ELEXON

16 December 2021

Neil Lawrence
Director of Retail
Ofgem

By email, cc retailpriceregulation@ofgem.gov.uk

Dear Neil

The BSC Panel has asked me to write to you on its behalf in response to the November 2021 Consultation on 'Reviewing the potential impact of increased wholesale volatility on the default tariff cap'.

The BSC Panel's role in considering action to take in relation to the default of BSC Parties, usually suppliers, means it has engaged frequently and often directly, with the experiences of such parties, and it has been the Panel's proper function to probe and understand the reasons for their default. This letter is therefore informed by and based on the Panel's understanding of the recent positions of many failing suppliers (26 since September) in the current market. I note also that the Panel wrote to Ofgem on 15 February 2021 drawing attention to the lack of risk management and good cash flow management evident in parties that had defaulted around a year ago, and suggesting that Ofgem should consider remedial action.

The Panel, as clearly confirmed in its February letter, does not condone parties who have not had sound business models or operated robust risk management policies, including as to making prudent hedging arrangements. However, in the wholly exceptional market circumstances operating since around September 2021, the Panel draws to your attention that there have been several examples of suppliers who have demonstrated to the satisfaction of the Panel that they have run their businesses well in the past, but are now unable to operate successfully, and have blamed the current price cap regulation. The Panel has observed that such suppliers have claimed they are unable to hedge their commitments at prices which bring their operating costs under the current price cap. This is seen as due to a lack of liquidity in the market, and also because of perceived limits on margins based on a historic cost base which no longer reflects the current high priced market. Moreover, given that they generally cannot envisage the position improving over this winter or even next spring, several have told us their investors cannot justify continuing to fund their losses at such a high level.

Whilst suppliers failing may be a normal facet of a competitive market, at this level of failure it suggests that something is going badly wrong and that the current market framework is not sustainable.

In most cases, suppliers come to the Panel's attention because they indicate an inability to pay any BSC Charges as they fall due, or are falling short on their duty to lodge credit. This credit is the 'buffer' that protects the wider market from exposure to any debts of suppliers who leave the market; so the Panel, in making its decisions on the appropriate approach for managing failing suppliers, must always be mindful of its duty to safeguard the wider industry. This is because of the 'circular' nature of all BSC and imbalance charges, where any debts or unpaid charges are 'smeared' across the remainder of the industry. This, of course, is not limited to BSC costs – surviving suppliers in the market are hit by a large variety of mutualised charges left behind by those who have failed, increasing the burden upon them. The escalating cost of mutualising market failures raises the question whether it is right that the full, increasing costs of supplier failures should be borne wholly by the non-failing suppliers and their customers, who have generally already been paying higher prices than the customers being protected. The Panel is of the view that those customers' interests are not being well protected.

In addition, there are tangible impacts of rising wholesale prices that feed directly through to costs on suppliers. High Imbalance Prices have led to greater Imbalance Charges and higher Credit Cover requirements, which in themselves are adding to the financial burden on suppliers.

The BSC Credit calculations are inextricably linked to wholesale prices – or, more specifically, forward Market Prices - because of their relationship to the 'Credit Assessment Price' (CAP). The CAP acts as a proxy Imbalance Price for the purpose of determining how much cash Parties must lodge as collateral against potential future debts under the BSC. On 17 December, the CAP is likely to be set to £305/MWh – and, potentially, this number will rise still further in January. For comparison, the maximum CAP prior to 2021 was £108/MWh and was set in 2008 during the market instability caused by the financial crash.

Elexon and the Panel have recently taken steps to amend the approach for setting the CAP, largely to try to avoid significant step changes in the recommended CAP and situations where BSC Parties are asked to lodge large sums of Credit Cover at short notice, recognising that this in itself could lead to cashflow issues.

In conclusion, whilst the BSC Panel accepts that it has no formal role in relation to the default tariff cap, the obligation for which sits wholly with Ofgem under the Domestic Gas and Electricity (Tariff Cap) Act 2018, it does have a role in relation to the promotion of 'effective competition in the generation and supply of electricity, and in promoting such competition in the sale and purchase (as defined in the Transmission Licence) of electricity' (see the Panel's objectives, set out in Section B1.2 of the BSC). With this objective in mind, the Panel is concerned about the impact on that effective competition and confidence in the market caused by the unprecedented numbers of failing suppliers, and the consequential impact on the remaining BSC Parties of failing suppliers' debts being mutualised. Therefore, the Panel was pleased to see Ofgem considering the operating of the default tariff cap with the recent package of consultation documents issued on 19 November 2021, and welcomes urgent steps to make the price cap adaptive to market conditions in order to prevent more well-run companies falling into distress.

This letter reflects the majority of Panel Members' views, and the Panel is content for it to be treated as public. Please do not hesitate to get in touch if you would like further detail on any of the points raised in this letter.

Yours sincerely,

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Elexon Board and BSC Panel Chairman

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