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Sent by email to: [priceprotectionpolicy@ofgem.gov.uk](mailto:priceprotectionpolicy@ofgem.gov.uk)

Dear Price Protection Policy team

## **Energy price cap operating cost review benchmarking working paper<sup>1</sup>**

Centrica welcomes the opportunity to respond to the working paper. In responding to the Call for Input (CFI) we supported Ofgem in its intention to set out a framework for choosing between benchmarking options, underlining the need to take a holistic approach to consumer protection objectives.

Ofgem is right to acknowledge potential tensions between objectives and that *“how we benchmark suppliers’ operating costs will lead to different outcomes being attained.”*<sup>2</sup> We agree, and consider that Ofgem’s current benchmarking approach is *prima facie* inconsistent with the wider consumer protection objectives it articulates – sustainable competition, high and enhanced customer service standards, in line with new licence requirements, and financial resilience – all of which require a looser cap.

Ofgem should, therefore:

- Abandon the current ‘stringent’ benchmarking approach – based on an aggressive benchmark between lower quartile and frontier - in favour of weighted average.
- Benchmark at total operating cost (opex) rather than component level and avoid cherry picking inconsistent component benchmarks that are cumulatively unachievable by any efficient supplier.
- Identify and isolate cost elements for which a general inflation index are not appropriate – notably smart costs and industry charges – so that they can be updated separately.

While we note Ofgem’s initial assessment of the effectiveness of different cap outcomes in relation to the statutory criteria enumerated in Section 1(6) of the Domestic Gas and

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<sup>1</sup> [Energy price cap operating cost review benchmarking working paper | Ofgem](#)

<sup>2</sup> Working paper, paragraph 3.6

Electricity (Tariff Cap) Act 2018 (the Act)<sup>3</sup> the effectiveness rating appears highly subjective, and we respectfully disagree with the suggestion that efficiency incentives are a function of cap stringency. Suppliers remain subject to strong incentives towards efficiency both through the need to compete with each other for customers (many of whom are acutely price-conscious) and in order to maximise profits *irrespective* of the level of the cap.

Observed lack of industry profitability in the period since the introduction of the cap despite strong pressure to reduce operating costs strongly point to a cap that has been too tight rather than too loose. The risk that observed costs since 2019 understate the true level of efficient cost due to artificial distortions imposed by the cap itself lends further support to the need for a conservative rather than aggressive approach to benchmarking.

We respond to Ofgem's specific consultation questions in further detail in the attached appendix and look forward to engaging further as the review progresses.

Yours sincerely

Don Wilson

**Retail Market Design and Policy**

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<sup>3</sup> Working Paper, Table 3.

## Appendix 1: Response to Ofgem consultation questions

### Overarching objective

1. *What is your view on how benchmarking options will lead to different outcomes?*
2. *In terms of achieving these overarching objectives, what outcomes should we focus on through the operating cost review?*
3. *Are there any other outcomes that we should consider achieving through the choice of benchmarking options?*

We welcome the fact that Ofgem is explicitly considering the impact of different benchmarking options on consumer outcomes.

In 2018, Ofgem took an aggressive approach to operational cost allowances based on a narrow interpretation of the Tariff Cap Act 2018; Ofgem effectively equated low prices with consumer protection. However, the supplier failures throughout 2021 and 2022 exposed the flaws of focussing unduly on price as the main determinant of competition and consumer interest.

As Oxera correctly noted in its report to GEMA last year:

*“It was Ofgem’s explicit intent in calibrating the price cap that it should be ‘a tough cap that ensures loyal consumers pay a fair price that reflects efficient costs’. To the extent that the price cap was calibrated to deliver stretching levels of cost efficiency, it may have left suppliers with insufficient headroom to deal with shocks.”<sup>4</sup>*

It is, therefore, imperative that Ofgem takes a broader view of consumer protection that includes sustainable competition, financial resilience, and incentives to invest in differentiated and enhanced customer service.

We note from Ofgem’s own analysis outlined in Table 2 that achieving any one of these wider objectives, let alone all three, requires a looser (weighted average) approach to benchmarking. To put it another way, maintaining Ofgem’s current ‘stringent’ approach to benchmarking (between frontier and lower quartile) is *prima facie* incompatible with sustainable competition, higher customer service standards or increased financial resilience, underlining the clear need for a substantial change in approach.

Ofgem elaborates its initial assessment of outcomes and the effectiveness of achieving primary objectives and the matters to have regard under each outcome in Table 3. Ofgem’s commentary in relation to the *status quo* outcome asserts that “*Stringent cap incentivises suppliers to improve efficiency to make efficiency gains now or in the long term*”. A stringent benchmark may necessitate aggressive cost cutting. However, aggressive cost cutting is not synonymous with efficiency in a broader sense. Indeed, as noted in relation to Table 2, maintaining the current aggressive approach to benchmarking conflicts with achievement of wider consumer protection objectives.

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<sup>4</sup> [Review of Ofgem's regulation of the energy supply market | Ofgem](#)

The relevant statutory requirement to which Ofgem must have regard is “*the need to create incentives for holders of supply licences to improve their efficiency.*” Incentives to improve efficiency are not a function of cap stringency; they result from other aspects of cap design, namely the certainty that efficiency gains will not be expropriated by a ratcheting down of allowances rendering such gains nugatory. Ofgem has previously recognised this explicitly:

*“4.64. The Act requires us to have regard to (among other matters) the need for incentives for suppliers to improve their efficiency. Setting an upfront allowance, and then not adjusting this over time (except for indexing by inflation), provides suppliers with an incentive to improve their efficiency. This is because suppliers know that if they make efficiency gains, they should be able to keep the additional revenue, rather than us adjusting the cap down in response. Similarly, suppliers know that if they allowed their costs to increase, they would not be able to recover this from customers.”<sup>5</sup>*

The present situation is thus quite different from a typical price control where it is expected that the price control will (repeatedly) be set by reference to a regulated firm’s own costs. In such a situation there is a concern that firms will have an incentive to allow costs to rise and accordingly there is a specific reason to set the control at a level which maintains incentives to efficiency. By contrast, the present cap is intended to be a safeguard cap against excessive prices usually for a particular subset of customers, imposed on a temporary basis, and with no mechanism by which suppliers’ incurred costs in one period could feed back to the price cap (or prices more widely) in a subsequent period. Consequently, suppliers remain subject to strong incentives towards efficiency both through the need to compete with each other for customers (many of whom are acutely price-conscious) and in order to maximise profits *irrespective* of the level of the cap.

In the context of reviewing the appropriate opex benchmark Ofgem should be mindful of the distorting impact a stringent cap may have had in terms of driving opex below the efficient level consistent with an effectively competitive market exhibiting normal commercial returns.<sup>6</sup>

Observed lack of industry profitability in the period since the introduction of the cap despite strong pressure to reduce operating costs strongly point to a cap that has been too tight rather than too loose. Against this background, Ofgem cannot safely assume that operating costs observed since 2019 reflect a neutral ‘efficient’ baseline which can be used directly to calibrate estimates of efficient costs prospectively. The risk that observed costs since 2019 understate the true level of efficient cost due to artificial distortions imposed by the cap itself lends further support to the need for a conservative rather than aggressive approach to benchmarking.

## **Methodology**

### *Treatment of cost lines*

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<sup>5</sup> [Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation \(ofgem.gov.uk\)](#)

<sup>6</sup> As noted in our recent response to Ofgem’s proposed competition framework, effective competition requires an expectation of reasonable profitability to support investment in innovation; it requires financial resilience to shield consumers from the fallout of reckless failed business models; and it requires a competitive level playing field to incentivise efficiency and support good customer outcomes.

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?*
5. *How should we treat costs (i.e. debt-related costs) that may be more uncertain than other costs?*
6. *Are there any other costs that we should isolate from the total core operating costs?*

As a general principle, there will be elements of operating costs that are cross correlated as in the case of debt-related costs Ofgem cites (all else equal, suppliers who incur more debt-related administration costs to manage debt collection may have lower level of bad debt costs in their accounts). In addition, there is unlikely to be complete consistency between suppliers in how they classify individual cost lines.

This is why Ofgem cannot responsibly benchmark across suppliers at a highly granular level; cherry picking “efficient” benchmarks narrowly and summing them disregards the link between lower costs in some areas and correspondingly higher costs in others, thereby producing an unrepresentative overall benchmark that is unattainable by any efficient supplier in practice.

We appreciate that Ofgem is attempting to build in some flexibility to isolate groups of costs in some areas to allow for separate treatment if appropriate. We agree in principle that Ofgem should aim to isolate industry-wide pass-through costs (e.g. DCC) costs which are subject to specific change drivers outside suppliers’ control which a general inflation index will not account for. Similarly, changes in non-pass-through smart meter costs will depend on factors such as roll out and therefore require separate treatment from other operating costs. As discussed further below in response to Q8, industry charges should also be isolated and treated as pass through costs.

As regards debt-related costs, we note that Ofgem is currently reviewing these separately and to a different timescale to the overall opex review. To the extent such costs can be isolated (and may be driven by factors that are not well reflected through a general inflation index) there may be a case for treating them separately. However, we note that Ofgem intends to elaborate why it may treat debt-related (and other) components separately in its policy consultation and consequently reserve our position pending further explanation from Ofgem on its proposed approach.

### *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?*

For all the reasons we have previously set out in response to the CFI, Ofgem should not set separate caps for smart meter and traditional meter customers:

- If separate tariffs were applied by meter type this would require a capability to accurately and reliably identify customers’ meter asset type in advance of offering a tariff, and an ability to migrate customers from one tariff to another if the designation of their meter changes.

- In the smart roll-out, a tariff change (requiring a consumption based personal projection) would have to be added to the journey increasing complexity for the customer and likely reducing uptake of smart meters.
- Based on the current SMNCC values the tariff for a smart credit meter is likely to be higher than for a traditional credit meter (for prepayment meters the reverse would be true). This means that credit customers may have a higher quote and be deterred from taking a smart meter. Informing the customer of this possible price increase would make it more difficult for us to promote smart meters because instead of describing them as 'free' and 'with no extra charge on your bill'<sup>7</sup>, suppliers would need to advise customers of a potential tariff change. This would impact our ability, and that of other suppliers, to meet the Governments' smart meter targets.
- When switching, in order for a customer to get a correct projection, they would need to know their meter type when getting their quote to switch. This is likely only possible if they know their meter number. As most customers are unlikely to know where to look for their meter number, the additional effort is likely to further reduce switching. For those customers who do make the effort, there is a risk that they get it wrong, creating a poorer experience when the supplier has to switch their tariff post-acquisition, possibly increasing what they pay.

Such an approach would be inimical to effective competition and should not be pursued.

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

Our strong view is that Ofgem should allow a pass through of industry charges rather than updating the baseline values by CPIH which is the current approach. Since the cap was implemented industry charges have significantly outpaced CPIH.

As previously detailed in response to the CFI, there was an estimated shortfall across the industry with £70m of costs unrecovered in 2021/22. The precise shortfall for future years will depend on indexation but given the materiality of the historic under-recovery, introducing a cost pass through seems proportionate despite any additional complexity to implement.

There have been a number of important changes in industry charges since 2017 including:

- The Retail Energy Code has replaced the Master Registration Agreement (MRA) and the Supply Point Administration Agreement (SPAA) in 2022/2023.
- Retail Energy Code costs have increased to £18m over the period up to 2022 and are expected to rise to over £60m by 2024/25. This is due in part to the movement of Central Switching Service costs from Smart Metering to the Retail Energy Code.
- Elexon charges increased significantly in 2021/22 partly as a result of MHHS related budget addition with a value of £14,553,035.

Ofgem should prioritise the requirements set out in the Act including satisfying the requirements of s.1(6)(d) of the Act.' S.1(6)(d) of the Act requires that that Ofgem must have

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<sup>7</sup> <https://www.smartenergygb.org/about-smart-meters#ASMcanigetasmartmeterforfree>

regard to “the need to ensure that holders of supply licenses who operate efficiently are able to finance activities authorised by the license.”

### *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?*

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

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

Non-efficiency factors are likely to be material and Ofgem needs to take this into account.

Previously, Ofgem’s 2018 decision to adopt a lower quartile approach (further adjusted by an arbitrary £5 reduction) posed a high risk that suppliers with materially higher costs due to non-efficiency related factors such as customer mix would not be able to recover efficiently incurred costs.

As Ofgem now acknowledges, such a stringent approach is unlikely to be consistent with sustainable competition, high customer service standards and financial resilience.<sup>8</sup>

It is not clear that Ofgem can appropriately account for non-efficiency factors using existing RFI data alone. We acknowledge that fully investigating and adjusting for non-efficiency factors is likely to be challenging. Ofgem must not, however, simply use difficulty as an excuse for failing to include sufficient allowance for non-efficiency factors. Rather, Ofgem should seek to mitigate the risk of under-recovery of efficiently incurred costs by an appropriate choice of benchmark (i.e. weighted average rather than frontier or lower quartile).

### *The stringency level of the cap*

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

Ofgem has correctly identified the risks associated with a stringent cap set between the lower quartile and frontier (as now) – namely that suppliers may be unable to finance their efficient costs, conflicting with consumer protection objectives including sustainable competition, high standards of customer service and financial resilience.

Ofgem must, therefore, consider an alternative (higher) benchmark such as weighted average in order to mitigate these clear risks. As Ofgem notes: “our view of uncertainty may suggest a weighted average approach is preferable in the round and should still facilitate our desired outcome.”<sup>9</sup>

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

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<sup>8</sup> Working Paper, Table 2 suggests a weighted average benchmark will be required to meet these objectives.

<sup>9</sup> 4.31

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?

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

Ofgem presents three options to account for the impact of expected regulatory changes that will not be reflected in historic cost data:

- **Option 1** - issuing another RFI to gather 2023 data. This would enable us to include the costs due to these expected regulatory changes, into the new baseline. However, it would depend on the data availability and may significantly delay our implementation of the operating cost review decisions. Some impacts may not be realised until 2024 and will therefore still require a different approach.
- **Option 2** - consider including a forward-looking adjustment to the benchmark. This would account for the net costs associated with these regulatory changes and make the cap more resilient to future updates. However, this involves making assumptions on future enduring costs, which may be somewhat uncertain at the time we set the new operating cost allowances.
- **Option 3** - setting a looser cap (e.g. weighted average benchmark) to account for these uncertainties on additional efficient costs due to these regulatory changes. This would address the direction of the impact, but the magnitude may not be reflected accurately.

Ofgem is right to recognise the need to account for expected regulatory changes but wrong to present the options as alternatives; in practice a combination of options may be required.

As noted throughout this response, there is a strong case for setting a less stringent cap more consistent with Ofgem's wider consumer protection objectives including the need to ensure suppliers can finance their efficient costs. It does not follow, however, that Option 3 effectively accounts for the impact of expected or future regulatory changes (the costs are unlikely to be reflected adequately in existing cost data) or will sufficiently support those objectives without further adjustment. Consequently, Ofgem will need to combine a looser benchmark with a separate mechanism to account for prospective regulatory changes e.g. by including a forward-looking adjustment as envisaged for Option 2.

Regarding uncertainty, we acknowledge that methodology and data limitations could impact the accuracy of Ofgem's baseline estimates of the efficient level of operating cost. However, there is presently no basis to infer that uncertainty will result in an allowance that is "too generous" or reflect "double counting". Uncertainty may equally result in underestimation of efficient costs requiring more conservative approaches to estimation, or additional headroom or risk allowances, or some combination of all three to ensure Ofgem's consumer protection objectives can be consistently met in practice.

#### *Benchmarking approach across operating cost allowances*

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

We have consistently flagged the conceptual flaw in benchmarking different cost components by cherry picking frontier or lower quartile outcomes in each area, resulting in an overall estimate of efficient costs that is unachievable by any supplier in practice.

It does not follow that Ofgem should necessarily apply an undifferentiated approach across all cost components. For instance, in relation to non-pass-through smart costs Ofgem has recognised that the underlying cost drivers include rollout, precluding reliance on a general inflation index for cap updates. Similarly, there is a strong case for treating industry charges on a pass-through basis.

So long as Ofgem maintains the current aggressive benchmark set between lower quartile and frontier costs, applying a weighted average benchmark to other components not only better reflects non-efficiency related factors relevant to those components but also mitigates the risk of cherry picking to some extent. However, this approach remains a sub-optimal response to the risk an inappropriately low benchmark poses to the achievement of Ofgem's broader consumer protection objectives.

The appropriate response to resolve this contradiction is for Ofgem to adopt a weighted average benchmark across the board, distinguishing between cost components only in the methodology applicable to updates where a general inflation index will not adequately reflect component specific changes (e.g. in relation to smart costs and industry charges).