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**Non-confidential**

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Sent by email to: [Neil.Kenward@ofgem.gov.uk](mailto:Neil.Kenward@ofgem.gov.uk); [Neil.Barnes@ofgem.gov.uk](mailto:Neil.Barnes@ofgem.gov.uk);

Dear Neil

**Statutory consultation on potential short-term interventions to address risks to consumers from market volatility**

Ofgem is consulting on short-term interventions that may be needed to address risks to consumers from market volatility. Under normal circumstances Centrica would not support the kind of options outlined in the consultation. But these are not normal circumstances; the extreme market volatility that drove supplier failures now combines with flaws in the retail price cap to impose heavy losses on even prudent suppliers. For Ofgem not to act to mitigate further losses would exacerbate the fragility of an already weakened sector, causing huge risks to consumers. The risks to consumers are: (a) the costs of further supplier failures; (b) the costs of incremental increases to the price cap; and (c) the loss of fair competition and investor confidence in the energy retail market.

We have weighed up the costs and benefits of the options outlined in the consultation. We believe that a well-designed version of Ofgem's Option 3 – the Market Stabilisation Charge (MSC) - best meets Ofgem's objective of protecting consumers in the short term.

Option 3 would be a proportionate response to extreme circumstances in the wholesale market; it would also therefore be temporary. The long-term solution to prevent the current situation repeating itself and to protect consumers more generally is a fundamental overhaul of retail price regulation and the introduction of robust financial resilience requirements. We encourage BEIS and Ofgem to engage with all relevant stakeholders to define the characteristics of the energy market they want to see, and then design price regulation to deliver those objectives. We do not believe that the starting point for the wider review should be the existing cap, which has been shown to be fundamentally flawed. But we would like to reiterate that we support price regulation which has well thought through objectives and is both principles-based and designed well enough to achieve those objectives.

We believe that a well-designed MSC will best protect consumers in the short term because it best meets the following assessment criteria:

1. It ensures that suppliers are incentivised to act responsibly and therefore are not at risk of being penalised for hedging to protect against rising prices.

2. It minimises cross-subsidy between consumer groups, avoiding regressive distributional effects.
3. It promotes sustainable competition, including by maintaining incentives for customers to switch.

As the assessment against these criteria suggests, a well-designed MSC will provide the greatest net benefit to consumers compared to the other options. By mitigating the risk of falling prices, it enables suppliers to hedge against rising prices, thereby protecting consumers from: (a) the costs of further supplier failures; (b) the costs of an incremental increase to the price cap; and (c) the loss of fair competition and investor confidence in the energy retail market.

Ofgem's own Impact Assessment (IA) suggests that Option 3 – the MSC - will bring greatest net benefit to consumers. In our main response we show how Ofgem's IA can be made more accurate, making the case for Option 3 even clearer. Given the net benefits to consumers of Option 3 and the adverse consequences of doing nothing or implementing Options 1 or 2, Option 3 is also most consistent with the statutory framework and in particular with the requirement that Ofgem take proper regard of the need for suppliers to finance their activities. Whilst we recognise that there are design and operational issues to work through in implementing a well-designed MSC, any costs in doing so should be significantly outweighed by the benefits to consumers.

In our main response to this consultation, we explain in detail: (a) why intervention is required; (b) how the risks, costs and benefits show that well-designed version of Option 3 best protects consumers; and (c) how to design an effective MSC. In this cover letter, we describe the wider context that compels Ofgem to intervene, including the causes of supplier failures, the flaws in the price cap and Ofgem's duties to consumers. We then briefly assess the options against the three criteria above.

### **The £3.5bn consequences of underregulated underhedged suppliers**

For a number of years the regulatory regime has permitted suppliers to not adequately hedge their customers' demand. Suppliers have entered the market with scarcely any cash reserves. Instead of using investor cash to build a business, suppliers have used customer credit balances to fund day-to-day operations and acquire more and more customers on loss-making tariffs. In many cases suppliers were not hedging for the fixed-term contracts they had been agreeing with customers, let alone for the period after the fixed contract ended.

Effectively, suppliers bet customers' money on wholesale prices staying benign. As long as wholesale prices stayed benign, this was not perceived to be a problem; consumers were switching in large numbers and apparently benefitting from low prices. However, any consumer benefits from this switching and competition were illusory; consumers have been exposed to a market in which irresponsible behaviour gave suppliers a competitive edge.

But as it happened the bet was wrong, and these inadequately hedged suppliers could not bear the sustained and very significant wholesale prices in the second half of 2021. The customers of these failed suppliers were transferred to some of the more prudent well-managed suppliers. But these prudent well-managed suppliers had to buy the energy for the transferred customers at the market rate available at the time, which was well above the regulated allowance. Overall the cost of supplier failures to consumers and taxpayers (i.e. including Bulb) is currently estimated at around £3.5bn. Had all suppliers been adequately hedged and adequately capitalised, the £3.5bn cost to consumers and taxpayers may not have transpired at all.

The energy supply crisis has starkly shown how hedging protects customers and how the regulatory regime must incentivise prudent risk management. It also underlines the need for a robust and well-resourced prudential style regulatory regime.

### **The unmanageable hedging dilemma that the 6-2-12 index creates even for prudent suppliers**

Now that an estimated £3.5bn has been spent moving customers from imprudent suppliers, Ofgem is now rightly worried that the price cap is imposing systematic and material losses on prudent suppliers. Ofgem first raised these concerns and proposed actions to address them in its consultation published on 19 November<sup>1</sup> (“November Wholesale Consultation”). On the first page of that consultation, Ofgem stated:

*“We are consulting on whether the recent rise in wholesale prices has caused the level of the price cap to materially depart from the efficient cost level allowed for in the price cap. It is in the interests of both consumers and industry to ensure that the price cap appropriately reflects the costs, risks and uncertainties facing suppliers.”*

The most material cost that Ofgem identified as not being allowed for in the price cap in the November Wholesale Consultation was unexpected SVT demand. This unexpected SVT demand was driven by – in Ofgem’s articulation – spot wholesale prices increasing by so much that customers rolling off fixed term contracts were unexpectedly choosing to stay on the cap – something that Ofgem did not envisage when the cap was first designed. Ofgem has recognised that the root cause of this problem is the eight month “lag” between spot FTC prices and the 6-2-12 index in the cap. In the November Wholesale Consultation, Ofgem’s proposed solution to the mismatch between efficient costs and the cap was to increase the wholesale risk allowance commensurately.

Ofgem is now consulting on whether and how to address what it views as the next phase of the unexpected SVT demand problem. This is the “SVT hedging dilemma”, which is that spot wholesale prices may go up or down and suppliers cannot protect against the risks – and losses – of both scenarios at the same time. In the event that wholesale prices fall and suppliers have bought ahead for their SVT customers, they are exposed to losses not accounted for in the cap from customers switching away and having to sell the hedges back at a loss. In the event that wholesale prices rise and suppliers have not bought ahead for their SVT customers, they are exposed to losses not accounted for in the cap from having to buy energy at higher spot prices for the customers they unexpectedly retain.

The options that Ofgem is considering to mitigate the next phase of the unexpected SVT demand problem are:

1. Requiring suppliers to make all new tariffs available to existing customers
2. Allowing suppliers to charge exit fees on certain Standard Variable Tariffs
3. Requiring suppliers to pay an MSC when acquiring new customers.
4. Do nothing (i.e. implement none of the options in the statutory consultation)

In its assessment of the options, Ofgem essentially compares - under different scenarios - the benefits to customers from switching against the losses imposed on suppliers, the latter of which in some scenarios leads to supplier failures and further costs to consumers. This “zero sum game” way of assessing the options is inconsistent with Ofgem’s principal objective to protect current and future consumers, and inconsistent with the requirement that Ofgem take proper regard of the need for suppliers to finance their activities. If Ofgem stands aside and lets the flaws in the price cap impose unrecoverable losses on suppliers, then it would make existing and potential investors seriously question whether this is a market worth operating in. Doing nothing will lead to diminished competition in the market and reduce the extent to which suppliers are able to finance the investments needed for the transition to net zero.

This “zero sum game” way of assessing the options is also inconsistent with the approach that Ofgem took in the November Wholesale Consultation, in which it recognised that it is not in the interests of either consumers or industry for suppliers to have unrecoverable efficient costs<sup>2</sup>.

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<sup>1</sup> [Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap | Ofgem](#)

<sup>2</sup> Ibid

A further read-across between the November Wholesale Consultation and this consultation is that the problem under consideration is essentially the same, and it has the same root cause. The problem under consideration in both consultations is the “SVT hedging dilemma”, which refers to the inability under the cap to protect against rising and falling wholesale prices at the same time. The only difference is when and how the problem has manifested: the November Wholesale Consultation considers price cap period 7, whereas this consultation considers what may happen in price cap period 8.

The clear implication of the read across between the November Wholesale Consultation and this consultation - and indeed consistent application of Ofgem’s statutory objectives and duties - is that the same solution to the problem may be required - to recover efficient costs through the price cap – if Ofgem does not solve it via other means. More specifically, to the extent that efficient losses are not mitigated by implementing an effective MSC, the requirements of the Domestic Gas and Electricity (Tariff Cap) Act 2018 will kick-in and require that they be recovered via the cap instead.

### **Which option best protects consumers?**

#### **1. Ensuring that suppliers are incentivised to act responsibly and therefore are not at risk of being penalised for hedging to protect against rising prices.**

- The MSC will  $\propto^3$ .
- Under the “do nothing” option, suppliers are left not being able to protect against rising and falling prices at the same time. Therefore, if Ofgem does not act, consumers are left fully exposed to: (a) the costs of further supplier failures; (b) the costs of an incremental increase to the price cap; and (c) the loss of fair competition and investor confidence in the energy retail market.
- The prohibition on new customer only tariffs is liable to make the situation worse than the “do nothing” option. Under this option, suppliers have to contemplate the potential position and market response of their competitors as well as their own position. Some suppliers – those with fewer customers on the cap – will have a competitive advantage in a scenario of falling prices because of the smaller cannibalisation risk. Option 1 would therefore be discriminatory, and ultimately it could recreate the “race to the bottom” of unhedged suppliers.
- There are related issues of consumer acceptability and ability to establish and enforce exit fees at a proportionate level which means that suppliers will have less comfort to protect against rising prices than they would under the MSC.

#### **2. Minimising cross-subsidy between consumer groups, avoiding regressive distributional effects.**

- It is more “switchy” consumers who have driven the unexpected SVT demand costs by taking the free option to stay on the cap at the end of their FTCs and/or have been moved via the SOLR process. It is likely to be that same group of more engaged consumers who drive further unexpected SVT demand costs in cap period 8 and beyond.
- The “do nothing” option compels Ofgem to make up the unrecovered efficient costs via the price cap. An incremental increase to the price cap would impose direct costs on the consumers on the cap, rather than the more “switchy” consumers who have driven the unexpected SVT demand costs. An incremental increase to the price cap is likely to have negative distributional effects because Ofgem states that those customers are more likely to be vulnerable.

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<sup>3</sup> As we said in response to the November Wholesale Consultation, the regulatory regime must incentivise prudent risk management in light of the events of 2021, so those who have hedged responsibly should not be penalised for doing so, given the importance of the activity to the wider functioning of the market.

- As it is triggered by a switch in certain wholesale market circumstances, the MSC more closely allocates the cost of mitigating the SVT demand risk to where those costs arise, which mitigates the regressive distributional effects of an incremental increase to the cap.
- Compared to the “do nothing” option, the prohibition on new customer only tariffs is liable to exacerbate the allocation of costs away from engaged customers and towards disengaged customers on the cap. It is liable to exacerbate the problem because – in the way described above – it could recreate the “race to the bottom” of unhedged suppliers and lead to greater switching and therefore losses in efficient costs that need to be recovered through the cap.

### **3. Promoting sustainable competition, including by maintaining incentives for customers to switch.**

- The effect of the MSC on consumer engagement and switching is that its effect should be the same as if wholesale prices remained constant (i.e. the volatility stopped). Engagement and switching do not stop in such a scenario – in fact history shows that periods of stable wholesale prices have high switching rates. Indeed - assuming that Ofgem swiftly implements new financial resilience requirements – the MSC should help reveal which suppliers can offer low prices on a sustainable basis, and therefore ultimately help customers make better informed switching decisions than before the crisis hit.
- Under the “do nothing” option, suppliers are forced to guess which way wholesale prices are going to move. Some suppliers will guess right, and others guess wrong, establishing an artificial and arbitrary competitive advantage and disadvantage. The key parameters of competition in the energy retail market should be customer service, cost control and product innovation and delivery, not gambling on wholesale energy price moves. As we discuss in our main response and legal annex, a key driver of supplier failures we have seen to date has been aggressive discounting and not hedging, as permitted by the regulatory focus on switching as the key measure of competition. It would be a serious error to retain a singular focus on switching to the detriment of risk management and financial resilience.
- Option 1 - the prohibition on new customer only tariffs - also forces suppliers to guess which way wholesale prices are going to move. It also forces suppliers to guess which way their competitors are going to guess. This kind of dysfunctional behaviour and use of resources does not serve consumers well.
- Both Option 1 and “do nothing” risk imposing unrecoverable losses on suppliers<sup>4</sup>, which would have adverse effects on sustainable competition from further supplier failures and damage to investor confidence in the regulatory regime.
- The MSC has an advantage compared to exit fees in that it is a charge that is allocated between suppliers in certain circumstances and therefore should not be visible to consumers. An exit fee is a charge imposed on a consumer – i.e. clearly visible - and therefore may potentially inhibit engagement.

In the consultation Ofgem states that “...we are *not attracted at this time to the more interventionist options of exit fees or customer acquisition charges...*” and “...there would be a high bar to any measures that put even modest and temporary constraints on switching”. The evidence of extreme volatility<sup>5</sup>, the costs of failed suppliers and the prospect of the price cap imposing losses on prudent suppliers clearly shows that any such bar to intervention must have been surpassed. The “SVT hedging dilemma” needs to be solved through Ofgem action. The responsible and proportionate course of action is to enable suppliers to hedge and therefore protect consumers by implementing a well-designed version of Ofgem’s Option 3 – the Market Stabilisation Charge.

Yours sincerely

Tim Dewhurst  
**Director of Regulation and Policy**

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<sup>4</sup> Notwithstanding the requirement for suppliers to be able to recover efficiently incurred costs through the price cap

<sup>5</sup> See further evidence in main response