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[redacted]

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By email: priceprotectionpolicy@ofgem.gov.uk

Response to Ofgem's call for input on the price cap operating cost review benchmarking working paper

Dear Dan

Thank you for the opportunity to respond to this call for input. We have the following observations:

1. **We urge Ofgem not to overwork its review of the benchmarking choice for the operating costs allowances and to proceed this review at pace.** Ofgem's review of the operating costs allowances should proceed quickly and should be tightly focused on ensuring that the allowances remain reflective of efficient costs and are future-proofed for a changing retail energy market. Some of the benchmarking options Ofgem is proposing would require more RFIs and push back implementation by some time. The time spent reviewing this should be commensurate with the impact on bills: opex is ~10-15% of bills.

2. **In the round, Ofgem should lean towards a benchmarking approach which drives suppliers to be operationally efficient and benefits consumers.** The price cap has been successful in driving efficiency - more effective potentially than decades of pure "competition" - which converts into lower prices for consumers. With the advent of AI and other technology, it's likely there is more "road to run" in terms of operational efficiencies.[1] Setting a high standard for efficiency is an important ongoing role which Ofgem should not shy away from.

[1] We also note that some suppliers are explicit that they expect operating costs to decrease further in future years. For example in their 2023 H1 results Centrica noted that: "*we have driven an average 8% reduction per year in cost per customer since 2019, and we see the possibility for this to reduce by a further 10-15% over time as our processes continue to improve and all customers migrate onto the new platform.*" See Centrica, 2023 Interim Results, 27 July 2023.

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3. **Ofgem should challenge some of its assumptions going into this review. In particular:**
    a. Lower opex and lower customer service is not a real trade off: Octopus is proof that you can have great, market leading customer service and low operating costs. Better service is likely to lead to happier customers and quicker resolutions. The answer to customer service issues is better monitoring from Ofgem and targeted interventions, not a more generous operating costs allowance.
    b. We disagree that a tighter opex allowance will necessarily harm suppliers' financial resilience. Financial resilience/cost recovery should not be a reason for setting a looser opex allowance, and the cap should not be seen as a policy tool for Ofgem to address financial resilience concerns - this can be done through other parts of the cap (e.g. the EBIT allowance) and through the the financial resilience framework and Ofgem's monitoring and intervention powers.

4. **In addition to ensuring the allowances reflect efficient costs in the round, we would like to see Ofgem's operating costs review focus on two things:**
    a. Looking at debt-related costs in the round: as set out in our response to the debt-related costs allowance consultation, suppliers are facing high debt costs right now related to cost of living issues which we think Ofgem should address through a temporary adjustment. If this is done, the operating costs review is the chance to look at debt costs in the round.

    b. Reviewing the allowance for the payment method uplift: We consider that Ofgem needs to carefully review the inputs and modelling behind the payment method uplift. The current approach is driving payment uplifts which are not credibly reflective of efficient costs and are specifically too high for standard credit. The standard credit payment uplift hits some of the most vulnerable and lowest income households in the country and is now effectively a profitable premium for suppliers who price in line with cap, incentivising them to keep customers on a less efficient and customer-friendly payment method. Addressing this is an important and tangible way Ofgem can support customers through the cost of living crisis.

5. **In terms of methodology for the operating costs allowances, we encourage Ofgem to remove - rather than add - complexity to the cap,** to be cautious of the information asymmetry risk inherent in operating cost RFIs and avoid spurious accuracy In particular:
    a. Ofgem should apply fewer, rather than more parameters to benchmarking: There are no data-driven reasons to benchmark gas and electricity customers separately. Where Octopus has provided costs split along these lines in the

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RFI we have done this purely on assumptions - this is not something we track internally as we do think it is necessary.

b. There is no need for Ofgem to consider the "non-efficiency factors" it has identified in its analysis. The "non-efficiency factors" Ofgem has identified (such as pension costs and offline customer costs) appear to be outdated and shaped heavily by legacy business models. These factors may have been relevant in 2017 but they don't reflect the competitive retail market today. Comparable costs are not factored into network price controls and certainly should not be costs that customers should bear in a market

c. Overall, simpler analysis, looking at broader categories of costs is quite often more accurate than very detailed analysis.

We would be happy to address any questions about our response and assist further in this review.

Yours sincerely

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Responses to working paper questions

Overarching objectives

1. **What is your view on how benchmarking options will lead to different outcomes?**

In terms of setting the benchmark for operating costs, we do not see the need for Ofgem to spend a lot of time updating the choice of the benchmark for the operating costs allowances and we think Ofgem should keep the benchmark relatively tight - at most lower quartile, as is the case for core operating costs and the payment method uplift. Of the outcomes set out by Ofgem in Table 2, we prefer outcome 1 being "*a strict efficiency driving cap to set a higher efficient expectation and maximise customer protection*"**.** We remind Ofgem that to date the price cap has been successful in driving efficiency - more effective potentially than decades of pure "competition" - which converts into lower prices for consumers. Independent analysis we have seen of legacy supplier Consolidated Segmental Statements shows that the introduction of the cap aligns with a fall in the growth rate of Big Six's indirect costs per customer. On average, indirect costs per customer rose every year on year between 2015 and 2018 for gas and electricity, and began to fall from 2019. Setting a high standard for efficiency is an important ongoing role for the regulator which Ofgem should not shy away from.

We want to specifically challenge some of Ofgem's assumptions in its analysis of trade-offs between options set out in Table 4 of the working paper. Specifically

- We disagree with Ofgem's assumption (e.g. in Outcome 3) that lower operating costs - in particular customer contact costs - means lower customer service levels and/or lower customer satisfaction. Octopus is clear proof that great customer service does not cost more - in fact it costs less. [redacted] At the same time, we have a Net Promoter Score (NPS) that is +39 points above the energy supplier average - the highest difference across any of the sectors that Bain surveyed - and one of the highest company NPS in any sector; and have been awarded the Which? recommended energy supplier six years in a row. Taken together, we think these show clearly that lower operating costs does not equal lower standards of service or customer satisfaction.
- We disagree with Ofgem's assumptions that a tighter opex allowance will harm suppliers' financial resilience. Ofgem can address the interplay between the price cap and supplier financial resilience by looking at the EBIT price cap allowance and making sure suppliers can recover costs outside their control (like wholesale costs and passthrough costs). Financial resilience/cost recovery should not be a reason for setting a looser opex allowance, and the cap should not be seen as a policy tool for

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Ofgem to address financial resilience concerns - this can be done through the financial resilience framework and Ofgem's monitoring and intervention powers.

2. **In terms of achieving these overarching objectives, what outcomes should we focus on through the operating cost review?**

The main focus of the operating cost review should be making the allowances more reflective of efficient costs, making the cap overall simpler, and doing this quickly.

3. **Are there any other outcomes that we should consider achieving through the choice of benchmarking options?**

No.

Methodology - treatment of cost lines

4. **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?**

Overall, we support Ofgem's preferred approach to take a top-down approach to operating costs, rather than breaking out into detailed lines as this is technically less complex. We think the structure of the cap needs to be much simpler and urge Ofgem not to overwork this review and focus on updating the cap where it will have the biggest impact on consumers.

In line with taking a simpler, more streamlined approach, we encourage Ofgem to take group costs together. We agree with the groups of costs that Ofgem has already correlated in the RFI through the indirect cost categories of (i) customer contact (ii) billing and payment collections; and (iii) metering. We consider these three groups of costs are the main drivers of the operating costs allowances and Ofgem should focus on these, rather than be distracted by the numerous other indirect costs that it has collected data on in the RFI.

In the case of the benchmark for customer contact costs, Ofgem should be going no higher than the lower quartile and should consider setting the benchmark at the frontier. This approach takes into account efficiencies expected between now and the new allowances coming into effect at the end of 2024 driven by the technological advances of AI. We are happy to support Ofgem with setting the benchmark at the frontier and have provided data in the RFI. Octopus is clear proof that great customer service does not cost more - in fact it costs less. [redacted]. The delivery of the new technology and billing platforms to energy suppliers is driving substantial efficiencies.

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5. **How should we treat costs (ie debt-related costs) that may be more uncertain than other costs?**

We support Ofgem using the operating costs allowances review to look at debt-related costs on the whole. Reviewing debt costs within the context of core operating costs. Looking at debt costs within a wider review means taking into account factors that are pushing operating costs down, such as technology innovations that have emerged since 2018. However, we also agree that there are a number of "abnormal" debt costs facing suppliers right now - these are costs related to the wider cost of living crisis and not driven solely by (and therefore disconnected from) energy costs. As set out in our November response to the debt-related costs allowance consultation, we consider Ofgem can manage this uncertainty by making a temporary 12 month adjustment for debt in April 2024, which can be reviewed annually.[2]

6. **Are there any other costs that we should isolate from the total core operating costs?**

No, we do not think there are any further costs that Ofgem should consider isolating. Overall, we would prefer to see Ofgem consolidating operating costs rather than isolating. In particular:

Industry charges: Ofgem has indicated it is considering setting up a new cost component for industry charges which can be updated separately. Insofar as industry charges are genuinely passthrough costs (i.e. suppliers cannot impact their level and therefore benchmarking is not very useful), we would be open to these be taken out of the operating costs allowances and set-up as a passthrough. This could allow Ofgem to take a more stable approach to setting the operating cost allowances, focusing on what is in suppliers' control.

Debt-related costs: see response to question 5.

Smart metering costs: We agree that the SMNCC model has become very complicated over time and urge Ofgem to move along from this and adopt a simple approach for the non-passthrough costs of smart meters. We also support Ofgem's step towards having a separate component to reflect the profile of remaining traditional meter costs, rather than transitional smart meter costs. In other words, given than the majority of the market is now smart it makes sense to move to a model that assumes a certain % of smart meters and a remaining cost of traditional meters, rather than starting from the other way around. This is a

[2] Octopus' view is that the default position should be that this temporary allowance expires by 31 March 2023, but Ofgem reviews in advance whether it should be extended. This would not be true-up. It would be looking at the wider changes in the market and in the price cap (which we hope will include the conclusion of the Opex review) and consider a) is there a case for continuing with a temporary uplift for debt related costs - i.e the cap is not sufficiently accounting for these costs and if so b) what is the correct level for this uplift for the year ahead.

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concrete way that Ofgem can ensure that its price cap work is building for the future market, rather than looking backwards.

Methodology - benchmarking parameters

7. **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?**

Overall, we do see any need to set separate operating cost allowances for smart meter and traditional meter customers. This would be a fundamentally backwards looking way of Ofgem regulating the market and is likely to be time-consuming. The requirement and expectation is that all meters will be smart meters, meaning there should be no difference in the metering costs across prepay and other customers. Ofgem should prioritise the next stage of the operating cost allowances work with this in mind.

We do think, however, that Ofgem should ensure that it sets the prepay payment method differential based on smart prepay costs to serve, rather than traditional prepay costs to serve. This smart meter penetration in the UK has increased considerably since 2017. The jump is particularly stark in prepay where smart prepay is increasingly the norm. The prevalence of smart should frame Ofgem's approach to metering cost allowances and is one way that Ofgem can fully support the end of legacy prepay.

8. **What other benchmarking parameters do you think we should consider setting separate allowance for?**

We urge Ofgem to simplify and modernise its approach to setting the operating costs allowance by using fewer rather than more benchmarking parameters. We are supportive of using payment type as a benchmark but do not think Ofgem should add any other parameters.We are pleased to see that Ofgem is no longer proposing benchmarking operating costs between meter types (e.g. single rate v multi-register).

In particular, we do not think it is necessary for Ofgem to set separate benchmarks for operating costs for electricity and gas. We see no material difference in operating costs between these two variables. At Octopus, we do not record costs based on the granularity of splits requested i.e. tariff, meter type, PSR category type etc. Therefore, we have had to create assumptions to split the majority of costs requested in the RFI.

Overall, in setting this operating cost allowance, it is crucial that Ofgem futureproofs and designs it for the market as it will be, not the market as it was. Being an energy supplier has changed from quarterly billing for commodity energy supply to majority direct debit billing, which will increasingly be based on more granular smart meter data and there are lots of factors impacting cost to serve a customer, which are only likely to change in future. For

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example customers with EV, solar, heat pumps and batteries can require a lot of support on a smart tariff. Ofgem can not possibly forecast all these changes so the most sensible approach is to keep the approach simple.

Methodology - non-efficiency factors

9. **What analysis do you think we should carry out in assessing the materiality of non-efficiency factors using the RFI data?**

As we set out in our June response to your Call for Input and the RFI, the non-efficiency factors Ofgem has described (as detailed below) are all immaterial to how Octopus runs its business and our operating costs. These factors may have been relevant in 2017/18 when the cap was being designed but do not reflect the market in 2023/2024 which is made up of large scale, independent challengers as well as legacy suppliers.

Accordingly, Ofgem should treat these "non-efficiency factors" as immaterial when designing the operating costs allowances. Overall, we do not think Ofgem should even be collecting data on this RFI. This level of data collection undermines the view of a "notional" supplier. Given the change in the supplier market over the last few years (from 68 to 21 active domestic suppliers between 2017 and 2023) and the fact that this growth has occurred through SOLRs and M&A and not just switching, we think it is reasonable for Ofgem to assume that the customer bases of the large suppliers are sufficiently similar for this cut of the data to be unnecessary and unhelpful. It is only likely to be used by certain suppliers (likely legacy suppliers) to argue that they have "different" customers who have higher costs to serve and that these costs are outside those suppliers' control. We strongly disagree with this argument. Octopus has spent years behaving and communicating differently with its customers and it gets different results from its customers, including when it comes to debt and payment methods.

In particular:

- Legacy pension arrangements: These should not be considered as impacting operating costs. These factors may just about have been relevant in 2017 but they do not reflect the competitive retail market today and including these measures just tilts the playing field towards legacy suppliers. Ofgem has not addressed this competition concern anywhere in its working paper. Ofgem could read across from its approach to network price control benchmarking, where benchmarking is done on overall staff costs with no separate for pension costs etc.
- Single fuel customers: Most domestic energy consumers have dual fuel accounts (70% of electricity customers and 80% of gas customers)[3] and so we expect that the impact of any additional cost for single fuel customers would be marginal.

[3] House of Commons Library, Introduction to the Domestic Energy Market, 23 October 2023.

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- Offline factors: OEL does have some “non-digital” customers who elect to receive all communications via post.These customers can still be served through our billing platform and therefore the additional costs to serve these customers are largely sending post - this is a marginal cost. In addition, this is a very small group of customers - we estimate that this is [redacted] of customers excluding change of tenancies. This factor is immaterial to overall operating costs and should be considered as such by Ofgem.

- Vulnerable customers: see response to question 11.

10. What other approach do you think we should take in how we account for non-efficiency factors?

As set out in response to question 10, we expect that the impact on operating costs allowances of the “non-efficiency factors” Ofgem has identified is immaterial so consider Ofgem should not spend too much time and effort on this analysis.

11. What is your view on the proxy for suppliers’ proportion of high-cost-to-serve vulnerable customers? Would you suggest an alternative approach?

As Ofgem is aware, it is difficult and not always helpful to draw bright lines around who is and who is not “vulnerable”. Customer vulnerability can be driven by circumstances and therefore be transient, rather than being a permanent state. However, our data does show that certain customers who may be vulnerable do tend to contact us more and this may lead to a higher cost to serve. [redacted]

In terms of measuring this group of customers, we agree with Ofgem’s reservations about the PSR; but think that it is probably a “good enough” - if not perfect - proxy, not least because it is well defined. Another option may be to include customers in receipt of WHD. We are cautious of Ofgem spending more time and effort designing a different measure of vulnerability which suppliers do not all use. Ifthis measure it’s taken, we expect it’s likely that number of customers on PSR/in receipt of WHD has been a fairly consistent proportion of households, therefore the operating cost of serving these customers should also stay fairly consistent.

Methodology - the stringency level of the cap

12. What level of stringency of the cap do you think we should consider?

Please see responses to questions 1-3 above.

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13. **How should we account for the impact of the expected regulatory changes mentioned above?**

Overall, we appreciate Ofgem's efforts to create an enduring allowance but we urge Ofgem to try to simplify the cap overall, rather than go to increasing levels of granularity. Regulatory changes could, for example, be addressed through the headroom allowance that already exists in the cap.

Further, the 2022 time period that Ofgem is using for its benchmarking included a large degree of regulatory change during a period of energy crisis. This baseline should therefore provide a good baseline going forward and act as a proxy for the forward-looking adjustment that Ofgem is considering. At Octopus, we do not track operating costs pertaining to regulatory initiatives such as EBSS, EPG etc. The operating costs of these programmes are also often offset by other "benefits" for suppliers (e.g. in lower bad debt levels) so accounting for them in operating costs explicitly could lead to double counting.

That said, we agree that there has been an incredibly high degree of regulatory change in 2022 and 2023. Much of this has been driven by Ofgem's overlay granular approach to the price cap - Ofgem has published 15 price cap consultations in 2023 - almost double the monthly rate in 2022. We urge Ofgem to simplify its approach to the price cap and this would already reduce regulatory uncertainty in the market.

14. **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?**

As set out in response to question 13, we do not prefer any of the options proposed by Ofgem and consider that these uncertainties are already managed through the cap's headroom allowance. We also think that Ofgem could use the 2022 data it already has which will already include a degree of regulatory change that can be taken for designing an enduring approach.

15. **How should we account for the limitations in our methodology and the associated uncertainty?**

As set out in our response to the June call for input, one way to limit uncertainty in the methodology is for Ofgem to make its RFI/s on operating costs tightly focused, as this controls against the information asymmetry risk between Ofgem and suppliers. We note that Ofgem has not heeded that advice in its RFI, but repeat it here:

- We urge Ofgem to make its RFI tightly focused on parts of opex which are tightly defined and not open to gaming by suppliers who can easily move costs around

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- As described in questions 9-11 above, we do not think Ofgem should collect characteristics (such as online/offline, PSR, tariff type) of the suppliers' customer bases as a set of parameters.

Benchmarking approaches across operating cost allowances

16. What approach do you think we should take to set the benchmarks for different operating cost allowances?

Ofgem should overall strive to keep the cap, and its approach to setting all the operating cost allowances simple. This likely means preferring using the same benchmark metric across components.

Our further view on benchmark considerations are in response to questions 1-3 above.