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Consumers & Competition  
Ofgem  
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London  
E14 4PU

2 March 2020

Dear Anna,

**Reassessing the wholesale allowance in the first default tariff cap period**

Thank you for the opportunity to respond to your consultation on reassessing the wholesale allowance in the first default tariff cap period.

Our comments on your proposed approach and issues raised in the consultation are in Annex 1 attached.

Should you have any questions on this response, please do not hesitate to contact James Soundraraju (Tel: 014 1614 2421, [jsoundraraju@scottishpower.com](mailto:jsoundraraju@scottishpower.com)) in the first instance.

Yours sincerely,



**Richard Sweet**  
Head of Regulatory Policy

## REASSESSING THE WHOLESALE ALLOWANCE IN THE FIRST DEFAULT TARIFF CAP PERIOD – SCOTTISHPOWER RESPONSE

### 1. Challenge 1: suppliers in scope

We agree that it would be consistent with Ofgem's approach elsewhere in the methodology to use the average of the former 'Big 6'. (As explained below, we think a weighted average would be fairer to customers than a simple average).

We agree with Ofgem's reservations about including Bulb in the sample, given its very different pricing strategy, and we think it would be consistent with its wider approach not to include Bulb.

### 2. Challenge 2: relevant cap periods

We would expect that any issues for price cap period 2 would be very small in comparison to price cap period 1. Therefore, we think it would be safe for Ofgem to disregard this issue and focus its attention on period 1.

### 3. Challenge 3: estimating comparable costs

It is unclear from Ofgem's explanation in the consultation document whether it intends to consider the hedging approach adopted by suppliers for the whole of Winter18/19 (ie Q4 + Q1) or their approach for Q1 alone. If Ofgem uses the hedging approach for the whole of Winter18/19 this could give incorrect results in the case where a supplier had adopted different hedging approaches for the period up to Q4 and for the period Q1 onwards. As a matter of principle, the hedging approach adopted by a supplier for Q4, which was outside the period of the cap, should have no bearing on Ofgem's reassessment of wholesale costs for Q1.

We will comment on any further issues identified with Ofgem's approach in the context of bilateral engagement around ScottishPower's actual costs.

### 4. Challenge 4: variation in costs

Ofgem says its starting point is that the allowance should reflect the average costs of the suppliers in its sample, but the allowance could in principle, differ from average costs if it considers that appropriate (eg to account for uncertainty and approximation in the estimates, or to improve protection for customers depending on the distribution of specific suppliers.)

A key issue is what form of average Ofgem should adopt and whether it should exclude 'outliers'. We would offer the following comments:

- There should be a high bar for excluding suppliers on the basis that they are 'outliers', certainly in the case of former 'Big 6' suppliers. (For the reasons Ofgem identifies under Challenge 1, there may be a case for excluding Bulb from the sample.) We think there should be a principle of restoring suppliers *on average* to the position they would have been in if the allowance had been set correctly, and we cannot see how excluding suppliers would be compatible with that. Furthermore, it may be difficult for Ofgem to

avoid a bias in favour of excluding suppliers whose costs were 'too high' in comparison with suppliers whose costs were 'too low'.

- We think that it is correct to give more weight in the averaging process to suppliers with larger numbers of customers. This makes it more likely that customers, on average, will be restored to the correct position (subject to the various limitations identified under Challenge 5) and is arguably fairer to consumers. Ofgem says it might consider using a simple average or median if it thought the weighted average was distorted by an outlying supplier. This runs contrary to normal rule of thumb that data points based on smaller samples are more likely to be outliers, and hence that weighted averages are more not less robust than simple averages.
- In light of the above we would encourage Ofgem to use either:
  - a weighted average; or
  - a customer-weighted median: ie rank the suppliers in order of cost and find the cost corresponding to the median *customer* in the sample;

and in each case using the weights from Tables 1 and 2 of the consultation.

## **5. Challenge 5: setting an adjustment charge**

It is clearly not possible to find a solution which restores every customer and every supplier to the position they would have been in had the original allowance been set correctly. We think Ofgem should seek to ensure that customers and suppliers are *on average* restored to this position.

## **6. Challenge 6: setting an adjustment period**

Ofgem says it expects a 12 month adjustment period (two price cap periods) may best balance the competing concerns (disruption to customers, declining supplier customer bases, uncertainty over future price cap extensions), but it will consider that in light of various factors, including the actual adjustment required, any development in the potential outcome of this year's review of the conditions for effective competition, and trends in customer numbers.

We think it would also be appropriate for Ofgem to consider this matter in light of the expected overall change in the price cap from period 4 to period 5. If the cap was expected to reduce significantly, eg as a result of falling wholesale prices, the objective of reducing volatility in consumer prices might in fact be better served by focusing the adjustment in one price cap period rather than two. This would also be preferable in terms of changing supplier customer bases. On that basis we think Ofgem's minded to position should be 6 months not 12 months.

ScottishPower  
March 2020