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Dear Graham

Thank you for the opportunity to respond to the proposed suppliers cost index. SSE is supportive of transparency in the market that will aid consumers and other stakeholders understanding of the background to energy price changes and would be supportive of any index that can achieve this. To be of value to stakeholders the information used in the index must be accurate and reliable, with appropriate qualifiers and assumptions clearly signposted to avoid any scope for misinterpretation. It is important that that the index is based on published audited information wherever possible. SSE is concerned that Ofgem's proposals for monitoring trends may not provide accurate information and risks confusing stakeholders.

The current policy intent of the index is unclear; to ensure that the index is fit for purpose Ofgem must be clear on the policy intent of the index, its rationale and the target stakeholders.

SSE is pleased to note that the proposed index will not estimate a rolling expected margin throughout the year. This forecasting of suppliers profit margins, used in Ofgem's suspended SMI, was difficult to estimate and provided an unreliable guide on supplier's profits that did not correspond with their published, audited accounts. This contributed to mistrust in the industry and discussions on suppliers' profitability based on inaccurate information.

I have provided a detailed response to the questions in the consultation document and have attached them in the following annex. Please do not hesitate to get in touch should you wish to discuss this further.

Kind regards

Louise Murphy

Regulation Manager

Annex

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?

SSE is supportive of transparency in the market that will aid consumers and other stakeholders to understand the background to energy price changes. To be of value the information must be accurate and reliable, and any underlying assumptions must be clearly communicated. It is vital that Ofgem is clear that the trends are estimates and not based on audited information.

SSE is concerned that Ofgem's current proposals for monitoring trends in suppliers expected costs will not be accurate and will therefore not improve transparency around ongoing developments in suppliers' costs.

In addition Ofgem needs to be clear about the purpose of the index, its rationale and target stakeholders. The proposed index presents costs on average and it will therefore not be clear what this means on an individual basis.

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

No, SSE did not use the SMI. It was not designed for use by suppliers and the challenges associated with a forward looking estimate of profit margins meant that the SMI was not a reliable source of information. However, it is worth noting that a considerable amount of time was required to defend against heated media and political comment based on forecasted pre-tax profits that were consistently found to be overestimated.[1]

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

As well as being transparent, reliable and easy to understand any replacement for the SMI must not be overly theoretical and should instead be based on published, audited information wherever possible.

In order to meet these criteria and provide customers and stakeholders with fully reflective, meaningful data, SSE considers it essential that the replacement for the SMI should include all suppliers, not just vertically integrated suppliers. In addition Ofgem must clearly set out

[1] NERA report May 2015

the policy objective of the index and explain that cost indexes are estimates and may vary from actual out-turn costs.

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?

Ofgem states that the supplier cost index will show trends over time in the expected costs of supplying a domestic customer with gas and electricity over the coming year and will chart what is driving the year on year change in the index. SSE agrees that a cost indicator is an appropriate way to do this and is a less emotive method of presenting the breakdown of costs on a bill than a £ estimate of costs per customer, which propagates a misleadingly specific set of costs based on a theoretical customer profile which will be inaccurate for the vast majority given the likely variations in their individual usage and the real cost base of their specific supplier.

SSE agrees that separate indexes should be calculated for gas and for electricity. It is essential that all relevant policy costs be calculate per fuel and included in a fuel specific index in order to better reflect the disproportionate share of policy costs borne by electricity only customers.

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?

All presented information must be easy to understand and clear. SSE does not have any preference in terms of presentation as the index will not be a primary source of information for SSE. It is important Ofgem clarifies the policy intent of the index, this will aid the design of the trends in expected costs in line with target stakeholders level of understanding and expectations.

It is important that the data has appropriate qualifiers and assumptions are clearly signposted to avoid any scope for misinterpretation. Where possible, this should be based on historical, audited data rather than forward-looking assumptions. Wherever data is not based on historical, actual data it is critical that this is immediately apparent.

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

Quarterly reporting will bring the cost index in line with other indicators published by Ofgem. It is SSE's opinion that Ofgem should have a consistent approach to reporting indicators.

Publication of the cost index should, when relevant, occur at the same time as the prepayment (PPM) price cap is updated. This will reduce the number of Ofgem publications about changes in costs which should minimise conflicting information. In addition Ofgem should provide information on differences between how costs are calculated in the cost index and in the PPM price cap and should also provide a narrative to explain any discrepancy between the cost trends and the price cap index. This comparison could provide a useful indicator of potential issues with the price cap indexation (e.g. if policy costs rise faster than is reflected in the OBR forecasts).

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

SSE does not believe Ofgem should try to link information on price indicators and the proposed new cost index. This approach may encourage stakeholders to directly relate the two without understanding that the index excludes suppliers operating costs and are not directly comparable. Prior experience with the SMI shows that any such data published by Ofgem is viewed as fact, despite the complex nature of the underlying data and assumptions, and the wide variations in individual supplier cost bases – even where suitable qualifiers are provided. This has in the past led to unwarranted criticism of energy suppliers based on forecasts that have in time proven to be inaccurate, potentially undermining customer trust.

Should Ofgem decide to link the price indicators and the new cost indicator, appropriate qualifications and background information must be provided to mitigate the risk that stakeholders misunderstand the data. SSE considers that there could be possible adverse unintended consequences for effective competition in the market if Ofgem's commentary on trends and prices creates an expectation of a particular pricing policy being the 'correct' strategy. This poses a risk that all suppliers adopt the one pricing policy. (I.e. hedging strategies converge, reducing customer choice).

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

It must be clear that operating costs are not included in the index and although these will vary from supplier to supplier there are some indirect costs that are mandatory and or defined by industry codes and practises. The roll out of smart meters is a prime example. It is a huge, government mandated project which will inevitably have a significant impact on suppliers operating costs. Ofgem should consider how to reflect such costs. However, Ofgem must clearly communicate that operating costs are omitted from the supplier cost index and explain that some operating costs are compulsory to suppliers. These costs should be estimated and the index should be accompanied by text to comment on the trends of these indirect costs.

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

SSE is content with the suggested base period relative to which the index is calculated; however believes that the proposal to rebase annually has no merit. It is difficult to understand how the rebased index will capture and represent long term trends in suppliers' costs.

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, SSE strongly agrees with this proposal as the estimated rolling expected margin consistently led to claims about supplier profit margins that were subsequently disproved by suppliers' published, audited accounts. This contributed to mistrust in the industry and discussions on suppliers' profitability based on inaccurate information. Supplier profit margins can vary dramatically based on unpredictable factors like the weather or different hedging approaches; at the same time, not all suppliers operate to the same financial year meaning they will have different levels of exposure to such factors in any one year. Equally different suppliers have very different cost bases, which is a key determinant of their profit margin. Any attempt to forecast profits margins is therefore likely to be misleading given the range of reported margins in evidence across the industry through the Consolidated Segmental Statements (CSS).

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?

SSE believes that the prepayment price cap is a separate issue from any cost index. However, it would be beneficial to publish information about the PPM price cap concurrently with updates to any new cost index.

To facilitate transparency and maintain stakeholder trust Ofgem must provide an explanation and reconciliation of any material difference between the two cost indexes and should consider if, how and when such discrepancies might present grounds to review the price cap indexation methodology.

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

SSE agrees that operating costs should not be included. Operating costs can vary widely from supplier to supplier and from year to year, and there would be no obvious basis on which trends in average costs could be predicted.

However, Ofgem must clearly communicate that operating costs are omitted from the supplier cost index and explain that some operating costs are compulsory to suppliers. (e.g. smart roll-out costs). These costs should be estimated and the index should be accompanied by text to comment on the trends of these indirect costs.

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

SSE agrees with this proposal, using medium TDVCs for gas and electricity will ensure consistency in information. This consistency should help stakeholders compare different sets of information. However, it must also be made suitably clear to anyone accessing the data that costs are estimated on the basis of a theoretical consumption profile from which individual customers are likely to deviate.

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?

SSE believes that using audited data where possible is the best way to provide accurate and reliable information. However CSS are only provided by the six largest suppliers and therefore are not representative of all suppliers' costs, especially smaller suppliers not obligated under ECO and WHD. SSE believes that all suppliers above a de minimis threshold should be required to publish a CSS; this would provide accurate data and aid transparency of costs in the industry.

Ofgem will need to communicate to stakeholders that costs used in the new index may not reflect either costs incurred by an individual supplier or an average bill breakdown.

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

As previously stated the suppliers' cost index will be theoretical, Ofgem is trying to estimate the costs incurred by a typical supplier based on assumptions that are likely to depart from the actual cost trends faced by individual suppliers, which will vary considerably depending on the purchasing strategy they choose to deploy and the profile of their particular customer base (e.g. higher numbers of prepayment meters). Again, this must be made explicitly clear to anyone accessing the data, with prevalence given to historical, audited data available through the CSS.

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

SSE does not believe it is appropriate for Ofgem to provide information on suppliers purchasing strategies as these are commercially sensitive and specific to each supplier. However, any publication should make clear that in a competitive market different suppliers adopt different purchasing strategies and therefore any estimates provided for a 'typical' supplier are based on assumptions and are unrepresentative of any one supplier. Care is required to avoid commentary which incentivises convergence on a particular (arbitrary) approach, such as the shorter term hedging requirement implicit within the prepayment price cap.

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

SSE believes that this is a practical approach. It should be noted that it is important that it is clear to stakeholders how the charges have been calculated.

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

SSE has no further comments on information sources or alternative assumptions.

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

No, non standard electricity meters represent a relatively small part of the market. The proposed index based on the majority of meters has the benefit of keeping the index simple. Also using the majority of meters is adequate for providing an average.

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?

SSE believes that this is a practical approach. However the Office for Budget responsibility's (OBR) forecast of Renewables Obligation (RO) cost is only a forecast and will be subject to error. It is important that it is clear to stakeholders how the costs have been estimated. It is also essential that any assumptions and limitations of the methodology applied should be clearly explained.

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?

Experience of previous schemes shows that the cost of delivering can vary significantly throughout its duration, based on fundamental drivers like the demand for and supply of qualifying measures; changes in Ofgem rules; and other funding sources available in the market. It can therefore be difficult to accurately forecast delivery costs of the scheme. Consequently, even though the government impact assessment will not be accurate, it's likely to be the most practical way of forecasting scheme costs.

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?

As ECO is a market based scheme, the cost to deliver is subject to a high degree of change throughout, as outlined in the response to 3.10. Therefore, any forecasting completed by suppliers would not be practical or any more accurate than those forecast by government. Using data which is currently collected through the notification process in the scheme would not be appropriate as costs at any point in time could be significantly different to costs at a later point in the scheme.

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?

There are concerns with using government impact assessments for the FiT as this is a demand led scheme that has been shown to exceed estimated costs, and therefore underestimate the impact on customer bills.

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?

SSE believes that this is a practical approach. It should be noted that it is important that it is clear to stakeholders how the costs have been calculated. It is also essential that any assumptions and limitations of the methodology applied should be explicit.

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?

Yes, however there are some additional costs which are missing from the proposal:

Non UK GoOs - in addition: when calculating total "eligible supply volume" the methodology should also deduct the expected volume of non UK GoOs because these can be used to reduce the volume of eligible supply from which the total cost of the Contacts for Difference (CfD) is collected, which will tend to increase the £/MWh cost to suppliers of the CfD scheme. The Low Carbon Contract Company does not take into account the additional cost of GoOs when it calculates the Interim Levy Rate (ILR). **Reserve fund cost of capital** - Suppliers are required in advance to pay into a reserve fund held by the Low Carbon Contracts Company. This advance payment will cause an additional cost to suppliers due to the cost of debt.

Administration charge – The Low Carbon Contract Company also charges suppliers an administration charge which is in addition to the ILR and is therefore an additional cost to suppliers.

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

The debt cost of reserve payments should be included since this is an additional cost to suppliers. However, we would agree that the reserve fund payments themselves should not be included because this is a cash flow item, not a P&L item.

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?

The approach of dividing the cost by the total number of domestic customers may be misleading. This would calculate an average cost per customer, but it would not calculate the cost per average customer. It would be important to take care when interpreting the final answer.

Administration charge –The Capacity mechanism also includes an administration fee which represents an additional cost on suppliers.