The voice of the energy industry

Ofgem
10 South Colonnade
London
E14 4PU

23 June 2023

Dear Price Protection Team,

We are writing in response to Ofgem's Call for Input on the Operating Cost Allowances Review (Operating cost review).

We start by noting that we are concerned about the timing and prioritisation of the Operating costs review and would welcome the publication of a work plan to understand the objectives and timeline of the review relative to other regulatory changes impacting suppliers. There are other areas that members feel should be a priority and are concerned by the scope of the supplier RFI and the Call for Input that this review becomes very broad whilst being based on problematic data periods for benchmarking.

Ofgem's ongoing work appears to require focused activity on operational costs to support assessing debt recovery, considering payment type differential levelisation and to evaluate proposals in the consumers standards review. We welcome this clear focus and encourage Ofgem to prioritise these outcomes.

To ensure that suppliers and consumers benefit from a well-functioning energy market under the price cap, it is vital that Ofgem focuses on the cap allowing suppliers to finance efficient costs including areas of under recovery, the right calibration of financial resilience frameworks, managing the reestablishment of competition whilst maintaining resilience.

Further, it appears that in this context and more generally, trying to rebaseline the operational costs allowance at this point will be challenging given that the data set out in the draft RFI to be collected will be reflective of a highly unusual and volatile period. The corrections and adjustments that would be needed to use recent benchmarking data will therefore likely be more subjective and contestable.

Finally, we note that there is uncertainty about what Ofgem is seeking to achieve and the process that will be followed. As noted above, a work plan that is structured against other competing objectives would help our members understand and feedback on the possible benefits and trade-offs this work might create.

**Operational costs are key to service outcomes**

Energy UK is concerned that that "*driving efficiency and feeding into supplier profitability*" does not capture the function of the operational allowance. We would welcome an articulation of the key role it has in supporting the quality and tailoring of suppliers' operational capabilities and the services suppliers need to provide to meet consumer objectives and policy and regulatory requirements, in the wider context of aiming to contribute to an innovative, resilient, diverse, competitive retail market.

For an Operating cost review that seeks to deliver change on a forward looking 18-month timescale and which is also attempting to be conscious of wider price cap review from Government, we hoped to see a clearer recognition that the price cap (which is the cost recovery mechanism for over 85% of the market) has to meet consumer needs and evolve to ensure it supports the energy transition and meet the UKs Net Zero targets. This will be through the development of consumer services, provision of price confidence for customers through data, tariffs and energy management tools that also help manage the grid. By being forward-looking it will help Ofgem address the inevitable lag in benchmarking data used to real operational costs.

Future articulations of operational costs role under the price cap should also include clearer awareness that the price cap as a whole has contributed to a protracted period of significant delayed cost recovery for energy suppliers. Meanwhile suppliers have managed exceptional operational pressures while successfully delivering huge industry change. Both trends are set out in Annex 1. This context limits suppliers' ability to effectively manage their operational costs under the cap and should be a key factor in a future review.

**A change in cap direction on consumer standards**

Ofgem should consider the trade-off on compressed operational capacity on the benefits realisation of ongoing customer service and operational change programmes.

The price cap should incentivise suppliers to acquire all customers irrespective of their challenges or cost to serve. The operational costs allowance needs to enable cost recovery of all customers and not be compelled to reduce customer service to provide a return under the price cap.

As set out in response to the consumer standards consultation proposals, Energy UK urge that rather than placing rushed, expensive and prescriptive input requirements on suppliers, Ofgem should prioritise funding an allowance that allows suppliers to work towards improved ease-of-contact for this winter. Understanding the evolving challenges will require co-ordination between the regulator, Government, consumer groups and energy suppliers could significantly improve ease-of-contact while minimising additional costs. This should be an opportunity for Ofgem to work more closely with industry and ensure that people who need extra support receive it.

To help achieve this outcome we would support a reformed approach to benchmarking at the appropriate time. We welcome Ofgem's consideration of the weighted average approach. However, we think Ofgem should go beyond weighted average and move to an upper quartile allowance to incentivise good customer service for all customers, including even those who are more expensive to serve.

**Volatility in wholesale costs and consumer engagement**

It should also be noted that there is now a limited scaling in the operational allowance for high costs and high customer service demand, particularly with a significant fixed element to the Earnings Before Interest and Tax (EBIT) allowance. The Market Stabilisation Charge (MSC) and backwardation allowance are currently temporary. There appears to be a strong case that they should remain as high wholesale cost triggered mechanisms, along with consideration of how to allow cost recovery to meet peaks in customer service demand beyond the control of an efficient supplier. Ofgem should seek to ensure there are mechanisms which will provide suppliers confidence that allowances will better scale to manage these periods of increased sectoral demands of wholesale market shock and increased cross sector customer engagement. We also encourage Ofgem to analyse periods of peak service demand across suppliers and reflect on whether supplier allowances ensure costs are recoverable when attempting to maintain service levels.

Please do get in touch if you would like to discuss this response in further detail.

Kind regards

Ed Rees

Senior Policy Manager, Energy UK

**Annex 1**

**Operational pressures**
Suppliers' operational costs have faced challenges over recent years due to high pressures on customer service. As mentioned before, more people than ever are contacting their suppliers following the delivery of bill support schemes, alterations to the Energy Price Guarantee (EPG) and more complex queries that require in-depth responses. This has meant that suppliers need to hire more staff, complete more re-training programmes, set up dedicated teams and often operate over wider opening hours.

Ofgem's recent consultation on a framework for consumer standards and policy options to address priority customer service issues, includes many proposals that would have significant impacts on suppliers operating costs, especially those proposed to address ease of contact issues for this winter. For example, requiring a supplier to operate a phoneline from 7 am-10 pm Monday to Sunday.

**Industry Change**
Suppliers have worked on, and delivered many industry programmes since 2017, some of which have been at a cost to them. They include:

- **Market-wide Half Hourly Settlement**. This programme started in 2017 and aims to maximise opportunities by smart metering, delivering consumer benefits and enabling smart and flexible energy systems by October 2025.
- **Smart meter rollout.** Suppliers have continued to roll out smart meters since 2011. From January 2022 all gas and electricity suppliers now have binding annual installation targets to their remaining non-smart customers by 2025.
- **Ofgem's Faster and More Reliable Switching programme** went live in July 2022, allowing customers to switch energy suppliers within 5 working days, making the process faster, easier and more cost-effective.
- **Implementation of the Government's Energy Bill Support Scheme (EBSS)**, providing a £400 non-repayable discount to eligible households between October 2022- March 2023 to help with their energy bills.
- **The Governments Energy Price Guarantee (EPG)** was introduced in October 2022 for two years, capping domestic customers' energy prices and compensating suppliers for providing energy below cost prices.
- **The Governments Energy Bill Relief Scheme (EBRS)** was also introduced in October 2022, until March 2023, providing energy bill relief for non-domestic customers. This evolved and has been replaced by the Energy Bill Discount Scheme (EBDS) since April 2023, which provides discounts to eligible on-domestic customer bills.
- **Ofgem's Supplier Code of Practice for Involuntary pre-payment meters (PPMs)** was published in April 2023.
- **Many Supplier of Last Resort (SoLR) acquisitions**, most notably following the failure of 30 suppliers since the beginning of 2021.
- **The government expanded the Warm Home Discount Scheme from 2022 – 2023**, increasing payments to £150 to those that are eligible.
- **Delivery of the Energy Companies Obligation (ECO) schemes**: ECO 3 began in April 2017, ECO4 and now EC0+, now called the Great British Insulation Scheme is running from spring

2023 for up to 3 years and extends support to hundreds of thousands of households more, who could receive new insulation measures for their home but who are not currently eligible for support under existing government-backed schemes.

- **Ofgem's Market Stabilisation Charge (MSC)** was introduced in April 2022, which aims to manage the impact of suppliers' exits on market stability.
- **Energy UK's Vulnerability Commitment (VC) launched in 2020**. The VC is a voluntary industry initiative under which suppliers who sign up for the scheme commit to improving the support they provide to vulnerable customers, over and above existing licence requirements. There are 14 signatories at current, which covers up to 90% of the retail market.

**Tariff differential levelisation**
As explained in our response to Ofgem's Call for Evidence on the levelisation of payment methods cost differentials, Energy UK urges Ofgem to establish key principles. These are:

- Levelising the tariffs should align with broader social/regulatory objectives. This is clearest with smart prepay and direct debit levelisation.
- It should only be done if it results in incentives that will be net positive or net neutral from a system perspective. This is important for an intentional approach to cross-subsidisation as well as to address any unintentional poor cost reflectivity that could create supplier incentives contrary to consumer interests.
- The costs should be recovered fairly in a way that doesn't result in market distortions that adversely impact competition.

These principles are important for an intentional approach to cross-subsidisation as well as to address any unintentional poor cost reflectivity that could create supplier incentives contrary to consumer interests. Ofgem should ensure that suppliers are incentivised to gain and operate all customers in such a that provides them with the best service and outcomes.

If any cross-subsidy is required, then all customers, and therefore all tariff types should contribute to the cost of levelisation, this will need to be done in a way that seeks to minimise market distortions. As a change which is designed to deliver an overarching desired market outcome, there is no rationale for a subsection of the market to bear the cost. This is important as more customers move onto fixed tariffs and switching suppliers increases, which should be a sign of a competitive market offering value to consumers.