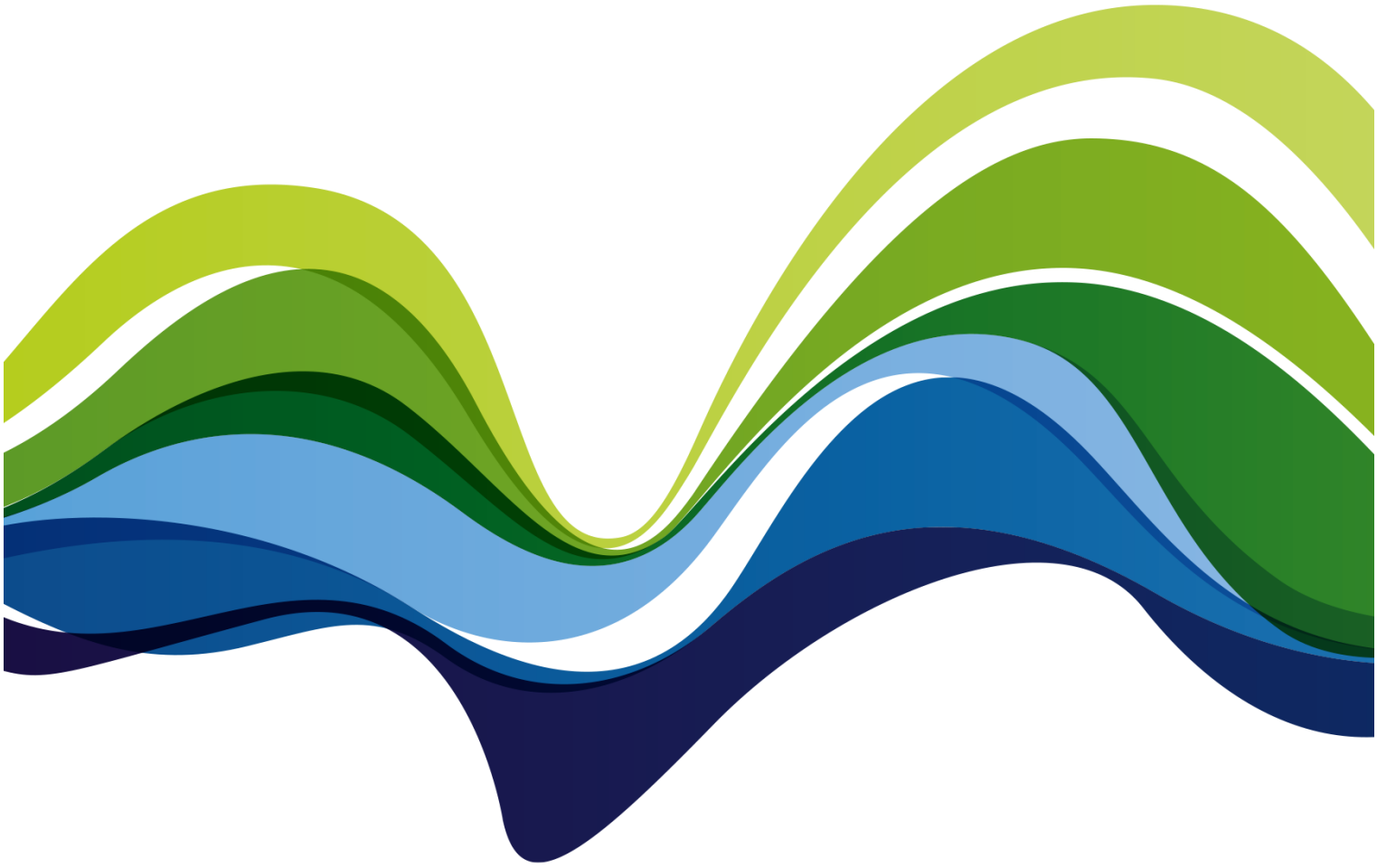
Flexible and responsive energy retail markets

SSE Business Energy response – 16 September 2019



Introduction

This response represents the views of SSE Business Energy (referred to as SSE within the response) which is SSE's non-domestic supply business. SSE Business Energy supplies around 550,000 business sites with electricity and gas, offering a wide range of energy contract solutions, including fixed and flexible contracts. SSE Business Energy serves a broad and diverse range of clients from small businesses to large national corporates, all supported by a UK-based customer service team.

As an energy supplier committed to a low-carbon future, SSE is a strong supporter of the net-zero ambition and has already taken steps to helps its customers decarbonise their energy with the introduction of SSE Green and SSE Green Gas, which provide 100% renewable electricity and gas respectively. However, we recognise that there is more to be done to contribute to, and prepare for, a decarbonised energy market and we are ready to play our role. SSE welcomes the opportunity to respond to this consultation and looks forward to engaging with BEIS and Ofgem as this work develops.

Summary

SSE supports the ambitions of this review but believes that any changes must give due consideration to the differences between the domestic and non-domestic supply markets. Regulation and policy need to be tailored appropriately for these different sectors to avoid unintended consequences for either type of consumer.

Regulatory simplicity and stability are important however SSE would urge BEIS not to pursue this at any cost. Given the reliance of consumers on the energy market, businesses should not be able to participate in the market without regulatory recourse and appropriate apportionment of costs. SSE would caution against any approach which allows businesses to participate in the market without appropriate upfront checks.

While SSE welcomes the recognition of market distortions, and the ambition to minimise these, not all market distortions appear to have been fully considered in the consultation. The response below sets out additional market distortions, including the volume of non-commodity costs and the impact this has, exemptions for energy intensive industries, the impact of behind the meter embedded generation and the risk of mutualisation and the supplier of last resort process, while considering steps which could be taken to mitigate these distortions.

Finally, SSE has a principled view that policy costs should be recovered progressively, rather than levied on customers' bills, and disagrees with the assertion that necessary policy costs will still need to be recovered from customers' bills. General taxation has the advantage of being means-tested, and proportionate to earnings, making it socially progressive, and should therefore be considered as a better alternative. If policy levies remain on consumer bills, there could be value in looking to levy these on all sources of fuel, rather than solely electricity, to ensure behaviours in line with decarbonisation ambitions are incentivised.

This consultation response covers only those questions which are applicable to SSE Business Energy. We would welcome further discussion on the areas covered.

Consultation response

1. **Do you agree with our vision for the future of the energy retail market, the outcomes we are seeking to achieve and our characterisation of the key challenges we need to overcome?**

   SSE Business Energy agrees with the overall vision for the future of the energy retail market, and particularly supports the ambition to minimise market distortions. SSE believes it would be helpful to draw a closer link between the work under the Ofgem Targeted Charging Review and the joint BEIS and Ofgem retail market review. Ofgem's principles of reducing harmful market distortions and ensuring fairness are helpful and equally applicable to the retail market.

   While SSE supports the principle of consistent consumer protection, consumer protection measures should be appropriate for the type of consumer they are targeting. Consumer protections appropriate for domestic customers may not be appropriate for translation into the non-domestic market, as there are several differences which set the non-domestic market apart. For example, non-domestic consumers place a greater reliance on brokers, will enter into supplier-customer negotiations given the greater scope for tailoring contracts and are more likely to sign up for longer-term contracts, which can happen a number of months or years in advance of the contract start date. Consumer protection measures should, therefore, be cognisant of the differences between the domestic and non-domestic markets. Where a consumer protection measure is intended to apply to both markets, there should be appropriate assurance that this will not lead to unintended consequences for any type of consumer.

   SSE welcomes the commitment to regulatory simplicity but would urge BEIS and Ofgem to not pursue this at the expense of consumer protection.

   SSE notes the references to increased flexibility in a low-carbon energy system and the ambition to enable customers to take advantage of this. In order to encourage greater participation in flexibility markets, the economic incentives from charging arrangements (for both network use and policy levies) need to be fit for purpose and consistent with each other, otherwise greater distortions can be introduced. Behind the meter embedded generation provides a prime example of this and is explored in question six.

2. **Are there examples of new products, services and business models that would benefit current and future consumers, but are blocked by the current regulatory framework?**

   SSE is not aware of any new products or services which are blocked by the current regulatory framework. In the last 18 months, SSE has successfully launched its Virtual Power Plant service and its Green Gas tariff. These are new and innovative products which have been brought forward in line with the existing regulatory framework.

   While not blocked by the regulatory framework, one thing SSE believes should be considered, as electric vehicle (EV) penetration increases, is where obligations for EV charging lie. Customers are likely to access numerous charging points which will be supplied by different types of energy supplier. For example, a charger at home is more likely to be covered by a domestic supply tariff, while on-street chargers and chargers at places of work may be supplied through non-domestic supply tariffs.

3. **Are there current or emerging harms to energy consumers which are currently out of scope of the regulatory framework? Do these differ for domestic and non-domestic consumers?**

   There is a growing reliance on energy brokers and third-party intermediaries (TPIs) in the non-domestic sector, but these organisations operate outside of the regulatory framework. This introduces the risk of poor practice which could lead to consumer harm. While SSE has worked diligently to strengthen contractual arrangements with TPIs, and has a positive relationship with many, the quality of a consumer's experience with a TPI lies out of the energy supplier's control.

   Regulating TPIs, energy brokers and price comparison websites, outside of the supply licensing regime, would help to address this potential risk. This could include setting requirements to publicise expected

service standards; steps such as these could enhance the consumer experience and provide additional protections for those consumers who choose to engage through a TPI.

SSE recognises the attempts that have been made to set up a voluntary TPI code of practice. However, SSE is concerned that the introduction of a voluntary code would create a two-tier market, where not all TPIs choose to abide by the standards agreed, and would introduce additional administrative burden for suppliers choosing to only work with those TPIs in accordance with the code of practice. To avoid this two-tier system, which could arguably introduce even greater harms for consumers, any regulation of TPIs, brokers and price comparison websites should be all-encompassing to ensure consistency.

4. **Would it be beneficial to allow suppliers to specialise and provide products and services to targeted groups of customers? If so, how can this be delivered while balancing the need for universal service?**

As there is no universal service obligation for the non-domestic market, suppliers already have greater flexibility to specialise or target groups of customers within broader supplier licence obligations. SSE believes this is the best approach for the non-domestic market. Any new supplier entering the market should be subject to a robust diligence process to ensure they are equipped to meet the needs of their customers and their broader market obligations.

Encouraging specialisation more explicitly could introduce greater market distortions. Certain customers could find there are fewer suppliers able to meet their needs and the distribution of costs, such as levies and use of system charges, could become even more distorted if they are not appropriately apportioned across market participants. Equally, if customers were sourcing energy services from more than one supplier at a time, the residual supply profile could become variable and unpredictable potentially leading to increased imbalance costs.

5. **Are incremental changes to regulation sufficient to support the energy transition and protect consumers? Or does this require a more fundamental reform, such as moving to modular regulation?**

While SSE recognises that incremental changes may be easier to achieve in the short term, this approach could result in a series of reforms over the coming years, creating uncertainty for suppliers already operating in the market and deterring new participants from entering the energy market. While SSE recognises the challenges associated with futureproofing the regulatory framework, not least predicting the needs of the market in ten years' time, stability and clarity would be preferable to a framework which is subject to incremental changes. Any changes that are implemented will need to be duly considered and given sufficient time for industry consultation, design, testing and implementation.

SSE does not believe that businesses should be able to operate within the energy market without regulatory oversight, to ensure appropriate levels of consumer protection are in place and that businesses are well equipped to operate in the energy market. The supplier hub model goes a significant way in supporting this outcome and this will likely be galvanised through the Supplier Licensing Review. Any further changes to the framework should be aligned with this work.

Due consideration must also be given to the apportionment of costs; market participants should contribute towards the costs of the infrastructure from which they're benefitting. If an electric vehicle tariff provider entered the market, they would be likely to rely on the transmission and distribution network infrastructure in place. Similarly, they would benefit from the low-carbon generation supported by a Contract for Difference and the security of supply ensured through the Capacity Market. Regulatory oversight would be crucial to not only protect the consumer experience, but also ensure the market participants' ability to pay the costs expected of it.

Given the importance of this regulatory oversight, SSE believes there should at least be a set of minimum entry requirements which all market participants, regardless of business model, are expected to abide by; for example, a set of principles which are regulated by Ofgem. A purely modular approach, where there is no common denominator such as a set of minimum requirements, could

create a more complex regulatory regime and increase difficulty for customers particularly when identifying how to access different services.

In addition to these minimum requirements there could be detailed sets of rules specific to the area(s) of the market in which businesses wish to operate. These minimum requirements would help create stability within the market, while detailed and proportionate rules could be introduced to keep pace with market developments. The existing supplier licence is a helpful starting point, providing appropriate regulatory controls, but clearer delineation could be introduced between requirements for 'traditional' suppliers within the domestic and non-domestic sectors. This, in itself, would reduce the risk of unintended consequences where a change is made specifically to target domestic or non-domestic consumers.

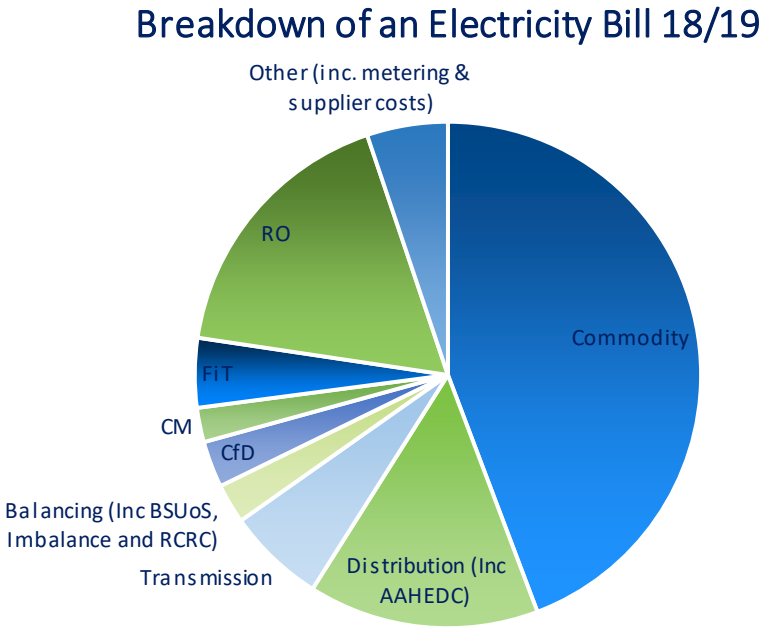
6. Are there any other potential market distortions we should be considering as part of our review?

SSE has a principled view that policy costs should be recovered progressively, rather than levied on customers' bills, and disagrees with the assertion that necessary policy costs will still need to be recovered from customers' bills. General taxation has the advantage of being means-tested, and proportionate to earnings, making it socially progressive, and should therefore be considered as a better alternative.

There are several distortions, largely created through policy levies, which are not explored in the consultation.

1. **Non-commodity costs** – Non-commodity costs accounted for more than 50% of an average electricity bill for an SSE Business Energy customer in 2018/19 (see figure one), with more than half of these due to policy costs (Capacity Market - CM, Contracts for Difference -CfD, Feed-in Tariff – FiT, and Renewables Obligation - RO) each subject to a different cost recovery mechanism.

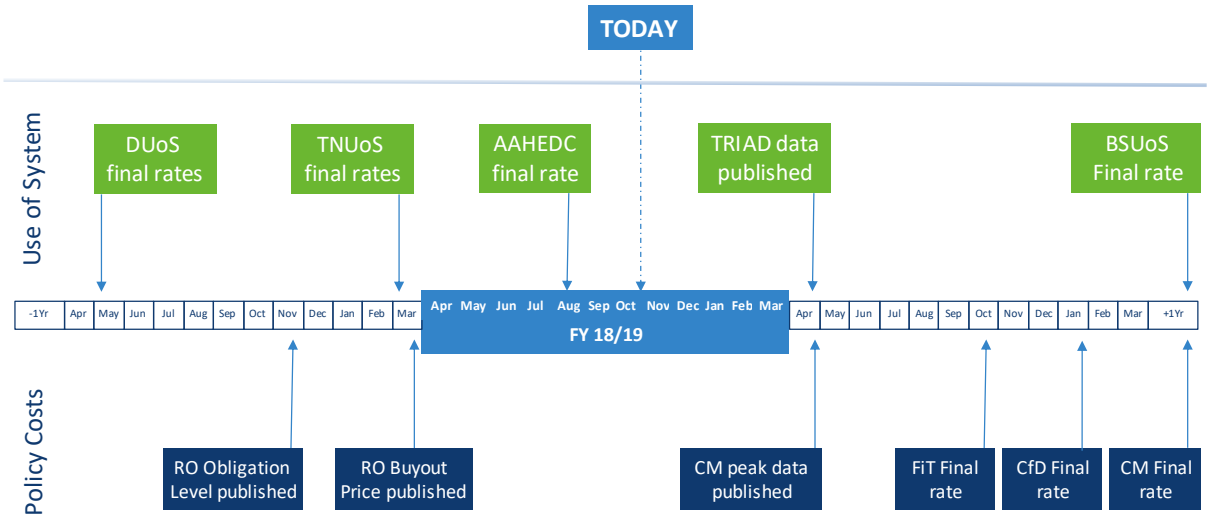
   Figure one – breakdown of an electricity bill for a non-domestic customer 18/19



The proportion of policy costs is expected to grow, exacerbating the challenges already associated with forecasting customer costs accurately. One of the greatest challenges is the lack of certainty in advance of a delivery year, which increases the recovery risk to suppliers. For the CM, CfD and FiT, the final rate due is not known until more than six months after the end of the relevant delivery year (see figure two). This will become more pronounced in future years, as CfDs make

up a greater proportion of total costs. Costs associated with CfDs are particularly challenging to forecast due to power price, installed capacity and weather sensitivities.

Figure two – non-commodity cost forecasting timescales



Any further levies would compound challenges suppliers and customers are already facing. SSE would include the new proposals for a RAB model for new nuclear in this. Collection of revenue from suppliers to fund a nuclear RAB model would not only add to the volume of policy costs being collected and introduce a new cost recovery mechanism, it would also transfer unacceptable construction risk onto consumers, based on current proposals. This is a significant departure from existing policy levies, where payments aren't made until electrons are delivered.

2. **Exemptions for energy intensive industries** – These exemptions result in a smaller proportion of customers covering a higher proportion of the costs of CfDs, FiTs and the RO. While SSE recognises the rationale for these exemptions, namely protecting UK industry competitiveness, they exacerbate the already existing distortions created by policy levies. Instead, some form of upfront compensation should be considered for energy intensive industries, which is not funded by non-exempt consumers.

3. **The risk of mutualisation and supplier of last resort** – The mutualisation of policy costs on insolvency results in other suppliers, which have ensured they are able to pay by pricing this into the tariffs, facing unanticipated costs. There is a heightened risk of mutualisation in relation to CM charges as a result of the standstill period and the subsequent pause on issuing invoices. While SSE has made provision for any retrospective CM charges, there is no guarantee that this will be the same across the industry.

   The costs of the supplier of last resort process, when a supplier fails, must also be met by competent supply businesses. SSE welcomes steps being taken by Ofgem under the supplier licensing review to increase confidence in the supplier market. More could be done to protect against insolvency and mutualisation, for example through properly risk assessed, Ofgem compliant changes to credit cover requirements and strengthened tests for suppliers on market entry.

4. **Behind the meter embedded generation** – While policy costs continue to be funded through customer electricity bills, behind the meter embedded generation enables customers to reduce their use of power from the grid, sometimes supported by levies such as the Feed-in Tariff, and thereby avoid payment of their share of levies. As the numbers of users who participate in this activity increases, the policy and system costs fall to a smaller group of consumers who are left

paying even higher charges, creating a feedback loop encouraging the avoidance of levy payment. This creates a distorted incentive for behind the meter generation regarding investment in generation capacity, its operational dispatch and distorts the market for flexibility compared with generation connected directly to the distribution or transmission networks. A move to fund such policies through general taxation, alongside welcome reforms introduced through Ofgem's Targeted Charging Review, would help address this challenge.

9. What effect does the range of Energy and Climate Change Policy Levies have on the retail market?

As highlighted in our response to question six, non-commodity costs make up more than 50% of an average electricity bill for a non-domestic customer. At the moment, the RO accounts for the largest portion of these costs. However, this is expected to be replaced by CfDs as new projects are commissioned. Each policy levy is subject to a different cost recovery mechanism with a different timeframe for understanding forecast and actual costs for each delivery year – this creates a significant administrative burden.

There are multiple drivers of policy cost variability which make pricing long-term contracts (three years plus), which are common in the non-domestic market and are often agreed months if not years in advance, challenging:

- The introduction of new schemes can increase costs. In the past five years, we have seen the introduction of the CM and CfDs and we are aware of future proposals such as support for new nuclear. The proposals in a separate consultation for the nuclear Regulatory Asset Base model to receive revenue from electricity suppliers during construction are problematic; it will prove difficult for suppliers to forecast construction costs and potential cost overruns.

- Often, policies are changed following implementation, which can have an impact on forecast cost changes and allocation of costs across customers. The introduction of a cap for the FiT and exemptions for energy intensive industries are examples of these. These changes are often introduced under short timescales, which limit a supplier's ability to adapt its pricing to take account of any changes. For this reason, SSE has long advocated for sufficient lead in time ahead of any policy changes to ensure appropriate cost recovery.

- Schemes can be dependent on market changes and weather variability. CfDs, for example, can vary significantly depending on wholesale power price and wind volumes.

- Not all suppliers may price sufficient risk margin when setting tariffs. In SSE's experience, this can mean that those suppliers which may under forecast the cost of levies are able to undercut the market and potentially gain market share. As a result, these suppliers can find themselves unable to pay the levy charges due, in a form of 'winner's curse'. As highlighted in our response to question six, these costs are then mutualised across other suppliers, resulting in them being twice disadvantaged in the market; firstly, in being undercut when seeking new business and, secondly, by covering the cost of policy levies when other suppliers default.

10. What actions could government take to reduce any negative impact of Energy and Climate Change Policy Levies?

As already highlighted, funding energy and climate change policy levies through general taxation would present a more progressive approach to cost recovery, remove market distortions created by these levies and remove the administrative burden faced by suppliers.

To improve suppliers' ability to forecast accurately, and therefore limit the risk of under or over recovery of costs, SSE would welcome greater transparency from BEIS with regard to obligation setting.

As the RO scheme is now closed, the forecast volume of ROCs should be relatively flat in the mid-term. BEIS's demand forecast has therefore become the key driver in variance between suppliers' obligation forecasts and the actual obligation as set by BEIS. It would be helpful if BEIS could share their demand forecast earlier to allow suppliers to factor this into their forecasts.

The RO provides the greatest opportunities to improve forecast accuracy in advance, as outlined above. The costs of CfD and FiT to suppliers are heavily dependent on outturn weather and demand, while the CM is dependent on outturn demand. Having earlier access to outturn data would be helpful, however SSE recognises that these processes are already completed in a reasonably short timescale. SSE believes there is value in exploring the potential for sharing updated demand outturn in relation to CM payments during the relevant November to February window rather than waiting for reconciliation in March and April.

As the RO scheme has the largest total cost and is collected annually six months after year end, it has by far the largest mutualisation risk of all policy levies. Given this, SSE would recommend BEIS focus first on reducing the magnitude of the impact caused by an individual supplier defaulting on levy costs. One manner of doing this would be through strengthened tests for suppliers.

In addition, some standardisation across the schemes could be helpful. All policy cost levies apply a slightly different measure of demand or base the demand volume on different settlement runs. Standardisation could make forecasting easier and hence reduce risk cost; RO, CfD and FiT could all be charged on the same demand basis.

11. Do you agree that now is not the time to make further changes on system and network cost recovery, metering and access to data as part of this retail market review?

SSE would urge BEIS and Ofgem to take a holistic look at the suite of changes being proposed both in this review and the ongoing workstreams on system and network cost recovery. Taking a holistic approach could help to identify and reduce potential distortions within the market and mitigate the risk of unintended consequences as a result of interactions between multiple live workstreams, not least Ofgem's Targeted Charging Review on residual charging and Significant Code Review on Access and Forward Looking Charges, the work the Electricity Networks Association is undertaking, smart metering, the growth of the EV market, and reforms to the Balancing Mechanism and ancillary services market, amongst others.

12. What total costs do suppliers face with regards to bad debt and supporting consumers who struggle to pay for their energy?

SSE would welcome further exploration of the treatment of aged debt, with the potential for changes to the non-domestic disconnection process to help limit the cost impact for suppliers. This becomes ever more pertinent with economic downturn forecast for the next few years, thus increasing the likelihood of customer failure and therefore bad debt.