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Dear Dan

ENERGY PRICE CAP OPERATING COST REVIEW - BENCHMARKING WORKING PAPER

We welcome the opportunity to respond to your working paper on the approach to benchmarking in Ofgem's review of the operating cost allowance in the price cap. Our responses to the stakeholder questions are in Annex 1 to this letter, however we would like to highlight the following points:

Choice of benchmark

1. Ofgem's choice of a lower quartile (LQ) benchmark for opex costs in the original price cap was heavily influenced by the CMA's finding that suppliers had made excess profits and grown very inefficient from lack of competitive pressure. The same justification for an LQ benchmark does not apply today. The last five years of stringent price caps (with most suppliers making losses for four out of five years) have already resulted in cost saving measures which are effectively locked in. Setting a similarly stringent opex allowance this time round, where there is far less scope for efficiencies, would be a risk to system resilience. Instead, the goal should be a well-functioning retail market, where suppliers can make a fair margin through sustainable competition and have space to innovate and create longer term partnerships with customers. It is crucial that suppliers can afford to innovate and invest for the future. Driving down the opex allowance to a LQ level would not be consistent with this. Instead, the fairest approach for suppliers and consumers is likely to be a weighted average.
2. If Ofgem does decide to use a LQ benchmark (which we do not believe it should), it must be extremely careful to avoid separately benchmarking cost groupings where there are inverse correlations, which may result in LQ benchmarks that are unachievable by any supplier. Ofgem acknowledges this risk in theory, but we would note that it appeared to overlook this risk in setting the original opex allowance, where it separately benchmarked opex costs and the DD-SC payment method uplift.

3. Further, if Ofgem decides to use a LQ benchmark, it must take great care to control for non-efficiency factors, the most important of which in our view is the proportion of customers with high debt-related costs to serve. We agree with Ofgem that both the Priority Services Register (PSR) and Warm Homes Discount (WHD) are poor proxies for this, for the reasons set out in the working paper, and Ofgem needs to find a better measure of customer deprivation.
4. We do not believe the headroom allowance is an appropriate way to reflect the costs of future regulatory changes where those changes can be identified and (even approximate) estimates made of costs. Ofgem should assess the costs of such programmes as best it can and reflect these in the opex allowance, leaving the headroom for genuinely unforeseen future regulatory costs.

Other issues with the opex allowance

5. Allowances under the price cap are by definition a “one size fits all” mechanism and in combination with ‘cost smearing’ (ie cross-subsidies between different customer categories) carry a risk of competitive distortion between suppliers with different customer mixes. In reviewing the opex allowance, Ofgem should seek to reverse such cross-subsidy and instead use the new PPM levelisation mechanism (or equivalent), to achieve the same social objectives without distorting competition.
6. Ofgem should also consider enabling recovery of certain categories of bad debt via separate mechanisms, such as ScottishPower’s proposal for a levy-based process for customers who meet the criteria for “Do Not Install” prepayment meters (PPM). We request further clarity on Ofgem’s thinking about this.

Process issues

7. Baseline year: Ofgem should consider the case for continuing to review the scope and methodology of the review but delaying its data collection exercise to allow use of 2023 data.
8. We would encourage Ofgem to consider how it can provide maximum transparency over the data and analysis lying behind any decisions on the level of future allowances, for example by means of confidentiality rings.

Please do not hesitate to contact Richard Sweet or Dena Barasi with any queries on this response.

Yours sincerely,



Richard Sweet
Director of Regulatory Policy

**ENERGY PRICE CAP OPERATING COST REVIEW BENCHMARKING WORKING PAPER
– SCOTTISHPOWER RESPONSE**

Overarching objective

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

Ofgem is considering three benchmarking options:

- frontier benchmark;
- lower quartile (LQ) benchmark;
- weighted average benchmark.

In terms of outcomes, Ofgem is reflecting on whether it should maintain a cap on supplier operating costs which has “high efficiency expectation and maximises customer price protection” or whether it should seek the following “alternative primary outcomes”.¹ It acknowledges that there is a debate on what constitutes consumer protection.

Ofgem’s operating cost review focuses on delivering the outcome of a cap that:

- sets a high efficiency expectation and maximises customer price protection (the status quo);
- promotes sustainable competition;
- facilitates higher customer service standards; and
- increases supplier financial resilience against shocks or detrimental changes in the market.

When deciding how the cap should be calculated, Ofgem’s focus must be protection of consumers.² The longer-term interests of consumers are served by a stable supply market, with participants able to plan and invest to deliver the system of the future. Two of Ofgem’s benchmarking options – frontier and LQ – would work against longer-term protection of consumers and fail to deliver against the outcomes that Ofgem is working towards, when this is considered in the round.

Ofgem’s assessment indicates that a benchmark metric “between frontier and lower quartile” would deliver the outcome of “a strict efficiency driving cap to set a high efficiency expectation and maximise customer price protection”.³ We consider that in the longer term, this does not hold true and the assessment of “outcomes and the effectiveness of achieving primary objectives and the matters to have regard under each outcome” outlined in Ofgem’s working paper is flawed because it appears to be based on the premise that a more stringent benchmark is necessarily in the interests of customer protection.⁴

A LQ benchmark may have been appropriate at the time the CMA issued its recommendation,⁵ however the same logic no longer applies today. The stringent approach previously taken by

¹ Working paper para 3.9

² In accordance with the Domestic Gas and Electricity (Tariff Cap) Act 2018, Ofgem must exercise its functions with a view to protecting existing and future domestic customers who pay standard variable tariffs (SVTs) and default tariff rates.

³ See Working Paper Table 2, page 9

⁴ Ibid Table 3 (page 12-13)

⁵ The CMA’s assumptions have been challenged, for example, here: [The CMA’s assessment of customer detriment in the UK retail energy market | Journal of Regulatory Economics \(springer.com\)](https://www.springer.com/journal/10997/issue/1)

Ofgem to setting the allowance for the core operating costs at LQ minus £5 in the default tariff cap⁶ has already increased efficiency in the remaining suppliers. There is little in the way of further efficiencies to be found. As the least efficient and the poorly hedged suppliers have now exited the market, using a weighted average should provide an accurate and fair reflection of efficient suppliers remaining in the market.

We strongly recommend that Ofgem adopts a weighted average benchmark approach, noting that within each cost category, the different payment methods - Direct Debit (DD), Standard Credit (SC) and pre-payment meter (PPM) - should be benchmarked separately. We also noted that, if Ofgem is intending to use a LQ benchmark for administration and working capital costs, it is even more crucial that payment methods are benchmarked separately since, if using all customer data, the suppliers with costs in the LQ will likely be those with high proportions of DD customers for whom debt administration and working capital costs are relatively low. Similarly, if using a LQ approach, suppliers' bad debt, administration and working capital costs should be benchmarked together.

Great care should be taken in any assessment of supplier efficiency to avoid unfairly comparing suppliers with different customer mix. Low costs in this area could be linked to an inefficient supplier with a lower proportion of customers that are expensive to serve. Similarly, high costs could reflect an efficient supplier with more low income and vulnerable customers. This is not unlikely given suppliers whose customer base are more deprived may well need to focus more on the efficiency of their debt collection approaches than those with a relatively wealthy customer base.

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

From the non-exhaustive list of outcomes that Ofgem has identified, we consider that "promoting sustainable competition" maximises consumer protection in the longer term and promotes true efficiency. This is aligned with the CMA's definition of competition as "a process of rivalry between firms" that "where it is effective, encourages firms to deliver benefits to consumers in terms of lower prices, higher quality and more choice."⁷ The table below summarises our views on the four outcomes Ofgem seeks from the price cap:

	Outcome	ScottishPower view
1	Sets a high efficiency expectation and maximises customer price protection (the status quo)	Ofgem should consider whether the stringent approach taken has truly maximised customer protection and whether it can be expected to do so in the future. There are risks that working towards this outcome through a LQ or frontier benchmark may result in an energy retail sector without sufficient resilience. A weighted average benchmark still incentivises increased efficiency
2	Promotes sustainable competition	Sustainable competition means rivalry over the longer term and will encourage innovation. This is needed to deliver the change that the system needs
3	Facilitates higher customer service standards	This is of key importance and links to the non-efficiency factors - can best be achieved through proper use of levelisation outside of the price cap
4	Increases supplier financial resilience against shocks or detrimental changes in the market	Need more transparency from Ofgem on how VaR is used and interpreted in assessment of risks

⁶ [Appendix 6 - Operating costs \(ofgem.gov.uk\)](https://www.ofgem.gov.uk)

⁷ [Competition impact assessment Part 1: overview \(publishing.service.gov.uk\)](https://www.publishing.service.gov.uk)

To maintain sustainable competition under the price cap, Ofgem requires a detailed understanding of supplier costs from the bottom up, as well as from the top down. This can be achieved through careful and detailed capturing of costs in its opex review, particularly where these may differ due to inherent characteristics of different suppliers' customer mix. Ofgem should take a holistic view of any changes that result from the operating cost review.

It is in the interests of consumers that suppliers can innovate, secure net zero investment and build long term partnerships with customers to reduce carbon emissions from homes and businesses. Stringent benchmarking that aims at delivering efficiencies, risks protecting consumers in the near term at the expense of their longer-term interests.

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

Ofgem will need to balance the need to drive competition in retail markets with the need for stable, predictable, and transparent regulatory arrangements. The inherent trade-offs should be managed in ways that are designed to deliver maximum benefits for current and future consumers.

To this end, the price cap arrangements should be transparent and accessible to all relevant parties. The expected impact of any proposed reforms must also be carefully considered, with the expected impacts of any changes fully consulted on, in line with Ofgem's published impact assessment guidance. If market participants do not have clarity around proposed changes and the evidence used to support them, there will be a greater likelihood of detrimental changes to the price cap methodology. This is particularly a concern given the heterogeneity of suppliers and their customer bases, meaning that information requests may be interpreted differently, with different sets of underlying assumptions. To maintain trust and confidence in the regulatory process, we consider it essential that Ofgem establishes a confidentiality ring/data room to facilitate third party scrutiny of its assessments.

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?

We think Ofgem means 'inversely correlated' rather than 'cross correlated'. As Ofgem has recognised, it is important not to benchmark separately cost categories where there is inverse correlation because this may lead to 'cherry-picking' and setting an unachievable aggregate benchmark. These issues relate mainly to LQ benchmarks (but could also arise for weighted average benchmarks if Ofgem is selective in which suppliers to use for the weighted averages). This can often be the case where suppliers face trade-offs which mean that low costs in one category lead to higher costs in another (and vice versa). For example, if a supplier invests heavily in a self-service website, this will increase its IT costs but reduce its call centre costs. Separately LQ benchmarking IT and call centre costs would clearly be wrong.

Another situation where inverse correlation issues can arise is if there are differences in the way that suppliers allocate costs internally. Ofgem would need to be cautious in benchmarking separately cost categories where there is discretion or judgement involved in cost allocation between them. This is not just a theoretical point. When Ofgem set the original opex

allowance in 2018, it separately benchmarked opex costs and the DD-SC payment method uplift. In doing so, it used Scottish Power as (one of two) LQ suppliers for the DD operational costs benchmark. As a result of (in our view) a more accurate cost allocation methodology between payment methods, our reported bad debt costs for DD were relatively low and costs for SC relatively high compared to other suppliers, ie there was a clear inverse correlation between these cost categories. Ofgem's approach of separately benchmarking DD opex and SC-DD therefore ran the risk of 'cherry-picking' and setting an unachievable benchmark.

As explained in our response to Ofgem's recent consultation on an additional allowance for debt-related costs, suppliers' bad debt, administration and working capital costs should be benchmarked together, given the scope for inverse correlation (eg low debt administration expenditure could be correlated with higher bad debt and working capital costs and vice versa). We also note that these cost groups are correlated with the proportion of customers that have a high cost-to-serve. This may mean that the level of correlation within groups of costs will vary from one supplier to another, depending on their customer mix.

We have highlighted in previous submissions to Ofgem that some legacy suppliers are likely to have a higher proportion of expensive-to-serve customers. Suppliers who started as new entrants to the market and have therefore had more scope to target customer acquisition will have a correspondingly smaller share of such customers.

If Ofgem decides to use a LQ benchmark, it is particularly important that it fully considers how costs are grouped and that Ofgem does not base their benchmarks on LQs that cannot be achieved in practice. Ofgem should consult on any proposed categories and we will be happy to comment on possible inverse correlation risks at that point.

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

Operating cost allowances should be set as far as possible to provide recovery of costs in the same period as they are incurred. Uncertain costs should therefore be funded on an ex ante basis, based on best view forecasts across the industry, with true up/down adjustments in subsequent cap periods. This will better match cost recoveries to the time periods when market participants are incurring costs.

Ofgem should avoid ex post cost recovery as far as possible, albeit an element of reconciliation will be required between forecast costs and actual costs incurred between price cap periods. Alternatively, Ofgem could consider a reconciliation payment (similar to the Market Stabilisation Charge) to reflect unrecovered costs when a customer switches supplier.

Ofgem should benchmark separately for each individual payment method (ensuring that any cost allocation issues, as mentioned above, are appropriately controlled for). Notwithstanding our response to Question 1 above, this is particularly important if Ofgem is intending to use a LQ benchmark, since the LQ may be dominated by suppliers with high proportions of DD customers, with a relatively low cost-to-serve.

As we have stated previously, efficient suppliers with different customer mixes are impacted differently by industry trends and by using the price cap to adjust for the impacts of these trends. Simple adjustments to the price cap to reflect costs that are uncertain brings risks of substantial distortions to competition.

We welcome Ofgem's consideration of our proposal for a levy mechanism which allows suppliers to recover costs relating to debt held by the cohort of customers that meet the Do

Not Install criteria.⁸ The proposed levy would allow costs to be recovered in a manner that mitigates competitive distortion and strengthens competition for the benefit of all consumers. We urge Ofgem to consult on this as soon as possible.

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

Ofgem is proposing to isolate pass-through industry charges, smart metering costs and debt related costs from the core operating costs. We agree that these are the obvious cost categories to isolate when setting the price cap allowance.

However, as a separate point, we would note that it will be important for Ofgem to provide much greater transparency and granularity around the approach it has followed in reaching the allowances for these costs. As a minimum, Ofgem's policy consultation and decision on its opex review should provide an indicative breakdown of the core operating cost allowance between the following headings:

- Customer contact
- Billing and payment collections
- Bad debt
- Metering
- Sales and marketing
- Central overheads (maybe consider splitting out corporate functions, IT costs and others).

It is unclear at this stage how far Ofgem will replicate the existing Smart Metering Net Cost Change methodology for smart metering costs, but with regard to metering, we believe Ofgem should consider isolating:

- Legacy prepayment meter costs. Some suppliers will face ongoing costs of supporting infrastructure for customers with legacy prepayment meters that other suppliers may not have much of.
- Costs relating to metering and the smart transition as inefficiencies may emerge due to legacy metering, which can get proportionally more expensive over time.

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?

It is not clear that the benefits of setting separate core operating costs allowances for smart and traditional meter customer would currently outweigh the costs. Splitting out operating costs relating to smart meter and traditional meter customers would not be straightforward and would require detailed guidance from Ofgem to ensure that this was done in a consistent manner by different suppliers. The necessary changes to suppliers' systems would have a significant lead time.

In the near term, smart meter customers may have a higher cost-to-serve, relative to those on traditional meters. Setting separate core operating cost allowances could create disincentives for the uptake of smart meters, making it more difficult for suppliers to meet their smart meter obligation targets.

⁸ As set out in Ofgem's recent publication: [Additional debt-related costs allowance policy consultation \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/publications-and-reports/consultations-and-statements/additional-debt-related-costs-allowance-policy-consultation)

In the future, if the cost to serve smart meter customers reduces to a level that is below that of traditional meter customers, reflecting this in the operating cost allowances could provide much needed encouragement for smart meter take-up (though it would be necessary to find a way of avoiding unfairness to those in properties that are not suitable for a smart meter).

That said, it must be recognised that moving to separate core operating cost allowances for smart and traditional meter customers would present significant operational challenges for suppliers in the near term. Any expected benefits from smart meter rollout would need to be balanced against a thorough assessment of these practical issues before moving ahead with different price caps for customers with smart and traditional meters.

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

Ofgem is proposing to set separate allowances for different fuel types and payment methods and is considering whether it should set a separate allowance for smart and traditional meters (see Question 7). There are no other benchmarking parameters that we would currently suggest for separate allowances.

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?

To date, the main factor identified as a significant non-efficiency factor is the **proportion of financially vulnerable customers** serviced by supply businesses, where costs of customer service and bad debt will be higher on a simple £/customer basis. Analysis should focus on the proportion of financially vulnerable customers and how they relate to non-efficiency factors, especially the cohort of customers with a high cost-to-serve. The Priority Services Register (PSR) does not reflect this properly as it is, by definition, a non-financial marker. This assessment should also consider the changes in the proportion of financial vulnerability over time, and how suppliers' costs-to-serve have changed over the energy crisis and the cost-of-living crisis. Further engagement with industry experts may be key to delivering robust analysis on this point.

Suppliers also face other non-efficiency factors that increase their operating costs. Ofgem published a list of non-efficiency factors in its May 2018 price cap policy consultation⁹ and we believe the following are the most relevant:

- **Payment method:** there remain significant differences in costs to serve customers within each payment method that are not fully captured in the uplift for customers on Standard Credit and PPM. In particular, payment method mix has a significant impact on debt related costs. We have previously suggested that Ofgem should redefine the definitions of the different payment methods so that Quarterly Direct Debit can be grouped with Standard Credit, which it is much closer to in cost. There are relatively small volumes of Quarterly Direct Debit customers, and so it would not be proportionate to set a different payment method uplift for Quarterly Direct Debit.
- **Proportion of low income or fuel poor customers:** following on from our points above regarding financial vulnerability, this is probably the most significant non-

⁹ Default Tariff Cap: Policy Consultation Appendix 8 - Operating costs', Ofgem, 25 May 2018, p18-28

efficiency factor driving differences in cost to serve between customers. The cohort of customers paying by Standard Credit for Supplier A may be significantly better or worse bad debt risks than the same cohort of Supplier B. For example, former incumbent suppliers may have a higher proportion of customers in deprived areas. Note that deprivation is recognised as a non-efficiency factor relating to debt by Ofwat, the water regulator.¹⁰

- **Proportion of customers with other vulnerabilities:** non-financial vulnerability can also have an impact on cost to serve, albeit to a much lesser extent than financial vulnerability. For example, eligibility for PSR services. Again, different suppliers may have different mixes of non-financial vulnerabilities for historical or other reasons.
- **Mix of online and offline customers:** Suppliers will have different mixes of customers who opt to transact online versus those who require paper billing and prefer to communicate by telephone. For example, former incumbent suppliers may have a higher proportion of elderly customers who prefer to transact offline. Online customers will generally be cheaper to serve and so the mix of customers will therefore affect suppliers' average cost to serve.

We consider that a weighted average benchmark approach for each payment method would be appropriate. In contrast, we think that a LQ or frontier benchmarking approach would be wholly inappropriate in today's circumstances and would almost certainly result in suppliers being unable to recover efficiently incurred costs.

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

Our view is that data must be controlled for non-efficiency factors. Supplier efficiency cannot be judged by plain comparison of data between suppliers, since different customer bases and payment methods have different costs-to-serve. Consideration of customer mix cannot be centred on simple metrics but should be considered in the round.

In our recent response to Ofgem's Additional Debt-related Costs Allowance Policy consultation, we noted that we would expect that the operating cost review would consider more enduring changes to the cap for debt-related costs. This should include correcting for elements such as deprivation (potentially via a levelisation mechanism).

Consideration should be given to how the non-efficiency factors can be addressed through cross-industry levelisation mechanisms. Allowances through the price cap area one size fits all approach and are likely to distort competition between suppliers. Ofgem should consider ways to allow cost recovery to better reflect actual costs incurred.

The DWP data used for the Warm Homes Discount scheme may be useful in assessment of the materiality of non-efficiency factors and it may be possible for Ofgem to access other relevant government data. As noted above, deprivation is recognised as a non-efficiency factor relating to debt by Ofwat.

¹⁰ For example, see [Ofwat - Final Deliverable](#)

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

We agree with Ofgem that both Priority Services Register (PSR) and Warm Homes Discount (WHD) are poor proxies for customer deprivation for the reasons set out in the working paper (paragraphs 4.26-27).

Identification of financially vulnerable customers is key to establishing an effective proxy for suppliers' proportion of high-cost-to-serve vulnerable customers. This could be established utilising a combination of the following (or equivalents in Scotland):

- Non-financially vulnerable indicators as per the PSR
- DWP information used to identify eligibility for the WHD
- Proportions of customers ineligible for PPM under the new Involuntary PPM licence conditions and PPM guidance with outstanding debt

This could be cross-checked or layered with other indicators, and as noted above, other government data may be useful here.

The higher costs faced by legacy suppliers are akin to a form of social obligation. They are not a sign of inefficiency – suppliers cannot refuse to supply a new customer if they become that customer's supplier by default. It is essential that Ofgem takes account of this in their review of benchmarking of operating costs.

As we have noted in our previous responses to considerations of additional allowances, if they are designed as a "one size fits all" mechanism, they have the potential to increase competitive distortions between suppliers. Ofgem could instead implement something along the lines of the proposed approach to PPM levelisation, to implement desirable cross subsidies in ways that avoid windfall gains to industry parties and do not distort competition. This would make previously implicit cross subsidies explicit in a way that helps overall transparency, with benefits for longer term transparency. In our view, the longer-term goal should be a social tariff aimed at protecting the more vulnerable in society.

As we have explained above, we believe a weighted average benchmark is appropriate for all these cost categories. The interactions between benchmarking options warrant careful consideration.

The stringency level of the cap

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

The LQ or frontier benchmarking approaches under consideration should be ruled out, as they would be expected to result in suppliers being unable to recover efficiently incurred costs. This would reduce supplier resilience to future market shocks and make it more difficult for suppliers to invest for the future.

We believe Ofgem should focus on appropriate implementation of the weighted average because it:

- better accounts for the impact of non-efficiency factors that increase supplier costs
- better enables the investment and innovation required to reach Net Zero
- is more compatible with Ofgem's focus on driving up customer service standards
- better reflects the very significant efficiencies made since 2017

- is in the longer-term interest of consumers in Great Britain

Care should also be taken to consider the potential impacts of any reforms on unexpected movements of customers on or off of Standard Variable Tariffs, and what that may mean for debt recovery.

With the Market Stabilisation Charge set to expire on 31 March 2024, and the Ban on Acquisition only Tariffs potentially also to expire, the potential for mass exit of customers from default tariffs under the price cap to Fixed Term Tariffs should not be underestimated.

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

Ofgem sets out three key options for accounting for the impact of expected regulatory change:

- Option 1 - issuing another RFI to gather 2023 data
- Option 2 - consider including a forward-looking adjustment to the benchmark
- Option 3 - setting a looser cap (eg weighted average benchmark)

Although this may cause some delay to implementation of the operating cost review decisions, we consider that a new RFI to gather 2023 data (option 1) is essential. Bad debt costs are a major component of the DD-SC differential and extraordinary bad debt costs incurred through the ongoing cost of living crisis are currently under review through the debt-allowances workstream. As set out in our recent response to that workstream, we are concerned at the lack of clarity as to how and when additional debt-related costs incurred after September 2023 will be recovered.

As a forward-looking measure, the updated baseline should reflect recent market trends and their associated costs. We note the extraordinary in-year factors that would have impacted 2022 data, which may include the legacy impacts of covid as well as high inflation and some of the transitory costs borne by suppliers appointed as Supplier of Last Resort in late 2021.

As outlined above, in our response to Question 5, operating cost allowances should be designed to provide recovery of costs in the same period as they are incurred. Uncertain costs should be funded based on the best available forecasts, with true up/down adjustments in subsequent cap periods. This will better match cost recovery to the time periods where companies are incurring costs and support financial stability across the supply market.

A forward-looking adjustment to the benchmark (option 2) may make the cap more resilient to future updates, however consideration should be given to the potential for sudden mass movement of consumers from default tariffs to other supplier products, and the implications this would have for debt recovery.

We agree with Ofgem that setting a weighted average benchmark (option 3) to account for the uncertainties around efficient costs associated with regulatory changes may not accurately reflect the magnitude of the impacts. It should be implemented with care to appropriately reflect costs in ways that drive efficiency, and in conjunction with options 1 and 2. For more detail, see our response to Question 12 above.

Ofgem states that costs due to regulatory changes should not be seen as non-efficiency factors on the basis that they should affect suppliers in a broadly even way.¹¹ While this may be the case for many changes, the differences in potential impact depending on customer mix

¹¹ Para 4.24 of Ofgem's Operating Cost Review Benchmarking Working Paper

should be considered for each substantive regulatory change, and mitigation implemented where appropriate.

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?

Ofgem should be transparent about the expected impacts of regulatory change under different plausible and reasonable worst-case scenarios. It should fully factor the potential risks and additional costs into decision making, including the decision on timing of implementation.

The key option for accounting for uncertainties in costs that is not covered above is the use of levies outside of the price cap, which are designed to allow costs to be recovered in a manner that strengthens competition for the benefit of all consumers.

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

The fundamental limitation of the price cap methodology is it is a one size fits all mechanism, and any additional allowances in the price cap are likely to create competitive distortions between suppliers. Complementary mechanisms to allow levelisation of costs will help ensure that the price cap delivers fairness for all consumers.

Transparency about the methodology and the use of a confidentiality ring/data room so that Ofgem's calculations can be exposed to third party scrutiny are key (see our response to Question 3).

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 consider that a weighted average benchmark should be used for each of the different operating cost allowances and that care should be taken to ensure that they are grouped appropriately.

ScottishPower

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