies to find, through investment in technology and staff. We believe there will continue to be efficiency savings over the coming years, and through the price cap Ofgem has a role to play in driving these to be realised.

With respect to benchmarking, we retain our original position that operating cost and debt-related cost allowances could be benchmarked at a more stringent level than the weighted average, which simply allows suppliers to recover the average reported cost across the industry, rather than reflecting notionally efficient costs. For operating costs, it is evident that the market has found efficiency savings since the price cap allowances were first set, but these are not evenly distributed across suppliers.

With regard to the debt allowances, our view remains that supplier performance plays a significant role in determining whether customers keep on top of their energy bills or fall into debt or arrears, and in previous consultation responses we have provided evidence to Ofgem of our experience with better supplier performance reversing the downward trend in repayments.² Ofgem should look to take a greater role in driving good supplier practice in this area and should not view debt as an exogenous variable that suppliers cannot do anything about, which is simply a feature of a supplier's customer base. This could have involved setting a more stringent benchmark for debt-related cost allowances than the weighted average, but also includes action on billing frequency and accuracy and speed and quality of complaint resolution.

We are surprised at the outcome of this review with regards to payment method allocations, as the SC uplift has increased (under Ofgem's proposals). We have consistently argued that, particularly after separating out debt costs, we see little difference in cost to serve between SC and DD customers. In this context, we are disappointed to see the SC customers paying £19 more compared to DD customers compared to the allowance in cap 13a. We are also surprised to see the huge difference in debt costs between SC and DD customers under a supplier-reported costs approach, and note Ofgem has had to change course and maintain the current differentials. In this case, we think this is the right course of action given the need to keep SC costs down.

However, Ofgem should not continue down the path of socialising costs between different customer groups, which risks creating a moral hazard and substantially reduces incentives for suppliers to innovate and improve their service offering. We would like to steer Ofgem strongly away from carrying out Phase 2 of levelisation.

On a broader note, updating only some of the allowances (i.e. operating costs, debt-related costs and SMNCC) can lead to a complex set of models that may introduce methodological inconsistencies across price cap allowances, subsequently affecting whether a benchmark is transparent, consistent and reliable. For example, later in our response we discuss the lower quartile benchmark for debt-related cost allowances resulting in a higher allowance than the weighted average, due to an interaction with the EBIT allowance. A simultaneous review of

² See Octopus Energy's responses to the previous operating cost review [consultation](#) and the debt and affordability [call for input](#).

all cap allowances would reduce the likelihood of these inconsistencies, and Ofgem could consider doing this in the round as it develops its thinking on the future of price protection.

More widely, if Ofgem wants to drive more investment in the retail market, rather than simply allowing suppliers to recover the average reported cost we believe it should look at these policy areas:

- **Financial resilience and capital adequacy reforms** - we have provided significant feedback to Ofgem of the potential unintended consequences of this policy on investment and competition in the GB retail market. The rules require firms to hold a significant degree of regulatory cash and capital and the impact is unevenly spread across types of firms, largely depending on length of time in the market and type of investor. The details of the reforms are untested. We encourage Ofgem to monitor closely and take corrective action where it is needed.
- **Competition and a level playing field** - markets which are more competitive, with a level playing field across actors, are much more likely to attract investment both in existing players and new entrants. Octopus Energy entered the market in 2016 as a challenger, and through investment in technology and people, has grown to be the largest energy supplier in Great Britain. We are concerned by differing levels of regulation between different firms engaging in energy services, including flexibility services, and we encourage Ofgem to ensure that its approach to regulating different players in the energy market is consistent and there are consistent consumer protections in place.

We have previously suggested to Ofgem that future price protection must be universal and apply to all customers when they do not engage, but how this looks should evolve over time. For example, in the future this could include simple default time of use (ToU) arrangements, at least for some customers. We encourage Ofgem to ensure the new cap allowances are easily translatable to any new price cap that it is considering e.g. zero standing charge, ToU.

Lastly, we urge Ofgem to proceed with implementation of the new allowances at pace to provide certainty to the market.

We are happy to answer any questions Ofgem may have about our response.

Best regards,

Alexandra Meagher
Group Head of Regulation



Operating costs

In summary, we believe that Ofgem could take a more stringent approach to benchmarking core operating costs than the weighted average, to maintain more of an efficiency incentive as there are still savings to be found. We also believe that the payment method differential is too wide, and Ofgem should do more to drive this down through improving supplier performance in this area. We urge Ofgem not to do this through levelisation which carries moral hazard and can be distortive. Ofgem could also set out an approach to reviewing the allowance over time. This does not mean that this needs to be frequent.


Our specific reactions to Ofgem's proposals are as follows:

Benchmark metric

We understand the reasons why Ofgem has proposed to take a weighted average approach to benchmarking. We have considered these, but still maintain our position that a lower quartile approach would be preferable. Overall, this would encourage greater efficiency and result in lower prices for consumers, at a time when many are struggling to afford their energy costs. A weighted average provides a weaker efficiency incentive for suppliers, as only those who are above the benchmark are really encouraged to improve efficiency, and on average the market is simply allowed to recover the costs they have reported. The benchmark should be based on an efficient supplier, rather than the average of costs reported by the market.

In response to the previous Ofgem consultation, we provided evidence showing how our investment in people and technology can reduce the number of customer service agents needed to serve a customer base, with no negative impact on customer service levels. We also cite the recent findings from the Energy Consumer Satisfaction Survey, published by Ofgem in November 2024,³ which found that Octopus Energy and Utilita were the only suppliers with a significantly higher proportion of customers who said they were satisfied or very satisfied with their supplier overall, compared to the average for July 2024. In addition to this, our advisers, Charles River Associates, advised us that for a DD dual fuel customer at benchmark consumption, the operating cost allowance excluding Octopus data (i.e. removing Octopus' data from the benchmarking) would be £ per year, while if only Octopus data was used, this would be £ per year.

This demonstrates that there is a wide range in reported costs from suppliers and, while the market has found significant efficiency savings since the price cap allowances were set, these are not evenly distributed across suppliers. This should make it clear to Ofgem that there are further efficiencies to be found in some suppliers.

We also expect that technology developments in the future will help suppliers find further efficiencies in operating costs. For example, the technology platform Octopus uses, Kraken, has unlocked a cost to serve which is ~% lower than other major retailers. Other major

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<https://www.ofgem.gov.uk/sites/default/files/2024-11/Customers%27%20satisfaction%20with%20their%20supplier%20-%20supplier%20level%20findings%20-%20July%202024.pdf>

retailers that have licensed Kraken have seen improvements in learner operations (increases in customers per service agent), cost savings (a £~~10~~⁹ earnings jump for one retailer) and increases in customer service. We expect therefore that other suppliers can achieve better efficiencies and better customer service. As we have set out in previous consultation responses, we also consider that artificial intelligence will play an important role in driving efficiencies while improving (or at the very least maintaining) customer experience, or at least stem increases in operating costs resulting from providing greater levels of support to vulnerable customers.

Allocating across customer groups

Payment methods

In our previous response, we said that Ofgem should take a more cost-reflective approach to allocating costs between payment methods, while also recognising the limits of interpreting the data provided by suppliers which are based on assumptions and subjective allocations. In particular, we felt that the uplift for SC and prepayment meter (PPM) customers was too high and Ofgem should try to drive this down (before levelisation, for PPM customers).

We are disappointed that the new operating cost allowances will result in an approximate £19 per customer per year increase in the uplift between SC and DD customers, compared to cap 13a,⁴ and are surprised that this has happened despite debt-related costs being moved into a separate allowance. Given that Ofgem has taken the approach of using the weighted average of supplier-reported differentials, we can only assume this outcome is a result of the subjective allocation of supplier costs between different payment methods. We are especially surprised by this as we are not aware of any difference in operating costs between serving SC and DD customers and reported this to Ofgem accordingly. This clearly demonstrates that cost allocation is as much an art as it is a science, and different suppliers are going to take very different approaches to doing this, and there is a significant degree of information asymmetry between Ofgem and suppliers. We discuss this further in our **wider comments on Ofgem's approach to the operating cost allowances review**.

We want Ofgem to continue to drive down price differentials, which are too high. However, this must not be a socialisation of costs and should not come at the cost of increasing prices for DD customers. Further artificial levelisation is not the right solution and we support Ofgem pausing Phase 2 levelisation. Instead, Ofgem should consider reviewing what suppliers are doing to make SC customers aware of the premium that they are paying, and see how effectively this is changing customer behaviour. This could be done through the planned billing MCR. We have been able to drive down the cost to serve SC customers vs DD customers, and this should be achievable for other suppliers too.

Standing charges and unit rates

⁴ From Table 4.1 in [Appendix 1: Core operating costs](#). The proposed operating cost allowance for a dual fuel customer with benchmark consumption for SC is increasing by £4 compared to cap 13a, while for DD this is decreasing by £15.

We have previously provided evidence to Ofgem on the potential distributional impacts of re-allocating operating cost allowances from standing charges to unit rates.⁵ Ofgem has now moved away from this proposal, and overall we agree with this approach.

Updating the allowance over time

We agree that the allowance should not need to be updated frequently, especially given that Ofgem has provided a more generous, weighted average approach to benchmarking. However, this does not mean that it does not need to be reviewed in the future. Ofgem should not simply implement the new allowance without any review periods or timeframes in mind. We recommend that Ofgem sets out a schedule for future reviews of the new operating cost allowance, which will enable it to observe whether the allowance is set appropriately and if needed, implement an adjustment.

We also agree that there is no need to update the allowance frequently to account for any known upcoming regulatory changes, including improvements in consumer standards or implementation of MHHS.

Debt related costs

In summary, we support Ofgem's proposals on the case for change and bringing more transparency to the debt allowances. We also support Ofgem's proposals to maintain the current payment method differentials in this case, as the supplier-reported differentials are too wide. We encourage Ofgem to consider a more stringent approach to benchmarking than the weighted average, as debt is not entirely exogenous and out of suppliers' control. Ofgem should take a transparent approach to updating the allowance in future if debt costs change materially.

Our specific reactions to Ofgem's proposals are as follows:

Case for change

We agree that simplifying the various debt-related allowances into a distinct debt allowance is the right approach. Historically, it has been very difficult to observe the debt-related allowances in the cap and to compare this to actual debt costs incurred. We note the challenges of estimating the current debt-related allowances in the price cap, mentioned by Ofgem in its additional debt costs review consultation from last year.⁶ Moving forwards, it is preferable to avoid this situation. Transparency is key, and it is right that stakeholders should have clear visibility over the debt-related costs allowances contained in the price cap.

Data and cost components

In our previous consultation response, we advocated for dividing the debt allowances into (i) a separate allowance for bad debt; (ii) a separate allowance for debt-related administrative costs; and (iii) address working capital costs through the EBIT allowance. Separating out (i)

⁵ See our response to Ofgem's Standing charges: domestic retail options [call for input](#).

⁶ Ofgem, [price cap: additional debt costs review consultation](#), January 2024.

and (ii) would help to emphasise that debt-related costs are about understanding ‘what is the efficient number of customers in debt?’ and ‘what is an efficient debt administration cost?’ as these may have separate answers and drivers. We understand the reasoning that Ofgem has raised, but we maintain this position.

If Ofgem is to proceed with its decision for consolidating these costs into a single allowance, in line with our above points about transparency, Ofgem should publish the value of all three debt allowances in each price cap update. This could be included in an annex accompanying the updated price cap documentation.

Benchmarking approach

Baseline period

It is right that Ofgem waits until it has the latest available data to make this decision and to explore the impact of different baseline periods on the resulting allowance. We do not have strong views on the baseline period that Ofgem selects, between the last 4 and last 8 quarters. However, Ofgem should be seeking to make the allowance as cost-reflective as possible into the future, and therefore our preference is to use a baseline period that is most indicative of the long-term future conditions for energy debt-related costs.

With this in mind, it is important that Ofgem recognises the context in which these new debt-related cost allowances are being set. Over the last few years, energy debt has increased to historic levels, but this may not continue. It would be particularly detrimental to consumers if Ofgem set a forward-looking allowance which meant that suppliers were over-recovering at the expense of consumers. Therefore, it is important that Ofgem continues to monitor debt and adjusts the allowances if conditions change materially. However, Ofgem should not carry out resource-intensive, drawn out true-up exercises.

Benchmarking across parameters


We agree with Ofgem’s proposed approach to aggregate costs across payment methods, as this methodology is less subject to information asymmetry around suppliers’ allocation methodologies. We also note that there can be an inverse relationship between bad debt costs and debt-related admin costs, so aggregating the three debt related costs before benchmarking is the right approach.

Benchmark metric

It is difficult to set out whether we agree with Ofgem’s proposed weighted average approach to debt-related cost allowances without seeing alternative data. While Ofgem has disclosed some data in this process, we have been unable to see any figures for debt-related cost allowances under different benchmark metrics (unlike what has been shared for the operating cost allowances).

In the absence of this information, in principle we support a more stringent approach than the weighted average, that drives suppliers to be better at recovering debt. This could be a lower quartile approach, but we note a quirk in this approach given Ofgem’s methodology


could mean that the lower quartile debt allowance is higher than the weighted average.⁷ Therefore, in this circumstance the lower quartile would not be appropriate, but Ofgem should consider an approach that drives suppliers' efficiency, such that the allowance is less than the weighted average. We believe that Ofgem should be cautious about simply assuming that debt-related costs are purely driven by the make up of the supplier's customer base, or that debt levels are an exogenous variable outside a suppliers' control. We reiterate our view that supplier performance plays a significant role in determining whether customers keep on top of their energy bills or fall further into arrears or debt, and our experience shows that better supplier performance can help reverse the downward trend in repayments. There is more that Ofgem can do to drive good supplier practice in this area.

With this in mind, we note that the debt allowances under the proposed methodology for a dual fuel DD customer in June 2024 prices would be £60 per customer per year, while if only Octopus data was used, this figure would be £ per customer per year. This difference is made possible by how we manage customers and debt differently. We have provided evidence of this in our previous consultation response as part of this operating cost review, showing the change in behaviour of customers in debt after we took on failed suppliers.

Update mechanism


We agree with Ofgem's proposals for updating the debt allowances, but note that there is not always a linear relationship between bad debt costs and energy costs, and Ofgem should monitor this relationship moving forwards.

SMNCC

We are disappointed by Ofgem's decision not to include premature replacement charges (PRCs) for SMETS2 meters in the SMNCC model as we are not confident that these charges are fully represented in the 2023 baseline operating costs. PRCs for SMETS2 are much higher than for SMETS1 and the proportion of PRCs for SMETS2 vs for SMETS1 will increase over time. For example, our data suggests that in 2024, our SMETS2 PRCs were nearly a  than they were in 2023. This is in part down to our growth, but we have for some time advocated and prioritised a customer-focused smart meter rollout, which includes ensuring faulty meters are replaced quickly and customers are benefiting from having a working smart meter. We urge Ofgem to keep this cost under review as part of its usual updates to the SMNCC.

Industry costs

We support Ofgem's proposals to set an allowance for industry charges as a separate pass-through component going forward and the proposals for implementing this. These are fixed costs that suppliers incur which are distinct from a supplier's operating costs.

⁷ We requested Charles River Associates to advise us of the value of the debt-related cost allowances under a lower quartile approach, to help inform our response to this consultation. Ofgem did not provide permission for them to do this, but allowed them to provide a qualitative indication that the lower quartile allowance was  than the weighted average allowance.

However, we would like Ofgem to consider its decision to allocate these costs across standing charges and operating costs using the existing cap approach. We have always encouraged Ofgem throughout this review to take a cost-reflective approach where possible, while also recognising the situations where this might not be possible. In this case, pass-through industry charges are clearly incurred on a per meter basis. In this context, could Ofgem take this opportunity to make this allowance cost-reflective and apportion this allowance (or at least the vast majority of it) to the standing charge?

To be clear, we **do not** support any increase to standing charges on energy bills overall and believe Ofgem should look to remove or minimise fixed costs in the energy system wherever possible. Therefore Ofgem would have to re-adjust the ratio of standing charges to unit rates in another allowance to accommodate this. This could be done in an allowance which is more driven by consumption.

Wider comments on Ofgem's approach to the operating cost allowances review

In addition to our reactions to Ofgem's proposals, we provide below some wider thoughts on the operating cost allowances review that Ofgem has been carrying out over recent years. These comments also apply to the debt-related cost allowances.

When conducting statistical analysis, the sample size is crucial in determining the reliability and accuracy of the results. A small sample size can lead to uncertainty and unreliability due to several potential factors, including increased variability which is not representative of the population, the disproportionate impact of outliers and errors and wider confidence levels indicating greater uncertainty. For this consultation, 12 suppliers have submitted data to Ofgem, which is already a small sample before excluding any suppliers from the analysis. Therefore, the analysis of this small sample is highly sensitive to the data submitted by each supplier. This sensitivity means that setting the allowances based on a single point in time and a single set of reported data could result in allowances that could quickly become out of line with suppliers' actual costs. As a result, further updates may be necessary in future.

A related issue is that different allocation methodologies used by suppliers may result in large variance in the data reported. As raised by Ofgem in Appendix 1 of this consultation:⁸

- The RFI data shows significant variation in supplier's methodologies for allocating their core operating costs between payment methods and fuel types.
- Ofgem found that suppliers have allocated costs using inconsistent approaches across Ofgem's sample.
- There are inconsistent approaches among the suppliers in Ofgem's sample, as well as within suppliers' own cost lines. This limits the degree of cost reflectivity and hinders Ofgem's ability to understand variation in suppliers' efficiencies.

This suggests a broad variety of cost allocation approaches among suppliers in response to Ofgem's submission instructions, highlighting a need for regular updates and aligned data capture. While Ofgem's proposed aggregate level, weighted average benchmarking attempts to address this, the validity of the results remains uncertain given that this is the

⁸ Paragraphs 3.44-3.47

first instance of suppliers submitting data in this format and benchmarking inherently requires a reasonable degree of comparability across suppliers.

The plans for future reviews are unclear. However, if this process is repeated with new submissions from suppliers, Ofgem could then assess the volatility and reliability of the data by identifying outliers, comparing the spread between submissions and determining whether the dataset is inherently volatile. Under different data distributions, the allowance results could vary significantly.