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Energy price cap operating cost allowances review

We agree that it is important to recognise that this review is being undertaken within the context of a number of wider interrelated reviews of pricing reforms. At a high-level level, we believe it is important to separate out the impact of the wider context on this review into 2 distinct areas:

- Areas considered within this review that would be better resolved elsewhere. In particular, we believe the allocation of operating costs between standing charges and unit rates should be done on a cost-reflective basis. Competitive distortions are created when allowances vary from actual costs faced. This can be managed by a process to levelise costs but should be left to the ongoing standing charge review. This will also ensure a more direct and transparent discussion.
- Areas where decisions made elsewhere may affect considerations within this review. For example, the introduction of targeted bill support would be expected to improve consumer price protection. This would affect the assessment of the potential trade-off between price protection and enabling competition, when considering how stringent benchmarking of costs should be.

Answers to selected consultation questions are provided below.

Yours sincerely,

Andy Manning

Head of Energy Systems Transformation

Responses to selected questions

1. Please explain your preferred approach to benchmarking (benchmark metric and benchmarking costs across parameters) and how it would align with the statutory framework. Explain your answer by providing evidence where possible.

The reasons for using lower quartile costs appear to remain valid and so clear evidence is to move away from this approach. It remains likely that most of the variation between different suppliers is due to their relative efficiency and lower quartile is a well-established approach to benchmarking analysis that avoids outlying companies driving the benchmark. Should there be clear evidence to move away from this approach, using medians should be considered instead of weighted averages as this would continue to prevent outlying companies from driving the benchmark.

3. Please explain if you think that future regulatory changes you know of will have material and systematic impact on core operating costs relative to 2023?

Any forward-looking adjustments need to reflect the overall change in efficient operating costs and not just specific areas of additional costs. Of particular note is that energy suppliers covering most of the market have generally been transitioning to 'software-as-a-service' solutions. In practice, during this transition suppliers will have been maintaining their legacy systems alongside these new solutions. For example, Centrica has stated[1]: *'…2023 profit was impacted by the increase in cost per customer reflecting our investment in customer service and system migration…'.* So, 2023 is likely to be an exceptional year for some suppliers and overstate ongoing costs i.e. compared to after system migration is complete. Adjustments will need to be made for this.

Ongoing productivity improvements should also be assumed, in line with standard practice for network companies.

If costs to meet expected regulatory changes are higher for a supplier because of previous under-investment or poor performance, these should not be included in any benchmark. Using a lower quartile or median approach, if an assessment of projected or emerging costs is made, would be a way to deal with outlying companies

4. Do you think technology developments will help make further efficiencies to core operating costs? Please give evidence to support your views.

As explained in our response to Q3, simply completing system migrations will improve overall efficiencies. Ongoing productivity improvements should also be assumed, in line with standard practice for network companies.

7. What approach do you prefer to allocating fixed operating costs between the standing charge and unit rate? What would be the impact on customers and suppliers of moving costs to the unit rate?

This review should seek to allocate operating between standing charges and consumption charges on a cost-reflective basis. Any distributional impact of this, including taking account of levelisation of

[1] https://www.centrica.com/media/bz5ljshq/centrica-2023-preliminary-results-announcement.pdf

standing charges between payment types, should be considered as part of the standing charge review. This will allow for transparent policy discussions between Ofgem and the Government following the call for input on energy affordability.

8. Please explain any views on how we could determine the adjustment factor under option 2 CPIH-X approach.

Ofgem has previously assessed a looser retail price cap as being extremely effective at enabling competition and incentivising innovation and that competition could also drive efficiency. However, it is unclear how these efficiency improvements would be enjoyed by consumers subject to the retail price cap. Therefore, especially if the approach to benchmarking is made more generous, it is essential a feedback loop is introduced that reduces operating costs as efficiency improvements are revealed through a competitive retail market.

9. Please explain any views on whether there are any other external indicators we should consider to index the allowance.

Efficiency should be expected to be improving over time. At least until the feedback loop described in Q8 is introduced, updating the core operating costs allowance needs to reflect expected improvements in productivity. Ofgem do this as standard practice when regulating the network companies by making use of external productivity indices.

10. Explain whether you think we should consider a bottom-up approach to estimate costs, and if so, could you please explain how we could improve our proposed approach?

We support considering a bottom-up approach. We have previously raised our concerns about relying on supplier estimates (provisions) of bad debt, not least because it means suppliers can have a direct influence on the allowance they receive. We are pleased to see Ofgem recognise this by presenting the impact of differing supplier assumptions when estimating bad debt as a reason for having a separate debt allowance. It follows that this impact would remain unacceptable for a separate debt allowance and so using the bad debt charge, which relies on supplier estimates, can be ruled out.

We agree that bad debt write-offs would be more accurate but share concerns over how long these costs take to crystallise.

11. Please explain your preferred approach to benchmarking (benchmark metric and benchmarking costs across parameters) across debt-related cost components. Explain your answer by providing evidence where possible.

We believe that lower-quartile is the appropriate approach to ensuring only efficiently incurred costs are allowed. This is well-established regulatory practice, across both the original price cap and network regulation, and is consistent with a focus on improving cost efficiency. It would also give some limited protection against suppliers' overestimating bad debt, if an approach relying on supplier estimates was used.

14. In the absence of levelisation phase 2, please explain whether and, if so, how we should consider spreading debt-related costs across different customer groups.

Differentials between payment types can be better resolved through levelisation to avoid the commercial distortions created by adjusting how costs are allocated.

General - Smart

We believe that setting separate core operating cost allowances for smart meter and traditional meter customers should remain under consideration and some of the risks identified can be managed.

One of the key benefits of smart meters should be lower bills. We think it is fair to pass on at least some of the cost savings from smart meters directly to customers who have adopted them. This price differential could also demonstrate the benefits to customers who have not yet had them installed, and who may currently see little value in adopting them. Direct savings were previously available to consumers through smart-only acquisition deals, but there are currently fewer of these new deals available. In any case, this approach did not enable savings for disengaged customers, including those who can't switch due to debt, whereas changes through the price cap could ensure all customers with smart meters see benefits.

Any differential would need to be proportionate, taking account of the fact that a minority of consumers cannot have a smart meter installed. Alternatively, these consumers could be temporarily charged at the smart meter rate until a smart meter installation becomes available. This would mirror protections in water, where providers apply bill reductions for people who apply to have a water meter but cannot have one installed for technical reasons. It may be feasible for suppliers to identify these customers automatically (for example based on checking postcodes against DCC coverage) or based on records of failed installations.

20. Do you agree with our preferred approach of setting a separate allowance for industry charges? Please explain your answer.

We do not agree with your preferred approach of setting a separate allowance for industry charges. These industry charges are subject to only light-touch oversight from Ofgem, certainly compared to costs that are already pass-through items such as network charges. Energy suppliers currently have a commercial incentive to ensure these costs are efficient. Making these costs pass-through will remove this incentive, risking these costs becoming less efficient over time.

Any charges treated as pass-through should have an effective method of scrutiny and challenge. If Ofgem does introduce a separate allowance for industry charges, it needs to improve its scrutiny of these charges, potentially introducing new approval processes for Elexon and xoserve budgets.

Suppliers receive a supplier margin that should be reflective of the risks faced. We have previously highlighted the series of decisions Ofgem has taken that have reduced the risk on suppliers and generally transferred that risk onto consumers. This would be a further decision to transfer risk from suppliers to consumers and so should be reflected in a lower supplier margin.