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Dear Neil,

STATUTORY CONSULTATION ON POTENTIAL SHORT-TERM INTERVENTIONS TO ADDRESS RISKS TO CONSUMERS FROM MARKET VOLATILITY

Thank you for the opportunity to respond to your statutory consultation on potential short-term interventions to address risks to consumers from market volatility. This consultation focuses on temporary actions to address risks the price cap imposes on both suppliers and customers at times of high market volatility. Currently, engaged customers are on the default price cap tariff since the level of the price cap has now materially departed from the costs to suppliers and this is the lowest tariff available. This situation has also caused a raft of supplier insolvencies and an almost complete cessation of the product / switching market.

The actions in the consultation focus on addressing the risk of previously engaged customers moving to lower priced products as soon as wholesale prices drop and products cheaper than the default price cap become available, a risk made more likely by the expected default tariff cap increase in April 2022. We urge Ofgem to continue to work with the government on both short-term and long-term reforms to market arrangements.

We have set out our views on the questions asked and the options proposed in the consultation in Annex 1 and would highlight the following points:

- **Impact of market uncertainty:** Ofgem is correct to highlight the huge challenge faced by suppliers in current market conditions, where they must balance the risks of hedging ahead for Standard Variable Tariff (SVT) customers and suffering large losses when the market falls and those customers exit to cheaper products, and suffering large losses when the market rises including when unexpected customers join SVT. We believe there is a compelling case for Ofgem to take further action, to reduce supplier hedging risks in the short run, and to mitigate the impact of a sharp price fall should it occur.
- **‘Do nothing’ is not enough:** we generally welcome Ofgem’s focus on improving financial resilience, but we do not believe the activities set out in Ofgem’s action plan will reduce the risks of a falling market to any large extent. Suspension of new licence awards could be circumvented by acquisition of an existing small licensee,

and milestone assessments are unlikely to hinder aggressive growth if a backer can demonstrate it is well capitalised.

- **Market Stabilisation Charge, MSC (Option 3):** We believe a MSC offers the best overall prospects of mitigating the identified risks and delivering consumer benefit. Ofgem should proceed with this option as soon as possible, but adopt less aggressive scaling factors so that the MSC represents a meaningful proportion of supplier economic losses (we would suggest more than 80%). If Ofgem waits until there is clear evidence that it will be needed, it will be too late.
- **Ban on acquisition tariffs (Option 1):** This new rule would be straightforward to introduce and implement, and is likely to offer a modest but worthwhile mitigation of risk. We would support its introduction whether or not Ofgem also adopts a MSC. (Unless the MSC recovers 100% of suppliers' economic costs, there will be a residual risk and this option could help mitigate that risk at relatively low cost.)
- **Ofgem's impact assessment:** Ofgem has provided an unbalanced view in its impact assessment by focusing on short term quantifiable consumer benefits (avoided cost mutualisation from failed suppliers via the SoLR or SAR process) and excluding the harder to quantify consumer benefits of avoided impact on investor confidence, innovation and competition, which we believe are likely to be significantly larger in the long run. Ofgem should find a way of factoring these wider benefits into its overall assessment.

Overall, we agree that there is a significant potential for risk to consumers and suppliers posed by current market volatility, and strongly urge Ofgem to take action in the short term.

Yours sincerely,



Richard Sweet
Head of Regulatory Policy

STATUTORY CONSULTATION ON POTENTIAL SHORT-TERM INTERVENTIONS TO ADDRESS RISKS TO CONSUMERS FROM MARKET VOLATILITY – SCOTTISHPOWER RESPONSE

Introduction

We consider that the current price cap methodology does not perform adequately in cases of wholesale market volatility. We have discussed our views on the price cap and the case for change in the medium and longer term in our response to the Ofgem call for input submitted on 13 January. In terms of the immediate risks prior to October 2022, that are the subject of this consultation, our view is that if there is either a sudden or gradual reduction in wholesale prices that brings the cost of products to more than £100 below the SVT tariff, suppliers will face significant volume risk from customers leaving SVT for more cheaply priced products.

Although Ofgem is progressing work on financial resilience and is restricting market entry in the near term, this does not fully address the risks suppliers and consumers face. Suppliers, in particular the larger remaining suppliers, who have a large number of customers on the SVT tariff and who have seen significant levels of unexpected customers moving to their SVT tariffs, are particularly at risk. Ofgem must assess the impacts of potential price decreases after April 2022 with this altered status quo in mind. Ofgem's consideration of scenarios must take into account that the starting point is very far from routine and the customer base is unpredictable and this is the basis on which to consider expectations of what suppliers "routinely" deal with, in relation to hedging, price and volume risk relative to the price cap. It is possible that the risks are slightly higher with sudden price decreases due to the likely media attention.

This annex is structured to address the questions posed by Ofgem:

1. Have we correctly identified and assessed the risks to consumers from continued wholesale market volatility?

We believe Ofgem has correctly identified the main risks to consumers from wholesale market volatility but has provided an unbalanced view in its impact assessment by focusing on short term quantifiable consumer benefits (avoided cost mutualisation from failed suppliers via the SoLR or SAR process) and excluding the harder to quantify benefits of avoided impact on investor confidence, innovation and competition, which we believe are likely to be significantly larger in the long run. Ofgem acknowledges these benefits in passing but fails to attach appropriate weight to them in weighing up the case for intervention:

"In addition, if some suppliers are unable to finance their activities and choose to voluntarily exit the market and/or high risks and losses deter further entry from new investors, then there may be a decrease in competition in the market. This could harm consumers in the long-run due to a lower competition in prices/services and lower investment/innovation."¹

¹ Paragraph 2.8 in this consultation document.

We agree with the above statement and believe the risks of further market exit (or deterred entry) are real. We accept that it is difficult to quantify these benefits with any precision, but it would be more balanced to present the conclusions in a way that invites the reader to consider how they might affect the assessment, eg “these unquantified benefits would only need to be as large as X for there to be a good case for intervention”.

Unless the supply sector can return to a more sustainable regulatory model, it will be impossible to attract the new investment, innovation and market entry that will be essential to reaching net zero. This includes the need to establish a more direct alignment, between wholesale energy costs, retail energy prices, time of use tariffs and a renewed drive to encourage the take-up of energy efficiency measures, heat pumps and other technologies to decarbonise domestic energy consumption. It is crucial that, in balancing the needs of consumers, Ofgem must also take into account consumers’ interest in having a dynamic, competitive and sustainable supply market, which depends critically on supplier financeability. This long term thinking must be in all of Ofgem’s decision making, even that aimed at short term fixes and whilst it is referred to in passing in this consultation, the long term does not appear to be a factor in Ofgem’s decisions here.

Indeed the “do nothing” option, considers that the measures on financial resilience and the pause on the award of new supply licences is enough to address the risks to consumers. These measures do not address the impact on investor confidence and investment. There has already been much damage to investor confidence as a result of the losses incurred up to now which we have informed Ofgem of in December². We do not think the impacts would be “relatively weak” as Ofgem has proposed. There is also little recognition that Ofgem has a legal obligation to have regard to the need to ensure that suppliers who operate efficiently can finance their activities.

Ofgem has noted that “We would not expect all consumers on default tariffs to react in the same way. We have historically seen large numbers of consumers remain inactive even when considerable savings are available from switching. It is uncertain whether this would continue as the price cap reaches higher levels”. We consider that scenarios that assess different levels of switching should be considered in the impact assessment since previously disengaged customers may be swayed not only by the savings available but also as a result of the current high profile media focus on energy prices. Alternatively, more consumers may be turned off market engagement as a result of the current media advice not to switch.

2. Do you believe that intervention is warranted in the interests of consumers?

We strongly consider that intervention is required and that Ofgem’s default position of “do nothing” is untenable. As discussed above, the current form of the price cap has shown that it does not work effectively in situations of market volatility. Suppliers have lost significantly as wholesale prices have increased without the price cap reflecting the increases. As such, new customers have moved to SVT tariffs as the cheapest available option. This has also caused suppliers to exit the market leaving significant mutualised costs to be picked up. In addition to these short term costs, the impact on investor confidence will cause significant damage to consumers and this impact has long term effects ultimately to the detriment of our ability to reach net zero.

² We responded to Ofgem on the significant supplier loss in response to the consultation “Reviewing the potential impact of increased volatility on the default tariff cap: November 2021” on 17 December 2021.

Table 1 below shows an illustrative calculation of potential wholesale losses from falling market prices across all domestic suppliers, informed by ScottishPower's experience. **These losses do not include the losses incurred from unexpected SVT demand when the market was rising for which suppliers have already provided estimates in response to Ofgem's November 2021 consultation.**

Table 1: Estimated wholesale losses from falling market prices

	Total losses @ £250-350 per customer
4m unexpected SVT	£1.0 – 1.4 bn
1m switchers away from SVT (10% of non-unexpected)	£0.25 – 0.35 bn
Total market losses	£1.25 – 1.75 bn

The calculations in Table 1 are based on the following assumptions:

- 4 million customers assumed to be 'unexpected SVT' as per Ofgem's assumptions³; this figure may be higher once SoLR customers are included.
- 100% unexpected SVT customers switch.
- 10% of non-unexpected SVT customers switch (assumed to be circa 10m)
- Prices fall on 1 April 2022 to a level equivalent to 40% of current (14 January) prices (closer to, but still above, the 50p/therm 'historic summer average' used in Ofgem's impact assessment).
- Suppliers' energy cost estimated as per the Ofgem wholesale allowance observation periods, with the range depending on the exact approach to hedging. (As noted above, the losses do not include the additional losses incurred by suppliers in procuring energy for unexpected SVT demand after the assumed observation period).
- The total loss is thus equivalent to around £250 to 350 per SVT customer switching away (on a dual fuel basis), depending on hedging decisions.

We believe these assumptions are conservative. The later the price fall occurs, the more unexpected customers will have moved to SVT and the greater the total loss. Furthermore, a very pronounced fall, such as we have assumed, would be likely to generate intense press interest and hence might prompt more than 10% of core SVT customers to switch.

Ofgem notes a potential lasting risk on customer engagement from options 2 and 3, the exit fees and the market stabilisation charge between suppliers. We do not agree that this is the case with the market stabilisation charge since the charge is between suppliers and the customer will not see this directly. Indeed, we consider that much more significant risks to customer engagement have occurred in recent months with media warnings to consumers not to switch as a result of the structure and operation of the price cap in a volatile market.

³ Paragraph 2.3, "Short-term interventions to address risks to consumers from market volatility"

3. Which of these possible interventions, if any, would be most effective and proportionate in addressing the risks identified in consumers' interests?

We consider a ban on acquisition tariffs alongside a market stabilisation charge would be the most effective approach. We discuss our preferred options below and then consider option 2 which is our least preferred option, but given the significance of the risks, better than “do nothing”.

Option 1: a ban on acquisition tariffs.

We cannot see a reason not to implement this as soon as possible. We believe it would offer some partial mitigation of the risks, reducing the intensity of price competition between existing suppliers, but there are still several scenarios in which suppliers could be highly exposed absent other interventions such as option 3, the market stabilisation charge.

Option 3: A market stabilisation charge

Option 3 is a market stabilisation charge paid on customer acquisition, by the gaining supplier to the losing supplier. This would only come into effect if wholesale prices were to fall significantly (30 – 50%) below the summer 2022 price cap. We consider that this option should be implemented (albeit with different threshold and sharing factors) and that the fact that the MSC only comes into play when the price has fallen significantly means that the charge only happens when justifiable, ie there is the “sufficient level of market volatility” that Ofgem is looking for.

We consider that this option is the best to address the risks for suppliers and customers in the market. Having the charge between suppliers reduces the effect that any charge might have on customer engagement. It also increases the chance that suppliers will actually recoup any such charge since it has proved difficult for suppliers to recover exit charges from customers historically. Since the gaining supplier can include the charge into its tariff prices, this option does not disadvantage low income/vulnerable consumers in the same way as an exit fee paid by customers does.

The additional confidence that this measure would give suppliers and their investors in both a rising and falling market as well as currently where the level of uncertainty and risk for suppliers is high, has not been included in the cost benefit analysis but as noted several times above, has greater longer term implications for the energy market and consumers.

We understand from Ofgem that it now considers the implementation may be less technically challenging than previously thought. In addition, we consider the processes it would introduce should be used in the medium term as a mechanism to allow the exit fees in the new fixed term default tariff to be payable between suppliers, as we have described in our response to Ofgem's recent call for input.

We discuss the level of the charge in answer to question 7 below.

Option 2: Allowing suppliers to charge exit fees on some Standard Variable Tariffs

Although we are not opposed to exit fees in general, we consider that introducing them to the current variable default tariff for customers who have not chosen this tariff and in current market conditions where the ability to switch is very small, might be seen as unfair, will likely not be welcomed by customers and is likely to lead to lots of call centre contacts.

When there is an exit fee that is paid from the customer to the supplier, it cannot be smoothed over the term of the new fixed tariff and hence could be a disincentive to switch for low income / vulnerable customers. In addition, suppliers often lack the ability to enforce exit fees and the propensity not to pay is likely to increase the higher the exit fee and the greater the need of the losing supplier.

As mentioned above, we consider option 1 alongside option 3 would be the most effective. We note that there are links with some of the options in the call for input, in particular the fixed default tariff that could impact the balance between the advantages and these implementation challenges.

- 4. For each option, are there particular benefits or risks for consumers, including those in vulnerable circumstances, that we have not identified?**
- 5. For each option, do you agree that we have identified the full range of expected impacts on suppliers, consumers and competition?**

We are responding to Questions 4 and 5 together.

As we commented in our response to question 1, although Ofgem has referenced the detrimental impact on investment leading to reduced competition and reduction in innovation, we do not consider that these risks have been sufficiently taken into account in its assessment and therefore the benefits that accrue as a result of intervention have not been included.

For option 1, we do not agree with one of the assumptions made with regards to option 1 and the falling price scenario, where prices fall from current levels to previous summer levels. The assumption is that since a ban on acquisition tariffs would reduce the potential savings that engaged consumers could achieve, it would therefore lead to lower levels of customer switching between suppliers. We consider that with such an extreme drop in wholesale prices, even with a ban on acquisition tariffs, there would not be much if any reduction in customer switching levels.

For option 3, we do not agree with the claim given in the assessment that the market stabilisation charge may dampen competition in the short term (resulting in the cheapest tariffs on the market being higher than in the 'do nothing' scenario). We do not think that such a charge would have a significant effect on competition. As Ofgem recognises, more efficient suppliers could still charge less and suppliers could still compete on price as well as other elements such as green tariffs, time of use tariffs and quality customer service. This is especially the case given the charge only comes into effect when the prices have dropped significantly.

- 6. Where applicable, do you agree that the draft Licence Condition text accurately implements the intervention as described?**

The licence condition to implement option 1 includes an obligation to offer tariffs to new *and* existing customers. The price cap was motivated in part over concerns the perceived loyalty penalty in the market. Offering low prices to existing customers is a reward to their loyalty and therefore we consider that the licence condition should be drafted in a way that does not preclude this.

We think the current draft licence conditions could be adjusted relatively easily to ensure suppliers would not be precluded from offering tariffs only to groups of existing customers. We would propose Ofgem make the following amendments to SLC 22B.1 and 22B.2:

22B.1 Subject to paragraph 22B.2, the licensee must ensure that all its Tariffs are available to, and are capable of being entered into by, ~~both new and~~ existing Domestic Customers.

22B.2 Paragraph 22B.1 does not apply to:

- a. A Closed Fixed Term Tariff;
- b. A Collective Switching Tariff;
- c. A Dead Tariff which complies with standard condition 22D; and
- d. Tariffs only offered to a particular group of Domestic Customers defined on the basis of criteria specified by the licensee, provided that the criteria do not in any way ~~exclude all existing Domestic Customers relate to whether or not the Domestic Customer is a new or existing Domestic Customer.~~

Option 3 – Market stabilisation charge

7. Do you agree that the methodology outlined in Appendix 2 best delivers the charge described in this consultation document?

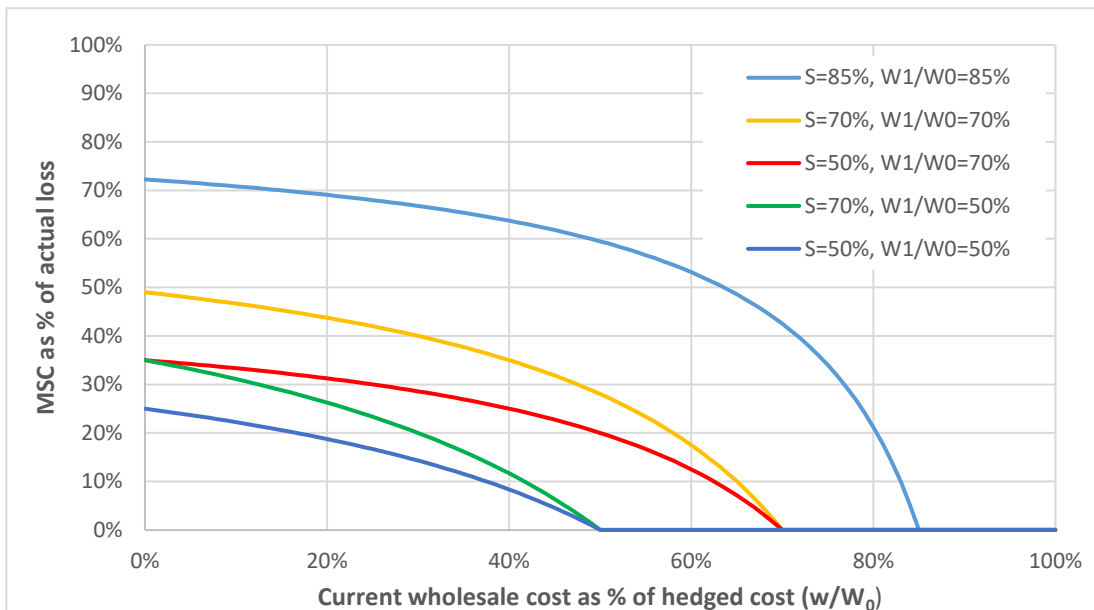
The key elements of the methodology outlined in Appendix 2 are the two scaling factors:

- The sharing factor (or derating factor), S
- The percentage fall in wholesale prices below which losses start to be calculated, W_1/W_0 (where W_1 is the price threshold for the MSC to kick in and W_0 is the original price paid for energy).

We agree with the inclusion of the factor W_1/W_0 which has the effect of creating a ‘dead zone’ in which small falls in the wholesale market do not lead to a MSC, and which avoids an abrupt step change increase in MSC at the edge of the dead zone. There is no need for the sharing factor given that the W_1/W_0 factor already scales back the MSC compared to the supplier’s actual loss.

More importantly, we believe that the ranges of values suggested for these two factors (50%-70% in each case) result in an excessively watered down MSC, which will not achieve the intended mitigation of risk. This is shown in Figure 1 which shows the MSC as a proportion of the supplier’s actual loss for different levels of wholesale price fall (w/W_0 , where w is the new wholesale price and W_0 was the price when the supplier procured the energy.) For a 50% fall in market prices, different combinations of parameter values suggested by Ofgem result in an MSC of between 0% and 28% of actual losses, which we believe is far too low. The chart also shows that if both parameter values are set to 85%, a 50% fall in prices results in an MSC of 60% of actual losses, which we think is below the minimum level needed to deliver a meaningful mitigation of risk.

Figure 1: Market Stabilisation Charge as a percentage of actual loss



8. Do you agree that an ex-ante publication of the charge delivers the best outcome for customers?

Yes, we agree with this approach.

9. Do you agree that a weekly publication represents an appropriate frequency of charge update?

In terms of the frequency of charge updates, we need to balance the interests of losing suppliers in updating the MSC more frequently with gaining suppliers and the need for predictability in what the MSC would be. We consider that if a weekly update option chosen, Ofgem should give consideration to how the week to week variation could be smoothed.

10. Do you agree that the payment mechanism described here is the most effective way of ensuring that charges are collected and paid?

Yes, we agree with this approach.

ScottishPower
January 2022