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Sent by email to: retailpriceregulation@ofgem.gov.uk

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Dear Anna,

SSE response to Ofgem Default Tariff Cap Policy consultation

We welcome the publication of the policy consultation and the opportunity to provide input for Ofgem's consideration on this important topic.

SSE fully recognises the challenging task at hand to deliver the objective of the bill, protecting current and future consumers who pay by SVTs or default tariffs, whilst adequately having regard to: the need to create incentives for suppliers to improve their efficiency; the need to enable suppliers to compete effectively; the need to maintain incentives for customers to switch; and the need to ensure that efficient suppliers are able to finance their licensed activities. We also recognise the imperative for Ofgem to introduce the cap as soon as practicable, and so have sought to provide clear and direct input throughout.

We are primarily concerned with ensuring the best outcome for our customers, and that arrangements support the development of a healthy, well-functioning and competitive energy supply market into the future.

Our response is structured into the following sections:

Annex 1 – SSE views on overarching regulatory process

Here we set out our views on the pace, scope and nature of the regulatory process for this extremely complex and far reaching intervention that has clear potential to lead to unintended and adverse consequences for consumers by undermining the competitive process; and highlight key matters to which Ofgem must demonstrate appropriate regard.

Annex 2 – SSE Response to main consultation questions (Q1-6)

In this section, we:

- Urge Ofgem to adopt a bottom-up approach to setting the default tariff cap, as we believe this minimises risk and maximises accuracy;
- Explain the way in which we believe inaccuracies in matching actual wholesale costs to an assumed index, have caused substantial inaccuracies in the PPM Cap, and risk being repeated here under a 'benchmark' approach, unless wholesale costs are precisely isolated in any indexation
- Make the case for utilising the most recent data to ensure the cap is set accurately, and outline why Ofgem should not consider using 2015 data;
- Propose that Ofgem reverses its decision to discard the option of updating the cap through a periodic review of costs;
- Set out the important role that headroom plays both in covering risk and enabling competition, and that EBIT allowances should be uplifted to a more realistic level;
- Provide guidance on how best to determine payment method uplifts between direct debit and standard credit;
- Explore the fact that any evidence that Ofgem might use support a recommendation to remove the cap will be tainted by the cap's expected dampening impact on the competitive process; and
- Assert that in our view the interests of future customers are best served by minimising the duration that any default tariff cap exists.

Annex 3 – SSE response to supplementary consultation questions (A1.1 to A14.5)

Within this Annex we respond the broad range of questions posed by Ofgem across the 14 appendices. Given the breadth of topics, short consultation window, and in places the incomplete analysis provided by Ofgem it is entirely possible that our perspective further evolves over time. To the extent that this the case, we will contact Ofgem at the earliest possible opportunity.

Throughout the document, we have endeavoured to be supportive of the process and to answer each question in a direct and helpful manner. Constructive guidance as to how to address flaws in 'benchmark' based approaches should not be misconstrued as support for those options; the only approach we are supportive of is one based on a bottom-up assessment of costs.

SSE is an efficient operator, with a track record of maintaining leading cost to serve performance, whilst operating at scale, serving a diverse base of customers and maintaining strong standards of customer service. We continue to maintain our long standing strategic focus on cost management; as such we fully expect to be able to make sustainable returns under a default tariff cap.

We would welcome the opportunity to discuss our response, and will be in touch to arrange this.

Yours sincerely

Patricia Hall
Regulation Manager

Annex 1: SSE overarching views on regulatory process

Major market intervention with great potential for adverse impacts

The Default Tariff Cap is a major market intervention carrying a huge risk of unintended and adverse consequences. Indeed, the CMA, following its Energy Market Investigation, concluded that such an intervention would run excessive risks of undermining the competitive process and was likely to result in worse outcomes for customers in the long run.[1] The European Commission has also long sought to limit regulated prices because they can limit the development of effective competition, discourage investments and the emergence of new market players.[2]

Therefore, it is imperative that Ofgem designs the Default Tariff Cap in a way that minimises unintended and adverse consequences and that allows competition to coexist with it. Indeed, it is only by designing the Default Tariff Cap in such a way that Ofgem can ensure that it meets the objective of protecting existing and future customers who pay standard variable and default rates. SSE is committed to working with Ofgem to achieve such a cap and believes that Ofgem must consider the interests of future customers thoroughly in its impact assessment.

Proper decision-making must not be sacrificed for speed of implementation

We recognise that the Bill requires Ofgem to make licence modifications imposing the Default Tariff Cap as soon as practicable after the legislation has been passed, but we have serious concerns that Ofgem's timetable is being driven by political pressure rather than a proper assessment of what is practicable in the context of a significant and complex intervention. In this context we note that the CMA, in its final report, expressed concerns about the relationship between DECC and Ofgem, highlighting that two of Ofgem's most important decisions in recent years, neither of which it considered had benefitted customers, had been taken against a backdrop of DECC taking or proposing to take powers to act in the event Ofgem did not act.[3] Ofgem must ensure that it does not sacrifice proper decision-making for speed of implementation, particularly given the significant impact a

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1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/531204/overview-modernising-the-energy-market.pdf, paragraph 44

2 Proposal for a Directive of the European Parliament and of the Council on common rules for the internal market in electricity (recast), COM (2016) 864 final/2 23.2.2017 (Explanatory Memorandum)

3 Paras 303 and 304 of the CMA's Energy market investigation final report, dated 24 June 2016

flawed Default Tariff Cap could have on consumers and the industry. We perceive this to be a significant risk.

We note that we have had only a period of one month (running over a half-term and bank holiday period) to prepare our response to a consultation that covers an extensive range of policy options, which posed a very large number of questions and involves a twin-track consultation relating to the safeguarding of additional customers. This is an astonishingly short period of time for such an important policy consultation and SSE considers that these timescales have conflicted with Ofgem's Consultation Policy[4] and good regulatory practice.

Ofgem's Consultation Policy states that when consulting, there 'must be adequate time for consideration and response' and that Ofgem should allow 12 weeks to consult on 'major issues' and 4 weeks for 'urgent issues'. It cannot be said that the lesser period would be appropriate here, particularly in circumstances where the consultation is taking place before the statutory underpinning for the price cap has even been enacted. Further calling into question Ofgem's compliance with their requirement to allow adequate time for consideration is the fact that the Default Tariff Cap consultation ran in parallel with multiple other work streams on price caps: the Statutory Consultation on data-matching for the Safeguard Tariff Cap; an RFI on Historic Revenue and Cost Data; an RFI with follow up questions on tariff data; and a Consultation Draft Licence Condition 28AD. Indeed, since January 2018, industry has made 17 Ofgem-driven submissions in relation to price caps. This pace is unprecedented and highly impractical.

We also note that the Government's own Consultation Principles: Guidance (last updated in March 2018), which are intended to give clear guidance to government departments on conducting consultations, notes at paragraph E that: "Consultations should last for a proportionate amount of time… Consulting too quickly will not give enough time for consideration and will reduce the quality of responses." We are concerned that a consultation of this magnitude and importance is not being given sufficient time for respondents and interested parties properly to consider all of the complex issues being consulted upon.

We believe that Ofgem should extend the timeline allocated to designing and delivering the Default Tariff Cap, in order to ensure that a thorough, considered and thoughtful consultation can be delivered in the best interests of current and future consumers.

Ofgem must not proceed on the basis of assumptions without carrying out its own review

Ofgem appears to be proceeding on an assumption that large suppliers' costs are not at an efficient level and on the basis of the CMA's assessment of suppliers' normal rate of return.

[4] https://www.ofgem.gov.uk/consultations/our-consultation-policy

We believe that Ofgem needs to reconsider both of these points. We believe that the CMA's analysis on these points was flawed at the time and events since the publication of the CMA's final report in June 2016 have confirmed this. The CMA's analysis of an appropriate rate of return was based on an incomplete understanding of the risks facing energy supply companies. The CMA's efficiency analysis was based on a "competitive benchmark" that was constructed using unsustainable prices and flawed adjustments drawn from the costs incurred by two companies with unrepresentative customers and hedging strategies that happened may well have been fortuitous in 2015. The collapse of three energy suppliers since the date of the CMA's final report, starting with the failure of GB Energy Supply in autumn 2016, indicates that some suppliers offer unsustainable - and unhedged - prices.

We therefore believe that it is inappropriate for Ofgem to adopt the CMA's conclusions on these matters without conducting a full review itself, given the evidence that has been presented to Ofgem that the CMA's analysis was flawed. Parliament decided to give Ofgem the task of designing the Default Tariff Cap as it is the body with the appropriate expertise on the energy market, built up over many years, and it would be inappropriate for Ofgem to defer to the CMA on this matter.

Ofgem must take full account of the experience under the PPM cap and the WHD extension

[redacted]

Having explained the shortcomings in the PPM cap methodology to Ofgem it would be unreasonable if our insights were not addressed when deciding on the methodology for this new cap. One of the principles underpinning Ofgem's Consultation Policy is that 'responses must be consciously taken into account'.

In outline, key points highlighted included that the business model (and pricing) of FU and OVO had not at the time been demonstrated to be sustainable; that we believed the PPM cap had approximated FU and OVO hedging costs rather than fully assessing actual costs; that the model had not accounted for reducing qualifying energy demand when determining policy costs per kwh; had failed to account for escalating smart meter roll out costs; and that in any case FU and OVO's customer bases were unrepresentative of the market as a whole.

[redacted]

Therefore, Ofgem must take into account the experience with the PPM cap when designing the Default Tariff Cap and ensure it avoids replicating the design flaws of the PPM cap, which would not be in the interests of customers. Separately, we also request that Ofgem takes action to address the issues with the PPM cap, whether by making formal representations to the CMA or otherwise.

Ofgem's assumptions regarding price-based rather than cost-based methodologies are flawed

Ofgem has raised concerns that it cannot gain a complete or accurate view of suppliers' costs, and that *'suppliers have a large asymmetry of information'* advantage in this regard and Ofgem appears to see this as a significant disadvantage of adopting a bottom-up cost assessment. SSE disagrees strongly with these concerns, and believes that Ofgem has the necessary powers to request whatever information it believes is required to establish a complete and accurate view of costs. Using a bottom-up methodology to design the benchmark for the Default Tariff Cap would involve Ofgem looking at historical costs which have already been reported and which largely comprise pass-through costs. Further, the existence of CSS accounts means that there is now consistency on how cost items are reported amongst the Big Six suppliers.

Ofgem should be much more concerned about the risks of relying on price-based benchmarks, particularly given the dynamics of the two-tier energy supply market identified by the CMA, where the CMA highlighted significant cross-subsidies arise and unsustainable acquisition tariffs abound. Indeed, it is clear that Ofgem is aware of unsustainable pricing by suppliers, which has been highlighted by the collapse of three energy suppliers, and it will be looking at the financial strength of suppliers as part of its recently announced review. It is important that Ofgem takes into account its understanding of this issue when determining the appropriate methodology for use in the design of the Default Tariff Cap.

It is clear that the lowest risk approach to designing the Default Tariff Cap is to base it on a bottom-up assessment of costs. Any price-based design would need very significant adjustments and would involve a high risk of inaccuracy that would not allow Ofgem to have any confidence that it was meeting its statutory obligations in a proportionate way. In particular, it is difficult to see how such a design would be compatible with Ofgem's duty to have regard to the need to ensure that holders of supply licences who operate efficiently are able to finance their supply activities.

Headroom is an essential feature of any cap in order to enable competition and adjust for risk

SSE strongly believes that headroom is a vital component of any price cap and in conjunction with a bottom up assessment of costs, it is the only way to ensure that Ofgem can meet its statutory objective to protect the interests of current and future SVT customers and each of its duties set out in the Bill, whilst minimising the risk of unintended consequences.

We note that whilst Ofgem had previously described headroom as existing to *'enable suppliers to compete and provide an incentive for customers to shop around'*[5], the emphasis has now shifted (without explanation) to being in place to *'account for uncertainty that has not already been allowed for when estimating the efficient level of costs'*.

It is important for headroom to perform both roles, and given that the headroom required cannot be determined until a cap methodology has been set (as the risk build up is not known until that point), it is concerning and unjustified that Ofgem has narrowed in on a range at this formative stage. Furthermore, it is concerning that Ofgem believes that under some approaches headroom may not be required at all – this cannot be true, as none of the cap methodologies reduce risks entirely or removes the need to enable competition (which should allow suppliers to compete both on price and on matters such as customer service and innovation). We note that even Professor Martin Cave, the sole member of the CMA Panel who was in favour of a price cap, emphasised that there must be an above-cost element to such a cap.

We also disagree with Ofgem's view that its duty under Section 1(6)(a) of the Bill (to have regard to the need to create incentives for holders of supply licences to improve their efficiency) supports setting headroom at a low level. We believe that competition is the best way to incentivise efficiencies and setting the Default Tariff Cap too low will be counter-productive as suppliers will be incentivised to reduce customer service levels, reduce innovation and avoid competing in the SVT segment of the market.

Ofgem should, at this stage, accept that headroom is an essential feature of any cap, and be unconstrained in its thinking as to the level of headroom that might be required (which should itself be considered and consulted on further).

The Default Tariff Cap must be proportionate

Ofgem must be careful to ensure that the Default Tariff Cap is proportionate, meaning that it must be effective in achieving its aim; be no more onerous than needed to achieve its aim; be the least onerous if there is a choice between several effective measures; and not produce disadvantages which are disproportionate to the aim.

In this context, we believe that Ofgem must be particularly careful to avoid outcomes which are disproportionate relative to the detriment initially identified by the CMA. The CMA set out its view that £1.4bn per annum of consumer detriment existed in the energy supply market between 2012 and 2015. While SSE continues to believe that this analysis of

[5] Working Paper 3 (Figure 3)

consumer detriment is flawed, we further note that the CMA perceived that lower levels of detriment existed for credit customers relative to Prepayment customers[6].

Ofgem must also ensure that the Default Tariff Cap does not produce disadvantages which are disproportionate to the aim, so Ofgem must fully consider the possible consequences of its proposed approaches. Unintended consequences of the intervention may include reduced customer engagement, reduced competition, suppliers exiting the market, new suppliers not entering the market, increased regulatory risk across the industry, and reduced innovation, all of which could have serious long and short term effects on both current and future consumers.

The Default Tariff Cap must allow an efficient supplier to finance its activities and not be discriminatory

SSE takes pride in its commitment to controlling costs and to being a responsible energy supplier. SSE over-indexes in serving vulnerable customers and has a strong track record in customer service, and yet typically has amongst the lowest SVT prices of any large energy supplier. Our focus on continual improvement of our cost to serve is a key strategic focus.

We are clear that we are an efficient operator, and so fully expect that any cap implemented should afford us the opportunity to make a positive margin, which in turn would allow us to be able to finance our ongoing activities. Any cap must take into account that some suppliers have customers with a higher cost to serve, to avoid the cap being discriminatory.

Detail and accuracy are critically important

In Annexes 2 and 3 we have set out our detailed responses to the questions posed in the main consultation document and the Appendices, and have highlighted where we disagree with Ofgem's approach. In this context, we wish to emphasise the importance of each point of detail because of the potential for cumulative inaccuracies to erode any headroom or margin that Ofgem intends to provide within the design. It cannot be assumed that inaccuracies do not matter because "in the round" they will cancel each other out, as this may or may not turn out to be the case. Further, even a small inaccuracy in respect of a key cost item, such as wholesale costs, can have a major impact on the level of the cap. Inaccuracies built into the construction of the PPM cap have resulted in the PPM cap operating quite differently from how the CMA intended it to operate. Therefore, Ofgem must adopt an accurate, transparent and verifiable approach to the construction of the Default Tariff Cap and not replicate the flaws of the PPM cap.

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https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/531204/overview-modernising-the-energy-market.pdf

Annex 2: SSE response to Ofgem Default Tariff Cap Questions 1-6

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

SSE strongly urges Ofgem to adopt a bottom-up approach to setting the default tariff cap

SSE's view remains that Option 4 (bottom-up cost assessment) is the most suitable approach to take when implementing such a far reaching regulatory intervention. We consider that Option 4 is the lowest risk, requires the least maintenance going forward, and would provide the most accurate output. We appreciate Ofgem's concern that taking a bottom-up approach could be more complex to construct, however we consider that the adjustments required against Option 2 and Option 3, to ensure they are cost reflective and representative, render those options as complex and much higher risk than Option 4. For example, ensuring wholesale costs are accurately accounted for in Options 2 and 3 will, in SSE's view, require those costs to be isolated from the benchmark (please refer to the evidence submitted as part of our response to Appendix 6). Adopting Option 4 has the important benefit that is it much more likely to lead to an outcome in which Ofgem and other stakeholders can have confidence that the cap will be set appropriately and will index accurately over time; it is our view that for such a significant market intervention this is the single most important consideration.

Given the significance of the cap and the volume of households this measure will impact, it would be entirely inappropriate to adopt any approach that gives rise to unreliable or unsustainable outcomes. [redacted]

We discussed in a bilateral meeting with Ofgem the reasons why we believe this has been the case, and assert that the best way to ensure such flaws are not replicated in the design of the default tariff cap would be to use a bottom-up approach from the outset. Failure to do so would make it unlikely that Ofgem can meet its statutory objective and duties under the Bill.

We believe that Ofgem has the power to request the necessary information to inform a bottom-up cost assessment – which would give Ofgem the benefit of access to actual costs as opposed to forecast costs – and that Ofgem should not misinterpret the requirement to introduce the cap "as soon as practicable" as an allowance to risk compromising the economic robustness of the design process it undertakes.

Essential considerations for benchmark methods

SSE fully supports Ofgem's decision to rule out the market basket approach (Option 1), and agrees with the broad range of issues Ofgem has outlined.

We believe that Option 2 (adjusted benchmark) and Option 3 (new competitive price reference) are entirely unworkable as currently proposed so would require significant adjustments if they are to be progressed. Even with such adjustments, they would lead to outcomes that are less reliable (and far less likely to balance the requirements of the Bill) than a bottom-up approach. The issues that we believe Ofgem would need to resolve are set out below.

Option 2: adjusted CMA methodology

Whilst we recognise there are advantages to adopting a cap methodology that all parties understand, SSE believe there are a range of important issues associated with this approach that must be addressed. It is unrealistic to expect that all these issues can be corrected through the use of headroom (as this would build in a structural, but unwarranted, advantage for certain suppliers):

- **Smart meter cost inflation:** We welcome the recognition that these costs should be indexed separately; however, Ofgem must share more detail than is provided in Appendix 10 to enable stakeholders to understand whether the proposed approach is suitable and to provide feedback to Ofgem;

- **The non-representative nature of benchmark suppliers:** We do not believe that the suppliers used in the benchmark are properly representative of the costs of supplying the whole market; in particular we note that FU and OVO customer bases under-index in terms of vulnerable customers and over-index amongst the direct debit payment method. We also believe it will be important for Ofgem to assess how best to ensure that the basket of firms in the benchmark are not simply those that had the benefit of a one-off fortunate hedging outcome; or worse, that the suppliers do not yet fully understand their end to end economics. To ensure the sustainability of the market and protect current and future customers, Ofgem must have regard for these points;

- **Incorrect hedging methodology used in PPM cap**: We believe that the PPM methodology attempted to apply the CMA's 6-2-12 hedging approach to the reference prices without any adjustment. Choosing this approach and applying it to suppliers able to provide cheaper tariffs at the reference point is likely to have 'baked-in' a short-term wholesale cost advantage into the PPM methodology that cannot be sustained using the CMA methodology. We examine this point in detail in our response to QA 6.1. To repeat this error when setting the default tariff cap would lead to a solution that contains a large degree of (good or bad) fortune being embedded from the outset; this is not reasonable and is likely to distort market outcomes.

- **Wholesale costs must be isolated from the benchmark:** Given the above point, and the variations in forward energy costs between 2015 and 2017, which would not be accurately reflected in a benchmark (as evidenced in our Appendix 6 response), we believe Ofgem must isolate wholesale costs from the benchmark to ensure they are accurately accounted for. Please note we would like Ofgem to refer to our responses to Working Papers 3, 4 and 5 as part of our response to this question.

- **Benchmark period needs to be updated**: If this option is adopted, we believe that costs must be re-benchmarked, at the very minimum, to FU and OVO in 2017 (rather than 2015) to better reflect current market conditions. [redacted] we believe this is related to the cap being indexed at a point that benchmark suppliers were in a relatively high-growth and low-price phase, and also to a failure to adjust the hedging arrangements used by the reference suppliers to accommodate the CMA's 6-2-12 approach. We have since observed that the benchmark suppliers have repriced to levels which appear to us to be more sustainable. However, the 2015 benchmarking process has locked-in lower than sustainable prices for PPM customers. To replicate this issue in the default tariff cap (by benchmarking to 2015, as proposed) would risk seriously undermining the opportunity an efficient operator has to finance its activities as authorised by the licence. We also believe the PPM cap has several indexation issues, which has impacted how the margins for this segment of customers have deteriorated since introduction. Learnings from the PPM cap need to be taken into account fully when setting the default tariff cap, especially given the substantially broader segment of customers that are in scope.

Option 3: competitive reference price

Whilst we again recognise there are advantages to adopting a cap methodology that all parties have experience with, SSE believe there are a range of important issues associated with this approach that must be addressed. It is again unrealistic to consider that all these issues can be corrected for simply through headroom (as this would build in a structural, but unwarranted, advantage for certain suppliers). Furthermore, extremely careful consideration needs to be given to benchmark supplier selection to ensure appropriate outcomes that reflect the diversity of customers and efficient suppliers in the market:

- **Smart meter cost inflation:** We welcome the recognition that these costs should be indexed separately; however, Ofgem must share more detail than is provided in Appendix 10 to enable stakeholders to understand whether the proposed approach is suitable and to provide feedback to Ofgem.

- **Non-representative nature of benchmark suppliers:** Ofgem must ensure that the suppliers used in the benchmark are properly representative of the costs of supplying the diverse spectrum of customers in the market. We also believe it will be important for Ofgem to assess how best to ensure that the basket of firms in the benchmark are not simply those that had the benefit of a one-off fortunate hedging outcome; or worse, that the suppliers do not yet understand their end to end economics fully. To ensure the sustainability of the market, Ofgem must have regard for these points.

- **Selection of benchmark suppliers**: SSE does not support Ofgem's intended approach of selecting those suppliers that would form the benchmark, which pays inadequate regard for the proven sustainability of each supplier, as it takes an overly narrow view of what the 'right' tariff strategy for an energy supplier should be. Our rationale and proposals are detailed in our response to Appendix 3.

- **Wholesale costs must be isolated from the benchmark:** Given the variations in forward energy costs in 2015 and 2017, which would not be reflected in a benchmark (as evidenced in our Appendix 6 response), we believe Ofgem must isolate wholesale costs from the benchmark to ensure they are accurately accounted for. Please note we would like Ofgem to refer to our responses to Working Papers 3, 4 and 5 as part of our response to this question.

- **Selection of benchmark suppliers on a single fuel rather than dual fuel basis**. We disagree with Ofgem's intention that the selection of benchmark suppliers is on a single fuel rather than dual fuel basis. This gives rise to an issue wherein the reference price may be affected by the gas / electricity pricing tactics of individual firms and so it would fail to account for varying margins for those suppliers between each fuel. Furthermore, we note that consumers typically compare offers and / or switch on a dual fuel basis. We therefore suggest that Ofgem selects suppliers for benchmark on a dual fuel, rather than single fuel, basis.

- **Typical Domestic Consumption Values:** We note Ofgem's focus on the use of Typical Domestic Consumption Values (TDCV), and the implicit assumption that an accurate cap could be set for all consumption levels, by establishing the price level at nil and TDCV, and then drawing a straight line between and beyond those points. Given the niche targeting of (for example) high consumption customers by suppliers this is likely to lead to unreliable outcomes; and could lead to substantial cross-subsidisation being built into the cap between customers consuming different amounts of gas and power. We recommend Ofgem undertakes analysis to understand the extent to which this will be an issue in practice.

- **Socialisation of payment method costs**: We note Ofgem's intention to partially socialise the cost of supplying standard credit customers over two caps, but believe that the approach Ofgem is minded to adopt would lead to standard credit customers becoming unprofitable, and in turn lead competitors in the market to reduce efforts to acquire or retain those customers. While SSE recognises Ofgem may consider that some level of socialisation might be warranted, Ofgem should take the signals already provided by the market as to what a suitable level of socialisation would be, by reference to current levels of MDD discounts offered. SSE believe that the outturn differential between MDD and Standard Credit should be ~£76 (which is in line with our MDD discount), and therefore propose that Ofgem socialise the remaining £38 between MDD and Standard Credit customers. This would, we believe, lead to a payment uplift of ~£15 for Direct Debit and ~£85 for Standard Credit.

- **An allowance for anticipated costs not yet being incurred:** Irrespective of the method of calculation, the benchmark needs to be adjusted to allow for anticipated costs which are not yet being incurred (plus the additional implementation costs applying to the default tariff cap and each bi-annual update). As examples, substantial levels of investment are anticipated in the faster switching programme, additional development and implementation costs will be incurred in respect of Ofgem's initiatives on consumer engagement and Ofgem are currently consulting on a switching compensation scheme, which would apportion costs to suppliers who may not be at fault.

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

Importance of headroom

We note that whilst Ofgem had previously described headroom as existing to *'enable suppliers to compete and provide an incentive for customers to shop around'*[7], the emphasis has now shifted (without explanation) to being in place to *'account for uncertainty that has not already been allowed for when estimating the efficient level of costs'*.

It is important for headroom to perform both roles, and given that the headroom required cannot be determined until a cap methodology has been set (as the risk build up is not known until that point), it is concerning and unjustified that Ofgem has narrowed in on a range at this formative stage. Furthermore, it is concerning that Ofgem believes that under

[7] Working Paper 3 (Figure 3)

some approaches headroom may not be required at all – this cannot be true, as none of the cap methodologies reduce risks entirely or removes the need to enable competition (which should allow suppliers to compete both on price and on matters such as customer service and innovation). We note that even Professor Martin Cave, the sole member of the CMA Panel who was in favour of a price cap, emphasised that there must be an above-cost element to such a cap.

As per our response to Working Paper 3, research from [redacted] the CMA has highlighted the importance of a minimum saving value to support continued consumer interest in switching. The CMA 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 annum'[8]. We note that similar trends were reported in the YouGov Utilities Tracker (October 2017, Wave 12), made available by YouGov and subscribed to by Utilities companies.

Allowing sufficient headroom will also help ensure holders of supply licenses who operate efficiently can finance activities authorised by the license and invest in programmes to incentivise engagement, e.g. the Smart Meter Rollout and the Switching Programme.

SSE does not accept Ofgem's assertion that 'headroom levels will affect suppliers' incentives to improve their efficiency' – in order to maintain shareholder investment, suppliers are continuously driven to pursue efficiency initiatives and this incentive will be all the more intense in any of the default tariff cap scenarios, which are all expected to reduce returns from supply activity relative to historic levels.

With regard to environmental and social scheme costs – which are managed with an element of risk – while Ofgem could seek to account for this via appropriate adjustments, SSE's view is that headroom is a more appropriate approach to allow for the necessary risk management associated with these costs once a reasonable index or reference point has been established.

We also think it is essential to recognise the risk that shock events may occur which lead to unexpected costs being borne by suppliers, which would never be recouped under a cap methodology, and which are too extreme in nature to be absorbed within headroom. For example, the 'beast from the east' caused a peak in wholesale market prices and consumer demand, leading to the need for suppliers to buy extra gas and power from stressed markets. Such an event would, if experienced under a cap, cause substantial unrecoverable costs for suppliers who would have no opportunity to reprice at the time, or to factor in those costs when repricing at a later point. Whilst this example is a demand issue, and a wholesale cost issue, triggered by a natural weather event, similar shocks could be caused by policy events.

[8] Energy Market Investigation Report for CMA, completed by GfK NOP, Feb 2015, Para 149

We believe that Ofgem should consider this issue and explain their thinking on how such high risk, low frequency events would be provided for within the cap design; and how the licence might be modified ahead of time, to protect all suppliers against unreasonable delays in being protected from the effects of such an occurrence.

We believe it will important for Ofgem to start by setting the default tariff cap using a rigorous bottom-up assessment of costs, ensure that it is set up to index accurately over time, and then to recognise that a number of risks will nonetheless remain. SSE maintains that when a high level of risk is involved, a larger amount of headroom must be provided; and so, a decision to use any approach other than a bottom-up assessment of costs would lead to the need for additional headroom.

Setting the cap

It is essential that Ofgem uses the most up to date cost and pricing data when setting the initial level of the cap. This is particularly important given recent movements in the cost of supply and revisions to standard variable prices across various suppliers. We believe that overall supply margins have been narrowed during 2018 with costs rising more quickly than prices; something which Ofgem will need to take carefully into account.

Ofgem must take care not to over-emphasise the importance of acquisition prices offered by suppliers with no track record of operating at scale, or delivering sustainable returns; as such acquisition prices are not a reliable guide for the long-term costs of supply on a fully scaled basis. Furthermore, Ofgem needs to ensure that those suppliers who serve a disproportionate share of the GB market's vulnerable customers are not penalised for doing so. Indeed, Ofgem's view is that >30% of the market is made up of vulnerable customers (evidenced by the scope of Ofgem's consultation of additional safeguarding), so this is far from a niche consideration.

SSE does not agree with Ofgem's choice of a 1.25% and 1.9% EBIT margin. The CMA – who we consider have underestimated the EBIT level required to ensure a retail supply business remains sustainable and financeable – has suggested a higher EBIT in the region of 1.9% for a supplier managing its own procurement, or of 2.4% to give a similar return to that seen in I&C (adjusted for the higher risks of the domestic supply market). Failure to set the EBIT component appropriately (i.e. failing to allow suppliers to earn their cost of capital) may lead to substantial and long-term unintended consequences for the supply market as capital investment is diverted to alternative uses.

When considering the opportunity that exists for suppliers to gain advantage from becoming a more efficient operator, it is important to provide context. Large suppliers' average

Operating Costs were £193 in 2016 (~17% of the total bill)[9], with a range of £165 (SSE) to £270 (nPower). A saving of £30 to move from average to leading would be a substantial ~15% reduction in operating costs, but only a ~2.5% reduction in overall bill. If Ofgem's view is that more opportunity than this exists (say double), a potentially implausible ~30% reduction in operating costs, would still only represent a ~5% reduction in a customer's overall bill, or £60 at TDVC. These savings (£30-60) are in stark contrast to the unsustainable savings available to customers who switch to acquisition offers.

This demonstrates that differentials in pricing are not only rooted in variances in efficiency, but also are a product of artificially low acquisition prices. Such prices may be supported by charging higher prices to other customers; or by making losses now in the hope of making profit later; or resulting from one off better than average hedging outcomes; or otherwise based on a lack of insight into the end-to-end costs of energy supply. In all cases, such savings cannot be sustainably made available to all customers.

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

As per our response to Q1, we note Ofgem's intention to partially socialise the cost of supplying standard credit customers over two caps, but believe that the approach Ofgem is minded to adopt would lead to standard credit customers becoming unprofitable, and in turn lead competitors in the market to reduce efforts to acquire or retain those customers. While SSE recognises Ofgem may consider that some level of socialisation is warranted, we believe Ofgem should take the signals already provided by the market as to what a suitable level of socialisation is in this case would be, by reference to current levels of MDD discounts offered. SSE believe that the outturn differential between MDD and Standard Credit should be ~£76 (which is in line with our MDD discount), and therefore propose that Ofgem socialise the remaining £38 between MDD and Standard Credit customers. This would, we believe, lead to a payment uplift of ~£15 for Direct Debit and ~£85 for Standard Credit.

On the issue of factoring costs into the standing charge, SSE's preferred approach is that standing charges are determined via the bottom-up approach to ensure they are cost reflective. In this scenario, costs included in the standing charge would typically consist of, for example, the fixed elements of operating costs, policy costs, network charges, and the payment uplift. SSE also considers it essential that an element of headroom is included in the standing charge, not only to ensure competition takes place for low consuming customers, but also to avoid knock-on implications for the 'slope' of the pricing curve.

[9] Ofgem retail market indicators

If Ofgem is minded to adopt a benchmark reference approach – as opposed to a bottom-up approach, and in doing so intends to use the average standing charge of the largest suppliers, SSE recommends Ofgem make several adjustments to ensure it is correctly indexed against fixed costs per customer. For example, we would expect Ofgem to index the standing charge to fixed elements of the operating costs, policy costs and network charges, smart metering costs, costs on other planned industry initiatives (such as faster switching) and an adjustment for payment uplift. In the case of smart metering costs, this is a significant element of cost inflation which is 'per customer' in nature, and so is best factored into the standing charge).

4 Do you agree with our proposals for how we will update the cap?

As we have stated consistently, SSE's firm view is that the bottom-up approach will provide an accurate, low risk, and low maintenance methodology for setting the benchmark for an efficient cost to serve, and keeping that appropriate benchmark up to date. As such, we support the option to update the cap using a periodic reviews of costs. As set out by Ofgem in Section 1.9 of Appendix 5, 'using periodic reviews of suppliers' realised costs would have the advantage of ensuring that all trends in costs can be taken into account in the level of the cap'. We do not agree with Ofgem's minded to position to discount this option.

If Ofgem is determined to adopt the third option, which is to use exogenous indices to update costs within the cap, we believe that subject to the right indices being selected, and appropriate focused adjustments being made, relying on such exogenous indices should be a sound alternative approach. It may nonetheless be necessary to benchmark to actual costs from time-to-time, to ensure that important changes in true underlying cost pressures are indeed being effectively picked up by the selected indices.

Careful consideration needs to be given to ensure that issues and inaccuracies do not exist at the point the cap is first constructed to avoid them becoming exaggerated over time. It should be noted the effect of this is even more exaggerated when accompanied by flaws in the indexation methodology. [redacted]

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

SSE has no strong opinion on the issue of renewable energy tariff exemptions.

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

Competition under the cap

As Ofgem highlights in their main consultation document, the implementation of a default tariff cap is likely to lead to lower levels of switching. Drivers of this include (i) lower price dispersion, (ii) a feeling among consumers that they don't need to take action, (iii) a potential reduction in the number of competitors, as well as (iv) the ability or willingness of remaining competitors to invest in growth or innovation.

SSE believes that Ofgem should monitor unintended consequences and be ready to intervene early to prevent long term damage to the functioning of competition in the energy supply market if required following the default tariff cap's implementation. It is possible that the default tariff cap might lead to several supplier exits, and a (financial and administrative) strain being placed on the SOLR process, which in turn would increase use of system costs for other suppliers. We welcome Ofgem's views on how they will monitor and address this risk.

Conditions for cap removal

By most measures of 'effective competition', it will be impossible for Ofgem to assess whether the conditions are right for the default tariff cap to be removed as planned at the end of 2020; as noted above switching rates are likely to be lower, competitive intensity may have reduced, and consumer complacency may have grown. It is our expectation that the longer the cap is in market, the more entrenched these issues will become, creating risk that the cap becomes self-perpetuating. As such we believe it would be in line with Ofgem's core objective (to protect the interests of existing and future electricity and gas consumers) to recommend the earliest possible end to the default tariff cap. This would be particularly the case if evidence showed that consumer engagement was trending down during the period of the cap being applied.

Whilst 'supply-side' initiatives (such as smart meter roll-out), and 'demand-side' initiatives (such as faster switching) may aid the long-term functioning of a competitive supply market, the cap does not need to be in place in order to see them progressed or delivered. Indeed, the existence of the cap is likely to make it harder to engage customers overall, and should be expected therefore to impact consumer interest in, and enthusiasm for, smart meters.

We believe that Ofgem should avoid placing a strong focus on default tariff cap removal criteria that centre on the delivery of supply side activities and regulatory-driven infrastructure programmes. Neither of these are within full control of Ofgem or suppliers as they are both highly influenced by a wide range of external drivers, meaning suppliers' and Ofgem's ability to contribute towards and help facilitate the removal of the cap is limited.

It is apparent that Ofgem has not reached any conclusions on the range of indicators that would lead to a recommendation to remove the default tariff cap. SSE would welcome engagement and discussion with Ofgem around such options once their thinking becomes more clear.

Annex 2: SSE response to Appendices 1 - 14

Appendix 1: Market Basket

QA1.1 – Do you agree that we should not further consider the use of a market basket to set the initial level of the cap?

SSE agrees.

QA1.2 – Do you agree that we should not further consider the use of a market basket to update the cap over time?

SSE agrees.

Appendix 2: Adjusted version of the existing safeguard tariff

QA2.1 – 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 customers acquisition adjustments, and other potential adjustments to operating costs

Whilst we recognise there are advantages to utilising a cap methodology that all parties understand, SSE believe there are a range of important issues associated with this approach that must be addressed. We note that in some cases it is unreasonable to consider that all these issues can be corrected for simply through headroom (as this would build in a structural, but unwarranted, advantage for certain suppliers):

- **Smart meter cost inflation:** We welcome the recognition that these costs should be indexed separately; however, Ofgem must share more detail than is provided in Appendix 10 to enable stakeholders to understand whether the proposed approach is suitable and to provide feedback to Ofgem;

- **The non-representative nature of benchmark suppliers**

  [redacted]

  We also believe it will be important for Ofgem to assess how best to ensure that the basket of firms in the benchmark are not simply those that had the benefit of a one-off fortunate hedging outcome; or worse, that the suppliers do not yet understand their end to end economics fully. To ensure the sustainability of the market, Ofgem must have regard for these points;

- **Incorrect hedging methodology used in PPM cap**: We believe that the PPM methodology attempted to apply the CMA's 6-2-12 hedging approach to the reference prices without any adjustment. Choosing this approach and applying it to suppliers able to provide cheaper tariffs at the reference point is likely to have 'baked-in' a short-term wholesale cost advantage into the PPM methodology that cannot be sustained using the CMA methodology. We examine this point in detail in our response to QA 6.1. To repeat this error when setting the default tariff cap would lead to a solution that contains a large degree of (good or bad) fortune being embedded from the outset; this is not reasonable and is likely to distort market outcomes.

- **Wholesale costs must be isolated from the benchmark:** Given the above point, and the variations in forward energy costs between 2015 and 2017, which would not be reflected in a benchmark (as evidenced in our Appendix 6 response), we believe

Ofgem must isolate wholesale costs from the benchmark to ensure they are accurately accounted for. Please note we would like Ofgem to refer to our responses to Working Papers 3, 4 and 5 as part of our response to this question.

- **Benchmark period needs to be updated**: If this option is adopted, we believe that costs must be re-benchmarked to FU and OVO in 2017 (rather than 2015) to better reflect current market conditions. [redacted] we believe this is related to the cap being indexed at a point that benchmark suppliers were in a relatively high-growth and low-price phase, and also to a failure to adjust the hedging arrangements used by the reference suppliers to accommodate the CMA's 6-2-12 approach. We have since observed that the benchmark suppliers have repriced to levels which appear to us to be more sustainable. However, the 2015 benchmarking process has locked-in lower than sustainable prices for PPM customers. To replicate this issue across default tariffs (by indexing to 2015, as proposed) would risk seriously undermining the opportunity an efficient operator has to finance its activities as authorised by the licence. We also believe the PPM cap has several indexation issues, which has impacted how the margins for this segment of customers have deteriorated since introduction. Learnings from the PPM cap need to be taken into account fully when setting the default tariff cap, especially given the substantially broader segment of customers that are in scope.

It is not, in our view, reasonable to consider that these issues can be addressed simply through headroom. We believe this builds in a structural, but unwarranted, advantage for certain suppliers.

It is positive that Ofgem recognise the need to make adjustments for differing accounting policies in relation to acquisition commissions. We believe similar thought needs to be applied to the accounting treatment of smart costs; as well adjustments being made for differences in the smart roll-out schedule of each supplier.

QA 2.2 – Do you agree with how we propose to adjust the benchmark at nil consumption

We believe that if Ofgem adopt their proposed [redacted]

adjusted for the payment method uplift, but with no headroom -– this will cause two key issues.

- (1) There will be no opportunity to earn a normal rate of return on very low consumption customers. This includes landlord's vacant properties, 2nd homes and holiday homes.
- (2) This will have implications for the 'slope' of the pricing, resulting in bills that are unnecessarily high for those above TDCV

These issues give rise to a situation whereby the costs of low consumption customers – who would be loss-making under this cap arrangement – are socialised across high consumption customers. This artificially skews the market so that lower consumption customers potentially become unattractive to suppliers. We believe Ofgem must be very careful not to inadvertently create perverse incentives in the market or discriminate between suppliers on the basis of their existing customers.

To address this, as we have set out in our response to question 4 of the main document, SSE's preferred approach is that standing charges are determined via the bottom-up approach to ensure they are cost reflective.

If Ofgem is minded to adopt a benchmark reference approach – as opposed to a bottom-up approach – and in doing so intends to use the average standing charge of the largest suppliers, SSE recommends Ofgem make several adjustments to ensure it is correctly indexed against fixed costs per customer and for the right period:

- We strongly believe Ofgem should reference average standing charges for 2017 instead of 2015;
- We expect Ofgem to index the standing charge to fixed elements of the operating costs, policy costs and network charges, smart metering costs, anticipated new policy costs and an adjustment for payment uplift. In the case of smart metering costs, this is a significant element of cost inflation which is 'per customer' in nature, and so is best factored into the standing charge); and
- We suggest that Ofgem should only use SVT tariff prices when taking an average of standing charges to ensure the output is truly reflective of the cost to supply at scale and on a sustainable basis. Clearly, any tariffs which advertise nil or reduced standing charges should not feature in any averaging calculations.

QA2.3 – Do you agree with our proposed approach for updating the level of the adjusted safeguard tariff cap?

SSE does not agree with Ofgem's proposed approach to updating the level of Option 2 (adjusted safeguard cap), as it is based on a 2015 base year. We have observed how poorly the PPM cap has indexed since introduction, [redacted] despite being one of the most efficient suppliers in the market. Additionally we have seen reduced price dispersion and reduced switching since the cap was introduced.

For this option to be workable, we believe it is essential that FU and OVO are re-indexed versus their 2017 prices at the very minimum, and the default tariff cap subsequently updated over time from that basis. Moreover, we are keen to see improvements in the indexation approach in relation to:

- **Smart meter rollout costs:** SSE is pleased to see that Ofgem has recognised that smart meter rollout costs require an independent indexation. However, we lack sufficient detail on the method or the input data to ascertain whether an appropriate level of indexation is being proposed by Ofgem for smart costs.

- **Adjusting to a representative share of vulnerable customers**: Ofgem must satisfy itself that the selection criteria for suppliers to be considered in the price reference approach will, together, be representative of the whole market so that stakeholders can be sure that the cap is suitably scalable and sustainable. In particular, Ofgem will need to ensure that there is an appropriate mix of vulnerable and non-vulnerable customers, as these groups have different requirements for service and support.

- **Wholesale costs must be isolated from the benchmark:** Given the variations in forward energy costs in 2015 and 2017, which would not be reflected in a benchmark (as evidenced in our Appendix 6 response), we believe Ofgem must isolate wholesale costs from the benchmark to ensure they are accurately accounted for.

Even once such adjustments are made, SSE does not believe this approach will lead to as reliable an outcome as Option 4, a bottom-up assessment of costs.

Appendix 3: Updated competitive price reference

QA3.1 – 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.

We believe that Option 3 (new benchmark) is entirely unworkable unless numerous issues are resolved, including:

- The relaxation of proposed Fixed Tariff lower limits from 50% to 20%, and upper limit for customers on SVT for 3 years or more from 25% to 50%, so as to better recognise that everyday fair pricing is an equally legitimate strategy as high-low acquisition pricing;
- Inclusion of a requirement that the selected basket of suppliers together account for 25% market share, so that stakeholders can be sure that capping relative to such a benchmark is suitably scalable and sustainable;
- Selection of the benchmark suppliers on a dual fuel rather than single fuel basis (in recognition that suppliers' margins may vary between fuels as a result of pricing tactics, and that consumers in general compare offers and / or switch on a dual fuel basis);
- Exclusion of suppliers who do not make single fuel tariffs available in the same manner as dual fuel tariffs. This exclusion is important to avoid skewing the customer base and associated costs.
- Exclusion of suppliers who cannot provide two full accounting years' operating cost data. Such suppliers should be excluded because their business model is too immature to represent a sustainable efficient operator.
- Exclusion of loss making suppliers (after amortising costs associated with growing the base / acquisitions costs). These suppliers should be excluded because their business model has not yet proven to be sustainable.
- Wholesale costs must be isolated and treated separately from the rest of the benchmarking approach as the difference between actual hedge costs of any supplier and any hedging benchmark (such as the 6-2-12) could introduce significant errors (see response in section 6.1).
- With regard to adjustments, SSE considers that all drivers listed in Table A8.2 of Appendix 8 are appropriate (not just those listed in Appendix 3), in particular Ofgem must ensure they address the issues associated with the treatment of smart meter cost inflation, and the potential non-representative nature of the benchmark suppliers' customer bases, and potential variations in actual hedging costs compared to a benchmark hedging approach. Note: we do not believe that these issues can be addressed simply through headroom (as this builds in a structural, but unwarranted, advantage for certain suppliers); and

Finally, we note Ofgem's focus on TDCV, and the implicit assumption that an accurate cap could be set for all consumption levels, by establishing the price level at nil and TDCV, and then drawing a straight line between and beyond those points. Given the niche targeting of (for example) high consumption customers by suppliers this is likely to lead to unreliable outcomes; and could lead to substantial cross-subsidisation being built into the cap between customers consuming different amounts of gas and power.

QA3.2 – Do you agree with the judgments we set out regarding consumer engagement, policy and wholesale costs, and constructing the benchmark?

SSE does not agree with Ofgem's judgment in relation to consumer engagement, which focuses on those suppliers that have implemented a 'high-low' pricing strategy. That is to say, have offered unsustainably low acquisition prices to customers, funding that by charging higher prices to longer standing customers (or by suffering short term losses).

SSE proposes the following in relation to Ofgem's selection criteria for the benchmark:

- An amendment of the proportion of customers on fixed term tariffs from 50% to 20%;
- An amendment of the proportion of customers who have been on SVT for 3 years or more from 25% to 50%; and
- An addition of two further points in the selection criteria:
    - That positive returns would have been posted for the prior financial year if the supplier had been operating at the efficiency frontier (measured by operating cost per customer); and
    - That together the basket comprises suppliers that hold a combined market share of at least 25%.

The final two criteria have the potential to ensure that the benchmark is sustainable, has scale, and would allow an efficient operator to finance its activities. Ofgem's adjustment for policy costs is logical (provided an appropriate benchmark for the new ECO scheme can be found), however it should be noted that smaller firms are still provided a commercial advantage as a result of the policy exemption.

With regard to wholesale costs, we believe actual wholesale cost must be taken into account when calculating benchmark prices. Variations in wholesale costs are material and hence any errors in assumed hedging costs (through a benchmark) vs actual hedging costs will introduce significant errors (see section 6.1).

The lower priced tariffs in the market may be competitive, due to low energy cost levels compared to the rest of the market. Hence assuming they have followed a particular

standard hedging approach may introduce systematic error into the benchmark calculation. This is another reason why the actual hedge costs must be used when inferring anything from benchmark prices.

Ofgem has indicated its intention to include at least two suppliers, and no more than 50% of qualifying suppliers. SSE believe that two is not enough, and that in any case, the suppliers forming the benchmark should have a combined market share of at least 25%.

Ofgem proposes to take a simple average of the selected benchmark companies. In this final stage, SSE believes Ofgem should weight the suppliers so as to achieve a representative proportion of vulnerable customers, and proposes that Ofgem use presence on the priority services register as a simple proxy for this. This is important to ensure that the cap reflects the average overall costs borne by those suppliers who support those who most need additional help.

We believe that it is inappropriate that Ofgem intends to select the benchmark suppliers on a single fuel rather than dual fuel basis (in recognition that suppliers' margins may vary between fuels as a result of pricing tactics, and that consumers in general compare offers and / or switch on a dual fuel basis).

These are vital points to consider - if the benchmark is set too low, this will both limit suppliers' ability to finance their licensed activities (which Ofgem must have due regard for as per the Tariff Cap Bill), and lead to reduced competitive intensity in the long run, harming future customers.

QA3.3 – 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?

As we have stated consistently, SSE's firm view is that the bottom-up approach will provide an accurate, low risk, and low maintenance methodology for setting the benchmark for an efficient cost to serve. As such, we support the option to update the cap using periodic reviews of costs. As set out by Ofgem in Section 1.9 of Appendix 5, 'using periodic reviews of suppliers' realised costs would have the advantage of ensuring that all trends in costs can be taken into account in the level of the cap'. We do not agree with Ofgem's minded to position to discount this option.

There are a number of amendments Ofgem must make to any approach for setting the benchmark at nil consumption under a reference price model. We have set out these concerns in response to question 2.2.

SSE does not agree that Ofgem should use the adjusted standing charges from the same suppliers included in the benchmark (if they were to adopt Option 2 or Option 3).

QA3.4 – Do you agree with our approach to weighting the benchmark at TDCV and nil consumption?

A per our response to QA2.2, we believe that a decision to set the benchmark at this level will cause two key issues.

- (1) There will be no opportunity to earn a normal rate of return on very low consumption customers. This includes landlord's vacant properties, 2nd homes and holiday homes.
- (2) This will have implications for the 'slope' of the pricing, resulting in bills that are unnecessarily high for those above TDCV.

These issues will give rise to unintended market disruption. Please refer to our response to QA2.2 as our full response to this question (QA3.4).

Appendix 4: Bottom-up cost assessment

QA4.1 – Do you agree with our assessment of the advantages and disadvantages of a bottom-up approach to estimating an efficient level of costs?

Given that this is the only option under consideration that will provide a low risk, highly accurate approach to identifying cost drivers, SSE is disappointed to see such limited consideration has been given to this approach. We strongly encourage Ofgem to take the opportunity to explore this option fully.

Ofgem has visibility of uniform and aligned financial data through the CSS process, and it would clearly be possible to broaden this to a larger subset of the market suppliers. Furthermore, Ofgem has the power to issue RFIs and has done so as part of this consultation process to deepen their insight into the financial composition and accounting practices of various suppliers.

Through these tools Ofgem has the ability to cut through any perceived issues relating to information asymmetry. It is important that Ofgem does not misinterpret the requirement to introduce the cap "as soon as practicable" as an allowance to risk compromising the economic robustness of the design process it undertakes.

The (average big 6 large supplier) energy bill is broadly made up 38% wholesale cost, 26% T&D, 8% policy costs, 1% other direct costs, 17% operating costs, 5% VAT and 5% EBIT. When describing the efficiency frontier and the implications of this for consumer bills, it is only the 17% operating costs that can be varied. If (a potentially implausible) ~30% reduction in operating costs were delivered by a supplier, it would still only represent a ~5% reduction in overall bill, or ~£60 to the average consumer.

Given the speculative nature of energy procurement all other approaches (aside from bottom-up assessment of costs) become corrupted by the much more material effect of hedging strategies that in out-turn were positive rather than negative. However, it is not reasonable to benchmark suppliers' costs against outturns that were effectively the result of luck, and cannot be recreated by an efficient supplier without the benefit of hindsight.

The other variable component is EBIT, wherein some suppliers are willing to absorb near term losses to grow their customer base. This reflects the vibrant competition that exists in the GB energy market. The absence of a transparent bottom-up approach to sizing and setting the default tariff cap is only serving to fuel anxieties that exist around the fairness of energy prices.

SSE is fully supportive of a bottom-up approach and would be happy to work with Ofgem in designing a workable approach to Option 4 (bottom-up), as we believe that this is the only

reliable way to ensuring the default tariff cap does not cause long term damage to effective competition in the supply market.

QA4.2 – Do you agree with our proposed approach to categorising different costs under a bottom-up cost assessment approach to setting the default tariff cap?

There are several elements of Ofgem's proposed approach with which SSE disagrees, and believe that Ofgem need to further consider.

SSE believes the best possible cap could be achieved through a bottom-up approach. In general, we support Ofgem's proposal in this regard and have a some suggestions on how to make it better reflect suppliers' cost drivers. Firstly, SSE's strong view is that there should be an explicit provision in wholesale costs for unidentified gas (UIG) (please also refer to our response to QA6.5 in Appendix 6). Secondly, we believe that smart metering costs should be categorised as a separate cost category rather than as a sub-section of operating costs. Thirdly – on a more minor point – we consider capacity market costs should be categorised as a policy costs instead of a wholesale costs.

Appendix 5: Updating the cap over time

QA5.1 - Do you agree with our proposal to update the cap in line with trends in exogenous cost drivers?

SSE recommends that the cap should be updated through a periodic reviews of costs. As set out by Ofgem in Section 1.9 of Appendix 5, 'using periodic reviews of suppliers' realised costs would have the advantage of ensuring that all trends in costs can be taken into account in the level of the cap'. We do not agree with Ofgem's minded to position to discount this option.

If Ofgem is determined to use movements in exogenous indices to update the cap, we believe that subject to the right indices being selected, and appropriate focused adjustments being made, relying on exogenous indices should be a sound alternative approach.

Careful consideration needs to be given to ensure that issues and inaccuracies do not exist at the point the cap is first constructed to avoid them becoming exaggerated over time. It should be noted the effect of this is even more exaggerated when accompanied by flaws in the indexation methodology. As we have set out previously, SSE's experiences of operating under the PPM cap provides a live example of this.

SSE is pleased to see that Ofgem has addressed some of the key areas of concern with regard to updating the PPM cap, namely by accounting for changes in qualifying demand and by recognising that smart meter rollout costs require an independent indexation. However, Ofgem have not to date shared sufficient detail on the method or the input data to ascertain whether an appropriate level of indexation is being proposed for smart costs.

QA5.2 - Do you agree with our proposed choice of cap and baseline periods?

As we have stated consistently, SSE's firm view is that the bottom-up approach will provide an accurate, low risk, and low maintenance methodology for setting the benchmark for an efficient cost to serve.

If Ofgem are determined to adopt a benchmark price reference approach (which we believe will be higher risk, higher maintenance and lower accuracy) then costs must be re-benchmarked to 2017 (rather than 2015) to better reflect current market conditions.

[redacted]

…we believe this is related to the cap being indexed at a point that benchmark suppliers were in a relatively high-growth and low-price phase. We have since observed that the benchmark suppliers have repriced to levels which appear to us to be more sustainable. However, the 2015 benchmarking process has locked-in lower than sustainable prices for PPM customers. To replicate this issue across default tariffs (by indexing to 2015, as

proposed) would risk seriously undermining the opportunity an efficient operator has to finance its activities as authorised by the licence.

QA5.3 - 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?

SSE considers that Ofgem's existing powers under the Utilities Act, and the Gas and Electricity Acts are sufficient to enable Ofgem to make licence modifications to amend the cap design in the event it is necessary. We note that such modifications would be subject to a consultation process.

We also think it is essential to recognise the risk that shock events may occur which lead to unexpected costs being borne by suppliers, which would never be recouped under a cap methodology, and which are too extreme in nature to be absorbed within headroom. For example the 'beast from the east' caused a peak in wholesale market prices and consumer demand, leading to the need for suppliers to buy extra gas and power from stressed markets. Such an event would, if experienced under a cap, cause substantial unrecoverable costs for suppliers who would have no opportunity to reprice at the time, or to factor in those costs when repricing at a later point. Whilst this example is a demand issue, and a wholesale cost issue, triggered by a natural weather event, similar shocks could be caused by policy events.

We believe that Ofgem should consider this issue and explain their thinking on how such high risk, low frequency events would be provided for within the cap design; and how the licence might be modified ahead of time, to protect all suppliers against unreasonable delays in being protected from the effects of such an occurrence.

Setting the wholesale allowance

SSE agrees with Ofgem's proposed approach to account for wholesale costs via the bottom-up approach. We strongly disagree with the proposed approach for the price reference models. We suggest the indexation period should be updated to 2017 to give the most up to date view of prices. Though the indexation movement from 2015 should broadly reflect the change in prices there will always be a margin of error and it would increase the accuracy to set the benchmark period over as recent a period as possible. In theory we agree that the indexation approach should broadly reflect the movement in wholesale costs. However, we do not believe the wholesale costs have been appropriately considered when setting the original reference and this could have resulted in significant errors.

A fundamental factor that must be given significant consideration when designing the cap is the impact of wholesale costs. Indeed, in Section 3.3 of Appendix 6 Ofgem recognises that 'Reported wholesale costs vary significantly between suppliers depending on the approach they have taken to purchasing their energy' and further 'it is difficult to estimate what an efficient level of wholesale costs in a given baseline period would have been for a given strategy'. This is particularly the case given that the price cap method has not yet been set (and will clearly have a very material impact on the hedging strategies that suppliers should select). It is also recognised that wholesale prices represent the largest proportion of the benchmark costs and therefore their impact will be material.

We therefore disagree with Ofgem's subsequent statement in Section 3.4, that the benchmark approach 'avoids the issue of considering wholesale costs independently because the benchmark already includes all of the expected wholesale costs'. We believe that possible variations in wholesale costs are material enough to distort any benchmark (particularly given differences in products offered by and hedging strategies adopted by different suppliers) and as such we believe it is entirely inappropriate to assume that wholesale costs will be accurately reflected in a benchmark of this type.

We have provided some analysis to demonstrate the variations in forward energy costs in 2015 (which is the benchmark period for option 2) and 2017 (which is the benchmark period for option 3)[redacted].This variation would not be reflected accurately by the proposed approach to benchmarking, which means that there is a high risk that suppliers would be unable to fully recover wholesale costs (or would earn windfall profits due to indexation inaccuracy). We believe that if Ofgem intends to adopt a price reference model, they must isolate the wholesale cost element from the benchmark price to ensure that it is accurately accounted for. However, our strong view is that a bottom-up model is the most accurate way to reflect cost drivers and ensure suppliers can recover costs via the cap and in doing so finance activities authorised by their licence, in line with the criteria set out by the Bill.

[redacted]

[redacted]

Given all of the above points, we firmly believe that if Ofgem intends to adopt a price reference model, they must isolate the wholesale cost element from the benchmark price to ensure that it is accurately accounted for. It is essential that Ofgem recognises that any benchmark-based approach needs to take appropriate account of the actual hedging strategy employed by the firm being benchmarked. To take that firm's prices, and reverse out their wholesale cost on the assumption it was 6-2-12, when in fact it was based on some proprietary strategy will lead to an uncertain outcome because it is based on a fundamental and false assumption. Therefore, our strong view is that a bottom-up model is the most accurately way to reflect cost drivers, and we would only be supportive of Ofgem adopting that approach.

QA6.2 - Do you agree with our approach to updating the wholesale allowance?

In theory we agree that the indexation approach should broadly reflect the movement in wholesale costs. However, we do not believe the wholesale costs have been appropriately considered when setting the original reference and this could have resulted in significant errors.

QA6.3 - 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?

We would suggest the 6-2-12 approach as more appropriate than the 6-2-6 approach. The 6-2-6 would introduce seasonality into the pricing levels that would be confusing for customers and potentially difficult to manage in household budgets. It would also create distortions against the fixed price market which generally has tariffs covering 1 year, 2 year or 3 year periods, making it more difficult for consumers to compare these options.

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 peak

load, and the cap will be semi-annual. If not, please provide evidence to support alternative approaches.

We agree the cap should be semi-annual. The initial shaping assumption based on a 70-30 split is a reasonable estimate but there is a wholesale price risk if actual customer usage differs from the assumed split. Analysis indicates a c£0.55/MWh impact on the wholesale index for a 10% change in the split. This risk should be covered by an additional allowance for shaping (see response to question A6.5).

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.

An allowance is required for both shaping and imbalance costs. Shaping costs are an inherent result of hourly/daily prices correlation with demand; higher demand periods naturally have higher prices. Imbalance is a natural result of inaccuracies in any demand forecast.

There should also be an allowance for the cost to suppliers of unidentified gas (UIG) on the system. There should also be allowance for BSUoS risk impacting the cost of supplying electricity to customers.

We believe the wholesale cost component of the PPM cap allows for some of these costs but does not cover all of the risk/costs faced by suppliers. We have set out an example below in Table 1.

[redacted]

ELECTRICITY

Our view is that an uplift of 114% for electricity reasonably covers the cost of system losses, the underlying cost of managing customer demand shape and imbalance costs.

However, a headroom allowance is required to cover the *risk* around customer demand shape and BSUoS risk.

Shape Risk

Customer demand shape can't be perfectly hedged ahead of time in the forward wholesale market and so near term wholesale price spikes will impact any underlying shape cost. We believe this risk is biased towards suppliers due to the correlation between higher prices and periods of higher demand. Our view is that a 1.25% allowance is required in energy costs to cover shape risk or this should be included in headroom calculations.

BSUoS Risk

An assessment of BSUoS prices during 2017/18 illustrates the BSUoS risk faced by suppliers. Half-hourly BSUoS prices reached c£19.5/MWh versus an average of c£2.5/MWh over the period (internal SSE BSUoS data). Our view is that a 1% allowance in energy costs is required to cover this risk or this should be included in headroom calculations.

GAS

Our view is that an uplift of 107% for gas covers most of the underlying cost of managing customer demand shape and the supplier cost of UIG, but not all of the cost. Our view is that a further 1% wholesale cost allowance is required over and above the 107%. This is partly due to the high level of UIG which is being recognised across the industry and is essential to fully capture the cost of purchasing gas.

In addition, an allowance is required to cover the *risk* around customer demand shape and associated with UIG.

Shape Risk

As with electricity, gas customer demand shape can't be perfectly hedged in the forward wholesale market and there is supplier risk due to the correlation between higher prices and periods of higher demand. Our view is that a 1.25% allowance is required in energy costs to cover this risk or this should be included in headroom calculations.

UIG risk

Our view is that a 3% allowance should be included to cover the risk associated with UIG. This is based on our assessment of UIG from Jun17 to Mar18. The average percentage UIG was c6% over the period and our view is that 50% of this cost should be included in energy costs or this should be included in headroom calculations (internal SSE UIG data).

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

There is a requirement for additional allowances relating to transaction costs and collateral costs. Transaction costs come from brokerage and the difference between the mid price (used in the index) and the offer price (which we are able to purchase at). Collateral costs relate to the interest paid on working capital employed to allow hedging to take place.

Our view is that a further 0.5% wholesale cost allowance is required to cover these costs for both electricity and gas.

In summary, across our responses to questions A6.5 and A6.6 our view is that an additional 0.5% wholesale cost allowance is required for electricity over and above the PPM cost uplift of 114%. Likewise, an additional 1.5% cost allowance is required for gas on top of the 107% uplift.

In addition, a 2.25% headroom allowance is required for electricity and a 3.25% allowance is required for gas.

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

The proposed indexation approach for the initial period is appropriate. We would suggest not changing this approach now as some suppliers may have already started hedging following this indexation.

Appendix 7: Policy and network costs

QA7.1 - 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 are broadly supportive of the approach proposed by Ofgem, given the information that is available. Using latest data directly from the scheme administrators combined with adjustments for changes in the qualifying demand will provide the best view. However, a number of risks remain, which Ofgem will need to consider when providing appropriate headroom. We have set out our views on the residual scheme specific risks and issues below, which we believe are material in aggregate.

For the avoidance of doubt SSE expects that scheme costs associated with ECO and WHD will be included in any benchmark exercise – or an appropriate adjustment made to any reference price – to ensure the costs of a fully obligated supplier are properly reflected.

We also note the importance of recognising that the inherent uncertainty in BSuoS forecast remains (see response to QA6.5) and should be addressed by Ofgem.

Energy Companies Obligation (ECO)

The estimate of ECO costs during the Cap period cannot be established by using historic delivery data for ECO2t. Supplier phasing decisions and the fundamental changes to the scoring, measure selection and 'findability' of eligible properties make this information irrelevant. Any bottom-up approach would need to use the ECO3 impact assessment, with adjustments or significant headroom to allow for the flaws in approach identified in our detailed response set out in A7.2 below.

Additionally, the obligation does not vary with short term changes in consumption (e.g. due to weather), which leads to a risk of under recovery in periods of low consumption. The use of historic supply data also means that suppliers with reducing market shares are less likely to recover their costs through the period.

Feed in Tariff (FITs)

Feed in Tariff costs will not be finalised until September 2018, which leads to a risk that the true costs are not available in time for Ofgem's modelling of a default tariff cap baseline.

A supplier's obligation is fixed based on their share of market (in kWh) over the period, creating an exposure for firms who see reduced customer numbers through the period.

The obligation will not (directly) vary with short term variations in consumption (e.g. weather) which leads to a risk of under recovery in periods of low consumption.

Contracts for Difference (CfD)

SSE agrees that CfD costs should be updated as proposed by Ofgem. Nonetheless, it is important to note that a supplier's liability is fixed based on share of market (in kWh) over the period, creating an exposure for firms who see reduced customer numbers through the period.

The obligation will not (directly) vary with short term variations in consumption (e.g. weather) which leads to a risk of under recovery in periods of low consumption.

Renewables Obligation (RO)

SSE agrees with Ofgem's proposal to use the buy-out price to determine an efficient RO cost, and has no other material concerns about how Ofgem should treat Renewable Obligation costs.

Capacity Market

SSE's view is that there is a time of use element which could weaken the link to consumption as the liability is fixed on share of market (in kWh) over the peak winter period (rather than simply for the year as a whole).

The obligation will not (directly) vary with short term variations in consumption (e.g. weather) which leads to a risk of under recovery in periods of low consumption.

Warm Home Discount

A suppliers' obligation is calculated based on customer account numbers in the prior year. This therefore creates a risk that obligated parties cannot fully recover WHD costs if their share of the market reduces through this period.

The obligation will not (directly) vary with short term variations in consumption (e.g. weather) which leads to a risk of under recovery in periods of low consumption.

QA7.2 - Do you agree with our proposed approach to forecasting the costs of each scheme?

General views on forecasting approach for each scheme

We agree with using forecast costs to set scheme costs where the actuals are not known in advance. All forecasts carry risk and where possible actual costs should be used. We welcome the recognition that ECO and AAHDEC (Assistance for Areas with High Electricity Distribution Costs) should have an explicit allowance.

We support the use of a separate forecast of the scheme costs (£m) and a current and dynamic view of qualifying demand (MWh) to calculate the liability (£/MWh) faced by suppliers.

Taking each scheme in turn. From a supplier perspective:

- RO costs (£/MWh) should be known in advance
- WHD costs (£m) are known in advance, but not the customer numbers over which those costs can be recovered
- CM costs (£m) should be known in advance (but may not align with Ofgem's pricing in periods for the default tariff cap). The qualifying demand is not known in advance
- FiT costs are not known in advance nor is the qualifying demand
- CfD costs are not known in advance nor is the qualifying demand
- ECO targets are known in advance, but not the cost (£m) nor the demand over which it can be recovered

We do not believe the current BEIS impact assessment (published March 2018) of £640m pa (indexed to RPI) for ECO3 at industry level will prove realistic. The historic data being used, and the assumptions made by BEIS, do not reflect the intention of the scheme to focus entirely on support for fuel poor households. We recommend a headroom allowance above the BEIS forecast to account for this clear risk of an under-estimate. Please refer to the section below for our detailed views on ECO.

On the other costs items, we support the use of data from the individual scheme administrators, rather than OBR data.

We caution that inherent uncertainty will remain on FiT and CfD due to weather, demand and wholesale price uncertainty. The same is true for BSUoS (although this is accounted for in energy).

Detailed views on forecasting approach for ECO

There is currently no reliable forecast of the actual delivery costs of ECO3. There is no basis to assume that cost data in respect of ECO2 and the ECO2t transition scheme will be a guide to the market rates in ECO3 and we agree with Ofgem's acknowledgement that suppliers' phasing decisions make the meaningful analysis of historic data difficult. In addition, BEIS

and Ofgem anticipate the lifetime bill savings scores for efficiency measures will reduce substantially, increasing the 'cost per £1 of lifetime savings' used to fund work. As the historic delivery data is made irrelevant by the scheme changes, the only reasonable option is to use the BEIS impact assessment, subject to our comments on adjustment or headroom below. Ofgem should apply this at an average level, rather than seeking to estimate what future efficient costs will be in a scheme which does not yet exist. We agree with Ofgem's own analysis that suppliers have limited scope to influence the market rate for funding this work, which would make any suggested use of lower quartile costs unreasonable.

As noted in our response to Working Paper 4, the scheme proposals are similar to the 'CERT SPG' target which proved extremely challenging to deliver. The impact assessment attempts to assess the impact of 'findability' of properties. To do this it uses a 'central case' methodology which is simply the mid-point between using the CERO target baseline (which is now completely removed from the scheme) and using the current scheme 'fuel poor' baseline (where the target can be achieved by replacing faulty or inefficient heating systems, a proposition which has more immediate appeal to consumers than home insulation which will be the focus of ECO3). BEIS recognise that the difference in their central case and their low case modelling for this one variable alone could cause an 80%-90% cost increase over the impact assessment rates (see chart 1 on page 21 of the consultation ECO3 impact assessment[10]). Due to the limitations of the baselines selected (neither of which relates to work qualifying under the new scheme), we believe that the overall analysis is flawed and the cost increases could be even greater. As such, we believe that a significant adjustment or headroom allowance would be required to reflect the fact that BEIS' own sensitivities acknowledge that scheme costs could nearly double if a single factor in their calculations is incorrect.

In addition, the rural element of the scheme is now a larger proportion of the overall delivery, with tighter restrictions. BEIS have assumed this can be achieved at no extra cost. The current scheme, without the same restrictions, has a premium for rural work (we believe the figure to be 10%). The proposed rural sub-target is very similar to the CSCO Rural sub-target in ECO1, however suppliers only managed to achieve 2% of the rural obligation in the first half of the ECO1. Government had to intervene and adjusted the rules, citing the increasing costs of delivery as the basis for change. The BEIS analysis fails to take this experience into account. Ofgem must either make an adjustment to the impact assessment cost or allow sufficient headroom.

We agree that the initial demand base should be estimated on the gas and domestic supply volumes of fully obligated suppliers. However, this calculation creates additional risk for

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https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/696443/ECO_3_Consultation_Stage_IA.pdf

suppliers, in that the data used is historic (the reference year will have started at least 21months before ECO3 begins), meaning that any supplier with a decreasing market share will not be able to recover the costs of the scheme without additional headroom allowance. Also, the obligation does not vary with short term changes in consumption, nor is allowance being made for the general decline in energy usage (meaning that, over time, each unit of energy needs to recover a greater proportion of a static scheme cost).

To update the cap, we believe that it may be appropriate to review the scheme cost averages for administration costs and lifetime bill savings rates reported to Ofgem (with the market rates being applied to the targets of obligated suppliers). Only ECO3 data could reasonably be used for this exercise, due to the fundamental redesign of the scheme. It would not be appropriate to use actual annual costs, as suppliers can phase delivery over the entire 3.5 year life of the scheme.

QA7.3 - 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 welcome the use of an appropriate 'qualifying demand' to determine the £/MWh liability faced by suppliers. This is an essential step to recognise the trend in policy costs.

SSE has not conducted any research into, and is not aware of, any alternative data sources that could be used. Thus, in the absence of an alternative, SSE is supportive of the data sources that Ofgem has selected to support their analysis and indexation work in this area. However, we have an outstanding concern in relation to the impact of changes in the size of a supplier's customer base on the ability to recover scheme costs appropriately.

Obligated parties with a growing customer base will have a cost advantage whereas those with a declining customer base are at a cost disadvantage. This is a position that suppliers can address through their business models in the current environment. However, once the default tariff cap is introduced suppliers will not able to address this imbalance, which is ultimately borne from a policy requirement (i.e. a cost driver not linked to efficiency). We believe that Ofgem has not yet recognised and addressed this risk, either in the headroom or elsewhere in the cap design. Ofgem must focus on this issue to ensure their forecasts of scheme demand do not disproportionately bestow an advantage or disadvantage on certain suppliers.

QA7.4 - Do you agree with our proposal to use the existing model to estimate the network costs that suppliers incur?

Although most Network charges are known in advance of the proposed cap levels being set, there are some volume risks that are not addressed in the existing model. These outstanding risks are set out below:

- There is no recognition of how time of use costs affect E7 and other off-peak tariffs;
- There is no recognition that the AQ (used to determine peak day capacity charges) may differ to consumption. We note that AQ typically lags the underlying trend in consumption; and
- There is a risk of a change of network charges as a result of a SOLR event. An increase in the frequency such events could lead to an increase in the overall materiality of this impact.

We also note the importance of recognising that the inherent uncertainty in the BSuoS forecast remains (see response to QA6.5) and should be addressed by Ofgem.

In our Working Paper responses, we have also noted the fact that small supplier exemptions can have substantial impacts on the future distribution of costs of ECO and WHD. Accordingly, any update mechanisms need to reflect the increased cost per MWh incurred by obligated suppliers where non-obligated suppliers increase their market shares.

QA7.5 - 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?

Due to short timescales SSE has not yet been able to form a view on this question. We would be happy to develop and share views on this issue under separate cover.

Appendix 8: Operating costs

QA8.1 - 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)?

Reaching a reliable and well-informed view on efficient operating costs is one of the most important tasks which Ofgem must undertake in order to deliver the default tariff cap. Although Operating Costs only represent 17% of the bill on average, it is the element that ought to be most controllable by firms, and this explains the range in prices offered once the effects of loss-leading or high-low pricing have been reversed out.

We agree with Ofgem's view that operating costs are best treated as a cost (£) per customer, rather than a cost which varies with consumption (£/MWh). However, bad debt may best be treated as having a fixed and variable component.

We appreciate that Ofgem will want to select a sample of suppliers, and analyse their operating costs, rather than seek to undertake this exercise for all suppliers. However, it is important that a representative selection of suppliers is used for this exercise, that help Ofgem understand the implications of different customer book dynamics.

We support Ofgem's intention to exclude suppliers with <250k customers, with niche business models, with unreliable data, and with serious compliance failures. We also believe that Ofgem should ensure that their selection of suppliers is diverse in terms of length of time in market, and in terms of their progress towards delivering their smart obligations. These two factors are likely to drive significantly different operating cost profiles, aside from any level of efficiency (or inefficiency) that may exist in their operation.

Whilst newer suppliers should form part of any benchmark, it is important that they have existed long enough to demonstrate that their business model is sustainable across periods of changing wholesale dynamics, as well as when considering the impact of debt and associated collection costs. A supplier who has been in the market for a short period of time may be less likely to have customers who have built up a debt. It is also worth noting that there are a number of suppliers who require payment in advance, rather than payment on receipt of bill, who are therefore less likely to have a debt impact.

We believe individual cost categories will need to be identified to ensure adjustments to 'normalise' costs to reflect the 'average customer' can be made. Most strikingly, metering costs will need to be separately identified to calculate any adjustment to normalise for differences in the smart meter roll out program. A significant proportion of costs involved are allocated to metering. The impact of smart meter roll-out level will also have an impact on the level of costs within the period examined (noting that larger suppliers are bound by

more intensive regulatory requirements in the early years of the rollout compared to smaller suppliers). It is important that this is taken into account so that there is no disadvantage for suppliers, who may or may not be included within Ofgem's operating cost assessment, caused by their level of progress with relation to smart installation.

Estimating a separate value for gas and electricity is acceptable where it is clear that costs have been fully allocated between them (such as within CSS statements), and the same supplier will feature in the benchmark for both gas and electricity. Where a supplier is not required to produce such detailed accounts, there is a concern that these costs could be skewed, giving an artificially low view of costs, which are then mistakenly treated as being efficient costs.

There are a number of suppliers who routinely make available dual fuel and electricity only tariffs on comparison sites or their own website, but require a consumer to phone in in order to receive a quote for a gas only supply. This may potentially lead to a skew in costs which should be taken into account. The simplest method for this would be to use availability of tariffs as a method for determining whether a supplier should be used within the cost estimation process. We suggest excluding suppliers who do not evenly promote both fuels.

Whilst we believe it is acceptable to estimate a separate operating cost value for gas and electricity, we do note Ofgem's consideration under Option 3 (updated competitive price reference approach) of selecting a different bench of suppliers for each fuel – an approach which we do not believe is robust, and expect would lead to wholly unreliable conclusions.

QA8.2 - Should a variable component of this allowance be split out to reflect differences in bad debt costs between customers with higher and lower consumption?

It is reasonable to assume that bad debt is a function of the bill size (and so varies with consumption) but it will also be a function of the likelihood of going into debt (which is more likely to be linked to social and financial factors). On balance, we believe a portion of bad debt costs could be allocated on a variable basis.

QA8.3 - 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 are supportive of Ofgem using the most recent data available in all areas of their analysis, and then to supplement that analysis by cross-checking with earlier periods. This is especially true as Ofgem seeks to understand Operating Costs, so as to ensure that any individual year's cost profile was not atypical. The risk of error is further reduced if Ofgem undertake a review of several suppliers' costs, and ensure that some or all of those suppliers have been operating long enough to have established a reliable baseline.

We believe that Ofgem has already gathered the data to allow them to perform this analysis, and in any case has the powers to request additional information if it is believed to be required.

QA8.4 - Do you consider that default tariff customers have higher or lower operating costs than other types of customers?

We do not have cost data at this level of granularity. However, there are some key customer characteristics, with associated cost drivers, where we see differences between SVT and FTC customers. These are set out below:

- A lower % of SVT customers pay by direct debit (which has a lower cost to serve)
- A lower % of SVT customers manage their account online (which has a lower cost to serve)
- A higher % of SVT customers are vulnerable and use priority services (which has a higher cost to serve)

QA8.5 - Do you agree with our proposal of where to exclude suppliers from our benchmarking analysis?

SSE supports Ofgem's intention to exclude suppliers with <250k customers, with niche business models, with unreliable data, and with serious compliance failures. We additionally believe that consideration should be given to the following exclusions:

- Exclude suppliers who cannot provide two full accounting years' operating cost data. Such suppliers should be excluded because their business model is too immature to represent an efficient operator.
- Exclude suppliers who do not make single fuel tariffs available in the same manner as dual fuel tariffs. This exclusion is important to avoid skewing the customer base and associated costs.

QA8.6 - Do you agree with our proposal of what to include in our definition of operating costs?

Subject to the following reservations, SSE agrees with the proposal:

Within Section 2.20 Ofgem discusses the exclusion of indirect costs associated with services other than sales of gas and electricity. In principle, this is an acceptable exclusion as the cap

should allow a sustainable profitable business based purely on the supply of gas and electricity, however as more tariffs become available on the market which bundle supplies together it is not clear how the cost associated with such offers can be clearly split out. There is a risk that these could skew the costs used in the benchmark (e.g. having a bundled tariff which includes a subscription to non-energy products e.g. connected home service, or home insurance related proposition). It is also an area which could be subject to 'gaming of the system'. Clearly this would depend on whether such suppliers are included within the benchmark.

The increasing frequency, scope and cost of Ofgem-led initiatives to engage customers, including mandatory trials of customer communications, should be built into the definition of operating costs, so as to allow the costs of such initiatives to be passed through appropriately.

We agree that acquisition costs should be included, and that amortisation of these costs is a reasonable approach if applied consistently across all suppliers.

While the principle of 'normalising the smart costs' is reasonable, Appendix 10 does not provide sufficient detail to allow us to understand the level of costs that are being fed into that process.

Please also note our comments earlier in this response, noting that an adjustment is required for anticipated costs under new industry initiatives.

QA8.7 - Do you agree with our proposed approach to benchmarking operating costs under a bottom-up cost assessment?

We believe it is necessary to normalise costs to represent the 'average' customer who will be on the default tariff cap, and avoid over-emphasis of the lower costs associated with managing niche customer groups. By excluding certain suppliers (as covered in Q8.1 and Q8.5) and applying adjustments where necessary (as covered in Q8.8), we believe that an appropriate cost pool can be created if this is used in aggregate. The cost benchmarking exercise should be completed using the data from within this cost pool. We believe the benchmarking should be to the 'mean' of these costs. This provides a strong incentive for the inefficient suppliers to reduce cost – from the data presented in Table A8.1 then the 'top quartile' would need to reduce operating costs by 8% to match the benchmark cost in 2017 and the 'maximum' would need to reduce operating costs by 21%. Benchmarking to a single supplier clearly runs the risk that costs are non-representative or distorted (particularly if a single year is used), as the exclusion and adjustment process, whilst necessary, will not be perfect. Similar to the selection criteria for option 3 (updated

reference price) we believe the benchmark should cover at least 25% of the market and cover more than two suppliers.

QA8.8 - 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?

We think all the factors listed are material when selecting a benchmark that is representative of the 'average' customer. Where necessary explicit adjustments should then be made to the costs to account for variations from the average.

We would like to make the following points that Ofgem must consider in order to ensure that any benchmark is made up of suppliers that provide appropriate representation across the market. Please see below:

- **The amortisation of customer acquisition costs** – we agree with the principle that these costs should be amortised on a consistent basis;
- **Stage of smart roll out** – Each supplier's investment in and progress towards smart meter roll is important to consider. Additionally, we would note that it is important to recognise the proportion of hard to reach customers (e.g. not on the communication network, or with exotic meter configurations).
- **Payment method breakdown** – It will be important for any benchmark to have a sound blend of direct debit and standard credit customers; and also for Ofgem to ensure appropriate payment method uplifts are applied.
- **Costs carried by incumbent suppliers that new entrants do not incur** – These are not related to the level of efficiency and would include (as noted by Ofgem): Legacy Pension Obligations, the costs of upgrading or replacing legacy metering systems to be able to support smart meters (in the event of replacing a metering system, there would be a transitional period where two systems are run in parallel, again incurring very high costs); the cost of taking all reasonable steps to install smart meter to a high proportion of hard-to-reach customers; and the higher costs associated with serving vulnerable customers.

We note that the materiality of the impact of these factors will vary significantly depending on the combination of suppliers Ofgem selects, and therefore we recommend that Ofgem conducts a thorough assessment to understand these impacts.

QA8.9 - Do you agree with our proposal to use CPIH to index the allowance for operating costs within the default tariff cap?

We believe that Ofgem's use of CPIH as the basis for inflationary indexation is reasonable, however, we would note that a key component of operating costs is our people costs, which bear closer relation to RPI than CPIH so a blend of these should be considered.

QA8.10 - 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?

We believe that for a short-term intervention such as this default tariff cap, the case for the cap reducing over time is not clear. This type of mechanism is more commonly used for long term price controls, but the Bill is clear that the default tariff cap should be removed at the end of 2020, or if extended, then no later than end 2023. Applying a tighter cap over time also carries the risk that the scope for suppliers to engage consumers (e.g. through differentiating their offer on price and other factors) is most seriously compromised at the end of the cap, making it even more difficult to re-establish effective competition once the cap is lifted.

Appendix 9: EBIT

A9.1 - Do you agree with our proposed approach for setting the EBIT margin?

The proposed EBIT margin of 1.9% is very low, and unless significant headroom is given may not be sufficient to allow energy suppliers to cover their costs (including cost of capital) associated with supplying customers subject to the price cap. Whether this is the case or not will depend to a significant extent on the capital requirements associated with the best strategy that can be found to minimise hedging cost/risk associated with the price-setting methodology selected. Therefore, in selecting a methodology Ofgem needs to keep in mind the extent to which it imposes significant risks/collateral costs on energy suppliers, and therefore the extent of capital (and therefore return on capital) required.

Ofgem should also be mindful of the CMA's EBIT benchmarking analysis, which suggested a benchmark of 2% - but where this 2% figure sat right at the bottom end of the relevant comparators (e.g. picking up the 2.2% allowed EBIT in Northern Ireland (where costs can be directly passed through) rather than the 4.5% allowed in New South Wales, and at the lower end of the 1.9% to 2.4% taken from the I&C market despite the ability to directly pass through cost increases in this market).

We also disagree with the assertion that the detriment established by the CMA can be explained by a combination of excess profits and inefficient operating costs: the CMA's methodology effectively assumed a different product mix and hedging strategy than the one actually employed by SSE during the relevant period (by benchmarking against the prices of suppliers who largely offered fixed term fixed price products): efficient supply costs are strongly influenced by the extent to which volatility in wholesale costs is passed on to end consumers, and the extent to which suppliers are able to effectively hedge to cover the risks of a mismatch between the costs of energy procurement and the prices at which energy is sold to customers. It is essential that Ofgem takes this into account in setting an appropriate EBIT and headroom, with reference to the price-setting mechanism chosen (and associated risks and collateral requirements imposed on suppliers).

QA9.2 - 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?

The CMA estimated WACC in the range 9.5-11.0%. It was therefore slightly arbitrary to select 10% as the WACC to be applied for its analysis of profits. At the very least, if adhering to the CMA's fundamental analysis, Ofgem should use the mid-point of the CMA's range, i.e. 10.25%. Better still would be for Ofgem to consider the range of EBITs that would be

consistent with the full range of possible WACC calculated by the CMA. SSE would consider that any deviation from the level of EBIT consistent with the 11.0% WACC at the top of the CMA's range should be based on a coherent rationale.

Given the profound impact on competition in the GB domestic energy market and therefore on customers that this policy will have. SSE does not consider that it would be appropriate to determine the level for the default tariff cap without proper consideration of all the input parameters. In particular, Ofgem should avoid settling on round numbers which may have been selected for arbitrary reasons.

QA9.3 - 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.

SSE argued throughout the market investigation that the CMA had underestimated the capital employed in energy supply. This was due, in particular, to understating the cost of collateral required to cover risk. The CMA's profitability analysis was not robust – small changes to input parameters resulted in significant movement in the calculated level of normal returns, or EBIT, that should be earned in domestic energy supply. SSE considers that Ofgem should review the working capital and the cost of additional collateral required to cover plausible business risk.

Scenarios of relevance include the impact of weather, where either a cold shock results in suppliers having to buy additional volumes of energy at prices higher than those factored into existing tariffs (e.g. the Beast from the East) or warm weather spells resulting in suppliers unwinding long positions into markets trading well below the level that applied during when the anticipated demand was hedged. SSE considers that the CMA underestimated the frequency and impact of such events and consequently grossly underestimated the capital requirements of large suppliers. Had the CMA calculated the capital requirements consistent with a more prudent and sustainable business model, the conclusion of its profitability analysis would have been far lower than the estimated annual detriment of approximately £1.7B.

As SSE set out in its response to the CMA's EMI, in calculating the capital requirements of a large standalone energy supplier the CMA assumed a business model (relying on a third party to manage contingent capital requirements in return for a fee) which does not exist at scale, and even at small scale not at such a low cost as the CMA's analysis assumed. As such, we do not believe that the resulting capital assumptions are valid. Of course, the capital requirements for energy retailers going forwards in relation to customers who are subjected to the price cap will be different, and will reflect the way in which the price cap is set, and

the extent to which suppliers need to hold risk capital in order to support the underlying energy procurement to support those customers.

QA9.4 - Do you agree with our proposed approach to updating the EBIT margin?

Given that key drivers of capital requirements are likely to be energy costs (both in terms of working capital and collateral requirements), it would make most sense to update EBIT in line with energy bills (i.e. to use a % EBIT rather than a £ EBIT calculation as the basis for each year's price cap).

However, it may be necessary/appropriate to make a more substantive adjustment to the allowed EBIT margin over time. If it becomes apparent that the price setting methodology in fact imposes more substantial capital requirements and risks on suppliers than was envisaged in the CMA's original analysis (on which the EBIT level is based), then it should be open to Ofgem to revisit its analysis of the relevant underlying capital requirements and WACC, and therefore the appropriate EBIT allowance. This is particularly the case given that the ROCE analysis on which Ofgem's proposed EBIT is based was relegated at the end of the CMA process from the key driver of its detriment assessment to merely a "cross-check".

Appendix 10: Smart metering costs

QA10.1 - 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 there needs to be a separate smart meter adjustment to reflect the higher year on year costs of rolling out smart meters, particularly as the benefits are likely to be back ended. However, we need to see more detail in order to form an opinion about whether it delivers an appropriate cost.

QA10.2 - 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 with Ofgem's position and believe this is an essential adjustment which needs to be incorporated. We would welcome more detail on how Ofgem propose to do this. To date the smart roll out program has been subject to repeated changes which have had significant cost implications.

QA10.3 - 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?

It is not possible to assess the Smart Metering Net Cost Change without sight of the detailed model and data used to produce it. In principle, the use of the BEIS CBA model as a calculation method is logical but the data being used and the forecast assumptions being made, which are key to the SMNCC being accurate, are unknown.

The calculation method for SMNCC appears to be backwards looking and reactive to increases in costs at a time when the costs of Smart installs and BAU operations are expected to increase as the energy industry starts to increase install volumes significantly, roll-out a new technology solution (SMETS2) as well as address increasingly difficult installs and engage with an increasing number of meter asset providers and small and medium energy suppliers. Given these factors, Ofgem should place great emphasis and importance on determining the most accurate forecast assumptions.

QA10.4 - Do you agree with the judgments 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?

The use of the BEIS CBA model as a calculation method is logical but the data and forecast assumptions used to drive the SMNCC are unknown. The current approach lacks the necessary transparency to be able to ascertain the appropriateness of the documented judgments.

The calculation method for SMNCC appears to be very backwards looking and reactive to increases in costs at a time when the costs of Smart installs and BAU operations are expected to increase as the energy industry starts to significantly increase install volumes, rollout a new technology solution (SMETS2) as well as address increasingly difficult installs and engage with an increasing number of meter asset providers and small and medium energy suppliers. Greater emphasis and importance should be placed on getting the right forecast assumptions.

QA10.5 - 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.

The costs of running Smart metered credit customers are higher on an enduring basis compared to heritage customers; therefore, suppliers will continue to see cost escalations over time as Smart penetration increases. As well as higher running costs, we incur significant costs on installing Smart meters - the costs of installing will increase as volumes ramp towards 2020 targets.

The costs of Smart rollout are expected to increase from 2017 onwards as the communication technologies required to successfully complete difficult installs are introduced. SSE expects 30% of its total installs to require an access technology other than SBCH (i.e. DBCH, Alt Han).

As already noted, we agree with drawing out the DCC costs (in particular) to be treated as a pass-through cost for the cap methodology – DCC costs are expected to grow more than 50% from 2017 annual levels.

Large suppliers in particular have incurred significant infrastructure costs to create the platform for Smart, and must operate Smart and heritage estates in parallel. – Where significant cash costs have been incurred and balance sheets used, we note that significant increases in depreciation charges to the profit and loss account will occur over the coming years, with significant increases likely versus 2017 levels.

The increasing prevalence of Smart is leading to increasing numbers of domestic energy suppliers and Meter Asset Providers which together are giving rise to increased administrative overheads.

QA10.6 - 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).

Without sight of the model it is not possible to ascertain the appropriateness of the methodology.

The methodology needs to recognise the investment costs incurred when the industry timetable is moved. This is a significant cost driver which is not related to efficiency of the supplier.

It should also recognise the additional costs incurred by suppliers with a large legacy base, who will be migrating their customers over the proposed cap period, and are in effect having to incur the additional cost of running and maintaining two parallel systems, one for smart and one for legacy, during the roll-out period. Newer suppliers have the advantage of introducing a single system which is 'backwards' compatible.

As per our response to QA8.7, our view is that Ofgem should normalise costs to represent the 'average' customer who will be on the default tariff cap. We believe the benchmarking should be to the 'mean' of these costs. This provides a strong incentive for the inefficient suppliers to reduce cost. Benchmarking to a single supplier runs the risk that costs are non-representative or distorted. As a minimum, we believe the benchmark should cover at least 25% of the market and cover more than two suppliers.

Reference should also be made to quality objectives – it is important the rollout is performed in a safe manner, to a high standard and in the best interests of the customer. By benchmarking a single low cost option, there is risk that quality may fall to the detriment of customers.

QA10.7 - 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.

Without sight of the detailed indexing method it is not possible to fully understand the impact of Ofgem's preference (option 3, specific smart updating approach based on net cost analysis) and whether it will provide a suitable outcome. SSE's strong preference is for

Option 2 (periodic cost assessment). However, from the information that is available to us and on the basis that Ofgem could accurately establish the right baseline costs, Option 3 would be preferable to Option 1 (no specific updating approach).

As Ofgem are aware, timescales for the delivery of the essential smart meter technical infrastructure and the cost of programme elements such as the DCC has escalated beyond expectations. As such cost benefit analyses in smart have typically produced an unrealistic and overly optimistic outcome. For this reason, SSE's strong preference is for a periodic cost assessment (Option 2).

For example, the 2016 CBA conclusions / valuations are considered flawed as the data used for this output was out of date at the time of issue (specifically around DCC costs); there have been significant cost escalations in the intervening period (again, most notably the DCC costs), coupled with the additional delays to the industry programme.

Any such indexing mechanism needs the capacity to capture increasing costs in the period that they occur. The stated principle that actual costs will be used and then updated for forecast fails to explain where the forecast costs come from and what triggers the use of forecast numbers over actuals.

The establishment of a low-cost envelope could result in suppliers working to the prescribed cost level rather than incurring those costs necessary to make the Smart rollout a success.

Appendix 11: Headroom

QA11.1 - 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?

SSE strongly believes that headroom is a vital component of any default tariff cap and in conjunction with a bottom-up assessment of costs, it is the only way to ensure that Ofgem can meet its statutory objective and each of its duties set out in the Bill and that the risk of unintended consequences is minimised.

We note that whilst Ofgem had previously described headroom as existing to *'enable suppliers to compete and provide an incentive for customers to shop around'*[11], the emphasis has now shifted (without explanation) to being in place to *'account for uncertainty that has not already been allowed for when estimating the efficient level of costs'*. In reality, it is important for headroom to perform both roles: headroom will be critical to achieving the Bill's objective of maintaining incentives for domestic customers to switch.

Given that the headroom required cannot be determined until a cap methodology has been set (as the risk build up is not known until that point), it is concerning and unjustified that Ofgem has narrowed in on a range at this formative stage. Furthermore, it is concerning that Ofgem believes that under some approaches headroom may not be required at all – this cannot be true, as none of the cap methodologies reduce risks entirely or removes the need to enable competition (which should allow suppliers to compete both on price and on matters such as customer service and innovation). We note that even Professor Martin Cave, the sole member of the CMA Panel who was in favour of a price cap, emphasised that there must be an above-cost element to such a cap.

We also disagree with Ofgem's view that its duty under Section 1(6)(a) of the Bill (to have regard to the need to create incentives for holders of supply licences to improve their efficiency) supports setting headroom at a low level. We believe that competition is the best way to incentivise efficiencies and setting the Default Tariff Cap too low will be counter-productive as suppliers will be incentivised to reduce customer service levels, reduce innovation and avoid competing in the SVT segment of the market.

Ofgem should, at this stage, accept that headroom is an essential feature of any cap, and be unconstrained in its thinking as to the level of headroom that might be required (which should itself be considered and consulted on further).

[11] Working Paper 3 (Figure 3)

Headroom would best be allocated on a percentage basis across all cost components, including network costs. This is because the many risks that exist are distributed across the various cost components, and there is no reason why those risks might not materialise in concert with each other.

Furthermore, the important role that headroom plays in enabling competition (and innovation) is played out in the retail marketplace (and therefore by reference to the retail price). By setting headroom as a percentage of all cost components Ofgem can best endeavour to ensure that adequate price dispersion remains in a post cap environment to allow switching to continue to exist.

QA11.2 - What are your views on whether we should change the level of headroom over time?

SSE believes that sufficient headroom will be required to provide cover for the many risks that suppliers will be exposed to, and to ensure price dispersion; and that neither of these requirements will change during the limited lifespan of the default tariff cap. As such SSE's view is that the level of headroom (expressed as a percentage of the total bill) should not change over time.

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

SSE's view is that the headroom required cannot be determined until a cap methodology has been set (as the risk build up is not known until that point), it is therefore concerning that Ofgem has narrowed in on a range at this formative stage. Furthermore, it is concerning that Ofgem believes that under some approaches headroom may not be required at all – this cannot be true, as none of the cap methodologies reduce risks entirely or remove the need to allow room for competition to take place beneath the cap. Setting a cap without (sufficient) headroom will be equivalent to simply setting a regulated price – and will not only rule out all competition in the short term, but will also make consumer engagement and competition much more difficult to re-establish once the cap is lifted.

Ofgem should, at this stage, accept that headroom is an essential feature of any cap, and be unconstrained in its thinking as to the level of headroom that might be required.

[redacted]

We explained the shortcomings in the PPM cap methodology to Ofgem at a bilateral meeting, and so look forward to seeing the insights provided feed into design considerations here.

In outline, key points highlighted included that the business model (and pricing) of FU and OVO had not at the time been demonstrated to be sustainable; that we believed the PPM cap had approximated FU and OVO hedging costs rather than fully assessing actual costs; that the model had not accounted for reducing qualifying energy demand when determining policy costs per kwh; had failed to account for escalating smart meter roll out costs; and that in any case FU and OVO's customer bases were unrepresentative of the market as a whole.

Given our experience under the PPM cap we believe that Ofgem should err on the side of caution and build in sufficient headroom to guard against unintended consequences of poor indexation, and note that such issues may only emerge as the cap matures over time. It is vital that Ofgem learn from the experience of the PPM cap to ensure that the Default Tariff Cap does not suffer the same issues and potentially result in default tariffs being loss-making for suppliers. This would make suppliers unable to finance their licensed activities, and unable to effectively compete by offering the type of price dispersion and service differentiation that encourages customers to engage in the market, and would therefore put Ofgem in conflict with the three of the four key objectives of the Tariff Cap Bill.

Appendix 12: Payment method uplift

QA12.1 - Do you agree with our proposed methodology for allocating additional costs between standard credit and direct debit customers?

We note Ofgem's intention to socialise the cost of supplying standard credit customers partially over two caps, but believe that the approach Ofgem is minded to adopt would lead to standard credit customers becoming unprofitable, and in turn lead competitors in the market to reduce efforts to acquire or retain those customers. While SSE recognises Ofgem may consider that some level of socialisation is warranted, we believe Ofgem should take the signals already provided by the market as to what a suitable level of socialisation is in this case would be, by reference to current levels of MDD discounts offered. SSE believes that the outturn differential between MDD and Standard Credit should be ~£76 (which is in line with our MDD discount), and therefore propose that Ofgem socialise the remaining ~£38 between MDD and Standard Credit customers. This would, we believe, lead to a payment uplift of more like ~£15 for Direct Debit and ~£85 for Standard Credit.

QA12.2 - Do you agree with our proposed methodology for calculating the additional costs to serve and the socialisation level?

SSE does not support the level of socialisation currently proposed by Ofgem, and believes this to be excessive. We foresee the potential for such an extreme level of socialisation to lead to standard credit customers becoming unprofitable, and that this in turn would lead competitors in the market to minimise efforts to acquire or retain those customers. This could ultimately lead to some vulnerable customers who are less likely to pay by direct debit being disadvantaged.

Appendix 13: Renewable tariff exemption

QA13.1 - Do you agree with our minded-to positions not to provide exemptions for renewable electricity or gas tariffs?

SSE has no strong views on this element at this time.

QA13.2 - What are your views on whether to provide a derogation for renewable electricity tariffs?

SSE has no strong views on this element at this time**.**

Appendix 14: Impact Assessment

QA14.1 - 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 note that Appendix 14 presents very little information on the Impact Assessment on which we can comment. In any case, we do not consider that a consultation on a c. 400-page document conducted over a four-week period, on one of the biggest regulatory interventions the retail market has seen, is an appropriate way for Ofgem to gather views or input for such an important Impact Assessment.

SSE is concerned with the timescales allocated by Ofgem to collect sufficient evidence to support their Impact Assessment. As the Impact Assessment is due to be published in August alongside the Statutory Consultation, with license conditions to follow, we do not believe this gives Ofgem or suppliers sufficient time to conduct an Impact Assessment or to mitigate the risks identified in the impact assessment before the cap comes in to full force. As we note in to Annex 1 (section: '*Proper decision-making must not be sacrificed for speed of implementation'*) we are concerned at the pace of this regulatory process. We have had only a period of one month (running over a half-term and bank holiday period) to prepare our response to a consultation that covers an extensive range of policy options, which posed a very large number of questions and involves a twin-track consultation relating to the safeguarding of additional customers. This is an astonishingly short period of time for such an important policy consultation and SSE considers that these timescales have conflicted with Ofgem's Consultation Policy[12] and good regulatory practice.

Ofgem's Consultation Policy states that when consulting, there 'must be adequate time for consideration and response' and that Ofgem should allow 12 weeks to consult on 'major issues' and 4 weeks for 'urgent issues'. It cannot be said that the lesser period would be appropriate here, particularly in circumstances where the consultation is taking place before the statutory underpinning for the price cap has even been enacted.

We also note that the Government's own Consultation Principles: Guidance (last updated in March 2018), which are intended to give clear guidance to government departments on conducting consultations, notes at paragraph E that: "Consultations should last for a proportionate amount of time… Consulting too quickly will not give enough time for consideration and will reduce the quality of responses." We are concerned that a consultation – and Impact Assessment – of this magnitude and importance is not being given

[12] https://www.ofgem.gov.uk/consultations/our-consultation-policy

sufficient time for respondents and interested parties to properly consider all of the complex issues being consulted upon.

Furthermore, Ofgem indicate that evidence will be drawn from formal information requests. It is not clear whether SSE will now face large information requests post consultation response. We are concerned that there has been no mention, nor indication, of anticipated time scales regarding responses to these formal information requests. We welcome clarity from Ofgem on this point.

QA14.2 - 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.

[redacted]

[redacted]

If the default tariff cap follows an identical bi-yearly cycle, in April and October as the existing safeguards, we would expect a significant increase in forecasted contact demand over those periods, meaning the related costs would likely increase further.

QA14.3 - 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.

SSE considers the following points as detrimental impacts on customers, related to the existing safeguard tariffs.

- **Disjointed and poor customer experience**; the sequencing of the initial implementation of vulnerable safeguard, in February, and subsequent April revision of the cap, meant customers were initially advised of a new tariff and price decrease, however a few weeks later were then readvised of a price increase.

- **Risk of disengagement**; as a supplier proactively notifies a customer they are being migrated to the safeguard tariff (based on pricing comparison against SVT), customers can perceive the safeguard tariff as the best tariff option for them. Therefore, there is a risk a customer becomes disengaged in the market, not considering other options available to them, for example a fixed term discounted tariff.

- **Vulnerable Safeguard small supplier exemption**; as eligibility for the vulnerable safeguard tariff is linked directly to Warm Home Discount eligibility, customers with an exempted supplier are excluded from the vulnerable safeguard tariff and do not realise the benefits attributed to that tariff.

Finally, we are unable to adequately consider any future potential consequences, from the implementation of the default tariff cap, until the methodology and timing related to that cap have been clearly set out by Ofgem. One likely outcome, however, is increased confusion amongst customers moving between two different cap arrangements depending on their transitory qualification for safeguarding (currently Warm Home Discount eligibility). Also, suppliers should not be placed in a position where it is unclear which cap arrangement is the appropriate choice for a customer, as this creates additional complexity, risk and administration cost. With this in mind, we believe that Ofgem should ensure that it follows its stated intention in its decision notice of December 2017 and removes the existing safeguard extension on the implementation of the default tariff cap.

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.

SSE does not believe the default tariff cap could disproportionately impact any of the nine protected characteristics under the Equality Act 2010.

We would, however, note that customers protected under the Equality Act will not be evenly distributed across all suppliers in the market. Indeed several of the nine protected characteristics overlap with Ofgem's definition of customer vulnerability, a group which SSE over-indexes against, and to whom we provide substantial financial and non-financial support. This fact further reinforces the need for Ofgem to take great care to ensure that those companies who provide the greatest support to the most vulnerable in society are not disadvantaged by the introduction of a default tariff cap.

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

[redacted]

As shown in Figure 3 below, our evidence shows that the volume of switches in 12 months to the 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. Looking beyond 2017 our data showed

that PPM switching had been on an upward trend prior to the cap, with a clear marked decline in switching since the cap introduction of the cap. Please refer to our response to Working Paper 3 for our full response to this question.

Figure 3: Total PPM gains and losses 2014 -2017