



Making a positive difference
for energy consumers

Price cap: Call for Input on the Operating Cost Allowances Review (Operating cost review)

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Executive Summary

The default tariff cap (the 'cap') was introduced in 2019 to protect existing and future customers on default tariffs. It currently covers around 29 million customers. The cap includes several allowances which relate to the operating costs associated with the supply of energy to domestic consumers. These are:

- Core operating costs allowance - a supplier's own costs of retailing energy;
- Smart Metering Net Cost Change (SMNCC) allowance - net cost of installing and operating smart meters as part of the transition for the smart meter rollout; and
- Payment Method Uplift (PMU) - allowances for the additional costs of serving customers who pay by different payment methods.

In this Call for Input, we refer to these allowances collectively as the operating cost allowances. For cap period 10b (July 2023 -September 2023), these allowances are £240 per customer per year for dual fuel customers who pay by direct debit at a medium typical consumption level (2,900 kWh for electricity and 12,000 kWh for gas).

Both the energy market and the cap methodology have experienced significant changes since the cap was introduced in 2019, which may have changed suppliers' operating costs.

It is important that the retail energy market is sustainable going forward, where a notional supplier can recover its efficient costs of supplying energy. A healthy market is good for consumers. It generates more competition and encourages investment in the sector, giving consumers more choice, driving up standards, and delivering the transition to net zero.

So, we are now reviewing suppliers' operating cost allowances for the following reasons:

- Market changes – there have been several economic and market shocks, changes in the market structure and industry change programmes;
- Regulatory changes - a number of regulatory changes have been introduced since we set the benchmark using 2017 data, for example we now update the cap on a quarterly basis (from October 2022) rather than every six months;
- Age of data – when the cap was introduced in 2019, most of the operating cost allowances were set based on 2017 data, or older, in the case of Prepayment Meter (PPM); and
- Interactions with other workstreams – For example, the Levelisation of payment method cost differentials workstream, if pursued, may require updated values of the additional costs of serving customers who pay by different payment methods to facilitate reconciliation between suppliers.

In this Call for Input, we are seeking views and evidence from stakeholders on whether the allowances still reflect the efficient operating costs a notional efficient supplier may incur.

We plan to look at key considerations across the core operating costs, the additional costs of serving customers who pay by different payment methods, smart metering costs, industry charges and the implementation approach. Some of the key considerations include (but are not limited to):

- How to benchmark costs (including considering the impact of non-efficiency differences between suppliers which affect their costs);
- How to allocate costs (eg between payment methods, and between the standing charge and unit rate);
- Our approach to considering customers using smart meters in the cap;
- How to update the baseline over time; and
- Whether the changes in the operating costs are temporary or enduring.

When considering changes, we plan to focus, in particular, on areas where the costs may have materially and systematically deviated from the allowances – this could be in either direction (up or down).

We are seeking responses by 23 June 2023 to priceprotectionpolicy@ofgem.gov.uk. We will use the responses and evidence provided to determine whether a review is appropriate and, if we proceed, to inform the scope of the review.

Introduction

Background

On 19 July 2018, the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the 'Act') came into force.¹ This legislation requires the Gas and Electricity Markets Authority (GEMA) to design and implement the default tariff cap. We introduced the default tariff cap (the 'cap') on 1 January 2019, which protects households on standard variable and default tariffs (which we refer to collectively as 'default tariffs'). The cap ensures that default tariff customers pay a fair price for their energy, that reflects the efficient underlying cost to supply that energy. We describe the legislative framework in Appendix 1.

The government has introduced the Energy Price Guarantee (EPG) to protect customers from high and volatile energy prices.² The EPG limits how much energy suppliers can charge per unit. The cap acts as a reference price for calculating the level of support offered by the government to suppliers. Ofgem's objective in setting the cap is to protect the interests of current and future consumers. There are several statutory considerations we must have regard to when making decisions about the cap. Should the cap rise above the EPG before the end of scheme (March 2024),³ further decisions related to price cap allowances will primarily impact public spending. Such a cap rise would result in increases in customer bills up to the £3,000 EPG target bill. Any changes to existing cap allowances would not increase customer bills beyond this but would have public spending implications.

The cap sets a maximum amount a supplier can charge default tariff customers for energy. It varies based on a number of different factors, including: fuel type, benchmark consumption, meter types, regional differences, and payment methods.

We calculate the cap using a bottom-up assessment of a notional supplier's costs. In other words, we calculate each cost component individually and then add them together. We set the cap to reflect the notionally efficient costs of supplying energy.⁴

The cap includes several allowances which relate to the operating costs (see Figure 1). These are allowances for the core operating costs, Smart Metering Net Cost Change (SMNCC) allowance and allowance for payment method uplift (PMU).⁵ In this Call for

¹ Domestic Gas and Electricity (Tariff Cap) Act 2018

<https://www.legislation.gov.uk/ukpga/2018/21/crossheading/the-cap/enacted>

² The EPG was legislated for as part of the Energy Prices Act 2022.

<https://www.legislation.gov.uk/ukpga/2022/44/enacted>

³ UK Parliament (2023), Gas and electricity prices under the Energy Price Guarantee and beyond.

<https://commonslibrary.parliament.uk/research-briefings/cbp-9714/>

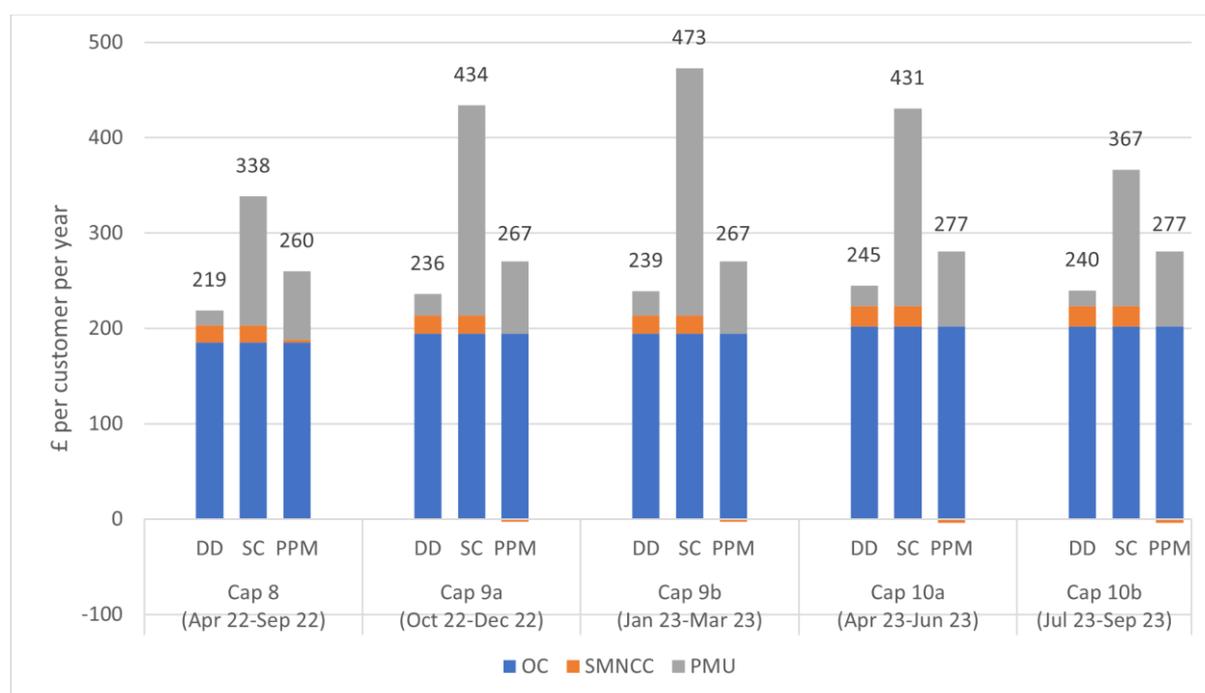
⁴ Notional supplier is a theoretical and efficient supplier that has no direct comparison with existing suppliers but draws from the properties across efficient suppliers in the market.

⁵ This allowance is to cover additional costs of serving customers who pay by different payment methods.

Input, we refer to them collectively as the operating cost allowances. The operating costs are typically costs that suppliers have greater control over and are impacted by commercial decisions.⁶ They are an important element of the cap for driving efficiency and feeding into supplier profitability. In setting the cap, we must have regard to a number of matters including the need to set the cap at the level that enables holders of supply licences to compete effectively for domestic supply contracts. This regard is important for promoting resilience in the market and reducing the risk of supplier failure, the cost of which is ultimately borne by customers.

It is important that the retail energy market is sustainable going forward, where a notional supplier can recover its efficient costs of supplying energy. A healthy market is good for consumers. It generates more competition and encourages investment in the sector, giving consumers more choice, driving up standards, and delivering the transition to net zero.

Figure 1. Operating cost allowances by payment method, dual fuel.



* OC stands for 'core operating costs allowance'; This is for medium typical domestic consumption value (TDCV) – 2,900 kWh for electricity and 12,000 kWh for gas.

Purpose and scope of review

The intention of the operating cost allowances review (which we refer to as the operating cost review) is to consider whether changes to the allowances are appropriate, and if the

⁶ This is in contrast to 'pass-through' costs in the cap such as network costs, where the cost is set through a charging statement which applies to all suppliers.

allowances still reflect the efficient costs a notional efficient supplier may incur. When considering changes, we will focus, in particular, on areas where the costs may have materially and systematically deviated from the allowances – this could be in either direction. We consider it is appropriate to review the operating cost allowances at this stage – we discuss the case for review later on in this document.

In order to achieve our objective, our intended scope of the operating cost review includes:

- **Core operating costs** – considering whether calculating a new baseline is appropriate based on re-benchmarking the core operating costs;
- **Payment method differentials** – exploring the options for measuring differences in operating costs between payment methods and calculating the differentials appropriately;
- **Smart meter costs** - exploring the options for reflecting the cost differences between smart meter and traditional meter customers;
- **Industry charges** – exploring costs associated with recent and future industry changes and the options for setting an allowance for them. Industry charges are a cost line within the core operating costs under the current cap methodology. We may consider this in two parts: pass-through industry charges (eg Elexon costs which are currently captured in the core operating cost allowance) and supplier system changes required to facilitate industry change programs; and
- **Implementation approach** – exploring the options for updating the allowances over time and allocating costs across the standing charge and unit rate.

As the above scope demonstrates, the operating cost allowances are broad and covers several different areas. The level of review depends on a number of factors. For example, a more detailed review could lead to allowances more accurately reflecting the costs of serving different customer groups. However, this could make it more challenging to progress the review in a timely way. In some cases, a more complex review could also be disproportionate, for example, if it requires us to gather large amounts of data to investigate cases where costs only differ marginally between customer groups.

Therefore, our data collection exercise is one key area where we intend to make a judgement on the scope. We intend to collect cost information split by fuel, payment method, and whether the meter is smart or traditional. We consider that it would not be proportionate to add other data splits (eg electricity meter type and tariff type).

However, as part of the draft Request for Information (RFI), we seek evidence on any other characteristics over which costs could vary but are not explicitly captured in our data collection. We welcome views from stakeholders on the appropriate level of detail for this review.

Table 1 summarises the areas we currently consider to be outside the scope of this review.

Table 1. Areas outside the scope of the operating cost review

Areas outside the scope of this review	Our considerations
EBIT (Earnings Before Interest and Tax) and Headroom, allowances	EBIT is a separate workstream that we are currently working on and Headroom allowance has been set out as an intended long-term workstream in our Programme of Work. ⁷
Allowances set in past cap periods	We do not intend to true up the operating cost allowances for past cap periods.
Providing specific allowances to facilitate innovation in how suppliers serve their customers	We encourage innovation, and there are other workstreams to facilitate innovation in the retail market, for example Ofgem’s Innovation Link and Innovation sandbox. In addition, there are incentives to innovate driven by other benefits such as cost reduction and the ability to differentiate.
Renewable Energy Guarantee of Origin (REGOs)	The Price Cap Green Tariffs Policy workstream is a separate long-term workstream, set out in our Programme of Work.

This Call for Input sets out more detailed considerations of the scope mentioned above. We also outline questions for each area within the scope (and list all questions in Appendix 2). It is an opportunity for stakeholders to provide information and comments, which will feed into our development of the operating cost review.

Questions

1. Do you agree with the scope set out in the introduction section for the operating cost review?
2. Do you agree with the areas that we consider are outside the scope of this review? Do you consider that there should be anything else in the scope of this review?

⁷ Ofgem (2023), Price cap – Programme of Work: Update, Table1.2
<https://www.ofgem.gov.uk/publications/price-cap-programme-work-update>

Case for review

In this section, we identify the main changes that have led us to consider revisiting the methodologies for the operating cost allowances.

Considerations

Market and regulatory changes

The majority of the operating cost allowances in the cap are set based on 2017 supplier data collected during the design phase of the cap in 2018 (or older in the case of Prepayment Meter (PPM)).

The market and energy industry have gone through significant changes since we introduced the cap in 2019, which may have impacted suppliers' operating costs. There have been a number of economic and market shocks (eg the COVID-19 pandemic, gas price crisis and cost of living pressure) and changes in market structure (eg supplier exits and mergers). Ofgem have introduced and are continuing to work on several industry change programmes (eg faster switching, a continued transition to smart meters and the upcoming Market-wide Half Hourly Settlement).

A number of regulatory changes have been introduced since we set the benchmark using 2017 data, for example we now update the cap on a quarterly basis (from cap period 9a, October 2022) rather than every six months.

In addition, one example of a potential upcoming change is our review of consumer standards following a decline in customer service. We are proposing some priority changes to our customer service rules for this winter, which could have an impact on suppliers' operations.⁸ We discuss market and regulatory changes in more detail in the core operating costs section and our general approach to update the allowances in the implementation approach section.

Therefore, we consider that it is an appropriate stage to consider the operating cost allowances given the age of data and these changes, to consider whether the allowances continue to appropriately reflect a notional efficient supplier's costs.

Interdependency with levelisation of payment method cost differentials workstream

We have launched a workstream looking at levelisation of the cost differences between customers on different payment methods (which we refer to as levelisation of payment

⁸ Ofgem (2023), Consultation on a framework for consumer standards and policy options to address priority customer service issues.
<https://www.ofgem.gov.uk/publications/consultation-framework-consumer-standards-and-policy-options-address-priority-customer-service-issues>

method cost differentials),⁹ and recently published a Call for Evidence to consider whether we should make payment charges more equal or equitable (but less cost-reflective), by socialising (or 'levelising') PPM costs across direct debit (DD) customers. We also intend to give regard to standard credit (SC) costs in the same manner.¹⁰

The Levelisation Call for Evidence does not include reviewing the reasoning behind the existing level of cost reflective payment differentials in the cap. However, the operating cost review intends to look at the underlying cost differences between customers on different payment methods (which we refer to as payment method differentials in the review) and consider whether to revise the calculation of the cost differences. If we update the payment method uplift methodology, the intention is that the new payment method differentials would be used as inputs to any future levelisation or other policy, which could be independent from the cap.

Interdependency with debt-related costs workstream

The debt-related costs workstream is considering whether an adjustment to the debt-related costs allowance in the cap may be required, looking in the round at 2022/23 costs and allowances, and anticipated costs and allowances in 2023/24.¹¹ The debt-related costs workstream may provide evidence of the ongoing costs for the operating costs review. Therefore, where appropriate, any relevant evidence submitted as part of the debt-related costs workstream will be considered in the operating costs review. The debt-related costs workstream is looking primarily at whether a temporary adjustment allowance is necessary. The operating costs review intends to consider whether an enduring change for debt-related costs is necessary, if we gather evidence that it is appropriate to make an enduring change to the debt-related allowances. This would be introduced from Winter 2024/25 if evidence suggests a review is necessary.

The allowance for debt-related costs is split across several parts of the cap, including the operating cost allowances. Some of these allowances are part of the payment method differential, which is an input to the levelisation workstream. Therefore, there is a clear interlinkage between the three workstreams.

Future price protection

The government intends to consult in the summer on options for a new approach to consumer protection in the energy market from April 2024 onwards, as well as on the

⁹ Ofgem (2023), Price cap -Programme of Work: Update, page 4

<https://www.ofgem.gov.uk/publications/price-cap-programme-work-update>

¹⁰ Ofgem (2023), Levelisation of payment method cost differentials: a call for evidence

<https://www.ofgem.gov.uk/publications/levelisation-payment-method-cost-differentials-call-evidence>

¹¹ Ofgem (2023), Price cap- Call for Input on the allowance for debt-related costs

<https://www.ofgem.gov.uk/publications/price-cap-call-input-allowance-debt-related-costs>

future of the price cap.¹² As set out in our recently updated Programme of Work, we have decided to prioritise the operating cost review workstream as we consider that an updated view of operating costs could help consideration of the future of price protection.

Our operating cost review does not pre-empt the outcome of work on the future of price protection.

Questions

3. What are your views on the case for review we identify in this section?

4. Do you agree that there is sufficient reason to carry out a review?

Main areas for consideration

In this section, we provide high-level descriptions of the current approach for the operating cost allowances and discuss our key considerations for potential changes. For each topic, we outline our questions and ask for stakeholders to provide evidence to support their views on these areas. We also welcome any wider feedback.

Core operating costs

We consider that changes in the market, industry and regulation may have affected a notional supplier's efficient operating costs, which we consider makes it appropriate to review the core operating costs at this stage.

Context

Cost lines of core operating costs

In our 2018 decision, we defined operating costs as a supplier's own costs of retailing energy. This excluded the costs of purchasing energy, the cost of meeting environmental and social obligations, and network charges.¹³

Under the current methodology, the cost lines included in our definition of core operating costs are shown in Table 2.¹⁴ These are typically indirect costs and are shared across the customer base rather than being attributable to any single account.

¹² HM Government (2023), Powering up Britain, Energy security plan
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1148252/powering-up-britain-energy-security-plan.pdf

¹³ Ofgem (2018), Default tariff cap: Statutory Consultation Appendix 6 – Operating costs, paragraph 1.2.
https://www.ofgem.gov.uk/sites/default/files/docs/2018/09/appendix_6_-_operating_costs.pdf

¹⁴ Ofgem (2018), Default tariff cap: Statutory Consultation Appendix 6 – Operating costs, Table A6.1.
https://www.ofgem.gov.uk/sites/default/files/docs/2018/09/appendix_6_-_operating_costs.pdf

Table 2. Key cost lines of operating costs.

Cost	Description
Customer contact	Costs associated with the operation of contact centres and other customer relations
Billing and payment collections	Billing, collections and bad debt costs
Metering	Meter rental, installation, maintenance, reading (including smart metering)
Sales and marketing	Sales activities, advertising and branding, third party commissions
Central overhead	Telecoms, IT, property, HR, regulation, corporate recharges
Depreciation and amortisation	Depreciation and amortisation, largely relating to investment in metering; IT and billing systems; and property
Industry charges	Charges from Elexon, Xoserve, and the smart metering industry bodies

Data used for calculating the baseline costs

We set suppliers' core operating costs allowance by benchmarking different suppliers' expenditures in 2017 - the latest full year of data available at the point we designed the cap.

We included ten suppliers with more than 250,000 customers (in April 2017) in our benchmarking sample. The aim of this was to ensure that our benchmark reflected the costs of a supplier that was operating at scale at the time and ensure that the sample represented a typical customer base. We also made a number of adjustments to supplier data to improve comparability when benchmarking costs.¹⁵

Benchmarking and update approach

Benchmark parameters – When benchmarking costs, we made a number of decisions on which parameters to compare costs over.¹⁶ First, we isolated total operating costs for DD customers through a number of adjustments.¹⁷ We then compared operating costs

¹⁵ Ofgem (2018), Default tariff cap: Decision, Appendix 6 – Operating costs, Paragraph 2.4, https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_6_-_operating_costs.pdf

¹⁶ When benchmarking operating costs, we did not break our estimate down between different types of expenditures (eg metering, customer service etc), instead focusing on a comparison of total operating costs.

¹⁷ Ofgem (2018), Default tariff cap: Decision, Appendix 6 – Operating costs, Footnote 3, https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_6_-_operating_costs.pdf

across suppliers' entire domestic customer base, rather than attempting to separate operating costs by region, electricity meter type or tariff type. This accounted for possible substitutability between different categories of expenditure, and reduced the risk of low comparability if operating costs were not allocated to individual categories on a consistent basis by different suppliers.

We chose our benchmark by comparing suppliers' total operating costs per customer account,¹⁸ rather than benchmarking gas and electricity separately. This was to avoid the risk that our benchmark was affected by differences in how suppliers had allocated costs between fuels.

Benchmark metric - We first chose the benchmark at the costs of the lower quartile supplier in the benchmarking sample, rather than at the frontier.¹⁹ We found that differences in suppliers' operating conditions could be driving variation in costs which meant that a frontier benchmark would unlikely be sufficient to cover the costs of an efficient supplier with a normal customer base. We also did not consider a weighted average approach to be proportionate because this approach would have concealed variations in operating costs driven by differences in the efficiency of different suppliers' approaches to managing their businesses.²⁰ We considered setting the efficient benchmark at the level of the supplier closest to the lower quartile would likely lie above an efficient level of costs for an efficient supplier with a normal customer base. We therefore set the operating cost benchmark equal to the reported operating cost of the supplier at the lower quartile for gas and electricity, minus an efficiency factor amounting to £5 for a dual fuel customer (3% below the lower quartile level), pro-rated between the fuels.²¹

Update approach - We index the core operating cost allowance by Consumer Price Index, including owner occupiers' housing costs (CPIH), to calculate the updated value at each cap period (indexed in the February and August cap update).

For cap period 10b (July 2023 - September 2023), the level of the core operating costs allowance for dual fuel DD customers at the medium TDCV is approximately £202 per customer per year, compared to £165 per customer per year in 2017.

¹⁸ We note that we count dual fuel twice.

¹⁹ For our 2018 analysis, the "Frontier benchmark" was calculated as a simple average of the operating costs of the two lowest cost suppliers in the benchmarking sample.

²⁰ Ofgem (2018), Default tariff cap: policy consultation – overview, Paragraph 2.40, https://www.ofgem.gov.uk/sites/default/files/docs/2018/05/appendix_8_-_operating_costs.pdf

²¹ Ofgem (2018), Default tariff cap: Statutory Consultation Appendix 6 – Operating costs, paragraph 3.55-3.56. https://www.ofgem.gov.uk/sites/default/files/docs/2018/09/appendix_6_-_operating_costs.pdf

Non-efficiency factors

In our 2018 decision, we considered that there was likely to be some variation in suppliers' operating costs, driven by aspects of the companies' operating environments or customer bases, or the limitations of the operating costs data we used, which did not relate to the efficiency of the supplier.²²

We identified a number of factors that were not related to efficiency, and which might have an impact on a supplier's operating costs, such as company size, legacy pension arrangements,²³ the proportion of vulnerable customers (proxied by whether or not a customer was on the Priority Service Register (PSR)), the proportion of single fuel customers and the proportion of offline customers.

We noted that these non-efficiency factors could, in principle, explain part of the difference in costs we observed between the lower quartile and the frontier. In our decision, we set the benchmark to reflect the cost variation due to the non-efficiency factors, which were the differences in customer base (proportion of vulnerable customers and single fuel customers). We did this by setting the benchmark £5 (a relatively small amount) beneath the lower quartile so that it is set closer to the lower quartile than the frontier.

Considerations

Potential drivers of changes in cost lines

We consider that both components and the value of the cost lines that make up suppliers' operating costs may differ from what was defined in the 2017 baseline (Table 2). We discuss several potential reasons for these differences below.

Mergers and acquisitions

Recently, there have been several mergers and acquisitions in the retail market resulting in a change to the number of market participants. In addition, there have been a number of suppliers exits leading to customer acquisitions through the Supplier of Last Resort (SOLR) process.²⁴ In December 2017, there were 68 active domestic suppliers offering electricity and or gas, but this number dropped to 21 in March 2023.²⁵ We had ten

²² Ofgem (2018), Default tariff cap: Statutory Consultation Appendix 6 – Operating costs, Paragraph 2.14-2.31.

https://www.ofgem.gov.uk/sites/default/files/docs/2018/09/appendix_6_-_operating_costs.pdf

²³ We found evidence which suggested that ex-incumbent suppliers' costs were higher as a result of final-salary schemes inherited at privatisation. These costs were outside of suppliers' control given the protections that were in place.

²⁴ The Special Administration Regime (SAR) process was used in the case of Bulb Energy.

²⁵ Ofgem (2023), Retail market indicators – Number of active domestic suppliers by fuel type (GB) <https://www.ofgem.gov.uk/retail-market-indicators>

suppliers in our benchmarking sample in our 2018 decision, however, only half of the suppliers in the sample still exist today.

The changes in the number and size of suppliers in the energy retail market due to mergers and acquisitions²⁶ could impact what constitutes a notional supplier now, compared to 2017.

We consider it is appropriate to seek to avoid capturing transitional impacts when setting an enduring allowance. These include, for example, any transitional costs from suppliers taking on customers through large acquisitions and in particular any costs recovered through the SOLR levy process (to avoid double counting).

New regulations and cap changes

In this review, we may also consider whether the evolution of regulatory obligations has resulted in and could lead to changes in a notional supplier's efficient operating costs.

From a backward-looking perspective, there have been a number of regulatory changes that have been introduced since we set the benchmark using 2017 data. For example, we now update the cap on a quarterly basis (from cap period 9a) rather than every six months. This ensures that the cap reflects changes in the cost of supplying energy more quickly. However, this change could impact some suppliers' operating costs, as they may need to contact their customers more often to update the price information.

On a forward-looking basis, there are also ongoing consultations on Ofgem's future retail strategy and upcoming regulatory changes. One example of a potential upcoming change is that we are proposing some priority changes to our customer service rules for this winter, which could have an impact on suppliers' operations.²⁷ For example, to improve ease of contact, we have proposed requiring suppliers to extend the operating hours of their freephone telephone number and alternative methods of contact (eg email). Some suppliers have suggested that our proposed new requirements will increase costs, such as increased customer call centre representative costs. However, some stakeholders note that some suppliers are already providing these levels of service (eg offering extended operating hours) within existing cost allowances. We also note that some stakeholders have suggested that improved standards may yield lower costs where less resource is required to deal with complaints and issues.

²⁶ As well as SoLR and SAR

²⁷ Ofgem (2023), Consultation on a framework for consumer standards and policy options to address priority customer service issues.
<https://www.ofgem.gov.uk/publications/consultation-framework-consumer-standards-and-policy-options-address-priority-customer-service-issues>

In general, where future changes potentially increase costs for suppliers, we intend to consider whether these costs are incremental to the efficiently incurred benchmark and whether they are offset by any benefits.

Evolution of the energy retail market

Customer expectations, business models and technology continue to evolve in the energy retail market, which may cause suppliers' operating costs to change at a different rate to inflation. We expect some suppliers may incur new operating costs, eg licensing new billing systems (software as a service). Some costs may have reduced significantly, eg new technologies such as webchat may offer customers additional options for contacting suppliers for certain enquiries at a lower cost to suppliers compared to more traditional contact channels. We intend to assess the net impact on suppliers' core operating costs as a whole.

External events

There have been a number of economic events that have impacted the market. COVID-19 is likely to have impacted suppliers on both the operational side (eg central overheads from staff costs) and the customer side (eg customer contact costs). The global gas crisis is likely to have had further customer impacts and has already driven some supplier exits and acquisitions.

We have already made a number of adjustments to the cap to reflect the impacts of these events, for example, our decision on the float and true-up process for COVID-19 costs.²⁸ We intend to be mindful to incorporate these into our thinking where appropriate and reduce the risk of double counting of the impacts from these external events. For the operating cost review, we intend to focus on where some of these impacts are enduring. For example, changes in business structure following greater use of hybrid working may have more enduring impacts.

Therefore, in the operating cost review, we plan to define the updated cost lines that make up suppliers' operating costs and consider the changing values for cost lines from the 2017 baseline, to consider whether it reflects suppliers' efficient and enduring operating costs.

²⁸ Ofgem (2023), Price Cap -Decision on the true-up process for COVID-19 costs
<https://www.ofgem.gov.uk/sites/default/files/2023-02/Price%20cap%20-%20Decision%20on%20the%20true-up%20process%20for%20COVID-19%20costs.pdf>

Questions

5. What cost lines do you think should be included within operating costs?
6. Do you consider there to be any new costs which may have not been included within the existing core operating costs allowance?
7. Do you consider that any new costs would be off-set by corresponding benefits?
8. Do you consider there to be any costs included within the core operating costs allowance but are now no longer incurred?
9. What external events do you think have impacted (or will impact) operating costs? Are these impacts permanent or temporary? Can you provide evidence on how costs have been affected, and by how much (ie per customer)?

What years of data to use for the baseline

In our 2018 decision, we set the baseline for the core operating costs allowance using data on suppliers' reported costs in financial year 2017. The main reasons for this decision were²⁹:

- We had not identified any reason to expect 2017 to be otherwise atypical. Costs could be atypical if they differed significantly from previous years due to exceptional events or as a result of where a particular supplier was in their investment cycle.
- We also decided to base our analysis of operating costs on the most recent complete financial year at the time of making the decision, so as to ensure that the cap reflected the most recent trends in operating costs.

We consider these reasons are still appropriate when choosing what years of data we should use for the new baseline. We still consider that it is appropriate to use the most recent data where possible. However, we need to be mindful of the potential impact of external events, for example COVID-19 and recent changes in the energy market (eg 29 energy suppliers failed between mid-2021 to mid-2022 due to high wholesale prices, potentially leading to costs to other suppliers of onboarding the customers acquired as a result). There is a trade-off between using data from one year (incorporating any exceptional events from that year) and averaging data across more years (which risks being impacted by temporary impacts of a wider range of exceptional events).

We intend to collect data for a number of quarters both pre and post COVID-19. Our current minded-to approach would be to use 2022 data to set the benchmark. We

²⁹ Ofgem (2018), Default tariff cap: Statutory Consultation Appendix 6 – Operating costs, paragraph 2.37-2.44. https://www.ofgem.gov.uk/sites/default/files/docs/2018/09/appendix_6_-_operating_costs.pdf

consider this may be more stable in relation to large acquisitions and temporary COVID-19 impacts. However, we are mindful that there may be some in-year factors that would impact costs and we would intend to consider correcting for these factors in setting the enduring benchmark. Alongside responses to this CFI, data collected through the RFI process will inform our position.

Questions

10. What time period do you think we should use for the updated baseline for core operating costs and why?
11. What factors should we seek to correct for in setting an enduring benchmark?

Overall approach (Bottom-up Vs Top-down)

To set the core operating cost allowance, we used a top-down approach for benchmarking. This means we benchmarked at the total operating cost level using supplier cost data. This was instead of calculating each individual cost line that would make up operating costs (a bottom-up approach).

We consider a top-down approach would still be preferable when calculating the core operating cost allowance. It is more proportionate from a time and data perspective, and less technically complex. A bottom-up approach would require a benchmarking or calculation methodology for each cost line. For benchmarking, there would be a risk that some cost lines were substitutes, with different suppliers choosing different balances between costs. This could mean that the sum of individual benchmarks might not be achievable by a notionally efficient supplier. For a calculation approach, we would need supplementary data to base the calculations on. For example, to calculate the cost of meter rentals, we could need data on the meter asset cost, installation cost, amortisation period, age of stock and rate of churn.

We still intend to collect the total operating costs by cost line, which still gives us the flexibility to isolate any particular cost lines and consider an alternative calculation approach. For example, in 2018, we decided to use industry charge statements for Elexon and Xoserve costs rather than the cost data submitted by suppliers.

Questions

12. What are your views on the options of our overall approach? Do you agree with our minded to approach?
13. Do you have any alternative approach for calculating the efficient level of core operating costs across suppliers?

Benchmarking approach

In our operating cost review, we will consider the options for setting a benchmark. For example, these could include the frontier, lower quartile, weighted average or other alternative options. We will consider which benchmark would be the most appropriate based on the evidence we gather and the trade-offs between different approaches.

As described in the previous section, variation in costs can be driven by efficiency and non-efficiency factors and this impacts the trade-offs between approaches. For example, a stricter metric (eg frontier) will provide a greater level of protection for customers and stronger efficiency incentives for suppliers. However, it could be less robust for non-efficiency differences, meaning that there could be a risk of setting the benchmark below efficient costs for a notional supplier or it would be less resilient to cost shocks. A looser metric (eg weighted average) would reduce the need to separately consider non-efficiency factors. However, it would provide a lower level of customer protection and reduced efficiency incentives compared to the frontier benchmark. We intend to consider the balance of trade-offs when deciding the approach, ensuring it benefits existing and future customers.

In our operating cost review, we plan to assess whether the existing non-efficiency factors (and any new ones) are driving cost variations among suppliers, based on new evidence we gather. We intend to consider how to control for these non-efficiency factors in our benchmarking exercise, whether that is through an adjustment or choice of benchmark metric.

Questions

14. Which benchmarking approach options do you think we should be considering?
15. How should we develop a framework for choosing between benchmarking options?
16. What non-efficiency factors linked to customer bases do you think drive cost variation among suppliers? Should we control for these through an adjustment or benchmark metric?

Allocating costs across different parameters

We currently intend to collect cost data split by fuel, payment method and meter type (smart or traditional). This reflects the data we would need to consider how the core operating cost allowance, payment method uplift and smart metering costs allowance are set. We do not intend to collect the cost data split by tariff type, electricity meter type (single rate and multi-register) and region.

In addition, we intend to collect characteristics of the supplier's customer base, including number of customers by tariff type, on PSR and whether they have an online account. These characteristics will help us to understand what impact non-efficiency factors may have on operating costs.

For tariff type, our intended approach is in line with how we currently set the operating cost allowance, which does not vary by tariff type. Overall, we would expect the total operating costs between tariff types to be similar. Additionally, when considering data in 2022, most customers have been on default tariffs. In general, we would expect suppliers to recover operating costs across all of their customers, including pricing these costs into their fixed tariffs. To help us consider our approach to tariff type, we intend to include a question asking suppliers whether their costs differ by tariff type and to provide evidence where they consider it to be the case.

We also plan to consider whether to continue the current approach of setting one operating cost allowance between electricity meter type, or to set different benchmarks for single rate electricity meter customers and multi-register electricity meter customers. To inform this, we intend to seek evidence on whether there are material cost differences between these customer types.

Generally, we expect that many operating costs will be similar between single rate and multi-register electricity meter customers. However, multi-register electricity meter customers typically have higher consumption than single rate electricity meter customers, which could affect bad debt costs.

Questions

17. Are there other parameters over which you think operating costs would materially differ?
18. Do you think there are any operating costs that would materially differ between serving single rate and multi-register electricity meter customers? If so, please provide evidence to support your view.
19. What is your view on the extent to which we should prioritise allocating costs between different parameters currently not included in our cost data breakdown?

Setting the allowance on an enduring basis

We would ideally like to calculate a new baseline that represents notional efficient suppliers' operating costs. Therefore, we do not need to review the baseline within a short period of time. However, there is a question of whether this is feasible in practice,

given the recent changes in the market, and whether the impacts of recent market developments on the suppliers' operating costs are permanent or temporary.

Questions

20. In the event that some of the cost drivers are impacted by recent events, how should we treat these costs to determine an allowance on an enduring basis?

Payment method differential

In our operating cost review, we plan to explore the options for measuring the payment method differential for operating costs and setting an appropriate allowance for it.

Context

There are cap levels for three payment methods: Direct Debit (DD), Standard Credit (SC) and Prepayment Meter (PPM). SC is defined as a payment method whereby a domestic customer pays their supplier directly for charges relating to supply activities after receiving a bill, such payment not drawn automatically from a domestic customer's bank account by reason of a direct debit authorisation or otherwise.³⁰ PPM is defined as a payment method whereby a domestic customer pays the licensee for charges for supply activities through a PPM or a Smart Metering System running in Prepayment Mode.³¹ The final payment method is 'Other Payment Method'. This is any payment method that is not SC or PPM and denotes DD.

We set the core operating costs allowance at the level for a DD customer. However, there are underlying cost differences between payment methods. We currently apply a "payment method uplift" on our efficient benchmark to account for how operating costs vary by payment methods (we refer this as the "payment method differential").

Payment method uplift for SC customers

There is a greater cost to serve SC customers in comparison to DD customers. This is reflected in three specific costs: additional working capital costs from SC customers paying in arrears, higher bad debt costs from a higher propensity to fall into debt, and additional administrative costs (eg debt collection and customer contact). We set the payment method uplift for SC customers using 2017 data to align with the core operating cost baseline.

³⁰ Ofgem, GAS ACT 1986 Standard conditions of gas supply licence, standard licence condition 28AD <https://www.ofgem.gov.uk/sites/default/files/2023-03/Gas%20Supply%20Standard%20Consolidated%20Licence%20Conditions%20-%20Current.pdf>

³¹ Ofgem, GAS ACT 1986 Standard conditions of gas supply licence, standard licence condition 28AD <https://www.ofgem.gov.uk/sites/default/files/2023-03/Gas%20Supply%20Standard%20Consolidated%20Licence%20Conditions%20-%20Current.pdf>

The Payment Method Uplift for the SC cap level is split into two sub-components:

- A percentage term (denoted as Payment method Adjustment Percentage) which covers the bad debt and working capital elements of the allowance. This term varies by consumption. We update this term by scaling it with other cap components.
- A flat term (denoted as Payment method Adjustment Additional Cost) which covers the additional administrative costs. This term does not scale with consumption. We update this term by indexing it to CPIH.

We benchmarked the additional SC costs by adding together the additional costs to serve across the three cost areas. We benchmarked this total to the lower quartile supplier. When setting the payment method uplift, we aligned the difference between DD and SC to what the market was pricing at the time. We decided to spread a portion of the bad debt and additional administrative costs across both DD and SC customers. This was because we did not consider it was appropriate for an individual SC customer who pays on time to incur the full cost of bad debt representative of that group. Details of our approaches can be found in our 2018 decision.³²

We allocated all of the additional working capital cost to SC customers, plus 60% of the additional bad debt and administrative costs. We spread the remaining costs across SC and DD customers, using the average proportion of SC customers on default tariffs.³³

For cap period 10b (July 2023 – Sept 2023), the PMU allowances for SC customer are approximately £62 and £65 greater than DD customers for gas and electricity respectively.³⁴

Payment method uplift for PPM customers

Following the end of the Competition and Market Authority's (CMA) PPM cap in 2020, we introduced a PPM specific cap level to the default tariff cap.³⁵

The costs of supplying PPM customers are generally higher than for DD customers. This is in part due to: higher costs for buying and maintaining traditional PPM meters than credit meters; PPM relying on a bespoke payment infrastructure; and PPM customers are

³² Ofgem (2018), Default Tariff Cap: Decision Appendix 8- Payment method uplift. Paragraph 2.39-2.49 https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf

³³ Ofgem (2018), Default Tariff Cap: Decision Appendix 8- Payment method uplift. Paragraph 3.40 https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf

³⁴ This is the increment on the PMU allowances, and there may be other costs that feed into the overall cap level differences between payment methods. This is based on the Medium TDCV of 2,900 kWh for electricity and 12,000kWh for gas.

³⁵ Ofgem (2020), Decision on protecting energy consumers with prepayment meters, https://www.ofgem.gov.uk/sites/default/files/docs/2020/08/protecting_energy_consumers_with_prepayment_meters_-_august_2020_decision.pdf

more likely to call their supplier resulting in higher costs to serve. However, there may also be some benefits, such as reduced bad debt.³⁶

To reflect this difference, we adopted the CMA's estimate of the additional PPM costs relative to a DD customer. This was based on historical (2014) supplier data and a bottom-up assessment that the CMA carried out.

We acknowledged that the additional PPM costs could be up to £17 per customer higher than the CMA estimate based on our updated analysis.³⁷ We therefore decided to offset this amount against the reduction in the PPM cap level from the benefits of the smart meter rollout.

For cap period 10b, the PMU allowances for PPM customers are approximately £41 and £21 greater than DD customers for gas and electricity respectively.³⁸

Considerations

Drivers of the payment method differential

As we mentioned in the case for review section, the age of the data is one of the main reasons for reviewing the payment method differential.

We plan to consider the impacts of existing and upcoming changes in regulation, and recent market events, on suppliers' efficient additional costs that drive the payment method differential. For example, we have now issued a Code of Practice on Involuntary PPMs (the 'Code').³⁹ The Code is a voluntary agreement to help drive up standards and protect consumers from harm from involuntary PPM. This new regulation could impact a notional efficient supplier's operating costs of supporting PPM customers if these involve changes in service obligations. We consider that there is a case for gathering evidence on the net impact of these changes on suppliers' payment method differential between DD and PPM. However, we recognise that there may be limitations on the data available for the costs of a new measure.

In addition, we are mindful of any overlaps between our consideration of payment method differentials and the debt-related costs workstream, which considers the impact of recent events on debt over the last year. We will be careful to not double count any costs or benefits.

³⁶ CMA (2016), Energy market investigation, Appendix 9.8, Paragraph 21 and Table 7, <https://assets.publishing.service.gov.uk/media/576bcc08ed915d3cfd0000b9/appendix-9-8-analysis-of-costs-by-payment-method-fr.pdf>

³⁷ Ofgem (2022), Price Cap- February 2022 Decision on credit and PPM SMNCC allowances. Paragraph 2.104 <https://www.ofgem.gov.uk/publications/price-cap-february-2022-decision-credit-and-ppm-smncc-allowances>

³⁸ This is the increment on the PMU allowances, and there may be other costs that feed into the overall cap level differences between payment methods. This is based on the Medium TDCV of 2,900 kWh for electricity and 12,000kWh for gas.

³⁹ Ofgem (2023) Involuntary PPM - Supplier Code of Practice - <https://www.ofgem.gov.uk/publications/involuntary-ppm-supplier-code-practice>

Questions

21. What drivers of change in the payment method differential should we consider as part of this review? Please provide evidence of any reported cost changes.
22. How have the recent external events affected drivers of differences in the payment method differentials? Are they one-off or permanent impacts?

Other payment methods

Under the current cap methodology, we set three payment specific cap levels for customers paying by DD, SC and PPM.

We intend to consider whether there are other payment methods we should include in the operating cost review. This may include, for example, different billing frequencies (eg monthly and quarterly standard credit) and different payment terms (eg prompt pay).⁴⁰

If there is sufficiently accurate and relevant data on the costs of any different payment methods, we may consider calculating a separate payment method differential for any such payment methods.

Questions

23. Are there other payment methods we should consider when setting the payment method uplift? If so, what are they? Please provide evidence of any differences in operating costs associated with serving these customers using other payment methods (if identified) relative to DD.
24. What variations do you observe within the three existing payment methods? (eg does the frequency of DD payments vary beyond monthly across supplier customer base?) How do these variations relate to costs (eg does the frequency of DD payments cause changes in operating costs)?

Benchmarking approach

We outline a number of benchmarking approach considerations in the previous section (eg benchmark metric and non-efficiency factors). These all largely apply to setting the benchmark for the payment method differential too.

⁴⁰ Prompt Pay- prompt payment discounts were previously offered to customers pay by quarterly cash and cheque, who were able to pay within 10 days after receiving their bills.
https://www.ofgem.gov.uk/sites/default/files/docs/2000/02/review-of-british-gas-tradings-price-regulation-final-proposals-1002_0.pdf

It was removed as a result of the Ofgem's retail market review (RMR) reforms.
https://assets.publishing.service.gov.uk/media/54f48e7840f0b61427000009/Retail_-_pricing_strategies.pdf

The benchmark metric we use for the core operating cost allowance does not necessarily need to determine the approach we use for the payment method uplift. We may consider using a different approach to payment method uplift if there is good reason to do so (for example, we use a lower quartile approach for the core operating cost allowance but a weighted average approach for the SMNCC to reflect the level of uncertainty for a new activity).

We will also consider whether to benchmark payment method differentials individually, or whether to select the same benchmark supplier for all payment method differentials. Individual benchmarking could help us to identify an efficient approach to serving each payment method. Different suppliers may have strengths in serving different payment methods. However, using a single benchmark supplier could be more appropriate if there are strong interlinkages between the costs of serving different payment methods. This would provide assurance that a supplier could achieve the benchmarks across its portfolio. We are mindful that we may take similar types of benchmarking decisions in the debt-related cost review. Where appropriate, we will seek to align our approach. However, before doing so, we still intend to consider the options on their own merits.

Questions

25. Should we use the same benchmarking approach for core operating costs and the payment method differential? Are there any additional or different considerations than for the core operating cost benchmarking approach?
26. Do you have initial views on whether we should benchmark payment differentials individually, or use the same benchmark for each supplier?

Costs allocation

In our operating cost review, we intend to consider how we should allocate the additional costs between payment methods.

As described in the context section, the current approach to setting the SC payment method difference does not allocate costs in a fully cost reflective manner. In our 2018 decision, we acknowledged cost reflectivity could be considered in different and conflicting directions.⁴¹ We consider that this is still the case and that there is not necessarily a clear approach to allocating costs. For example, allocation of bad debt requires some judgement as customers can move between payment methods and incur debt throughout that journey. These movements can occur a result of payment

⁴¹ Ofgem (2018), Default Tariff Cap: Decision Appendix 8- Payment method uplift. Paragraph 3.48-3.49 https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_8_-_payment_method_uplift.pdf

difficulties, adding to the level of judgement required in deciding which payment method they sit under.

To know what costs to allocate, we would require an assumption for the proportion of customers on each payment method. We would normally use recent data to update this assumption. However, this data may currently be impacted by the migration of customers to default tariffs during the high energy price crisis. More engaged customers, who tend to pay by DD, have moved to default tariffs. This means that DD customers make up a higher fraction of default tariff customers. We intend to consider whether current data is likely to be reliable as a measure of the likely proportions of default tariff customers across payment methods in future.

Within this review, our focus is on identifying the costs of different payment methods. We intend to explore options for allocating costs between payment methods. This may not necessarily reflect cost reflectivity, acknowledging there are a range of options and judgments. We are also mindful of interactions with the levelisation of payment method differentials workstream, any decision taken with regard to levelisation will then use these payment method differences as the underlying differential.

Questions

27. What is your view on how we should allocate the identified cost categories between payment methods?

Smart metering costs

Context

As part of the government's ambition to ensure that households and small businesses can benefit from smart meters, the Smart Meter Targets Framework has been introduced to ensure timely delivery of the smart meter rollout.⁴² Collectively, across both large and small energy suppliers, there were 29.6 million (55% of all domestic meters) smart meters in domestic properties in Great Britain at the end of 2022.⁴³

One cost to suppliers is the net cost of installing and operating smart meters as part of the transition for the smart meter rollout.⁴⁴ We reflect this in the cap through two allowances:

⁴²BEIS (2023), Smart Meter Targets Framework

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1134681/smart_meter_targets_framework_mid_point_review_consultation.pdf

⁴³BEIS (2023), Smart Meter Statistics in GB: Quarterly Report to end December 2022

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1143890/Q4_2022_Smart_Meters_Statistics_Report.pdf

⁴⁴ Net costs means "net" of the estimated benefits to suppliers of installing a smart meter.

- The core operating cost allowance – which includes the smart metering costs in the 2017 baseline year (alongside other operating costs). This allowance is uplifted for CPIH when updating the cap.
- The Smart Metering Net Cost Change (SMNCC) allowance – which reflects the change in smart metering costs since 2017. Under the current cap methodology, we use the SMNCC model to calculate the overall SMNCC allowance, by bringing together the pass-through and non-pass-through element.

SMNCC pass-through element

The pass-through element includes allowances provided for the costs of smart metering relating to industry charges.⁴⁵ Under the current methodology, the SMNCC pass-through costs include:

- Data Communications Company (DCC) charges. DCC manages the smart data communications network. Communication hubs send information from smart meters to suppliers;
- Smart Energy Great Britain (SEGB) charges. SEGB is an independent, not for profit organisation that promotes the benefits of smart meters; and
- Consolidated Metering Code of Practice (CoMCoP) (previously, Smart Meter Installation Code of Practice, SMICoP). CoMCoP specifies the minimum requirements that apply to the undertaking of installation, operation and maintenance of Metering Equipment.

We calculate SMNCC pass-through costs using publicly available charging statements and budgets. We determine the pass-through SMNCC in Annex 5 to Standard Licence Condition 28AD.

SMNCC non-pass-through element

The non-pass-through element comprises of allowances provided for changes in costs and benefits to suppliers from rolling out smart meters.⁴⁶ These are the impacts on suppliers' own costs, rather than the costs passed through in charges from external bodies. Suppliers incur costs from rolling out smart meters, particularly the costs of smart metering equipment (ie smart meters, communication hubs, In-Home displays) and costs of installing it. Suppliers also receive benefits from reduced operating costs (eg

⁴⁵ When we refer to "pass-through" we mean adjustments made to reflect the average cost across suppliers for smart industry bodies (DCC, SEGB and CoMCoP).

⁴⁶Ofgem (2018), Default tariff cap: decision – overview, Appendix 7- smart metering costs, Paragraph 2.8, https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_7_-_smart_metering_costs.pdf

fewer meter reading and inspection visits, lower switching costs and fewer customer enquires).⁴⁷

We include a non-pass-through SMNCC, rather than simply indexing costs with inflation, to reflect that net costs will change as the rollout progresses.⁴⁸

We currently set a separate non-pass-through allowance for PPM and credit meter (DD and SC) customers. This reflects differing costs and benefits between smart and traditional meters for PPM customers.

The SMNCC model

The non-pass-through SMNCC model is loosely based on the Department for Energy Security and Net Zero's (DESNZ, previously BEIS) cost benefit analysis model, which we modified for the purpose of setting the SMNCC allowance. We have made updates to our non-pass-through SMNCC modelling approach through each subsequent annual review.

Over time this has increased the complexity of the model. In response, we consulted on indefinitely pausing future methodological reviews;⁴⁹ reflecting a judgement that potential gains in accuracy from changes would likely be outweighed by the costs of increased complexity. A majority of suppliers agreed with this judgement, resulting in a decision in February 2023 to no longer regularly review SMNCC modelling. We have, however, maintained a commitment to keep the current models updated with the latest data and to publish updated non-pass-through values.

Considerations

A proportionate approach to setting the allowance for smart metering costs

We consider that the SMNCC allowances are still appropriate for the current market conditions. However, if we review the core operating costs allowance, we will intend to consider changes in smart metering costs from the new baseline year.

The smart meter rollout has progressed significantly since the cap was introduced. Rollout costs incurred to date would be reflected in an updated core operating cost benchmark. In this context, we intend to consider whether maintaining a similar approach to calculating the SMNCC would be proportionate if we had already updated the core operating cost benchmark. We are aware of the complexity of the SMNCC model, and, in response to SMNCC consultations, stakeholders have commented on how

⁴⁷ Ofgem (2023) Decision on approach to reviewing the SMNCC allowances, Paragraph 3.21, <https://www.ofgem.gov.uk/publications/price-cap-february-2023-decision-approach-reviewing-smncc-allowances>

⁴⁸ Ofgem (2018), Default tariff cap: decision – overview, Appendix 7- smart metering costs, Paragraph 2.1, https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_7_-_smart_metering_costs.pdf

⁴⁹ Ofgem (2023) Decision on approach to reviewing the SMNCC allowances, <https://www.ofgem.gov.uk/publications/price-cap-february-2023-decision-approach-reviewing-smncc-allowances>

complicated the SMNCC model has become over time. We will therefore explore whether, going forward, a simpler approach would be preferable.

At present, we set a single cap level across smart and traditional meter customers. As more smart meters are rolled out, we therefore reflect the impact of changes in smart metering costs and benefits through changes in the SMNCC. A possible alternative approach would be to set separate cap levels for smart and traditional meter customers. In that case, the impact of additional smart meter rollout would be recognised through more customers paying the smart meter cap level, rather than by updating an SMNCC component. However, in considering such an option, we would need to be mindful of any implications on the incentive to take up a smart meter and the costs for the falling stock of traditional customers.

We will also consider exploring whether we need a different approach from the current SMNCC model to reflect further changes in the smart meter rollout. In the case where we consider there to be a need for a separate approach, we intend to assess if we make use of the current SMNCC model to set the remainder of the cap allowances.

Based on how far along the rollout is, we may also consider whether the mix of operating costs are closer to reflecting a smart meter baseline and therefore if it would be appropriate to have a separate component to reflect the profile of remaining traditional meter costs, instead of the transitional smart meter costs.

Questions

28. If we updated the core operating costs baseline, what factors should we consider when considering options for updating smart metering costs over time?
29. What approach should we take to setting the allowance for smart meters in the cap and why?
30. Do you think a separate allowance to update smart metering costs in our operating cost review should be considered, if so, what approach do you suggest?

Industry charges

Context

A number of bodies are involved in administering the energy system levy charges on suppliers, in order to recover their costs. These charges are outside suppliers' control and are recovered in the cap across two components:

- The core operating cost allowance - industry charges are cost lines to the core operating costs that include administration costs of Elexon and Xoserve, as well as any other obligatory industry charges that are specific to supply. We calculate

these costs as part of the core operating costs, using 2017 data, and index the core operating costs with inflation;⁵⁰ and

- The SMNCC pass-through element – changes in the costs for DCC, SEGB and CoMCoP (previously SMICoP) since the 2017 baseline. The SMNCC allowance directly reflects changes to these costs. We discuss reviewing smart metering costs in the smart metering costs section of this document.

Considerations

Changes in industry charges

Since the introduction of the cap, the retail market has seen considerable changes. There has been the introduction of schemes like the Retail Energy Code (REC) and Faster and More Reliable Switching (FMRS). There are also further changes under development, for example, Market Wide Half Hourly Settlement (MHHS). The costs from these industry changes can be split into the pass-through costs needed to administer them and the implementation costs to suppliers (eg IT system changes). We consider the pass-through element of industry charges in this section. We expect implementation costs to be captured by the consideration of the core operating cost allowance.

As part of the operating cost review, we are keen to understand and identify whether there are costs of industry charges that have changed at a different rate from inflation, given that we index the core operating cost allowance by CPIH.

We note that some industry charges will replace other industry charges, for example Retail Energy Code Company (RECCo) has taken on functions from other industry bodies. We would therefore be keen to understand the overall (net) changes in costs in such cases.

Questions

31. Are there sufficient reasons to indicate that there may be a need for a review of the industry charge methodology?
32. What are the important changes in industry charges since 2017?

Approach to setting and updating industry charges

We could continue including certain industry charges within core operating costs and then update them with inflation. Alternatively, we could separate out industry charges as a distinct component, and then update them on a pass-through basis. This would be similar to our current approach for pass-through smart metering costs. Separating out

⁵⁰ Ofgem (2018) Default tariff cap: policy consultation, Appendix 8, Paragraph 2.21
https://www.ofgem.gov.uk/sites/default/files/docs/2018/05/appendix_8_-_operating_costs.pdf

these charges could mean that the updated allowances would more closely reflect changes in the underlying charges. However, it would add complexity to the modelling, so we plan to consider whether it would be proportionate, given the size of these charges.

Questions

33. What advantages and disadvantages do you think we should consider when developing an approach to setting and updating industry charges?

34. Do you have an initial preference between the potential approaches?

Implementation approach

Context

Updating the operating cost allowances

Under the current cap methodology, we update each component of the operating cost allowances differently when updating the cap:

- For the core operating costs allowance and the flat element of the payment method uplift allowance (eg additional SC administrative costs and the PPM uplift), we update the baselines using CPIH.
- We set the payment method uplift allowance for additional bad debt and working capital costs for DD and SC customers as percentage values, which scale with other cap components.⁵¹
- We update the allowance for SMNCC pass-through costs to reflect changes to relevant industry charges. We update the allowance for SMNCC non-pass-through costs using the SMNCC model to reflect changes in rollout and the main costs and benefits.

Setting the cap at nil consumption

Most tariffs on the market have a fixed charge (standing charge) and a variable element (unit rate). The standing charge allows suppliers to recover costs that do not vary with a consumer's consumption, such as fixed network charges. Variable costs allow suppliers to charge consumers for the incremental costs they incur when customers consume more energy, such as fuel costs.

We set two separate benchmarks: one at nil consumption and one at the Typical Domestic Consumption Values (TDCV), which are applied when we set the cap, so the

⁵¹ These cap cost components are: wholesale costs, operating costs, policy costs and network costs.

level of the cap varies in proportion to consumption.⁵² The maximum standing charge (a daily value) is the cap at nil consumption divided by the number of days in a year.

We set the cap at nil consumption in line with market prices for standing charges in 2017, rather than using a bottom-up/cost reflective approach. This was to avoid significantly increasing charges for low consumption default tariff customers.⁵³

To achieve this, we took a top-down approach to calculate the implied core operating costs allowance and scaled-down a version of the SMNCC at nil consumption.⁵⁴ This resulted in the level of standing charge at nil consumption in the 2018 decision being lower than would be required to collect all fixed changes.

This decision did not affect operating costs at typical consumption. We, therefore, include some operating costs in the standing charge (those included in the cap at nil consumption) and the remainder in the unit rate (the additional amount included in the cap at typical consumption).

Considerations

Updating the allowances over time

As we've identified in this paper, there are a number of future market changes (eg MHHS and consumer standards changes) that may impact a notional supplier's efficient operating costs. As part of this review, we intend to consider how we capture future changes in costs that may not have started to materialise yet.

We will need to balance uncertainty (eg how predictable a future cost is at this point in time) and proportionality (eg the frequency at which we should consider changes to the operating cost allowances). In doing so, we could consider options such as setting a future profile of operating cost allowances against a simpler indexed update approach. We are mindful that the update approach will also interact with how we set the benchmark (particularly the stringency of the level we set).

Another key consideration will be whether any costs arising in future are temporary as part of a transitional/one-off impact or enduring in nature. Alongside this, we would also consider whether there are any benefits to suppliers from the cost area that would offset some or all of the costs, so we are considering the impact symmetrically.

⁵² Ofgem (2018), Default tariff cap: decision, appendix 1 Benchmark methodology, paragraph 1.2 https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_1_-_benchmark_methodology.pdf

⁵³ Ofgem (2018), Default tariff cap: Decision, Overview document, paragraph 2.96 https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document_0.pdf

⁵⁴ Ofgem (2018), Default tariff cap: Decision, Appendix 1 – Benchmark methodology, paragraph 2.28 and 2.32 https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_1_-_benchmark_methodology.pdf

Our ambition is to set the enduring operating cost allowances that remains appropriate over time, without the need for frequent benchmarking exercises.

Questions

35. Do you agree with our considerations for updating the benchmark? Are there any other approaches we should explore for incorporating future costs?

Allocating operating costs across the standing charge and unit rate

In our operating cost review, we will collect new data and carry out cost assessments. This will allow us to consider options for setting the cap at nil consumption. We intend to consider the following options:

- Option 1 - We could maintain the current approach. In practice, this would mean setting the cap at nil consumption in line with current levels. We would not be able to gather new tariff data to replicate the original approach, given that most customers are currently on capped tariffs.
- Option 2 - We could set the operating cost allowance at nil consumption in line with our revised assessment of the operating cost allowances at typical consumption, taking into account any operating cost differences between nil and typical consumption.⁵⁵ This would be a cost-reflective approach. However, depending on the outcome of our cost analysis, it could lead to an increase in the standing charge. This would have distributional consequences across customers.

Questions

36. Which option do you think we should use to allocate costs across the standing charge and unit rate?

37. Are there other options for allocating costs across the standing charge and unit rate which we should consider?

38. What is your view on the extent to which we should prioritise this topic in our review?

Next steps

Following stakeholders' feedback, we will consider the consultation process for a review of these allowances. We welcome stakeholders' responses to the questions set out in this document and, as far as possible, ask that responses are supported with appropriate evidence.

⁵⁵ While we expect that most operating costs are similar between nil and typical consumption, there could be some differences, such as bad debt.

In addition, we have issued a draft Request for Information (RFI), related to this review, to suppliers with over 100,000 domestic customers on a default tariff. We invite suppliers with the number of domestic customers below this threshold to contact us if they wish to provide comment on the draft RFI.

Following stakeholders' feedback on the draft RFI and the Call for Input, we intend to issue a final RFI, as a mandatory RFI under Standard Licence Condition 5 of the gas and electricity supply licences, to all suppliers with over 100,000 domestic customers on a default tariff. Suppliers who do not meet this threshold will be encouraged to complete the final RFI on a voluntary basis.

We intend to use the data and information we gather from the RFI and this Call for Input responses to determine whether a review is appropriate and if deemed so, determine the scope of the review.

Depending on the responses and evidence we receive, we intend to consider whether publishing working papers on specific policy areas to explore the options further would be beneficial; following the working papers, we intend to proceed our normal consultation process, to publish a policy consultation later this year.

Question

39. Should we include published working papers as part of our policy development process. If yes, are there any particular topics covered in this CFI that you would like us to expand on through a working paper?

Stakeholder feedback

Please send any responses to priceprotectionpolicy@ofgem.gov.uk by 23 June 2023, including detail and supporting evidence wherever possible. As part of your comments, please explain how any suggested approach would be deliverable in practice. If you have any questions, please contact us at the above email address.

Yours faithfully,

Dan Norton,

Deputy Director, Price Protection

Appendix 1 - Legislative and consumer interest frameworks

Legislative framework

The Domestic Gas and Electricity (Tariff Cap) Act 2018 requires us to put in place and maintain the licence conditions which give effect to the cap. The objective of the Act is to protect existing and future default tariff customers when the cap is being set. We consider protecting customers to mean that prices reflect underlying efficient costs. In setting the cap we must have regard to the following five matters. The need to:

- Create incentives for holders of supply licences to improve their efficiency;
- Set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- Maintain incentives for domestic customers to switch to different domestic supply contracts;
- Ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence; and
- Set the cap at a level that takes account of the impact of the cap on public spending.

The requirement to have regard to the five matters is identified in section 1(6) of the Act does not mean that we must achieve all of these. In setting the cap, our primary consideration is the protection of existing and future consumers who pay standard variable and default rates. In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often, a balance must be struck between competing considerations.

Consumer interest framework

The cap objective aligns with Ofgem's consumer interest framework.⁵⁶ In our framework, we set out four high-level objectives: Fair prices, Quality & Standards, Low-Cost Transition and Resilience. While the cap cuts across all of these objectives, it is most closely linked with Fair prices. The cap objectives and consumer interest framework are relevant to our decision making when making changes to the cap methodology.

⁵⁶ Ofgem (2022) Net Zero Britain: developing an energy system fit for the future, <https://www.ofgem.gov.uk/publications/net-zero-britain-developing-energy-system-fit-future>

Appendix 2 – Summary of areas for feedback

In this Appendix, we provide a summary of the areas for feedback which have been cited throughout this document. We ask for stakeholders to provide evidence to support their views on the areas which have been outlined.

Introduction

1. Do you agree with the scope set out in the introduction section for the operating cost review?
2. Do you agree with the areas that we consider are outside the scope of this review?
Do you consider that there should be anything else in the scope of this review?

Case for review

3. What are your views on the case for review we identify in this section?
4. Do you agree that there is sufficient reason to carry out a review?

Main areas for consideration

Core operating costs

Potential drivers of changes in cost lines

5. What cost lines do you think should be included within operating costs?
6. Do you consider there to be any new costs which may have not been included within the existing core operating costs allowance?
7. Do you consider that any new costs would be off-set by corresponding benefits?
8. Do you consider there to be any costs included within the core operating costs allowance but are now no longer incurred?
9. What external events do you think have impacted (or will impact) operating costs?
Are these impacts permanent or temporary? Can you provide evidence on how costs have been affected, and by how much (ie per customer)?

What years of data to use for the baseline

10. What time period do you think we should use for the updated baseline for core operating costs and why?
11. What factors should we seek to correct for in setting an enduring benchmark?

Overall approach (Bottom-up Vs Top-down)

12. What are your views on the options of our overall approach? Do you agree with our minded to approach?

13. Do you have any alternative approach for calculating the efficient level of core operating costs across suppliers?

Benchmarking approach

14. Which benchmarking approach options do you think we should be considering?

15. How should we develop a framework for choosing between benchmarking options?

16. What non-efficiency factors linked to customer bases do you think drive cost variation among suppliers? Should we control for these through an adjustment or benchmark metric?

Allocating costs across different parameters

17. Are there other parameters over which you think operating costs would materially differ?

18. Do you think there are any operating costs that would materially differ between serving single rate and multi-register electricity meter customers? If so, please provide evidence to support your view.

19. What is your view on the extent to which we should prioritise allocating costs between different parameters currently not included in our cost data breakdown?

Setting the allowance on an enduring basis

20. In the event that some of the cost drivers are impacted by recent events, how should we treat these costs to determine an allowance on an enduring basis?

Payment method differential

Drivers of the payment method differential

21. What drivers of change in the payment method differential should we consider as part of this review? Please provide evidence of any reported cost changes.

22. How have the recent external events affected drivers of differences in the payment method differentials? Are they one-off or permanent impacts?

Other payment methods

23. Are there other payment methods we should consider when setting the payment method uplift? If so, what are they? Please provide evidence of any differences in operating costs associated with serving these customers using other payment methods (if identified) relative to DD.

24. What variations do you observe within the three existing payment methods? (eg does the frequency of DD payments vary beyond monthly across supplier customer base?) How do these variations relate to costs (eg does the frequency of DD payments cause changes in operating costs)?

Benchmarking approach

25. Should we use the same benchmarking approach for core operating costs and the payment method differential? Are there any additional or different considerations than for the core operating cost benchmarking approach?
26. Do you have initial views on whether we should benchmark payment differentials individually, or use the same benchmark for each supplier?

Costs allocation

27. What is your view on how we should allocate the identified cost categories between payment methods?

Smart metering costs

A proportionate approach to setting the allowance for smart metering costs

28. If we updated the core operating costs baseline, what factors should we consider when considering options for updating smart metering costs over time?
29. What approach should we take to setting the allowance for smart meters in the cap and why?
30. Do you think a separate allowance to update smart metering costs in our operating cost review should be considered, if so, what approach do you suggest?

Industry charges

Changes in industry charges

31. Are there sufficient reasons to indicate that there may be a need for a review of the industry charge methodology?
32. What are the important changes in industry charges since 2017?

Approach to setting and updating industry charges

33. What advantages and disadvantages do you think we should consider when developing an approach to setting and updating industry charges?
34. Do you have an initial preference between the potential approaches?

Implementation approach

Updating the allowances over time

35. Do you agree with our considerations for updating the benchmark? Are there any other approaches we should explore for incorporating future costs?

Allocating operating costs across the standing charge and unit rate

36. Which option do you think we should use to allocate costs across the standing charge and unit rate?
37. Are there other options for allocating costs across the standing charge and unit rate which we should consider?
38. What is your view on the extent to which we should prioritise this topic in our review?

Next steps

39. Should we include published working papers as part of our policy development process. If yes, are there any particular topics covered in this CFI that you would like us to expand on through a working paper?