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3 May 2018
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Dear Jemma,

SSE response to Ofgem Working Paper 5: Updated competitive reference price

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 5.

In particular, we welcome Ofgem's recognition of the importance of identifying suppliers that represent the market as a whole, rather than a sub-set of it. Getting this right, is vital to ensure the stability – and financial viability – of efficient operators within the market.

Summary of SSE's feedback

- SSE remains of the view that a bottom-up assessment of costs would be the most robust and least hazardous approach to setting a default tariff cap. A number of important adjustments are essential before a reference price approach could become workable. We have set out detailed feedback on these adjustments within Annex 1.
- If Ofgem is minded to pursue option 3 (updated competitive reference price), SSE believes that the collection of more recent input data is essential, and that Ofgem should include suppliers that represent the market as a whole, taking account of all tariffs not just the cheapest of fixed tariffs; We consider that Ofgem should prioritise the exclusion of suppliers whose pricing strategies are yet to be proven to be sustainable, which by definition is likely to include the newest market entrants.
- We are concerned with Ofgem's proposal to use the tariffs with the lowest prices for the reference price as a way of ensuring the benchmark reflects efficient costs. Using these prices as a reference point would mean that efficient suppliers could not recover their costs.



- In order to provide views on Ofgem’s approach to calculating an updated competitive reference price, we would have welcomed a more complete proposal on which to comment. We therefore look forward to increased engagement on this topic once Ofgem are further forward in their thinking.
- Ofgem’s proposals for weighting suppliers are too simplistic. Any weighting approach should achieve a representative socio-demographic mix. This is the only way to ensure that the basket is fully representative of the diversity of GB households and greatly improves the chances that the benchmark will produce a sound result.

Our views are set out in detail within Annex 1.

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 5

We note Ofgem's approach to this working paper is to address the objective for developing a recalculated benchmark by splitting it into two sub-objectives: Selecting suppliers who are pricing competitively and selecting suppliers who would be relevant market-wide comparators. Taken together, our views on these two objectives also feed in to the third element of the working paper, which seeks to address 'robustness'.

1 Objective 1: Pricing Competitively

SSE considers that Ofgem's proposed approach to identifying suppliers who are pricing competitively lacks the necessary substance for such a significant regulatory intervention. As SSE has set out in our response to Working Paper 1, in our view the use of a rigorous bottom-up cost assessment is the only approach that would give Ofgem the necessary confidence in what is an efficient level of costs. Using price references as a proxy for efficient costs is fraught with uncertainty and risk. Our views on Ofgem's proposals within section 4 are set out below.

1.1 Basing price reference on suppliers with low prices

Ofgem's suggestion that suppliers with more competitive prices may be more likely to represent an efficient level of costs is cause for concern. As Ofgem has alluded to in previous working papers – and in section 5.2 of this working paper – there could be many reasons why prices might not be cost-reflective e.g. a supplier might be seeking to grow its customer base quickly; it might have an atypical business model that is not representative of the market as a whole, or it may be willing to pass on the benefits of relatively low policy costs, an advantage which would be lost as the customer base grows. Low prices are unlikely to be driven by a long-term pricing strategy, particularly because in some cases low prices can be loss making for a supplier, or because those prices might be supported by a one-off fortunate hedging strategy.

SSE considers that basing a price reference on suppliers with low prices carries a serious risk that the cap is set based on unsustainable pricing strategies and as such, puts at risk the financial viability of efficient market operators. We have conducted some internal analysis to better understand the potential impact of this.

1.2 Basing prices on suppliers with 'engaged customers'

SSE disagrees that being on a fixed price tariff is a good proxy for being engaged; this would only represent a sub-set of engaged customers. Customers may engage in all manner of ways e.g. opting for online account management, signing up for a rewards programme, registering for the Priority Services Register, changing payment method, or opting for a smart meter. In addition, Ofgem also note in 4.4 that it is possible for an engaged customer to select a variable tariff, which highlights how inappropriate it would be for Ofgem to use tariff type as a measure of engagement.

1.3 Basing prices on fixed price offerings only

Fixed tariffs are clearly used as an acquisition vehicle by many suppliers, so there is no reason to believe that the pricing is scalable or sustainable, and as such a singular focus on such tariffs is a poor basis for the cap. The CMA PPM cap explicitly recognized this fact, and the benchmark used in this case all the tariffs provided by First Utility and OVO, rather than a narrow subset of fixed or acquisition tariffs. Clearly it would require significant justification to move away from an 'all tariffs' approach for suppliers used as a benchmark and could be seriously damaging to the stability of the market.

As we set out in our working paper 3 response, our view is that the market for fixed tariffs and variable tariffs (including all forms of default tariff) are linked and that Ofgem must have equal regard for both when seeking to meet the Bill's objectives. There is a risk that the introduction of a cap could dampen the level of discount offered on some products by limiting revenues across the entire market and thereby limiting suppliers' ability to differentiate between tariffs. This again carries the risk of reduced consumer engagement, even beyond the SVT segment.

Indeed, Ofgem's own analysis in the 2017 State of the Energy Market Report states 'we estimate that if SVT prices were reduced so that they provided the same gross profit margin as fixed tariffs, then suppliers would have made a 6% loss.'¹ SSE's view is that any default tariff cap will have an impact on fixed tariffs.

Using fixed price tariffs only also has implications due to the wholesale hedging approach used for these tariffs. Different suppliers will have different approaches but it is likely that wholesale energy for use with a particular tariff is purchased around the time of determining the tariff price level (shortly before launch). This is quite different from the theoretical approach used when determining benchmark wholesale prices for the PPM cap for instance. The use of fixed price tariffs only exacerbates the possible differences between the wholesale costs used to determine tariffs that are used in the reference price, and the wholesale benchmark that will be used in determining the cap.

1.4 Basing cap on prices from suppliers with fixed customers only

We believe that the only suppliers making sustainable returns are those with customers on a blend of fixed and variable tariffs. The emergence of suppliers with fixed-only customer bases is more nascent and the sustainability of their pricing strategies is yet to be proven. We would be very concerned that these pricing strategies could not be applied across the entire GB customer base without hindering the financial viability of efficient operators as those prices would not enable such operators to recover their long-term costs.

¹ Higher prices for SVT customers; Ofgem State of the Energy Market, 2017

2 Objective 2: relevance as a market-wide comparator

SSE welcomes Ofgem's recognition of the importance of identifying suppliers who represent the market, and not just a sub-set of it. We are supportive of the notion that it is essential that diverse providers operating at scale are considered when selecting suppliers as relevant market-wide comparators. The selected suppliers must reflect the costs of serving a diverse range of customers. Doing otherwise would put the stability of the market at risk. We have set out our justification for this position below.

2.1 Current PPM benchmark ineffective for market-wide representation

The mid-tier suppliers used in the PPM benchmarking exercise have targeted a subset of the high value / low cost customers (SSE has provided evidence to support this in our response to Ofgem's consultation on extending the safeguard cap). It is therefore not reasonable to assume that their prices (or cost base) should represent a sound benchmark for the market as a whole, in particular those energy suppliers that have a more inclusive policy, and consequently more diverse and representative customer bases (with the associated higher costs to serve and capital requirements that come with serving those customers).

Some examples of services that incur higher costs to service (for SSE) include Sign Video services, translation services and other adapted communications (with a variety of different formats to support customers including Braille, large print and specific formats and colours). These are essential in ensuring that we make things as easy as possible and maximise the engagement of customers in a range of circumstances. SSE is eager to continue to enable and engage customers through these facilities. This has been demonstrated through our recent achievement of the 'gold standard' for identifying and responding to customers in vulnerable situations: the British Standard for Inclusive Service Provision (BS 18477). We urge Ofgem to consider the importance of these services when designing the default cap.

2.2 Importance of mitigating the risk of supplier failure

Furthermore, as we have expressed previously in discussions around the Supplier of Last Result process, Ofgem has a vital role to play in mitigating the risk of supplier failures, both at the point at which a licence is awarded and through its regular market monitoring. The importance of this duty extends very much to the design of the default tariff cap, and in particular the selection of suppliers to represent sustainable pricing strategies for the whole of the market. Ofgem must exercise careful consideration to ensure that the introduction of a poorly benchmarked cap – or a cap that is reliant on the pricing strategies of suppliers whose pricing strategies may not be sustainable – does not unduly introduce or heighten the risk of failure amongst efficient or potentially efficient suppliers.

3 Feasible adjustments

SSE's view is that to be included in the benchmark, each individual supplier needs to be making sustainable returns and operating at scale; and that together all of the selected suppliers as a group are serving a representative and diverse cross-section of GB households. As such, before consideration is given to feasible adjustments to improve reliability of any benchmark, it is first important to be clear on the necessary supplier exclusions from the benchmarking process. We consider that Ofgem should prioritise the exclusion of suppliers whose pricing strategies are yet to be proven to be sustainable, which by definition is likely to include the newest market entrants.

We remain of the view that a more robust approach to creating a benchmark, which would be less prone to error, is to adopt a bottom up assessment that seeks to accurately account for costs from the outset. If Ofgem is minded to pursue a price reference approach, we are of the strong view that many essential adjustments must be made before it becomes workable. We have set out below our feedback on the cost adjustments listed in 5.3 – 5.13 of the working paper.

3.1 Wholesale prices

The most challenging adjustment for the benchmark is to align wholesale purchasing costs relevant for a given tariff or supplier (to be used within the reference price) with the relevant benchmark wholesale cost used to calculate the cap. Tariff levels could be set based on wholesale purchasing at any particular moment in time or over a period of time based on each supplier's hedging strategy. The differences between these approaches and the benchmark should be accounted for when working out feasible adjustments.

This is particularly complex as it involves understanding the hedging approach for all of the suppliers and attributing purchases to individual tariffs. However, this is necessary to make the benchmark credible.

3.2 Operating Costs

We believe that critical adjustments should be made for any over or under-indexing of safeguarded customers.

3.3 Payment Methods

Different prices and costs exist for customers who use different payment methods and so it is appropriate for Ofgem to build appropriate adjustments in for this.

3.4 EBIT adjustment

We see practical issues with making EBIT adjustments and we are unclear how they would be resolved by Ofgem. Only six of 63 suppliers in the market publish consolidated segmental statements, which makes like-for-like comparison difficult. It is likely that suppliers will be adopting a range of accounting approaches to capital investment, depreciation, amortisation,

and management of their intra-group position. These factors will impact each supplier's reported EBIT, and in combination make it difficult for Ofgem to make accurate or appropriate reference price adjustments.

It may be possible for Ofgem to address this in the short term by issuing appropriate RFIs to relevant smaller suppliers, requiring that the equivalent information is provided on a basis consistent with the requirements of SLC 19A. In the medium term, SSE would once again urge Ofgem to consider widening the scope of SLC 19A to ensure that all suppliers above some *de minimus* level are obligated to produce a CSS annually.

3.5 Network costs

We support Ofgem's view that adjustments should be made to the cap to allow for network costs.

3.6 Policy costs

We have set out our views on Ofgem's proposed approach to account for policy costs in Working Paper 4. We are, however, disappointed not to have had an earlier opportunity to engage in Ofgem's thinking on how smart costs will be addressed in the cap. Our strong view is that careful adjustments need to be factored in for the costs of the smart meters to avoid a benchmark being densely populated with prices of suppliers' who have chosen to back-end their smart rollout (and whose prices, therefore, are not yet reflective of those costs).

We look forward to reviewing Ofgem's proposals on smart metering costs at the earliest possible opportunity, which we anticipate will be the policy consultation.

4 Assembling a benchmark

We note the purpose of this working paper is to seek views on how Ofgem could calculate an updated competitive reference price. To this end, we would have welcomed a more complete proposal on which to comment. For example, this paper only deals with changes to the *basis* of the reference price, not with how the cap moves over time. We note that working paper 4 explores some of most of the primary dysfunctions experienced with PPM cap, which SSE welcomes; however, we note the omission of smart metering from that working paper. The costs of this programme must be carefully accounted for and so we look forward to increased engagement on this topic once Ofgem are further forward with their thinking.

5 Concerns with proposals on weighting

5.1 Ensuring the diversity of society is represented

Any weighting approach should achieve a representative socio-demographic mix. This is the only way to ensure that the basket is fully representative of the diversity of society and greatly improves the chances that the benchmark will produce a sound result.

SSE's view is that in order to be included in the benchmark, each individual supplier needs to be making sustainable returns and operating at scale; and that together all of the selected suppliers as a group are serving a representative and diverse cross-section of society. In achieving this, Ofgem should therefore seek to ensure that relevant customer groups are properly represented in the selected group of suppliers, and weighted appropriately. For example, Ofgem might seek to ensure the benchmark contains a representative proportion of households on the PSR register, in each demographic segment, and using low cost service channels such as online account management.

To weight the impact of each supplier's prices, Ofgem should align the weighting in accordance with the UK average of those particular customer groups.

5.2 Drawbacks to Ofgem's proposals

If Ofgem were to adopt a simple average weighting approach – as proposed – this would lead to an uncertain outcome that is unlikely to represent the true costs of an efficient supplier. We therefore consider it entirely inappropriate. Similarly, we consider the alternative proposed approach to weight suppliers by customer numbers might lead to a wholly unrepresentative selection of consumers, depending on the combination of suppliers selected, and as such cannot be relied upon to achieve an outcome that adequately represents the diversity of society.