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Energy price cap operating cost review benchmarking working paper

This working paper goes beyond what benchmarking approach best reflects an efficient level of operating costs. It instead considers what outcomes the retail price cap is seeking to achieve and seeks to set the benchmarking approach to best meet those. In this context, we believe that the operating cost review should not be done in isolation but alongside other potential changes that will impact consumer outcomes. These include the potential introduction of targeted financial support, often referred to as a social tariff, the treatment of acquisition tariffs and any reform of the retail price cap.

These all will affect any trade-offs between competing objectives and so, at a minimum, the assessment of these trade-offs needs to be tested against different scenarios. For example, the introduction of a social tariff would be expected to improve consumer price protection and so would affect assessment of the potential trade-off between price protection and enabling competition.

Notwithstanding this, we have a number of observations on the suggested approaches to benchmarking and their high-level assessment:

- The reasons for using lower quartile costs appear to remain valid and so clear evidence is required to move away from this approach. It remains likely that most of the variation between different suppliers is due to their relative efficiency and lower quartile is a well-established approach to benchmarking analysis that avoids outlying companies driving the benchmark.
- The key tradeoff is between the primary objective of protecting consumers and promoting sustainable competition. HIgher customer service standards and appropriate levels of financial resilience needs to be delivered in all cases and we believe can be achieved with any approach to benchmarking.
- A better understanding of the impact on competition of a looser price cap is needed to resolve this remaining trade-off. Whilst the working paper acknowledges an imperfect market and the presence of market power, a looser

cap is nevertheless assessed as being extremely effective at enabling competition and incentivising innovation. This appears optimistic.
- Across all approaches, efficiency should be expected to be improving over time. The process for updating the operating cost allowance, once set, should include an ongoing efficiency reduction.
- We support approaches which pass through benefits to customers with smart meters, where these are fair and proportionate.

Answers to selected consultation questions are provided below.

Yours sincerely,

Andy Manning

Principal Economic Regulation Specialist

Responses to selected questions

1. What is your view on how benchmarking options will lead to different outcomes?

This operating cost review should be seen in the context of other potential changes that will impact consumer outcomes. These include the potential introduction of a social tariff, the treatment of acquisition tariffs and any wider reform of the retail price cap.

These all will affect any trade-offs between competing objectives and so, at a minimum, the assessment of these trade-offs needs to be tested against different scenarios. For example, the introduction of a social tariff would be expected to improve consumer price protection and so would affect assessment of the potential trade-off between price protection and enabling competition.

2. In terms of achieving these overarching objectives, what outcomes should we focus on through the operating cost review?

The key tradeoff is between the primary objective of protecting consumers and promoting sustainable competition. HIgher customer service standards and appropriate levels of financial resilience needs to be delivered in all cases and we believe can be achieved with any approach to benchmarking.

The working paper acknowledges that setting consumer standards is required to deliver higher customer service standards, rather than relying on suppliers to use a premium provided by the retail price cap to invest in customer service. An efficient supplier should have sufficient funding to deliver higher customer service standards but this does not mean a looser price cap is required. Any assessment of the costs required needs to ensure that suppliers are not rewarded for previous poor performance. I.e. If some suppliers need to make additional investment because of historic underinvestment, this should not be allowed to drive the benchmark.

More generally, we do not believe suppliers should be directly rewarded for bringing customer service levels up to meet reasonable expectations and so the supplier profit margin should not be applied to any additional allowance for delivering higher customer service standards.

We do not believe that simply increasing supplier profits, by inflating operating costs, to improve financial resilience is necessary or justified. Ofgem already has a set of measures to improve financial resilience and tools to manage supplier failure risk.

So, we believe the key tradeoff is between the primary objective of protecting consumers and promoting sustainable competition. We note the intention to assess against the competition framework and agree that a better understanding of the impact on competition of a looser price cap is needed to resolve this remaining trade-off. Whilst the working paper acknowledges an imperfect market and the presence of market power, a looser cap is nevertheless assessed as being extremely effective at enabling competition and incentivising innovation. This appears optimistic. We note the suggestion that competition could also drive efficiency. However, it is unclear how these efficiency improvements would be enjoyed by consumers subject to the retail price cap. Indeed, across all approaches, efficiency should be expected to be improving over time. The process for updating the operating cost allowance, once set, should include an ongoing efficiency reduction.

7. What are your views on setting separate core operating cost allowances for smart meter and traditional meter customers, given the risks we discussed in this section?

One of the key benefits of smart meters should be lower bills. We think it is fair to pass on at least some of the cost savings from smart meters directly to customers who have adopted them. This price differential could also demonstrate the benefits to customers who have not yet had them installed, and who may currently see little value in adopting them. Direct savings were previously available to consumers through smart-only acquisition deals, but there are currently fewer of these new deals available. In any case, this approach did not enable savings for disengaged customers, whereas changes through the price cap could ensure all customers with smart meters see benefits.

Any differential would need to be proportionate, taking account of the fact that a minority of consumers cannot have a smart meter installed. Alternatively, these consumers could be temporarily charged at the smart meter rate until a smart meter installation becomes available. This would mirror protections in water, where providers apply bill reductions for people who apply to have a water meter but cannot have one installed for technical reasons.[1] It may be feasible for suppliers to identify these customers automatically (for example based on checking postcodes against DCC coverage) or based on records of failed installations.

11. What is your view on the proxy for suppliers' proportion of high-cost-to-serve vulnerable customers? Would you suggest an alternative approach?

Making use of eligibility for Warm Home Discount would be sensible in establishing a proxy. It is expected that the vast majority of households for the WHD receive the rebates automatically, so issues around eligible households not claiming should be reduced. It is worth exploring whether this can be augmented with other data. For example, whether the data matching process used to identify households eligible for WHD could be adjusted to include more households (such as those with a disability may not get the WHD rebate). It also may be possible to triangulate with PSR data.

12. What level of stringency of the cap do you think we should consider?

The reasons for using lower quartile costs appear to remain valid and so clear evidence is to move away from this approach. It remains likely that most of the variation between different suppliers is due to their relative efficiency and lower quartile is a well-established approach to benchmarking analysis that avoids outlying companies driving the benchmark.

Should there be clear evidence to move away from this approach, using medians should be considered instead of weighted averages as this would continue to prevent outlying companies from driving the benchmark.

13. How should we account for the impact of the expected regulatory changes mentioned above?

[1] Citizens Advice - [Changing to a water meter]

Any forward-looking adjustments need to reflect the overall change in efficient operating costs and not just specific areas of additional costs. This should include ongoing efficiencies.

If costs to meet expected regulatory changes are higher for a supplier because of previous under-investment or poor performance, these should not be included in any benchmark. Using a lower quartile or median approach, if an assessment of projected or emerging costs is made, would be a way to deal with outlying companies.