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Sent by email: CDconsultations@ofgem.gov.uk

Dear Jemma,

SSE response to Ofgem consultation on extending the safeguard tariff

SSE welcomes the opportunity to provide views on Ofgem's proposals via consultation and via the recent consultation workshop at Church House.

At this event we noted Ofgem's enthusiasm to receive feedback on the policy proposals, which were described very much as early options and open to amendments. SSE has therefore tried to provide clear and direct feedback on the proposals so as to inform positive amendments. We are particularly interested in setting up a bi-lateral discussion to focus on SSE's experience with the PPM cap so far, and what we see as essential alterations that need to be made to the cap to ensure it achieves the stated objectives.

We have provided specific answers to Ofgem's questions in Annex 1 and set out our wider positions below.

– **The proposed price cap extension should not be progressed**

We believe that the compressed timeline and the proposed short shelf-life of the cap extension, the fact that there are existing protections in place for almost 20% of the GB market, and the distortive effect it would have on competition mean that this proposal should not be progressed. We believe that the urgent need for extensive engagement around any potential SVT cap should take precedence at this time.

– **The case for broadening support is not clear or compelling**

If support is extended, SSE believes that financial support should be focused where it is needed the most to avoid disproportionately impacting on other customers and inadvertently distorting competition in the market.

SSE understands well the financial pressures that households across Great Britain are faced with, but nonetheless we believe it is inappropriate for a safeguard protection to be as broadly based as is proposed here. We urge Ofgem to consider whether capping prices is the right solution for all the customers captured within this definition. We consider this very extensive cap places an unfair burden on those households that fall outside the safeguard definition criteria.

Furthermore, we do not support the argument that Ofgem makes around the need to safeguard affluent vulnerable customers via financial support. While the arguments to support the provision of non-financial support to these groups are clear, the requirement for financial support is weak.

- **The cost of safeguard protection should be fairly distributed**

If the cap extension is introduced, Ofgem must ensure a fair distribution of the lower revenue seen among safeguard tariff cap customers. We believe therefore that Ofgem should develop a similar reconciliation provision to that of the WHD. As well as ensuring that all suppliers play a fair and equitable role in delivering this policy, this approach would avoid introducing any possible disincentive on suppliers to compete for vulnerable customers.

- **Significant flaws in the PPM cap methodology need to be addressed**

If the cap extension is introduced, the PPM methodology must be revised to properly reflect the costs of an efficient supplier with sustainably priced tariffs. SSE has significant concerns with the outcomes in practice of the current PPM methodology. We have set out evidence within Annex 1 to highlight to Ofgem both the gravity of the errors in the methodology, as well as the need for urgency in resolving them.

The errors we set out are: The cost to serve benchmark is too low; smart investment is not recognised; cost of shaping demand profile is not reflected; and policy costs have escalated more quickly than the cost inflation index.

- **Insufficient time has been allocated to due diligence**

While we strongly advocate the protection of the most vulnerable customers, we believe that in capping prices for such a large segment of the market (set to increase to c.25%) the potential for unintended, market distorting, consequences is significant if this policy is rushed.

One such consequence is the reversal of positive trends in switching. Since the introduction of the PPM cap in April 2017, SSE has witnessed a [*Redacted*]% reduction in PPM switching rates[1]. We do not consider that Ofgem are allowing sufficient time or due diligence for risks such as this – and those of a more commercially disruptive nature – to be fully understood, addressed and mitigated.

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[1] PPM gains and losses for April-December 2017 compared to same period in 2016.

Furthermore, the consultation states that the safeguard would fall away with a market-wide price cap; however it has no sunset provision if the market-wide cap is not introduced. We consider it vital that Ofgem is clear about the sunset clause and gives industry and itself the necessary time to fully work through the policy as a whole, given both its potential duration as well as its complexity.

– **We request a bilateral discussion at the earliest opportunity**

We wish to work constructively with Ofgem on this and we firmly believe that it is crucial the issues with the current methodology are resolved in advance of broader, or continued, application of the current approach.

We therefore request the opportunity to discuss with Ofgem our experience of the financial implications of the PPM cap thus far, and to engage in a technical discussion about how to resolve these flaws, with substantiation of the issues we describe in 7.4 through presentation of SSE data and analysis.

In the meantime, if there are any questions on this submission, please do not hesitate to get in touch.

Yours sincerely

Patricia Hall
Regulation Manager

Annex 1 – SSE response to safeguard tariff cap extension

1 What are your views on our preferred approach of identifying consumers for safeguard tariff protection by primarily relying on data-matching?

SSE disagrees with an approach that relies 'primarily' on data-matching. If Ofgem is to pursue the extension of the safeguard tariff then we believe it is necessary for this to be achieved 'entirely' by relying on data-matching. We believe that this is the only reliable way of ensuring that the intervention benefits those it is intended to, and that unintended distortive effects on competition are minimised. Our views are set out below.

1.1 Lack of evidence to support a two-pronged approach

As Ofgem set out in their consultation, a data-matching exercise with the DWP would offer a precise, reliable and consistent way to identify Ofgem's target customer group. Ofgem suggest that the cost of setting up the necessary data matching processes for non-compulsory WHD suppliers would be prohibitively high.

Ofgem have not provided any evidence to support this claim. The feedback from a number of small suppliers at Ofgem's workshop (23rd January 2018) was that setting up such a process is neither costly nor time-consuming. Indeed, one supplier quoted that it cost them £400 and took three days.

SSE would urge Ofgem to identify and resolve any potential issues preventing all suppliers using data-matching (including seeking guidance from the Information Commissioner's Office) as a matter of urgency if it intends to progress this policy.

1.2 Importance of consistency

Irrespective of the cost or complexity involved, there was unanimous support at the recent workshop for using a consistent approach across all suppliers to avoid the serious unintended consequences of using a less-reliable alternative (as discussed in Q2). Ofgem must ensure customers are not disadvantaged depending on their supplier and that those suppliers that are most proactive and socially responsible in identifying and supporting customers with vulnerabilities are not penalised.

Given the prominent disparity in the proportion of customers on the Priority Services Register (PSR) across suppliers – as highlighted in Ofgem's 2017 Consumer Vulnerability Report[2] (see our response in 2.1) – if price caps were linked to the PSR indicator customers with equivalent vulnerability indicators who are customers of smaller suppliers could well fall through the net and not benefit from the safeguard protection. This would be a clear failure point for the effective delivery of Ofgem's policy objective.

SSE is not supportive by any means, of a two-pronged approach. In order to protect both customers and competition, all suppliers should be taking a fair and equitable role in

[2] https://www.ofgem.gov.uk/system/files/docs/2017/10/consumer_vulnerability_report_web_003.pdf

delivering this policy and customers should receive equal protection irrespective of their supplier.

1.3 Avoiding customer confusion and disengagement

Without consistency this policy will create customer confusion across the market, which is widely recognised as a barrier to engagement. Ofgem has been clear that engagement and competition is the right long-term solution for these customers, so it would conflict with Ofgem's specific policy intent to risk provoking further disengagement amongst these customers.

More generally it contradicts the wider direction of retail energy policy, driven both by Ofgem and the CMA, to focus on increased customer engagement. For example the relaxation of the prescriptive RMR (Retail Market Review) rules, Cheapest Market Offering Communication trials, the disengaged database, the Switching Guarantee, Faster Switching, the Switching Programme, as well as the Smart Meter Rollout. We are concerned that this contradiction in policy direction could compromise the effectiveness of these flag-ship programmes and in doing so it would also jeopardise the vast investment the industry has already made.

SSE has already seen a [*Redacted*]% decrease in PPM customer switching since the introduction of the PPM price cap[3].

1.4 Time constraints are insufficient justification for policy sacrifices

Given the sacrifices from a policy and operational perspective made during the design and implementation of the first safeguard tariff, it would represent a significant failure if the need for an expedient solution again took precedence over accuracy and fairness of outcome or process. For Ofgem to suggest that a less reliable identification approach could be taken for a subset of suppliers on the basis of time-constraints is hugely concerning given the importance Ofgem have placed on delivering this policy. We urge Ofgem to focus on the right solution, not the fastest one.

2 What are your views on our backstop option that requires suppliers to use the information they hold (such as Priority Services Register and debt information) to identify vulnerable consumers?

The back-stop approach is wrong for customers, wrong for suppliers, wrong for the market, conflicts with Ofgem's policy intent, and is not supported by the views expressed so far by smaller suppliers. We strongly advocate the removal of this approach as a fall-back option and urge Ofgem to focus on the right solution, not the fastest one. Our views are set out below.

2.1 Perverse disincentive for suppliers

[3] PPM gains and losses for April-December 2017 compared to same period in 2016.

SSE believes that supply licensees have a critical role to play in identifying those customers who should be placed on the PSR. Crucially, in doing so, suppliers can provide essential non-financial protection to ensure continuity of supply and enhanced support where required.

We believe the tying of safeguard tariff support to the PSR creates a perverse disincentive for suppliers to go above and beyond to identify customers in genuine need of Priority Service.

Using information submitted via the supplier Social Obligation Reports, Ofgem will be well aware of the disparity across suppliers of PSR uptake. Indeed, Ofgem's Consumer Vulnerability Report[4] states that large suppliers have generally been more proactive than small and medium suppliers in identifying PSR-eligible customers and that the average percentage of customers on the PSR for large suppliers is 18%, compared to 6.5% for small and medium suppliers.

Ofgem specifically states in this report that they want suppliers to do more to get customers onto the PSR and so it appears contradictory that Ofgem would consider introducing a policy that could discourage the promotion of the PSR.

The impact of this could be incredibly serious (for example) for those customers who have a medical requirement for continuity of supply. We could not support a policy proposal that jeopardises such an essential service for so many consumers.

SSE is highly customer-focused organisation and we have substantially more customers on the PSR (c.[*Redacted*]%) than the average for large suppliers (18%). However, not all suppliers have this view. Some may prioritise commercial outcomes over customer outcomes. We therefore consider that some suppliers would be disproportionately impacted by a price protection policy driven by the PSR and Ofgem should carefully consider whether the potential for market distortion is an appropriate risk to take. Please also refer to section 4.4.

2.2 Perverse incentives for consumers

We note Ofgem's proposal that customers in debt could be deemed to need safeguarding, which we believe would not be appropriate. It is important to provide support and guidance to customers who fall into arrears; and this will include identifying if safeguarding support is available to them.

To make indebtedness a qualifying criterion for safeguard protection creates a perverse incentive for customers to maintain a debit balance on their account. Clearly such behaviour increases risk for those households that their debts spiral out of control; negatively impacts cash flows for the energy supplier; and effectively penalises those customers who pay their bills on time.

[4] https://www.ofgem.gov.uk/system/files/docs/2017/10/consumer_vulnerability_report_web_003.pdf

2.3 Transient nature of debt

The transient nature of identifiers such as debt used in the back-stop approach could mean customers are constantly falling in and out of the safeguard tariff so would constantly see their prices fluctuate (and would need to receive the relevant regulatory notifications regularly e.g. PINs).

This would be hugely confusing and stressful for consumers, even more so if they are going through a particularly difficult – albeit temporary – time in their life e.g. a bereavement or illness. We do not consider that introducing this sort of additional stress would be appropriate and seriously risks further disengaging this customer base from the market.

2.4 Requirement for customers to opt-in to PSR

The PSR is not a proxy for disengagement. Ofgem's policy intent is for customers to receive safeguard protection automatically and given the PSR is something to which customers actively opt-in, there is a clear conflict with Ofgem's policy intent. Furthermore, this could create a barrier to switching or risk of unfair consequences, in that customers would be required to go through a separate process of opting-in with any new supplier.

We also note that the PSR is intended to provide a prompt to support customers who are likely to require a range of practical assistance. There is insufficient justification to require the provision of financial support to all of the members of this group (some of whom may be affluent), which could effectively mean that customers who don't qualify for the cap (and are possibly less affluent) will be subsidising the cost of this policy.

2.5 Insufficient justification for small supplier carve out

Please also refer to our response in 1.1 and 4.1. We urge Ofgem to identify and resolve any issues that would prevent a universal, reliable and accurate approach to be taken across all suppliers and consider, based on feedback at the recent workshop, that there is no reason for these to be insurmountable if given appropriate priority.

By considering a small supplier carve out, Ofgem risks further entrenching the disparities created by small-supplier exemptions. These disparities in cost bases contribute to the two-tier market identified by Ofgem as a concern in this consultation, with those suppliers unencumbered by these costs setting the market rate for the acquisition of new customers.

At the workshop on 23rd January 2018, there was unanimous opposition to the backstop approach. The potential negative impacts of this approach on consumers and the market are extremely serious and market distorting. We consider that it would be irresponsible for Ofgem to progress this option and would argue strongly that no intervention would be better than a damaging one.

3 Are there other methods for identifying vulnerable consumers that we should consider, either alongside or as an alternative to, our preferred approach?

We consider that the case for broadening temporary financial protection to a quarter of the GB market, ahead of a widely-anticipated market-wide cap, to be unfounded. If, however, Ofgem are to pursue this initiative then our strong view is that Ofgem should focus on the right solution, not the fastest one.

3.1 Identifying vulnerable customers to meet current policy objectives

We advocate the removal of the back-stop approach from the list of options and believe that in order to achieve current policy objectives, Ofgem should focus entirely on data-matching.

It became clear at the consultation workshop (23rd January 2018) that there are two small, but surmountable, barriers to overcome in order to progress the data-matching option; these barriers are the co-operation of the DWP and potential amendments to the Digital Economy Act.

SSE strongly believes Ofgem should be prioritising this activity over any consideration for the proposed back-stop option when there is a serious risk it might inadvertently misallocate – and possibly under allocate in some cases – the very protection this policy seeks to deliver.

Furthermore, in seeking to deliver their policy objectives Ofgem imply that the Digital Economy Act is the only Act that could facilitate this policy. SSE believes that there are provisions under both the Data Protection Act 1998 (Schedules 2 and 3) and the GDPR (Article 6 or Article 9) which should enable all suppliers to be able to data-match for the purpose of delivering this policy.

3.2 Identifying vulnerable customers to meet a revised policy objective

As per the consultation document, Ofgem notes the Digital Economy Act already allows for data-matching in order to address fuel poverty. We would encourage Ofgem to explore a revision to the policy intent to instead target fuel poor customers. This would mean suppliers could use data-matching to deliver price protection to the most in need of financial protection; and it would be more achievable within Ofgem's desired tight timescales.

4 What are your views on our proposal for all suppliers to be required to provide safeguard tariff protections to vulnerable consumers? What impact would this have on suppliers? Please provide evidence to support your views.

We agree all suppliers should be required to provide protections, but importantly that they should do so in the same way. Our views are set out below.

4.1 There is no justification for small supplier opt-out

As stated in our response to Q1 (paragraph 1.1), we note a distinct lack of evidence to support the notion that data-matching administration costs are disproportionately higher for smaller providers.

The newest suppliers are often supported through the set-up process by a third-party who manages much of the industry complexity. It should be possible for such consultancy support to be extended to include data-matching. Suppliers that have entered the market in recent years are often highly digitised, so data-management is likely to be an existing core competence.

We urge Ofgem to identify and resolve as a matter of priority any issues that would prevent a universal, reliable and accurate approach to be taken across all suppliers. Any dependencies on other organisations, such as the DWP, should be clearly identified and escalated given government's stated support for this agenda.

A two-tier approach would be likely to reduce engagement. As Ofgem are well aware, the industry has committed to and invested in various initiatives to foster competition. These initiatives include Faster Switching, the Switching Guarantee, and the Ofgem Switching Programme.

Indeed, Ofgem acknowledged in their 2017 Retail Market Report that switching between suppliers has been increasing substantially[5]. It is therefore important that Ofgem recognises the importance of continuing to foster strong competition and building on the positive reaction customers are having to these initiatives rather than risk jeopardising their success.

4.2 Impact on suppliers

In terms of impact on suppliers, the extension of the cap will carry significant operational costs. SSE currently has multiple teams across its business engaged in the delivery of the current safeguard tariff. We have experienced serious implementation issues in delivering this first safeguard cap, all of which are a consequence of working at great speed to deliver a project that reaches across our entire domestic customer portfolio. It is vital that implementation programmes are allowed sufficient time to identify and resolve issues in good time; this is an essential feature of programme management and we would urge Ofgem to fully consider this.

We note Ofgem's intention to move customers who will be protected under the current safeguard cap on to the extended safeguard cap within a very short time-frame (only 8-12 months). We expect this to carry substantial operational challenges.

[5] "Rates of switching between suppliers increased substantially in 2016, with 16% of gas and electricity accounts changing suppliers… Switching has increased further in 2017 so far, with rolling annual switching rates reaching almost 17% in June 2017, the highest since August 2011"
https://www.ofgem.gov.uk/system/files/docs/2017/10/state_of_the_market_report_2017_web_1.pdf

We have observed in our discussions with Ofgem that the safeguard cap is more complex to deliver than the PPM cap, given that the eligible customers are currently using a range of tariff and meter types. The requirement to reconfigure and test systems and communications, to brief and train frontline staff and ensure that the additional regulatory reporting requirements are met is both expensive and risks impacting service to our broader customer base.

Furthermore, the consultation states that the safeguard would fall away with a market-wide price cap; however it has no sunset provision if the market-wide cap is not introduced. As such, Ofgem is curtailing engagement and consultation on a far-reaching proposal which has no pre-determined end-date. We consider it vital that Ofgem is clear about the sunset clause and gives industry and itself the necessary time to fully work through the policy as a whole, given both its potential duration as well as its complexity.

We again urge Ofgem to re-visit whether this is an effective step to take at this time, particularly given the progress of the Government's draft Price Cap Bill.

4.3 Fair distribution of the Safeguard Tariff Cap

The mechanics of the WHD scheme are such that the cost of supporting those most in need is spread across the industry in proportion to the scale of competitors in the Supply Market, with Ofgem undertaking a reconciliation exercise where suppliers over or under index. This mechanism is a key policy principle and is reflective of Government's understanding that, firstly, those customers in need of WHD are not evenly distributed across all suppliers, and secondly, that it is appropriate and justified that suppliers contribute a level of funding that is reflective of the size of their customer base as a whole.

[*Redacted*] We consider there to be a risk that SSE and some other suppliers have more vulnerable customers than their market share and are therefore very likely to be disproportionately impacted by the extension of the safeguard tariff cap.

To ensure a fair distribution of the lower revenue seen among safeguard tariff cap customers (versus each suppliers Weighted Average Selling Price), Ofgem should develop a similar reconciliation provision to that of the WHD. As well as ensuring that all suppliers play a fair and equitable role in delivering this policy, this approach would avoid introducing any possible disincentive on suppliers to compete for vulnerable customers.

We believe that this feature of a safeguard tariff cap is important irrespective of the target headroom provided. We also believe that as an annual process this is unlikely to create an unmanageable administrative burden for suppliers or Ofgem.

5 What are your views on our proposal regarding the tariff types and meter types our extended safeguard tariff protections would apply to?

We have no objections to the inclusion of default and SVT tariffs, and all meter types, with the obvious exclusion of PPM, where Safeguarding arrangements are already in place.

6 Which of our two options for setting the benchmark component of the safeguard tariff would be most effective?

SSE does not support Ofgem's proposal that additional safeguarding should be introduced at this time. We believe that the compressed timeline, proposed short shelf-life, potentially harmful impacts on customers and competition, and the critical need for early and extensive engagement around any SVT cap arrangements, mean that this safeguard protection should not be progressed.

We consider that both options proposed by Ofgem carry serious risk and we specifically oppose any further consideration by Ofgem of the basket of tariffs option. Further, we note that Ofgem has discounted three of the five proposed options in the interests of rapid implementation. However, given that we believe it is essential that Ofgem allows sufficient time for due diligence and should prioritise the right solution over the fastest solution, full consideration should be given to all five options.

While we believe that full consideration should be given to all five options, we have set out our thinking below in response to Ofgem's question in relation to which of Ofgem's preferred two solutions would be most effective.

6.1 Revised PPM price cap methodology preferred

SSE has significant concerns with the outcomes in practice with the current PPM methodology. Evidence on relative cost to serve for the most recent Consolidated Segmental Statements suggests that SSE is amongst the most efficient large suppliers[6]. Nonetheless, our experience of the PPM Cap to date is that [*Redacted*]. We trust this experience highlights to Ofgem both the gravity of the errors in the methodology, as well as the need for urgency in resolving them.

6.2 Risk of not revising PPM price cap methodology

Continuing with a flawed calculation would erode supplier headroom and compromise our ability to compete for these protected customers. Given this proposed extension seeks to capture 25% of the market, it is vital we ensure price protected customers remain attractive to suppliers to avoid devastating and long-terms impacts on the competitive market.

We have set out our views on the PPM methodology in Q7 below.

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[6] http://www.ofgem.gov.uk/publications-and-updates/energy-companies-consolidated-segmental-statements-css

7 Do you have any comments on the design issues for either of our two options?

In Ofgem's consultation document and at the recent consultation workshop, a number of serious concerns were raised in respect of the basket of tariffs option. Specifically, SSE is concerned that the cheapest tariff in the market at a certain point in time may not be reflective of efficient and sustainable operating costs for a large customer base. For example, the cheapest tariff might be a deep discount short term offer with a capped customer base, targeted specifically at smart customers (for example). How Ofgem would calibrate the safeguard cap around such highly variable and potentially unsustainable market offers, while ensuring suppliers have sufficient headroom to compete for this large customer group, is not clear.

We do not believe that consideration of the basket of market tariffs approach should be progressed – and we took that to be the view of the rest of suppliers at the consultation event – so have not commented in detail on its associated design issues. Please advise if you require us to comment further on this approach.

We believe that if the PPM Price Cap methodology is to be utilised, then a number of issues urgently need to be addressed. These issues fall into four areas:

7.1 The cost to serve benchmark is too low

Our analysis shows that the cost to serve benchmark in the cap is too low, and does not reflect the costs of an efficient supplier operating at scale, serving a diverse range of customers, using a sustainable and proven business model.

The Mid-Tier Suppliers used in the benchmarking exercise have targeted a subset of the high value / low cost customers. This is supported by consumer profiling data (GB TGI 2017, Kantar Media), which shows that both OVO and First Utility under index in terms of the proportion of their customers who have annual incomes <£17k per annum (24-25%, vs 28% of GB Households), and reflects stringent credit checking and advance payment policies that are employed by these firms. It is therefore not reasonable to assume that their prices (or cost base) should represent a sound benchmark for energy suppliers that have a more inclusive policy, and consequently more diverse and representative customer bases.

Furthermore, the 2016 Statutory Accounts for Ovo[7] and First Utility[8] (the Mid-Tier Suppliers used in the benchmark) indicate that neither business has yet proven its ability to generate the sustainable profits that should be expected from an efficient operator.

We also have concerns about how wholesale prices may have impacted the level of the benchmark tariff and potentially given the impression of a more efficient operator. A large proportion of direct costs come from energy and the volatility in market prices and hedging approach can have a significant impact on costs. We do not know the hedging approach that

[7] Ovo Energy Ltd, Annual Report and Financial Statements for the Year Ended 31 December 2016
[8] First Utility Limited, Report and Financial Statements for the Year Ended 31 December 2016

was employed by OVO and FU during the benchmark period but with falling wholesale prices over 2015 it is likely they had a benefit over larger suppliers' SVT hedge levels as these are likely to have been purchased over a longer period. This impact should be removed from the benchmarking calculation or a different approach should be taken.

7.2 The cap does not recognise the full investment in smart metering and associated systems

Our evaluation is that the cap does not appropriately recognise the significant investment in smart metering and associated systems, and that application of CPI to this component of the PPM price cap is overly simplistic. The benchmark was set without reference to differences in OVO and First Utility's smart meter roll out strategy relative to other market participants, fails to recognise the implications of delays in the programme moving from SMETS1 to SMETS2, and fails to acknowledge the importance of smart meter roll out to overall customer economics.

The costs incurred by suppliers in rolling out smart metering are complex, and have increased substantially since the Government's 2011 smart programme cost benefit analysis. We urge Ofgem to avoid oversimplifying these costs and to conduct a review – through the consideration of an appropriate data source – so that they are properly accounted for in any price cap methodology. The importance of closely matching allowable costs (under cap price revisions) to the costs seen by suppliers who are efficient in rolling out smart meters should not be under-estimated.

To support our point, we have set out some examples below of the substantial revisions to the 2011 costs protections (some of which may increase further), which we do not consider have been factored into the PPM methodology to allow all suppliers to recover them properly.

Example cost increases[9]:

- DCC Costs –[*Redacted*]

- SMETS 1 volumes **-** SMETS1 meters are more expensive per annum than SMETS2. As SMETS1 volumes escalate the costs of our data service contract simultaneously rise, with this contracted on a per meter basis. Larger volumes of SMETS1 meters also increase the costs of their enrolment into the DCC.

- Marketing costs – [*Redacted*]

- Capex costs – [*Redacted*]

[9] This information comes from an internal SSE analysis looking at cost escalations since the 2011 Government impact assessment.

7.3 **The energy cost provision does not reflect the true costs of shaping**

We believe that the energy cost provision within the PPM cap is too low. Our analysis suggests it does not appropriately take account of the full cost of supplying our customers' demand profile (in each settlement period).

7.4 **Policy costs have escalated more quickly than the cost inflation index**

We believe there are significant errors within the methodology, and that failure to address these will lead to an unsustainable divergence of the true costs and the indexation.

For environmental costs (RO, FiT, CfD, and CM) an OBR forecast is used to index the costs. The index is based on a forecast of the total industry costs (£bn) but takes no account of the declining demand (TWh) over which the costs are to be recovered. This will impact the cost of the environmental policy on a price per unit basis (p/kWh), which is crucial in accurately calculating the cap.

7.4.1 Impact of declining demand on cost recovery

The demand over which the environmental costs are being recovered is declining as a result of energy efficiency and the exemption of both the Energy Intensive Industries and Guarantees of Origin volumes. This is adding significant cost inflation, which is missing from the cap indexation. We believe that Ofgem should update the methodology to appropriately reflect declining demand.

7.4.2 Impact of uncertainty on cost recovery

Notwithstanding this fundamental issue, it is important to note that there is no certainty over the environmental costs, and the lack of any reconciliation process exposes suppliers to significant risk. The OBRs forecast lacks detail and we note that there are higher forecasts being produced by respected independent consultants. Uncertainty on some costs (such as FITs and CfD) will remain throughout the year as these are dependent on installed capacity, utilisation, weather and wholesale prices. We would like to see improved transparency and a true-up mechanism to correct for inevitable deviations from the forecast.

7.4.3 **Impact of volatility on cost recovery**

There are similar significant errors due to the volume issues on ECO, as declining demand (TWh) and the continued growth in small suppliers (who are exempt from ECO) mean the costs of delivering ECO are being recovered from a smaller subset of customers, each of whom have progressively lower levels of consumption. Moreover, our experience of ECO has shown that costs cannot be certain with supply and demand issues creating volatility in ECO market prices.

The likely move towards an entirely fuel poverty-focused scheme will increase measure costs. In addition, the increased compliance burden on contractors carrying out retrofit work, coupled with on-going policy uncertainty, is reducing the pool of active installers in the market. This is already beginning to result in upwards pressure on ECO funding rates. These dynamics are combining to push up the prices per unit (p/kWh). We believe that Ofgem should revisit the cap indexation methodology and ensure that this issue is appropriately addressed and that the resulting treatment of the Energy Intensive Industries exemption remains appropriate.

7.5 Resolving issues of the current PPM cap methodology

We request the opportunity to discuss with Ofgem our experience of the financial implications of the PPM cap thus far, and to engage in a technical discussion about how to resolve these flaws, with substantiation of the issues we describe above through presentation of SSE data and analysis.

We believe that it is crucial that issues with the current methodology are resolved in advance of broader (or continued) application of the current approach.