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Dear Jemma,

SSE response to Ofgem Working Paper 4: environmental and social obligation costs

SSE welcomes Ofgem's continued engagement with the industry on the development of the default tariff cap and is pleased to respond to Working Paper 4.

Summary of SSE's key considerations

- The range of obligations considered in WP4 is incomplete in that Ofgem's approach to account for the movement in costs of the smart programme has been omitted.

- Generally, SSE agrees with Ofgem's assertion that for the majority of schemes suppliers are unlikely to have material control over the cost of complying and that the per MWh or per-customer charges will be similar for all those suppliers with the same obligations.

- Ofgem should consider an appropriate mechanism to accurately model 'qualifying demand' within the cap indexation, and so ensure that each scheme is incorporated on a per MWh or per customer basis as appropriate.

- In addition to adjusting for declining overall demand across the entire market, Ofgem will need to consider the effect of small supplier exemptions with the on-going growth in the number of exempt suppliers. In principle, the mechanism needs to recognise the high likelihood that, each year, a higher proportion of ECO and Warm Home Discount spend will be recovered against a reducing number of customers, who are also using less energy.

- For schemes that have a market-place or auction dimension to them it is not reasonable for Ofgem to suppose that all suppliers could achieve the lowest cost; instead Ofgem should consider an average cost.

- SSE believes that accuracy should prevail over simplicity when indexing the cost of each policy and how that should feed into the cap.

- ECO costs are subject to significant uncertainty, as the scheme goes through substantial change; accordingly, the past does not provide a reliable guide to the future. We believe there are substantial issues with the impact assessment which is currently supporting the consultation.

- SSE recognises that Ofgem could seek to deal with uncertainty over environmental and social policy costs through any, or a combination of, adjustments, correction factors, or the provision of additional headroom. Our preference is for Ofgem to rely predominantly on the provision of sufficient additional headroom.

As always, our intention is for our response to be constructive and we would be happy to follow up the points made with Ofgem at a suitable time, if helpful.

Yours sincerely

Patricia Hall
Regulation Manager

Annex 1: SSE response to Working Paper 4

1 Omission of approach to smart meter cost

We regret to see that in Working Paper 4 Ofgem has opted not to provide their thinking on how the cost of the smart meter rollout will be provided for in the cap methodology. Smart meter roll-out cost indexation has been one of the biggest issue areas with the PPM Safeguard Cap, as outlined to Ofgem in our bilateral meeting (March 2018). We therefore anticipate that this will be covered in the policy consultation and look forward to providing feedback through that process.

2 Improvements in cap design

SSE welcomes the differences in approach for the default tariff cap, versus the current PPM cap (such as the conversion of the OBR forecasts to £/MWh or £/customer estimates) and the recognition that ECO will require an explicit forecast (4.18). While we agree that the BEIS impact assessment (£640m pa) is a useful reference point, it is important to consider that there is still considerable uncertainty over the cost of delivering ECO3. We also welcome the proposal to add an allowance for AAHEDCC (4.18) and the recognition (4.11) that cost liability is dependent on customer profile for Capacity Mechanism and will therefore need to vary across Peak/Off Peak. We would add that Contracts-for-Difference costs are seasonal and to a (lesser) degree depend on the customer profile also.

Further, while SSE supports Ofgem's proposal to use the OBR for source data in most cases, we note that it is fairly opaque process wherein suppliers cannot see the assumptions the OBR apply. We also note that the OBR produce two forecasts a year (one in Nov and May), which will give rise to timing issues if Ofgem intend to update the Default Tariff Cap in Apr and Oct, as is the case for the PPM Cap.

3 The importance of accuracy in cost forecasts

SSE believes that Ofgem should prioritise accuracy over simplicity when indexing the cost of each policy and determining how that should feed into the cap. We stress the point made in previous responses that inherent forecast inaccuracies are inevitable, particularly in relation to some of the policy costs, and to avoid the knock-on effects in the market of such errors, we believe Ofgem needs to ensure inclusion of an approach that addresses such risks in the default tariff cap methodology.

While we generally support the use of the OBR as a data source for policy cost forecast, we are of the view that an alternative approach is required for ECO and the Capacity Market to ensure accuracy. Thus, we support the proposal for an explicit forecast for ECO (4.18).

4 Headroom for risk management

All environmental and social scheme costs are managed with an element of risk and while Ofgem could seek to account for this via appropriate adjustments, SSE's view is that headroom is a more appropriate approach to allow for the necessary risk management associated with these costs.

We are, however, very concerned with the risk that ECO costs will be incorrectly forecast in the cap if Ofgem is to use BEIS's Impact Assessment, and urge Ofgem to be particularly mindful of the potential inaccuracies within it. SSE would be happy to share our response to the BEIS consultation. Given the substantial likely volatility associated with ECO costs going forward, Ofgem might consider a bespoke approach to cost forecasting in the cap.

5 Supplier control over scheme costs

Aside from a few exceptions, SSE generally agrees with Ofgem's assertion (1.4) that for the majority of schemes suppliers are unlikely to have material control over the cost of complying, and that the per MWh or per-customer charges will be similar for all those suppliers with the same obligations. We have set out our specific feedback and forecast recommendations in relation to each scheme below:

5.1 Renewable Obligation

The Renewable Obligation (RO) is set in October of each year and the buy-out price is fixed at this point. We do not believe suppliers have any meaningful ability to influence their exposure to these costs, and would welcome clarification on what drives Ofgem's assertion that suppliers have control over the RO costs. In particular, we would welcome clarification as to whether a supplier meeting its RO obligation by paying into the buy-out-fund would, in Ofgem's view, be considered to be operating efficiently.

5.2 Feed-in-Tariff

The key risks in forecasting the costs associated with FITs include uncertainty over qualifying demand, installed capacity and level of utilisation. We are unclear what assumptions the OBR

will be making on this and caution that it will not include the most recent information on installed capacity. We therefore consider that a forecast must be made on the new installed capacity, although at this stage we are uncertain as to the source data to inform such a forecast. In terms of the risk associated with utilisation, this is driven by the fact it is weather dependent which translates into an inherent forecast uncertainty. To ensure the cap allows suppliers to recover the costs of this scheme, there should be an additional allowance in the headroom on top of the cost forecast informed by the OBR to account for utilisation risk.

5.3 Contracts-for-Difference

The key risks in forecasting the costs associated with CfD include uncertainty over qualifying demand, installed capacity, level of utilisation and wholesale prices. As with FITs, the OBR will take an early view on installed capacity so may exclude latest developments. In terms of the risk associated with utilisation, this is driven by the fact that it is weather dependent which translates into an inherent forecast uncertainty, as with FiTs. The risk associated with wholesale prices relates to the fact that the CfD scheme guarantees a certain strike price to generators, which creates wholesale market volatility that suppliers need to balance. To ensure the cap allows suppliers to recover the costs of this scheme, there should be an additional allowance in the headroom on top of the cost forecast informed by the OBR to account for these risks.

5.4 Capacity Mechanism

The key risks in forecasting the costs associated with CM include uncertainty over qualifying demand and the outcome of T-1 capacity auctions. T-1 auctions take place at the end of January / start of February, which may give rise to a timing issue should this be too late for the auction outcome data to feed into the OBR forecast. As such, Ofgem might consider an alternative approach to forecasting CM policy costs independently of the OBR, or factor in the ability to make a post auction adjustment.

5.5 Energy Companies Obligation

The current BEIS impact assessment of £640m pa (indexed to RPI) for ECO3 at industry level may not prove to be realistic. We have provided more detail in paragraph 7 below, but at a high level, we do not believe that historic data being used, and the assumptions made by BEIS, are an appropriate reflection of the move to a scheme focused entirely on support for fuel poor households. As Ofgem are aware, while suppliers may be able to phase their expenditure, the actual scheme costs at a given time depend largely on market supply / demand economics.

Given our view on the limitations of the modelling approach taken within the BEIS impact assessment, and the fact that the future of the scheme is still in development, we consider

that the risk that the cost of ECO being inaccurately accounted for in the default cap is particularly pronounced. To ensure scheme costs are covered within the cap methodology, we recommend a headroom allowance above the BEIS forecast. This would allow for the very real possibility that the cost estimates for the scheme are substantially under-estimated. Delivery costs should be reviewed annually and an adjustment be applied. In any case, Ofgem should undertake their own critical up front analysis of the BEIS Impact Assessment.

5.6 Warm Home Discount

Other than the substantial risk inherent in the increasing imbalance between obligated and non-obligated suppliers discussed below, the main risk in cost recovery of the WHD lies in churn. We consider that the OBR forecast should be accurate at industry level but that there will be some variation across suppliers depending on gains and losses through the year. We would encourage Ofgem to adequately address this issue.

5.7 AAHDEC

Ofgem's proposed approach to forecast costs seems logical and we have no additional comments to make at this stage.

6 Qualifying demand issues

As is clear from our comments in section 2 above, it is critical to note that not all MWh's or suppliers fall under the qualifying criteria for some schemes, and that accurately modelling the 'qualifying demand' within any indexation approach is essential to ensure that costs can be recovered in their entirety by obligated parties.

We see several related factors contributing to this issue. Firstly, even where policy costs are static and all suppliers share the same obligation, overall domestic energy use is falling.

Secondly, volume exemptions apply to different schemes. These concentrate the overall scheme costs recovery across a smaller volume increasing the 'cost per unit' for those not subject to the exemption.

Using ECO as an example, the impact of the continuation of market share changes between obligated and non-obligated suppliers at their current rate and the suggested taper changes could result in larger suppliers seeing an increase in their individual obligations of c20% over the life of the scheme while their customer numbers reduce. This increase will then need to be recovered from a smaller number of customers who are using less energy (and would apply before any costs increases arising under the scenarios discussed below). The effect is similar in respect of the Warm Home Discount.

For other policy costs such as RO, CfD and potentially FiTs, an exemption is applied for Energy Intensive Industries (EII) which reduces the qualifying demand over which scheme costs can then be recovered, which again has the effect of increasing the 'cost per unit' applied to domestic customers. A similar issue exists for Guarantees of Origin (GoOs) which are exempt from CfD and FiT policy costs.

7 Approach to ECO costs requires further consideration

SSE have provided feedback to BEIS, highlighting concerns with the ECO3 impact assessment modelling. The scheme proposals are similar to the 'CERT SPG' target which proved extremely challenging to deliver (with average delivery costs rising rapidly towards the end of the target). Our key points of concern include:

- The 'findability' of homes to treat – the impact assessment uses a 'central case' methodology which is simply the mid-point between using an 'able to pay' target baseline (which is now completely removed from the scheme) and using the current scheme 'fuel poor' baseline (where faulty or inefficient heating systems are being replaced, a proposition which has more immediate appeal to consumers than home insulation). BEIS recognise that the difference in their central case and their low case modelling for this one variable could cause an 80%-90% cost increase over the assumed level in the £640m impact assessment. Due to the limitations of the baselines selected, we believe that the overall analysis is flawed and the increases could be greater.

- Failing to recognise the rural premium - the rural element of the scheme is now a larger proportion of the overall delivery, with tighter restrictions. BEIS have assumed this can be achieved at no extra cost. The current scheme, without the same restrictions, has a premium for rural work. The proposed rural sub-target is very similar to the CSCO Rural sub-target in ECO1. Suppliers only managed to achieve 2% of the rural obligation in the first half of the ECO1. Government had to intervene and adjusted the rules, citing the increasing costs of delivery as the basis for change.

- Use of historic costs is inappropriate - Current ECO scheme costs have been used as a baseline for the majority of modelling, with no consideration for the fundamental changes being proposed which will result in a focus on smaller dwelling types and different measure types which will have a significant impact on scheme costs.

We would be happy to provide our detailed analysis on the impact assessment if it would assist Ofgem.

8 Summary of cost issues associated with environmental and social schemes

SSE's key messages in relation to all these cost elements are:

- Suppliers are unlikely to have material control over the cost of complying with the majority of environmental and social schemes

- These costs are also subject to significant uncertainty, meaning that any cost forecast will inevitably be inaccurate. Moreover, given that volumes are falling and many of these costs are associated with recovering static or increasing costs from a smaller (and lower consuming) customer base, estimates based on historic data are likely to be *under* rather than *over* estimates on a per customer or per MWh basis.

- This uncertainty therefore needs to be minimised and/or managed, either through allowing costs to be corrected ex post (e.g. through adjustments to the future price cap level to adjust for any historic under-recovery/over-recovery of costs); and/or by allowing additional headroom to manage the risk (and the associated capital cost implications of managing such risks). SSE's preference is for these cost elements to be sufficiently accounted for in the cap headroom.