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23 June 2023

By email: priceprotectionpolicy@ofgem.gov.uk

Response to Ofgem's call for input into the Operating Cost Allowances in the Price Cap

Dear Dan

Thank you for the opportunity to respond to this call for input. The structure of the current price cap has to change and this work is an important step forward. Overall, we would like to see Ofgem limit the time it spends fixing the current cap, and free up more time to work with DESNEZ on the future of price protection and consumer protections for a smart tariffs/products world. We have a number of important reactions:

1. **We urge Ofgem not to overwork this review and focus on updating the cap where it will have the biggest benefit for consumers.** In terms of priorities, we suggest:
    a. **Reducing the uplift for standard credit to make it more cost-reflective.** The current approach is driving payment uplifts which are not credibly cost reflective. This hits some of the most vulnerable and lowest income households in the country and is now effectively a profitable premium for suppliers who price in line with cap, incentivising them to keep customers on a less efficient and customer-friendly payment method. Addressing this is an important and tangible way Ofgem can support customers through the cost of living crisis.

    b. **Assessing any temporary changes to debt costs within this holistic review, rather than designing a float and true-up arrangement.** As the approach to Covid-related debt showed, the float and true-up mechanism is flawed. It should be avoided as it is unlikely to be fair to consumers. Looking at debt costs within a wider "in the round" opex review will allow Ofgem to take into account factors that are pushing operating costs down, such as technology innovations when setting the new allowance.

2. **Ofgem should be aware of information asymmetry between suppliers and Ofgem - and avoid it where possible.** Reviewing opex allows suppliers to highlight line items which have increased, obscure those that have gone down and lobby for higher allowances. There's a risk this could lead to decisions which are not in

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customers' interests. One way of addressing this may be for Ofgem to take a more top-down approach, being cautious around areas that are open to gaming by suppliers.

3. **Ofgem needs to refresh its assumptions going into this review.** We are not confident that the significant changes in the market over the past seven years are reflected in the Call for Input which seems to freeze the market in 2017. We want to remind Ofgem that:
    a. **Better customer service does not mean or require higher opex** - Octopus's experience shows that getting service right the first time for the customer and investing in self-serve options helps achieve industry leading opex efficiency.
    b. **The price cap has been successful in driving efficiency** and is potentially more effective than decades of pure "competition". Setting a high standard for efficiency is an important role which Ofgem should not shy away from.
    c. **A technological revolution is happening in customer service driven by a wave of generative AI** - what is "notionally efficient" in 2022 will not be notionally efficient even in 2024 so the benchmarking must be done with this in mind.
    d. The **"characteristics" of a supplier's customer base are not an exogenous variable that drives cost.** This is old style thinking which ignores the influence that all retailers can have over key cost drivers (like payment method and debt levels), and which some retailers like Octopus have achieved. There should not be an adjustment to opex to account for differences in customer composition.
    e. **Ofgem's framing of "efficiency" and "inefficiency factors" is shaped heavily by legacy business models and should be abandoned.** These factors (such as pension costs) may have been relevant in 2017 but they don't reflect the competitive retail market today. Including them just tilts the playing field towards legacy suppliers and should be avoided.

We are keen to work collaboratively with you in this area and stand ready to assist, particularly in demonstrating that standard credit costs should come down and that great customer service does not need to cost more.

Yours faithfully

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Group Head of Regulation

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Responses to questions in the Call for Input

Introduction

1. Do you agree with the scope set out in the introduction section for the operating cost review?
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 urge Ofgem not to overwork this review and focus on updating the cap where it will have the biggest impact on consumers. We think the next stage of Ofgem's operating cost review should have a narrower focus looking at:

- Payment method differentials - reducing the uplift for standard credit to make it more cost-reflective, and removing the uplift for prepay.
- Reviewing debt costs within the context of core operating costs. Looking at debt costs within a wider review means taking into account factors that are pushing operating costs down, such as technology innovations that have emerged since the cap was set. Specifically we think it would be helpful for Ofgem to take a top down review of the benchmarks for each of the cost lines of a) customer contact b) billing, bad debt and collections and c) metering costs; and avoid reviewing the other categories.

We suggest the next stage of the review including the RFI should focus on these priority areas. To do otherwise would be complex and disproportionate.

We agree with the areas that are 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?

We agree there is a case for light touch review overall (completed via this call for input) and then deeper dives into priority areas. There is a strong case for a deeper review of:

- <u>Payment method differentials</u> - the standard credit payment uplift is the key area where there is a strong case for a review.This has escalated significantly from £80 when the price cap was introduce do over £200, this is well in excess of the cost to serve differential and is causing harm to some of the most vulnerable customers in

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society, with 28% of those paying in this way being over the age of 65.[1] The current situation also favours suppliers with a relatively large proportion of standard credit customers, which are likely to be legacy suppliers. This provides a perverse incentive on suppliers to keep customers on a less efficient and customer-friendly payment method. This issue is effectively a hidden "loyalty penalty" as standard credit customers are often those who have never switched supplier. Reviewing it is an important way that Ofgem can support customers through the affordability crisis.

- Reviewing any temporary changes debt costs within the context of core operating costs. The key question for Ofgem to assess is whether debt costs have risen such that there is a need for a temporary uplift to the opex allowances. Looking at debt costs within a wider review means taking into account factors that are pushing operating costs down, such as technology innovations that have emerged since the cap was set. This approach is advisable over the float and true up mechanism consulted on in May. However, we would expect that any temporary uplift would be reviewed in two-three years, should the cap still be in place then.

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? 7. Do you consider that any new costs would be off-set corresponding benefits? 8. Do you consider there to be any costs included within the core operating costs allowance but are now no longer incurred? 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 (ie per customer)?

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

We agree with the description of the key cost lines. In terms of next steps, we think it would be helpful for Ofgem to take a top down review of the benchmarks for each of the cost lines of a) customer contact b) billing, bad debt and collections and c) metering costs; and avoid

[1] Octopus Energy, Octopus calls on Ofgem to clamp down on payment penalty for careful customers, 30 January 2023.

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reviewing the other categories. These are substantive drivers of opex, will potentially have changed significantly since the cap was set, and they are less open to gaming by suppliers (e.g central overhead is very subject to internal cost allocation approaches) in an RFI than many of the other cost lines.

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

No. This review should not be seen as an opportunity to add more cost allowances in the price cap.

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 (ie per customer)?

We agree with the various potential drivers of changes in cost lines identified by Ofgem and make the following additional observations:

- Replatforming and technology changes have driven supplier efficiencies - since the introduction of the price cap, we have seen replatforming by most other legacy suppliers[2]. [redacted]
- A further technological revolution is happening in customer service driven by a wave of generative AI - what is "notionally efficient" in 2022 will not be notionally efficient even in 2024. This will drive down costs and the benchmarking should keep that in mind. This is likely to be permanent.
- Ofgem's framing of "efficiency" and "non-efficiency factors" appears to be shaped heavily by legacy business models and should be abandoned or - at least - applied very cautiously. References to factors such as "legacy pension arrangements" should not be considered at all in relation to opex. These factors may just about have been relevant in 2017 but they don't reflect the competitive retail market today and including these measures just tilts the playing field towards legacy suppliers.
- Increase in smart metering - smart meter penetration is the UK has increased considerably since 2017. The jump is particularly stark in prepay where smart prepay is increasingly the norm. The prevalence of smart should frame Ofgem's approach to metering cost allowances.

[2] E.ON and Kraken Technologies form strategic partnership for E.ON's UK residential and commercial customer business, 23 March 2020; EDF strikes deal to move its 5 million customers to Octopus Energy Group's Kraken platform, 4 November 2021; Centrica signs strategic partnership with ENSEK to accelerate digital transformation and help position the company for growth, 18 August 2021.

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Core operating costs - 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?

We agree that the baseline year needs to be updated. We urge Ofgem to try to choose a baseline year which is "representative" of a normal year, whilst recognising that recent years may not be representative.

We caution against using data from 2022 only to set the baseline for customer contact costs given it was such an unusual period both with the emergence from Covid and the energy crisis. For a customer contact cost baseline, Ofgem might want to look at time series data on number of customers per customer service agent to find a representative year.

In the case of bad debt costs, 2023 is more likely to be a useful baseline.

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

We note that any benchmark developed based on recent history is unlikely to be particularly enduring. This is because the rapid development and use of generative AI in customer service is likely to change standards of operational efficiency rapidly over the next few years. In other words, what is "notionally efficient" in 2022 may not be the same in 2025. This is one reason why the current cost stack price cap needs to be reviewed. In the event that the current price cap is still in place in 2025, Ofgem should plan for a further update of core opex allowances to account for these technological developments.

In the case of a review of bad debt costs, we also think that any uplift to the price cap should be temporary, rather than enduring.

Core operating costs - 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?

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

We support your 'minded to' approach which is a continued top down approach to benchmarking core operating costs. The accuracy of a bottom up approach is undermined by different definitions and accounting conventions across the industry. As above, we

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suggest you might want to use customers per customer agent to triangulate the relative core opex figures across retailers.

We do not have any alternative approaches for calculating the efficient level of core operating costs across suppliers.

Core operating costs - Benchmarking approach

14. Which benchmarking approach options do you think we should be considering?
15. How should we develop a framework for choosing between benchmarking options?

In the case of the benchmark for customer contact costs, Ofgem should be going no lower than the upper quartile and should consider setting the benchmark at the frontier. This approach takes in account efficiencies expected between now and the new opex allowance coming into effect in the end of 2024 driven by the technological advances of AI.

We are happy to support Ofgem with setting the benchmark at the frontier. Octopus is clear proof that great customer service does not cost more - in fact it costs less. [redacted]

We encourage Ofgem to be bold in setting the benchmark for billing and payment collections, including bad debt. We are concerned that a narrative is emerging in industry that bad debt costs are an exogenous variable that are outside suppliers' control. We do think this is the case. The benchmark on these costs provides an incentive for suppliers to, for example, to encourage their customers off standard credit, to contain any additional costs associated with serving standard credit or prepay customers and/or to replace legacy prepay with smart prepay. Our own experience is that highlighting the higher cost to consumers of standard credit does prompt a change in behaviour. For example, in September last year we reviewed our prices and made direct debit SVT cheaper than other payment methods (a change we had previously held off). At the point we informed customers that non-direct debit prices would be £80 higher we saw a surge in customers setting up a direct debit. This is one example of how suppliers can influence bad debt costs through the the payment method their customers adopt.

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?

We are concerned that Ofgem's framing of "efficiency" and "non-efficiency factors" appears to be shaped heavily by legacy business models and should be abandoned or, at least, applied very cautiously. Similarly, Ofgem's seeming assumption that "characteristics" of a supplier's customer base are an exogenous variable that drives cost is old style thinking. This is not credible given the amount of change in the market, and undermines the "notional supplier" model. We think these should not be a significant part of Ofgem's review of opex.

Core operating costs - Allocating costs across different parameters

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

We do agree that operating costs are higher for standard credit than for direct debit customers and that payment type is the key parameter over which operating costs materially differ. Ultimately, this means that Ofgem needs to have an understanding of how cost lines vary across payment methods. However, we urge Ofgem to be aware that the allocation by suppliers of these costs to different payment methods is subjective and open to gaming. We encourage Ofgem to consider ways that it can address this gaming risk, by triangulating the data that suppliers share. For example, Ofgem could look at actual bad debt levels of standard credit customers versus direct debit customers, or evidence of the different customer contact volumes by payment type.

<u>We do not agree with Ofgem's approach to collecting characteristics on the supplier's customer base (tariff type, PSR and online account) as a set of parameters.</u> We do not think this level of data collection is necessary or helpful. It also undermines the view of a "notional" supplier. Given the change in the supplier market over the last few years (from 68 to 21 active domestic suppliers between 2017 and 2023) and the fact that this growth has occurred through SOLRs and M&A and not just switching, we think it is reasonable for Ofgem to assume that the customer bases of the large suppliers are sufficiently similar for this cut of the data to be unnecessary and unhelpful. It is only likely to be used by certain suppliers (likely legacy suppliers) to argue that they have "different" customers who have higher costs to serve and that these costs are outside those suppliers' control. We strongly disagree with this argument. Octopus has spent years behaving and communicating differently with its customers and it gets different results from its customers, including when it comes to debt and payment method.

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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 do not think it is necessary for Ofgem to deep-dive into operating cost allowances between electricity meter types. This is a fundamentally backwards looking way of Ofgem regulating the market and is likely to be a time-consuming exercise. The requirement and expectation is that all meters will be smart meters, meaning there should be no difference in the metering costs across prepay and other customers. Ofgem should prioritise the next stage of the operating cost allowances work with this in mind.

Core operating costs - 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?

See response to question 11 above.

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.

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

<u>Standard credit</u>

We strongly welcome Ofgem taking steps to review the significant and growing price cap uplift for standard credit customers, as we have been requesting. The uplift for standard credit customers has crept up in the price cap and is no longer cost-reflective. Under the cap, these customers can be charged ~£200 more than direct debit customers, whilst we consider a more cost-reflective figure may look more like ~£80 (which is how we have priced our tariff).

The results show that the inputs are out of date and the methodology has clearly not stood the test of time in a high wholesale market. It seems that the % uplift approach is broken as it is driving payment uplifts which are not credibly cost reflective. In other words, the relationship between wholesale costs and additional cost to serve standard credit customers

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is not what Ofgem anticipated when it designed the cap. One reason might be because the cap does not take into account the impact of government bill support programmes like EBSS.

We remind Ofgem that they have considerable flexibility in setting this uplift and it is an art not a science. If the uplift is set at a level that is truly stretching for retailers this could drive helpful behaviours as it will incentivise suppliers to encourage their customers off standard credit and to contain any additional costs associated with serving standard credit customers. As set out above, we do not believe that bad debt costs are an exogenous variable that are completely outside suppliers' control and are concerned about Ofgem agreeing to this narrative.

<u>Prepay</u>

The differential for prepay should be updated to be set on the basis of smart prepay metering and cost to serve, rather than legacy prepay costs. In particular, prepay meter customers should not pay the PPMIP costs and these should be socialised. This could be done alongside Ofgem setting a clear end date for winding down of legacy prepay infrastructure. Removing a prepay uplift will encourage suppliers to replace legacy prepay meters with smart prepay. Currently, we are removing approximately 600 legacy prepay meters a month in favour of smart meters - all suppliers could be doing this. This is even more the case given that the new Code of Practice on involuntary prepay has a commitment to smart by default.

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.

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)?

We do not think that any other payment methods available are material enough for you to consider.

We don't understand question 24 so have not provided a response to this question, but would be happy to discuss further with Ofgem.

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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?

See response to questions 14 and 15 above.

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

See response to question 21 above.

Payment method differential - Costs allocation

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

We agree with Ofgem that there is not necessarily a "correct" approach to allocating costs - this is an art not a science. In other words, Ofgem has considerable flexibility here. In this context, Ofgem should keep in mind the real impact on vulnerable customers of the standard credit uplift. The uplift is now effectively a profitable premium for suppliers who price in line with cap and actually provides a perverse incentive on suppliers to keep customers on a less efficient and customer-friendly payment method. This behaviour is particularly egregious in a cost of living crisis which has seen more customers switch to standard credit to have "control" over their payments, only to be put on higher rates by suppliers who then benefit from those higher rates.

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?

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

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?

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We agree that the SMNCC model has become very complicated over time and urge Ofgem to move along from this and adopt a simple approach for the non-passthrough costs of smart meters.

We also support Ofgem's step towards having a separate component to reflect the profile of remaining traditional meter costs, rather than transitional smart meter costs. This is a concrete way that Ofgem can ensure that its price cap work is building for the future market, rather than looking backwards.

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?

We see no substantive reasons for reviews to the industry charges methodology.

Industry changes - 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?

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

We are not providing a response to these questions.

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?

We agree that Ofgem has identified the right considerations. We remind Ofgem that to date the price cap has been successful in driving efficiency - more effective potentially than decades of pure "competition". Setting a high standard for efficiency is an important ongoing role for the regulator and Ofgem should keep this in mind when updating the benchmark. To this end, if the price cap still exists in its current form in 2025, we would expect to see a further review from Ofgem of operating costs.

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?

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

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

We are very concerned about high standing charges and about any proposals where the standing charge might increase relative to unit rate charges. To this end, if the price cap still exists in its current form by winter 2024/25, we would expect to see a review of Ofgem's approach to standing charges and their fairness. Standing charges can make it more difficult for hard-pressed customers to save money through efficiency. To help support our customers we give all customers on our standard variable tariff a 4% reduction on standing charges relative to Ofgem's price cap. In addition, we offer a standing charge holiday for 6 months to customers in greatest need. This programme has enabled customers who need it most to benefit from energy savings and no longer be penalised just for having a meter.

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 encourage Ofgem to move quickly and take an "open policy making" approach to this review. In practice this might look like quickly identifying priority focus areas, sharing working papers on these areas and structuring engagement so that you hear from the diversity of the sector via bilaterals and workshops, and not just written consultation responses.

We would welcome working papers/workshops on the priority areas that we have identified of payment method differentials and debt costs within wider operating cost allowances. We offer all assistance on this.

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When writing the RFI, Ofgem must be cautious of the information asymmetry risk. We urge Ofgem to make its RFI tightly focused on these priority focus areas, and to focus on parts of opex which are tightly defined and not open to gaming by suppliers who can easily move costs around. As we set out in our response to the draft opex RFI earlier this month, most of the data items Ofgem request in the RFI are unlikely to be systematically captured by suppliers, leaving suppliers open to making their own assumptions about how to allocate otherwise aggregated costs. Ofgem should work hard to ensure that it does not encourage this information asymmetry. For reasons set out above, we do not think Ofgem should collect characteristics (such as online/offline, PSR, tariff type) of the suppliers' customer bases as a set of parameters.