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23 June 2023

Sent by email to: dan.norton@ofgem.gov.uk; priceprotectionpolicy@ofgem.gov.uk

Re: Call for Input on the Operating Cost Allowances Review NON-CONFIDENTIAL VERSION

Dear Dan,

Thank you for the opportunity to provide views and evidence in response to the Call for Input on operating cost allowances.

Ofgem will need to undertake any review of the operational cost allowances holistically and extremely carefully. In doing any review, Ofgem should closely examine the impact of the approach it took to setting the operational cost allowances in 2018, including the incentives it placed on the behaviour of suppliers. In 2018, Ofgem took an aggressive[1] approach to operational cost allowances based on a narrow interpretation of the Tariff Cap Act 2018; Ofgem effectively equated low prices with consumer protection. Ofgem should take a broader view of consumer protection that includes incentives to invest in differentiated and enhanced customer service. The supplier failures throughout 2021 and 2022 exposed the flaws of focussing unduly on price as the main determinant of competition.

In 2018, examples of Ofgem's aggressive and narrow approach to setting the operational costs allowance included using the lower quartile benchmark, minus an arbitrary £5. Ofgem cherry-picked benchmarks for different cost allowances. Ofgem did not fully take account the different costs of serving different customer groups, the reasons for which have nothing to do with efficiency. In our response to Ofgem's 2018 statutory consultation on the price cap[2], we provided a detailed breakdown of how Ofgem's allowances were insufficient to cover efficient costs and that headroom was more than eaten up. We have updated and resubmitted this analysis to Ofgem since 2018. Ofgem has never engaged with this analysis.

[1] "We have set an operating cost allowance below large suppliers' historical costs, sharpening incentives to reduce costs." Ofgem, Decision, Default tariff cap – Overview document, 6 November 2018, p.6
[2] https://www.ofgem.gov.uk/publications/default-tariff-cap-overview-document

The problem with the one-size-fits-all approach to setting the cap is that some suppliers cannot recover their efficient costs. If some suppliers are heavily weighted towards particular segments of the market who are more likely to be vulnerable and/or have a high propensity to engage frequently and by telephony channels rather than digitally, then a mechanism needs to be found to enable these suppliers to recoup their costs. We welcome Ofgem's more open and creative approach in this area, such as considering cross-supplier levelisation outside of the cap mechanism.

When we say that any operational cost review should be holistic, amongst other things we mean that Ofgem's expectations and aspirations for customer service – such as any new consumer standards – should be fully funded. It would not be legitimate for Ofgem to hold suppliers to standards that are not achievable because of lack of resources provided under the cap and/or levelisation mechanisms.

Ofgem has brought forward the operating costs review in its most recent update to the price cap programme of work.[3] This is because it considers 'that an updated view of operating costs could help consideration of the future of price protection' in anticipation of the forthcoming government review. However, the timing means that some areas of regulatory change that could have a significant impact on operating costs are in the policy development phase.[4] It is therefore not clear that reviewing the operating costs allowances now would enable these costs to be included in any updated allowance or whether a subsequent review would be required. Ofgem needs to consider this issue before moving forward in its review, including whether it can produce the impact assessment that would be required to estimate these costs within its proposed timeline. More broadly, Ofgem has not made the case for a wider review at this time including whether this is proportionate given the significant data requirements that will be placed on suppliers

If Ofgem proceeds with the review, it proposes to exclude any review of the headroom allowance from the scope of the review noting that the headroom allowance is due to be reviewed as a long term workstream. However, when Ofgem set the operating costs allowances for the current cap it included an uncertainty allowance within headroom to account for 'suppliers with different customer bases, in light of the uncertainty affecting our estimates'.[5] There is therefore a clear link between the headroom allowance and the approach to benchmarking that Ofgem takes in any review of operating costs. Ofgem will need to consider this point in its framework for choosing between benchmarking options if the headroom allowance continues to be out of scope.

We support Ofgem in its intention to set out a framework for choosing between benchmarking options. Ofgem must balance a number of requirements that it must have regard to in setting the price cap which are set out in the Domestic Gas and Electricity (Tariff Cap) Act 2018, S.1(6).[6] A framework is important for Ofgem to articulate how it will balance these requirements. The framework should set out whether an efficiency incentive is embedded in the benchmark and how this incentive interacts with the requirement that holders of supply licences who operate efficiently are able to finance activities authorised by the licence. The framework should also set out how Ofgem will meet its objective to protect existing and future default tariff customers. Ofgem has said that it will consider 'protecting

[3] Price cap - Programme of Work | Ofgem
[4] Ofgem published a consultation on consumers standards and policy options to address priority customer service issues on 3rd May 2023.
[5] Default tariff cap: decision - overview | Ofgem, Appendix 6 — Operating costs, Paragraph 3.17.
[6] And updated in the Energy Prices Act 2022 (legislation.gov.uk), Schedule 3.

customers to mean that prices reflect underlying efficient costs'.[7] Ofgem should address wider impacts of the cap on consumers in its framework including on customer service and investment and innovation. As Ofgem set out in the Call for Input:

> *'It is important that the retail energy market is sustainable going forward, where a notional supplier can recover its efficient costs of supplying energy. A healthy market is good for consumers. It generates more competition and encourages investment in the sector, giving consumers more choice, driving up standards, and delivering the transition to net zero.'*[8]

Linked to this, the framework should also set out how Ofgem will determine the benchmark supplier and how this relates to the concept of a supplier with a 'normal customer base' to which it refers in the Call for Input. In doing so Ofgem needs to set out transparently and precisely the characteristics of the benchmark supplier recognising that this benchmark supplier represents the set of services that Ofgem is allowing all suppliers to provide. When setting a framework for the benchmark supplier Ofgem should also consider the data that it has available and how it will deal with uncertainty.

The scope of the proposed review is very broad, and we agree that Ofgem should progress to working papers in key areas. One such area is the costs of smart metering. As the smart meter rollout has progressed since the cap was set in 2018 it is now even more important that Ofgem takes into account suppliers smart rollout profile and its impact on their operating costs. Moving forwards, Ofgem will also need to account for how smart metering costs will change. A separate smart meter tariff would potentially include a tariff increase as well as complicating the customer journey when a customer switches to 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'[9], suppliers would need to advise customers of a potential tariff change. This would have implications for the smart meter rollout and Ofgem should rule it out.

Ofgem should also proceed to a working paper on the framework for choosing between benchmark options looking holistically at all the operating costs allowances. In addition to the points raised above, this framework should cover the level at which Ofgem will benchmark costs for each of the allowances and how the benchmarks relate to each other. If Ofgem adopts different benchmark suppliers for the core operating costs allowance and payment method uplift, the overall benchmark will imply the existence of an efficient supplier that does not exist and does not reflect what is obtainable by an actual supplier. There would also be a significant risk of error in benchmarking using allocated costs because suppliers may not have a consistent approach to cost allocation.[10]

On the process

We are pleased to see that Ofgem has set out this programme of work including an indication of when the policy consultation would be issued and from when the allowance would be effective. We also appreciate that Ofgem intends to use the Call for Input to

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[7] Price cap - Call for Input on the Operating Cost Allowances Review | Ofgem, Appendix 1.
[8] Ibid, Page 3.
[9] About smart meters: smart meters explained | Smart Energy GB
[10] This point would also apply to separate benchmarks across individual costs lines and fuel types, for example.

enable it to make a decision on scope in advance of issuing the RFI which is a proportionate approach.

We hope that this response is useful and we look forward to engaging with Ofgem during this process.

Yours sincerely,

Alun Rees
Head of Wholesale and Retail Market Design and Policy

Appendix – responses to consultation questions

Scope of the Review

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

As set out in the cover letter, Ofgem will need to undertake any review of the operational cost allowances holistically and extremely carefully. In doing any review, Ofgem should closely examine the impact of the approach it took to setting the operational cost allowances in 2018, including the incentives it placed on the behaviour of suppliers. In 2018, Ofgem took an aggressive[11] approach to operational cost allowances based on a narrow interpretation of the Tariff Cap Act 2018; Ofgem effectively equated low prices with consumer protection. Ofgem should take a broader view of consumer protection that includes incentives to invest in differentiated and enhanced customer service.

Some elements of the proposed review are linked to ongoing consultations on Bad debt[12] and Levelisation[13]. These workstreams are addressing specific issues within the operating costs allowances independently of the proposed review. In assessing the scope of a potential review Ofgem should not duplicate these workstreams. However, any review of the operational costs allowance may for example reveal further costs that need to be levelised: Ofgem should keep an open mind to this possibility.

2. **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?**

Ofgem has excluded four areas from the proposed review. We comment on the exclusion of Allowances set in past cap periods and The EBIT and headroom allowances.

Allowances set in past cap periods

Whilst we agree that allowances set in past cap periods should not be subject to retrospective and legally impermissible clawback, Ofgem should examine the impact of the approach it took to setting the operational cost allowances in 2018, including the incentives it placed on the behaviour of suppliers.

Ofgem has said that allowances set in past cap periods including any 'true up of the operating costs from past cap periods' are out of scope of this workstream.

A true up mechanism was used in relation to Covid 19 debt costs[14]. In this case it referred to the intention to adjust an initial estimate (the float) to reflect the final costs once they were fully known (i.e. a 'true up').[15]

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[11] "We have set an operating cost allowance below large suppliers' historical costs, sharpening incentives to reduce costs." Ofgem, Decision, Default tariff cap – Overview document, 6 November 2018, p.6

[12] Price cap - Call for Input on the allowance for debt-related costs | Ofgem

[13] Levelisation of payment method cost differentials: a call for evidence | Ofgem

[14] Price Cap – Decision on the true-up process for COVID-19 costs | Ofgem

[15] Ibid, Paragraph 1.4.

We are concerned that Ofgem considers a true up would be appropriate in this context. A true up that is equivalent to a 'clawback' breaches a number of important legal principles. There is a legal presumption against retrospection, as any clawback would go against and severely interfere with regulatory certainty, which in turn would cause a significant threat to business and investment confidence. Accordingly, the burden on Ofgem in setting an ex-ante price control, which seeks to correct for past errors is a high one.

However, if Ofgem is referring to limiting scope to exclude any adjustments for efficiently incurred costs that were not included in the allowance when set this would be quite separate as it would relate to the expectation that price-capped companies will normally recover their efficiently incurred costs, no matter when those costs were incurred. It is entirely standard for this to apply to costs incurred in the past. If the analysis required for the proposed review finds evidence of such a case, it should be included in the scope.

The EBIT and headroom allowances.

When Ofgem set the operating cost allowances in 2018 it acknowledged that there were interactions between these allowances and the overall headroom provided. In particular, Ofgem noted that ' the overall cap has been set at a level above our efficient benchmark by including a headroom allowance. Part of the reason for this is to provide for suppliers with different customer bases, in light of the uncertainty affecting our estimates..'[16]

However, Ofgem is now not planning on reviewing the headroom allowance until after considering changes to the other cap components, if at all.[17]

Analysis updated by Centrica in December 2021 showed that the headroom allowance had been persistently set at a level that did not allow an efficient supplier to recover its costs.[18] There is therefore a clear link between the headroom allowance and the approach to benchmarking that Ofgem takes in any review of operating costs. Ofgem will need to consider this point when deciding on a benchmarking approach, if the headroom allowance continues to be out of scope.

Case for Review

3. **What are your views on the case for review we identify in this section?**
4. **Do you agree that there is sufficient reason to carry out a review?**

The operating cost allowances were last set based on 2017 data and this is one of the drivers for the update. In addition to this Ofgem points to a number of factors that may have impacted suppliers operating costs:

- Cost shocks: Covid, Gas prices, Cost of living pressure;
- Changes in market structure: SoLRs; and
- Industry change programmes and regulatory change.

Some of these factors have already led to adjustment/review of the price cap. An allowance was paid in cap periods six and seven for additional bad debt costs incurred during Covid

[16] Default tariff cap: decision - overview | Ofgem, Appendix 6 — Operating costs, Paragraph 3.17,
[17] Price Cap - Programme of Work: Update | Ofgem, Table A1.2.
[18] Centrica response to Ofgem's Consultation on the potential impact of increased wholesale volatility on the default tariff cap, December 2021.

(which was later 'trued up in period 10a)[19] and Ofgem is currently reviewing debt related costs in cap periods eight – nine and 10a – 11b.[20]

Our view is that Ofgem has not yet made the case for a wider review at this time including whether this is proportionate given the significant data requirements that will be placed on suppliers. In particular, the broad scope of the review means that the data requirements are significant and may be disproportionate.

One area where we agree that suppliers will incur costs not allowed for in the current cap is regulatory change related to customer standards.[21] However, given these requirements are only at the policy consultation stage, it is not clear that reviewing the operating costs allowances now would enable these costs to be included in any updated allowance. The same would apply to costs relating to the PPM code of practice; however, these could be addressed through the current review of debt related costs.

Core operating costs

Potential drivers of changes in cost lines

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

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

The core operating costs allowance was set in 2018 based on the operating costs of the lower quartile supplier adjusted by £5. These costs were then indexed by CPIH. With this context we would note that we cannot know which costs were included within the allowance as they were based on a benchmark supplier, and therefore the costs that it incurred in 2017. This would determine what, if any, new costs were not included in this allowance.

Whilst we cannot comment on the costs of the benchmark supplier there are a number of industry wide costs that would not have been included in any of the benchmarked suppliers operating costs in 2017. Some of these were known to Ofgem at the time, for example, the costs of the faster switching programme. There are also a number of regulatory requirements that will come into effect in the future and will create new costs. Ofgem has identified some of these costs in the Call for Input and we discuss them in the section on Implementation approach.

7. **Do you consider that any new costs would be offset by corresponding benefits?**

The regulatory change programmes mentioned would have had benefits; some of which may accrue to suppliers. Ofgem should consider the relevant impact assessments and

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19 Price Cap – Decision on the true-up process for COVID-19 costs | Ofgem
20 Price cap - Call for Input on the allowance for debt-related costs | Ofgem.
21 Consultation on a framework for consumer standards and policy options to address priority customer service issues | Ofgem

consult with suppliers on the corresponding benefits of any regulatory change. As benefits can be uncertain, Ofgem should consider any corresponding benefits cautiously and ensure that they do not conflate benefits of regulatory changes with broader efficiency savings.

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

As noted in the response to question 6, we cannot comment on the costs of the benchmark supplier.

9. 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 (i.e. per customer)?

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

Ofgem would need to consult further on this point if it proceeds with a review of the operating cost allowances.

If the review proceeds, we would expect Ofgem to use a request for information to gather data on a historic period and use this to propose a baseline year evidenced by an analysis of the data. As noted above, at that time, Ofgem should consult stakeholders on this proposal including sharing the benchmarking model that it proposes.

Ofgem's current minded to approach is to use 2022 data to set the benchmark. However, it has noted that 'there may be some in-year factors that would impact costs and we would consider correcting for these factors..'[22] Correcting for in year factors is likely to add complexity to any benchmarking analysis and has the potential to distort the outcome. Any such corrections should also be consulted on widely with stakeholders.

In general, Ofgem should adopt a transparent approach to selecting the baseline year including setting this out in the framework it proposes to consider benchmarking options in question 15.

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

In 2018, Ofgem took an aggressive[23] approach to operational cost allowances based on a narrow interpretation of the Tariff Cap Act 2018; Ofgem effectively equated low prices with consumer protection. Ofgem should take a broader view of consumer protection that includes incentives to invest in differentiated and enhanced customer service. The flaws of focussing unduly on price as the main determinant of competition were exposed by the supplier failures throughout 2021 and 2022.

In 2018, examples of Ofgem's aggressive and narrow approach to setting the operational costs allowance included using the lower quartile benchmark, minus an arbitrary £5. Ofgem

[22] Price cap - Call for Input on the Operating Cost Allowances Review | Ofgem, Page 18.
[23] "We have set an operating cost allowance below large suppliers' historical costs, sharpening incentives to reduce costs." Ofgem, Decision, Default tariff cap – Overview document, 6 November 2018, p.6

cherry-picked benchmarks for different cost allowances. Ofgem did not fully take account the different costs of serving different customer groups, the reasons for which have nothing to do with efficiency. In our response to Ofgem's 2018 statutory consultation on the price cap[24], we provided a detailed breakdown of how Ofgem's allowances were insufficient to cover efficient costs and that headroom was more than eaten up. We have updated and resubmitted this analysis to Ofgem since 2018. Ofgem has never engaged with this analysis.

The problem with the one-size-fits-all approach to setting the cap is that some suppliers cannot recover their efficient costs. If some suppliers are heavily weighted towards particular segments of the market who are more likely to be vulnerable and/or have a high propensity to engage frequently and by telephony channels rather than digitally, then a mechanism needs to be found to enable these suppliers to recoup their costs. We welcome Ofgem's more open and creative approach in this area, such as considering cross-supplier levelisation outside of the cap mechanism.

When we say that any operational cost review should be holistic, amongst other things we mean that Ofgem's expectations and aspirations for customer service – such as any new consumer standards – should be fully funded. It would not be legitimate for Ofgem to hold suppliers to standards that are not achievable because of lack of resources provided under the cap and/or levelisation mechanisms.

Correcting for non-efficiency factors

We set out our views on the characteristics (account and customer) over which costs could vary in our previous response . Ofgem should consider all of these factors in setting an enduring benchmark. In addition, Ofgem should consider the smart meter rollout profile of any benchmark supplier. We explain this in our response to question 29.

However, these are only some of the known drivers of cost differences between suppliers. Ofgem must also account for unobserved factors which may lead to cost variation between suppliers. The presence of unobserved factors should be taken into account by Ofgem as a factor in setting an enduring benchmark and through its framework for choosing between benchmarks noted in question 15.

Dealing with shocks

The current price cap was intended to be stretching for suppliers and Ofgem set out the price cap should be 'a tough cap that ensures loyal consumers pay a fair price that reflects efficient costs'.[25] In setting the next cap, Ofgem should not replicate the approach taken to setting the previous review without understanding the impact that it had on the energy supply market. Ofgem has already begun this process in the report it commissioned from Oxera to review its regulation of the energy supply market.[26] This report identified 'four specific concerns with the implementation of the price cap' in the context of the 2021 wholesale price rises. The first of these was that 'calibrating a 'tough' price cap may have left some suppliers with insufficient headroom to deal with shocks'.[27]

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[24] https://www.ofgem.gov.uk/publications/default-tariff-cap-overview-document
[25] Ofgem strategic narrative: 2019-23 | Ofgem, Page 14.
[26] Review of Ofgem's regulation of the energy supply market Prepared for Ofgem 3 May 2022.
[27] Ibid, page 42.

Ofgem should consider the impact of shocks on operating costs in setting an enduring benchmark.

Overall approach (Bottom-up Vs Top-down)

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

Ofgem proposes an overall approach of benchmarking at total operating cost level using supplier cost data rather than based on each individual cost line. Ofgem said that this 'gives us the flexibility to isolate any particular cost lines and consider an alternative calculation approach'.[28]

We agree with Ofgem's approach to consider both operating costs at an aggregate level and individual cost lines. However, we note that Ofgem sets out that a top-down approach is preferable because 'It is more proportionate from a time and data perspective, and less technically complex.' We understand that Ofgem would consider proportionality in its proposed review. However, cost benchmarking can be a complex exercise and we expect it to consider the merits of all approaches. As a comparator, the RIIO ED2 price control used three approaches to determine total expenditure allowances for Distribution Network Operators (DNOs), these were 'a combination of aggregated (totex) and disaggregated (activity level) benchmarking to assess DNOs' normalised submitted costs, supported by technical assessment where benchmarking is not suitable, such as where costs are company or project specific.'[29]

We agree that Ofgem should consider the technical complexity of a bottom-up approach and the availability of comparable data when setting the overall approach. If Ofgem were to carry out a bottom-up assessment it would need to provide evidence that the resulting overall benchmark is achievable by any efficient supplier. For example, for the current cap we welcomed the fact that Ofgem chose to undertake the benchmark analysis on a dual fuel basis, given the inaccuracies that benchmarking on a single fuel basis would lead to. Given the limitations of the data available to Ofgem, we also agreed that carrying out benchmarking based on all customers (rather than just those on SVTs) is a reasonable course of action. However, we noted in our response to the 2018 decision on the default tariff cap that we disagree with Ofgem's statement that SVT customers are "…likely to have significantly lower sales and marketing costs". Finally, we also strongly agreed with the principle of excluding from the sample firms with atypical customer bases, which would not be a reasonable basis upon which to estimate a benchmark.

Ofgem should allow respondents to check for errors

When setting the original cap, Ofgem made a number of significant errors in its application of the bottom-up methodology for setting the operational costs allowance. The result was that the bottom-up cap that was proposed was set at a level that is too low to satisfy the requirements of s.1(6)(d) of the Act.

At the time, we were not able to ascertain all of the reasons for this, given that Ofgem prevented stakeholders from being able to properly assess and evaluate the proposals. A "bottom-up" calculation, by its nature, is entirely reliant on the information provided to Ofgem

[28] [Price cap - Call for Input on the Operating Cost Allowances Review | Ofgem](), Page 18.
[29] RIIO-ED2 Final Determinations Core Methodology Document Publication date: 30 November 2022.

by suppliers. Ofgem should therefore release all operational costs that are used to determine the allowance to Centrica's advisers, in the controlled environment of a Disclosure Room. This approach will materially reduce the risk of error in Ofgem's ultimate conclusions.

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

We agree that a top-down benchmarking approach for core operating costs, meaning benchmarking at the aggregate operating cost level, is likely to be an appropriate starting point. However, adjustments are likely to be needed – for example through levelisation - to accommodate legitimate variations in cost that have nothing to do with efficiency. However, the correct approach will depend on the data that is available for Ofgem and we would expect Ofgem to consult widely on this including disclosing all operational costs that are used to determine the allowance to Centrica's advisers, in the controlled environment of a Disclosure Room.

Benchmarking approach

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

Operating costs are a supplier's own costs of retailing energy. These costs determine the level of service that a supplier can provide day-to-day for its customers. Operating costs also support innovation in those services and investment in improving them. If Ofgem proceeds to reset the operational costs allowances, it must ensure that it takes a broad view of consumer protection. This means that prices must be set at a level that allows suppliers to meet customer needs in the long-term.

Ofgem's approach to benchmarking is critical in this respect. Ofgem rightly recognises the need to control for non-efficiency factors in setting an enduring benchmark. However, it must recognise that there are limitations to the data that will be available and therefore unobserved factors may lead to cost variation between suppliers. Ofgem, recognised this when the cap was set in 2018 through its approach to the headroom allowance.[30] Given this allowance is out of scope for the proposed review Ofgem would need to ensure that its benchmark allows all suppliers to recover their efficient costs directly, through the operating costs allowances.

To that end, our view is that Ofgem should set out a framework for choosing between benchmarking options, as it notes in the next question. This framework should be consulted on. Once agreed a well thought through framework will enable Ofgem and consultees to consider an appropriate benchmark option given the data that is available.

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

We agree that Ofgem should develop a framework for choosing between benchmarking options. Ofgem must have regard to a number of factors in line with its duties in the Domestic Gas and Electricity (Tariff Cap) Act 2018, some of which require trade-offs. A

[30] Default tariff cap: decision - overview | Ofgem, Appendix 6 — Operating costs, Paragraph 3.17.

framework should set out how Ofgem will deal with these trade-offs and provide transparency to respondents on how each factor is met.

The framework should set out how Ofgem will meet its objective to protect existing and future default tariff customers. Ofgem has said that it will consider 'protecting customers to mean that prices reflect underlying efficient costs'.[31] Ofgem should address wider impacts of the cap on consumers in its framework including on customer service and investment and innovation.

The framework should also set out how Ofgem will determine the benchmark supplier and how this relates to the concept of a supplier with a 'normal customer base' to which it refers in the Call for Input. In doing so Ofgem needs to set out transparently and precisely the characteristics of the benchmark supplier recognising that this benchmark supplier represents the set of services that Ofgem is allowing all suppliers to provide. When setting a framework for the benchmark supplier Ofgem should also consider the data that it has available and how it will deal with uncertainty.

The framework should also address the efficiency incentive. When the cap was set in 2018, Ofgem did not articulate how an efficiency incentive was built into the cap, if indeed it was. It is crucial that Ofgem is transparent about any efficiency incentive that they include in the operating cost allowances. This will allow suppliers to respond effectively to consultation. A key part of this will be setting out the duration of any efficiency incentive and any triggers for future review.

16. **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?**

Ofgem should consider all of these factors in setting an enduring benchmark. In addition, Ofgem should consider how the smart meter rollout profile of any benchmark supplier used. We explain this in our response to question 29.

Allocating costs across different parameters

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

18. **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.**

19. **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?**

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[31] Price cap - Call for Input on the Operating Cost Allowances Review | Ofgem, Appendix 1.

Setting the allowance on an enduring basis

20. 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?

This question would more appropriately be asked in relation to specific cost drivers when these are known to Ofgem for respondents to provide a reasoned answer supported by evidence where available. Furthermore, as noted above, we would expect Ofgem to consult widely on this including disclosing all operational costs that are used to determine the allowance to Centrica's advisers, in the controlled environment of a Disclosure Room.

Payment method differential

Drivers of the payment method differential

21. 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.

One driver of change will be the Code of Practice on involuntary prepayment meter installations which Ofgem published in April 2023.[32] Ofgem plans to consult on incorporating the Code into suppliers' licences, which would make it legally enforceable. Alongside the Code Ofgem has asked suppliers to not restart involuntary PPMs 'until they can demonstrate readiness to implement the new Code.'

We recently submitted a response to Ofgem's Call for Input on the allowance for debt-related costs.[33] Ofgem should refer to that response .

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

See response above.

Other payment methods

23. 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.

24. 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)?

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[32] [Energy suppliers sign up to new Code of Practice on involuntary prepayment installations | Ofgem]()
[33] [Price cap - Call for Input on the allowance for debt-related costs | Ofgem]()

In the call for input, Ofgem set out that 'If there is sufficiently accurate and relevant data on the costs of any different payment methods, we may consider calculating a separate payment method differential for any such payment methods.'[34]

In our response to the levelisation workstream we have recommended that Ofgem levelises prepayment meter (PPM) and direct debit (DD) unit rates and standing charge but retains a differential between standard credit (SC) and DD to incentivise customers to move to DD or PPM.

We believe that this option delivers the right outcomes for customers and suppliers and has the added benefit of being simplest for customers to understand – i.e., if a customer is on one of the prompt payment types of PPM or DD, their tariff will be the same.[35] Should Ofgem consider additional payment types it should consider whether these add additional complexity for customers and what the impact of this would be.

Benchmarking approach

25. 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?

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

Our view is that Ofgem should take into account interlinkages between the costs of serving different payment methods and provide assurance that a supplier could achieve the benchmarks across its portfolio. These requirements are most likely to be met by using a single benchmark supplier across the core operating costs allowance (which applies to direct debit customers) and payment differentials (which we assume would be calculated for prepayment and standard credit customers).

In 2018 the standard credit uplift was calculated separately from core operating costs and was based on bad debt costs, working capital calculation and SC administration costs.[36] Initially, Ofgem proposed to benchmark each of these cost components separately – in contrast to the approach for core operating costs. Following stakeholder input Ofgem adapted its approach to benchmark across the total of all three components.

Our view is that benchmarking payment differentials separately from operating costs or at a disaggregated level[37] makes little sense. There is a risk of an unachievable benchmark if different suppliers make up the benchmark. If suppliers allocate costs differently, one might allocate costs to payment method uplift whereas another to operating costs, benchmarking the best supplier for each component would mean the benchmark becomes unachievable.

For example, benchmarking the costs associated with SC customers separately to benchmarking all other operating costs means that a firm may have a low payment method

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[34] Price cap - Call for Input on the Operating Cost Allowances Review | Ofgem
[35] Centrica response, Call for evidence on levelisation of payment method cost differentials,18 May 2023.
[36] Default tariff cap: decision - overview | Ofgem, Appendix 8 - Payment method uplift.
[37] Benchmarking separately by cost category or by fuel.

cost differential between DD and SC as a result of incurring relatively high DD costs, rather than low SC costs. It would be more consistent for Ofgem to use the payment method differentials of the benchmark company chosen in its operating costs analysis. However, Ofgem would also need to be careful to choose a benchmark company with as representative mix of customers as possible, prior to making adjustments.

In the case of benchmarking by cost component, Ofgem must recognise that there may be substitutability between different categories of expenditure. For example, one component of "other administrative costs" relates to debt recovery. A supplier may choose to spend more on debt recovery in the expectation that this will reduce levels of default (and therefore bad debt charge).

Ofgem should set out the framework it will use to choose between benchmarking options (referred to in question 15) and apply this to both the payment method uplift and core operating costs.

Costs allocation

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

The Call for Input notes that Ofgem intends 'to explore options for allocating costs between payment methods. This may not necessarily reflect cost reflectivity, acknowledging there are a range of options and judgments.'[38]

We set our our views on the allocation of cost categories between payment methods in our recent response to Ofgem's call for evidence on levelisation of payment method cost differentials.[39] Please refer to that response.

Smart metering costs

A proportionate approach to setting the allowance for smart metering costs

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

The key factor will be the rollout profile of the benchmark supplier. In addition, Ofgem should consider how the model is updated to account for changes to the costs of smart meters.

The rollout profile of the benchmark supplier

The core operating costs baseline will include the costs of smart metering, to the extent that the benchmark supplier is incurring these costs in the baseline year. It is crucial that Ofgem takes this into account. If Ofgem were to select a benchmark supplier with a relatively low smart rollout profile, the smart metering component of the core operating costs benchmark would only reflect that relatively low smart rollout profile. Therefore, other suppliers with

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[38] Price cap - Call for Input on the Operating Cost Allowances Review | Ofgem, Page 26.
[39] Centrica response, Call for evidence on levelisation of payment method cost differentials,18 May 2023.

higher efficient smart metering costs will not be funded to meet their obligations under the mandate.

Changes to the costs of SMNCC allowance

Ofgem last updated the SMNCC model in 2022.[40] This update considered the sunk and productive installation costs, general economic inputs and impact of SoLR process on the rollout profile. Following this review, Ofgem decided to cease annual reviews of the SMNCC model.[41]

In its final review in 2022 Ofgem considered whether the GDP deflator remained an appropriate index for the model. Our view was that CPIH should be used, and we shared with Ofgem an independent report setting this out. Given Ofgem did not update the index at that point we consider Ofgem should reconsider whether the GDP deflator is an appropriate index if it updates the core operating costs baseline.

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

Ofgem proposed that an alternative option to the SMNCC would be to set separate cap levels for smart and traditional meter customers. There are a number of issues in implementing a smart cap and we do not agree that Ofgem should proceed with this option.

Implementing a SMART cap

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'[42], 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.

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[40] Price Cap - August 2022 decision on credit and PPM SMNCC allowances | Ofgem
[41] Price cap - November 2022 consultation on approach to reviewing the SMNCC allowances | Ofgem
[42] About smart meters: smart meters explained | Smart Energy GB

30. 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?

Yes, Ofgem currently provides an allowance for the net cost change because of the smart meter rollout. Whilst the rollout has progressed there remain over 23 million non-smart meters installed in Q4 2022.[43] Ofgem needs to consider how to allow for these costs under the operating costs allowances and engage with suppliers on this.

We agree with Ofgem that it may be 'appropriate to have a separate component to reflect the profile of remaining traditional meter costs' but this would not necessarily replace the transitional smart meter costs. Unit costs of traditional meter costs could increase as the number of traditional meters falls, meaning that metering costs embedded within the core operating costs allowance would increase faster than the CPIH index assumed.

Any substantive revisions to the SMNCC model or revised methodology for determining smart cost allowances must be subject to full and transparent consultation. We agree that it should not, as a matter of course, fall to suppliers to engage independent experts to check Ofgem's model for straightforward errors that could and should have been picked up at an earlier stage by robust quality assurance. However, we note that it is only as a result of previous disclosure and external scrutiny that material errors have come to light, contributing to the 'maturity' of the model on which Ofgem now relies to justify less intensive review. It therefore remains important that any new modelling approach (including but not necessarily limited to the context of future review of operational costs) should be subject to full consultation, scrutiny, and disclosure.

Industry charges

Changes in industry charges

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

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

Approach to setting and updating industry charges

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

See response to question 31. 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

[43] Information about the Smart Meters Statistics in Great Britain, quarterly report to end December 2022. Department for Energy Security and Net Zero.

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

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

See response to question 31.

Implementation approach

Updating the allowances over time

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

Ofgem has said that it will consider two options for updating the allowances over time: setting a future profile of operating cost allowances and a simpler indexed update approach.

The considerations Ofgem has set out in choosing between these two options are:

- the need to balance uncertainty and proportionality;
- whether future costs will be temporary or enduring; and
- whether any benefits offset future costs.

Balancing uncertainty and proportionality

Our initial view is that, given the timeline for the update of the operating costs allowances, there is likely to be significant uncertainty in predicting efficient operating costs over time. In particular, Ofgem does not have impact assessment data to estimate the costs of the consumer standards requirements[44] or the PPM code of practice.[45]

We don’t agree that Ofgem should balance this uncertainty with ‘proportionality’. Ofgem’s priority in setting the cap should be the legislative framework which requires that it give regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence. Ofgem should therefore ensure that it has reliable estimate of these costs when setting the operating cost allowances and should therefore prioritise developing a robust impact assessment for both measures. .

Ofgem should also be clear that price-capped companies will normally recover their efficiently incurred costs, no matter when those costs were incurred. Including, where costs were incurred in the past. Therefore, efficiently incurred costs that were not included in the allowance when set may be recovered in the future. As was the case with Covid 19 debt related costs.[46]

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[44] Consultation on framework for consumer standards and policy options to address priority customer service issues, 3 May 2023.

[45] The MHHS programme will also have a significant impact on suppliers costs but given the maturity of this programme we expect Ofgem to be able to set a future profile of operating costs including these new costs.

[46] [Price Cap – Decision on the true-up process for COVID-19 costs | Ofgem]

Whether future costs will be temporary or enduring

We agree that Ofgem should consider whether future costs are temporary or enduring. However, Ofgem must base any findings on robust data on supplier impacts including any impact assessment data that sets out transition and ongoing costs.

Whether any benefits offset future costs

We agree that any offsetting benefits should be taken into account when considering how to update the benchmark where those benefits directly accrue to suppliers. However, Ofgem should take care not to conflate offsetting benefits with efficiency gains.

In the 2018 decision, Ofgem found that future costs of regulatory change may be offset by cost reductions resulting from automation and digitisation.[47] We are concerned that this undermined the incentives within the price control for suppliers to improve their efficiency, which is an objective Ofgem needs to have regard to.[48] In order for the cap to create efficiency incentives it is necessary for suppliers to be able to make efficiency gains and retain the benefit of those gains, at least for a period of time. By removing benefits from automation and digitisation in advance Ofgem is reducing that incentive.

Finally, we note that Ofgem has also stated that any update approach will interact with the 'stringency' of the benchmark. We are concerned by this as it infers that Ofgem may make a subjective judgement on its choice of benchmark based on a lack of evidence on suppliers' future costs. Ofgem is required to have regard to "the need to ensure that holders of supply licenses who operate efficiently are able to finance activities authorised by the license" by S.1(6)(d) of the Act. The setting of the benchmark is key in meeting this requirement and it should therefore be done based on evidence. Where Ofgem does not have sufficient evidence or considers the evidence it does have to be uncertain it must be cautious in its approach.

Allocating operating costs across the standing charge and unit rate

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

We do not think Ofgem should proceed with Option 2 which would likely mean an increase in the standing charge. As Ofgem notes, an increase in the standing charge would have distributional consequences across customers because low consumption households would pay more.

Whilst option 1 would be less cost reflective at nil consumption, if Ofgem is able to accurately forecast and update consumption at TDCV, it would still allow suppliers to recover their efficient costs through the variable rate. Furthermore, where Ofgem has the power – such as relevant network charges – it should enable a reduction in the standing charge by changing fixed costs to consumption-based costs.

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

[47] Default tariff cap: decision - overview | Ofgem, Appendix 6 — Operating costs, Paragraph 3.61.
[48] S.1(6)(a) of the Act requires that that Ofgem must have regard to "the need to create incentives for holders of supply licences to improve their efficiency".

We consider that Ofgem should propose a third option in which the standing charge is reduced for customers on the default tariff. A simpler pricing structure would benefit consumers making it easier to understand the costs of energy use.

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

We agree that Ofgem should prioritise this topic.

Next steps

39. 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?

Yes, we agree that Ofgem should include published working papers as part of the policy development process. We would encourage Ofgem to cover at least the approach to smart metering costs and the framework for the benchmarking approach.