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Dear Dan

CALL FOR INPUT ON THE OPERATING COST ALLOWANCES REVIEW

We welcome the opportunity to respond to Ofgem's call for input on the operating cost allowances review. We provide a detailed response to Ofgem's questions in Annex 1 and summarise our key points below.

Benchmarking

In general, we agree that Ofgem should repeat its top-down approach to calculate suppliers' core operating costs. However, we encourage Ofgem to reconsider its past use of a lower quartile benchmark for efficient costs and use a weighted average moving forwards. We believe Ofgem should use 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

We comment further on benchmarking and non-efficiency factors in our responses to Questions 14 to 16.

Interaction with other workstreams

We note there are interactions with a number of Ofgem's other ongoing workstreams and it will be important to coordinate carefully with these. For example:

- the interaction between payment method price levelisation and the decision around how to allocate payment method differentials between different customer groups;

- the debt-allowances review and its impact on the calculation of the payment method differentials, and the correction for in-year factors in the baseline year;
- the EBIT consultation and the definitions of fixed assets, collateral capital and working capital used in other areas of the operating cost allowance;
- the PPM warrant installation Code of Practice (and its implementation in licence conditions) and its potential impacts on the PPM-DD and SC-DD differentials.

Smart metering

Smart metering costs are currently included in the price cap through an allowance in the core operating cost baseline, and the additional SMNCC allowance, which accounts for changes in smart metering costs or benefits over time. This call for input considers a number of alternative approaches, for example a separate smart meter cap, with far-reaching operational implications. We do not believe the time is right to consider changes to the current methodology, which is an adequate approach for allowing suppliers to efficiently recover their smart metering costs.

Industry programme costs

We consider that industry programme costs have materially increased since 2017. Drivers of these increases include new industry charges, such as the Retail Energy Code, and expansions in scope of existing charges, eg Elexon and MHHS. We believe Ofgem should proceed with separating industry charges into a separate pass-through allowance, which would allow suppliers to more accurately recover their costs.

Baselining

We have some concerns about Ofgem's minded-to position to use 2022 data to calculate the operating cost baseline and make corrections to accommodate for in-year factors. The operating costs allowance, as a forward-looking measure, and its baseline should be representative of supplier costs in a typical market. 2022 was atypical and we expect our costs to be materially affected by events such as spiking inflation, the cost of living crisis and implementing exceptional Government programmes. We recognise the case for reviewing the operating cost allowance, but are not confident that the 2022 data can be robustly corrected for these in-year factors. Ofgem should consider the case for continuing to review the scope and methodology of the review but delaying its data collection exercise until costs have better stabilised, eg to use a dataset of 2023 data.

Timescales for consultation

The four week response window allowed for the current call for input has been challenging for suppliers, given the complexity of the issues raised and the large number of questions. It will be vital for Ofgem to allow sufficient time for suppliers to respond to future policy consultation on the opex review, given its potential to materially affect the level of the price cap and thus suppliers' ability to recover costs, and given the number of interactions with other Ofgem price cap initiatives. We would also 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.

Yours sincerely,

Richard Sweet
Director of Regulatory Policy

Annex 1

CALL FOR INPUT ON THE OPERATING COST ALLOWANCES REVIEW – SCOTTISHPOWER RESPONSE

Q1. Do you agree with the scope set out in the introduction section for the operating cost review?

Ofgem proposes to review the major components of the Operating Cost allowance, including:

- Core operating costs;
- Payment method differentials;
- Smart meter costs;
- Industry charges; and
- Implementation approach.

We agree that a comprehensive review is required. The original assessment was based on data from 2017 and the market has changed significantly since then. As a result of regulatory and market changes the current allowance is likely to be not fully cost reflective. We elaborate further on the case for reviewing operating costs in response to Question 4.

We note the ongoing workstreams that may interact with areas of the operating cost allowance:

Cost Levelisation

The cost levelisation call for evidence reviewed different options for whether to levelise standing charge and/or the unit rate for SC and PPM customers to DD. We consider this has a direct impact on to the topic covered in Question 27, which concerns the allocation of payment method differential costs between consumer groups. Currently, Ofgem smears the costs between SC and DD based on observed market price differentials in 2017. We believe the question of how, or whether, to smear the costs between SC and DD is a value judgement better answered in the cost levelisation process.

Debt-allowances

Ofgem will use supplier RFIs to recalculate the payment method differentials. Bad debt costs are a major component of the SC-DD differential and extraordinary bad debt costs incurred through COVID and the cost of living crisis are currently under review through the debt-allowances workstream. Ofgem should consider this interaction as it uses its top-down approach to calculate observed supplier payment method differentials.

EBIT

We believe the EBIT statutory consultation and the operating cost allowances review interact with each other. Additional working capital costs are a major component of the SC-DD differential and considerations of the cost of capital in the EBIT workstream should be reflected in the differential calculations. This should also apply to the calculation of quarterly-monthly DD differential which we highlight in our response to Question 23.

We note that Ofgem considers depreciation and amortisation in the core operating cost baseline. The calculations made for the operating cost allowance form the bases for the

calculation of collateral capital required by suppliers[1]. Therefore, any recalculation of depreciation and amortisation should be reflected by changes made to collateral capital, which could impact on the EBIT workstream.

Overall, we support the scope Ofgem has proposed.

Q2. Do you agree with the areas that we consider are outside the scope of this review? Do you consider that there should be anything else in the scope of this review?

We agree with Ofgem that its suggested areas should be outside the scope of this review. This includes Ofgem's suggestions for matters they will not be under consideration, which are:

- past operating cost allowances;
- specific innovation allowances; and
- REGOs.

As we noted in our response to Question 1, there is some interdependency with Ofgem's calculation of depreciation and amortisation and the calculation of the fixed capital required by suppliers. While we understand that EBIT is a separate workstream we believe any updates to the percentage of supplier revenues that undergoes depreciation and amortisation should be reflected in the assumptions made for fixed capital in the EBIT calculation.

Q3. What are your views on the case for review we identify in this section?

Ofgem identifies the following as sufficient reasons to review the operating cost allowance:

- the age of the 2017 data
- new operating costs
- regulatory and market changes
- the effects of mergers and acquisitions
- increased industry charges

We agree that each of these factors may have had a material and enduring impact on operating costs. We would also highlight changes to industry charges and the temporary and enduring effects of external events.

Q4. Do you agree that there is sufficient reason to carry out a review?

For the reasons given above we agree that there is sufficient reason to carry out a review. However, we think Ofgem should be cautious about using 2022 data as the baseline to calculate the updated operating cost allowance – Ofgem should consider the case for a delay until a more suitable time period that is not affected by the same degree of in-year factors as 2022.

Q5. What cost lines do you think should be included within operating costs?

Ofgem has published this call for input in advance of their data collection exercise, which we consider will advise what cost lines should be included in the scope of the review.

[1] Price Cap - Statutory Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance, 4.24

Q6. Do you consider there to be any new costs which may have not been included within the existing core operating costs allowance?

The existing allowance was set in 2017 in a very different market environment. Below is a non-exhaustive list of additional operating costs that would not have been accounted for by the current allowance:

- the introduction of the quarterly cap and its effects on customer communication costs
- the effect of the energy price shock, the accompanying media attention on energy prices and greater customer contact costs
- potential new costs associated with developing technologies and software
- regulatory change, including MHHS, Guaranteed Standards and the PPM moratorium and Code of Practice
- new compliance structures, eg personnel costs related to stress tests, market resilience reports, market compliance reviews.

Q7. Do you consider that any new costs would be off-set by corresponding benefits?

The existing allowance was calculated using 2017 data as a baseline year, meaning any new costs or benefits that have developed since then may not have been accounted for in the allowance. There may be some new costs that have been offset by corresponding benefits in other areas of the operating costs allowance. For example, the impact of the energy price shock and the cost of living crisis may have increased customer contact costs, but temporarily reduced switching costs.

We note that Ofgem previously considered the operating cost baseline in the round using a top-down approach. We agree with this methodology and encourage its use again – this will appropriately account for the offsetting of new costs in one area with benefits in another.

Q8. Do you consider there to be any costs included within the core operating costs allowance but are now no longer incurred?

We have not identified any such costs so far.

Q9. What external events do you think have impacted (or will impact) operating costs? Are these impacts permanent or temporary? Can you provide evidence on how costs have been affected, and by how much (ie per customer)?

It is likely that external events, such as COVID-19 and the cost of living crisis, have impacted operating costs. Suppliers may account for costs related to external events differently based on the event, making it difficult to attribute a benchmarked value per event. Ofgem should therefore consider costs related to external events in the round.

We note that certain operating costs associated with external events may overlap with other workstreams, for example bad debt costs and the debt-allowances review.

Ofgem should treat these costs, split between temporary and enduring, in a manner suggested in our response to Question 20.

Q10. What time period do you think we should use for the updated baseline for core operating costs and why?

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 Ofgem's minded-to time period of 2022, which may include the legacy impacts of COVID, the

cost of living crisis, high inflation and increased levels of consumer debt. Ofgem's proposal to use 2022 and correct for these factors places an unnecessary risk relating to providing an accurate baseline reflective of actual supplier costs.

Our suggestion would be to delay the baselining to use 2023 data, which would reduce the correction required to calculate an accurate baseline and be more reflective of the market in the near future. For example, 2023 may avoid some of the transitory costs borne by suppliers appointed as SoLRs in late 2021.

Q11. What factors should we seek to correct for in setting an enduring benchmark?

We believe it would be inappropriate to accept the baseline year's data without correcting for exceptional in-year factors. These include:

- legacy COVID-19 impacts
- costs associated with taking on the large number of customers associated with SoLR events in 2021
- high levels of inflation
- the cost of living crisis and its effect on consumer ability to pay - and related Government programmes

We are aware that Ofgem plans to account for the impact of external events on operating costs. It is likely that there will be significant overlap between the correction of 2022 in-year factors and the correction of costs due to external events, eg the ongoing cost of living crisis. We suggest Ofgem separate the two and avoid any overlap or potential double-counting.

There may also be some interaction between the correction of in-year factors and other workstreams, particularly the debt-related allowances review. Again, Ofgem should avoid doubly correcting these effects.

Q12. What are your views on the options of our overall approach? Do you agree with our minded to approach?

Overall, we agree with Ofgem's minded-to position and consider that the benchmark should be calculated using a top-down approach.

Q13. Do you have any alternative approach for calculating the efficient level of core operating costs across suppliers?

We note that Ofgem will collect data on individual costs lines, giving it the flexibility to isolate certain cost lines if required. We believe industry charges should be separated from the core operating costs stack and grouped into a separate allowance – we give our full thoughts in response to Questions 31 to 34.

Q14. Which benchmarking approach options do you think we should be considering?

We believe Ofgem should use a weighted average benchmark. A weighted average benchmark considers:

- the impact of non-efficiency factors (explained further in our response to Question 16) which increase supplier costs
- the efficiency gains that took place from 2017 onwards, which have likely tailed off prior to the energy market crisis
- the focus of the retail sector must be on investment and innovation to achieve net zero

- the additional expenditure needed to improve customer service, particularly for vulnerable customers

The design of the 2017 baseline was impacted by the CMA's investigation of supplier inefficiencies. The subsequent core operating cost allowance set the baseline below the lower quartile supplier's costs, even though this supplier was found to be the lowest-cost supplier with typical market characteristics – indeed, Ofgem had regard to the CMA's tighter view on efficiency than the lower-quartile option[2].

We believe the rationale used to determine the 2017 cost baseline would not be reflective of today's market priorities. The effects of COVID-19, the cost of living crisis and other events since 2017 have resulted in large numbers of supplier exits, with 68 active suppliers in 2017 compared to 21 by March 2023. Ofgem should recognise the likelihood that surviving market participants, who have navigated through an unprecedented period of volatility, are likely to be operating more efficiently.

Further, the market's priorities have shifted from being solely focused on cost efficiencies towards stability, financial resilience, the investment required to achieve net zero and a focus on the relationship with and experience of the customer. We believe the goals for an efficient supplier, and therefore its expected incurred costs, have developed since 2017. Therefore, a weighted average approach is best placed to ensure that customers are charged fairly while allowing the notional supplier to recoup efficiently incurred costs and invest and innovate to deliver net zero (and in consideration of various non-efficiency factors).

Q15. How should we develop a framework for choosing between benchmarking options?

We believe that Ofgem should be focused on ensuring that an efficient supplier can recoup its expected costs. We recognise that a balance needs to be struck between protecting customers from incurring the additional costs of inefficient suppliers and protecting suppliers from incurring additional costs related to non-efficiency factors. Therefore, Ofgem's framework should be developed around how to best net out the competing effects of inefficient suppliers and non-efficiency factors – we believe a weighted average approach does this best. Ofgem should be mindful of the characteristics of the notionally efficient supplier compared with market-observed supplier characteristics – we believe the gap in efficiency is narrower than what was considered in 2017 by Ofgem and the CMA.

Q16. What non-efficiency factors linked to customer bases do you think drive cost variation among suppliers? Should we control for these through an adjustment or benchmark metric?

Suppliers face non-efficiency factors that increase their operating costs. Ofgem published a list of non-efficiency factors in its May 2018 price cap policy consultation[3] and we believe the following are the most relevant:

- **Payment method:** We acknowledge that Ofgem provides an uplift for customers on SC and PPM, but note significant differences in operating costs to serve customers within each payment method – we expand on this in our response to Question 24.
- **Proportion of low income or fuel poor customers**: This is probably the most significant non-efficiency factor driving differences in cost to serve between customers. The bad-debt related payment method uplift partially controls for this, since financially disadvantaged customers are more likely than better off customers to pay by SC, but

[2] Appendix 6 – Operating Costs, 2.27
[3] 'Default Tariff Cap: Policy Consultation Appendix 8 - Operating costs', Ofgem, 25 May 2018, p18-28

this does not completely control for it. The cohort of customers paying by SC 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

- **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 the mix of customers will therefore affect average cost to serve.

We consider that a weighted average benchmark approach would be the best way of accounting for these non-efficiency factors; it would balance the increase in costs due to these factors, which each supplier faces differently to one another, with the lower costs expected of an efficient supplier.

In contrast, we think that a lower quartile (or similar) benchmarking approach would be wholly inappropriate in today's circumstances and would almost certainly result in suppliers being unable to recover efficiently incurred costs. When Ofgem first set the operating cost allowance in 2018 it was against a backdrop of the CMA Market Investigation having found evidence of significant supplier inefficiencies and a strong policy push to drive down costs. Five years later, after numerous well publicised cost cutting programmes and consolidation, not to mention sustained EBIT losses, suppliers are generally in a much leaner position, with minimal scope for further cost cutting. The challenge now is to improve investor confidence and the financial resilience of suppliers, so that suppliers are well positioned to support the journey to net zero.

Q17.Are there other parameters over which you think operating costs would materially differ?

We will be able to comment on this further as we review our internal data as part of responding to other elements of Ofgem's programme of work.

Q18. Do you think there are any operating costs that would materially differ between serving single rate and multi-register electricity meter customers? If so, please provide evidence to support your view.

In general we would expect multi-register electricity meter rental to be more expensive than single rate (for both traditional and smart). There is considerable variation between rental agreements and it would require a careful review to provide a robust quantification of the difference. We are not in a position to provide this data at present, but would encourage Ofgem to consider this within its review.

Q19. What is your view on the extent to which we should prioritise allocating costs between different parameters currently not included in our cost data breakdown?

Ofgem says it does not intend to collect data split by tariff type, electricity meter type (single rate and multi-register) and region. As noted above, we think there may be material differences between single rate and multi-register meters, and we believe Ofgem should investigate this further before ruling out this parameter.

Ofgem also says that it intends to collect characteristics of suppliers' customer bases, including number of customers by tariff type, on PSR and with an online account. In this context we would stress that number of customers on supplier **PSRs is not a good indicator of a supplier's proportion of expensive-to-serve customers**. PSR is a measure of non-financial vulnerability and the key driver of cost to serve is financial vulnerability (via bad debt). Indeed, in our experience, the vast majority of customers on the PSR do not incur any material additional costs to serve in relation to the non-financial support services. Ofgem should consider whether there are other metrics (such as eligibility for WHD payments) which could serve as a better proxy for high cost to serve customers.

Q20. In the event that some of the cost drivers are impacted by recent events, how should we treat these costs to determine an allowance on an enduring basis?

Recent events may have impacted supplier operating costs. These impacts may take the form of new costs, such as the administration of EBSS payments, or changes to existing costs. In general, Ofgem should seek to add enduring net costs to the allowance and correct for temporary net costs. This may be simpler for net new costs, which would not have an existing counterpart in the current allowance and could be added/subtracted to the revised allowance as necessary.

For costs that were already incurred but were affected by recent events, we suggest Ofgem:

- removes net temporary costs from the baseline allowance
- adds net enduring costs to the baseline allowance
- ensures that, for temporary costs, it uses historical data to calculate what would have been included in the baseline in the absence of recent events.

Q21. What drivers of change in the payment method differential should we consider as part of this review? Please provide evidence of any reported cost changes.

The SC-DD payment differential is largely explained through the additional debt-related costs incurred by SC customers. We note the ongoing debt-related allowances review, which was accompanied by a data collection exercise. The drivers to the SC-DD differential are explained through drivers to increased bad debt costs, i.e. the ongoing cost of living crisis and the energy price shock.

The PPM-DD differential was based on the 2014 CMA estimate. We consider that the age of the data warrants a review of the differential. The drivers to increased PPM costs include:

- regulatory change, including the PPM Code of Practice, which increases supplier service obligations
- increased personnel costs, particularly call centre costs
- complexities between new types of meter
- increased costs of managing PPM top-ups

Q22. How have the recent external events affected drivers of differences in the payment method differentials? Are they one-off or permanent impacts?

We note the ongoing debt-allowances review, which overlaps with the question of whether external events have affected the SC-DD differential. Therefore, we comment solely on the PPM-DD differential.

The costs of serving PPM customers are likely to have increased relative to 2018 for a number of reasons:

- New licence conditions introduced by Ofgem obliging suppliers to monitor PPM customers for self-disconnection/self-rationing
- New licence obligations to provide additional support credits (the impact of this on bad debt should be covered by Ofgem's recent debt RFI)
- Ofgem's recent PPM CoP which is likely to increase the costs of installing PPMs and ongoing monitoring of those customers

It is likely that external events, eg COVID-19 and the cost of living crisis, have increased the PPM differential. The notional supplier, affected by customers with greater levels of bad debt, would have increased their rate of PPM installations, as did many suppliers in the market.

We consider that the increased rate of PPM installations may have been a temporary effect of external events. We also note Ofgem's responses to perception of involuntary installations, with, first, a moratorium on new installations and, second, the proposed Code of Practice. However, external events may have had an enduring impact on the per-unit cost of installing a PPM meter. We have observed increased costs of the meters themselves and to the labour costs of hiring new installers, who are now in high demand.

We consider that Ofgem should respond to the impact of costs due to external events in the same manner we suggest in our response to Question 20.

Q23. Are there other payment methods we should consider when setting the payment method uplift? If so, what are they? Please provide evidence of any differences in operating costs associated with serving these customers using other payment methods (if identified) relative to DD.

As noted in our response to Ofgem's draft operating cost RFI, we believe Ofgem should consider the quarterly Direct Debit payment method offered by ScottishPower. In this payment method option, the customer receives a quarterly bill based on consumption during that period and the amount is then drawn automatically from the customer's bank account via the agreed Direct Debit. This payment method therefore has similar working capital (and other) costs to our Standard Credit (largely cash) payment methods, since both involve payment quarterly in arrears unlike monthly Direct Debit.

However, within SLC 28AD, Standard Credit is defined as "a Payment Method whereby a Domestic Customer pays the licensee for Charges for Supply Activities, where electricity is not supplied through a Prepayment Meter, and such payment is not drawn automatically from a Domestic Customer's bank account by reason of a direct debit authorisation or otherwise" This has therefore had the effect of requiring ScottishPower to categorise our quarterly Direct Debit payment method within the "Other Payment Method" category alongside monthly Direct Debit, despite it being closer in key respects to Standard Credit.

We therefore consider Ofgem should be revisiting the definitions of payment method to ensure that sub-categories of payment method are able to be better aligned within the higher level main categories based on the operational costs incurred.

Q24. What variations do you observe within the three existing payment methods? (eg does the frequency of DD payments vary beyond monthly across supplier customer base?) How do these variations relate to costs (eg does the frequency of DD payments cause changes in operating costs)?

As noted above, DD customers can choose whether to pay monthly or quarterly. Accordingly, these two groups of customers carry different operating costs – suppliers can expect greater bad debt costs to accrue with quarterly DD customers than monthly, who in this regard act similarly to SC customers.

Therefore, Ofgem should consider redefining the definitions of the different payment methods so that Quarterly DD can be grouped with Standard Credit, which it is much closer to in cost than monthly DD. We expect there are relatively small volumes of Quarterly DD customers across the market, and therefore we do not think it would be proportionate to set a different payment method uplift for Quarterly DD.

Q25. Should we use the same benchmarking approach for core operating costs and the payment method differential? Are there any additional or different considerations than for the core operating cost benchmarking approach?

Ofgem should calculate the overall differential costs using a top-down approach to establish the observed payment method differential per supplier. We consider this approach to be less complex and more reflective of supplier practices where each firm may make decisions to focus on one component of differential costs to another.

It should then set a benchmark differential based on a weighted average across suppliers to set the notional supplier's payment differentials. Ofgem should be mindful of any differences in non-efficiency factors compared to those that affect the core operating cost stack, either if there are separate factors for SC-DD and PPM-DD or if they are more/less prominent. Non-efficiency factors could include:

- Proportion of vulnerable customers
- Proportion of offline/online customers
- Proportion of smart/traditional metered customers, especially for PPM

We consider that a weighted average approach would balance the notional supplier's efficient costs and the non-efficiency factors that increase those costs.

Q26. Do you have initial views on whether we should benchmark payment differentials individually, or use the same benchmark for each supplier?

Levels of supplier payment method differentials will depend on how efficiently they serve customers on varying payment methods *and* their underlying DD costs. We consider that there may be some interaction between DD costs and payment method differentials – for example, in the case of SC-DD uplifts, differences between suppliers' internal cost allocation processes may result in lower DD costs and higher SC uplifts or vice versa. Using separate suppliers to calculate the DD opex benchmark and SC uplift benchmark could therefore result in 'cherry picking' and setting allowances too low. We suggest using a weighted average benchmark to calculate both the core operating cost allowance (DD) and the payment method differentials (SC and PPM), which would avoid these problems.

Q27. What is your view on how we should allocate the identified cost categories between payment methods?

At the start of the price cap, Ofgem calculated the observed market price differential to guide the 'smearing' of identified cost categories between SC and DD customers. We do not believe that Ofgem should replicate this process. Firstly, the product market is not thriving and no meaningful differential could be observed. Secondly, it is more appropriate to have a cost reflective SC, DD and PPM price and consider the overall question of how, or whether to, smear costs between the different payment methods. We note that this is a matter for the ongoing cost levelisation review.

To allocate between SC and DD efficiently, Ofgem will need to use the most recent data on customer splits. However, historically, there has been a lower proportion of DD customers on

the price cap than in the product market. As a result of the energy market crisis, over 95% of customers are on the price cap tariffs and as such we do not consider the current split to be representative of what we expect when competition resumes and engaged customers move off the price cap onto products. This would be difficult for Ofgem to do.

Q28. If we updated the core operating costs baseline, what factors should we consider when considering options for updating smart metering costs over time?

Suppliers should be confident that the costs they incur due to the smart meter rollout can be recovered through the price cap. Currently, the operating costs baseline includes a smart meter cost line, inflated by CPIH, and suppliers receive an additional SMNCC allowance which reflects changes to smart metering costs over time. This allowance contains a pass-through element and a non-pass-through element recalculated annually. We believe accurate cost recovery is the most important factor to consider as Ofgem decides how to update smart metering costs over time – a notionally efficient supplier must be able to recoup their costs. In this context, with particularly high wage inflation for installers, it is important to minimise (or preferably mitigate via indexation) the time lag between costs being reported (eg through Annual Supplier Returns) and those costs being recovered through the cap.

Ofgem may also consider how to allocate smart meter costs between traditional and smart metered customers. We expand on the disproportionate complexities of implementing a separate smart meter price cap in our response to Question 30.

Q29. What approach should we take to setting the allowance for smart meters in the cap and why?

We believe the focus should be on accurate cost recovery and that continuing with the current approach best achieves this outcome. Ofgem should use the results from its data collection exercise, adjusted for in-year factors, to calculate a new baseline smart metering costs and inflate it with CPIH. Further, it should continue to set the SMNCC allowance split between pass-through and non-pass-through elements.

We are aware of the potential complexity added by the non-pass-through element model. We note that this may be offset by the simple calculation of the pass-through element through supplier published charging statements.

We note the exceptional rise in costs during the baseline year (2022) caused by inflation. We believe the RPI index best represents suppliers' experience of cost increases in this period, which were primarily caused by increases in wage costs. As noted above, we suggest Ofgem account for inflationary pressure on smart metering costs by making an appropriate adjustment to the allowance.

Q30. Do you think a separate allowance to update smart metering costs in our operating cost review should be considered, if so, what approach do you suggest?

We believe a separate SMNNC allowance should be used to account for changes to smart meter industry and supplier costs related to the meter rollout. Ofgem should follow the approach suggested in our response to Question 29, and continue with the current methodology.

The present methodology smears the costs, and benefits in PPM's case, of the smart meter rollout across smart and traditional customers. While theoretically we can agree that some customers, particularly smart PPM customers, could benefit from a separate price cap, Ofgem should consider the considerable operational barriers to implementing such a change. A separate price cap would introduce new problems of cost recovery through the price cap for

suppliers. One example of these operational barriers is the requirement for synchronous data between the smart meter and the supplier. Currently, due to regular outages this data is often interrupted, presenting a cost recovery risk for suppliers who must understand which customers are charged according to the smart or traditional price cap to price accordingly – there is also an accompanying compliance risk of not being able to submit accurate data for RFIs. Further, problems with synchronous data present a significant challenge for call centre costs, as customers understandably try to contact their supplier during outages.

In addition, it should consider the case of vulnerable customers who are unable to adopt a smart meter. These vulnerable customers currently bear a smeared SMNCC allowance shared between all consumers, but if Ofgem decided in favour of a separate cap, they would bear a larger additional cost of having to remain on a traditional meter spread over a narrowing pool of customers.

Q31. Are there sufficient reasons to indicate that there may be a need for a review of the industry charge methodology?

We believe there are sufficient reasons to review the industry charge methodology. We consider that industry charges have materially increased since they were calculated in 2017 and that this is sufficient cause to review the methodology. For example, Elexon costs have increased from £33.3m in 2016/17[4] to a projected £98.2m[5] in 2022/23, yet the standardised element calculated for the 2017 core baseline was only updated with CPIH. Further, suppliers anticipate new industry charges which are currently unaccounted for in the present methodology, eg the Retail Energy Code.

Q32. What are the important changes in industry charges since 2017?

Suppliers are liable to cover the costs of industry regulatory bodies, eg Elexon and Xoserve. Therefore, any changes to the operating scope of these industry bodies, or the introduction of new Energy Codes, will affect supplier costs.

Examples of these changes include:

- The development of MHHS
- Introduction of the Retail Energy Code
- Administration of the Government's EPG and EBSS programmes
- Faster and More Reliable Switching

Q33. What advantages and disadvantages do you think we should consider when developing an approach to setting and updating industry charges?

We agree that Ofgem should consider the additional complexity of adding a separate industry charge allowance. However, given the materiality of industry charge costs, we consider that any added complexity would be proportionate to the industry charges included in the separate allowance.

Q34. Do you have an initial preference between the potential approaches?

We prefer to have industry charges separated out into its own allowance and updated on a pass-through basis. This would allow suppliers to recoup their efficiently incurred costs.

[4]2017/18 BSCCO Business Plan p44
[5]Elexon Business Plan 2022/23 p46

Q35. Do you agree with our considerations for updating the benchmark? Are there any other approaches we should explore for incorporating future costs?

We believe CPIH is an appropriate measure for updating the core operating cost baseline over time.

We are wary of making specific suggestions for how to incorporate future costs when those costs remain vague and unknown. In general, we suggest Ofgem make ad-hoc changes to the core stack as and when future regulatory costs begin to materialise, eg due to the minimum consumer standards programme. These costs should be adjusted to baseline terms to adjust for inflation.

Q36. Which option do you think we should use to allocate costs across the standing charge and unit rate?

We support Option 1 – Maintaining the current approach – as the best way of allocating costs between standing charge and unit rate for the DD benchmark. Setting the standing charge to be reflective of supplier fixed costs would significantly increase the nil consumption rate; this would negatively affect low-consumption vulnerable customers. The cost-reflective approach could also lead to distortive market effects once customers move off the price cap, as low-consumption vulnerable customers are also likely to be inactive market participants.

Q37.Are there other options for allocating costs across the standing charge and unit rate which we should consider?

We believe industry charges should be separated from the core operating cost allowance into its own allowance. Ofgem should consider separately how it will implement the industry charge allowance between standing charge and unit rate. We consider that industry charges should be set predominantly on standing charges, which would reflect the equal value each customer attains from implementing industry enhancements.

Q38. What is your view on the extent to which we should prioritise this topic in our review?

Given the context of the cost of living crisis and the focus on addressing consumer vulnerability, we consider that this should be a priority item for Ofgem. The allocation of costs between standing charge and unit rate has significant distributional consequences for customers and has the ability to distort the market.

Q39.Should we include published working papers as part of our policy development process. If yes, are there any particular topics covered in this CFI that you would like us to expand on through a working paper?

We believe both Ofgem and suppliers would benefit from working papers on upcoming operating costs due to regulatory change, eg the expected costs of the minimum consumer standards and the PPM Code of Practice. This work could advise on how to approach the topic raised in Question 35 around considerations for updating the benchmark.

ScottishPower
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