

## SUPPLEMENTARY SUBMISSION ON TARIFF CAP

### 1. Introduction

- 1.1.1 SSE's response (the *Response*) to the Provisional Decision on Remedies (*PDR*) clearly explains why SSE considers that the proposed price cap covering all prepayment tariffs is not necessary or appropriate, and also describes a number of specific technical flaws and unintended consequences of the CMA's proposal. This supplementary submission discusses some important aspects of the price cap which were not fully explored in the Response due to logistical constraints affecting the timing of data released via the confidentiality ring.
- 1.1.2 The Response described a number of serious shortcomings of the proposed prepayment meter (*PPM*) price cap which, for convenience, are summarised below where relevant to the further discussion in this submission. Whilst supportive of initiatives to provide essential support for vulnerable customers, SSE has explained that it does not believe that a PPM price cap is the best means to pursue this policy objective.<sup>1</sup>
- 1.1.3 This submission presents new evidence showing that some aspects of the CMA's proposed design of the price cap risk particularly adverse consequences. SSE's analysis indicates that there could be serious unintended distributional implications from the operation of the cap, adversely impacting low users and customers with electric heating. This would be particularly detrimental for many of the most vulnerable households, the very customers this remedy is intended to assist. These aspects are discussed in detail in Sections 4 and 5 of this submission.
- 1.1.4 Notwithstanding that there is no basis for any form of price cap, the analysis provided below is intended to assist the CMA in its ongoing work to develop and refine the package of remedies described in the PDR, by highlighting that there are far less damaging formulations than the option currently proposed by the CMA. Specifically, in order to mitigate the potential adverse consequences for customers discussed in detail below, SSE considers that, at the very least, the CMA should:
- (a) **Set the cap at a viable level:** rebase the price cap to a more sustainable level to mitigate the risk that suppliers are forced to closely shadow the cap leading to unintended distortions such as higher standing charges;
  - (b) **Simplify the price cap:** reduce the number of tariff types from five to three (standard electricity, Economy 7 and gas) to remove the unnecessary complexity and ambiguity that is inherent in the proposed dual fuel price caps;
  - (c) **Carry out a proper cost-benefit analysis:** carry out a full distributional analysis of the impact on competition for different customer groups (including electric heating customers and low using vulnerable customers).
  - (d) **Ensure the cap is sustainable:** seek expert advice or enlist Ofgem to set up a practical and robust indexation process, most importantly with regard to wholesale prices in order to minimise the very significant market risk imposed on suppliers by the price cap and to ensure that suppliers can hedge PPM

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<sup>1</sup> See the *Response*, para. 4.5.2.

customer demand at a price compatible with the level of the cap throughout the lifetime of this transitional measure; and,

- (e) **Clarify the operation of the cap:** reformulate the price cap such that the ambiguities in the current specification are removed and a maximum permitted level is defined for each tariff element to avoid the risk that compliant tariffs result in large percentage bill increases for low users;

## 2. Consequences of the price cap

### 2.1 Tightness of the cap

- 2.1.1 We do not believe that the CMA intended to remove PPM customers from the competitive market completely but setting the price cap too tightly is exactly what this proposal would do. The consequence is that suppliers will be forced to price as close to the cap as possible in order to maintain the commercial viability of tariffs for this segment of their customer portfolio. Therefore, the structure of the cap and the implied balance between standing charges and unit rates (and the balance between day and night charges for Economy 7 tariffs) will be critical as we expect that suppliers may need to shadow them closely.
- 2.1.2 The Response identified a number of errors of fact and assessment relevant to setting the level of the cap. SSE's Authorised Advisers used the information made available through the Confidentiality Ring to conservatively estimate the sensitivity of the CMA's proposed price cap to these errors<sup>2</sup>.
- 2.1.3 Firstly, it is clear from a review of the evidence on the PPM v Direct Debit (**DD**) cost differentials collected by CMA that a difference of £76 has a much stronger basis than the figure of £54 assumed by CMA. The figure of £54 is clearly erroneous as it is not derived from the "efficient" operator level as indicated by CMA but quite the opposite, as it is based on the SLEF with the *highest cost to serve DD customers*.
- 2.1.4 Secondly, the choice of only two suppliers offering introductory prices as a benchmark is another clear distortion, compounded by the fact that one of these suppliers operates below the level of profit deemed competitive (1.5%) by the CMA.
- 2.1.5 SSE's Authorised Advisers calculated the impact of bringing OVO Energy's tariffs into line with those of First Utility, which were themselves clearly below a sustainable level. Even on the basis of these conservative adjustments made by SSE's Authorised Advisers, it was found that the benchmark tariff for dual fuel PPM customers would increase by an additional £40-60. A more realistic adjustment would provide: a sustainable EBIT margin for the benchmark firms; a level playing field on the cost of government schemes; and an incremental cost to serve estimate for PPM customers of £90 (which is actually the cost differential associated with the most efficient SLEF). Adjustments on this basis would push the price cap higher still. The £40-60 range we propose for the required loosening of the cap is therefore a very conservative estimate.
- 2.1.6 Leaving aside the detailed analysis of how PPM costs are built up and the shortcomings of the adopted benchmarks, it is obvious from a broad overview of the CMA's headline conclusions that the proposed level of the price cap is far too low. The CMA calculates that the impact of the cap on suppliers would equate to a £300m

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<sup>2</sup> See the *Response*, paras. 4.6.2 – 4.6.8.

reduction in revenue yet elsewhere concludes that the excess profit in the domestic market is only £240m. The consequences are serious; in all likelihood it would mean that energy firms would be at risk of supplying PPM customers at a loss, which – far from supporting the development of a “well-functioning market” – would remove all incentive to compete for these customers.

- 2.1.7 As set out in the Response<sup>3</sup>, a review of the PPM prices on offer at the time of the CMA’s assessment shows that examples of prices at the cap level are sparse, even in the case of heavily discounted and highly targeted offers. Even when comparing the proposed cap to this manifestly inappropriate benchmark, the CMA finds a large number of regions in which the price cap would fall below the lowest available tariffs.
- 2.1.8 The adopted process for establishing the base level of the cap is not related to a balanced assessment of suppliers’ underlying cost drivers but, instead, on over-laying a set of rudimentary adjustments on a snapshot of the prices used to support the acquisition tactics of two new entrants. This means that suppliers are likely to be forced to price very close to the cap across the consumption range of their customer base. In other words, a likely but unintended consequence is that many suppliers may be forced to mirror the level of standing charges and unit rates implied by the cap parameters. Standing charges may increase substantially as a direct result of the current cap proposal if it is not amended to a more sustainable level. For customers with low usage such increases in the standing charge would impose a significant percentage increase on their total bill.

### **3. Key parameters in the tariff cap**

- 3.1.1 The proposed formulation of the price cap is overly complex. This section addresses the principal sources of complexity, each of which suggests possible simplicity gains which could be made.

#### *Breakdown of tariffs*

- 3.1.2 The CMA specification is based on *five* different classifications of tariff. In SSE’s view, there is no benefit in going beyond three tariff types (i.e., electricity, gas, and Economy 7) for the purposes of administering a cap. This would help to eliminate a number of the anomalies in the CMA’s current proposal, in particular:
- 3.1.3 The dual fuel to single fuel differential varies with consumption in the CMA’s proposal and rises to over £30 at the high consumption point. This is clearly not reflective of the real cost differential and is simply an unintended artefact of the way the cap has been derived.
- 3.1.4 In any case, billing systems do not necessarily have an accurate matching of all electricity accounts with the associated gas account. This means that the problem of distinguishing “dual fuel” from “twin fuel” will introduce an unnecessary compliance risk for suppliers since the cap levels are not consistent between these categories. SSE notes that not all suppliers offer a dual fuel discount – on this basis it would be more appropriate for the CMA to consider single fuel caps only, and to recognise that dual fuel discounts, where offered at all, are one means for suppliers to compete

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<sup>3</sup> See the *Response*, paras. 4.6.2 – 4.6.8.

below the level of a sustainable cap. This would be more consistent with the CMA’s objective of establishing a framework for effective competition.

*Regional variation*

3.1.5 An unavoidable complexity (in the absence of a system of national use of system costs, as previously proposed for consideration by SSE) is setting regional variations for each tariff definition. The CMA has elected to use the 14 electricity areas as its foundation, although this necessarily involves some inaccuracy and compromise in the setting of the gas price. This may be pragmatic but it is not appropriate for a regulatory body to be making such intrusive commercial judgements as to the basis of pricing policy. The consequence is that we have five tariff types split into 14 regions, giving 70 separate caps.

*Consumption level variations*

3.1.6 The CMA proposes to base the cap on benchmark direct debit bills (net of network costs) at three different consumption levels. However, it appears that the values of the benchmark had, at the time of publishing the PDRs, only been evaluated at one of these points (the medium typical domestic consumption value (*TDCV*)).

3.1.7 Our estimates of the three consumption points implied by the CMA methodology obtained from the analysis conducted by our Authorised Advisers are set out in Table 3.1 below. If these values are plotted, they show an implied tariff line that is almost a straight line for each of the single fuels, and an implied tariff that is slightly kinked at the median TDCV for dual-fuel.

**Table 3.1 Benchmark DD bills (net of network costs)**

<b>TDCV Level:</b>	<b><u>Low</u></b>	<b><u>Medium</u></b>	<b><u>High</u></b>
<b>Electricity</b>	<b>2,000 kWh</b>	<b>3,200kWh</b>	<b>4,900kWh</b>
<b>Gas</b>	<b>9,000kWh</b>	<b>13,500kWh</b>	<b>19,000kWh</b>
<b>Dual Fuel (standard).</b>	<b>£513</b>	<b>£728</b>	<b>£1,012</b>
<b>Dual Fuel (E7)</b>	<b>£480</b>	<b>£670</b>	<b>£919</b>
<b>Electricity: Standard</b>	<b>£239</b>	<b>£353</b>	<b>£513</b>
<b>Electricity: Economy 7</b>	<b>£221</b>	<b>£315</b>	<b>£448</b>
<b>Gas</b>	<b>£297</b>	<b>£402</b>	<b>£531</b>

Source: Additional runs of CMA analysis carried out on behalf of SSE by Frontier Economics.

3.1.8 Three variations on each of the 70 caps, yields 210 constraint points along with their connecting lines to define the cap. This is an overly-complicated way of arriving at a constraint boundary for bills. Aside from reducing the number of tariff categories, the CMA should eliminate the use of three different consumption bands. This would also eliminate ambiguity over the interpretation and enforcement of the caps above and below the higher and lower consumption points.

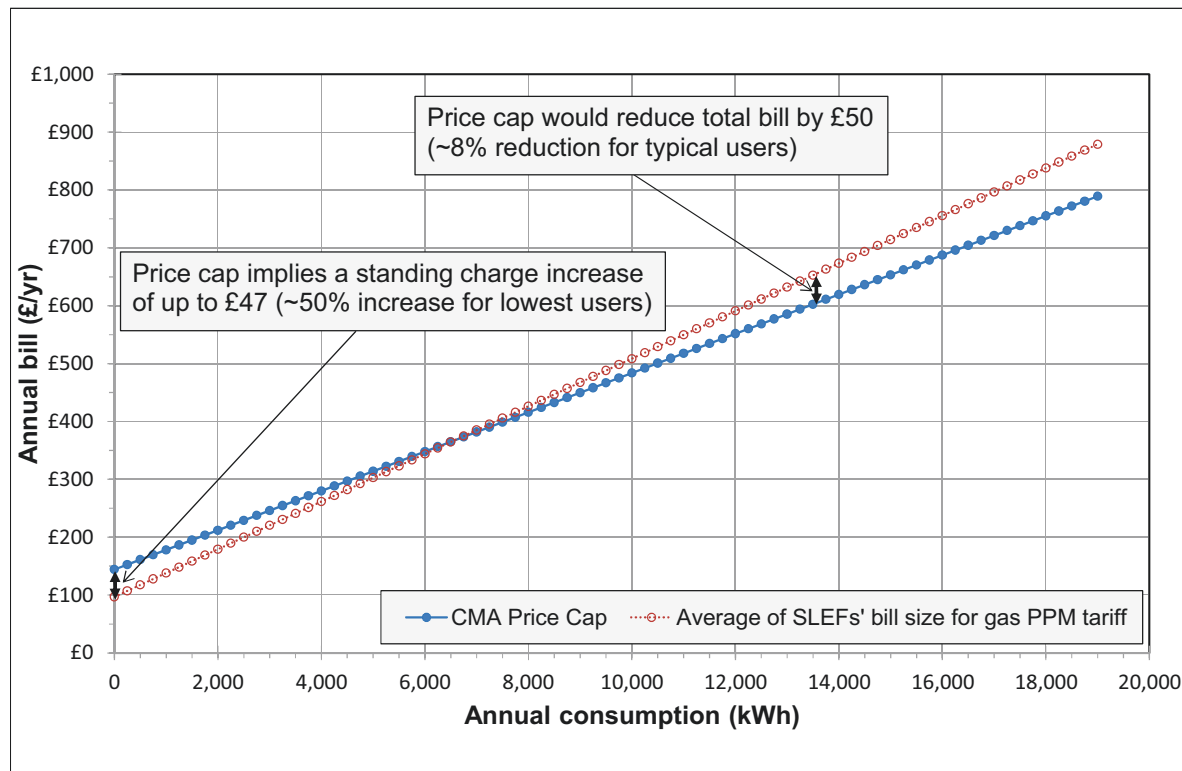
3.1.9 An obvious simplification (that would also provide greater transparency) would be to set a maximum standing charge and unit rate for each tariff type in each area. As part of this change, any calculation of a maximum standing charge should be based on a cost plus approach.<sup>4</sup> The base level of the unit rate(s) could either be set on a cost-plus basis or to meet a required value for the bill at median consumption, based on a more widely based market comparator.

#### 4. Analysis of potential distributional impacts

##### 4.1 Implications for level of the standing charge

4.1.1 The consequence of not adopting a simpler and more transparent approach is immediately apparent when network costs, the assumed PPM differential and the proposed headroom are added to the benchmark costs to plot out how the cap would actually operate on a total bill based on a standing charge and unit rate.

**Figure 4.1 Implications of the price cap for PPM gas tariffs**



Note: Bills are calculated inclusive of CMA headroom, network costs and cost to serve.

4.1.2 The example in Figure 4.1 (above) shows the case for single fuel gas but similar conclusions would hold for the other four cases (although throughout this analysis it has been difficult to reconcile exact figures with CMA results and decomposing the dual fuel caps to examine the impact on constituent fuels requires a number of assumptions to be made).

<sup>4</sup> The PDR (para. 7.33) notes that SSE did not support a cost-plus approach in the context of Remedy 11. In fact, SSE's position is more nuanced. Cost-plus is the most economically sound means of setting a price control; SSE's opposition stemmed from the difficulty of *accurately* assessing *all* costs necessary for the price cap. SSE considers that a cost-plus methodology is feasible for setting the maximum level of the standing charge.

4.1.3 Figure 4.1 plots the average SLEFs' bill size across the consumption range (in red). It is calculated as the unweighted average of all live standard variable gas tariffs offered by the SLEFs as at 30 June 2015 across all PES areas. The line connecting the three reference bills defining the CMA price cap is shown in blue – comparing this line to the red line shows that the cap would cause an overall reduction in revenue of around 8%. However, the CMA price cap implies a different balance between standing charges and unit rates. If suppliers held standing charges close to their current level they would be forced to operate well below the cap at the medium consumption level, making the required reduction in revenue considerably more than 8%. It will be clear from the evidence in SSE's response to the PDR, summarised above, that this is unlikely to be commercially sustainable. The only viable option may be to shadow the standing charge and unit rates implied by the cap as closely as market conditions permit, putting upwards pressure on the level of standing charges. This would be particularly disadvantageous to lower users, a group which includes some of the most vulnerable customers. This was clearly not the intention of the CMA when devising the price cap but shows the potential pitfalls of the current approach being complex and not fully transparent.

## 4.2 Implications for electric heating customers

4.2.1 Whilst the implications for the standing charge described above are relatively straightforward, there are also potential adverse impacts on customers with electric heating which are more complex in nature.

4.2.2 To appreciate this effect it is necessary to understand the additional complexities associated with the Economy 7 cap. SSE notes that the CMA has not calculated a cap based on the appropriate Economy 7 TDCV but instead used the considerably lower TDCV for single rate electricity.<sup>5</sup> More importantly, the benchmark values have been calculated on the assumption that only 38% of usage is consumed in the off-peak period.<sup>6</sup> This is considerably lower than would be the case for customers using the tariff to support electric storage heating, which is commonly the case for customers living off the gas grid.

4.2.3 Where a supplier's customer base has a different average off-peak split, it is important to appreciate that a range of different revenues are possible when pricing *exactly at the level of the cap*, dependent on the particular combination of standing charge, peak rate and off-peak rates that is set to comply with the three bill sizes calculated on the theoretical 38:62 split of consumption.

4.2.4 In Figure 4.2 (below), bill sizes under different conditions are plotted for a population of customers with a 50:50 split of usage between peak and off peak. This would be a more likely situation for suppliers with a more balanced proportion of customers using the tariff to support electric storage heating.

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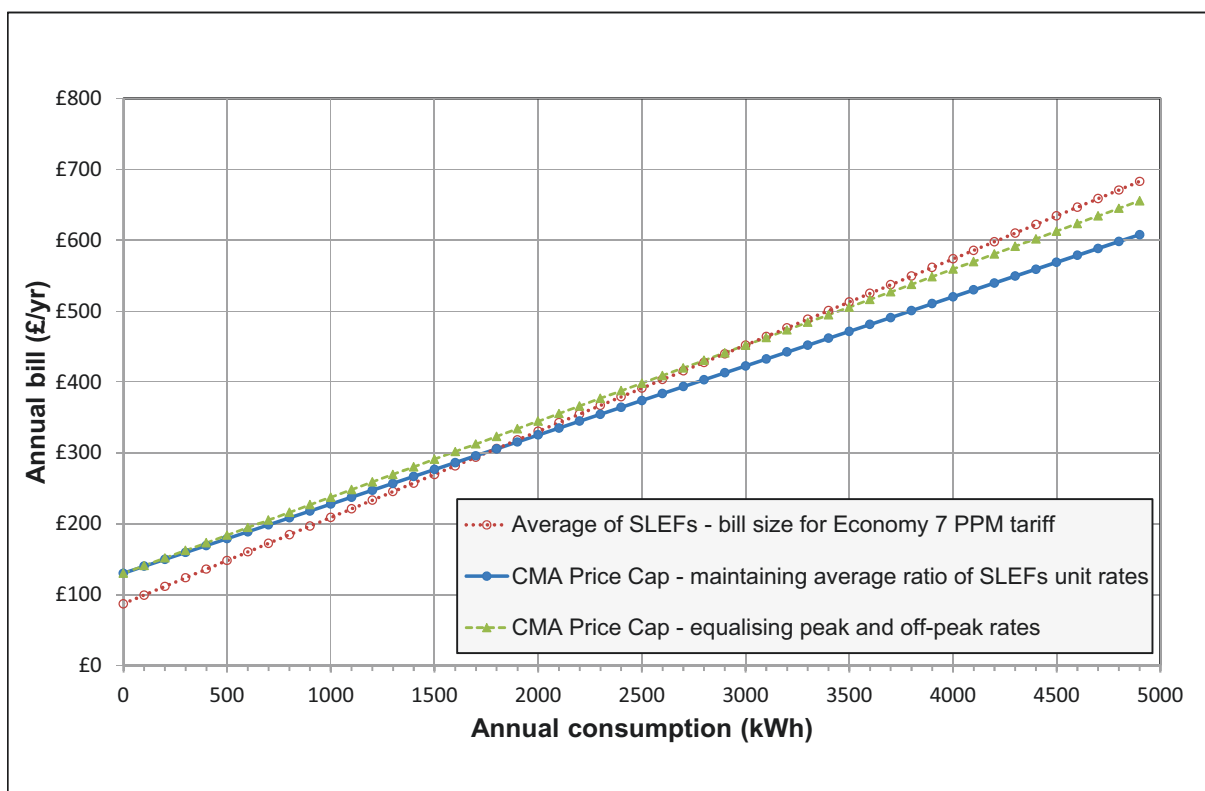
<sup>5</sup> SSE believes that this may be an error and the policy intention might be to use the correct values in due course. However, this error necessarily complicates stakeholders' analyses and any discussion of the impacts of the cap on customers.

<sup>6</sup> SSE recognises that the 38%:62% split is drawn from the gains from switching dataset and therefore reflects an average level for the market (PDR, fn 998). It is important, however, to recognise that the actual level of this split for each supplier will vary considerably, due to difference in customer base and each supplier's pricing policy relating to the level of off-peak usage that defines the 'break even' point compared to the equivalent unrestricted tariff.



4.2.5 The current tariff (in red) is a convenient reference but would not be compliant with the proposed cap at annual usage above 1,700kWh. The blue line shows one means of complying with the cap, which again entails raising the standing charge but lowering the unit rates in equal proportion, such that the existing proportional split (ratio) between day and night rates is maintained. However, the higher green line would also be compliant with the cap but raises more revenue by eliminating the differential between day and night rates altogether (this may still be cheaper than the single rate standard tariff due to lower network costs for Economy 7). This remedy would create a clear incentive for suppliers to narrow the differential between day and night rates; this would be an unwelcome development for off gas grid customers and other potentially vulnerable groups reliant entirely or in part on the use of electric storage heaters.

**Figure 4. 2 Annual bill size for Economy 7 PPM tariffs and 50% of usage off-peak.**



Note: Bills are calculated inclusive of CMA headroom, network costs and cost to serve.

## 5. Other problems with the cap as currently proposed

5.1.1 The Response set out other problematic features of the current proposal, many of which relate to the process for updating the cap values which is likely to compound the distortions caused by the initial setting of the base level for the cap. There are problems associated with updating all of the cost categories: wholesale costs, network costs, government policy costs and indirect costs. The problems associated with the wholesale cost, which is the largest single cost element of customer bills, is described further below.

## 5.2 Wholesale prices

- 5.2.1 The approach of capping the overall bill size at three distinct consumption levels has led to a specification where the real impact of cost movements is being distorted at different consumption levels. This arises from the CMA’s proposal to break the benchmark bill down into wholesale, policy and indirect cost components based on fixed percentages which are the same for low, medium and high TDCVs. This ignores the fact that the percentage splits used are only applicable for the medium TDCV at which they are calculated.
- 5.2.2 In reality, the proportion of the bill accounted for by these different cost types varies with the level of consumption. For example, a low bill will have a higher proportion of indirect costs (many of which are fixed with respect to consumption) and a lower proportion of wholesale costs.
- 5.2.3 By failing to take into account these differences, the CMA’s proposed indexation causes the “low” and “high” ends of the price cap to drift away from the level the CMA regards as sufficient. For example, if wholesale costs rose at a greater rate than indirect costs, the “high” price cap would not take this fully into account (since the weighting of wholesale costs is too low for this level of consumption), resulting in the price cap being too low.
- 5.2.4 The scale of this effect is evident in Table 5.1, which calculates the wholesale cost implied by the CMA’s proposed methodology. Focusing on electricity costs, the implied wholesale price varies from a minimum cost of £51.75 (derived from the high consumption bill for Economy 7) to a maximum of £67.64 (derived from the low consumption bill for standard meters) – a variation of over 30%. Even focusing in the range within the implied costs for standard electricity customers (to control for the effect of demand profile) the variation is more than 14% (for simultaneously hedged homogeneous wholesale products). (For gas the implied wholesale price varies by over 18%.) Clearly this is simply an artefact of a flawed methodology which fails to account for the effect of the standing charge.

**Table 5.1 Variation in wholesale costs implied by price cap methodology.**

		Dual Fuel		Electricity		Gas
		<i>Standard</i>	<i>E7</i>	<i>Standard</i>	<i>E7</i>	<i>Standard</i>
<b>Energy cost percentage</b>		59.0%	59.0%	56.6%	56.6%	66.4%
<b>Benchmark annual bill</b>	Low	£513	£480	£239	£221	£297
	Med	£728	£670	£353	£315	£402
	High	£1,012	£919	£513	£448	£531
<b>Energy cost in benchmark bill (£)</b>	Low	£303	£283	£135	£125	£197
	Med	£430	£395	£200	£178	£267
	High	£597	£542	£290	£254	£353
<b>Implied wholesale market price (£/MWh)</b>	Low	£27.52	£25.75	£67.64	£62.54	£21.91
	Med	£25.72	£23.67	£62.44	£55.72	£19.77
	High	£24.98	£22.69	£59.26	£51.75	£18.56



- 5.2.5 This example highlights the benefits both in terms of simplicity and in terms of reflecting actual market conditions (a prerequisite for end user energy price controls) of defining the maximum unit rate based on the bill size determined at median consumption only.
- 5.2.6 The Response identified the other obvious shortcoming of the proposed wholesale indexation which is that it implausibly implies that all suppliers should hedge their entire PPM customer demand on the same day that the wholesale index is assessed. SSE would urge the CMA to seek expert advice or to enlist Ofgem's assistance to ensure that the treatment of wholesale costs reflects market conditions and is consistent with a practicable and commercially viable hedging strategy.

### **5.3 Ambiguities affecting interpretation and compliance**

- 5.3.1 There are a number of ambiguities in how the price cap will operate. These ambiguities have a significant bearing on the level and functioning of the price cap. The PDR fails to make clear in particular:
- (a) whether the CMA proposes to update the TDCV levels used to define the price cap in line with revisions that Ofgem make to the TDCVs;
  - (b) whether the CMA intends the price cap to bind at consumption levels below the "low" TDCV, or above the "high" TDCV;
  - (c) whether suppliers should verify the validity of an E7 tariff with respect to the assumed 38:62 off-peak/peak split, or to each consumer's actual split; or
  - (d) whether suppliers should confirm the validity of their dual fuel tariffs with respect to the electricity/gas split inherent in the TDCV levels, rather than the actual electricity-to-gas proportion of each customer.
- 5.3.2 In the case of the last two assumptions, our working assumption is that the off-peak/peak and gas/electricity mix assumed when setting the cap must be the relevant levels to determine compliance, but this needs to be made explicit. The compliance monitoring requirements are already unnecessarily onerous and opaque but, in SSE's view, this remedy would become unworkable if compliance is assessed for individual customer's actual usage rather than at the tariff level based on defined usage assumptions.

## **6. Conclusion**

- 6.1.1 In the Response, SSE set out the reasons why a price cap would be a significant backwards step for competition in the retail market. In light of the issues described above, it is clear that the specific version of the price cap currently proposed by the CMA is particularly unlikely to be effective in achieving the CMA's objectives and carries a particularly significant risk of adverse unintended consequences. If this remedy were nevertheless to be implemented, it is imperative that it is reformulated in a way that limits its adverse consequences and disproportionate effects. In particular, the CMA must ensure that the adverse consequences that might arise for any customer group from suppliers setting tariffs at the level of the price cap do not outweigh the perceived benefits of this remedy.

6.1.2 Accordingly, while there is no basis to introduce any price cap (and the introduction of such a mechanism would do more harm than good), the CMA should seek to minimise its negative and disproportionate effects in particular by:

- (a) **Setting the cap at a viable level:** rebase the price cap to a more sustainable level to mitigate the risk that suppliers are forced to closely shadow the cap leading to unintended distortions such as higher standing charges;
- (b) **Simplifying the price cap:** reduce the number of tariff types from five to three (standard electricity, Economy 7 and gas) to remove the unnecessary complexity and ambiguity that is inherent in the proposed dual fuel price caps;
- (c) **Carry out a proper cost-benefit analysis:** carry out a full distributional analysis of the impact on competition for different customer groups (including electric heating customers and low using vulnerable customers).
- (d) **Ensuring the cap is sustainable:** seek expert advice or enlist Ofgem to set up a practical and robust indexation process, most importantly with regard to wholesale prices in order to minimise the very significant market risk imposed on suppliers by the price cap and to ensure that suppliers can hedge PPM customer demand at a price compatible with the level of the cap throughout the lifetime of this transitional measure; and,
- (e) **Clarifying the operation of the cap:** reformulate the price cap such that the ambiguities in the current specification are removed and a maximum permitted level is defined for each tariff element to avoid the risk that compliant tariffs result in large percentage bill increases for low users;

6.1.3 In addition, SSE considers that it would be prudent to define a sunset clause that allows for the tariff cap to be reviewed or removed in the event that a change in Government policy regarding targeted support for vulnerable customers (e.g. reform of the Warm Home Discount scheme) renders the price cap obsolete before 2020. In addition, as stated in the Response, the CMA must also identify the conditions under which the price cap mechanism should be reopened for review. This is necessary to prevent unintended consequences leading to lasting damage to the market, such as: falling switching levels within the PPM segment; falling numbers of tariffs available to PPM customers; or a marked increase in customer complaints related to effects arising from the annual indexation process (e.g., volatile prices leading to significant price shocks for vulnerable customers).