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Dear Jemma,

SSE response to Ofgem Working Paper 3: Approach to Headroom

SSE welcomes Ofgem's continued engagement with the industry on the development of the default tariff cap and is pleased to respond to Working Paper 3. This is a particularly important topic to which we were keen to allocate sufficient time and resource, so we very much welcomed the extension granted by Ofgem.

We look forward to increased engagement on this topic once Ofgem is closer to a conclusion on their preferred approach.

Summary of SSE's key considerations

- Sufficient headroom is required so that suppliers can innovate, invest and compete (objective b);
- Sufficient headroom is required to facilitate price dispersion, which is key to incentivising switching (objective c)
- The PPM market provides a live example of how prices can converge and switching decrease following the introduction of a cap; Ofgem must duly consider this evidence, as well as evidence from other market e.g. New South Wales;
- Sufficient headroom is required to allow suppliers to manage the inherent uncertainty of operating in the retail energy supply market (objective d);
- Headroom is a vital element of the cap and we consider that this will not interfere with incentives to improve efficiency (objective a);
- The markets for fixed and variable tariffs are linked and Ofgem should have due regard for the interdependencies of both products when designing the cap and not focus purely on the price reference of a fixed product.



Additional considerations at this stage

Cost of Smart Meter Rollout

We regret to see that in Working Paper 4 Ofgem has opted not to provide their thinking on how the cost of the smart meter rollout will be provided for in the cap methodology. We are very concerned by this. We would like to understand when and how Ofgem intends to consult industry on their thinking in this area.

Future of safeguard tariff

SSE would welcome confirmation that Ofgem remains committed to removing the existing safeguard tariff cap if the default tariff cap is introduced this winter. This is to inform our resource and project planning in relation to our safeguard tariff team and system support.

Commentary on Annex B of safeguard consultation technical document

SSE welcomes the invitation for comments on the methodology contained in Annex B. Overall the approach is clear and logical, and it is positive that Ofgem have recognised the numerous assumptions and limitations involved here.

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

Yours sincerely

Patricia Hall
Regulation Manager



Annex 1: SSE response to Ofgem Working Paper 3

SSE strongly believes that headroom is a vital component of any default tariff cap and that, in conjunction with a bottom up assessment of costs, it is the only way to ensure that the four policy objectives (below), can be balanced.

Objective a	The need to create incentives for holders of supply licenses to improve their efficiency
Objective b	The need to set the cap at a level that enables holders of supply licenses to compete effectively for domestic supply contracts
Objective c	The need to maintain incentives for domestic customers to switch to different domestic supply contracts
Objective d	The need to ensure that holders of supply licenses who operate efficiently are able to finance activities authorised by the license.

We have set out our position on Ofgem’s approach to headroom within this Annex, looking at specific areas of concerns and pointing to evidence where available.

1 The importance of headroom

Until we understand the methodology Ofgem intends to adopt and where, within that methodology it intends to make a provision for headroom, SSE is unable to provide our view on the level of headroom required. However, there are important roles headroom plays in any cap methodology, which should be duly considered in the decision process.

1.1 Ensuring that efficient operators are able to finance activities authorised by the license

Headroom is particularly relevant to achieving objective (d). Although it is important that the cap is set with reference to suitable benchmarks that reflect the true costs of serving retail customers, inevitably it will be very difficult to construct a benchmark that *perfectly* captures the true costs of the business. As we set out in our previous submissions, this risk is particularly pronounced under some mechanisms (e.g. those based on a market-basket and/or based on a very slim EBIT allowance to cover the cost of capital). Although the cap should be designed to minimise such risks, such a significant intervention in the market will inevitably create mismatches between the price cap and true underlying costs. Allowing sufficient headroom to support consumer engagement will also help ensure that such risks can be met without damaging the financeability of the businesses supplying them.

1.2 Enabling switching, by providing headroom for a diversity of strategies

It is widely recognised that cost is a primary incentive for customers to engage in the energy market¹. For customers to benefit from cost savings through switching, price dispersion is essential and it is therefore necessary that Ofgem's cap design allows for it. Indeed, objective (c) laid out in the legislation requires that the cap maintains incentives for customers to switch supply contracts; the fact that this is stipulated in legislation underlines the very real risk that the cap could negatively impact customer engagement if not designed correctly.

Headroom is the mechanism that allows suppliers to innovate, invest and compete, and in doing so, incentivise engagement. For Ofgem to propose (in paragraph 3.4) that headroom might not be necessary is contradictory not only to the objectives of the legislation but also to Ofgem's wider focus on – and indeed industry's substantial investment in – programmes to incentivise engagement e.g. the Smart Meter Rollout and the Switching Programme.

When sufficient headroom is allowed for, the market (which now constitutes 60 domestic suppliers²) can adopt and adapt a variety of strategies to compete for and engage consumers. For example, pricing towards the lower end of the headroom range either to increase customer base or to minimise customer churn; or pricing towards the upper end of the headroom to allow for investment and innovation that seeks to engage customers in the long run, and funding this as necessary through the headroom. For example, there is evidence to show that some consumers are engaged but choose not to switch precisely because they value a supplier's customer service offering, which of course requires investment on the part of the supplier.

It is in the range of strategy options open to suppliers that customer choice and competition is enabled, which in turn leads to price and service offer dispersion and customer engagement. By contrast, if insufficient headroom is available (or if the cap is flawed meaning that the headroom has to be used simply to recover costs), the ability of suppliers to differentiate their offer by pricing below the cap becomes more limited. In turn, customers are less likely to find sufficient reward in engaging with the market (as has already been seen in relation to PPM), and may well get "out of the habit" of engagement – seeing all offers as much the same. This could then make it very difficult to re-establish full competition for this segment in due course

Given the severity and scale of the potential consequences of such a scenario, SSE cautions Ofgem to carefully consider the allocation of headroom within the cap to ensure that it is sufficiently high to facilitate competition and the financial viability of efficient market operators.

1.3 Providing flexibility to manage uncertainty

¹ 'Making savings was listed as an incentive to switch by 91% of customers from 2014 – 2017' Figure 2.4; Ofgem State of the Energy Market report, 2017.

² 'Domestic Retail Energy Market Structure' p 20. Ofgem State of the Energy Market report, 2017

Ofgem references the importance of headroom in enabling suppliers to compete and provide incentives for customers to shop around (paragraph 3.3). SSE entirely agrees with this statement; however it is vital that Ofgem recognises that the risk associated with operating in the energy supply market – which is substantial and multi-faceted – also needs to be appropriately accounted for in the headroom (or explicitly accounted for elsewhere in the methodology) to ensure that Ofgem adheres to policy objective (d). Please refer to section 6 below where we explore further some of the most volatile areas of uncertainty that must be accounted for in the methodology.

1.4 Price-based indexation approaches require the highest headroom

We note Ofgem’s preference for there to be a price-related component to the cap – which was explored in our bilateral meeting on 21 March 2018. We do not consider this the most appropriate option, and believe that embedding pricing data into the cap mechanism itself presents significant risk that the resultant cap will be volatile and unreliable; in particular, we are concerned that movements in the price cap would not bear close relation to movements in underlying costs. This has the potential to create substantial hedging risk, and therefore a significant cost to managing this risk – which must be recovered through a higher EBIT allowance and/or managed through headroom.

Our strong view is that a rigorous bottom up approach will better balance the four policy objectives and minimise the scope for the cap to be skewed by unsustainable or unrepresentative price indicators. If Ofgem are to pursue the use of price references, then substantial headroom would be required to absorb the inevitable inaccuracies and volatility in the methodology to avoid adverse market outcomes (such as risk of efficient, or potentially efficient, companies being unable to continue to finance their supply activities, in conflict with objective (d) on financeability as set out in the legislation).

2 Headroom should not interfere with incentives to improve efficiency

Ofgem set out in paragraph 3.4 that the provision of headroom may not be necessary to meet the objections within the legislation. We consider it important to clarify that the inclusion of headroom poses no risk that a supplier may lack incentive to improve efficiency.

There are a range of reasons that a supplier may have superior efficiency relative to its rivals in any given period, including:

- (i) A strong focus on reducing costs over time, for example via strategic decisions to use lower-cost systems and offer less differentiated customer service;
- (ii) Acquiring customers who cost less to serve (because they use self-service channels, have low debt intensity, do not draw on vulnerable customer support, etc.); and
- (iii) The implementation of a successful (or fortunate) hedging strategy.

Further cost advantages are also likely to apply, which while not related to being an efficient operator are nonetheless important, for example outsourcing hedging arrangements have lower associated capital requirements (and consequently result in a lower normal rate of return). Such advantages result in additional opportunity to invest in a particular strategy set.

Taken together these points illustrates that incentives do exist and will continue to exist in a price cap environment where sufficient headroom is provided for in the methodology. This should therefore alleviate any concern that the provision of headroom might not align with objective (c) as set out in the legislation.

3 Price differentials are essential to maintaining incentives to switch

Given the evidence available, which we have set out below, we consider that Ofgem should be extremely careful when setting the default cap that the design does not jeopardise the financial viability of operating in the retail energy market as well as the incentive for customers to engage. In particular, the early evidence from the PPM segment provides a concerning picture of how some of the most important features of a competitive market can be eroded in a short space of time and it cannot be disregarded.

3.1 CMA and YouGov research highlights the importance of a minimum saving value

In order to support continued consumer interest in switching, sufficient differentials need to exist between the Default Tariff Cap prices and the alternative offers that consumers might choose. Research conducted as part of the CMA Energy Market Investigation explored the attitudes of consumers to switching. This research found that consumers require a minimum saving per annum of £158 (on average) to encourage them to switch. The median saving value was £114 per annum³. We note that similar trends were reported in the YouGov (October 2017, Wave 12, YouGov Utilities Tracker), made available by YouGov and subscribed to by Utilities companies.

This research highlights the importance of ensuring sufficient price dispersion exists so that consumers are offered sufficient price savings to encourage switching.

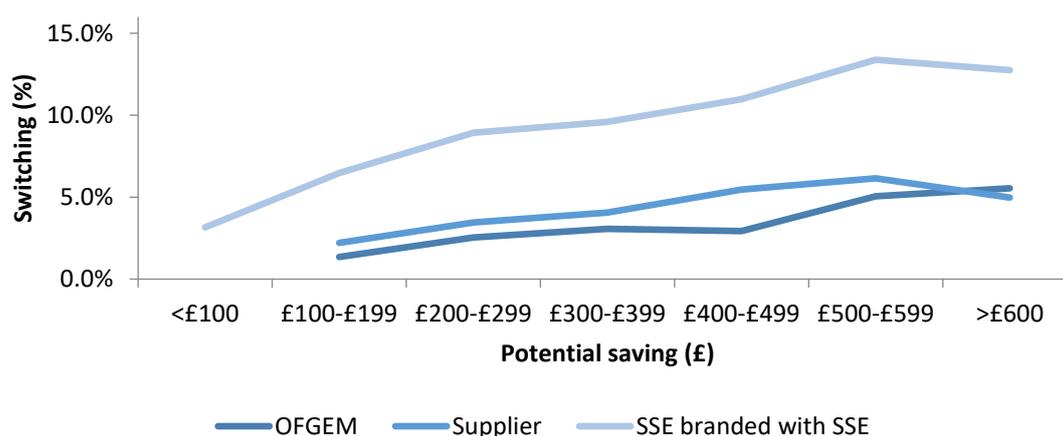
3.2 In-house SSE trials reinforce the importance of price dispersion

SSE ran a parallel trial alongside the Ofgem 2017 CMOL trial, to understand whether including an SSE tariff would further increase customer switching. Using data points from this, we analysed the correlation between switching rates and annual savings and found that up to a

³ Energy Market Investigation Report for CMA, completed by GfK NOP, Feb 2015, Para 149

certain point, higher savings correlated with higher switching. Please see Figure 1 below which illustrates the trends observed.

Figure 1: Results of SSE’s CMOL parallel trial showing switching activity at each saving point



Source: SSE CMOL Parallel Trial, trials conducted in June 2017, and included 94,878 participants across all trial arms (there were three trial arms).

This further strengthens the argument that savings and switching are linked and that to adhere to policy objective (c) – maintaining incentives to switch – Ofgem must ensure that headroom is provided at an appropriate level to avoid the introduction of a cap that diminishes price dispersion and thus the potential savings that a customer requires in order to engage in the switching process.

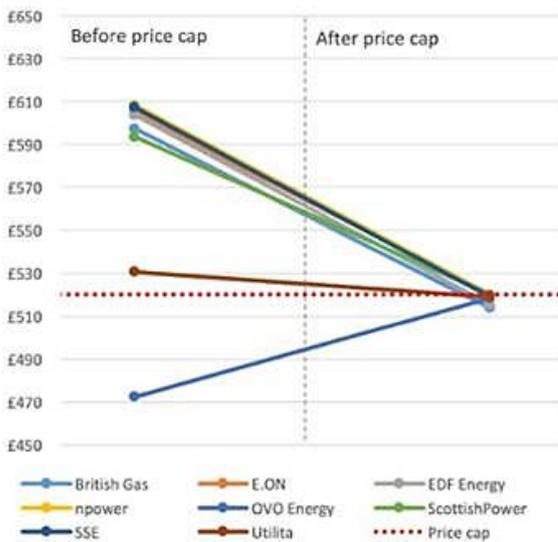
3.3 The prepayment price cap illustrates the risks when cap prices are set too low

Trends in the PPM market offer a live example of how the market might converge after a cap is introduced. Ofgem’s own research into the impact of the safeguard tariff on the PPM market illustrates the reality of post-cap price convergence very clearly. Please refer to Figure 2 below, which is taken from Ofgem’s 2017 Retail State of the Market Report⁴.

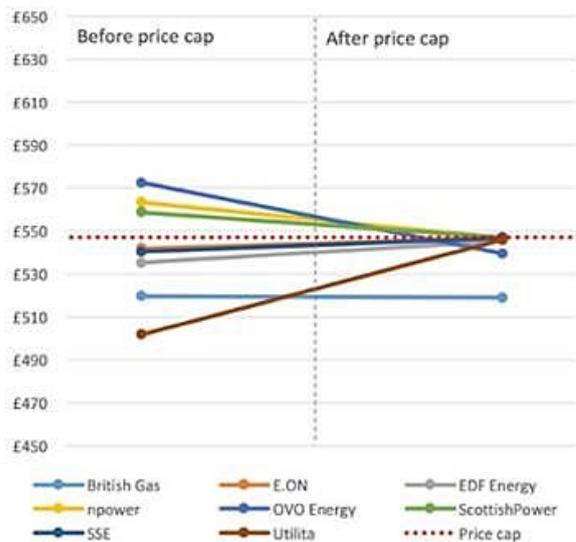
Figure 2: Ofgem’s analysis showing post-PPM cap price convergence (“Prepayment tariff prices before and after the price cap”)

⁴ Impact of Safeguard Tariff for PPM prices; Figure 2.13; Ofgem State of the Energy Market, 2017

Annualised cost of gas for a typical household



Annualised cost of electricity for a typical household



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

Source: *Impact of Safeguard Tariff for PPM prices; Figure 2.13; Ofgem State of the Energy Market, 2017*

As set out in our response to Ofgem's safeguard cap extension consultation, SSE's firm view of the PPM cap is that the cost to serve benchmark is too low; smart investment is not recognised; the cost of shaping demand profile is not reflected; and policy costs have escalated more quickly than the cost inflation index.

SSE is not alone in the assertion that the benchmarking and cost-reflectiveness of the PPM cap is flawed. Ofgem published a summary of responses to their consultation on extending the PPM cap, in which Ofgem state "most respondents also highlighted a number of concerns with the accuracy of the existing benchmark. Most respondents, including the vast majority of suppliers, highlighted that it was essential to consider whether the methodology should be at least modified, and ideally recalculated, to ensure it is cost-reflective."⁵

Our expectation is that price convergence is occurring at the top end of the cap because suppliers are forced to use the allowable headroom to recover costs, a situation that results from poor indexation. We believe Ofgem should be concerned about the impact this has had

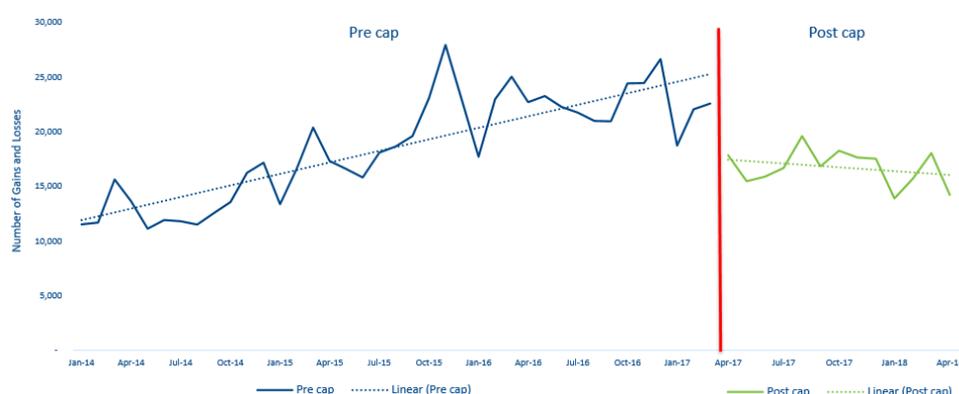
⁵https://www.ofgem.gov.uk/system/files/docs/2018/03/providing_financial_protection_to_more_vulnerable_consumers_-_summary_of_consultation_responses_0.pdf

on switching and indeed what the consequences of the poor indexation could have been if there had not been an allowance for headroom to mitigate this.

3.4 SSE in-house analysis on PPM switching rates

As we have explained previously, seeing less switching in this segment than before the cap. In Figure 3 below, we have provided data charting the total gains and losses on a quarterly basis of PPM customers since 2014. In terms of total volume of SSE’s PPM customer switching, the volume of switches in the 12 months to 31st March 2018 was 25% lower than in the 12 months to 31st March 2017 (when the cap was introduced) and 20% lower than in 2015/16. Thus, while there are various factors that might affect switching activity in this segment it is clear to see that there has been a marked decline in switching since the cap was introduced. Looking beyond 2017 in Figure 3 we can also see that PPM switching activity had been on an upward trend, increasing in line with general industry movements, and then drops once the cap is introduced, again this is illustrative of a potential emerging trend in this part of market.

Figure 3: Total PPM gains and losses 2014 - 2017



3.5 Evidence from New South Wales

It is prudent for Ofgem to consider experience in other markets where price caps have been used. Of particular relevance is the example of price caps in New South Wales, provided by Energy UK in their response to Working Paper 3 (exert provided below).

The example of New South Wales illustrates how price controls can reduce price dispersion and weaken competition – and conversely, how relaxing the price control can allow competition to flourish.⁶ 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

⁶“[Review of Regulated Retail Prices and Charges for Electricity](#)”, Independent Pricing and Regulatory Tribunal of New South Wales (IPART) (2013): p. 114 (table 9.2).

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). 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 Independent Pricing and Regulatory Tribunal (IPART) to ultimately conclude that the price control could be removed altogether.

3.6 The market for fixed and variable tariffs are linked so overall price dispersion is key

Ofgem notes (paragraph 3.6) the importance of considering fixed tariffs versus variable (and default) tariffs. Our view is that the market for fixed tariffs and variable (and default) tariffs are inextricably linked and that Ofgem must have equal regard for both when seeking to meet the Bill's objectives. There is a risk that the introduction of a cap could dampen the level of discount offered in non-capped products by limiting revenues across the entire market and thereby limiting suppliers' ability to differentiate between tariffs. This again carries the risk of reduced consumer engagement, even beyond the SVT segment.

Indeed, Ofgem's own analysis in the 2017 State of the Energy Market Report states 'we estimate that if SVT prices were reduced so that they provided the same gross profit margin as fixed tariffs, then suppliers would have made a 6% loss.'⁷ SSE's view is that any default tariff cap will have an impact on fixed tariffs.

Dermot Nolan, Chief Executive of Ofgem, gave evidence to the BEIS select committee as part of its pre-legislative scrutiny of the draft price cap Bill (January 10th 2018). While Dermot Nolan was supportive of the cap, he acknowledged the importance of price differentials in a competitive market.

Ofgem's acceptance of this fact further emphasises that great care needs to be taken not to set the cap at a level that would disrupt the healthy competition currently taking place to acquire customers, often onto fixed tariffs⁸. As set out in section 4.1, it is vital that Ofgem is also cognisant of what research is telling us, not just about minimum incentives to switch but also the immediate and early trends in PPM market post PPM cap (see section 4.2).

4 Supply-side risk factors need similar careful consideration

The energy supply market is a volatile and high-risk environment and requires that suppliers balance uncertainties and risk on a constant basis, which makes it essential that Ofgem's

⁷ Higher prices for SVT customers; Ofgem State of the Energy Market, 2017

⁸ 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"

chosen methodology for the default cap – even if it is a cost-based approach – accurately accounts for these uncertainties either by providing sufficient headroom or introducing an appropriate correction factor. In order to do this, Ofgem must fully understand these uncertainties, and that they are frequently outside of suppliers’ control. We have listed some of these below:

Energy costs

There are several considerations in relation to energy costs, assuming similar wholesale price indexation as PPM cap, which are listed below:

- Shape: Customer demand shape cannot be perfectly hedged ahead of time in the forward wholesale market. The current methodology does not account for the risk of near term wholesale price spikes that can have an adverse impact on the underlying shape cost.
- Bid/Offer spread: The wholesale price indexation within the current methodology is based on the mid-point of forward market price data (bid and offer prices), which is published by ICIS Heren. The cap methodology needs to account for the risk that suppliers are not able to transact at the midpoint and therefore incur losses.
- Baseload/Peak ratio: Electricity hedging is calculated using a weighted average of baseload and peak products (Baseload 70%, peak 30%). There is a risk that this weighted average – which is essentially a forecast – is not perfectly matched with actual customer usage. Such a mismatch is a price risk that must be factored into a cap methodology.

Policy

Any forward-looking mechanism will struggle to account for the inherent uncertainties in forecasting policy costs.

- For example, weather will play a significant role in setting the outturn level of FiT, CfD and RO costs, and wholesale price movements will further influence the final CfD costs.
- In addition, certain aspects of the policy costs may not be known in sufficient detail at the time the cap is set, for example with the auctions for the Capacity Mechanism and in finalising the ECO3 scheme rules.

Use of System costs

- Generally network charges are set sufficiently in advance that any changes should be picked up – however some shorter term impacts may not be, such as the recovery of SOLR costs through network charges and the raft of modifications being considered on Transmission charges.
- BSUoS costs cannot be known with any certainty as they are only determined by particular network constraints and supply/demand conditions.

Other costs

- There are a number of factors outside the supplier's control. For example, the economic climate can affect the levels of customer debt and debt write off. The introduction of new regulatory or legal obligations can increase the cost to serve burden.
- Also, included in 'other costs' is the cost of financing the smart meter rollout, which is escalating above the original impact assessment. We expect Ofgem to address smart costs in great detail either view the upcoming consultation and would welcome insight into Ofgem's early thinking.

Demand

There are a number of inherent demand uncertainties outside the supplier's control.

- At a national level these determine the volume of qualifying demand over which policy costs are recovered, which in turn determines the outturn unit rate costs faced by suppliers.
- At a customer level fluctuating demand (e.g. due to the weather) introduces uncertainty into energy procurement as mentioned earlier, but also impacts the recovery of any fixed costs that is not fully reflected in the standing charge. This would extend to include any 'capacity' based costs being recovered through the unit rates (eg gas transportation charges).
- At a settlement level these can drive a cost gap between Purchase volumes and Sales volumes – this could be due to level of theft, errors in the system operator's losses and shrinkage estimates, or changes in the settlement allocation rules.

These risks must be managed by energy companies and there is a cost to managing such risks. As can be seen from the factors set out above, different cap designs will have major implications for the level of risk to be managed. This risk will either need to be managed through allowing a higher EBIT (to reflect the higher cost of capital associated with a riskier business profile and cash flows) and/or a higher headroom, to allow volatility in profit streams to be smoothed through the competitive process.

5 Working Paper 3 gives rise to some key questions we believe Ofgem should engage with industry to address

5.1 Does Ofgem intend headroom to protect against model and indexation issues?

The default tariff cap will need a mechanism to deal with issues of model accuracy and imperfections in indexation. In some schemes (such as Northern Ireland) this is managed through a correction mechanism, in other schemes (such as the prepayment cap) correction

for certain errors are built into the headroom design. SSE's view is that the provision of additional headroom would be less administratively burdensome than a correction factor but this is critically dependent on Ofgem's selected methodology. If the cap design is predicated on a relatively low 'normal rate of return' then a more complex correction mechanism such as is used in NI would be required in order to secure the financial viability of efficient suppliers. We are interested to understand Ofgem's thinking on this issue.

5.2 How does Ofgem intend to calculate 'normal rate of return'?

SSE notes that Ofgem's formulation of the price cap presented in Section 3.1 includes a normal rate of return as part of the assessment of efficient costs. However, it is clear that if there is insufficient headroom to cover all of the significant uncertainty inherent in indexing efficient costs over time, then the normal rate of return earned by efficient suppliers will be eroded, as in the case of the PPM cap. This is a material risk that could potentially leave efficient suppliers unable to finance their licensed activities.

The CMA's Energy Market Investigation failed to land on a plausible estimate of a normal rate of return for energy supply based on any comparison either with other market segments in the UK or with energy markets in other jurisdictions. It is entirely incongruous that the EBIT margin of 1.9% as presented in the CMA's Final Report⁹ (for large suppliers that managing their hedging activities in-house) was significantly below the regulated margin in Northern Ireland¹⁰ – a market in which suppliers are exposed to significantly lower risk than suppliers operating in GB. We note that the WP also refers to NI retail price controls as including no headroom: again, the very different risks relating to Power NI (as a firm still with a dominant share of the NI market, and with a tariff structure designed to provide full adjustments for over- or under-recovery of wholesale costs, for example) need to be taken into account before concluding that this would be an appropriate approach for the mainland market.¹¹

SSE presented analysis to the CMA addressing the specific concern that EBIT figures cannot easily be compared between different market sectors due to the fact that these sectors can have different levels of capital intensity. This issue could be addressed by limiting the comparator set to asset light companies with a relatively low level of capital intensity. A high-level analysis of FTSE100 companies revealed that, within the period from 2008 to 2013, companies with the 5th and 10th percentile lowest capital intensity made an average margin of around 5% and 6%, respectively.¹² This is an example of a practical and evidence-based

⁹ CMA FR Appendix 9.10: Analysis of Retail Supply Profitability, para 159.

¹⁰ The regulated margin in NI was 2.2% when the CMA's Final Report was published.

¹¹ See <https://www.uregni.gov.uk/sites/uregni/files/media-files/Electricity%20Tariff%20Briefing%20Paper%20-%20August%202017.pdf> for the latest tariff review.

¹² The capital intensity is calculated as the sum of net debt and market capitalisation of equity, divided by revenue. The 5th percentile average in the sample is supported by 12 companies from 9 industries over 5 years of data with 26 observations.



step that can be taken to adjust for differences in risk and improve the comparability of the benchmark group.

Ofgem will have its own view on the normal rate of return appropriate to energy supply but must have due regard to the systemic risk that would be imposed on suppliers should the price cap be formulated with insufficient headroom. Any erosion of the normal rate of return earned by suppliers on the default tariffs serving the majority of GB households would necessarily jeopardise suppliers' ability to finance their activities.