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Sent by email: retailpriceregulation@ofgem.gov.uk

Dear Jemma,

SSE response to Ofgem Working Paper 1: Setting the Default Tariff Cap

Following the clarity provided to date by the progress of the Tariff Cap Bill through Parliament, we welcome Ofgem's clear determination to engage with industry in planning for the cap.

This is a complex task for Ofgem and SSE shares its desire for any cap mechanism to balance the four policy objectives identified in the draft Bill and minimise the risk of unintended consequences associated with such a major intervention in what is a rapidly evolving competitive market. SSE is committed to providing positive, constructive and timely input to this process.

We found our bilateral on Wednesday 21 March extremely useful and will endeavour to follow up on the various requests from Ofgem as soon as possible. In particular, we would like to further explore – and offer our views on – how options 3 and 4 would work in practice.

In Annex 1, we have set out our responses to what we believe to be the most relevant and high impact considerations within this paper, and have provided a summary below.

Summary

– SSE welcomes Ofgem's consultative, iterative approach.

– We believe it is possible to design a cap which balances the four objectives.

- Our strong view is that the ‘bottom up’ approach would provide the most robust, fair and low-risk method.

- Embedding pricing data into the cap mechanism itself carries significant risk. However, if Ofgem is determined to take this approach, then we believe that whilst options 1 and 2 are entirely unworkable and would not meet the policy objectives, option 3 could become workable subject to a number of major modifications.

- In any scenario, it’s critical that the cap is applied fairly and representatively, is reassessed regularly and enables correction when appropriate.

- We do not agree with the assessment of an appropriate EBIT allowed under a cap (1.25%). SSE considers that there is more work to be done to arrive at the right level, to ensure a retail supply business remains sustainable and financeable. We will continue to explore this internally and will be happy to discuss further with Ofgem.

- We also consider it vital that sufficient headroom is afforded on top of the appropriate EBIT to allow competition to continue effectively.

- SSE is keen to participate in further detailed discussions and will continue to contribute constructively.

We hope our response is useful and would be happy to follow up the points made with Ofgem at a suitable time.

Yours sincerely

Patricia Hall
Regulation Manager

1 Annex 1: SSE response to Ofgem Working Paper 1

2 Estimating an efficient level of costs – review of models proposed

Ofgem proposes 4 options; (1) basket of market tariffs, (2) existing safeguard tariff approach, (3) updated competitive reference price, and (4) bottom up cost assessment. We have set out our position in the sections below.

2.1 SSE considers the bottom up approach (option 4) best balances policy objectives

SSE welcomes the inclusion of this option in Ofgem's working paper and considers that this option would best balance the four policy objectives set out in the legislation.

We fully appreciate this approach is more effort-intensive but given the significance of the cap for the domestic supply market and the volume of households this measure will impact, it is critical to get this right and avoid scope for the cap to be skewed by unsustainable or unrepresentative price indicators. The benefit of this approach is that it still allows room for competition and places sufficient incentives on suppliers to drive down controllable costs.

We note that Ofgem has already issued a draft RFI which – when published and completed by suppliers – should produce a workable cost assessment on which to base this approach.

2.2 Updated competitor reference price (option 3) could be made workable but only subject to major revisions

We note Ofgem's preference for there to be a price-related component to the cap – which was explored in our bilateral on 21 March. We do not consider this the most appropriate option, and believe that embedding pricing data into the cap mechanism itself presents significant risk. However, if Ofgem is determined to take this approach, then our view is that option 3 has the most potential to become workable, if a number of major modifications to the approach– designed to mitigate these risks – were to be made.

We consider it vital that the methodology takes the price benchmark from a representative sample of the most efficient suppliers, which should include those with a diverse customer base that is representative of the full breadth of society, as opposed to a small sub-section of more digitally engaged customers, for example.

It is also essential that costs are appropriately captured, in particular the cost of smart metering and social and environmental policies. As discussed at our bilateral, the true cost associated with the smart meter rollout is simply not reflected accurately in the methodology. To continue with option (3), this needs to be addressed. We understand that Ofgem recognises this issue and we will endeavour to provide any smart cost data we consider to be useful for the cap design process.

In terms of policy costs, decreasing volumes of qualifying demand have not been factored into policy cost indexation. Underlying demand is falling, while the number of exemptions has been growing, resulting in higher policy inflation as cost is being recovered over fewer units. If Ofgem were to pursue option (3), we suggest that Ofgem consider a suitable 'correction' mechanism to retrospectively true-up any indexation issues that become apparent in any given period.

2.3 The basket of market tariffs (option 1) and the existing safeguard tariff approach (option 2) could have severe unintended consequences and should be discarded

Since option 1 does not track any costs, the risk is too high that it is open to influence by the decisions of individual competitors. We believe that significant risk exists that movements in the price cap do not bear close relation to movements in underlying costs. This is because the basket of tariff in the market at a certain point in time may not be reflective of efficient and sustainable operating costs for a supplier with a large and diverse customer base. Our views on this approach are unchanged since our response to the December 2017 consultation.

In the same consultation response, we also explained our issues with option (2) (the existing safeguard tariff approach). Namely that (a) OVO / FU were not a valid basis for benchmark as their commercial performance was unproven and their customer base was unrepresentative, (b) the cap did not track smart costs, or ECO costs appropriately, (c) there was no correction factor, and (d) the headroom was set at a level that has reduced switching with no headroom provided on T&D costs (despite specific risks managed in this area such as BSuoS).

These four issues are combining to mean that actual costs are not tracking in line with the cap's indexation methodology.

SSE's conclusion is that neither the basket of market tariffs (option 1) nor the existing safeguard tariff approach (option 2) are appropriate for further consideration by Ofgem, particularly given that this cap will be applied across the entire GB market.

3 Overarching views on methodology for estimating efficient costs

3.1 Any model should be applied fairly, reassessed regularly and corrected when needed

It is SSE's view that:

- Ofgem should reassess costs over time based on pass through of those costs that are most heavily subject to external influences, and an indexation approach for those costs that are more directly controllable.
- Ofgem should conduct six monthly reviews to balance stability for customers and suppliers with cost-reflectivity.
- In reviewing the cap, there should be an appropriate correction mechanism to ensure external cost components of the cap reflect reality.
- The cap should be applied fairly to all suppliers – this requires an approach which recognises the fact that some suppliers are exempt from social policy costs. The most obvious way to address this is to apply social policy costs across all suppliers irrespective of their scale.
- The cap must accurately reflect the costs associated with supplying different customer groups; and so regional, payment type, consumption level and time of use (including off-peak) cost differences must be built into the cap mechanism.

3.2 Any model should incorporate EBIT and headroom levels which reflect the true risks, costs and capital requirements of supplying energy to all customers

We have set out our feedback below, differentiating between EBIT and headroom, which is essential to support discussions in this area.

- EBIT reflects the profit that an efficient supplier can realise. The existing cap makes a provision for a 1.25% margin (in the 'other costs' category), which we believe is too low. Even the CMA – who we consider have underestimated the EBIT level required to ensure a retail supply business remains sustainable and financeable – has suggested a higher EBIT in the region 1.9 – 2.4%. SSE intends to do more work to clarify our views on the necessary sustainable level, and will be happy to discuss these views further with Ofgem over the coming weeks.

- The headroom needs to provide the necessary space for competition and any inaccuracies or risks in the cap design. We believe the current provisions are too low, particularly, for a market wide cap. Higher headroom is required for innovation and product development, the inevitable inaccuracies in the benchmark and indexation and finally the inherent uncertainty within some of the policy and energy costs due to weather, demand, utilisation and wholesale prices.

4 Legislative framework

4.1 Introduction timing

To facilitate industry engagement that supports the timely implementation of the right methodology, we would welcome early clarity on any decision to abort plans to further extend safeguard protection. This would allow us to align our resources in preparation for implementation of the relevant cap.

4.2 Cap removal procedure and criteria

In our bilateral we discussed the two ways Ofgem might measure whether ‘conditions are in place for effective competition’: 1) looking at indicators of competition e.g. switching, and 2) looking at the delivery status of industry changes aimed facilitating competition e.g. smart meter rollout, CMA remedies. We look forward to receiving further information from Ofgem on their thinking.

4.3 Cap review processes

We support Ofgem’s intention to review the cap level every 6 months. We also believe it is important for Ofgem to consider a suitable ‘correction’ mechanism to retrospectively true-up any indexation issues that become apparent in any given period.

4.4 Application across all suppliers

We note the intention that the cap be applied to all suppliers, but observe that not all suppliers are exposed to the same costs (for example ECO and WHD). The result is that non-obligated suppliers completely avoid some costs to which obligated suppliers are subject. It is important this imbalance is addressed to avoid building in unintended structural margin advantages for certain competitors, which risk being accentuated by the volatile nature of ECO costs. We believe that Government needs to review the scope of the exemptions in light of market developments and the proposed cap, and would urge Ofgem to encourage this.

5 Summary

SSE recognises both the complexity and urgency of this piece of work and is committed to being a constructive stakeholder in the cap design process.

Logically it strikes true that in order to balance the objectives set out in the draft legislation, the cap should be set with sufficient room for profitable competition to take place amongst efficient operators; the cap should accurately track those costs that are predominantly outside each supplier's direct control; and the cap should encourage downward pressure on those costs that are most directly under supplier's own control.

In particular, we believe that the policy objectives which relate to competition and switching can only be achieved if meaningful additional headroom is provided to enable competition to continue to thrive. A sufficiently high headroom figure, combined with a rigorous bottom up cost assessment as outlined above, would have the potential to strongly incentivise suppliers to become more efficient, but also critically to enable them to meet the other objectives of financing their operations, preserving competition and promoting customer engagement in the market.

SSE sees significant risks in developing options 1 and 2, and our strong view is that the bottom up approach (option 4) would provide the most robust, fair and low-risk method. However, if an element of price-related benchmarking is necessary, option 3 could be made to work but only subject to major revisions.

We would be happy to discuss any of our views further with Ofgem and look forward to our ongoing engagement on this topic.