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Price cap – Operating cost review- Benchmarking - UW response

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Utility Warehouse was one of the first ‘challenger’ brands when it entered the retail energy market over 20 years ago, and we have a unique perspective in that we operate across numerous regulated markets: energy, telecoms and insurance. Today we serve over 900,000 households.

UW overarching view

Operating costs should be benchmarked using a weighted average approach.

- Of the options presented, a weighted average is by far the most appropriate and accurate way to reflect an efficient industry cost. It is a practical mechanism that best achieves a fair, cost-reflective, and achievable benchmark in the best interests of consumers. Table 3 rightly shows that a weighted average approach (specifically outcome 2) best enables Ofgem to have regard for all matters set out in the Act.
- We caution against using a lower quartile or frontier approach as this carries the risk of misrepresenting costs, driving under-investment, and creating an impossible and unachievable benchmark for suppliers to target, with potentially negative unintended consequences.

Of the options that allow for a weighted average, outcome 2 is the most appropriate.

- Table 3 sets out how each option scores against the matters to which Ofgem must have regard as set out in the Act. This clearly puts outcome (2) as the most effective mechanism to deliver an adjusted operating cost allowance fit for the future, while delivering the right outcomes for consumers and the market.

We do not agree with a strict efficiency driving cap, outcome 1

- A strict efficiency-focused cap does not enable competition or incentivise switching. While Ofgem states that such a cap protects consumers, our perspective differs. While it may impose a lower cap on consumers, setting it excessively low will not protect consumers if it results in poor customer service outcomes due to under-funding, lack of investment in the transition to net zero, or (in an extreme case) suppliers failing or exiting the market.
- Achieving efficiency requires investment in improving activities and the cap should accommodate for this, rather than presuming all suppliers can instantly achieve this without incurring any costs. A strict efficiency cap would likely render the majority of suppliers financially unsustainable, operating at a loss on their operational expenses.

Consultation questions

Q1	<p>What is your view on how benchmarking options will lead to different outcomes?</p>
	<p>We welcome and agree with the logic Ofgem has set out in Section 3 with respect to the different outcomes under each of the options. We believe that operating costs should be benchmarked using a weighted average approach:</p> <ul style="list-style-type: none"> - Of the outcomes presented, a weighted average is the most accurate way to reflect an efficient industry cost. It is a practical mechanism that best achieves a fair, cost-reflective, and achievable benchmark. As Ofgem demonstrates in Table 3, a weighted average approach (specifically outcome 2) best enables Ofgem to have regard for all matters set out in the Act. - We caution against using a lower quartile or frontier approach as this carries the risk of misrepresenting costs, driving under-investment, and creating an impossible and unachievable benchmark for suppliers to target with potentially negative unintended consequences. It fails to recognise how a supplier may be achieving the lower quartile (e.g. possibly because it is achieving higher quartile in other cost areas through sub-optimal business processes). This creates a risk that suppliers are driven to achieve targets in operating costs, by compromising performance and standards elsewhere. Further, it fails to accommodate the fact that a diverse market should be made up of varied business models that are not easily compared. - A weighted average benchmark allowance will allow suppliers to adapt to shocks or changes in the regulatory environment. We also believe it is important for Ofgem to maintain consistency with the benchmarking approach used in other allowances e.g. the COVID-19 true-up. - Lastly, the benchmark should reflect the market conditions we face today, ensuring that suppliers can efficiently recover the costs they incur; a weighted average allows for this. - Looking specifically at the four options presented by Ofgem, we strongly encourage the use of a weighted average benchmark methodology, and we believe that of the options that allow for this, outcome 2 is the most appropriate option. Table 3 sets out how each option scores against the matters to which Ofgem must have regard as set out in the Act. This clearly puts outcome (2) as the most effective mechanism to deliver an adjusted operating cost allowance fit for the future, while delivering the right outcomes for consumers and the market. <p>Additionally, we have set out our view to caution against outcome 1:</p> <ul style="list-style-type: none"> - While it may impose a lower cap on consumers, setting it excessively low will not protect consumers if it results in poor customer service outcomes due to under-funding, a lack of investment in the transition to net zero, or (in an extreme case) suppliers failing or exiting the market. - Achieving efficiency requires investment in improving activities and the cap should accommodate for this, rather than presuming all suppliers can instantly achieve this without incurring any costs. A strict efficiency cap would likely render the majority of suppliers financially unsustainable, operating at a loss on their operational expenses. - We agree that this option is less likely to enable competition and increase switching. As such, Ofgem should seek to deliver upon its function within the Act

	‘to promote competition wherever possible’ through fostering healthy and sustainable competition i.e. outcome (2).
Q2	In terms of achieving these overarching objectives, what outcomes should we focus on through the operating cost review?
	The primary focus should be on establishing a cap that fosters sustainable competition (outcome 2), alongside this the cap should drive higher customer service standards and increases supplier resilience (outcome 3 and 4), ensuring fairness for customers and enabling suppliers to consistently channel investment into efficiency and innovation, this will ultimately benefit consumers and aid in the achievement of the Net Zero goal. It is imperative that the resulting measures do not place an additional regulatory reporting burden on suppliers or permit some suppliers to exploit price-capped Standard Variable Tariffs (SVT) as a means of generating profits to cross-subsidise more engaged consumers, for instance, through below-cost tariffs.
Q3	Are there any other outcomes that we should consider achieving through the choice of benchmarking options?
	Ofgem hasn't recognised that a weighted average approach will achieve an additional outcome of a more sustainable market environment for investment and long-term strategic planning. Given that not all suppliers can achieve immediate efficiency gains without incurring costs, the ability to allow suppliers to forward plan investment in efficiency improvements is important. It will also help reduce the frequency of cap allowance revisions by ensuring the allowance is reflective of the cost of investment in efficiency.
Q4	Are there groups of costs captured within the operating cost review that are cross correlated and therefore those costs should be considered and benchmarked together?
	Our view is that all costs captured within the operating cost review should be benchmarked at a weighted average. This ensures that cross correlated costs are already collectively benchmarked, thus ensuring consistency and a fair, cost-reflective, and achievable benchmark.
Q5	How should we treat costs (ie debt-related costs) that may be more uncertain than other costs?
	Costs that may be more uncertain like debt-related costs should be benchmarked on a weighted average basis. A weighted average benchmark will allow suppliers to adapt to shocks or changes in the regulatory environment, ultimately supporting higher service standards. We also believe it is important that the benchmark should reflect the market conditions we face today, ensuring that suppliers can efficiently recover the costs they incur.
Q6	Are there any other costs that we should isolate from the total core operating costs?
	No, there are no other costs which should be isolated from the total core operating costs. Considering the varied approaches and provision assumptions among suppliers, the isolation of costs may result in inconsistencies and pose the risk of underrepresenting the actual costs involved. If all operating costs are benchmarked on a weighted average basis, isolating costs from this will not result in a different outcome.
Q7	What are your views on setting separate core operating cost allowances for smart meter and traditional meter customers, given the risks we discussed in this section?

	<p>We believe that separating the core operating cost allowance for smart meter and traditional meter customers is unnecessary. Many suppliers have already transitioned a substantial proportion of their customer base to smart meters, therefore as the smart meter roll out progresses, the majority of costs within the core operating cost allowances will already pertain to smart meters.</p> <p>Instead, we encourage Ofgem to implement strategies that promote the adoption of smart meters. Measures such as mandating a smart meter when ECO measures are installed, or legislating for a Treasury-funded social tariff that requires a smart meter would achieve increased take up of smart meters without placing additional financial burden on individuals. Furthermore, mandating the take up of smart meters would help to solve the roll-out issues without placing further burden on the consumer in terms of costs.</p>
Q8	What other benchmarking parameters do you think we should consider setting separate allowance for?
	<p>We do not believe that any further segmentation is required for the default tariff cap-beyond the current segments of the price cap, the data becomes more difficult to accurately split and we do not see a distinct group of customers who would receive benefits from further segmentation.</p>
Q9	What analysis do you think we should carry out in assessing the materiality of non-efficiency factors using the RFI data?
	No response
Q10	What other approach do you think we should take in how we account for nonefficiency factors?
	No response
Q11	What is your view on the proxy for suppliers' proportion of high-cost-to-serve vulnerable customers? Would you suggest an alternative approach?
	<p>Given the dynamic nature of vulnerability and the evolving circumstances of customers, using static proxies like the PSR, WHD or DNI list may not comprehensively capture all high-cost-to-serve vulnerable customers.</p> <p>We encourage Ofgem to work with the Government to progress the concept of a treasury-funded social tariff, which would introduce a progressive, more equitable policy mechanism for providing financial support to the most vulnerable in society. On the specific point about targeting, we would encourage Ofgem to review the relevant section of the recent report from the Social Market Foundation (SMF)¹. This report addresses the complexities of the different dataset options and offers sensible recommendations on utilising the most appropriate data to effectively capture vulnerable customers.</p> <p>We believe that such a treasury-funded future social tariff must sit alongside a continuing universal SVT price cap. The purpose of the price cap and a social tariff should not be confused. A price cap and a social tariff offer different protections, to different customer groups, for different reasons. They are not mutually exclusive. The introduction of a social tariff (or equivalent) for the most vulnerable does not justify the removal of market-wide</p>

¹ [https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Fairer,%20warmer,%20cheaper%20\(March%202023\)%20\(1\).pdf](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/Fairer,%20warmer,%20cheaper%20(March%202023)%20(1).pdf)

	price protection. One policy prevents exploitation, and one policy addresses the affordability challenge.
Q12	What level of stringency of the cap do you think we should consider?
	We emphasise the importance of sustainability and suggest that Ofgem carefully considers a cap that accommodates future regulatory changes and recognises the need for investment. Simultaneously, it should strive to maintain the price cap to closely reflect a notionally efficient supplier's costs in order to comply with the objectives of the Cap. Please also refer to our response to Q1.
Q13	How should we account for the impact of the expected regulatory changes mentioned above?
	<p>Ofgem has mentioned that they intend to set a suitable benchmark on an enduring and forward looking basis and do not plan to review the operating cost allowance again in the near term. It is therefore of the utmost importance that we accurately impact the expected regulatory changes to be reflected in the benchmark.</p> <p>We support Option 3, a looser cap set using a weighted average benchmark is simple, consistent and effective in accounting for these uncertainties on additional efficient costs due to these regulatory changes. It is a practical mechanism that best achieves a fair, cost-reflective, and achievable benchmark.</p> <p>Issuing additional RFI's to gather data (Option 1) entails significant time and costs for suppliers. It may also result in inconsistencies due to differences in how suppliers split and allocate costs. Additionally, the regulatory cost may not be fully realised but the time Ofgem issues this RFI and waiting for accurate data may result in a delay in the implementation of the operating cost review.</p> <p>We urge Ofgem to prioritise this major adjustment and aim to deliver this with pace by Winter 24/25.</p>
Q14	Which option of accounting for the uncertainties in costs driven by upcoming regulatory changes do you agree with? What other options do you think we should use to account for these costs?
	Please refer above to our response to Q1 (weighted average benchmarking methodology) and Q13 (setting a looser cap).
Q15	How should we account for the limitations in our methodology and the associated uncertainty?
	Please refer above to our response to Q1 (weighted average benchmarking methodology) and Q13 (setting a looser cap).
Q16	What approach do you think we should take to set the benchmarks for different operating cost allowances?
	<p>We strongly encourage Ofgem to use a weighted average benchmark for each of the different operating cost allowances. In summary, the key reasons for our position on this are that a weighted average approach:</p> <ol style="list-style-type: none"> 1) ensures that any cross correlated costs are already collectively benchmarked, removing the need to undertake a dedicated exercise to achieve this;

	<p>2) lowers the risk of misrepresenting costs and driving underinvestment (a risk that exists with both the lower quartile and frontier approaches); and</p> <p>3) of all the outcomes, it best allows for the diversity of business models within the market, which we believe the regulatory framework should foster, not prevent.</p>
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