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2 March 2010

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Dear Ed

Quarterly Price report

Thank you for providing SSE with the opportunity to comment on the issues raised in Ofgem's retail/wholesale report.

In the attached paper we have explained in detail why we believe that Ofgem's reports have overstated the gross and net margins and where there is a need for greater transparency.

In particular, we consider that:

- Ofgem's 18 month hedging model does not reflect the complexities associated with managing wholesale energy costs;
- Consumption levels, and therefore revenue and profit assumptions are too high;
- It is not clear what has been included in energy balancing related costs <u>and</u> they are too low; and
- The additional costs/uncertainties associated with running a retail business in the context of the current economic climate and the introduction of new social/environmental obligations have not been included.

It is therefore imperative that the headline tables in the next report are adjusted to reflect the most accurate assessment possible. We also believe that, to avoid confusion, where Ofgem acknowledges that supplementary adjustments should be applied to its analysis they should be clearly stated at the front of the report rather than lost in the text.

We continue to urge Ofgem to avoid publishing potentially inaccurate information on supplier margins. We are deeply concerned that customers, as well as other stakeholders give an inappropriate level of credibility to Ofgem's assessment of margins and retail prices.

We would welcome the opportunity to discuss our detailed comments in more detail with Ofgem.

Yours sincerely

Katherine Marshall
Regulation Manager

Quarterly Price Report Discussion paper: Response from SSE

General comments

In discussions with Ofgem in recent months we have commented that we believe that Ofgem's analysis overstates the gross and net margins.

It has been less than helpful when the report has been quoted out of context by media and political commentators. Whilst we appreciate that Ofgem has limited control over this, we do have concerns that these commentators have a tendency to latch on to the headlines of the report and may draw inappropriate conclusions without taking full account of the underlying detail, which Ofgem itself has acknowledged.

There is a real risk that too much certainty of the outcome on margins and retail prices is attached to Ofgem's analysis and that it inadvertently misleads customers and other stakeholders, rather than inform opinion. As we have explained in our detailed comments below, it is our view that suppliers are going to be taking an even more cautious approach because of the uncertainties in the market.

It is therefore imperative that the headline tables in the report are adjusted to reflect the most accurate assessment possible. We also believe that to avoid confusion, where Ofgem acknowledges that supplementary adjustments should be applied to the numbers they should be clearly stated at the front of the report rather than lost in the main body of the text.

Furthermore, the industry is in a transitional period as new Government initiatives such as Feed In Tariffs, CESP and the extended CERT are implemented. The precise impact of the changes to distribution charges from April 2010 has not yet been formally notified to suppliers. Against this backdrop of uncertainty it is therefore extremely difficult to properly assess tariffs.

SSE has consistently stated to Ofgem that it would like to follow the reduction in energy prices implemented in March with a further reduction if it is possible. In practice we have been unable to commit to such a reduction, although we would stress that we remain committed to ensuring our prices are as low as possible over the medium term, taking account of the new objectives arising from the probe.

Chapter 1

Question 1: Have we used an appropriate level of aggregation for customer bills, i.e. wholesale energy cost, other costs and VAT? If not, what other splits would you suggest?

We believe that the levels of aggregation are appropriate for the summary, but believe that there could be greater detail in the appendices to provide greater transparency over costs.

Question 2: Do you think the 18 month hedging model provides a reasonable indication of suppliers' wholesale energy costs?

We have explained below why we believe that an 18 month hedging model is an over-simplification and therefore does not provide a reasonable indication of suppliers' wholesale energy costs.

Ofgem uses a stylised hedging strategy which is inevitably not going to reflect individual company positions. Notwithstanding that Ofgem does make this point clear in the report, we do have concerns that commentators tend to latch on to this general analysis and will not take account of the complexities and uncertainties associated with managing wholesale costs and risks.

An 18 month hedge is an attempt to model the lag in the market, however in practice suppliers will have a range of hedging policies and their use of them over time varies.

When setting prices to our customers we aim to recover our costs over the long term and make a small return. By securing energy in advance we seek to protect our customers from a volatile wholesale market and provide stable and predictable tariffs. It is the value of this approach which has ensured that we have not passed on all of the increases in wholesale prices to domestic customers over the last few years. This lag effect also means that retail prices will (and indeed should) be slower to respond to falls in wholesale prices.

The gas market arrangements incentivise shipper/suppliers to meet 1 in 20 and 1 in 50 peak demand and accordingly we take account of this as part of our approach to risk management.

Under any hedging strategy there is a proportion of energy that will have not been covered. Under an 18 month hedge we anticipate that roughly one third of demand over the next year will still need to be purchased and is therefore exposed to future movements in the wholesale price with all the corresponding risks associated with uncertainty. Given past volatility we would expect suppliers to factor in an additional risk premium.

Whilst Ofgem acknowledges these points generally in its report, it has not attributed sufficient costs to this under its 18 month hedging model. We believe that these additional costs and uncertainties should be explicitly recognised in Ofgem's analysis. We have expanded more on the costs that we believe ought to be included in our response to question 3 below.

We therefore suggest that to avoid inappropriate conclusions being drawn, Ofgem should identify clearly that there is a range of hedging strategies likely to be used by suppliers. In the medium term we anticipate that the new requirement to publish regulated accounts will provide greater transparency over the entire value chain for individual players, as Ofgem has intended. We would also re-emphasise that in the case of SSE we look at the profitability of our business across the integrated value chain of generation, portfolio optimisation and supply.

Question 3: Do you have any comments on the assumptions and methodology outlined in appendix 4 of the document?

As a general point we would find it helpful for there to be more transparency about the costs that have been included in Ofgem's gross margin calculations to help us to understand the underlying analysis of costs.

We have commented more specifically on the consumption levels, revenue assumptions, energy costs and other methodology below.

Consumption levels

In the latest report Ofgem has used a lower average domestic consumption level for gas (18,200 kWh). We believe that the actual level for a standard customer is lower than this and in our experience average demand is more likely to be 15% lower, i.e. 25% lower than the current 20,500 kWh, at around 15,300 kWh. We are aware that Ofgem plans to review these standard consumption levels. However we consider that Ofgem should start using up to date consumption numbers in its next report.

The successful implementation of energy efficiency measures has contributed to a fall in gas demand. More recently the economic downturn has suppressed demand beyond reasonable expectations.

Lower consumption levels for gas will have a number of effects on Ofgem's analysis and therefore the conclusions of the report. We have outlined these in more detail below.

Revenue and fixed cost recovery

Ofgem's view of gross margins should be reduced to reflect the overall reduction in consumption levels.

The reduction in consumption levels will have a disproportionate impact on gross margins, as revenue is more sensitive to changes in consumption than costs. We expect the bulk of "other costs" (excluding VAT) to be fixed in nature against any movement in average consumption. This is particularly the case in gas, where 95% of network distribution charges are fixed per customer through the capacity charge. A large element of these fixed costs have traditionally been recovered through the unit rate and therefore a supplier's recovery of these costs will be influenced by the volume consumed.

Tariffs used in the revenue calculation

Ofgem needs to include other non standard tariffs in its gross margin calculation.

Energy Costs

As we have explained above, Ofgem's 18 month hedging model is an over-simplification and therefore does not provide a reasonable indication of suppliers' wholesale energy costs.

Our understanding of the methodology in the 18 month hedging model is that it uses seasonal and peak prices in electricity, and quarterly prices in gas. This does not reflect the full energy costs incurred by suppliers.

We believe that the following additional costs are incurred:

- Market Participation Costs (BSUoS, RCRC, Imbalance Charges);
- Providing the required cover to match the typical domestic demand profile, i.e. the costs associated with providing additional swing; and
- Costs associated with demand matching i.e. meeting short term fluctuations away from the typical full domestic demand profile.

Furthermore, the marked fall over recent months in the underlying amount of energy customers are using (in particular gas as described above) and, depending on a supplier's hedging strategy, means that there is a trading loss on the wholesale market associated with the shortfall. This energy was purchased at prices which were much higher than is currently the case. No allowance for this trading loss has been made.

These energy costs that we have identified can be significant and we are concerned that they are not being fully accounted for in Ofgem's methodology. Greater transparency over these costs would be helpful.

Impact of the recent cold weather period

It has been widely reported that in recent weeks Great Britain has experienced a 1 in 30 peak in demand. During the recent period of peak demand there has been no significant disruption to customers of their supply, i.e. security of supply has been maintained. There have been some interruptions in the industrial and commercial sector but only of interruptible, not firm load, and this is reflected in the prices paid by these customers.

We are now approaching the end of a winter which has seen both extremes in terms of unseasonally mild weather between October and mid-December 2009 and a severe cold spell in January 2010. We do not know what the weather will be like in February and March.

It is important that this winter is considered in context. In spite of the cold snap in December, actual average domestic gas consumption for SSE customers has fallen by 11% over the period October-December 2009 compared with 2008.

In addition, short-term wholesale prices have not peaked in the way that might have been expected given the record demand levels. We believe that this can be attributed to the impact of suppliers' hedging strategies, which has meant that customers' needs have been met.

Other Costs

We are not clear how Ofgem's analysis models the network costs for gas. In our view a clear distinction needs to be made between the Annual Quantity (AQ), which is used directly to determine the capacity related costs, and the expected level of consumption, which determines revenue and is used in demand planning. These two measures can and do differ. As a result our distribution charges are much higher than implied by consumption and this will need to be reflected in our tariffs.

Conclusion

In conclusion therefore we believe that in the most recent report Ofgem has overstated the gross margin by at least £50 - £80 and that greater transparency over what has/had not been included by Ofgem under the costs umbrella is required to help inform our assessment of Ofgem's analysis.

CHAPTER: Two

Question 1: **Is the level of net margin presented in the value chain analysis reflective of actual industry margins?**

No, we believe that the industry level of net margin is overstated and that this will be demonstrated when the regulatory accounts are published later in the year.

Question 2: Are there any other costs we should be including?

We believe that the Ofgem analysis needs to include a number of other costs in its analysis, which it identified during the energy supply probe but does not feature in the calculation of suppliers' "margins". Such costs include those associated with operating a retail business and of social and environmental obligations.

Looking forward, these costs are becoming more difficult to predict because of the many new initiatives such as Feed In Tariffs, CESP, the extended CERT, Carbon Reduction Commitment, changes to the RO and the changes to electricity distribution charges all of which are being implemented now or will be implemented in April 2010. As mentioned above a significant portion of our energy costs are exposed to future movements in the wholesale market.

In addition, there are a number of other significant industry projects being discussed which will influence a supplier's view of the risk in the market and the associated costs which will need to be incorporated when assessing tariffs. These projects range from Ofgem's Project Discovery, its wholesale market liquidity review and RPI-X@20 to Transmission Access Reform, the Renewable Heat Incentive, the proposed CCS levy, and the mass roll-out of smart metering.

Turning more specifically to the other costs that Ofgem should be including in the gross margin calculation, we have set out our detailed comments below.

Metering

Ofgem needs to clarify what has been included in metering costs. We include all elements in our internal analysis such as meter reading, capex, rental and PPMIP.

Balancing costs

As we have explained in our earlier commentary, Ofgem should make an adequate allowance for the costs associated with specialised energy trading which is needed to meet customers' demand from whatever the hedged position might be to close to real time balancing. In addition to the additional costs associated with selling wholesale energy bought as a consequence of hedging strategies at a loss in the short-term traded market, industry balancing costs such as BSUoS, RCRC and gas neutrality should also be included.

Furthermore, Ofgem needs to specifically include the costs of RbD which are set out in the recent Ofgem report into unallocated gas, where it is acknowledged that the costs of RbD are approximately £9.33 for each domestic customer. This cost needs to be included when Ofgem calculates the gross margin.

Cost to serve (level of operating costs to determine net margin)
We would also comment that whilst we have a view on our own operating costs, it is difficult for us to comment specifically on Ofgem's assessment of industry costs.

We believe that the overall cost to serve domestic customers has grown since the information gathered during the energy supply probe.

In particular the costs of managing bad debt/debt risk have increased in recent months given the impact of the economic recession.

As we have outlined above there are other costs associated with meeting new Government and Ofgem initiatives as well as those attributable to the new licence obligations arising from the retail market probe remedies, and the preparation we are doing for the mass roll-out of smart metering.

We believe that these costs will continue to go up over the next quarter (and beyond) and should therefore be reflected in Ofgem's report.

CHAPTER: Three

Question 1: Do you agree with the data presented in this chapter on choice in the market?
We agree that competition continues to flourish in the retail market and that suppliers continue to seek new ways to attract new and retain existing customers.

We agree that following implementation of the two new licence conditions regarding pricing, there has been a positive effect on our competitors' price differentials between payment methods and in and out of area pricing. We view the discounts which are being offered to electricity only customers in some regions as potentially discriminatory and do not understand how they can be viewed as a welcome development.

We continue to believe that our payment differentials are cost-reflective.

Question 2: Can you provide any extra information about choices available to consumers?
As described above, SSE continues to seek to meet the varying challenges of competition. We continue to review our tariff propositions to maintain our competitive position and we have launched a series of products aimed at new customers.