SCOTTISHPOWER

Rupert Steele OBE
Director of Regulation

Amar Kadri
Ofgem
9 Millbank
London
SW1P 3GE

14 September 2016

Dear Amar,

Monitoring trends in suppliers' expected costs

Thank you for the opportunity to respond to the above consultation seeking views on a proposed replacement for the Supply Market Indicator (SMI).

We broadly welcome Ofgem's proposals, which go a long way to addressing the problems experienced with the previous SMI. In particular, we believe Ofgem is correct to focus its forecasting efforts on key supplier costs rather than on revenues or margins. Any monitoring of trends in revenues and margins should be done *ex post* on the basis of information in segmental statements. We also agree that it is better to present the information in terms of a cost index rather than absolute values of cost.

We have a number of detailed comments on the proposed methodology for forecasting individual cost items and have provided these in our response to the consultation questions (see Annex 1 attached).

I trust this is helpful, but please feel free to contact me if you have any queries.

Yours sincerely,

Rupert Steele

Rupert Steele
Director of Regulation

ScottishPower London Office, 4th Floor, 1 Tudor Street, London EC4Y 0AH
Telephone +44 (0)141 614 2000, Fax +44 (0)141 614 2001, Direct +44 (0)141 614 2012
rupert.steele@scottishpower.com www.scottishpower.com

Annex 1

CONSULTATION ON MONITORING TRENDS IN SUPPLIERS' EXPECTED COSTS – SCOTTISHPOWER RESPONSE

CHAPTER 1: INTRODUCTION

Question 1.1: Do you agree that Ofgem should provide estimates of ongoing trends in suppliers' costs, in addition to the analysis we publish of realised costs for previous financial years?

This was suggested by the CMA in its report. As Ofgem notes, the analysis of actual costs from suppliers' CSS relates only to previous years, and there is likely to be a demand from stakeholders for information on the cost trends that will influence future price movements.

Question 1.2: Did you use the SMI? What were its advantages and disadvantages?

ScottishPower did not use the SMI, other than needing to be familiar with the results in order to engage in any resulting media debate.

Question 1.3: Are there additional or alternative criteria that we should take into account in deciding on how to replace the SMI?

Ofgem is proposing three main criteria that any replacement for the SMI must meet, reliability, transparency and ease of understanding. These seem a reasonable set of criteria.

CHAPTER 2: THE SUPPLIER COST INDEX

Question 2.1: Do you agree with our proposal to use a cost index? What do you see as the advantages and disadvantages of the alternative approach of calculating a £ estimate of costs per customer for a given level of consumption?

Yes, we believe a cost index is more appropriate than a £ estimate, since it suggests to the reader that the focus is on cost *trends* rather than absolute cost values.

Question 2.2: How can we present trends in expected costs in a way that is easiest for stakeholders to understand? What, if any, charts should be included on our website?

A chart of the three main cost indices (electricity, gas, dual fuel) against time would be helpful.

Question 2.3: Is quarterly an appropriate frequency for our updates?

Ofgem is proposing to base the cost index on the estimated costs over the next 12 months, updating the index quarterly. We agree that a quarterly update frequency is likely to be sufficient.

Question 2.4: What information on trends in suppliers' prices should we provide alongside the cost index?

Ofgem already publishes information on trends in suppliers' prices as part of its retail energy market indicators reporting, including for different types of domestic tariffs. We believe this information is sufficient, and would caution against attempting to define a single price index

to present alongside the cost index. A single price index would require complex assumptions to be made about the weights that are applied to different types of tariff (which vary considerably between suppliers), and this is likely to detract from the transparency and robustness of the information. It would also obscure the different market dynamics that apply to the SVT and fixed price segments of the market.

If price and cost index information are published together, it will be important to make it clear that the cost index does not reflect all the costs incurred. Therefore, although increases in costs are likely to lead to increases in prices, the percentage changes would not necessarily be expected to be the same.

Question 2.5: What, if any, additional information should we provide about trends in the individual categories of suppliers' costs?

Given that the cost index is built up from estimated fuel, network and policy costs, it would be helpful to show the breakdown into these components. It will also be important to explain the nature and significance of the costs that have not been included.

Question 2.6: How should we choose the base period relative to which the index is calculated, and how frequently should we update this?

Ofgem is proposing that the index would be set to 100 at the January two years previously, bringing forward the base date by one year each January. (So in January 2017 the index would be rebased to 100 in January 2015 instead of January 2014). This will allow trends to be charted over a period of between two and three years. This seems reasonable.

Question 2.7: Do you agree with our proposal to no longer estimate a rolling expected margin throughout the year? If you disagree, how should expected margins be calculated?

Yes. The attempt to estimate a rolling expected margin was one of the most problematic and contentious aspects of the SMIs. Outturns rarely bore any resemblance to the predictions made. Ofgem is correct to discontinue it.

Question 2.8: What do you see as the implications of the prepayment price cap on how the SMI should be replaced? Would publishing the indices used to update the cap every six months be sufficient on its own to provide the necessary transparency around trends in suppliers' expected costs?

We agree that the price cap cost estimates are not ideally suited to the SMI replacement, as different criteria apply in each case. In the case of the price cap, there is a need for stability and predictability meaning that cost estimates are updated relatively infrequently and relatively far in advance. In the case of the SMI replacement it will be helpful to stakeholders to update the index more frequently and with the most current information available.

Hence we understand the proposal to define a separate cost index for the SMI replacement which can be updated quarterly rather than 6-monthly. However, we believe it will be important for transparency and stakeholder confidence that Ofgem provides a comparison of the two indices and a reconciliation of any differences.

CHAPTER 3: DETAILED METHODOLOGY

Question 3.1: Should the supplier cost index include suppliers' operating costs? If so, how should these be estimated?

We see no merit in including operating costs in the index. Operating costs can vary widely between suppliers and from year to year, depending (for example) on what point the supplier is at in its IT replacement cycle and on its payment plan mix. The most reliable source of information on operating costs (at least for the larger suppliers) will be the CSS, and there will in general be no basis on which Ofgem could reliably predict movements from one year (or quarter) to the next.

Question 3.2: Do you agree with our proposal to hold consumption fixed over time at medium TDCVs in estimating trends in expected costs?

Yes, we agree with this proposal as it simplifies the calculation of the index and is appropriate if the index is to be used to understand trends in prices.

However, it is important that in its wider market commentary, Ofgem is careful to distinguish between trends in prices (which don't depend on consumption) and trends in average/typical bill values (which do). Suppliers' success in reducing average consumption through programmes such as ECO should be appropriately acknowledged.

Question 3.3: Do you agree with our proposal to rely on the most recent CSS to calibrate the relative importance of different elements of suppliers' costs?

Yes.

Question 3.4: Do you agree with our proposed approach to estimating trends in wholesale costs?

Ofgem is proposing to base the wholesale cost element of the index on the price of wholesale gas and electricity contracts for delivery in the coming 12 months as observed in the month prior to the date of the update, based on a weighted average of relevant monthly/quarterly product prices from ICIS Heren.

A weakness of this approach is that it is effectively taking four quarterly snapshots of market prices. In benign market conditions this is unlikely to be a problem, but in the presence of market volatility and price shocks, the resulting index could present an inaccurate picture of cost trends. Consider for example an upwards price shock (perhaps caused by geopolitical events or events such as the recent Rough Storage operational announcement) which lasts for 2 months and falls in between quarterly updates of the index. Suppliers would see the impact of this price shock in their procurement costs but its effects would be absent from the index. This problem could be mitigated by calculating the index on a monthly basis rather than quarterly in each of the three previous months and taking the average – albeit at the cost of introducing a slightly greater lag into the index.

Limiting the index to 12 months forward view of prices is not likely to be representative of the range of hedging periods applied by suppliers for hedging SVT customers or for long term fixed tariffs; if Ofgem wishes to reflect these segments of the market an index covering the forward 18 months would be more appropriate.

Finally, we would note that even if the index is representative of suppliers' costs on average, changes in the actual costs incurred by individual suppliers may vary significantly from the

index, whether due to different hedging durations, volatility in the spot and cashout components of wholesale costs (which are not reflected in the index), or the precise volume and price weightings of wholesale costs incurred in each period under review. This should be brought out in any commentary about the index.

Question 3.5: What, if any, regular information should we provide on suppliers' purchasing strategies, and what these mean for suppliers' costs?

Ofgem says it is considering whether it should publish information on trends in suppliers' outturn wholesale costs given their current purchasing strategies (which would be the subject of periodic information requests). We see no merit in such an approach. As Ofgem notes, suppliers' purchasing strategies are highly commercially sensitive and great care would need to be taken to avoid disclosure of any information from which such strategies could be inferred. If this information were to be published, there is a risk that suppliers will converge on a single strategy to avoid any risk of being out of step, reducing the opportunity for competitive pressure to discover the most efficient strategy.

The most reliable source of information on outturn costs for the larger suppliers is the CSS, and we would note that the CMA has recommended a greater level of disclosure in this respect such that suppliers split their costs into a 'standardised opportunity cost' and a residual.

If Ofgem considers there is a need to provide more information on the effects of individual suppliers' purchasing strategies, we would suggest that mid- tier (and potentially some smaller suppliers) are requested to provide similar wholesale cost information as is reported in the CSS.

Question 3.6: Does our proposed approach accurately reflect the expected annual network charges faced by a supplier for a typical domestic customer?

Ofgem is proposing to use the same broad approach to estimating network costs as used in the previous SMI (and as adopted by the CMA for the prepayment price cap, except for geographic averaging), ie using published charging information from network companies and assumptions around domestic consumption. This seems reasonable.

Question 3.7: Are there additional information sources or alternative assumptions that we could use to improve our estimates?

None that we are aware of at present.

Question 3.8: Should we also seek to provide information on trends in costs for customers with non-standard electricity meters?

We do not think it would be appropriate to provide separate cost indices for customers with non-standard meters, since this would make the index vastly more complicated. The cost index should be a weighted average over all meter types including non-standard meters. If there are significant differences in cost trends for particular non-standard meter types, this could be noted in any commentary provided by Ofgem.

Question 3.9: Do you agree with our proposed approach to estimating the cost to suppliers of the Renewables Obligation scheme? Is there additional or alternative information that we should use to estimate these costs?

Ofgem is proposing to estimate the cost of the RO scheme using the final buy-out price as a proxy for the cost of a ROC faced by a supplier, multiplied by the obligation level to obtain an

£/MWh cost. Forecasts of the next year's RO charges will be based on the year-on-year change in the OBR's projections for the total costs of the scheme. This seems reasonable to us and we are not aware at present of any additional/alternative information. We would note that the variables within the ROC forecast (demand, generation, inflation etc) mean that this is one of the more uncertain costs to predict. If Ofgem intends to make use of OBR forecasts, it should take the precaution of back-testing them.

Question 3.10: Do you agree with our proposed approach to estimating the expected costs associated with the ECO scheme? Is there additional or alternative information which we should use to estimate these costs?

Ofgem is proposing to estimate ECO costs based on the total projected scheme cost taken from government impact assessments, divided by the total number of gas and electricity customers in the market. In our experience ECO impact assessments may not be updated sufficiently frequently for the purpose of the cost index and we believe it would be preferable to use more up to date information where this is available.

For example, BEIS publish actual cost information as reported to them by suppliers on a quarterly basis, broken down by cost category (delivery, administration etc) and by obligation.[1] This raw cost data will also be a function of each supplier's rollout profile, but it could be adjusted for the purpose of the cost index by calculating average unit costs and then multiplying by an assumed linear rollout profile.

Question 3.11: What are the pros and cons of using information collected from suppliers on their forecast ECO costs to estimate the expected costs of the programme?

We do not currently provide forecast ECO cost information to BEIS or Ofgem and we do not think it would be proportionate to introduce any new obligations in this respect. As noted above, we believe that suppliers' submissions on the previous quarters' actual costs could be used to help forecast future costs, and are likely to be a better indicator than the Impact Assessment.

Question 3.12: Do you agree with our proposed approach to estimating the expected costs associated with the FiT scheme? Is there additional or alternative information which we should use to estimate these costs?

Ofgem is proposing to estimate FiT scheme costs from the most recent government impact assessments, making adjustments for any exemption for energy intensive industries (EIIs). This seems broadly reasonable to us and we are not aware at present of any additional/alternative information. However, we would recommend that Ofgem monitors the accuracy of the government impact assessment by reference to the latest quarterly costs to ensure that it is on track.

We would also note that Ofgem will need to make adjustments for exemptions other than EIIs, such as the current exemption for non-GB sources of renewable generation.

Question 3.13: Does our proposed methodology accurately reflect the expected costs faced by customers relating to the WHD scheme? Is there additional or alternative information which we should use to estimate these costs?

[1] See Headline Release Tables at https://www.gov.uk/government/statistics/household-energy-efficiency-national-statistics-headline-release-june-2016, tables 2.8 and 2.8.1.

Ofgem is proposing to estimate WHD scheme costs by dividing total anticipated costs by the number of relevant customers, as submitted to Ofgem. This seems reasonable to us and we are not aware at present of any additional/alternative information.

Question 3.14: Does our proposed methodology accurately reflect the expected costs faced by suppliers in meeting the supplier obligation with respect to Contracts for Difference? Is there additional or alternative information which we should use to estimate these costs?

Ofgem is proposing to estimate CfD supplier obligation costs on the basis of the Interim Levy Rate (ILR) quarterly values/forecasts published by LCCC, weighting each quarter by expected consumption. This seems reasonable to us and we are not aware at present of any additional/alternative information.

Question 3.15: Do you agree that reserve payments to the TRA should be excluded for the purposes of calculating the cost index?

Yes, we agree that payments to the CfD Total Reserve Amount (TRA) should be excluded for the purposes of calculating the cost index.

Question 3.16: Does our proposed methodology accurately reflect the expected costs that suppliers will face in meeting the supplier obligation with respect to capacity market payments? Is there additional or alternative information which we should use to estimate these costs?

Ofgem is proposing to estimate CM supplier obligation costs on the basis of the aggregate payment amount for each year published by National Grid, weighted by the proportion attributable to domestic consumers. . This seems reasonable to us and we are not aware at present of any additional/alternative information.

Scottish Power
September 2016