26 June 2023

David Hall
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Operating Cost Review
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Email: Alisonrussell@utilita.co.uk

Dear David and Rishi,

Re: Price Cap: Call for Input on the Operating Cost Allowances Review

Thank you for the opportunity to comment on the Call for Input. As you are aware, Utilita is a specialist smart prepay supplier, and as such has a unique focus and expertise within the industry, in particular with respect to the efficient costs faced by prepay suppliers.

We have engaged in policy and costs development throughout the lifetime of both the Prepayment Charge Restriction and the Default Tariff Cap (DTC). We will not repeat all previous points here, though ask they are taken into consideration. We have made some general points in this cover letter and then addressed the individual questions in Appendix 1.

Utilita has pressed for a review of the operating costs since implementation of the price cap. The review is long overdue and much needed. This is an opportunity to review the lower quartile benchmark which currently means that 2/3^{rds} of suppliers will not recover their efficient costs and will have contributed to the 30 supplier failures and ongoing losses once the one-off adjustments are removed. Ofgem has been aware through the segmental statements, financial reports and RFIs that the cap has been underfunding suppliers for years and failing to allow efficient cost recovery. This must be addressed.

We fundamentally disagree with Ofgem's position that it will not allow recovery of past errors. This approach may be discriminatory given that Ofgem has allowed this in Bad Debt, Backwardation and Fixed Term Contract run-off costs. Ofgem's approach is also inconsistent in that it has embedded cross subsidy and imposed ongoing under-recovery on prepay specialist suppliers, while assisting larger suppliers. Ofgem plans to collect data for the relevant periods via the RFI, and where the data shows an under-recovery, Ofgem will have the means and has an obligation to allow efficient cost recovery.

The price cap is a device to protect SVT customers from excessive profits. The purpose of the cap - and Ofgem's remit - is not to set prices, but to protect the interests of consumers, where possible by competition. We believe that there is a significant gap in the approach as the draft RFI requests reconciliation to suppliers' financial data but makes no attempt to split out the operational costs of FTC from SVT. We believe the cost differentiation between SVT and FTC is material and should be included to ensure that customers on SVT tariffs – who are more likely to be vulnerable – do not fund benefits for FTC customers who may be more able to engage with that sector of the market.

We welcome the chance to contribute to the review at this early stage. We take this opportunity to urge Ofgem to move all aspects of this Operating Cost Allowances Review (Operating Costs Review, OCR) forward in tandem. We also support the process of sharing working papers to allow expert contributions from industry participants and other consultees. However, throughout the process we

must not lose sight of the fundamental purpose of the price cap, which is to protect customers from excess profits, not to determine the cost stack.

This work is critically important to ensure that consumers are well-served by a range of resilient suppliers, competing effectively for customers below the cap with a rich and varied range of service offerings.

In order for this project to really benefit consumers, it needs to move forward at pace with all relevant aspects being taken forward together, rather than the proposed piecemeal approach which lacks clarity and fails to provide the necessary confidence to suppliers and investors.

We would welcome an opportunity to discuss this contribution in more detail with Ofgem colleagues once you have had chance to consider our submission. Please let me know suitable dates and I will be happy to co-ordinate diaries.

Kind regards

By email only

Alison Russell
Director of Policy and Regulatory Affairs

Appendix 1 – Call for Input on the Operating Cost Allowances Review (OCR)

In this section, we have reproduced the questions as per the OCR, including section headings. This Appendix should be read in conjunction with the attached covering letter.

Introduction

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

We are broadly in agreement with the scope of the review and support the combination of multiple cost allowances in this review.

We have stated our concerns over the complexity and inaccuracy of the SMNCC previously and this represents an opportunity to simplify and more accurately reflect the costs of suppliers. An aggregation of allowances will help remove inaccuracies due to the allocation of costs across different allowances due to different business models, which make the current concept of the notional supplier an unrealistic one.

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?

We welcome the opportunity to comment on scope at this stage. We agree that REGOS and Innovation should be excluded. Specifically, if the changes we recommend at implemented, we believe that innovation will flow naturally from a competitive sector, where investors can make reasonable returns. In respect of EBIT, we acknowledge that this is being considered through a separate workstream, but as stated elsewhere we consider that the interactions are critical and must be carefully managed.

However, in respect of the provisions on true-up we do not agree. This is fundamentally wrong. Essentially, Ofgem is stating that no matter how unfair or inadequate the previous allowances, it plans to force suppliers to absorb these losses. It is this type of approach by Ofgem which has contributed to the ongoing ebbing of investor confidence in the sector.

Ofgem has taken this piecemeal approach in other areas such as Bad Debt and Backwardation, where some true up has been allowed. At the same time, Ofgem is clearly aware there remains a problem. To assist in correcting this issue going forward - Ofgem is also requesting data for these periods. This means that it will have available to it all the data it needs to assess any understatements by payment type and to calculate the appropriate value for recovery. Ofgem has a responsibility to allow suppliers to recover their efficient costs and it cannot ignore this duty when it has (or can obtain) the data to do so.

In addition, we disagree with the approach and timing, and further, we consider that there are significant omissions from the review. While this may be oversight, it is symptomatic of the approach applied generally by Ofgem of increasing supplier obligations while seeking to avoid properly funding the requirements.

As we have stated elsewhere in the submission and previously, this comes from a fundamentally erroneous approach to the cap. The Price Cap is intended to protect customers from super-normal profits – not identify what an efficient supplier is - especially not on the poorly conceived 'pick n' mix' approach, which excludes important obligations and seeks to implement one-way change.

Equally, Ofgem fails to apply appropriate logic in respect of the SMNCC. An efficient supplier should be smart – and suppliers have had firm obligations to install smart meters. Costs therefore should reflect smart meter costs not traditional meter costs.

In setting allowances for operating costs, Ofgem must take account of the increasing levels of obligations being imposed on suppliers and the duration of such obligations. Adding new and onerous obligations such as the levels of ASC demanded post the changes in December 2020 is an ongoing

requirement, with associated impacts on operating costs (OC)/cashflows both in terms of providing the support and management of the process, including repayment by customers. It is not therefore an obligation where the costs can reasonably be met via headroom which is intended to be a mechanism to enable management of uncertainty. Such obligations should be properly assessed and factored into OC. We believe that a bottom-up approach to assessment of costs obligations and reviewing the notional supplier is needed as a first step.

In respect of Headroom, as we have said before, we do not agree that Headroom should be a long term workstream. The over-reliance by Ofgem on Headroom - including on an ongoing basis - means that an allowance intended to enable Suppliers to manage uncertainty is not available for that purpose.

Finally, we are seriously concerned at the lack of urgency demonstrated by Ofgem's approach. This OCR is too slow. Suppliers must operate in and fund their activities in the real world, where inadequate allowances, a regulatory misunderstanding of operating costs and a regulatory failure to allow suppliers to recover efficient costs under the cap bring with them a real risk of business failure.

We understand (and to a large degree support) the numerous activities Ofgem has initiated recently in respect of improving resilience and other measures – but it is critical that Ofgem also acknowledges that the most fundamental underpinning for all these measures – allowing suppliers to recover their efficient costs – is within Ofgem's hands, not suppliers'.

Reviewing the price cap should not be piecemeal. The objective of the price cap is simple and clear – to protect customers from excessive prices while at the same time allowing suppliers to operate and innovate.

The Case for Review

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

Utilita agrees that increased obligations on suppliers have increased operating costs since the allowance was set. We have repeatedly engaged with Ofgem on the deficiencies of the price cap and the original assumptions as well as on policy changes which need price cap funding.

However, we believe the case for review is stronger than identified as the section on market and regulatory changes omits an important factor – affordability. Ofgem's approach of paring allowances to the bone, failing to factor in the costs of new obligations, and creating as its notional supplier one that cannot exist, acts against its own wish to implement customer facing change rapidly. Where suppliers cannot recover efficient costs, the approach set out on page 9 of implementing costly customer service changes ahead of winter, with a potential review of costs ex-post is flawed. Imposition of costs prior to income imposes further uncertainty and regulatory risk on suppliers.

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

We agree that a review is needed. As noted above, suppliers are significantly loss making under normal market conditions, which is unsustainable. The cause is in a large part due to an understated operating cost allowance in the price cap, which must be addressed if the market is to be viable.

Ofgem has known for a long time that the price cap does not allow efficient cost recovery and that it is failing to meet the objective of allowing efficient suppliers to fund their businesses. This review must progress at pace, and the planned timelines are simply too slow and too fragmented.

Core operating costs - Potential drivers of changes in cost lines

We agree the material drivers of change noted in the consultation are all important, though as set out in this submission, not all factors have been identified and addressed. Ofgem should also not make any

determinations based on the fact that services have been offered previously by some suppliers and therefore can be excluded. The critical fact is that if the services are licence obligations and so form part of suppliers' efficient costs, they should be recoverable. Ofgem cannot know what economies suppliers have been obliged to make or what investment has been excluded in order to deliver unfunded obligations and should not simply make assumptions. The Notional Supplier approach chosen means that an unrealistic notional supplier will be set.

The price cap is not intended to set the market price, it is intended to be an upper limit to protect consumers. On this basis:

- Ofgem should not use lower quartile or lower quartile less an arbitrary reduction, they should look to use a weighted average which would be more representative
- A price cap which fails to allow recovery of efficient costs will not drive efficiency, it will simply make the sector higher risk and more expensive, discouraging investment. Investment, innovation, and competition will drive efficiency and lower prices.
- Ofgem has a requirement to consider both current and future customers, which includes the levels of service available to customers.

Looking at the benchmark approach we continue to believe that errors in cost allocation by Ofgem (at these levels of 'accuracy') are more likely to explain differences in cost from the notional supplier than efficiency.

Finally, we raise significant concerns on a number of the assertions in the section on new regulations and cap changes. Ofgem is aware suppliers cannot recover efficient costs under the cap, has made a number of adjustments recently to assist even larger suppliers facing difficulties and is aware that many, if not most, suppliers are posting losses at the Supplier licensee level. Ofgem is also aware that the expected profits being posted in the next 12 months are one-offs and will still not allow recovery of prior year losses imposed by the cap.

We recognise that increasing allowances will come at a time when to allow suppliers to make profits may appear challenging, but Ofgem must not bow to short term public pressure at the expense of a robust, financially resilient and competitive sector in the longer term.

We believe that – under these conditions - the rationale underpinning assertions on page 15 around provision of extended service levels within existing cost allowances is flawed. Equally concerning is the rationale around improved services reducing complaints – we agree that this is likely, but it must be underpinned by rigorous cost benefit analysis not just isolated points take out of context. If Ofgem hopes to rely on such assertions, they must be transparently evidenced, including quantitative not just qualitative analysis, in each case.

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

All cost lines Ofgem previously included in its 2018 calculation should be included, but this will not be the complete costs to be considered.

Moving to the specific OCR Draft RFI, initial review of the RFI indicates Ofgem has the material items however we suggest Ofgem leave some slack in the process and framework to modify the scope as suppliers provide data to ensure that all costs are captured.

The risk with looking at different allowances separately is that costs fall between the cracks and so Ofgem must allow for this in an iterative approach.

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

Implementation of industry, government and Ofgem schemes, initiatives and instructions. The costs of administering ASCs, both the operating costs and the cost of capital on the money lent to customers,

are new. Many other cost elements have increased by more than the rate of inflation, such as IT costs related to interacting with the DCC and employee salaries.

Other areas for consideration here, although being addressed by separate workstreams, are proper accounting for bad debt – for all payment types - and cost of capital.

In addition, in line with our answer to Q5, on initial review of the draft RFI, it is unclear where the administration for schemes another than WHD sit, how Ofgem accounts for temporary schemes such as EBSS, AFP, ND-AFP, EBRS and EPG (see Q2 re true up of costs) and the administration costs of ECO4. Ofgem cannot ignore that these all had material operational costs to suppliers.

In Other Direct, REC is highlighted but it is not explicitly clear whether this should include other industry costs, EUK, Ombudsman etc. Ofgem requests DCC costs but has left no space for SMSO costs to be included.

The cost of responding to Ofgem or government initiatives or directions must not be omitted. In addition, we have repeatedly noted the increased burden of regulatory reporting and RFI's on businesses. Ofgem must acknowledge that under the current model, these increased costs are not recognised or addressed. We believe that a fundamental review of data gathering by Ofgem, and Government is needed, but in the meantime, the costs of data provision must be funded.

Ofgem repeatedly criticises suppliers in MCR processes for example if it considers that internal reports may not be as extensive as it might wish to see. It must acknowledge the degree to which Ofgem and Government has absorbed those scarce resources and prevented further development. Table 1 below illustrates the increased burden.

Table 1 – RFI requests and reporting requirements 2021 to 31 May 2023

Quarter	Regular RFI	One off RFI
Q2 23*	**45**	**8**
Q1 23	**38**	**23**
Q4 22	**37**	**11**
Q3 22	**27**	**14**
Q2 22	**29**	**12**
Q1 22	**32**	**5**
Q4 21	**24**	**5**
Q3 21	**33**	**7**
Q2 21	**23**	**2**
Q1 21	**35**	**1**

*There may be slightly different definition of one off and regular in this line, but the totals are the same. Note also that Q2 23 only includes 2 months' data.

Finally, while the review is taking place, a more realistic approach is needed to move away from the spurious accuracy associated with the current methodologies. With the levels of uncertainty and regulatory risk faced by suppliers, to suggest that all suppliers can managed all costs to within 2-3% is simply not correct. In aggregate, *ceteris paribus,* this might just be a possibility. However, when individual allowance categories are pared back, cost allowances are omitted for new obligations, efficient costs cannot be recovered, unfair cross subsidies are embedded and a lower quartile, unrecognisable notional supplier is used to set allowances – expecting cost management within 2-3% will not happen.

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

This cannot be an underlying assumption. It is becoming clear that the cost of Smart is increasing. We support the smart rollout and are market leaders with our smart portfolio at over 90%, but is it clear that

a lot of the benefits sit outside the supplier's control and outside the scope of operational costs, planning of renewables, balancing, consumption reduction etc. This means that operational costs are increasing for suppliers, but the benefits are not as an example.

Some cost elements have probably reduced overall, such as printing and postage costs as more customers elect to engage in a wholly digital manner. However, for a supplier such as Utilita, with our high proportion of PSR customers, and in particular, prepay customers needing extra help, our overall costs are likely higher, and many such customers may prefer not to be fully digital. The cost to maintain legacy systems to service those consumers who are not digitally engaged is increasing. For example, the additional complexity and risk in providing a wider range of communication methods.

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

No, all are still required. As identified the issue is failure to include missing costs.

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)?

Retail prices have had a large effect on operating costs as customers are much more likely to call the supplier to ask for financial assistance than when retail prices were lower. The cost may lessen if prices fall further but will return should prices increase. We must also recognise that given the difficulties consumers face on the wider cost of living, it is likely that any such fall may be lagged by quite some way.

Inflation is critical. However, using headline economic inflation for example may not be representative of wage inflation, particularly among lower skilled contact centre staff where the cost-of-living crisis has resulted in higher than average % increases. Further, in key skills such as IT where there is a skills shortage, but staff are critical to the on-going efficiencies and innovation, wage bills rise.

Increased costs of regulatory compliance and indeed managing responses to the regulator and government as set out above.

What years of data to use for the baseline

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

The initial cost review used by the CMA and Ofgem looked at data pre- 2017, which is simply not representative of the stresses the industry has faced over the last years. In addition, the DTC replaced the Prepayment Charge Restriction, therefore we think it is appropriate to start from financial year 2019 onwards as indicated in the draft RFI.

Utilita agrees that to achieve the most accurate result the most recent time period possible should be used. Given the high rate of inflation, even the most recent historical data will likely understate current operating costs, and so the result may have to be adjusted for inflation since the time period to which the data relates.

Given the extent to which obligations and costs imposed on suppliers have changed since the implementation of the cap, we would suggest a short period may need to be used for the new baseline. If a slightly extended period is used, it will be essential to map the cost impacting changes and adjust the baseline appropriately.

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

The lower quartile represents an unachievable notional supplier, ultimately reducing customer service, and destroying public and investor trust in the sector and Ofgem. Suppliers should at least be able to recover the average of the benchmark, however we would argue that the price cap is a cap below which competition should be able to flourish. The purpose of the cap is to stop over charging not set target efficiencies. Setting it at the top quartile would be most aligned to Ofgem's obligations and desire to see an innovative range of customer offerings. Using the lower quartile for an unachievable notional supplier will not provide the necessary framework for such offerings to be developed.

Industry and regulatory obligations, which can vary by payment method, are not adequately indexed using a general measure like inflation, and new obligations or industry schemes must be reflected in the price cap. This will have the incidental effect of discouraging changes that are not in the customer's interest as when the cost to the customer exceeds the gain from a given initiative, it will be less likely to be implemented.

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?

A top-down approach is only adequate as long as the costs of new obligations or requirements are properly quantified and explicitly included in the operating cost allowance rather than relying on uncertainty mechanisms.

Ofgem cannot ignore variations in business models, size and customer mix. Ofgem should recognise and take account of these in setting the allowances so that innovation and competition can exist. The document states that previously the benchmark was set £5 lower than the lower quartile and is relatively small. Historically (when prices were c. £1200 for a dual fuel customer and EBIT was 1.9%, that £5 was material to suppliers, its more than 20% of profit. We agree its small to consumers (in fact even more so now), but it is material to suppliers in aggregate.

Finally, as stated above the overall approach is too piecemeal and lacks urgency. The majority of the review must be completed together, and more promptly. The current arrangements do not fairly remunerate suppliers for the risks that are borne, and this situation must be addressed sooner rather than later or more suppliers may be placed at risk as a result.

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

The use of the lower quartile is clearly inappropriate, as is the deduction of an arbitrary 'efficiency factor'. If calculated accurately, this will result in at least three quarters of suppliers losing money, and possibly all suppliers losing money, with none being able to meet the theoretical level of efficiency which has been ‘set’ by the regulator.

This problem is exacerbated by the use of different cost elements within the cap, meaning different suppliers that have reported costs differently or specialise in different areas of energy retail, will artificially suppress the lower quartile such that it could not be achieved by a supplier that has lower quartile costs in aggregate.

The purpose of the price cap is to protect customers on default tariffs from excessive prices, not to set a theoretically perfect level of efficient costs and cap retail prices at (or below) this level. An energy retail market where over three quarters of suppliers are expected to lose money is clearly unsustainable. Given the aim of price capping is to protect customers from excessive prices while allowing suppliers to cover their costs and compete below the price cap, using the upper quartile cost would be a better solution, or as a minimum a weighted average.

The overall average is the efficient cost, every supplier will have different inefficiencies and therefore removing these will result in an artificially low allowance.

Benchmarking Approach

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

Prior to considering the actual questions in this section we question the ability of Ofgem to 'Benchmark' suppliers under these conditions. Again, the purpose of the price cap was to protect customers from super profits, not to define a perfectly efficient business. We therefore believe it is essential to move away from the lower quartile approach and the removal of "inefficiencies".

As we set out in the last question but restate here to ensure it is considered for both questions - the use of the lower quartile is clearly inappropriate, as is the deduction of an arbitrary 'efficiency factor'. If calculated accurately, this will result in at least three quarters of suppliers losing money, and possibly all suppliers losing money, with none being able to meet the theoretical level of efficiency.

This problem is exacerbated by the use of different cost elements within the cap, meaning different suppliers that have reported costs differently or specialise in different areas of energy retail, will artificially suppress the lower quartile such that it could not be achieved by a supplier that has lower quartile costs in aggregate.

The purpose of the price cap is to protect customers on default from excessive prices, not to set a theoretically perfect level of efficient costs and cap retail prices at this level. An energy retail market where over three quarters of suppliers are expected to lose money is clearly unsustainable. Given the aim of price capping to protect customers from excessive price while allowing suppliers to cover their costs and compete below the price cap, using the upper quartile cost would be a better solution.

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

Utilita suggests the first step is referring back to the matters to which Ofgem must have regard in the default tariff cap act. The upper quartile cost approach provides incentives to improve efficiency (which in any case exist without the existence of a price cap), enables competition for domestic supply contracts, maintains incentives to switch, and allows suppliers to finance their activities.

Ofgem's priority must be to create a competitive sector, it now has new responsibilities relating to Net Zero which will only be achieved by engaging the entire supply chain. A properly funded supplier can increase its level of service and become the required trusted provider of future energy solutions to consumers.

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?

There will be a number of factors to consider here including whether customer demographic, portfolio levels of vulnerability, whether the company is growing or stagnant and the degree of IT investment. Other types of factors will include that the average time on supply of a customer is likely to be much higher for a former monopoly incumbent supplier, which will have the effect of understating efficient customer acquisition amortisation costs. A notional supplier, operating without the advantage of an incumbent customer base, would not have this advantage and would experience a shorter average time on supply.

Utilita are uniquely placed for this question having suffered for years the detrimental effects of an embedded cross subsidy due to having a higher proportion of smart prepay customers. Ofgem must not allow this to continue. Our customer mix is not "non-efficient", it is efficient at supporting the needs

of vulnerable customers and innovating to support our specific customer base, but such support has associated costs. By deeming it non-efficient, Ofgem will perpetuate under investment in those that need it the most and continuing to discourage suppliers for competing for such customers.

Allocating costs across different parameters

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

No additional comments

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.

We consider that more complex arrangements do incur some additional operating costs in customer contact as customers are more likely to be confused by energy charges or fail to understand how to manage energy costs. In addition, certain unusual metering configurations may require additional support which may result in additional costs, though this would be extremely difficult to quantify by meter type, a reasonable estimate of the increase could likely be made in aggregate.

However, while this question raises the point about single vs multi-register meters, we believe that the more significant impact relates to meters being installed and left in an uncommissioned state, requiring another supplier to bear costs of remediation. It is also clear that some operational costs – installing SMETS2 for example – are higher, though the variance may reduce over time. This may have contributed to some suppliers leaving prior to completing commissioning.

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?

Cost allocation should be kept to a minimum, the greater degrees of complexity that are attempted, the more room there is for error and market distortion. RFI data become less reliable at lower granularity as more variables are introduced. As set out above, the overall objective is to protect customers from super normal profits, and to facilitate competition rather than to identify a specific efficient price.

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?

The high rate of inflation does make it likely that even recent data will understate a supplier's ongoing operating costs, and adjusting costs to reflect inflation since the time period to which the data relates will help make the cost assessment more realistic. It is essential, if the price cap is to continue, that the allowances are realistic on an enduring basis, reflecting the true costs of the obligations imposed on suppliers and ensuring that these costs can be recovered.

Ofgem needs to allow suppliers to recover costs now and on an enduring basis. If suppliers invest and innovate to make efficiencies or reduce costs, then these need to be capable of being retained for a period to provide an incentive. Ofgem should then only review if there is a material change (as they do with increases).

Payment Method Differential: Drivers of the payment method differential

This area of the price cap requires fundamental reform. As we have long argued, Ofgem should implement a single price cap for all payment methods defined at the level of Standard Credit (the most

expensive payment method. This approach continues to deliver the requirement to protect customers from supernormal profits – there are large numbers of vulnerable customers in this cohort, but Ofgem has determined that this cap is compliant with the requirements.

Ofgem must then let the market deliver a range of options for customers through competition at lower prices. As set out above, it is not reasonable to expect healthy competition in a market where the regulator is enforcing prices at a level where more than 75% of participants cannot expect to recover their efficient costs.

To achieve a healthy competitive market with a good range of offers for all customers, including prepay and those who are more vulnerable, along with a range of service provision levels from basic to enriched, suppliers must be able to afford to innovate and invest. Operating a single cap with a continuation of the Ban on Acquisition only tariffs, while allowing modest joining incentives will drive an effective market which will ensure consumers gain lower prices which are implemented at a level that is sustainable in the long run.

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.

Prepayment customers are much more likely to contact their supplier for advice and financial assistance, high energy prices are a key driver but is not the only one. The requirement to provide an ASC under almost any circumstances has also increased prepayment cost to serve considerably, not just in the cost of working capital, but also in the cost of handling these calls, which are longer and managing repayment terms, including arrangements to pay. As levels of repeated ASC build, these customers build debt, and it takes longer for the ASCs to be repaid. Historically, small credits were usually quickly repaid – this is no longer the case.

We have estimated that based on our own data, the frequency with which we provide interest free ASCs is comparable to around 20% (by number) of the payday loan market. This is not sustainable on an unfunded basis.

Equally, the current approach to prepay meters being installed or credit customers no longer being moved to prepay will increase costs of managing these customers in the longer term – debt levels will rise for customers who cannot or will not pay and credit management costs for both credit and prepay customers will increase. While we understand the issues around prepay – indeed none better – as an industry, we must be honest and recognise that these changes are not cost free. These changes drive an increase in operational costs and the bad debt allowance, Ofgem must ensure that all costs are captured.

Regular planned and unplanned DCC outages significantly increase the cost of serving smart metered prepayment customer, who will naturally contact the supplier when a top up fails. The inability of the DCC to update meters without communications also adds to suppliers' costs. At present, the SMNCC allowance for prepayment meters does not consider the additional operating costs incurred by suppliers due to the design and operation of the DCC's systems (as opposed to SMETS 1 systems, which reduced operating costs, and form the basis of the SMNCC allowance).

We have long argued for a price cap set above the current 3 as a single cap to allow competition to take place. Ofgem should be setting a cap and not a price. The current SMNCC is flawed and overly complicated, with an embedded cross subsidy between payment types which should be removed. With smart meters, customers can move as required from DD, PoRB and PPM in line with the customers' needs and preferences at any point in time.

Ofgem must not offset allowances as acknowledged in the prepay cap with a £17 uplift being offset against the smart meter benefit. It must be transparent and clear on all cost allowances. It is our firm view that the £17 and the prepay smart benefits are understated. This has been demonstrated by capacity issues at the DCC which will specifically impact prepay customers and will have a substantial knock-on impact to suppliers in servicing their customers. As above we do not dispute the benefits of

smart, but we do dispute that the cost and benefits for suppliers are accurately represented.

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

It is incontrovertible that prepay customer contacts have increased both in frequency and duration with retail prices. While retail prices are expected to be lower this winter than last, without taxpayer support schemes the cost faced by customers is not likely to reduce materially and so this additional cost is likely to persist for the time being. We also need to recognise that energy bills are not the only difficulty faced by customers, and that as a consequence, customers can be expected to continue to struggle.

In addition to the empirical evidence of additional prepay customer contact, it is clear that Ofgem has imposed more regulation in this space and has increased suppliers' obligations. Utilita supports the improvements in supporting prepay and vulnerable customers, but Ofgem must recognise that these additional services are not costless and must fund these requirements properly via operating costs. Ofgem cannot continue to rely on suppliers having an average portfolio of customers to subsidise costs, this is not an inefficiency it is an unjustified cross subsidy that ultimately disadvantages vulnerable customers.

Payment Method Differential: 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.*

While we welcome the fact that Ofgem is seeking to consider a range of options, we believe that the proposed approaches under consideration would merely complicate the cap and make it more confusing for customers, with no benefit.

As described above, Ofgem ought not, and indeed cannot, calculate perfectly efficient costs and therefore has to consider every eventuality. Ofgem ought to set the caps at a level where suppliers can compete and, for example, allow suppliers to offer incentives for prompt payment and the like.

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)?*

Ofgem should not concern itself with DD frequency, that is a supplier choice and does not require this level of regulatory micromanagement. There will be a lower cost of quarterly billing in terms of operational cost but a higher credit risk vs monthly billed.

Large legacy suppliers will likely have a higher proportion of quarterly DD customers who are not/less engaged (the sector Ofgem should be focused on protecting with the likes of the FCA acquisition pricing ban). Ofgem must not pick and choose what variables to flex the model on, instead taking a simpler approach and allowing innovation and competition will deliver additional consumer benefits.

Some prepay customers for example, may tend to top up more frequently as prices rise, though others' behaviour will not change as they will prefer to only top up £10 a time regardless of price or frequency. For clarity, we do not suggest Ofgem look at this dynamic but simply consider it as a clear illustration of an example where assessing the granularity for payment uplifts becomes too small to be worthwhile.

Payment Method Differential: 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?

As we have set out above, we believe strongly that a fundamental shift to a single cap is needed with a consistent approach.

Given that different suppliers will specialise in customers of differing payment methods and that cost allocation methods are likely to vary between suppliers, it is imperative that the ostensible lower quartile (plus reduction) cost is not used for the benchmark, as this will almost certainly understate true operating costs for the vast majority of suppliers. For these reasons, and those stated above an upper quartile cost should be used, applied to a single cap.

Utilita are 90% prepay and 90% smart, Ofgem should recognise that many of the new 'efficient' incumbents have a lower prepay percentage than average and that therefore it is in their interest to not allocate costs to prepay, but instead to inflate the cost of DD/PoRB. If Ofgem continues to insist on maintaining payment method differentials it could adopt a weighted average approach, but this should be based on the suppliers' portfolio mix to better represent the true costs of supporting those customer groups.

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

Using payment methods individually would not meet the objectives to which Ofgem must have regard under the default tariff cap act as it would be impossible for a notional efficient supplier to be as efficient as a specialist supplier in each payment category. Suppliers' efficiency should be considered in aggregate for each supply, and not separately by category.

As we have set out above, we believe that a single price cap should be implemented without a payment differential. Adopting a purely RFI approach will be inaccurate due to suppliers having different incentives due to their portfolio mix and the added complexity of allocating costs accurately across the subcategories with such variations by supplier.

Payment Method Differential: Costs Allocation

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

While we consider that Ofgem should move to a single price cap, if payment method differentials are to be maintained at an overall cap level, then to ensure appropriate incentives to compete for customers, especially those that Ofgem is most anxious to protect, allowances must be set in a cost reflective manner.

The payment levelisation workstream must then work to address the resulting differentials by payment method. If Ofgem deliberately understates costs allowances for customer groups it considers to be generally more vulnerable, for example, after payment method levelisation the only effect will be suppliers not offering choice and competing for these customers or seeking to improve service to these customers i.e., it will have the opposite effect to that intended by Ofgem.

The second serious issue with these proposals which has not been addressed is that of Fixed Term Contracts (FTCs). Ofgem has not asked suppliers to allocate costs to FTCs - it should. Suppliers should be asked to recognise their total costs back to their financials within this submission. The SVT cap should not include FTC costs, and detailed recognition back to financials will ensure that Ofgem has the necessary information to avoid SVT customers bearing costs and risks rightly attributable to FTC customers – who then reap the benefits.

We highlighted this issue in the recovery of unexpected SVT costs where we strongly disagreed with it, given the outcome that SVT customers bore the costs associated with the FTC base suddenly accessing the then cheaper SVTs. In line with this proposed approach, suppliers should allocate costs between FTC and SVT in order to more accurately reflect the true cost of an SVT customer, without the imposition of excess costs which should be attributable to the ex-SVT customers who are benefitting. There will be some areas in which costs are higher and some that are lower.

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?

As stated above, we have a fundamental concern with the approach of making extra provision for legacy prepay meters. This is the one area in which Ofgem could legitimately use the cap to drive efficiencies rather than continuing to support the ongoing installation of non-smart meters. This amounts to nothing less than a penalty for smart.

However, if working within the current framework, we support the review of the three cost allowances in one go and suggest that they be replaced with a single allowance. Smart has benefits and costs in different areas and by different payment types. Once Ofgem has properly established the RFI and model (including all definitions and documented assumptions) for assessing costs, suppliers can re-provide the data, all based on the same logic and hence of better quality for Ofgem's purposes.

Ofgem should set a standard and a frequency for update going forward, and ensure that no changes to the RFI, even to definitions are not executed without consultation and due notice. These data are extremely complex to produce, and change is costly. We would suggest updating data every 24 months unless there was an indicator of material change. In which case an annual update could be provided based on six weeks' notice of the request.

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

No specific SMNCC allowance is required. Smart should be the standard now. As Ofgem is keen to remind suppliers. A separate allowance contradicts Ofgem and government's stance.

The additional costs associated with DCC system failures and flaws are not currently accounted for in the price cap, and ought to be in future.

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?

No additional comments

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?

As Ofgem notes, the nature of industry charges has changed in recent years. Ofgem could, if it so wishes, calculate these charges explicitly and add new charge line items should new industry bodies or charges appear. We believe that this would be a reasonable, cost justified approach which would be entirely consistent with our demand that new obligations placed on suppliers should be properly costed, based on robust quantitative analysis and built into the cap at the next quarterly update.

This ensures that no reliance is placed on Headroom for more than one quarter of a change and ensures that suppliers are efficiently funded for the costs and risks they bear.

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

As Ofgem highlights, there are significant changes in the past and to come. The development costs of these are usually depreciated over future periods and therefore not present in the P&L cost stack.

Ofgem must take a view on required investment in these material programs in advance and allow cost "cash" recovery before implementation. Ofgem must bring the price cap into compliance with normal business practice in this area and recognise that there are costs to be borne in advance of material industry change.

Making cost reflective allowances at an early stage will result in reduced cost implications for customers in the long run as suppliers are reasonably supported for their necessary investments in a timely manner, rather than after the event.

Industry Charges: 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?

Industry changes are not pass through, SMETS2, Faster Switching, MHHS require and will require continued improvement. Treating them as one-off pass throughs is not helpful. Suppliers need to be compensated for the upfront investment in a timely manner but also compensated for the ongoing additional costs, if any, as the benefits of such schemes may not sit with the supplier or within the operational cost element.

As described above, calculating these charges explicitly would be more accurate. The only disadvantage would be increased complexity in setting the price cap.

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

Utilita's preference is for the increased accuracy associated with explicitly calculating existing and any new industry charges.

However, we recognise that the initial investment could be taken as a pass though cost for suppliers to recover costs of one-off industry changes – if this were the case then it would be essential that Ofgem agrees in advance that bi-directional, accurately calculated true-ups based an actual data will be provided without imposition of additional cross-subsidy.

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?

Utilita agrees with Ofgem's ambition (although it is rather vague!). New industry charges ought to be added to the operating cost allowance, and any that cease be removed – both in a timely manner - without need for 1onerous consultation or benchmarking exercises.

Utilita would support an uplift – pass-through element for the investment required. The ongoing costs should form a part of a regular assessment of operating costs.

As above once the model has been agreed and fully documented, suppliers can re-provide the RFI on the same basis and Ofgem can update accordingly. Ofgem must try to get to a standard approach when it comes to data requests / definitions / assumptions so that the cost and time of these reviews can be reduced. We suggest that an expert working group of the Ofgem team and supplier equivalents would be beneficial, allowing necessary changes to the model and data to be co-operatively considered by those best placed to advise and support the process.

Implementation 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?

Ofgem should set the cap at a cost reflective level to ensure the viability of the energy retail market and that customers are not disadvantaged by being uneconomical to serve. Distributional impacts ought to be addressed by direct relief e.g., through payment method levelisation of standing charges and unit rates coupled with a social discount, being in effect a discount to the standing charge, for qualifying customers, who may be of any payment method but being equally in need of support.

More specifically, Utilita does not operate a standing charge because of the distributional impact on our predominantly prepay customer base. This approach is costly to Utilita, but we believe it's the right thing to do to support prepay customers who have been traditionally very poorly served.

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

Please see above.

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

It is important for the viability of the energy supply market and the welfare of customers that Ofgem does not diverge from a cost reflective approach in setting the underlying level of the price cap.

However, this is clearly an issue for the general consumer and therefore needs to be addressed fairly in order to build trust. It must be a priority, there will as ever be some winners and some losers.

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?

As a general point of principle, the high importance of this topic means that Ofgem ought to produce working papers on any area about which it has any doubt in calculating an accurate allowance and invite expert contributions from the industry. We are happy to apply resources to assist Ofgem in this process.

We recognise that the complexity of the price cap means that this process must be iterative, to ensure that the best and fairest outcomes can be developed. We support the parallel review of 3 allowances but acknowledge as this develops, workings in correction to definitions, allocations and inclusion and removal of costs will occur and should be transparent.