

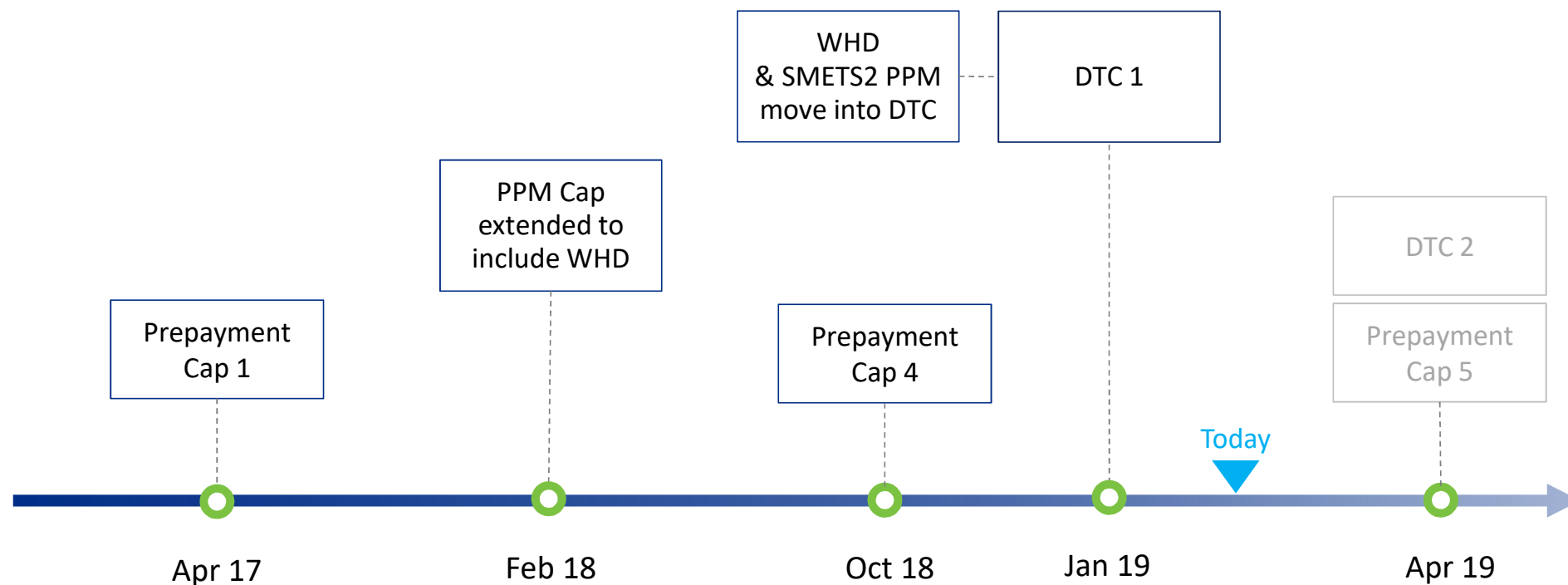


**SSE response to CMA invitation to comment on a
proposed review of the Energy Market Investigation
(Prepayment Charges Restriction) Order 2016**

Appendix 1



Ofgem constructed the (Warm Home Discount) WHD extension and Default Tariff Cap (DTC) with the benefit of Safeguard Tariff (PPM) learnings. This has been a complex journey for customers and the risk of confusion remains.



The potential for customer confusion and a loss of confidence in the integrity of the suite of caps seems clear unless action is now taken

Now that a DTC exists, we see strong rationale for extending the DTC scope to include Prepayment

A Two interpretations of costs

- Critical differences exist in assessing common costs
- Differences are even more pronounced for non-Typical Domestic Consumption Values (TDCV) and for customer who do not pay by Direct Debit
- Indexation is applied to costs differently so gaps are likely to grow over time
- There is likely to be unintended consequences and price anomalies

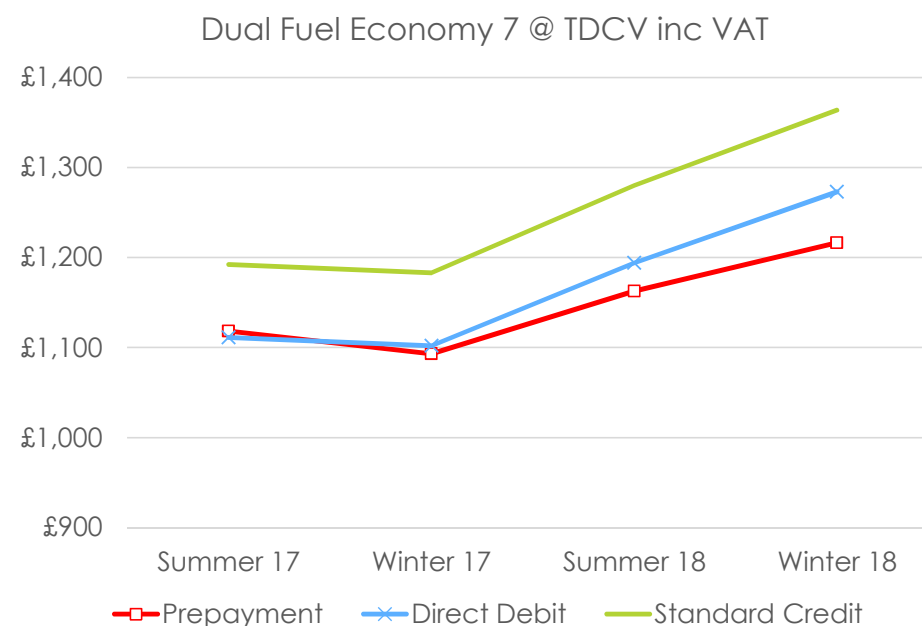
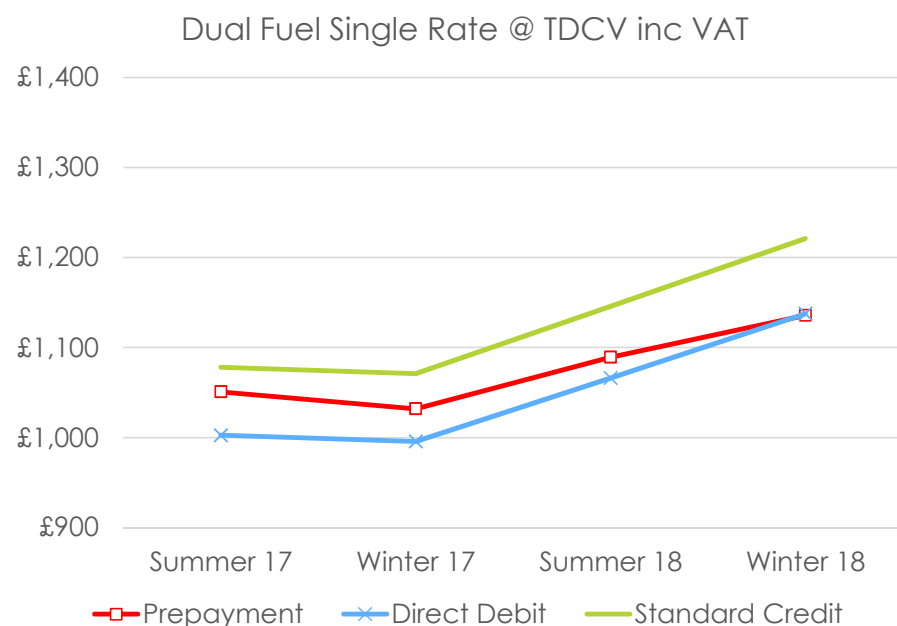
B DTC constructed to be cost-reflective

- The DTC is benchmarked to 2017 rather than 2015 so reflects more appropriate cost data
- A comprehensive bottom-up approach was used to determine efficient operating costs
- The assessment of wholesale costs has a fuller measure of shape costs
- There is a dedicated model to reflect smart rollout costs (SMNCC)
- The DTC takes a comprehensive scheme specific view of policy costs

C PPM easy to incorporate

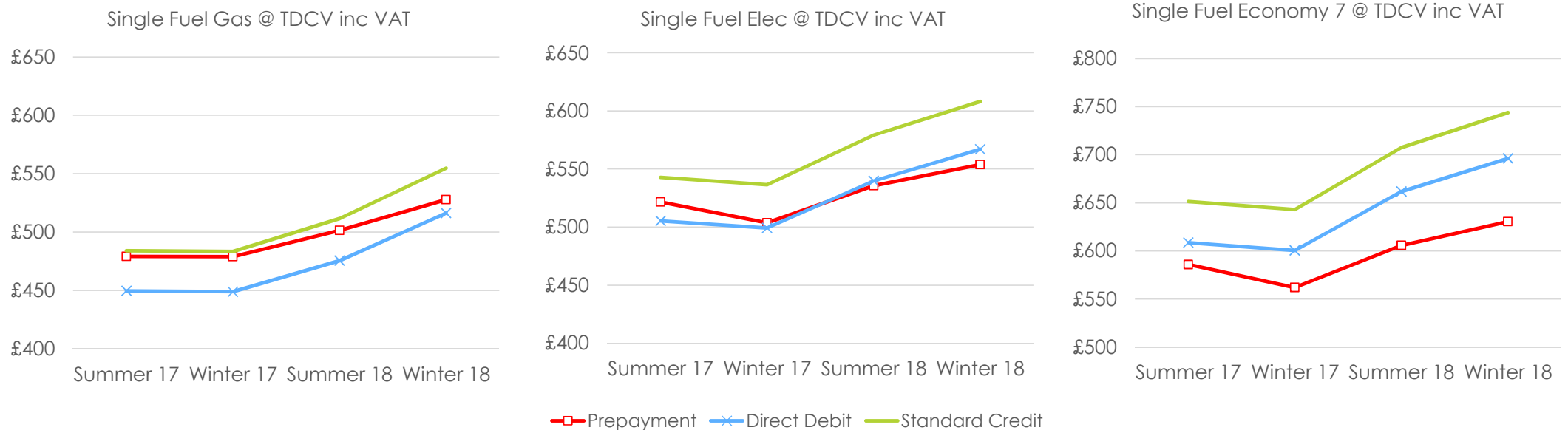
- The payment uplift mechanism in the DTC methodology is easily extended to include PPM cost to serve
- The process to gather payment costs data for the DTC can easily be repeated to capture PPM costs
- The level of cost socialisation across each payment method can be taken as an integrated policy decision

Ofgem's DTC historical level tables shows that payment-type divergences have shifted over the past two-years, demonstrating clear issues (even at TDCV)



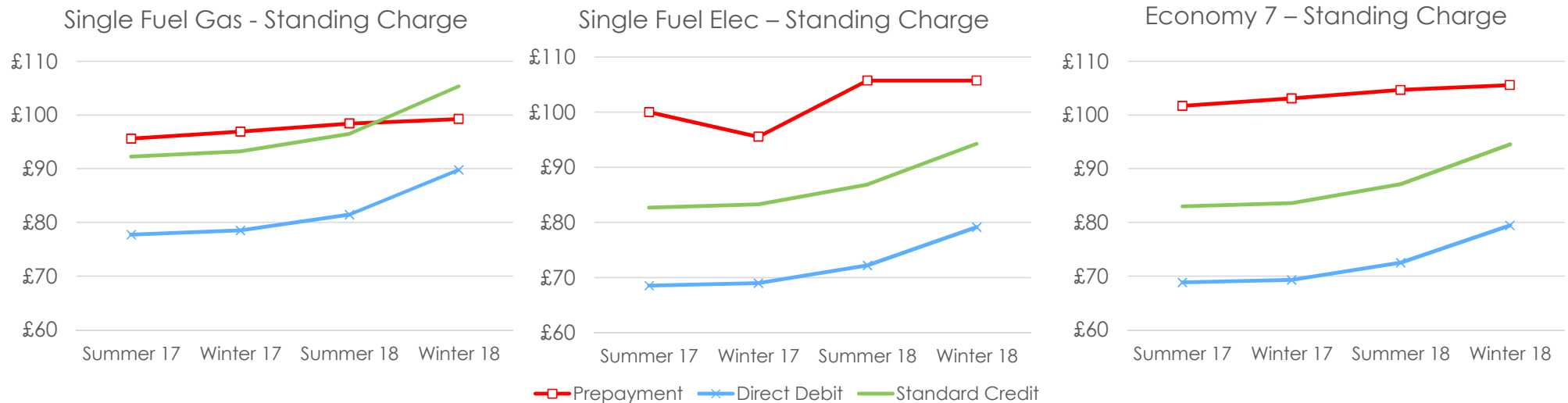
Unless addressed increasingly serious divergences are likely to emerge in future periods

Single fuel price divergences are changing at different rates, with prices for Direct Debit customers lower than Prepayment in gas but higher than Prepayment in electricity



Unless addressed increasingly serious divergences are likely to emerge in future periods

At zero consumption the relativity of standing charges has changed over time, with Prepayment moving below Standard Credit for Gas.

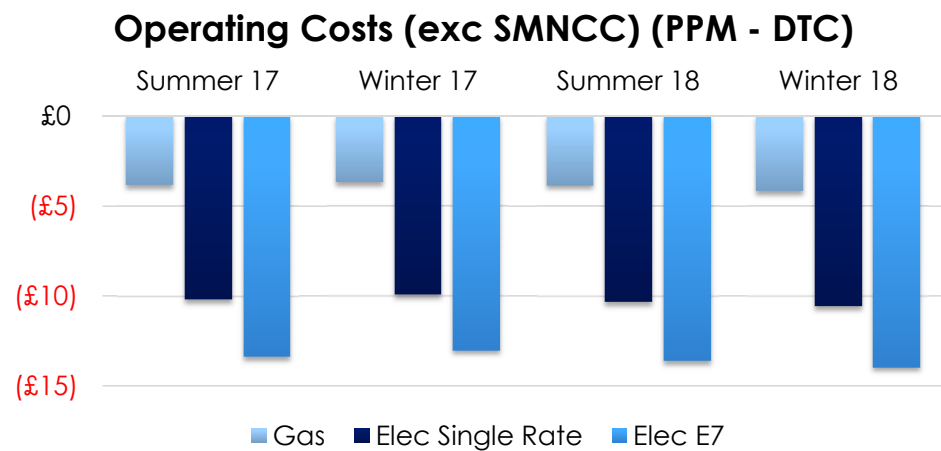
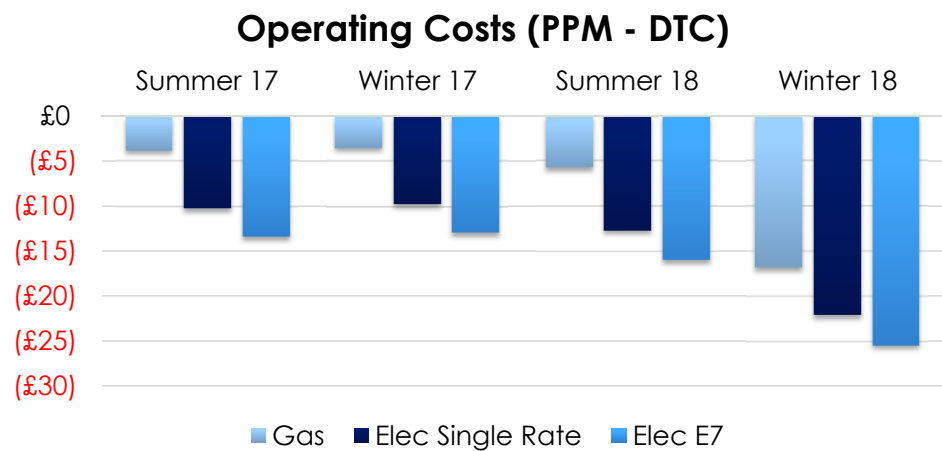
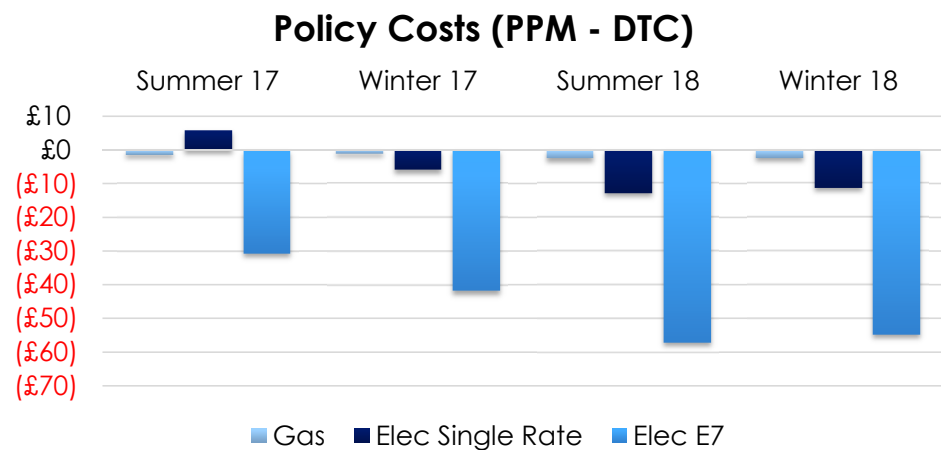
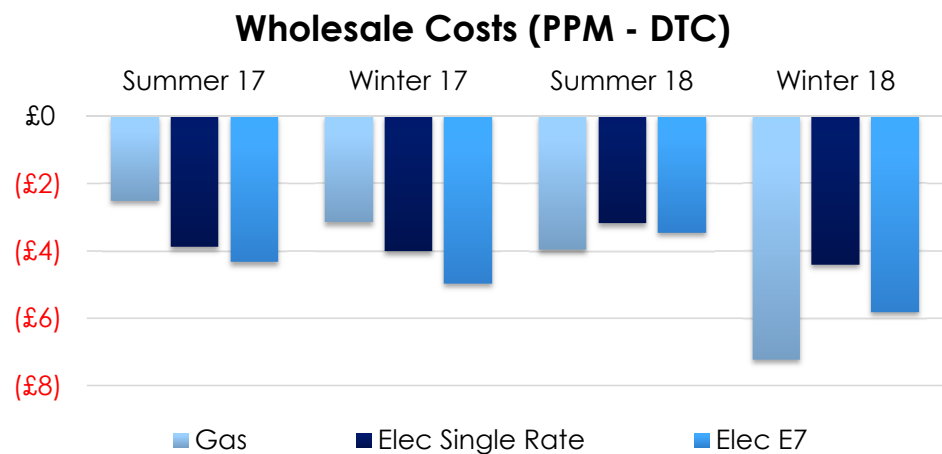


At zero consumption the relativity of standing charges should be maintained

To explore this further, we have made the following adjustments to allow a fully comparative analysis of the caps

Cost Category	PPM Cap (Consumption rebased throughout to match TDCV levels)	DTC
Wholesale Energy	No change	- Capacity Market moved to <i>Policy</i> - Price Risk moved to <i>Headroom / EBIT</i>
Network	No change	No change
Policy	No change	Incorporated Capacity Market
Other / Operating Costs	EBIT allowance moved to <i>Headroom / EBIT</i> in line with DTC	SNMCC visible as separate line to facilitate comparison
Payment Method uplift	No change	No change
Headroom / EBIT	Incorporated EBIT	Incorporated Price Risk

Comparison of components of the caps demonstrates important inconsistencies in a number of areas (at TDCV post adjustment for alignment)



Wholesale Costs – While baselined to the same data, there are a number of differences between the methodology which we believe should be aligned

PPM Cap

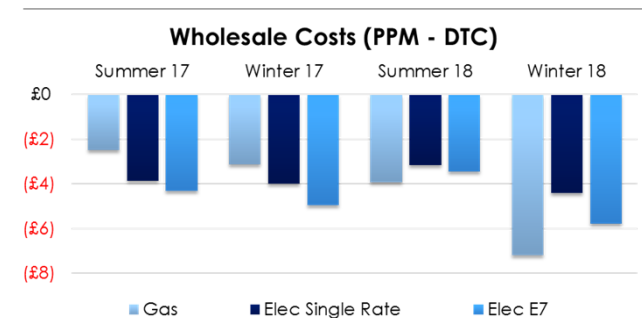
- Indexed to Heren
- 6-2-12 hedging (6 months observation ending 2 months before cap looking at prices for forward year (or 12 months))
- Elec weighted : 70% Baseload / 30% Peak, and 47% summer / 53% winter
- Gas weighted quarterly averaging : 38% summer / 62% winter
- Further uplift for shape 14% elec (incl network losses) & 7% gas
- No UIG
- Additional costs / risks in headroom

Default Tariff Cap

- Indexed to Heren
- 6-2-12 hedging
- Elec weighted : 70% Baseload / 30% Peak, and 43% summer / 57% winter
- Gas weighted quarterly averaging : 25% summer / 75% winter
- Further uplift for shape 16% elec (incl network losses) & 4.6% gas
- Plus UIG on gas of 2%
- Plus further 1% for risk

Different Outcomes

- DTC is £11 higher for a dual fuel customer (excluding risk uplift)
- DTC has higher weighting to winter prices
- DTC includes UIG as well as price risk
- DTC uplift is higher on elec but lower on gas (before UIG and risk)



Recommendation



Align methodologies and include UIG.

Policy Costs – Significant differences in granularity of application within the caps

PPM Cap

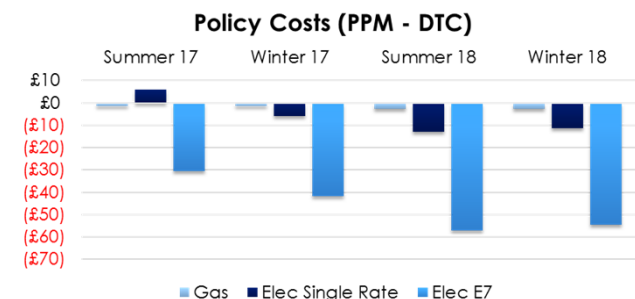
- Baselined to 2015 costs
- Total Costs then indexed to OBR forecast £bn movement – no account of qualifying demand or individual variances by policy type
- Gas indexed by CPI
- Elec indexed by OBR economic and fiscal outlook (supplementary fiscal table 2.7)
- While baseline for EO and E7 are different, the indexation is the same.

Default Tariff Cap

- Baselined in 2017
- Scheme costs calculated individually – and includes changes in qualifying demand
 - Renewable Obligations
 - Contracts for Difference
 - Feed in Tariffs
 - Energy Company Obligation
 - Warm Home Discount
 - Assistance for Areas of High Electricity Distribution Costs
- Capacity Market modelled separately and captured under Wholesale.

Different Outcomes

- DTC is £12 higher for a dual fuel customer (including capacity market)
- The granularity involved in the DTC produces differing indexation causing the relative levels of policy costs to diverge
- Declining qualifying demand increases the per unit cost which is not captured in the OBR outlook



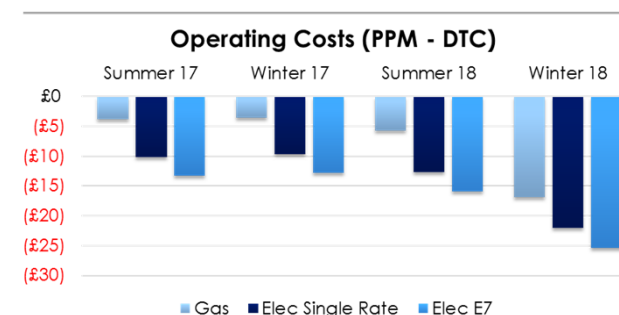
Recommendation



Align the policy cost approach to DTC methodology

Operating Costs – Differing methodologies and included items, PPM baselined against suppliers who have since shifted significantly their market positioning.

PPM Cap	Default Tariff Cap	Different Outcomes
- Costs for a Direct Debit customer - Top down calculation – as a netback from weighted average direct debit price - First Utility and OVO Energy used as benchmark - Based on 2015 data - Indexed to CPI - No adjustment for smart meter roll out - Added with EBIT (1.25%) to form 'Other Costs'	- Costs for a Direct Debit customer - Bottom Up calculation - using supplier cost data* 10 suppliers in benchmark – costs pegged to bottom quartile less £10 - Based on 2017 data - Indexed to CPI - Includes a smart adjustment (SMNCC) - EBIT accounted for separately * cost data was collected for 15 suppliers – 5 were excluded due to size or atypical customer portfolios. Adjustments were made to make data comparable across suppliers.	- DTC is £38 higher for a dual fuel customer (accounting for EBIT) - Key difference is the Inclusion of SMNCC under DTC where there is no adjustment within PPM accounting for £24 - Leaves a residual £14 cost differential which can be seen in 2017 comparison which has a diverging trend



Recommendation



Use the DTC benchmarking with SMNCC fully applied across

Smart – The treatment of smart differs between the caps with the key addition of SMNCC charge within the DTC

PPM Cap

- Costs in FU/OVO at 2015 inflated by CPI

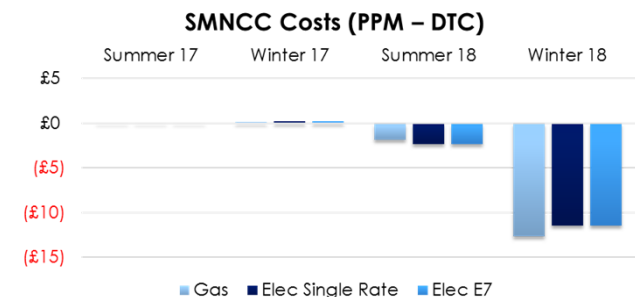
Default Tariff Cap

- Costs in 2017 benchmark inflated by CPI
- SMNCC (all costs vs. equivalent smart in 2017)
 - Assumes rollout profile based on 2019 EU target equating to 55% and 54.3% of meters smart by Dec '19 (elec and gas respectively).
 - Industry costs (DCC, SEGB, SMICOP etc.) are calculated as a direct pass through, and will be reviewed regularly.
 - All other smart related costs: asset (meter & IHD), install costs, maintenance, comms equipment, PRCs, pavement reading inefficiency, and organisational support costs less smart benefits are included in the model to generate the remaining element of the SMNCC.

Different Outcomes

- SMNCC accounts for £24 of the higher DTC costs for a dual fuel customer
- As the cost associated with the SMNCC increases the level of cap associated with the smart roll out continues to diverge further.

Other Issues



Recommendation



Ensure that the smart rollout costs are fully represented across the caps

Other Elements of Caps – EBIT, Headroom and Payment Method treatments

PPM Cap	Default Tariff Cap	Different Outcomes
• 1.25% EBIT in 'Other Costs • Headroom of £15 per fuel which has been applied as a percentage of costs (excluding network) – Elec Standard 4.23%, Gas 3.48%, Elec E7 3.41%. • Payment uplift of £24 for Elec and £39 for Gas (according to model) – Fixed £ uplift only – Indexed in line with CPI	• 1.94% EBIT applied to all costs • 1.46% Headroom subsequently applied to costs (including EBIT, excluding Networks) • Energy component includes a 1% risk uplift • Payment Uplift includes socialisation of costs with fixed element indexed with CPI – Fixed element baseline • Standard Credit Elec £13.75 Gas £13.44 • Direct Debit Elec £3.42 Gas £3.19 – Variable element • Standard Credit Elec 5.83% E7 5.79% Gas 5.75% • Direct Debit Elec 0.49% E7 0.48% Gas 0.41%	• DTC is £7 lower on EBIT & Headroom for a dual fuel customer (including wholesale energy risk) • Structure of payment uplift differs - with DTC having a variable element. • Gas payment uplift at TDCV close to Standard Credit level for Gas but diverging with Standard Credit moving above the Prepayment level Other Issues Complication for transition between prepayment and credit payment methods due to the differing structures of the uplift



Recommendation



Align the structural methodology of payment uplifts

Summary and recommendations

- | | |
|---|---|
| <div style="border: 1px solid #002060; padding: 5px; display: inline-block;">1 Market context</div> | <div style="color: #00AEEF; font-size: 24px; line-height: 1;">▶</div> <ul style="list-style-type: none">• Substantial change in market context since PPM Cap designed• Ofgem has applied insights from PPM Cap in designing DTC |
| <hr style="border-top: 1px dashed #ccc;"/> | |
| <div style="border: 1px solid #002060; padding: 5px; display: inline-block;">2 Coherent overall approach</div> | <div style="color: #00AEEF; font-size: 24px; line-height: 1;">▶</div> <ul style="list-style-type: none">• A coherent overall approach to price caps is essential• This will ensure consumers can remain confident• And ensure administration costs can be optimised |
| <hr style="border-top: 1px dashed #ccc;"/> | |
| <div style="border: 1px solid #002060; padding: 5px; display: inline-block;">3 DTC provides framework</div> | <div style="color: #00AEEF; font-size: 24px; line-height: 1;">▶</div> <ul style="list-style-type: none">• Following delivery of DTC Ofgem is well placed to extend across PPM• This would support integrated approach to cost socialisation and payment differentials |
| <hr style="border-top: 1px dashed #ccc;"/> | |
| <div style="border: 1px solid #002060; padding: 5px; display: inline-block;">4 Transition considerations</div> | <div style="color: #00AEEF; font-size: 24px; line-height: 1;">▶</div> <ul style="list-style-type: none">• Opportunity exists, through this review, to consider how best to transfer ownership for PPM price controls to Ofgem through extension of DTC |



SSE is keen to engage and support in order to ensure that the best outcomes for consumers and for the development of competition in the market

END