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Dear Rob

SSE response to Ofgem Open Letter on Capacity Market allowance in the Default Tariff Cap

SSE strongly objects to Ofgem's proposed approach under Scenario (b) to adjust the wholesale costs Annex within the Default Tariff Cap to remove the allowance for the recovery of Capacity Market Supplier Charges ahead of Charge Restriction Period 2.

We believe the proposed approach is contrary to the Government's expectations around the recovery of supplier charges during the standstill period and that the current regulatory framework would prevent Ofgem progressing changes to the methodology in this way and in the time permitted.

We believe that Ofgem will introduce a serious risk to suppliers' financeability during the standstill period by removing the ability for suppliers to recover Supplier Charges (which is an efficiently incurred cost) via the Default Tariff Cap. This risk is enhanced by the impact of growing mutualisation costs associated with the rate of supplier failures we are currently seeing in the market, which is already eroding the headroom allowance. We firmly believe that the headroom should not be used to fund policy costs that are known and should be accounted for in the methodology. We respectfully request visibility of any impact assessment Ofgem has conducted on these proposals. We also request the sensitivity analysis conducted by Ofgem on the impact of including mutualisation costs in the headroom (referenced in Appendix 2 of the Default Tariff Cap Decision Document).

We recommend that Ofgem seek to make alternations to the cap methodology only once there is evidence to warrant such an intervention i.e. once Government has confirmed the final position, not before. We also firmly oppose any proposal to use the headroom allowance to recover known policy costs; these costs must be allowed for in the cap methodology.

Our full response is set out in Annex 1 and we would be happy to discuss any of the point included in this response.

Yours sincerely
Patricia Hall

Annex 1: SSE response to Ofgem Open Letter on Capacity Market allowance in the Default Tariff Cap

1 The proposed approach does not support the Government's expectations around the recovery of supplier charges during the standstill period

In its consultation this month on proposals for technical amendments to the capacity market, BEIS clearly state that:

- if and when the State Aid case is approved, BEIS will be able to make deferred payments for all suspended payments;
- the Commission have confirmed that they have no objection to BEIS resuming collections from suppliers during standstill;
- the Government has received a range of representations that it would be beneficial for confidence and for efficient operations to resume monthly collections now in anticipation of deferred payments being required at a later date;
- it are minded to re-start the collection of the Supplier Charge during the standstill period (indeed BEIS were also consulting on their intended approach to collect these payments); and that
- suppliers may feel it is sensible to continue to collect money from their customers to fund this charge.

This consultation therefore makes it crystal clear that payments are intended to restart during the standstill period, but that in the event they are not restarted during the standstill period suppliers will be required to make deferred payments to generators at a later date. The consultation also makes it clear that BEIS considers it 'sensible' for suppliers to continue to collect money from their customers to fund this charge. Even without this certainty, we do not believe Ofgem should set a precedent of removing a cost allowance in advance of a cost potentially not being incurred. This is particularly true given its policy decision implies that such changes are only warranted when the materiality of an error or inconsistency can be demonstrated. We do not believe there is sufficient justification or evidence for the removal of the Supplier Charge allowance in the Default Tariff Cap at this stage.

As Ofgem will appreciate, in the event that the mechanism was removed, this would cause a delay in the collection of funds to pay for the Supplier Charge which would in turn create a future spike in costs to suppliers and their customers. This would create unnecessary price fluctuations and confusion for customers covered by the Default Tariff Cap and introduces a risk that some suppliers may fail to put aside the necessary funds to make the deferred payments when requested. At a time of unprecedented supplier failures in the market – and the disruption we are seeing from non-payments to the Renewable Obligation, FITs, and WHD – we believe that Ofgem should be doing everything they can to avoid further damage the financial stability of the market and the suppliers that operate within it.

Given the above, we strongly oppose Ofgem's proposed approach in scenario (b). We recommend that Ofgem retain the methodology as it stands until evidence to justify an amendment is available. This would also minimise the administrative burden on both Ofgem and suppliers in avoiding a potentially unnecessary change in methodology that needs to be corrected later.

2 There is insufficient justification or time for Ofgem to alter the methodology before Charge Restriction Period 2 begins

In its Decision Document, Ofgem explain that in addition to the routine updates to the cap, there are scenarios where unforeseen trends in efficient costs warrant a change in the methodology. Firstly, due to limitations in the cap design i.e. assumptions and simplifications could mean there are systematic features in the cap that make it too low or too high; and, secondly, supplier outturn costs could depart from forecasts i.e. Ofgem's forecasts include uncertainty so it is possible that actual costs depart from forecasts. In these cases, Ofgem can adjust the models used to update the cap or they can make SLC modifications to change the methodology. In either case, we would expect that, in order to trigger these processes, Ofgem would need evidence to substantiate their view that:

- in the case of adjusting the cost models, there had been a significant and unanticipated change of circumstances such that the annexes no longer reflect an efficient level of costs as allowed for in the annexes; or
- in the case of changing the methodology within the SLCs, that there are material systematic issues that require correction.

We do not consider that adjusting the cap to pre-empt changes that may or may not occur meets these criteria. Ofgem cannot know at this stage whether these criteria are met. In contrast, what is currently clear is that Government would consider it 'sensible' for suppliers to continue to collect this money from their customers. We consider the notion that these payments will not need to be made is unsubstantiated and does not warrant a change in methodology from Ofgem at this stage.

Furthermore, in either of the options above Ofgem would need to consult industry. Ofgem would need to consult for 28 days (as per the Act) and allow time for any licence changes to take effect. Given Ofgem need to publish the cap level for Charge Restriction Period 2 within two weeks of this Open Letter closing, this option is not available to Ofgem.

3 Headroom must not be used to recover the Capacity Market Supplier Charge

In the event that Ofgem progress with this proposal – despite the lack of robust evidence to trigger a cap or cost model correction (as detailed in the Decision Document) – we caution that the headroom should not be used pay for the recovery of these costs. We believe there are policy and legislative barriers that prevent Ofgem using the headroom to pay for the Capacity Market Supplier Charge and that this action would increase the risk of supplier failures.

In setting the headroom allowance, Ofgem explain in their Decision Document that it has given regard to the extent to which an efficient supplier would, on average, face a net cost of residual risk and uncertainty that is not already allowed for in the cost assessment. Given the costs of the Capacity Market Supplier Charge is known and allowed for in the wholesale costs assessment, it would be entirely at odds with the policy decisions already made by Ofgem to attempt to recover these charges through the headroom.

We believe that requiring suppliers to pay for known policy costs without being able to recover them from their customers is contrary to the section of the Default Tariff Cap Act that requires Ofgem to have regard when setting the cap to the need to ensure that suppliers can finance activities permitted under the licence. Using the headroom in this way may also mean that some suppliers fail to put aside the necessary funds and are then unable to make the deferred payments when requested.

As Ofgem are aware, the very low 1.46% headroom allowance is already being used to recover the costs of suppliers exiting the market, which includes the ROC shortfall of £58.6M and FITs shortfall of £4.1M (it will also be used to recover WHD shortfalls we expect to see). These unplanned and substantial increases in costs will already be placing a significant financial burden on struggling suppliers and we believe that introducing the requirement to pay for the Capacity Market Supplier Charge via the headroom would increase this burden and heighten the risk of more suppliers exiting the market.

At a time of unprecedented supplier failures, we believe that Ofgem should be doing everything they can to avoid further damage to the stability of the market and the financial viability of the suppliers that operate within it. The headroom allowance was not designed to fund a recurring cycle of supplier failures or for recovery of known policy costs and Ofgem should be seeking to prevent this occurring. We recommend that Ofgem only make alternations to the cap methodology once there is full certainty that an alternation is required (i.e. once it is known whether costs incurred align with forecasts), not before, and that the very high-risk proposal to use the headroom allowance is not progressed.