SCOTTISHPOWER

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Dear Anna,

DEFAULT TARIFF CAP: POLICY CONSULTATION

Thank you for the opportunity to respond to this consultation. While we remain of the view that a default tariff cap will not be in the interests of consumers, we are grateful for a further opportunity to formally respond to this policy. Our consultation response covers four areas:

1. Ofgem obligations

We are concerned that the need to implement the price cap 'as soon as practicable' may be allowed to over-ride Ofgem's duty to set the cap in a proper manner, and that the consultation process and transparency around smart meter rollout costs, in particular, is inadequate

While we recognise the difficulty of introducing the cap "as soon as practicable" after the Act has passed, we do not think this should be at the expense of following due process. It is important that Ofgem take account of all relevant evidence with a thoroughness commensurate with such a critical intervention. We are particularly concerned about two areas of due process that, if not resolved, increase the risk of challenge to the eventual proposal.

Firstly, we do not believe that the current proposal meets Ofgem's obligations to enable effective competition and maintain incentives for customers to switch. We are concerned, based on the options Ofgem is considering for efficiency benchmarks and headroom, that the cap will be set at a level that cannot maintain incentives for switching and competition, contrary to Ofgem's obligations. Based on a detailed model of consumer switching behaviour prepared by Oxera and provided to Ofgem, we think that Ofgem has significantly under-estimated the reduction in switching that would result from its proposals.

Secondly, we do not believe the consultation process and transparency around smart meter rollout costs is adequate. For example, the preliminary estimates that Ofgem has presented of smart meter net cost change (SMNCC) are far lower than our own cost forecasts but there is no way for us to identify where the gaps have arisen from the information provided in the consultation. It is established practice in price controls for there to be a process of iteration where the regulator sets out its evidence, assumptions, and analysis in a transparent way that allows parties an opportunity to critique.

ScottishPower's net smart costs are forecast to peak at £[✂]m per annum during the initial period of the proposed cap. Given the lack of precedent for analysing smart costs, there is a pressing need for a meaningful and detailed process of consultation. We urge Ofgem to (1) disclose all non-confidential data relating to its assessment of smart meter rollout costs as a matter of urgency, and (2) establish a 'data room' process to allow appropriate critique of the model as per the example set in the Competition and Markets Authority's Energy Market Investigation (CMA EMI).

We welcome Ofgem setting out its initial views on how it will meet its obligation to assess whether conditions for effective competition are in place. Given the challenges inherent in conducting such an assessment when a price cap is still in place, we would ask that Ofgem fully consult and engage on the methodology it will use for its statutory review in 2020.

2. Initial cap

We are concerned that the proposed methodologies do not properly account for critical cost distortions.

We agree with Ofgem's decision to rule out methodology Option 1 (market basket). Option 4 (bottom-up cost model) appears to be comparatively more robust than the others and will be easier to justify to stakeholders.

However, if either reference price approach is adopted (Option 2 or 3), we agree with Ofgem's proposals to adjust prices for profitability and for exemptions from Government obligations. However, the price adjustments must also account properly for:

- differences in smart meter rollout progress of selected suppliers at the reference date, which can have a very material impact on overall costs;

- the significantly higher costs faced by incumbents in respect of expensive-to-serve customers compared to small suppliers who are able to 'cherry pick' (evidence of which is provided in the Baringa report we provided to Ofgem);

- differences in profitability of gas and electricity, given that over the last 3 years EBIT margins have on average been much higher for gas than electricity.

Furthermore, Ofgem must guard against a situation where its exclusions for Option 3 and its final selection criteria together result in an excessively stringent efficiency benchmark.

Finally, as noted above, we have serious concerns over Ofgem's decision to base its assessment of smart metering cost changes between the reference date and initial cap on the BEIS model, which was never designed for this purpose and has never been subject to external validation by suppliers. Our preliminary analysis suggests that Ofgem may have significantly under-estimated cost categories and over-estimated benefits.

3. Headroom

We are concerned that the level of headroom will not enable competition to flourish.

The optimum amount of headroom will reflect a balance between consumer protection and competition. In the case of the prepayment price cap, opportunities for competition are limited by technical constraints which are not present for credit meters. All other things being equal, this suggests that the impact on competition should be given a greater weight for credit meters and the headroom allowance should be higher than in the CMA's prepayment cap.

There is also a strong argument for the headroom to increase over time. The example of New South Wales, Australia illustrates clearly that price caps can reduce price dispersion and weaken competition. From the same example, it is clear that relaxing a cap can allow competition to flourish to the extent that the cap can be lifted. Allowing headroom to increase towards the end of the period would help facilitate a smooth transition to the more competitive market that would need to exist when the cap is removed.

4. Adjusting the cap over time

We are concerned that the indexation of wholesale costs is not sufficiently comprehensive especially given recent increased volatility in the wholesale markets.

We agree in general with Ofgem's approach of adjusting the cap between periods based on exogenous cost indices (wholesale, network, and social/environmental levies) and changes in smart costs. However, we are concerned that the proposed approach to indexation of wholesale costs assumes that all purchases are made on a forward basis. There are important components of direct fuel costs, such as shaping costs, imbalance costs, forecasting errors and unidentified gas, which may not correlate with the forward purchase costs that drive the proposed index. These may need to be indexed separately.

We agree with Ofgem's decision not to include a routine mechanism for truing the level of the cap up or down based on actual costs incurred. However, it is important that Ofgem retains the ability to make discretionary changes in response to exceptional circumstances or events. Ofgem should specify in advance a materiality threshold for such changes.

Finally, if a decision is taken to extend the price cap beyond 2020, certain aspects of the cap will need to be reviewed, such as smart meter costs where rollout obligations beyond 2020 are currently undefined.

Should you have any questions on this response, please do not hesitate to contact me.

Yours sincerely,

Neil Clitheroe
CEO, ScottishPower Retail

Annex 0

DEFAULT TARIFF CAP: POLICY CONSULTATION: OVERVIEW DOCUMENT
SCOTTISHPOWER COMMENTS

Chapter 2 – setting the cap

Question 1: Which approach for setting a benchmark for efficient costs do you think would be most appropriate?

In summary:

We agree with Ofgem's decision to rule out methodology Option 1 (market basket). Option 4 (bottom-up cost model) appears to be comparatively more robust than the others and will be easier to justify to stakeholders.

However, we are concerned that the proposed methodologies do not properly account for critical cost distortions. If either reference price approach is adopted (Option 2 or 3), the price adjustments must account properly for:

- **differences in smart meter rollout progress of selected suppliers at the reference date, which can have a very material impact on overall costs;**
- **the significantly higher costs faced by incumbents in respect of expensive-to-serve customers compared to small suppliers who are able to 'cherry pick' (evidence of which is provided in the Baringa report we provided to Ofgem);**
- **differences in profitability of gas and electricity, given that over the last three years EBIT margins have on average been much higher for gas than electricity.**

In respect of Option 3, Ofgem must use a sufficiently large and representative sample of suppliers to average out hedging-related differences in wholesale costs. It must also guard against a situation where its exclusions and final selection criteria together result in an excessively stringent efficiency benchmark.

Choice of methodology

We agree with Ofgem that a market basket should not be used for setting a benchmark for efficient costs due to its susceptibility to gaming, level of unpredictability/volatility and the risk that it has never been tried before in the UK.

Of the other three methodologies Ofgem is considering for setting a benchmark of efficient costs, the bottom-up cost assessment (Option 4) has the advantage that it:

- provides greater transparency, which makes it easier for Ofgem to demonstrate that it has appropriately balanced the matters set out in Clause 1(6) of the Bill.
- gives confidence in which costs are included in the cap and how these costs are treated, supporting easier communication to stakeholders on how the price cap has been set;

- avoids the key challenges inherent in using price data, where supplier pricing strategies may mean prices are not a valid indicator of supplier cost; and

- is the most appropriate option to ensure the benchmark is reflective of an efficient supplier's costs.

We continue to see challenges in using either Option 2 or Option 3 to set the efficient benchmark. An adjusted version of the CMA methodology (Option 2) would still be based on an out of date baseline and would require too much correction, and we think that Ofgem would likely face the same challenges setting an updated competitive reference (Option 3) as the CMA did (choice of comparators and transparency of adjustments). If either reference price approach is adopted (Option 2 or 3), we think Ofgem must make a wider set of price adjustments than currently proposed. These points are included in our summary below of the challenges in using Option 3.

Issues with updated competitive reference price methodology (Option 3)

While we welcome Ofgem's proposals to widen the sample of companies used to assess an updated competitive reference price (Option 3), we have some concerns about the criteria proposed and as noted above think Ofgem would likely face the same challenges setting an updated competitive reference as the CMA did (choice of comparators and transparency of adjustments) albeit with less room for error given the wider market coverage.

If either reference price approach is adopted (Option 2 or 3), we agree with Ofgem's proposals to adjust prices for profitability and for exemptions from Government obligations. However, the price adjustments must also account properly for:

- **Smart meter rollout progress:** Differences in the smart meter rollout progress of selected suppliers at the reference date (or the period leading up to it) may have a very material impact on overall costs. Ofgem should use the insights from its model of smart meter rollout costs to make explicit adjustments in this respect.

- **Customer mix:** incumbents face significantly higher costs in respect of expensive-to-serve customers, particularly in respect of bad debt, compared to small suppliers who are able to 'cherry pick' their customers.

- **Gas vs electricity profitability**: Over the last three years EBIT margins for the six large energy firms (SLEFs) have on average been much higher for gas than for electricity, the gap reaching 11.1% for gas versus -1.1% for electricity in 2016. The reason for this asymmetry between gas and electricity margins is unclear, but it seems likely that medium and smaller suppliers will have been influenced by the same market conditions and on average made higher margins in gas than electricity. Given the size of this imbalance, it is vitally important that Ofgem makes appropriate adjustments in its reference price process. At the end of the proposed Option 3 process when Ofgem comes to adjust revenues to bring them back to a normal EBIT margin, it is essential that this adjustment is done separately for gas and electricity.

Wholesale costs can also vary widely between suppliers depending on the hedging strategy that they have adopted and how well or badly that strategy has turned out in the light of market movements. Although some suppliers may be more efficient than others in their wholesale energy procurement, the vast majority of cost variances will come down to timing not efficiency. Analysis performed in the context of the CMA EMI showed that while the hedging strategies of the SLEFs had performed worse than the CMA's alternative benchmark over the period initially considered by the CMA, when the analysis was done

over a later period they performed better. This is particularly important if Ofgem is proposing to use a reference date of end 2017, since markets have been relatively volatile over the last year (exacerbating the differences between hedging strategies) and because SLEFs, medium and small suppliers have typically adopted rather different strategies, with SLEFs tending to hedge significantly further forward than small suppliers. The only practicable way of addressing this issue if Ofgem adopts Option 3 is to average over a sufficiently large and representative sample of suppliers in deriving the reference price.

Finally, Ofgem must guard against a situation where its exclusions for Option 3 and its final selection criteria together result in an excessively stringent efficiency benchmark. Ofgem's proposal to exclude suppliers on the basis of customer engagement will mean that the SLEFs most likely to be inefficient (according to the CMA's analysis) will already have been excluded. The long-list of included suppliers should therefore already provide a representative efficiency benchmark when taken on average. If in addition, Ofgem averages over the lowest 50% of included suppliers, this would be similar to setting a lower quartile benchmark based on a population which has already been pre-selected (by exclusions) to be more efficient than average.

Question 2: What are you views on the issues we should consider when setting the overall level of the cap, including the level of headroom?

In summary:

We are concerned that the level of headroom will not enable competition to flourish. The headroom allowance should be significantly higher than for the CMA's prepayment cap if Ofgem is to meet its obligations for switching and competition under the Bill.

The Bill requires that Ofgem set the cap at a level that protects existing and future default tariff customers while having regard to a number of factors including enabling effective competition and maintaining incentives for consumers to switch. Ofgem notes that lower overall cap levels will protect more customers and provide higher levels of protection to those customers, however Ofgem also recognises that lower levels of headroom could damage consumer protection in the long term, by reducing price dispersion and the incentive to switch, and impacting on supplier ability to innovate or improve service to customers. We think it is very important that Ofgem balances these issues appropriately when setting the overall cap level, by providing sufficient headroom to encourage switching and competition to continue.

<u>The case for headroom</u>

We agree with Ofgem that it must consider the efficient benchmark and the level of headroom together as it is the overall level of the cap that will influence how suppliers set prices, and ultimately if or how consumers react to those prices. Ofgem rightly sets out that including headroom in the cap will allow for some uncertainty in estimating the level of efficient costs, where it cannot or has not been factored into the benchmark methodology.

However, uncertainty is not the main driver for including headroom in the cap, and we set out in detail in our response to Appendix 11 why we think the proposed legislative framework provides a clear rationale for Ofgem to include headroom in the cap in relation to limiting the impact of the cap on switching levels and competition in the market.

We cannot see how Ofgem could have regard to the 'matters' relating to switching and competition without including a reasonable allowance for headroom. The CMA recognised the need for headroom for the prepayment price cap, and there is strong evidence that lower levels of headroom will lead to reduced price dispersion, depress switching levels and reduce competition. This has been recognised by independent research[1,2], experience from other markets with price controls[3], and is reflected in Ofgem's own analysis set out in Appendix 11.

In addition, recent experience of the prepayment price cap showed a significant reduction in price dispersion and switching levels have reduced significantly in this part of the market, at odds with the trend for customers on credit meters. While we recognise that the prepayment market may not be a direct comparison with the credit market, the experience is consistent with other markets.

Setting the level of headroom

Ofgem is considering four scenarios for the level of headroom, including an extreme case of providing no headroom. We do not think Ofgem should consider this scenario any further, as it would not be consistent with its requirement to have regard to maintaining incentives for switching.

We have set out in previous submissions the strong reasons for Ofgem to include a larger headroom allowance than in the CMA's prepayment cap (the 4% scenario). The optimum amount of headroom reflects a balance between competition and consumer protection. In the case of the prepayment price cap, the opportunities for competition are limited by technical constraints, which are not present for credit meters. Other things being equal, this suggests that the impact on competition should be given a greater weight for credit meters and the optimum level of headroom should be higher.

Furthermore, as pointed out by the CMA, the presence of headroom provides a degree of contingency for deviations between the costs facing efficient suppliers and those reflected in the price cap, such that these costs can be recovered while still remaining compliant with the price cap. This is all the more important for the default tariff cap given that it covers more than 50% of the market (with an indirect impact on the rest of the market) compared to the ~15% covered by the prepayment cap.

Ofgem's analysis shows the potential impact that setting headroom at or below the current safeguard tariff could have on switching levels, with zero headroom showing over 50% reduction in switching, and 4% (same as current safeguard tariff cap) suggesting between 25% and 50% reduction in switching. We think this level of reduction in switching would not be consistent with Ofgem's requirement to have regard to *maintaining* switching incentives and Ofgem should therefore rule out the zero or 4% headroom options. Indeed, based on a detailed model of consumer switching behaviour prepared by Oxera for the CMA EMI (and provided to Ofgem), we think that Ofgem has significantly under-estimated the reduction in switching that would result from its proposals.

[1] Armstrong, A., Vickers, J. and Zhou, J. (2009), "Consumer protection and the incentive to become informed", Journal of the European Economic Association, 7:2–3, pp. 399–410.
[2] Detailed Oxera model on switching commissioned by ScottishPower to help understand the likely impact of remedies being considered by the CMA, confidential report previously provided to Ofgem.
[3] Eg experience of New South Wales in Australia.

Headroom methodology

We agree with Ofgem's intention to set headroom as a percentage rather than absolute figure, and also agree that headroom should be applied to all cost components except for network costs.

Ofgem says it is minded to have a consistent level of headroom (as a percentage) over the full period the price cap is in place, but is open to considering a level that changes over time (eg reducing over time to allow inefficient suppliers time to adjust to the cap). Rather than reducing headroom over time, we think there is a strong argument for the headroom to *increase* over time. As noted in our response to Appendix 11, the experience of New South Wales in Australia illustrates how price controls can reduce price dispersion and weaken competition – and conversely, how relaxing the price control can allow competition to flourish to the extent that the control can be lifted. Allowing headroom to increase towards the end of the period would help facilitate a smooth transition to the more competitive market that would need to exist when the cap is removed - and potentially give Ofgem additional evidence on which to conclude that the conditions were in place for the cap to be removed.

Question 3: Do you agree with our approach to accounting for different costs, in particular additional costs of serving consumers paying by standard credit?

In summary:

We agree that cost differences intrinsic to the payment method should be reflected in the cap and cost differences relating to customer mix should be socialised between direct debit and standard credit.

Ofgem's estimated additional cost to serve of £114 per dual fuel customer appears too low. As Ofgem acknowledges, incumbents face significantly higher costs in respect of expensive-to-serve customers, compared to small suppliers who are able to 'cherry pick' their customers. We are concerned that Ofgem may have disregarded higher cost data points on the grounds of inefficiency which in fact were due to customer mix, and we request that Ofgem provide more detail as to how it has arrived at the £114 estimate.

Number of caps

We agree with Ofgem's proposed approach to have separate caps for fuel, meter type, regions and payment method. On payment method uplift, we agree with Ofgem's proposal to have two separate caps, one for payment by Direct Debit (DD), and one for payment by standard credit (SC). A single blended cap would risk distorting competition between suppliers and incentivising inefficient payment method choices by customers.

We agree that cost differences that are intrinsic to the payment method in question (eg working capital cost differences) should be reflected in different levels of the cap. If these costs are not reflected, it could create inefficient incentives for customers to favour SC over DD, even though the costs to the supplier are higher. We agree that cost differences which are more to do with the mix of customers on the payment method could be socialised. For example, the bad debt costs associated with the SC payment method are generally caused by a subset of customers in a poor financial position.

Ofgem's estimate of payment method cost differences

Ofgem's estimated additional cost to serve of £114 per dual fuel customer (Table A12.1) appears too low. ScottishPower's additional costs are substantially higher than this, and we believe these additional costs are largely due to our mix of customer rather than differences in efficiency. We have provided Ofgem with a report commissioned from Baringa[4] which shows the extent to which costs can vary across different customer demographics. For one particular set of customers (mainly properties occupied on a short term basis by tenants in a 'transient renter' demographic profile) the cost to supply on standard credit terms is around £150 greater than for the average customer on standard credit (mainly as a result of bad debt). If a supplier has a higher proportion of such customers than average, this could easily account for observed differences in average cost to serve, without being due to differences in efficiency. Given that the customer groups in question are generally disengaged, and given the ability of smaller suppliers to 'cherry pick' their customers, differences in the distribution of such customers between suppliers are to be expected.

In the interests of transparent and proper consultation, Ofgem should provide further detail of how it arrived at its estimate of £114 and explain how it has taken into account customer mix-related cost differences between suppliers.

EBIT

We do not agree with the approach adopted by the CMA to profitability assessment. We do not believe that Return on Capital Employed (ROCE) is an appropriate metric for asset-light supply companies, and we note that Ofgem appears to have reached a similar conclusion in deciding not to proceed with the CMA's recommendations to estimate ROCE going forward. There are a number of serious weaknesses in the CMA's analysis behind the 1.25% and 1.9% benchmarks, relating to its treatment of capital employed (notably valuation of customer bases and risk capital).

We agree that it would not be a good use of Ofgem's time to conduct its own analysis of ROCE, but we do think that Ofgem could usefully undertake some more conventional benchmarking of EBIT margins for asset-light businesses, which we believe would likely result in a somewhat higher competitive level than the CMA's 1.25% and 1.9% figures.

How the cap varies with consumption

As a general principle, we believe that the balance between the standing charge and unit rate caps should reflect the underlying cost to suppliers. We set out our views of Ofgem's approach to setting the standing charge under each chosen methodology (the cap at nil consumption) in our responses to Appendices 2, 3 and 4. However, we are generally comfortable with Ofgem's approach. We also think Ofgem's proposal to continue to offer derogations for suppliers wishing to offer tariffs with zero or low standing charges is sensible.

We also agree with Ofgem's proposal to align the treatment of multi-register tariffs (other than Economy 7) to the approach used for the prepayment cap, whereby caps are based on assumed consumption splits, avoiding the complexity of specifying multiple caps. We would also support alignment of the timescales for determining the splits, as far as possible.

[4] A non-confidential version of which is here https://www.scottishpower.com/pages/retail_energy_market_baringa_report.aspx

Chapter 3 – updating the cap

Question 4: Do you agree with our proposals for how we will use cost data to update the cap?

In summary:-

The consultation process and transparency around smart meter rollout costs is seriously inadequate for such a vitally important area. Ofgem's preliminary estimates of SMNCC are far lower than our own cost forecasts but we cannot identify where the gaps have arisen.

Ofgem should disclose all non-confidential data relating to its assessment of smart meter rollout costs as a matter of urgency and establish a 'data room' process to allow confidential model details to be properly scrutinised.

We are concerned that the indexation of wholesale costs is not sufficiently comprehensive especially given recent increased volatility in the wholesale markets. Key components of direct fuel costs which may not correlate with the forward purchase costs should be indexed separately.

Ofgem must retain the ability to make discretionary changes in exceptional circumstances but subject to a materiality threshold.

If the cap is extended post 2020, smart rollout costs will need to be reviewed.

Updating the cap over time

We agree the level of the cap should be updated twice a year in line with the timescales for updating the existing safeguard tariff cap. We think this strikes the right balance between ensuring changes in costs are reflected in the cap level as quickly as possible and minimising uncertainty for consumers and operational costs for suppliers and Ofgem.

We have set out our views on Ofgem's proposals for updating each cost component of the cap under the relevant Appendices 6 to 12. While we are generally comfortable with Ofgem's approach, we would note the following points:

Smart costs

The treatment of smart meter rollout costs is one of the most important aspects of setting the default tariff cap and should be a particular area of focus for Ofgem. We agree in principle with Ofgem's proposal to include a separate smart metering cost index to reflect costs changes since the baseline (2017) with exogenous costs such as the DCC treated as pass-through, but we are concerned that Ofgem's initial estimates of cost changes significantly under-estimate the actual costs of rollout.

However we are concerned that the preliminary estimates that Ofgem has presented of smart meter net cost change (SMNCC) are far lower than our own cost forecasts but there is no way for us to identify where the gaps have arisen from the information provided in the consultation.

It is normal practice in price controls - and indeed a basic requirement of administrative law and regulatory good practice - for there to be a process of iteration, where the regulator sets

out its evidence, assumptions and analysis in a transparent way, and parties have an opportunity to challenge and critique. Given the lack of precedent for analysing smart costs, and the materiality of the net costs (in ScottishPower's case peaking at £[✂]m per annum during the initial period of the proposed cap) there is a pressing need for a meaningful and detailed process of consultation.

In our view Appendix 10 does not provide the level of detail and transparency which Ofgem should be consulting on at this stage in the process. We recognise that some of the input data is commercially confidential, but not to the extent it cannot be anonymised or aggregated in this consultation. We see no reason why Ofgem should not immediately share non-confidential information which is essential to forming a meaningful understanding of allowances proposed for net costs of smart metering, including:

- the average rollout profile from 2018 to 2020;
- the costs and benefits estimated for each year broken down into the BEIS cost and benefit categories and how these have changed following Ofgem's use of input data from Annual Supplier Returns 2017;
- the data and assumptions that have informed the calculation of the "pass through" costs (relating to DCC, Alt Han Co, SECAS, SEGB and SMICoP).

The above will assist us in identifying where there may be a divergence between Ofgem's model (as defined in Appendix 10) and actual costs and benefits. But in order to provide an appropriate level of critique of this model, we believe Ofgem should also adopt a 'data room' process similar to that used successfully in the CMA EMI.. We have written to Ofgem separately on this point and note that access to the model and associated confidential data would be granted to suppliers' economic advisers subject to strict non-disclosure conditions, and the advisers would report direct to Ofgem with their analysis. This 'data room' process could extend beyond the end of the policy consultation.

Given the criticality of this aspect of the policy consultation, we believe it is essential that Ofgem makes the data and models (ie the model described above and any separate model used to derive the competitive benchmark) available as soon as practicable. Suppliers and other stakeholders should then have a reasonable period to review the model and relevant data and provide feedback to Ofgem.

Wholesale costs

It is important that the cost allowance for the forward purchase element of direct fuel costs is based on a well-defined and transparent hedging strategy. In our view, Ofgem's proposed approach to indexation is too simplistic and wrongly assumes that all purchases are made on a forward basis. There are important components of direct fuel costs (shaping costs, imbalance costs, forecasting errors, unidentified gas, etc) which may not correlate with the forward purchase costs that drive the proposed index, and which may need to be indexed separately. (Furthermore, if these other cost are not accounted for properly, they may result in an under-estimate of bottom-up costs.)

Dealing with uncertainty

The default tariff cap will cover more than 50% of the market (with an indirect impact on the rest of the market) compared to the ~15% covered by the prepayment cap. Therefore, if there is any significant error in the cap methodology including the estimation of costs, the impact on suppliers could be very severe.

Ofgem has considered three approaches to dealing with uncertainty in the cost forecasts used for the cap: an automatic correction mechanism, a discretionary process to adjust the cap and no correction mechanism. We understand the difficulties involved in designing an automatic mechanism and would not support a 'routine' adjustment mechanism. However, we think it is important that Ofgem retains the ability to make discretionary changes in exceptional circumstances, eg where obligations on suppliers have been changed or forecasts turn out to be substantially wrong. Ofgem should specify in advance a materiality threshold for such changes.

Review at 2020

Given the current uncertainty as to what smart rollout obligations may persist beyond December 2020, calculating the SMNCC beyond that date will be very difficult. If the cap is to be extended post 2020, the treatment of smart rollout costs will need to be reviewed at that point.

Implications for default fixed term tariffs

There is a risk that introduction of a price cap will reverse the good progress that ScottishPower and other suppliers have made in defaulting customers at the end of a fixed term contract onto a fixed term tariff instead of SVT. (This results in improved customer engagement as result of the annual end of fixed term prompt.) We would welcome confirmation from Ofgem that the default tariff cap will count as a suitable external index for the purposes of SLC22C.11, so that suppliers can offer fixed term default tariffs at a specified discount to the cap.

Chapter 4 – potential exemptions from the cap

Question 5: Do you agree with our assessments of whether an exemption for tariffs that appear to support renewable energy is necessary and workable?

In summary:-

We agree with Ofgem's approach to meeting its obligations under the Bill for tariffs supporting renewable energy.

We agree with Ofgem's proposal not to provide an automatic exemption for tariffs supporting renewable energy but instead to allow a supplier to apply for a derogation where it wishes to offer such a tariff. We think the criteria that Ofgem would consider when granting such exemptions are appropriate and should ensure that tariffs granted exemptions demonstrate true additional benefit to renewable energy production.

Chapter 5 – conditions for effective competition

Question 6: Do you have any views on what information we should use to assess the conditions for competition?

In summary:-

We welcome Ofgem's acknowledgement that it will not be able to monitor whether the characteristics of effective competition are in place while the cap itself remains.

We agree with Ofgem's assessment that it will not be able to monitor whether the *characteristics* of effective competition are in place while the cap itself remains. In particular, the existence of the cap is likely to decrease the level of customer switching as a result of reduced price dispersion and consumers feeling "safe" and "protected" by the capped tariff. This acknowledgement echoes industry wide concerns that the challenge of lifting the cap by reference to an assessment of competition will prove difficult, such that there is an unintended risk that the cap may be left in place indefinitely.

Ofgem therefore proposes to look at a range of supply side and demand side indicators to assess whether conditions for effective competition are in place. We believe that much greater thought will need to be given to these indicators over the coming years. Ofgem's initial list of demand side indicators (progress with the faster switching programme, initiatives to allow easier sharing of data, and Ofgem's trialling programme for prompting consumers to engage) seems sensible. These are all changes that will support greater engagement by consumers and hence competition, and are achievable within the timescales for the price cap to be removed.

We also think some of Ofgem's supply side measures (eg entry by innovative players using new technologies such as mobile and smart) are potentially suitable, but would encourage Ofgem to be cautious in setting too much store by more radical changes to market structure, such as moving away from the 'supplier hub' model. While we agree that Ofgem should be considering such changes for the longer term, we are concerned that the timescales may not be compatible with the envisaged end date for the cap, particularly if new legislation and/or major redefinition of industry relationships are required.

We would ask that Ofgem fully consult and engage on the methodology to be used in its ongoing reporting and, separately, consult on the basis and methodology to be used for the statutory review in 2020.

Annex 1

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 1 – MARKET BASKET
SCOTTISHPOWER COMMENTS

Chapter 1 – Overview

Question A1.1: Do you agree that we should not further consider the use of a market basket to set the initial level of the cap? We set out our reasoning in Chapter 3.

We agree that Ofgem should not further consider the use of a market basket to set the initial level of the cap. We have previously set out our concerns about the use of a market basket to set the initial level of the default tariff cap (in our response to Ofgem's December consultation and to Ofgem's first and second working papers) – notably the susceptibility to gaming, the risk of volatility, the difficulty in specifying *ex ante* the design of the basket and the fact that this approach has never been tried before in the UK.

Question A1.2: Do you agree that we should not further consider the use of a market basket to update the cap over time? We set out our reasoning in Chapter 4.

We agree that Ofgem should not further consider the use of a market basket to update the cap over time. We set out our concerns in our response to working paper 2 that using a market basket to update the cap over time could expose suppliers to significant risk that changes in the market basket do not reflect changes in costs. We therefore agree with Ofgem's conclusion that this is not a suitable method for updating the cap over time.

Annex 2

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 2 – ADJUSTED VERSION OF THE EXISTING SAFEGUARD TARIFF SCOTTISHPOWER COMMENTS

Chapter 3 - Our proposed approach for setting the cap

Question A2.1: Do you agree with, or have views on, our approach to adjusting the CMA's methodology to make its benchmark appropriate for the default tariff cap? In particular, how we propose to address: additional standard credit costs, existing overheads and customer acquisition adjustments, and other potential adjustments to operating costs.

Using an adjusted CMA benchmark to set the cap

We do not think that an adjusted version of the CMA's methodology should be considered for the default tariff cap but we agree with the advantage noted by Ofgem, that it is a familiar methodology for suppliers and other stakeholders who have had experience through the existing safeguard tariff. We explained why we thought this would be an inappropriate method for setting the cap in our response to Ofgem's December 2017 consultation and working paper 1, and Appendix 2 (paragraph 1.9) suggests that a number of stakeholders fed back similar views. Reasons why the CMA's benchmark would be inappropriate include:

- it uses a very small sample of only two suppliers (Ovo and First Utility);
- it was based on prices at a single date in June 2015;
- it will be more than three years out of date by the time the cap comes into effect;
- the CMA's adjustments for the characteristics of these companies (loss-making, growth phase, extent of ECO/WHD obligations etc), was not done in a transparent way and had to make do with limited historical data.

We believe Ofgem's proposed adjustments to the CMA's benchmark would need to be more significant than Ofgem is proposing to:

- ensure the level of the cap is applicable to the default tariffs it would apply to
- reflect the significant changes in the energy market since the safeguard tariff was implemented
- address areas where we believe adjustments made to the CMA's benchmark may not have been done in a transparent way or were based on limited historical data at that point.

In Appendix 2, Ofgem says it has considered adjustments to overhead costs, customer acquisition costs, smart metering costs and other potential cost variations. We note however, that Ofgem is undecided on its approach to overhead costs, and its minded to position suggests that the only adjustment Ofgem is currently proposing is to cover changes in smart metering costs since the CMA benchmark was set. While we agree that a review of smart metering costs is required whichever methodology is used (see our response to Appendix 10), we believe other significant adjustments are required to set the cap at a level that represents an efficient level of costs for suppliers.

We also note that Ofgem's analysis in some of the areas above relies on information sourced to support Option 4 (the bottom up cost analysis). Hence, if such detailed costs are being considered it is likely to be more robust to use a bottom up cost assessment (Option 4)

as the approach to setting the reference price, or completely reassessing the competitive reference price (Option 3).

Ofgem's proposed adjustments to the CMA's benchmark

We have the following comments on Ofgem's proposed adjustments:

(a) **Overhead costs**: We do not believe there is merit in Option 1 (do nothing, ie retain CMA downward adjustment) or Option 2 (remove CMA adjustment, leaving average of the two benchmark suppliers), as both continue to rely heavily on the CMA benchmark which we regard as inappropriate. Option 3 (Ofgem's own adjustment to the safeguard tariff reference price) would be a better reflection of an efficient level of overhead costs. We do not agree that a bottom-up cost assessment weakens this option due to asymmetries of information.

(b) **Customer acquisition costs:** We note that Ofgem is minded to maintain the current standardised approach to customer acquisition costs. The rationale and analysis in response to specific points raised by Oxera is also noted but Ofgem does not elaborate sufficiently to persuade us that the current customer acquisition cost adjustment would continue to be appropriate.

(c) **Smart metering costs:** Our views on potential variations in smart metering costs are in Annex 10.

(d) **Other potential cost variations:** Ofgem says it is not minded to make any adjustments for factors not related to efficiency or inefficiency. However, as we have set out above, we have concerns around the robustness of the underlying CMA adjustments which are not related to relative efficiency or inefficiency, and Ofgem should consider further adjustments before a final decision is made.

Chapter 4 - Our proposed approach for setting the cap at nil consumption

Question A2.2: Do you agree with how we propose to adjust the benchmark at nil consumption?

Ofgem's minded-to position for Option 2 is to replace the current safeguard tariff cap at nil consumption with one based on the standing charges of the SLEFs at 30 June 2015 for direct debit customers, and applying a payment method uplift for standard credit customers.

As a general principle, we believe the balance between the standing charge and unit rate caps should reflect the underlying cost to suppliers. We are comfortable with Ofgem's approach under this option for setting the benchmark at nil consumption. As Ofgem notes, this would better reflect the segment of the market the cap would apply to.

Chapter 5 – Updating the cap

Question A2.3: Do you agree with our proposed approach for updating the level of the adjusted safeguard tariff cap?

We agree in principle with the proposed use of exogenous indexation to update the default tariff cap. However, the approach will only be effective if the baseline and the indices are fit for purpose. In that regard, we would be concerned if Ofgem's default position is to maintain alignment with the methodology used to update the prepayment (PPM) price cap.

We have particular concerns with the indexation used to update the CMA's PPM price cap where a single index based on forward market price is used to update the *total* direct fuel cost. This ignores the fact that there are a number of components in the cost stack which are unlikely to track this index. We elaborate further in our response to Appendix 6 on wholesale costs but it underscores our general concern that exogenous indexation could easily be undermined by inappropriate indices.

Annex 3

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 3 – UPDATED COMPETITIVE REFERENCE PRICE
SCOTTISHPOWER COMMENTS

Chapter 2 - Our proposed approach for setting the cap

Question A3.1 Do you agree with our proposed approach for an updated price reference approach? In particular, how we select price data and exclude suppliers or adjust data.

Using an updated competitive reference price to set the cap

As we set out in response to Ofgem's working papers 1 and 5, we think Ofgem would likely face the same challenges setting an updated competitive reference as the CMA did (choice of comparators and transparency of adjustments) albeit with less room for error given the wider market coverage. We therefore do not think it is an appropriate methodology for setting the level of the cap and we continue to believe that the bottom up cost assessment methodology is most likely to ensure the level of the default price cap is accurate.

If Ofgem were to use this approach to set the efficient benchmark, we think its proposal to widen the sample of companies used is helpful, but we have significant concerns about Ofgem's minded-to position on selecting suppliers for the benchmark, as set out in response to Question A3.2 below.

Supplier selection criteria and adjustments

Ofgem says in Chapter 1.2 of Appendix 3 that "suppliers with more competitive prices should be more likely to represent an efficient level of costs". Such a generalisation can only be valid if the suppliers concerned are operating in a sustainable manner. We therefore agree it is essential that (as proposed in para 2.18) Ofgem adjusts the revenues of selected companies to achieve an EBIT margin commensurate with a normal rate of return.

As explained below, this revenue adjustment needs to be done separately for electricity and gas, to ensure that both are adjusted to the same EBIT margin.

We agree that the only viable approach (as recognised by the CMA) is to use a 'request for information' (RFI) to determine the *average* price charged by selected suppliers ie averaged across all their customers, and preferably over more than one point in time. It would be entirely inappropriate to base the benchmark on a particular subset of tariffs.

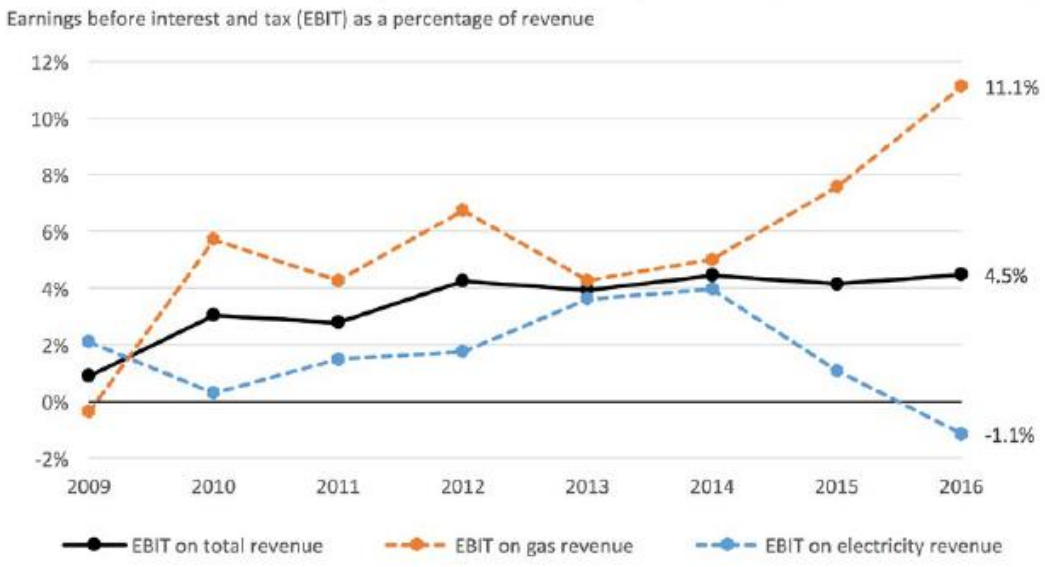
We agree in principle with Ofgem's intention to include suppliers who are relevant market-wide comparators and exclude suppliers who have low customer engagement, niche business models, failed compliance requirements and suppliers without reliable data.

EBIT adjustment – gas versus electricity

As shown in the figure below, taken from Ofgem's 2017 State of the Market report[5], the last few years have seen EBIT margins for the SLEFs significantly higher in gas than electricity.

[5] https://www.ofgem.gov.uk/system/files/docs/2017/10/state_of_the_market_report_2017_web_1.pdf

Figure 2.10 Profits of the six largest suppliers before interest and tax as a percentage of sales, 2009-2016



Source:

Ofgem analysis of Consolidated Segmental Statements.

This trend continued into 2017, with an average gas margin of 9.1% versus 0.4% for electricity (see table below).

Domestic net EBIT/Revenue % (UK Supply business)								
	SP	**Centrica**	**E.ON**	**EDF**	**RWE**	**SSE**	**Flat Average**	**Weighted Average**
Domestic Total								
2017	0.5%	8.0%	5.2%	0.9%	(4.9%)	6.8%	2.8%	4.2%
2016	5.2%	7.2%	6.8%	(0.9%)	(6.3%)	6.9%	3.2%	4.5%
2015	5.7%	7.0%	4.4%	(0.7%)	(6.8%)	6.2%	2.6%	3.9%
2014	5.8%	5.3%	4.6%	(0.2%)	2.7%	6.0%	4.0%	4.4%
Domestic Electricity								
2017	(0.9%)	(1.5%)	1.9%	0.8%	(4.5%)	5.1%	0.1%	0.4%
2016	3.0%	(3.9%)	3.0%	(2.8%)	(9.0%)	1.8%	(1.3%)	(1.1%)
2015	5.7%	(0.2%)	4.0%	(1.3%)	(7.0%)	2.8%	0.7%	1.0%
2014	8.2%	1.4%	5.0%	1.5%	2.0%	6.1%	4.0%	3.9%
Domestic Gas								
2017	2.5%	15.4%	10.7%	1.1%	(5.4%)	9.8%	5.7%	9.1%
2016	8.4%	15.1%	12.4%	2.4%	(2.5%)	15.1%	8.5%	11.1%
2015	5.7%	11.7%	5.0%	0.3%	(6.4%)	11.4%	4.6%	7.3%
2014	2.4%	7.8%	4.2%	(3.3%)	3.5%	6.0%	3.4%	4.9%

The reason for this asymmetry in EBIT margins between gas and electricity is unclear. It may in part be due to relative movements in wholesale gas and electricity costs in the period (and lags in retail prices responding), but it seems likely that part of the reason may be the strength of Centrica's position in the market and its ability as the only former gas incumbent to set a 'price to beat' for gas.

Whatever the reason for this distortion, it seems likely that medium and smaller suppliers will have been influenced by the same market conditions and will also on average have made higher margins in gas than electricity. Given the size of this imbalance, it is vitally important that Ofgem makes appropriate adjustments in its reference price process. At the end of the

process when it comes to adjust revenues to bring them back to a normal EBIT margin**, this adjustment must be done separately for gas and electricity.**

It is particularly important that Ofgem avoids setting the cap too high for gas (and correspondingly too low for electricity) given the greater likelihood that in extreme cold weather conditions, customers will be hit by unexpectedly large gas bills – which can cause particular difficulties for the fuel poor.

Chapter 3 - Key judgements

Question A3.2 Do you agree with the judgements we set out regarding consumer engagement, policy and wholesale costs, and constructing the benchmark?

We set out our comments on each of these judgements below.

Issue 1: Consumer engagement

Ofgem is minded to adopt its 'Option 4' in which it would exclude suppliers who have:

- less than 50% of non-prepayment customers on fixed term tariffs; and
- more than 25% of non-prepayment customers on a SVT for more than 3 years.

ScottishPower has around 61% of non-prepayment customers on a fixed term tariff (of which 6% are on fixed term default tariffs) and around 18% of non-prepayment customers on a SVT for more than 3 years. We would therefore expect ScottishPower to be included in the updated benchmark on the basis of these criteria. We think this is reasonable, given that ScottishPower has been the most successful of the SLEFs in encouraging customers to move off SVT onto fixed term tariffs, and (based on the Consolidated Segmental Statements (CSS)) has the lowest indirect costs per customer of the SLEFs.

We agree that Option 4 is the best of the four options Ofgem has considered. We think any approach that includes only a subset of cheaper tariffs in the benchmark, such as Option 1, would be totally inappropriate as these tariffs may not fully reflect suppliers' fixed costs.

As noted under Issue 4 below, we do have a concern that, in combination, *excluding* suppliers with low consumer engagement and *selecting* suppliers with the lowest costs may result in an excessively narrow focus on the very lowest cost suppliers.

Issue 2: Adjustment for policy costs

We agree with Ofgem's proposed approach to adjusting for policy costs and are pleased that it has recognised the need to adjust for 'lag' effects when suppliers are growing in size.

Issue 3: Adjustment for wholesale costs

We agree that there would be practical difficulties in replacing suppliers' actual wholesale costs with Ofgem's view of wholesale costs based on market data (Option 2) and that Ofgem should reject this option.

However, great care is needed if Ofgem is to proceed with Option 1 (do nothing). Wholesale costs can vary widely between suppliers depending on the hedging strategy that they have adopted and how well or badly that strategy has turned out in the light of market movements. Although some suppliers may be more efficient than others in their wholesale energy procurement, the vast majority of cost variances will come down to timing not efficiency. Analysis performed in the context of the CMA EMI showed that while the hedging strategies

of the SLEFs had performed worse than the CMA's alternative benchmark over the period initially considered by the CMA, when the analysis was done over a later period they performed better.

This is particularly important if Ofgem is proposing to use a reference date of end 2017, since markets have been relatively volatile over the last year (exacerbating the differences between hedging strategies) and because SLEFs, medium and small suppliers have typically adopted rather different strategies, with SLEFs tending to hedge significantly further forward than small suppliers.

We have previously argued that the only practicable way to address this issue is to average over a sufficiently wide and representative set of data points to ensure that these variances will average out. We would suggest that the sample needs to:

- include at least 10 and preferably 20 different suppliers
- be averaged across at least two different points in time, chosen with regard to market conditions;
- include a representative mix of SLEFs, mid-tier and small suppliers (ideally weighted on the basis of percentage of customers on SVT, since hedging strategies for SVT are more likely to align with Ofgem's proposed indexing scheme than hedging strategies for fixed term products).

Although Ofgem says (para 3.23) "we agree that [wholesale costs] may be one factor influencing our view on how many suppliers to include", we are concerned that Ofgem is not giving this matter sufficient weight. **Achieving effective averaging of wholesale costs should be a key consideration for the number of suppliers selected in the final benchmark (Issue 4).**

Issue 4: Number of suppliers selected in the final benchmark

Ofgem says it is minded to include at least two suppliers in the benchmark and at most half of the remaining suppliers (after exclusions) – in each case selected on the basis of the lowest prices after adjustment. We disagree with this minded to position on two grounds and believe Ofgem should be adopting Option 4 (all suppliers remaining after exclusions).

- Our first ground is that (as explained under Issue 3 above), it is vital that the benchmark is based on a sufficiently wide sample of suppliers to average out the effects of different wholesale energy procurement strategies. Selecting only two suppliers would be totally inadequate as they may very likely have adopted similar hedging strategies. Even including half of the remaining suppliers may result in under-representation of SLEFs, who tend to have different hedging strategies from small suppliers (and whose hedging strategies are likely to be better aligned with the CMA indexing methodology).

- Our second ground is that, taken in combination, Ofgem's approach of (a) excluding suppliers on grounds of engagement and (b) making a final selection based on lowest adjusted costs will result in an excessively narrow focus on the very lowest cost suppliers. The legislative provisions for the cap were strongly influenced by the CMA's (disputed) finding of £1.4bn pa consumer detriment, of which it claimed much was down to inefficiency on the part of the SLEFs. Ofgem's proposal to exclude suppliers on the basis of customer engagement will mean that the SLEFs most likely to be inefficient will already have been excluded. The long-list of included suppliers should therefore already provide a representative efficiency benchmark when taken on average. Averaging over the lowest 50% of included suppliers would be

equivalent to setting a lower quartile benchmark, where the population has already been pre-selected (by exclusions) to be more efficient than average.

Ofgem justifies its decision on the basis that using fewer suppliers would allow it to focus more on understanding the companies and making the correct adjustments (para 3.28). Given that the adjustments need to be made *before* the selection (since the selection is based on adjusted costs), we cannot see how this would work in practice. Ofgem also justifies its decision (para 3.30) on the basis that Option 4 could result in a benchmark that was a long way from the efficiency frontier and deliver insufficient consumer protection. As explained above, Option 4 would be equivalent to taking the average cost of a set of suppliers which already excludes the suppliers which (according to the CMA's assessment) account for the majority of the inefficiency identified by the CMA. It should therefore provide a good level of consumer protection and incentive to improve efficiency.

Issue 5: Weighting of suppliers within the initial benchmark

We disagree with the minded to position to use a simple average to weight the suppliers included in the benchmark, so that they have equal weight.

There is a serious risk that a simple average will be skewed by low outliers, eg where unusual circumstances have not been fully adjusted for in the methodology. The risk is asymmetric as high outliers will already have been screened out. This risk is particularly acute with a final sample size of two, but is still a problem even with the much larger sample size that we have argued for above (Issue 4).

On balance we consider that a weighted average is likely to be more robust. As explained in our response to working paper 5, a weighted *median* approach would best avoid the risk that the average is dominated by unrepresentative outliers.

Chapter 4 – Approach at nil consumption

Question A3.3 Do you agree that, under an updated competitive reference price approach, we should set the benchmark at nil consumption using the adjusted standing charges from the same suppliers included in the benchmark at typical consumption?

We agree that Ofgem should set the benchmark at nil consumption using the adjusted standing charges from the same suppliers included in the benchmark at typical consumption (Option 1).

Chapter 5 - Approach for updating the cap

Question A3.4 Do you agree with our approach to weighting the benchmark at TDCV and nil consumption?

Ofgem is proposing to weight the benchmark at TDCV using absolute values developed under the bottom-up cost assessment for wholesale costs and environmental and social costs. It would then subtract these from the updated competitive reference price, treating the residual as an estimate of operational costs and normal rate of return (Option 1b). This approach seems reasonable.

In weighting the benchmark at nil consumption Ofgem is proposing to assume that all social and environmental costs are zero at nil consumption. Ofgem acknowledges that this is not

the case for WHD costs, which scale with the number of customers, but we agree that this approximation is probably acceptable given the relative magnitude of WHD costs.

Annex 4

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 4 – BOTTOM-UP COST ASSESSMENT
SCOTTISHPOWER COMMENTS

Chapter 1 – Overview of the approach

Question A4.1: Do you agree with our assessment of the advantages and disadvantages of a bottom-up approach to estimating an efficient level of costs?

As we stated in our response to Ofgem's working paper 1, we think that a bottom-up approach to estimating an efficient level of costs offers a number of advantages over other methods. We agree with Ofgem that this approach provides greater confidence in which costs are included in the cap and how these costs are treated, and that it avoids the key challenges inherent in using price data where supplier pricing strategies may mean prices are not a valid estimate for supplier costs. We also think this approach offers greater transparency and makes it easier for Ofgem to demonstrate that it has appropriately balanced the matters set out in Clause 1(6) of the Bill. Another advantage of a bottom-up cost assessment is that it would be easier to communicate to stakeholders.

We also note that if Ofgem were to use another methodology to set the level of the cap, it intends to use an assessment of bottom-up costs to inform particular areas of these approaches. We agree with this, as supplier information is likely to be the most accurate source of actual supplier costs, particularly for smart meter costs and direct fuel costs.

We recognise the challenges that this approach would present, for example the potential for different suppliers to categorise or treat different costs in a different manner. However, we think many of these can be mitigated by Ofgem's approach to sourcing information from suppliers. In particular, Ofgem has already requested a large amount of supplier cost data including assessing differences in cost treatment. We therefore expect that Ofgem may have sufficient information to make the required adjustments to the dataset in order for this approach to be used for setting the cap. We have previously noted the cost categorisation within the CSS would be a sensible approach to use. All the large suppliers have reported on this basis for a number of years, so comparisons can readily be made, and we note Ofgem used this as a basis for the recent information request.

Chapter 2 – Categories of costs

Question A4.2 Do you agree with our proposed approach to categorising different costs under a bottom-up cost assessment approach to setting the default tariff cap?

We generally agree with Ofgem's proposed cost categorisation and have provided more detailed comments on the proposals within our responses to the relevant appendices and in particular, our responses to Appendices 7, 8, 9, 10 and 12.

Annex 5

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 5 – UPDATING THE CAP OVER TIME
SCOTTISHPOWER COMMENTS

Chapter 1 – Approaches to updating the cap

Question A5.1: Do you agree with our proposal to update the cap in line with trends in exogenous cost drivers?

As set out in our response to Appendix 1 on the market basket approach, we agree that this is unsuitable for updating the cap over time.

As Ofgem notes, using realised supplier costs would be the preferred methodology to ensure that all costs are included in setting the level of the cap. Ofgem's concerns centre around the potential to lessen supplier incentives to reduce costs and the risk that this will result in a higher cap. However, we are not convinced that this risk is material given suppliers will naturally have an incentive to reduce costs to compete for customers on fixed term tariffs. We do however think that this methodology could be particularly onerous from an operational perspective for both suppliers and Ofgem.

We agree with Ofgem's stated benefits for using exogenous cost drivers to update the cap and therefore on balance agree with Ofgem's proposal to use this methodology to update the cap over time.

Chapter 2 – Our proposal

Question A5.2: Do you agree with our proposed choice of cap and baseline periods?

Price Cap Periods

We agree with Ofgem's proposal to update the level of the cap twice a year in line with the timescales for updating the existing safeguard tariff cap. We think this approach strikes the right balance between ensuring changes in costs are reflected in the cap level as quickly as possible, and in minimising uncertainty for consumers and operational costs for suppliers and Ofgem.

Baseline Periods

We comment in more detail on the baseline period for each methodology in our response to the relevant appendix on methodology (annexes 2, 3 and 4) and on costs (annexes 6 to 12).

Chapter 3 – Dealing with uncertainty

Question A5.3: Do you consider that further provision is required for us to re-open aspects of the design of the cap, beyond our licence modification powers – and if so, why?

The default tariff cap will cover a much larger proportion of the energy market than the prepayment price cap and safeguard tariff cap (>50% compared to circa 15%). Therefore, if there is any significant error in the cap methodology, the impact on suppliers and therefore

other consumers in the market will be much greater. We therefore think it is important that Ofgem considers how any significant and/or unforeseen changes either in costs and/or market structure that creates a material divergence in costs and the level of the cap would be managed, including where the impact would result in higher or lower costs compared to the cap. We set out our thinking under Ofgem's two areas of consideration of risk below.

Systematic design issues

We agree with Ofgem that the Bill provides sufficient powers for Ofgem to make supplemental licence modifications to capture any required changes to the default tariff cap methodology where it systematically or materially departs from the efficient level of costs. There is however no detail on how Ofgem proposes monitoring this throughout the period the price cap is in place to understand when such changes would be needed, or how Ofgem would manage such a process of review and consultation. We would welcome more detail from Ofgem on this at the next stage of consultation.

It is important however that suppliers have as much certainty over the methodology as possible and therefore, while we agree that there should be a process to update the cap methodology where a material divergence from costs is identified, it is important that Ofgem's current assessment of the preferred methodology identifies the one that will most accurately track supplier costs in the absence of unforeseen material changes to market circumstances.

The Bill requires Ofgem to assess in 2020 whether the cap should be extended based on whether conditions for effective competition are in place. Given the potential for change in the energy market, eg relating to policy for social and environmental issues or smart rollout obligations post 2020, we think a full reassessment of the methodology should be undertaken at that point if the cap is to be extended.

Forecast uncertainty

If the price cap methodology is robust, the risk of material forecast error should be low assuming no significant changes to the market structure (which in any event could be managed via a change to the licence conditions as set out above).

We agree with Ofgem's decision not to include a routine mechanism for truing the level of the cap up or down based on actual costs incurred. However we do think it is important that Ofgem retains the ability to make discretionary changes in response to exceptional circumstances or events. (For example, the insolvency of the DCC is an unlikely event which could have significant cost implications for suppliers if it were to happen, and which we would expect Ofgem to deal with on a discretionary basis or using its existing powers). Ofgem should specify in advance a materiality threshold for such changes.

Annex 6

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 6 – WHOLESALE COSTS
SCOTTISHPOWER COMMENTS

Chapter 3 - Setting the initial wholesale allowance

Question A6.1: Do you agree with our approach to setting the wholesale allowance? In particular using 2015 for the base period of the adjusted existing safeguard tariff approach.

Adjusted Safeguard Tariff

For the purpose of the adjusted safeguard tariff approach Ofgem does not propose to make any adjustment to the wholesale cost allowance. We disagree with this approach and believe that Ofgem should be looking at adjustments to take account of unforeseen changes in wholesale costs between 2015 and the present, including changes resulting from:

- cash out reform
- unidentified gas (UIG).

Updated Competitive Reference Price

As with the adjusted safeguard tariff approach, Ofgem is not proposing to make any adjustments. Given that the competitive reference price would be based on more recent tariffs (end 2017 proposed) this seems more reasonable.

Bottom Up Approach

For the bottom up approach Ofgem is proposing to use a version of the CMA model to calculate the costs of energy, subject to appropriate adjustments being made to account for all the various components that make up the wholesale costs and not just forward contracts. This sounds sensible, but it will be important for Ofgem to undertake a more thorough analysis of these additional costs, including:

- Costs associated with forecast variances, including costs of adjusting position up to gate closure and imbalance costs (which have increased as a result of changes to cash out arrangements). Typically on cold days additional volumes are bought at 'high' prices and on warm days excess volumes are sold at 'low' prices. This was clearly demonstrated in early March 2018 when very high demand contributed to the £5 per therm gas price.

- Shaping costs, ranging from half-hourly shaping within day to monthly shaping within season. The CMA's forward index approach systematically under-estimates the costs of winter season energy because winter consumption is weighted heavily towards the winter peak months (Dec to Feb) where prices are higher. Adjusting purchased volumes to match monthly demand therefore incurs a significant additional cost. Similar issues arise in shaping the daily consumption profile to match peak demand.

- Unidentified gas (UIG). In contrast to electricity losses which are reasonably predictable, the costs of unidentified gas (UIG) are volatile and unpredictable, and

there is evidence to suggest they may have increased significantly following project Nexus. Xoserve estimated the annual average cost of UIG at around 1% prior to Project Nexus but we estimate that since June 2017 UIG volumes have averaged above 5% and spiked on occasions to over 10% with resultant increase in UIG costs. Furthermore, UIG costs are likely to vary by supplier according to the distribution of their customers across LDZs. Given that this is not a matter of efficiency; the allowance for UIG costs should be based on the supplier with the highest UIG costs.

Chapter 4 - Updating the allowance

Question A6.2: Do you agree with our approach to updating the wholesale allowance?

Ofgem is proposing to update the wholesale cost allowance on a 6 monthly basis, using the CMA's indexing methodology (or a variant thereof). We agree that a 6 month update frequency is appropriate, and comment in response to Question A6.3 on possible variants of the CMA indexing methodology.

Our main concern about Ofgem's proposed approach is that it does not account for the fact that there is a significant component of wholesale energy costs which is not necessarily well correlated with movements in forward energy prices, such as costs associated with forecast errors, shaping and imbalance. In general, these costs will increase as weather conditions (or other drivers of demand) become more unpredictable and as wholesale market prices become more volatile. For example, there is reason to believe that extremes of wholesale prices (such as were seen in early March 2018) may arise more frequently as coal-powered generation is phased out and the UK gas market becomes more dependent on imports. There is no reason why changes in these costs should be correlated with the index developed by the CMA – indeed they could potentially move in opposite directions. As part of its bottom-up modelling we would suggest that Ofgem obtains data on how these costs have evolved over time and conducts analysis to test whether there are any discernible trends.

For example, the volatility in half hourly electricity and daily gas prices represents a significant risk for all suppliers and a back-test of the historic financial impact of this volatility would provide a guide for the magnitude of the impact of shaping costs but should also take account of any expected increase in price shape volatility. This could then be used to calculate the risk allowance required for shaping risk to be applied to the forward index. The costs of forecast variance including the allowance for imbalance costs could also be based on a historical simulation of the imbalances that would have been incurred under the assumed hedging strategy, with an appropriate allowance for risk.

Chapter 5 - Adjusting the CMA's model and setting allowances - Bottom up and update approaches

Question A6.3: Do you agree with our proposed approach to use a semi-annual cap period, compared with a 6-2-12 annual model, or shorter observation period? Please explain how the alternatives would affect you, if we were to choose those options instead.

We agree that there is potentially a trade-off between more frequent updates to the cap (which requires greater administration on the part of Ofgem and suppliers) and less frequent (which creates additional commercial risk for suppliers). Given the wider market coverage of the default tariff cap it is particularly important that commercial risk to suppliers is minimised. We would therefore not support an update cycle less frequent than every 6 months.

We agree with Ofgem that the mismatch between the time horizon for indexation (forward contracts covering an annual period) and the duration of the charge restriction period (6 months) creates some risk for suppliers. We believe this risk of mismatch could be mitigated by including 50% of the indexed price for each 2nd season of the index period in the next subsequent annual index. An illustrative example is shown below (where equal weightings between Summer and Winter are used to simplify the illustration)

SVT Proposal		Index period	Win 18	Sum 19	Win 19	Sum 20	Win 20
Sum 19	Index	Feb 18 - Jun 18		£40.00			
	Index	Jul 18 - Jan 19		£45.00	£65.00		
	Cap			£53.75			
Win 19	Index	Jul 18 - Jan 19			£65.00		
	Index	Feb 19 - Jun 19			£60.00	£45.00	
	Cap				£53.75		
Sum 20	Index	Feb 19 - Jun 19				£45.00	
	Index	Jul 19 - Jan 20				£47.50	£60.00
	Cap					£53.13	

In this example, the Summer 19 Annual Index Price = 25% of Summer 19 seasonal price (as indexed Feb 18-Jun 18) plus 25% of Summer 19 seasonal price (as indexed Jul 18-Jan 19) plus 50% of Winter 19 seasonal price (as indexed Jul 18-Jan 19), ie 50%*(50%*£40+50%*£45)+50%*£65=£53.75. (The pricing for the initial index period would require a separate, one off arrangement.)

This indexing approach has two advantages. First, the indexation can be hedged more effectively by suppliers, thereby reducing exposure to significant market price movements between indexation windows. Second, it would smooth the impact of seasonal market price movements on the cap price, providing a benefit to the end customer.

Question A6.4: Do you agree with our approach to modelling forward contracts? In particular: that initial shaping should be based on a 70-30 spilt between baseload and peakload, and the cap will be semi-annual. If not, please provide evidence to support alternative approaches.

Yes, we generally agree with the proposed approach to modelling of forward contracts with initial shaping based on a 70-30 split between baseload and peakload.

However, as stated in our response to question A6.1, our main concern in relation to calculating the energy cost component is that the existing methodology is too simplistic and wrongly assumes that all purchases are made on a forward basis, which is not the case and can lead to an underestimation of suppliers' costs. We therefore think that an additional allowance should be made for shaping based on products relating to other delivery periods (including spot markets).

Ofgem could calculate the additional allowance for shaping by performing an analysis, using industry data available to Ofgem, to identify the difference between the forecast and actual domestic customer offtake, and pricing this against the difference between the APX spot (or day-ahead) price and the CMA forward index. Given Ofgem's access to the necessary data we believe it would be best placed to carry out this analysis.

Question A6.5: What are your views on the necessity and size of an additional allowance for shaping and imbalance costs? Please provide evidence to support this.

As noted in response to Question A6.1, We believe that there is a need to include an additional allowance for both shaping and imbalance costs. This allowance should then be subject to indexation based on observed trends over time.

An analysis of historic imbalance costs for suppliers should be available to Ofgem from their previous significant code review on electricity balancing (and Elexon's subsequent studies under P305) which could be used to set a baseline for an imbalance costs allowance. This could then be adjusted to reflect expected changes in imbalance price, for example the change from Price Average Reference (PAR) 50 to PAR 1 in November 2018 will increase the imbalance costs faced by suppliers and would need to be reflected in the forward imbalance allowance.

Question A6.6: What are your views on the necessity and size of an additional allowance for transaction costs relating to brokers and collateral?

We agree that in any bottom-up approach there is a need to consider non-energy costs such as broker and exchange fees, costs of operating a trading desk and costs of credit and collateral. However, we would suggest these costs should not be included in wholesale costs but as a separate line within operating costs. The costs will vary significantly from supplier to supplier (eg SLEFs have market-making obligations under Ofgem's Secure and Promote policy) and while a single allowance will never represent the full range of costs incurred it will at least acknowledge these necessary costs.

Question A6.7: Do you agree that our approach to updating the benchmark for the first cap period is appropriate?

Yes, we agree that if the cap has to be in place by 1 January 2019 the proposed 6-3-12 three-month approach is appropriate.

Annex 7

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 7 – POLICY AND NETWORK COSTS
SCOTTISHPOWER COMMENTS

Chapter 3 - Estimating the costs of environmental and social obligations in 2017/18

Question A7.1 Do you agree with the way we propose to estimate the costs of each of the schemes for setting the baseline level of the cap?

We agree that cost estimates for each of the schemes should make use of scheme operator data as this is likely to be the most robust and up-to-date source. However, the calculation must be sufficiently flexible to reflect the outcome of any new changes in policy or scheme design which may affect the scheme operator figures.

We agree the level of the cap should be set to reflect the policy costs which would be incurred by a fully obligated supplier in steady state.

Chapter 4 - Estimating trends in the costs of environmental and social obligations

Question A7.2 Do you agree with our proposed approach to forecasting the costs of each scheme?

We agree that it will generally be appropriate to forecast costs with reference to the latest BEIS Impact assessments (IA) and forecasts for each appropriate cost element. It is important however that any IA used as the basis of a forecast is updated promptly where there is any evidence that costs are likely to be different from forecast.

Question A7.3 Do you agree with the data sources that we propose to use to forecast the expected demand base for each scheme? Do you have any alternative suggestions which would more accurately track trends in eligible demand?

We agree that the data sources proposed to forecast the expected demand base for each scheme appear appropriate and consistent across suppliers. There is however significant dependency on BEIS consultation and IA outcomes within these approaches, and it is important that these are reviewed promptly to drive calculation of eligible demand.

Chapter 5 - Network charges

Question A7.4 Do you agree with our proposal to use the existing model to estimate the network costs that suppliers incur?

We agree that the existing network cost model is an appropriate way to estimate the network costs that suppliers incur. The basis of the model should be reviewed at least twice a year to reflect any potential mid-year adjustment, which remains a possibility within transmission costs.

We agree that it is appropriate to include supplier of last resort (SoLR) payments within the network costs allowance, as this is a component of DUoS charges.

Question A7.5 Do you have any views on the impact of using information on the average share of consumption that takes place in peak periods to estimate electricity transmission charges?

Given that Ofgem is proposing to set different caps for customers with single and multi-register meters, it would make sense in principle to calculate separate electricity transmission costs for these different categories of meter, taking into account their different shares of consumption in the relevant peak periods.

Annex 8

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 8 – OPERATING COSTS
SCOTTISHPOWER COMMENTS

Chapter 2 – Estimating an efficient level of operating costs

Question A8.1 Do you agree with our proposed approach to estimating suppliers' operating costs (including our focus on total historical costs per customer, and estimating separate values for gas and electricity)?

We agree with Ofgem that operating costs should be analysed on a cost per customer rather than a cost per unit consumption basis.

Question A8.2 Should a variable component of this allowance be split out to reflect differences in bad debt costs between customers with higher and lower consumption?

We agree with Ofgem's suggestion that the cost of bad debt will be assumed to scale in proportion to customer consumption, as customers with higher consumption will, other things being equal, have larger bills and run up larger debts if those bills go unpaid.

Of course there will be other factors which influence the level of bad debts costs for a given supplier, such as the demographic profile of the customer base and the mix of payment methods used by those customers, but this does not invalidate Ofgem's proposed approach.

Question A8.3 Do you consider 2017 to be an appropriate period on which to base our benchmark, or are there reasons to think a longer period would be more representative?

We agree that 2017 is a reasonable period to use for the benchmark in this instance. This is the most recently available data for the majority of suppliers and should therefore reflect the most up to date view of supplier costs.

While we can see advantages in using a longer period to smooth the impact of any significant deviations from "normal", we do not think 2017 was impacted by any such atypical events (and Ofgem's own analysis set out in Table A8.1 also suggests this).

Question A8.4 Do you consider that default tariff customers have higher or lower operating costs than other types of customers?

We think there are likely to be some areas where default tariff customers may have higher operating costs than other types of customers. It is convenient to divide these into cost differences which are intrinsic to the default tariff and those which result from the types of customer using the default tariff. The main intrinsic cost difference is:

- Price change announcements. In ScottishPower's case, the cost of implementing an increase in SVT prices (notifying customers and dealing with inbound calls) is in the region of £[✂]m (see response to Question A14.2). In recent years we have changed SVT prices less than once per year, and for fixed term customers we go

through the end of fixed term notice (EoFTN) process less than once per year on average (because fixes are on average longer than one year). The default tariff cap will increase the frequency of SVT changes to twice a year. Not all of these changes will be increases (and therefore require notification under current rules), but even so, we expect the average cost to increase significantly and likely above the equivalent costs for fixed term customers.

Cost differences resulting from the customer mix on default tariffs include

- Bad debt costs. As noted in our response to Ofgem's working paper 1, in ScottishPower's case a substantial proportion of bad debt write-off costs relate to properties occupied on a short term basis by tenants, who largely fall within a particular 'transient renter' demographic profile. These customers (and other demographic profiles with high bad debt costs) are more likely to be on SVT than fixed term tariffs, increasing the proportion of bad debt costs attributable to SVT.

- Service costs. Customers on SVTs are generally less engaged that customers on fixed term tariffs who have actively chosen a tariff. This is likely to mean higher customer service costs, as a result of less frequent provision of meter readings (notably at the point of a change in tenancy process) resulting in higher billing and metering costs.

- Acquisition costs. Ofgem suggests that suppliers will have lower acquisition costs for default tariffs than for customers on fixed term tariffs. While this may be the case for customers who have been on a default tariff for a long period of time, a significant proportion of SVT customers (around 50% for ScottishPower) have been on SVT for less than three years, and will likely have defaulted from a fixed term tariff. Given that many fixed tariffs are around one year in length, suppliers are likely to have incurred costs of acquisition as recently as one year prior to the customer moving onto the default tariff. In summary, while we agree that these costs may be lower for customers on default tariffs compared to those on fixed tariffs, it would be wrong to assume the costs were zero.

Question A8.5 Do you agree with our proposal of where to exclude suppliers from our benchmarking analysis?

We set out below our views on each of Ofgem's proposed exclusions:

- We agree with Ofgem's proposal to exclude suppliers with fewer than 250,000 customers as these companies are likely to have different cost bases to larger firms and therefore including them may risk the cap being set at a level that does not reflect operating costs of a company at scale.

- Ofgem proposes excluding suppliers with unreliable data, which we agree with, but at this point suggests no such companies have been identified. If companies are excluded on these grounds, this should be clearly communicated with an explanation to the cause.

- We agree with Ofgem's proposal to exclude suppliers with niche business models and suppliers who are non-compliant.

Question A8.6 Do you agree with our proposal of what to include in our definition of operating costs?

Overall the approach looks reasonable. It is correct to start from the CSS (a reliable starting point for the larger firms), make adjustments to exclude ECO, FIT, WHD industry initiatives and energy transaction costs, and add in acquisition costs, smart costs, depreciation and other direct costs which are not included in other parts of the allowance.

We agree that non-licensed activity costs should be excluded. In the case of the SLEFs these costs will already be excluded from the CSS, but adjustments may be required for small and medium sized suppliers.

Ofgem says it plans to add customer acquisition cost "where it is appropriate to do so". We think it is important for these costs to be included, and for Ofgem to explain how it has estimated them.

We agree that direct smart meter rollout related costs (DCC, SEGB and SMICOP) should be treated as a separate item, not included in indirect costs.

Question A8.7 Do you agree with our proposed approach to benchmarking operating costs under a bottom-up cost assessment?

Ofgem takes the view (para 2.27) that cost variations across suppliers are likely to reflect differences in efficiency. This may be a reasonable assumption for comparisons between the SLEFs, as all produce an audited CSS and all will have a varied customer based including a larger proportion of disengaged and vulnerable customers than smaller firms.

It is not clear however that cost differences between larger firms and smaller firms will necessarily be driven by efficiency. It will be important for Ofgem to take into account any factors which are particular to incumbent suppliers. Legacy pension costs are mentioned, but there will be a range of others, including mix of customer base and proportion of single fuel customers.

Question A8.8 Which if any of the factors listed in Table A8.2 do you think we should take into account when choosing our benchmark? Do you have any suggestions for how we could estimate the materiality of the impact of any of these factors on costs?

Our comments on the factors are set out in the table below.

Features of the supplier	
a) Company size	It is unclear to us whether company size will be an important factor, as distinct from other factors listed below.
b) Customer acquisition costs	Yes, we agree that Ofgem should in principle take account of customer acquisition costs. Small suppliers seeking to grow rapidly may have higher acquisition costs (in proportion to their customer base) than SLEFs, but SLEFs also incur significant acquisition costs simply to replace losses, and (prior to 'whole of market' reforms to the Confidence Code) small suppliers may have been able to avoid paying commission to PCWs if their tariffs were ranked sufficiently highly in comparison tables.

c) Stage of smart meter rollout	Yes, this is critical to understand. Smart rollout costs are critically dependent on what stage the supplier has reached in its rollout, with suppliers who are more advanced in their rollout likely to have incurred higher costs. There will be wide variations between suppliers which have nothing to do with efficiency.
d) Legacy pension obligations	This should be included where these costs can be identified, but it is not clear to us whether they are material.
e) Customer service level	This may be relevant for certain comparisons, eg comparing SLEF costs against 'no-frills' small suppliers who may offer very limited channels of customer communication.
f) Participation in industry code panels and work groups	This is unlikely to be a significant factor in establishing the benchmark.
Features of the customer base:	
g) Payment method breakdown	All these factors are relevant to consider when setting the benchmark. In most cases these factors will contribute to SLEFs having higher observed costs than smaller suppliers, and for reasons which have nothing to do with efficiency.
h) Proportion of vulnerable customers	
i) Proportion of customers serviced online	
j) Proportion of dual fuel and electricity-only customers	

Chapter 3 – Updating the cap to reflect trends in operating costs

Question A8.9 Do you agree with our proposal to use CPIH to index the allowance for operating costs within the default tariff cap?

Yes, we agree this is a reasonable approach.

Question A8.10 Should the default tariff cap be reduced over time to reflect an expectation of general productivity improvements – and if so – at what level should this efficiency factor be set?

Assuming that the initial cap is set at an efficient level then it will not be necessary to further reduce the cap to drive efficiency. If there were to be a significant improvement in general productivity, it would be better to take advantage of the opportunity for greater competition below the level of the tariff cap, rather than requiring an adjustment to the operating costs level in the short term. Indeed, rather than reducing headroom over time, we think there is a strong argument for the headroom to *increase* over time (see our response to Appendix 11).

Annex 9

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 9 – EBIT
SCOTTISHPOWER COMMENTS

Chapter 2 - Our proposed approach for setting the cap

Question A9.1: Do you agree with our proposed approach to setting the EBIT margin?

We do not agree with the approach adopted by the CMA to profitability assessment. We do not believe that ROCE is an appropriate metric for asset-light supply companies, and we note that Ofgem appears to have reached a similar conclusion in deciding not to proceed with the CMA's recommendations to estimate ROCE going forward. There are a number of serious weaknesses in the CMA's analysis behind the 1.25% and 1.9% benchmarks, relating to its treatment of capital employed (notably valuation of customer bases and risk capital).

While we agree that it would not be a good use of Ofgem's time to conduct its own analysis of ROCE, we do think that Ofgem could usefully undertake some more conventional benchmarking of EBIT margins for asset-light businesses, which we believe would likely result in a somewhat higher competitive level than the CMA's 1.25% and 1.9% figures.

Chapter 3 – Key judgements

Question A9.2: Do you agree that it is acceptable to retain the WACC figure used by the CMA? If not, do you have views on the factors we would need to consider if we were updating the WACC?

Yes, we think the 10% WACC used by the CMA remains appropriate.

Question A9.3: Do you agree that we should maintain the CMA's estimates of the capital employed by energy suppliers? If not, please specify which element you think we would need to revalue.

In our response to the CMA's Appendix 9.10 to its final report on supplier profitability, we explained why we considered it had underestimated capital employed by energy suppliers, particularly with reference to risk capital (wholesale price risk, volume risk and working capital risks) and the valuation of the customer base. However, as noted above, we do not think it would be a good use of Ofgem's time to conduct further analysis of ROCE, rather it should consider more conventional benchmarking of EBIT margins.

Chapter 4 – Updating the cap

Question A9.4: Do you agree with our proposed approach to updating the EBIT margin?

We are comfortable with Ofgem's proposed approach to updating the EBIT margin.

Annex 10

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 10 – SMART METERING COSTS
SCOTTISHPOWER COMMENTS

Chapter 1 – Our proposed approach for setting the cap

Question A10.1: Do you agree with our minded-to position to include a separate smart metering index to reflect the changes in costs from the baseline (2017) to the initial year of the cap (2018)?

We agree that smart metering costs vary in a different manner to other elements of operating costs and therefore agree, in principle, with Ofgem's minded-to position to include a separate smart metering index to reflect cost changes from the baseline (2017) to the first year of the cap (2018).

Ofgem proposes that the smart metering index will apply in the bottom-up cost assessment or either of the two reference price approaches. We note that the baseline for the adjusted version of the safeguard tariff is in 2015. We would agree in principle with the use of a separate smart metering index to reflect cost changes from this baseline as well.

Whilst we consider the concepts described in the methodology to be broadly acceptable we have significant concerns about the omission from the consultation of key input data and modelling assumptions without which it is impossible to comment meaningfully on Ofgem's substantive proposals. We elaborate further in our response to Question A10.3.

Question A10.2: Do you agree with our minded-to position to include an adjustment to the Reference Price (SMRPA) in the event a material difference is identified between the smart metering net costs of the suppliers making up the reference price and the model?

We agree in principle with the inclusion of the smart meter reference price adjustment (SMRPA). We are unable to fully assess the impact of it given the absence of information we outline in our response to Question A10.3.

Ofgem notes (para 1.33) that the SMRPA would be applied where a significant difference is identified between the smart metering costs of reference tariff suppliers and the model. But the consultation does not define what Ofgem would regard as a 'significant' (or 'material') difference and this omission is another factor preventing us from assessing the impact of the SMRPA.

Question A10.3: Do you agree with our initial assessment for the Smart Metering Net Cost Change, including our inclusion and assessment of the costs of SEGB, SMICoP and DCC charges?

Estimate of SMNCC

We do not agree with Ofgem's initial assessment of the Smart Metering Net Cost Change (SMNCC). Ofgem's initial estimates of SMNCC against 2017 baseline (Table A10.1) are as follows:

Period	Electricity	Gas	Dual Fuel
Dec 18 - Mar 19	£9.30	£8.75	£18.05
Apr 19- Sep 19	£9.60	£9.00	£18.60
Oct 19 - Mar 20	£10.40	£9.75	£20.15
Apr 20 - Sep 20	£11.20	£10.50	£21.70

We compare Ofgem's estimates with our analysis of what we believe to be efficiently incurred ScottishPower SMNCC for dual fuel customers in the table below. (As per Ofgem's definition, the ScottishPower SMNCC is the difference between ScottishPower's net smart costs in the year in question and its net smart costs in 2017.) ScottishPower's detailed financial model of smart meter rollout costs on which this comparison is based has already been provided to Ofgem in response to the default tariff cap RFI.[6]

	Calendar Year			
	2017	**2018**	**2019**	**2020**
ScottishPower net cost of smart meter rollout (£m)	[✂]	[✂]	[✂]	[✂]
Cost per dual fuel customer (assuming 2.5 million dual fuel customers)	[✂]	[✂]	[✂]	[✂]
ScottishPower SMNCC vs 2017 baseline	£0.00	[✂]	[✂]	[✂]
Ofgem provisional SMNCC vs 2017 baseline (per dual fuel customer)[7]	£0.00		£18.85	£21.31
Difference between SP's estimate of SMNCC and Ofgem's			[✂]	[✂]

There are striking discrepancies between Ofgem's and ScottishPower's estimates in 2019 and 2020. The difference is particularly significant for 2020 and gives us serious concerns about the robustness and comprehensiveness of Ofgem's approach. We are unable to work out where and why the discrepancy arises without more granular data from Ofgem. We believe it is essential that Ofgem publishes the information set out below as soon as possible (and in any event well ahead of the proposed statutory consultation) as well as a far more detailed description of the input assumptions, analysis and modelling behind these SMNCC estimates:

- the average rollout profile from 2018 to 2020;
- the costs and benefits estimated for each year broken down into the BEIS cost and benefit categories and how these have changed following Ofgem's use of input data from Annual Supplier Returns 2017;
- the data and assumptions that have informed the calculation of the pass through costs (relating to DCC, Alt Han Co, SECAS, SEGB and SMICoP).
- the model described in this appendix and any separate model used to calculate the competitive benchmark.

[6] ScottishPower response to Ofgem RFI for the Default Tariff Cap, dated 29 March 2018. We have made two minor adjustments to the cost data provided in response to the RFI. We have excluded costs and benefits associated with traditional prepayment meter payment systems (since the default tariff cap relates to credit meters) and we have excluded an estimated benefit from reduced imbalance costs (as this would be captured under changes in direct fuel costs).

[7] We have assumed for the purpose of comparison that Ofgem's SMNCC for October to December 2020 is the same as for April to September 2020.

Initial identification of gaps

In the absence of the data needed to make an informed assessment of Ofgem's analysis, we have provided in the tables below a simple comparison between the magnitudes of costs and benefits predicted in the original 2016 version of the BEIS model and the actual costs and benefits forecast by ScottishPower (on which our SMNCC comparison above is based).

Our approach to estimating the costs and benefits within the BEIS model has previously been described to Ofgem[8] and is subject to a number of significant assumptions and approximations. We have also had to make difficult judgements in how to map each cost and benefit line in ScottishPower's detailed financial mode onto the categories used by BEIS. However, notwithstanding the uncertainty around the individual cost and benefit lines, the tables are sufficient to illustrate the dramatic extent to which the BEIS model fails to predict the actual costs and benefits now expected to be incurred. We note that Ofgem says it has updated the BEIS model to reflect a more realistic rollout profile and updated costs, but given the discrepancy between Ofgem's initial SMNCC figure and our actual data highlighted above, we suspect that very substantial problems with the BEIS model still remain.

NB: The mapping from ScottishPower to BEIS categories is approximate. Comparisons at individual line level may not be meaningful but are more likely to be informative for the main headings **BEIS categories**	**Average 2019-2020 (£m)**		
	BEIS 2016 (pro-rated to SP market share)	**SP forecast costs at April 2018**	**Diff**
In premise costs	**69.5**	[✂]	[✂]%
Meters & IHDs + Installation	50.9	[✂]	
Operation and maintenance of meters	7.1	[✂]	
Communications equipment in premise	11.5	[✂]	
DCC related costs	**23.1**	[✂]	[✂]%
DCC Licence and Data Services	6.9	[✂]	
Communications services (exc hubs)	15.1	[✂]	
SMETS1 Communication services (Non-DCC)*	0.0	[✂]	
Other service providers	1.1	[✂]	
Suppliers' and other participants system costs	**11.3**	[✂]	[✂]%
Supplier capex	6.1	[✂]	
Supplier opex	3.5	[✂]	
Other industry capex	1.0	[✂]	
Other industry opex	0.8	[✂]	
Other costs	**8.3**	[✂]	[✂]%
Disposal	0.1	[✂]	
Pavement reading inefficiency	3.1	[✂]	
Legal and organisational	2.9	[✂]	
Marketing	2.2	[✂]	
Total costs	**112.1**	[✂]	[✂]%

**Not in BEIS model*

[8] ScottishPower response to Ofgem consultation on providing financial protection to more vulnerable consumers, dated 2 February 2018, Annex 3

In comparing costs and benefits it is important to note the ScottishPower model assumes [✂]% higher installation rates in the period 2019-20 but [✂]% lower cumulative installations.

	Average 2019-20	
	Installed in year	Cumulative at mid year
BEIS (2016)	23%	80%
SP model v6	[✂]%	[✂]%

- Although **in-premises costs** appear to be fairly well aligned, the ScottishPower costs are for [✂]% fewer smart meters and therefore significantly higher pro-rata. We suspect that a major area of divergence (which Ofgem has already noted) is early retirement costs for traditional meters, together with higher than expected installation costs (due to difficulties with engagement). There may also be differences as a result of BEIS's model focusing on capital costs and depreciation compared to suppliers who focus on rental payments.

- **DCC** costs have increased very significantly (by a factor of ~2.8) relative to the BEIS assumptions.

- **SMETS1 data collection costs** are much higher than assumed by BEIS due to delays in the DCC.

- **Supplier capex**, notably costs of IT systems are substantially greater than estimated by BEIS

- Extended duration of the programme and frequent changes have contributed to higher **legal and organisational costs**.

A similar comparison table for supplier benefits is shown below.

BEIS categories	**Average 2019-2020(£m)**		
	BEIS 2016 (pro-rated to SP market share)	**SP forecast costs at April 2018**	**Diff**
Business benefits - Supplier			
Avoided site visits	24.4	[✂]	
Inbound enquiries	8.4	[✂]	
Customer service overheads	1.5	[✂]	
Debt handling	8.3	[✂]	
Remote (dis)connection	1.9	[✂]	
Reduced theft	1.9	[✂]	
Customer switching	12.2	[✂]	
Total benefits	**58.5**	[✂]	[✂]
Net Cost	**53.7**	[✂]	[✂]
ScottishPower dual fuel customers (millions)	2.5	2.5	
Net cost per dual fuel customer	*£21.47*	*£*[✂]	[✂]%

The contrast between the estimates of benefits is even more pronounced, with the ScottishPower estimate of benefits at only [✂]% of BEIS's estimate. As with the costs, part of the difference will be due to different rollout assumptions (which should have been corrected in Ofgem's updated model) but that only accounts for a small part of the

difference. We suspect a wide range of factors are at play, including the following, but this can only properly be understood with a proper explanation of the modelling assumptions

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- There are significant additional costs of running two systems in parallel (traditional and smart meters) during the transition from traditional to smart, which may not have been captured in the BEIS model.

- The volume of enquiries and general customer services costs increase initially due to smart meter queries, outweighing for some time any long term reduction in billing queries.

- Expensive-to-serve customers (where the greatest savings are to be realised, eg in bad debt and meter reading) are often the hardest to persuade to have a smart meter installed, so benefits will be back-loaded.

- Switching benefits are unlikely to be realised until the Faster Switching programme is fully implemented – and will likely be outweighed by Faster Switching programme costs in the initial period of the cap.

Pass through costs

We agree that charges for SEGB, SMICoP, DCC, Alt Han Co and SECAS should be treated as pass-through items for the purposes of the default tariff cap. However, we have concerns about the proposed methodology to forecast the levels of these costs.

Using the charging statement (or budget) from the relevant industry organisation and for the relevant baseline period would be sensible, if there was confidence in their accuracy and stability. However, the cost forecasts in some of the charging statements/budgets (from the DCC in particular) have consistently been underestimated to date.

At a meeting held on 20 June 2018, the DCC shared an indicative charging statement for 2019/2020 which is already forecasting an increase of £71m for the industry in 2019 from the charging statement released in Q1 2018. This latest indicative charging statement also forecasts similar increases in 2020 and 2021 as the DCC belatedly begins considering costs associated with enrolment and adoption of SMETS1 and other potential changes.

We do not believe DCC charging statements contain accurate forecasts of the full cost of enrolment and adoption of SMETS1 meters by the DCC and the deployment of the Alt Han solution. The provision in the DCC licence to apply for in-year changes to charging statements adds a further degree of uncertainty to forecast costs.

We think it would be prudent to require the DCC, SMICoP governing body and SEGB to provide updated and credible forecasts at appropriate interim points and provision made in the methodology to allow adjustments for material changes in pass-through elements of SMNCC (or SMRPA).

Chapter 2 – key judgements

Question A10.4 Do you agree with the judgements we have set out regarding smart costs; in particular our choice of data and model, identification of relevant costs and benefits, and approach to variation?

Judgement 1: Modelling the Smart Metering Net Cost Change

On balance, we believe that developing a model using the BEIS Smart Metering Implementation Programme (SMIP) is a better starting point compared with the option of Ofgem building a new smart metering model.

However, we have concerns about the compatibility of a CBA model designed to measure overall GB welfare to one intended to accurately reflect smart metering net costs to suppliers. To our knowledge, the BEIS model has not been externally validated nor critiqued by suppliers and wider stakeholders. Specific weaknesses of the BEIS model include:

a) It segments costs according to the economic entity performing the activity, rather than according to who is providing goods and services to the supplier (the supplier centric view). This makes comparisons between suppliers' views of cost and BEIS's view of costs difficult (since it involves assumptions about how costs flow along the value chain). It may under-estimate costs (eg where mark-ups are added along the value chain) and it may result in inappropriate phasing of costs (eg BEIS's calculations of meter rental costs are derived from meter asset and installation costs provided by suppliers, but this may not reflect actual market rental prices).

b) Simplistic linear scaling assumptions may suit the purposes of a GB welfare model but may not be sufficient for the purposes of the detailed assessment of year by year cost changes required for the SMNCC; for example, the benefits derived from smart meter rollout are unlikely to be a precisely linear function of smart meter penetration, but operational factors contributing to the non-linearity may not be captured in the model.

In addition, the three modifications Ofgem proposes to make to the BEIS model carry risks. We elaborate on these below:

Ofgem Modification 1: Adjust to focus on relevant supplier costs and benefits

As stated above, we have concerns about the compatibility of the BEIS model and concerns over the lack of information in Appendix 10 (as outlined in our response to Question A10.3 and our letter to Ofgem on 14 June 2018). In our view, a full explanation of the modelling assumptions behind each of BEIS's cost and benefit categories, how Ofgem has modified these assumptions and how it has updated the input parameters is required to properly assess this judgement.

We broadly agree that Ofgem has identified the right subset of costs and benefits from the BEIS model to focus on, with two exceptions:

a) Ofgem is proposing to exclude the 'Industry capex' and 'Industry opex' lines which appear in BEIS's model under 'Suppliers' and other participants' system costs'. The DECC/BEIS cost benefit analysis (CBA) documents explain that these lines relate to costs incurred by DNOs and Energy Industry Agents. We agree it is appropriate to exclude the DNO element (since these will be reflected in network costs) but we believe it is incorrect to exclude Energy Industry Agent costs as these will be passed on to suppliers through Agents' charges.

b) Ofgem is proposing to include the 'microgeneration' benefit category. BEIS categorises this as a benefit to consumers, explaining the benefit as follows (BEIS CBA, para 4.6.1.2): *"Smart meters can be used to deliver export information, reducing the need to install an export meter for microgeneration devices. To estimate the size of this benefit, an estimate of the number of microgeneration devices that will be in use by 2020 has been multiplied by the expected cost savings from not having to install a second meter*." Ofgem justifies including it as a supplier benefit (para 2.21) on the basis that it represents a reduction in suppliers' costs from not having to install a separate export meter where a customer with microgeneration has a smart meter. However, it is unclear to us on what basis Ofgem considers that:

- Suppliers would be required to install a separate export meter - given that suppliers are not required to install a separate export meter for Feed-In-Tariff (FIT) installations with a total installed capacity of 30kW or less.

- Even if suppliers were to be obliged to install a separate export meter, why they would not be entitled to charge the consumer for the installation, since to socialise such costs across all consumers would be unfair to consumers who are unable to benefit from PV installations.

In view of the above we request that Ofgem review its decision and provide further justification it if still considers it appropriate.

Ofgem Modification 2: Updating the model with data from 2017 ASR

ASR data is accurate in so far as it is prescriptive on what suppliers are required to provide. The rigid definition of what suppliers have to include or exclude leaves the ASR information caveated with assumptions by suppliers and therefore open to interpretation when used to update the BEIS model.

BEIS acknowledge there are gaps in the ASR and have approached us for views on what additional information beyond what is currently provided would need to be captured in order to fully assess the SMIP. The items below are key gaps we have highlighted to BEIS[9]:

- Early replacement costs for traditional meters being replaced by smart meters in advance of the end of their asset life
- Smart programme costs - the operating costs of the rollout such as personnel costs, legal costs, marketing and literature costs, compliance costs etc
- Smart Energy GB costs - ScottishPower contribution to the industry wide advertising campaign to promote smart meters in the UK
- DCC Costs – mandatory charges based on market share for all suppliers
- Costs that we incur for third party service provision of communication services for SMETS1 meters
- Rental costs of traditional and smart meters
- IT costs to support upgrades to internal systems

We note that Centrica, in its published response to Ofgem's working papers, has provided a list of proposed additional data requirements for the ASR. We agree with this analysis and have already compiled figures for the items listed in it. We would be pleased to provide this additional cost information to Ofgem in response to a request for information.

[9] Communication to Ellen Migo (BEIS), 1 June 2018

Ofgem Modification 3: Update DCC, SEGB and SMICoP costs

As we noted in response to Question A10.3, forecast costs in charging statements and budgets have a tendency to be under estimated and introduce a risk that the SMNCC is lower than it should be. We illustrate this point with a high level analysis of DCC costs incurred by ScottishPower in the year to 31 March 2018. As shown in the table below, the difference between our budgeted expenditure (based on DCC charging statements available at the start of the financial year) and actual DCC expenditure was £2.8m, an increase of 13%.

Period	Budget	Actuals	Difference
April 2017 – March 2018	£20.8m	£23.6m	£2.8m (13%)

Judgement 2: What are relevant smart metering costs?

We believe the high level BEIS categories in Table A10.3 are unlikely to represent the full range of costs and benefits that suppliers are exposed to. These categories have not evolved much from the initial BEIS model in 2012[10], well before any operational experience of smart meter rollout. We have provided in Annex 10a a list of the full range of costs we are exposed to, many of which we suspect are not properly captured in the BEIS model.

The high level comparison between BEIS and ScottishPower cost estimates that we provided in response to Question A10.3 illustrates the magnitude of the issue.

Judgement 3: Controlling for non-efficiency costs variations?

It is difficult to form a view on this judgement given the consultation presents the conclusions from the analysis rather than the analysis itself. On the basis of the initial analysis results Ofgem has presented we agree in principle that there is no strong evidence to suggest that non-efficiency adjustments (eg for scale and rollout maturity) need to be made in how Ofgem assesses efficient costs.

Judgement 4: Estimate the efficient cost of rolling out a smart meter?

We have provided above a comparison of BEIS and ScottishPower estimates to highlight our concerns that the estimates and profiling of costs and benefits in BEIS' model significantly understates net costs to suppliers. We understand that Ofgem aims to update this model but would reiterate the following fundamental points preventing us from reaching a firm view on this judgement:

- the consultation does not provide sufficient information to assess the methodology proposed;
- there are gaps in the ASR (as highlighted in the Centrica table referred to above) and possible issues with the interpretation of the data which make it an incomplete input data set for refreshing the BEIS model;
- We would need visibility of the model Ofgem is using, how Ofgem proposes to use the existing ASR data to update this model and how Ofgem proposes to deal with gaps in data

[10] Smart meter roll-out for the domestic sector (GB) Impact Assessment April 2012 : https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/48803/4906-smart-meter-rollout-domestic-ia-response.pdf

- We do not have sight of the assumptions Ofgem proposes to use in order to establish a counterfactual of what it would cost to not roll out smart meters and instead operate the existing non-smart meters. As we note in response to Question A10.6, we disagree with the use of the frontier or lower quartile approach to estimate the efficient cost of smart metering. We think the average cost approach is the best way forward but note that Ofgem is yet to reach a minded-to position on this.
- Ofgem states its intention to review the latest basis of evidence for supplier smart metering benefits in the period before the statutory consultation. It is unclear what this evidence base will be. We have regularly highlighted the risk of benefits being over-stated and we consider this to be a significant issue and we call for more transparency on this matter.

Question A10.5 Do you consider that there will be any significant change in the costs or benefits of smart metering from 2017 onwards? For example, installation costs or asset costs. Please provide evidence to support your view.

We agree with Ofgem's view that 2018 is a crucial point in the rollout for the reasons outlined in the consultation. Significant upward trends in the smart metering programme costs for ScottishPower from 2017 onwards include:

a) **Fewer SMETS2 (and more SMETS1) meters being deployed** (due to delays associated with central systems) and therefore the cost of purchasing meters being higher - original SMETS1 cost was c.£ [✂] compared to c.£ [✂] for SMETS2 (average)

b) **Installation Costs** – from the outset of 2018 ScottishPower has experienced higher installation costs and we anticipate this trend to continue into future years.

Average cost of an installation	ASR 2016 (£)	ASR 2017 (£)	Percentage change
Total average cost of Electricity Single Fuel Installation by Internal Workforce*	[✂]	[✂]	[✂]%
Total average cost of Electricity Single Fuel Installation by External Agents	[✂]	[✂]	[✂]%
Total average cost of Dual Fuel Installation by External Agents**	[✂]	[✂]	[✂]%

* Note - ScottishPower's internal meter deployment workforce have capability to install single fuel electricity only premises.
** Accounts for around [✂]% of total installations

c) **Customer Engagement costs** will rise in this period as illustrated in the increase we are anticipating from £[✂]m in 2017 to £[✂]m in 2018. This trend is being driven by new innovative ideas/routes to customers being implemented in support of the 'All Reasonable Steps' licence obligation. Engaging with customers has proven challenging. We are investing in a number of process improvements and implementing new strategies to maximise conversion from 'contact' to 'install'. We are now utilising the following channels:
    - Reactive Conversations (eg when a customer interacts with ScottishPower, through the web, sales, contact centres, billing, meter reading)
    - Proactive Conversations (eg letters, emails, automated interactive messaging)
    - Site visits

d) **CGI (DCC equivalent for SMETS1 meters for ScottishPower)** costs will arise from having significantly more SMETS1 meters than originally anticipated due to delays in the delivery of the SMETS2 solution. Operational costs for CGI, which are in addition to

contractual costs, will continue into 2018/2019 based on deployment volumes. We summarise the projected increase in contractual costs below.

		2017	2018	Percentage change
CGI contractual costs	£m	[✂]	[✂]	[✂]%
CGI Variable cost	per installed meter	£[✂]	£[✂]	[✂]%

Question A10.6 Please comment on the proposed methodology for calculating the efficient cost of rolling out a smart meter, indicating a preference with supporting rationale, on the efficiency option (average cost approach, pure frontier cost approach, lower quartile approach).

We agree with Ofgem's current view that the supplier pool for calculating the efficient cost should be restricted to the six largest energy firms (SLEFs).

But we are concerned that Ofgem is still considering the frontier (lowest cost SLEF) or lower quartile (second most efficient SLEF) approach in the methodology for calculating efficient costs for smart metering. Both of these approaches (frontier, in particular) risk placing unrealistic targets on suppliers in terms of efficiency improvements.

Smart meter rollout is a new activity which all suppliers have commenced at roughly the same time, and where there is little reason to suppose that the larger 'legacy' suppliers would have accumulated inefficiencies through over-resourcing or under-investment in technology. Of course, as in any market, some suppliers will be more efficient than others, but in the absence of evidence that inefficiencies are *due to a weakness of competition* (as the CMA has argued is the case more generally), it would be wrong to set the level of cost recovery below average costs (whether at the frontier or lower quartile). To do so would guarantee that the industry on average will lose money on smart metering rollout.

Chapter 3 – Updating the cap

Question A10.7: Do you agree with our approach to updating smart costs? In particular, our intention to specifically index smart cost changes, based on net cost analysis (option 3), and whether any other approaches would be preferable to option 3.

We agree in principle with the approach of updating the cap based on net cost analysis where the smart metering net cost change between the baseline and following years is modelled and converted into a £ value per customer per fuel type for inclusion in the cap. Ofgem notes that it does not currently cater for un-forecasted developments. Therefore, we think Option 3 (specific smart indexation based on net cost analysis) would be stronger if combined with periodic cost assessments and a provision in the licence for adjustments in exceptional or material circumstances eg in the event of DCC insolvency. Ofgem should specify in advance a materiality threshold for such changes.

Annex 10a

SMART METER ROLLOUT MODEL – FULL RANGE OF COSTS

Cost	Description
Operations	
Rental of smart metering systems	The rental charge SPERL (Scottish Power Energy Retail Ltd) pay other MAPS for current Scottish Power customers who have a smart meter installed
Rental of smart metering systems - gains	The rental charge SPERL (Scottish Power Energy Retail Ltd) pay other MAPS for a meter which has churned into Scottish Power
Implementation Support and Transfer of Smart Programme to BAU	Additional staff required to support the roll out of smart meters
In Home Display (IHD) unit costs	Costs for In Home displays
DCC Service Providers costs	Payment of the costs for the Data Communications Company (DCC) for supplier charges for their services to create the UK network to support the deployment of smart meters
Gas and Electricity Termination Fees Incurred	Cost applicable to removing a meter from the wall before it's useful life has ended.
Forecasted Communications equipment failure	Cost relating to site visits by energy suppliers required to deal with potential failures of the communication hub
Salaries	Staff costs including Contractor salaries
CGI Communication costs	Costs associated for the provision of smart services (Instant Energy) via contract with CGI UK Limited. SMETS1 meters are managed through this contract until these meters are enrolled and adopted by the Data Communications Company (DCC)
Customer Services:	
Additional call volumes during deployment - front office	Increase in call volumes to support the roll out of smart Meters based on a cost per call
Complaints	Costs associated with complaints
Compensation	Compensation paid to customers covering a variety of reasons
Ombudsman	Costs associated with complaints being escalated to the Ombudsman
Training costs	Costs associated with training Service staff
Sales and Marketing and Customer Experience Costs:	
Customer Leave behind materials	Costs associated with customer collateral (eg promotional items/ literature) left by each installer
Development costs	Costs associated with customer communication and the development of new literature packs
Community Outreach costs	Costs associated with Joint initiatives with other bodies (eg) Age Concern, RNIB to increase customer engagement.
SMICOP	This is a mandated cost and covers quarterly invoices, external audits with Grant Thornton (Audit Services), video enhancements
Printing - Audible literature	Costs associated with the creation of audible printing packs.
[✂] Software Maintenance	Licence cost payable to [✂]. The costs associated with the maintenance of software [✂] This software allows us to [✂]
[✂]	Third party analysis to [✂]. Annual review required to ensure data is updated. This cost relates to smart specific data for [✂]. This data will be managed by the Business as a whole in the future.
Data Quality	Costs associated with the purchase of customer data to assist with customer engagement

Cost	Description
Vulnerable customer support	Costs associated with providing extra support to our vulnerable customers
IHD / [✂] Development	This is a provision in the event we require use of [✂] system to assist with IHD derogation activity
Marketing Campaign	Costs associated with direct marketing campaigns including supporting SEGB, events and community outreach, digital advertising amongst others. Also included is Marketing costs per premise
Technical, Deployment and Security and external relationship costs	
Transport costs/Asbestos Contracts/Repairs	Transport costs associated with moving meters from one installer to other or due to installers' inability to accept more deliveries, to stock them temporally at Warrington/Newarthill. An asbestos emergency response framework and an asbestos waste handling contract to support our new process. Meter box repairs to allow SP to fit a smart meter and reduce the number of aborted jobs. Ofgem clarified that "standard installation" should cover any ancillary work and all reasonable steps should be taken to fit the smart meter
Vulnerable Customers	An allowance has been made to ensure that vulnerable customers would not be left without heating should their boiler not 'fire up' after the Smart meter has been fitted.
Policy & Security Requirements	Budget covers conference attendance and research to inform policy and implement best practice from global Smart deployments
Training costs	Training costs to cover any courses required to enable staff to carry out their role effectively/ gain accreditation to safety standards
SMDA	Share of agreed contribution to the setup of Smart Metering Device Assurance and ongoing costs. The SMDA Scheme has been set up to provide assurance to consumers, suppliers and financiers that smart meter equipment will work effectively in a smart environment. The Scheme provides assurance testing of smart metering equipment covering both interoperability and interchangeability of the devices
Maintenance of Meter Asset test facilities and Miscellaneous investments	Costs associated with maintenance of test benches and compressors, calibration of RF monitors and any other revenue expenditure (revex) costs
ISO 27001 fees	Internationally recognised quality standards applying to IT systems. Costs for compliance and security audits.
VSS Costs:	
VSS Retailer	These are costs relating to VSS payments as a result of no longer needing Customer Service, Metering and Back office employees due to efficiencies created in smart metering
ITBS Costs:	
Systems UK Support Costs	Support costs include licenses, infrastructure support and gateway costs. Additional support [✂] and CGI post implementation
Other Costs:	
Programme and Ofgem review costs	Costs associated with Ofgem reviews and 3rd party carrying out a review to establish savings and efficiencies in the roll out of smart meters
Guaranteed Standards	These costs are paid out to the customer when SP fails to turn up to a scheduled metering appointment. If SP don't pay the initial £30 on time a further £30 will be due to the customer as a late payment charge
Change Management	Costs associated with change initiatives, transition and 'To be' processes. Development and delivery of training needs and materials, 3rd party resource to deliver training material (including cartoonite / voiceovers)
Legal costs	This covers costs for negotiation of various Smart contracts ([✂]) and regulatory matters ([✂]).

Cost	Description
Energy UK Subscriptions	Payment of agreed contribution to the smart metering project costs for 2018
Management & Support costs	Various miscellaneous costs
Travel and Subsistence	Travel, Meals and Hotel and accommodation costs

Annex 11

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 11 – HEADROOM
SCOTTISHPOWER COMMENTS

Chapter 2 – Our proposed approach

Question A11.1: What are your views on headroom being a percentage? Do you think it should be applied to all cost components except for network cost? Alternatively, do you think headroom should be applied as a percentage to only controllable costs?

We agree with Ofgem that headroom should be set at a percentage figure rather than an absolute figure, as this allows for the headroom element to scale with consumption which we think is important to ensure a fair outcome for lower consuming customers.

We also agree with Ofgem's proposal to set the headroom as an absolute level initially, which would then be converted into a percentage of selected cost components, as a basis for updating it over time. The selected cost components would exclude network costs (on the basis that there is no justification for headroom to vary regionally) and possibly also wholesale energy costs (on the basis that they are not controllable). However we see no particular reason to exclude costs on the basis that they are not controllable, and suggest that Ofgem sticks with the CMA approach of excluding only network costs.

Question A11.2: What are your views on whether we should change the level of headroom over time?

To address this question, we first set out our views on the need to include a level of headroom in the cap, as in order to assess any potential for changing the cap level, and the potential impact of doing so, it is important to understand why headroom is required within the overall cap level.

In Chapter 1 of Appendix 11, Ofgem's main argument for including headroom in the cap is to account for uncertainty in estimating the level of efficient costs. We think that as far as possible, risk and uncertainty should be accounted for in the tariff cap methodology for specific cost areas (both in how the initial cap is set and how it is updated over time), rather than simply assuming that it can be covered by the headroom. Accounting for it explicitly in the methodology will be more transparent and reduce the risk of under-provision.

Therefore while we agree that headroom has a role to play in mitigating uncertainty in cost estimation that cannot be factored into the cap design itself, it should not be the only or main driver for including headroom in the cap. As we set out in our response to Ofgem's working paper 3, we think the proposed legislative framework provides a clear rationale for Ofgem to include headroom in the cap in relation to limiting the impact of the cap on switching levels and competition in the market – indeed we cannot see how Ofgem could have regard to the 'matters' relating to switching and competition without including a reasonable allowance for headroom.

The risk that a price cap will depress switching levels and reduce competition has long been recognised by economists and indeed is reflected in Ofgem's own analysis in Chapter 4 of this appendix assessing the impact of different levels of headroom:

> *"... a price cap which protects consumers from bad deals may be a mixed blessing. The direct effect of the regulation is positive for consumers because high pricing is prevented. But the policy reduces price dispersion and blunts incentives to become informed about the available prices, which in turn weakens the competitive pressure on firms to offer low prices. This indirect effect of regulation weakening competitive market forces goes against its direct effect in curbing high prices."* [11]

Where headroom is provided within the cap level, Ofgem sets out that it is minded not to design the cap in a way that provides for the level of headroom to change over time, however also notes that it will continue to consider this as it completes its full analysis for the cap design.

In assessing whether the level of headroom should change over time, Ofgem's analysis focuses on the possibility that headroom might be reduced over time to incentivise suppliers to improve their efficiency, and/or to allow a transitional period for inefficient suppliers to adjust. However we also think there is a strong argument for headroom to *increase* over time rather than reduce, which has not been considered in Ofgem's analysis to date.

We have previously highlighted the experience of New South Wales (NSW) in Australia, which illustrated how price controls can reduce price dispersion and weaken competition – and conversely, how relaxing the price control can allow competition to flourish.[12] We set out more detail of this analysis in our response to Question A11.3 to support our reasoning why Ofgem should provide for a relatively higher level of headroom for the default tariff cap (compared to the current safeguard tariff).

However, looking at this experience in light of the potential for headroom to change over time, we think there could be a reasonable justification for increasing headroom throughout the period the cap is in place. In NSW for the 2007-10 price control period, the level of 'incentive' (a measure of headroom in the price cap) was relatively low and the number of customers opting for regulated as opposed to 'market' prices increased over the period. In the next price control period 2010-2013, the incentive was increased four-fold (to approximately 10% of total costs), resulting in a much looser price control. This caused price dispersion to widen from 4-5% (in 2009/10) to 5-15% (in 2012/13), the switching rate to increase from 12% to 19% and the number of customers on regulated tariffs to fall from 65% to 40%, leading the regulator to conclude that the price control could be removed altogether.

In summary, we think the main consideration in setting the level of headroom should be to allow Ofgem to meet the requirement to have regard to the 'matters' relating to switching and competition. Rather than keeping the headroom allowance constant, we suggest **Ofgem should consider allowing the headroom to increase towards the end of the period**. This would help facilitate a smooth transition to the more competitive market that would need to exist when the cap is removed - and potentially give Ofgem additional evidence on which to conclude that the conditions were in place for the cap to be removed.

[11] Armstrong, A., Vickers, J. and Zhou, J. (2009), "Consumer protection and the incentive to become informed", Journal of the European Economic Association, 7:2–3, pp. 399–410, http://else.econ.ucl.ac.uk/papers/uploaded/314.pdf.

[12] Independent Pricing and Regulatory Tribunal of New South Wales (IPART) (2013): "Review of Regulated Retail Prices and Charges for Electricity", p. 114 (table 9.2).

Chapter 4 – Headroom scenarios

Question A11.3: Bearing in mind the analysis and scenarios presented, what are your views on the appropriate level of headroom to include in the default tariff cap?

Ofgem's analysis in Chapter 3 of this appendix considers the impact of different levels of headroom on consumers and suppliers and the potential for this to impact on Ofgem's obligations within the Bill to protect existing and future SVT customers and the areas Ofgem must have regard to in doing this. Namely:

- Creating incentives for suppliers to improve their efficiency
- Enabling effective competition
- Maintaining incentives to switch
- Ensuring efficient suppliers are financeable

We think this is a sensible approach to Ofgem's analysis and ensures that Ofgem considers headroom as a key factor in allowing suppliers to compete under a price cap (and therefore support Ofgem in demonstrating its compliance with the Bill) rather than simply viewing headroom as a method of covering risk and uncertainty in the cap methodology.

Ofgem's chosen scenarios and the case for headroom

Ofgem's initial analysis concludes that lower levels of headroom will protect more customers and provide higher levels of protection, however it also recognises that lower levels of headroom could damage consumer protection in the long term, eg by reducing the incentive to switch through reduced price dispersion, and impacting on supplier ability to innovate or improve service to customers.

Setting the right level of 'competitive headroom' allowance is a key part of getting the design of the default tariff cap right, and represents a trade-off between promoting competition (for the benefit of all consumers) and reducing maximum prices for vulnerable consumers. Ofgem's analysis to date focuses on four levels of headroom, zero, 4%, 10% and 15%, however Ofgem notes that it intends to focus on only the first three levels for its future analysis on the basis that its ultimate aim is to protect consumers. We do not think that Ofgem should discount the 15% option at this point, particularly if it continues to include the 0% option in its analysis, which we think is implausibly low, given Ofgem's need to have regard to switching and competition.

The CMA recognised the need for a level of headroom in designing the prepayment price cap, stating:

> *"Even with a price cap design that accurately tracks costs we consider it is appropriate to include a headroom allowance so that suppliers are able to compete to offer a range of profitable tariffs at different levels. To the extent that there are also small deviations between the costs facing suppliers and those reflected in the price cap, the headroom allows some margin for error such that these costs to be recovered while still remaining compliant with the price cap."* [13]

We do not think there is any justification for Ofgem to continue to assess the option of a zero headroom scenario and think its focus should be on understanding the impacts and benefits to consumers and suppliers of providing the same or greater level of headroom than the current safeguard tariff.

[13] CMA Final Report, para 14.118

The need for higher headroom than the current safeguard tariff

We have set out in previous responses why we think there are good reasons for Ofgem to include a somewhat larger headroom allowance than in the CMA's prepayment cap (the 4% scenario). The optimum amount of headroom reflects a balance between competition and consumer protection as noted above. In the case of the prepayment price cap, the opportunities for competition are limited by technical constraints, which are not present for credit meters. Other things being equal, this suggests that the impact on competition should be given a greater weight for credit meters and the optimum level of headroom should be higher.

Furthermore, as pointed out by the CMA (see above) the presence of headroom provides a degree of contingency for deviations between the costs facing efficient suppliers and those reflected in the price cap, such that these costs to be recovered while still remaining compliant with the price cap. This is all the more important for the default tariff cap given that it covers more than 50% of the market (with implications for much of the rest of it) compared to the ~15% covered by the prepayment cap.

Ofgem's analysis in Chapter 4 shows the potential impact that setting headroom at or below the current safeguard tariff could have on switching levels, with zero headroom showing over 50% reduction in switching, and 4% (the same as the current safeguard tariff cap) suggesting between 25% and 50% reduction in switching. We think this level of reduction in switching would not be consistent with Ofgem's requirement to have regard to *maintaining* switching incentives and therefore think that Ofgem should not focus its further analysis on the zero or 4% headroom options.

Further analysis to inform Ofgem's ongoing assessment of headroom

The analysis presented by Ofgem in Chapters 3 and 4 is helpful, however we think it is important that suppliers get full transparency of Ofgem's analysis as it considers headroom in conjunction with the full cap design. We have previously provided some other useful analysis that we think Ofgem should use to inform its further analysis, and set out a summary again below.

- We provided with our response to working paper 3 a report on the Oxera switching model commissioned by ScottishPower to help understand the likely impact of CMA remedies. These included 'Remedy 11', a market-wide cap on SVTs, which was ultimately rejected by the CMA but which was broadly similar in concept as the default tariff cap. Oxera's model showed the significant impact that reduced price dispersion has on switching, with a reduction of SVT bills by an average of 4% for electricity and 3% for gas, in conjunction with a 1% increase in fixed price tariffs, resulting in a fall in switching of just over 50%. This suggests that Ofgem's assessment of switching impacts cited above may be rather optimistic. We estimate that a 4% headroom allowance (as modelled in Ofgem's scenario 2) would result in a sharper reduction in SVT prices than assumed by Oxera, in which case the reduction in switching may be significantly *more* than 50% (compared to the 25-50% estimated by Ofgem.)

- As we have noted above, the case for more generous price headroom is supported by the experience of NSW in Australia, which illustrated how price controls can reduce price dispersion and weaken competition – and conversely, how relaxing the

price control can allow competition to flourish.[14] We provided a detailed summary of this in response to Ofgem's working paper 3, but again believe it is strong evidence to support higher levels of headroom than the lower ranger Ofgem is minded to consider at present.

We think each of the above demonstrates the importance of headroom in supporting Ofgem to meet its obligations in setting the price cap at a level that allows competition to evolve and ultimately to allow the price cap to be removed. We welcome further sight of the additional analysis Ofgem intends to undertake to inform this assessment.

[14] Independent Pricing and Regulatory Tribunal of New South Wales (IPART) (2013): "Review of Regulated Retail Prices and Charges for Electricity", p. 114 (table 9.2).

Annex 12

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 12 – PAYMENT METHOD UPLIFT SCOTTISHPOWER COMMENTS

Question A12.1: Do you agree with our proposed methodology for allocating additional costs between standard credit and direct debit customers?

We agree that cost differences that are intrinsic to the payment method in question (eg working capital cost differences) should be reflected in different levels of the cap. If these costs are not reflected, it could create inefficient incentives for customers to favour SC over DD, even though the costs to the supplier are higher.

We agree that cost differences which are more to do with the mix of customers on the payment method could be socialised. For example, the bad debt costs associated with the SC payment method are generally caused by a subset of customers in a poor financial position.

Ofgem invites views (para 2.28) on whether any of the administrative costs can be regarded as a direct and necessary feature of SC and not the result of customer characteristics. In our experience SC customer typically require more effort chasing up late payments than DD customers. This is distinct from chasing up bad debt and should arguably be considered intrinsic to the payment method.

Question A12.2: Do you agree with our proposed methodology for calculating the additional costs to serve and the socialisation level?

We disagree with Ofgem's approach in taking the lower quartile of its sample when calculating the efficient additional costs to serve. Ofgem says it considers that variations in costs are wide and more likely to reflect the effectiveness of a supplier's administration. However we have provided evidence (including the Baringa report provided in support of working papers 4 and 5) which suggests that differences are heavily influenced by differences in customer mix between suppliers, and we do not consider it is reasonable for Ofgem to dismiss this evidence without explanation.

In particular, Ofgem's estimated additional cost to serve of £114 per dual fuel customer (Table A12.1) appears too low. ScottishPower's additional costs are substantially higher than this, and we believe these additional costs are largely due to our mix of customer rather than differences in efficiency. We have provided Ofgem with a report commissioned from Baringa[15] which shows the extent to which costs can vary across different customer demographics. For one particular set of customers (mainly properties occupied on a short term basis by tenants in a 'transient renter' demographic profile) the cost to supply on standard credit terms is around £150 greater than for the average customer on standard credit (mainly as a result of bad debt). If a supplier has a higher proportion of such customers than average, this could easily account for observed differences in average cost to serve, without being due to differences in efficiency. Given that the customer groups in question are generally disengaged, and given the ability of smaller suppliers to 'cherry pick'

[15] A non-confidential version of which is here https://www.scottishpower.com/pages/retail_energy_market_baringa_report.aspx

their customers, differences in the distribution of such customers between suppliers are to be expected.

In the interests of transparent and proper consultation, Ofgem should provide further detail of how it arrived at its estimate of £114 and explain how it has taken into account customer mix-related cost differences between suppliers.

Aside from these issues, we consider that it is reasonable to develop the approach outlined in Option 3b.

Annex 13

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 13 – RENEWABLE TARIFF EXEMPTION
SCOTTISHPOWER COMMENTS

Question A13.1: Do you agree with our minded-to positions not to provide exemptions for renewable electricity or gas tariffs?

We agree with Ofgem that it would not be appropriate to provide a specific exemption for renewable electricity or gas tariffs.

Question A13.2: What are your views on whether to provide a derogation for renewable electricity tariffs?

We support the use of an effective, efficient and timely derogation for renewable electricity tariffs where there is evidence of direct benefit to renewables. The onus should be on suppliers to demonstrate how a tariff may meet criteria for derogation. However, it will be helpful in due course for Ofgem to provide more detailed guidance on what it expects to see in an application.

Annex 14

DEFAULT TARIFF CAP: POLICY CONSULTATION: SUPPLEMENTARY APPENDIX 14 – IMPACT ASSESSMENT
SCOTTISHPOWER COMMENTS

Chapter 1 - Introduction

Question A14.1: What is your view on the overarching approach that is proposed for conducting the impact assessment? In particular, on the scope of the assessment, and material issues that we have not referred to. Please provide details of any relevant sources of data and evidence that you think should be considered.

We consider the overarching approach set out by Ofgem is reasonable. There are a few points within this that we would suggest Ofgem consider:

- International evidence: We are pleased to see that Ofgem will be incorporating international evidence into this assessment. Our response to question A14.3 captures our views on the experience of other countries where similar policies have been implemented.

- The challenges of ending the cap: We support the view that a policy should be assessed over its lifecycle but find limited references in the overarching approach to assessing the costs and impacts of unwinding the cap.

Chapter 4 - Initial views on the impact of the default tariff cap

Question A14.2: Do you consider that suppliers will incur a change in administration costs as a result of the default tariff cap? If so, please provide estimates with supporting evidence. Please specify whether any administration costs are fixed or variable. If variable, on what basis do these costs vary? For example, on a per customer basis.

Yes, suppliers will incur a change in administration costs as a result of the default tariff cap. The impact will be the cost of processing two price changes rather than one. We also anticipate additional communication and customer engagement ahead of the cap coming to an end.

Costs we incur when communicating a price change to customers and handling of increased inbound calls to contact centres are itemised below:

Cost	ScottishPower estimate
Communication, comprising Letters (c700k offline customers) Email (c.300k online customers)	**~£**[✂] [✂] [✂]
Inbound calls Over 28 days Multi Media Contacts from Impacted Customers Over 28 days Calls from Impacted Customers	**~£**[✂] [✂] [✂]

We disagree with Ofgem's comment (para 4.53) that suppliers already have a tendency to update prices on SVTs twice a year to reflect changes in supply and demand between winter and summer months. This is simply incorrect.

Question A14.3: Are you aware of any unintended consequences, in the form of detrimental impacts on customers that were observed as a result of the existing safeguard tariffs? If so, please provide details of these unintended consequences.

UK Experience of the prepayment price cap

Experience of the CMA's prepayment price cap remedy provides some pointers to the possible impact of a market-wide cap. There are technical reasons which limit the number of different tariffs that can be offered to non-smart prepayment meters, and price dispersion has always been less than for credit meters. Nevertheless, what price dispersion there was for prepayment meters was dramatically reduced by the introduction of the price cap, as shown in the charts below taken from Ofgem's 2017 State of the Market report.

Figure 2.13 Prepayment tariffs before and after the price cap

Note:
The chart shows each supplier's standard variable prepayment tariff only. These suppliers serve 90% of consumers using prepayment meters.

Source:
Ofgem's analysis of Energylinx data

With reduced price dispersion the savings available from switching are reduced and switching rates would be expected to fall. This has indeed happened for ScottishPower, where we have seen our overall level of customer losses (and the percentage of losses that are prepayment customers) fall significantly. In the year since 1 April 2017 when the cap came into effect, prepayment losses have reduced year-on-year by [✂]% compared with an *increase* of [✂]% for direct debit.

When Uswitch analysed the impact of the cap on prepayment switching in October 2017[16] they found that although the absolute numbers of prepayment switches had stayed level since the price cap was introduced, the proportion of prepayment switches (as a percentage of total switches) had reduced since the prepayment cap. They also found that the 'prepayment conversion to switch rate' had dropped in recent months, which may suggest

[16] "Has the Prepayment Price Cap Impacted on Switching Levels at uSwitch?- October 2017"

that more customers are deciding it is not worth the hassle of switching when they see the size of the savings on offer.

While overall prepayment switching rates have not fallen as fast as might be expected, it seems likely that much of the switching is now driven by offers of improved functionality (notably smart meter enabled top-up options) rather than by tariff differences.

France

France is an example of how a tariff deficit can arise, where the regulated price is below the underlying costs. In 2013, six years after competition was introduced in the French domestic retail market, the two incumbents EDF and GDF remained dominant, accounting for about 95% of the supply market.[17] The main barrier to greater competition, as acknowledged by the regulator, CRE, was that regulated tariffs had become lower than the true energy supply costs,[18] which had not only turned the regulated tariff effectively into an unbeatable 'price to beat' since 2009, but was also against the law.[19] In recognition of this, the CRE made increases to the regulated tariff in August 2013, and the French authorities agreed that the amount of the deficit would be paid back to EDF by the end of 2018 with interest.[20] In order to improve levels of competition, regulated tariffs were to be phased out by the end of 2015.[21]

Spain

Spain is another example of how price regulation can lead to tariff deficit. The Spanish tariff deficit started in the mid-2000s, and economic and political conditions extended the problem to around €30bn in debt to the parent groups of the Spanish 'Big 5'. Despite repeated attempts, successive governments were unable to eliminate the structural deficit until 2014.

New South Wales, Australia

Experience in New South Wales (NSW) illustrates how price controls can reduce price dispersion and weaken competition – and conversely, how relaxing the price control can allow competition to flourish. In the 2007-10 price control period, the level of 'incentive' (a measure of headroom in the price cap) was relatively low and the number of customers opting for regulated as opposed to 'market' prices decreased over the period. In the next price control period 2010-2013, the incentive was increased four-fold (to approximately 10% of total costs), resulting in a much looser price control. This caused price dispersion to widen from 4-5% to 5-15% (in 2012/13), the switching rate to increase by 50% and the number of customers on regulated tariffs to fall from 59% to 40%, leading the regulator to conclude that the price control could be removed altogether.

17 http://www.datamonitorenergy.com/2013/03/12/edf-and-gdf-still-dominate-the-french-retail-power-market/

18 The origin of the tariff deficit is spread out across different components of the 'Contribution to the Public Electricity Service' (CSPE), which covers: support to renewables and co-generation; subsidies to costs in Corse and other islands; and the social tariff. Major cost increase in recent years on renewables account.

19 Commission de Régulation de l'Énergie (2013). *Analyse des coûts de production et de commercialisation d'EDF dans le cadre des tarifs réglementés de vente d'électricité.*

20 A. J. Linden *et al.* for the European Commission (2014): "*Electricity Tariff Deficit: Temporary or Permanent Problem in the EU*?", Economic Papers 534.

21 Commission de Régulation de l'Énergie (2014). *Délibération de la Commission de régulation de l'énergie du 30 octobre 2014 portant avis sur le projet d'arrêté relatif aux tarifs réglementés de vente de l'électricité.*

Question A14.4: Do you have reason to believe the default tariff cap could disproportionately impact any of the nine protected characteristics under the Equality Act 2010? Please provide any supporting evidence.

In principle, we do not believe that the default tariff cap could disproportionately impact any of the nine protected characteristics under the Equality Act 2010.

Question A14.5: Do you have any additional information or data on the impact of the implementation of the existing safeguard tariffs on switching rates that would inform this analysis?

As noted above (in our response to Question A14.3), ScottishPower's losses of prepayment customers have fallen by [✂]% year on year, compared to a [✂]% increase in losses of direct debit customers.

ScottishPower
June 2018