

Centrica response to Ofgem's Statutory Consultation on potential short-term interventions to address risks to consumers from market volatility

This response is non-confidential

17 January 2021

1. Centrica agrees with Ofgem that the current levels of volatility in the wholesale market pose significant risks to consumers. Such volatility, combined with the Default Tariff Cap, also exposes efficient and prudent suppliers to significant losses and the potential for failure, exacerbating the fragility of an already weakened sector.
2. As shown in the graph below, in the period before Ofgem released its consultation, wholesale prices had reached historic highs and were exhibiting substantial volatility. Under these conditions, it is impossible for suppliers to forecast with any certainty whether the prices available during the Summer 2022 cap period and beyond will be above or below those currently being incorporated into the price cap allowance, and therefore whether consumers are likely to move to FTCs or remain on SVTs. The price cap therefore exposes suppliers to the twin risks of:
 - a. having unhedged SVT demand which must be purchased in a market with wholesale prices above the cap allowance; and
 - b. having to unwind excess hedges in a falling market.
3. This combination of wholesale market volatility and a price cap which makes no allowance for this risk has already led to substantial unrecovered costs, which have contributed to the recent spate of supplier bankruptcies. As we described in our response to Ofgem's consultation on the potential impact of increased wholesale volatility on the Default Tariff Cap published on 19 November 2021 (November Wholesale Consultation), the unexpected rise in wholesale prices and resulting movement of customers to SVTs led to a shortfall against the cap of around £ in unexpected SVT demand costs (during cap period 7, on an annualised basis).
4. As Ofgem develops its thinking on longer-term adaptations to the price cap methodology, it will be vital for it to consider how this issue – the "SVT hedging dilemma" – can be avoided in future. To avoid the sorts of adverse effects we have seen, the price cap must provide suppliers with the ability and incentive to adopt sustainable hedging and pricing strategies.
5. In the meantime, the potential losses beyond cap period 7 are even greater. For example, were prices to rise in line with Ofgem's "rising" scenario, and if suppliers were to hedge £ of volumes (given the risks of falling SVT customer numbers), the unrecovered cost per SVT customer over a year might be in excess of £. Similar losses per customer would be incurred if prices were to fall and customers to leave SVTs, were suppliers to have hedged a high proportion (e.g. £) of their SVT volume in expectation of prices remaining high. Such losses lead directly to customer detriment since:
 - a. If suppliers are unable to sustain these losses, costs of supplier failure will be mutualised – leading to a direct cost for consumers.
 - b. As described below, even where losses do not drive suppliers from the market, the requirements of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the **Act**) mean that these efficient costs will need to be recovered through the cap.
 - c. The resulting costs will fall heaviest on those customers who did not benefit from the unsustainably low tariffs being offered prior to the rise in wholesale prices, leading to an adverse distributional impact.

- d. If suppliers are unable to finance their efficient costs, this will lead to diminished competition in the market and reduce remaining suppliers' ability to finance the investments needed for the transition to net zero.

UK Natural Gas Futures for delivery in April 2022 (ICE)



6. In this context of extreme volatility, the costs of failed suppliers and the prospect of the price cap imposing losses on prudent suppliers, normal operation of the competitive market is impossible and its basic integrity is under threat. Therefore, we do not understand how Ofgem can state in its consultation that *“...we are not attracted at this time to the more interventionist options of exit fees or customer acquisition charges...”* and that *“...there would be a high bar to any measures that put even modest and temporary constraints on switching”*. Given the clear case for change due to the current unprecedented volatility, doing nothing would be irrational and not consistent with Ofgem’s duties. The legal annex submitted alongside this consultation response sets out why the setting of an arbitrary “high bar” represents a fundamental legal error.
7. Since Ofgem’s consultation was released, the case for intervention has increased even further. As shown above, since 15 December 2021, prices for natural gas delivered in April 2022 rose from 189p/th to 336p/th, fell back to 156p/th, and are currently at 190p/th. Ofgem’s consultation notes that *“...by the start of February... the market situation may have evolved and, with it, our assessment of the likelihood and impact of any risks in this space”*. Regardless of the exact level of prices at the point when Ofgem makes its decision at the beginning of February, the market is clearly in a state of extreme volatility and suppliers are mutually exposed to the risk of rising prices and the risk of falling prices at any given time.
8. This is the very last opportunity for Ofgem to make an amendment that would take effect for the forthcoming summer price cap. If the market volatility we have seen to date is insufficient to prompt action, it is difficult to understand what *would* be required.

Ofgem’s Impact Assessment (IA) shows a strong case for intervention, even before making requisite improvements to the IA which would strengthen the case

9. The analysis that Ofgem has undertaken in its IA is high-level and we have not been able to fully replicate it. We have not been able to replicate the analysis because:
 - a. The model contains confidential data relating to suppliers’ hedging positions and financing arrangements. As Ofgem has not operated a disclosure process, we have not been able to verify how this confidential data is used within the model.
 - b. The description of the model within the consultation document is incomplete. For example, it is not clear how the return of prices to seasonal norms in winter has been modelled, or how Ofgem’s switching analysis distinguishes between “disengaged” and “engaged” customers. Although Ofgem provided some additional information ✂,

this information has been received too late to replicate every aspect of Ofgem's model.

10. Despite not being able to fully replicate Ofgem's IA, we have identified a number of deficiencies relating to how Ofgem has interpreted both the quantitative and qualitative results, which we outline below. Correcting for these issues provides a strong rationale for the implementation of an effective version of Ofgem's Option 3 – i.e. a well-designed Market Stabilisation Charge (MSC) – as we explain below.
11. **First, Ofgem has not considered the outcomes of all options under all scenarios simultaneously.** We would expect any cost-benefit analysis to bring together the quantified outcomes of each option (including do-nothing) and assess whether, on balance, they are superior. Ofgem's consultation document does not include such analysis. However, taking Ofgem's analysis at face-value and focussing only on the direct costs it identifies for consumers, there is already a strong case for action. As shown in the table below, when averaging the consumer benefits over all of Ofgem's price and hedging scenarios, the expected consumer cost is minimised under the MSC option.

Quantified consumer benefits reported by Ofgem (£bn)

Option	Falling	Steady	Rising	Average
Do nothing	0.6 – 1.5	0.0 – (0.1)	(1.8) – (2.6)	(0.4)
Make tariffs available to existing and new customers	0.2 – 0.3	(0.1) – 0.0	(1.8) – (2.6)	(0.7)
Allowing exit fees on some SVTs	0.1 – 0.8	0.0	(2.6) – 0.0	(0.3)
Market Stabilisation Charge	0.6 – 0.7	0.0	(2.6) – 0.0	(0.2)

12. This type of analysis will be somewhat sensitive to the probabilities associated with the price and hedging strategies, which are difficult to quantify:
- As shown in the graph above, the volatility of wholesale prices increased markedly in December. Given the short amount of time that has elapsed since then, it is difficult to construct a distribution of possible prices.
 - Suppliers' hedging strategies will depend on their expectations of these prices, and are therefore also very difficult to predict.
13. However, the same results are obtained from a least-worst regrets approach, a common way of making decisions under uncertainty. The table below shows, for each price scenario (and considering the average of the range of consumer benefits reported by Ofgem across different supplier hedging strategies), the "regret" associated with each option – that is, the amount by which the consumer benefits quantified by Ofgem are lower than the consumer benefits that would have occurred had the optimal option for that scenario been chosen. The option with the lowest worst regret is the MSC, while "do nothing" (together with Option 1) has the highest worst regret. This assessment in favour of the MSC and against do nothing/Option 1 is driven by the high cost to suppliers (and therefore consumers) if prices rise and suppliers are under-hedged, a risk that neither "do nothing" nor Option 1 do anything to mitigate.

Regret associated with quantified consumer benefits reported by Ofgem (£bn)

Option	Falling	Steady	Rising	Worst regret
Do nothing	0	0.05	0.9	0.9
Make tariffs available to existing and new customers	0.8	0.05	0.9	0.9
Allowing exit fees on some SVTs	0.6	0	0	0.6
Market Stabilisation Charge	0.4	0	0	0.4

14. We do not understand why Ofgem does not come to this same conclusion. In its conclusion in paragraph 2.16 Ofgem states that “*On the basis of the falling price scenario alone, the case for intervention is relatively weak.*” However, it is meaningless and irrational to focus on a single scenario, when the key issue is the *volatility* of prices – i.e. the uncertainty of outcomes. It would be a mistake of fact to not consider that suppliers are mutually exposed to the risks of rising and falling prices at any given time.
15. **Second, Ofgem’s interpretation of its results are inconsistent with the statutory framework more broadly, and in particular with the requirement that Ofgem take proper regard of the need for suppliers to finance their activities.** Ofgem’s analysis shows how under a “do-nothing” scenario suppliers would make losses in all scenarios – of up to £7.5bn, which equates to approximately £300 per customer. This leads to supplier bankruptcies, reflected in the costs of mutualisation.
16. The structure of the price cap provides consumers with a “free option” to take advantage of SVT prices when they are lower than FTC prices, and vice versa. Without changes to the market, it is impossible even for an efficient supplier to manage these risks. For example, while hedging 100% of current SVT volumes would help avert this risk if prices rise, it would only increase the loss that suppliers would incur were prices to fall. While Ofgem characterises these risks as “*hard to manage*”, this is incorrect – they are impossible to manage given the price cap. It is therefore inevitable that, under conditions of market volatility, the price cap will fail to cover suppliers’ efficiently incurred costs. As we explained in our response to Ofgem’s November Wholesale Consultation, the statutory framework and in particular the Act requires Ofgem to take proper regard of the need for suppliers to finance their activities – which will ultimately mean passing efficiently incurred costs to consumers.
17. As shown below, once these figures are correctly accounted for, the rationale for intervention (and in particular the MSC) becomes greater.

Sum of quantified consumer benefits and supplier losses reported by Ofgem (£bn)

Option	Falling	Steady	Rising	Average
Do nothing	0.5 – 0.1	(0.1) – (0.4)	(3.3) – (10.1)	(2.2)
Make tariffs available to existing and new customers	0.2 – 0.0	(0.2) – (0.3)	(3.3) – (10.1)	(2.3)
Allowing exit fees on some SVTs	0.1 – 0.0	0.0 – (0.2)	(2.6) – (6.2)	(1.5)
Market Stabilisation Charge	0.6 – 0.0	0.0 – (0.2)	(2.6) – (6.2)	(1.4)

18. **Third, the distributional consequences of doing nothing are more severe than implied by Ofgem’s consultation.** Ofgem states in paragraph 2.12 that low income and vulnerable customers are less likely to switch tariff, and so may pay for the costs of supplier failure in a falling prices scenario, without obtaining the benefits of falling prices. Ofgem’s distributional analysis already shows that, for these customers who do not switch, the available options (and particularly the MSC) provide a benefit over “do nothing”.
19. Ofgem’s analysis is however likely to understate the longer-run distributional impacts. Such customers who have not switched or switched less will have historically taken less advantage of the unsustainably low FTCs that were offered by some suppliers prior to the recent price rises, and are already paying the price for this behaviour through the impact of Supplier of Last Resort (SoLR) levies on their bills. The flaws in the price cap and supplier licensing regime have therefore already disadvantaged this group, and doing nothing now would put them at a further disadvantage.
20. Despite asking for it, we have yet to see Ofgem’s full distributional analysis (which we understand considers the impact on different customer archetypes), so are unable to comment further about what Ofgem has done. However, we note that Ofgem’s Impact Assessment

guidance¹ suggests that distributional weights should, where appropriate, be applied to results. Given the assertion by Ofgem that the customers least likely to switch tariff are low income and vulnerable, applying such weights would increase the overall case for action above what is shown in the tables above.

21. Fourth, Ofgem has misinterpreted the impact of the different options on competition.

When comparing options 2 and 3 to “do nothing”, Ofgem describes two competitive effects:

- a. a short-run reduction in competition as switching rates decrease; and
- b. a long-run increase in competition if suppliers that would otherwise have exited are able to stay in the market.

22. This first impact does not represent a true lessening of competition. As described by the CMA’s guidance, “*Competition is a process of rivalry between firms and, where it is effective, encourages firms to deliver benefits to customers in terms of lower prices, higher quality, and more choice.*”² In the context of the retail energy market, effective competition means that firms that are more efficient (i.e. can sustainably serve customers in a cheaper way) or otherwise offer greater value to customers should be able to attract customers to switch to them.

23. The switching modelled by Ofgem in its “do-nothing” scenario does not reflect such competition. Instead, it relates to customers being able to take advantage of the flaws in the price cap, switching to SVTs when the structure of the cap forces them to be priced at an unsustainably low level, and switching back to FTCs when this is not the case. This should be clear from the way in which Ofgem has modelled levels of switching in a falling market that would overwhelm current industry systems: such a level of switching is clearly not driven by any sudden “real” competitive advantage. Rather, it is driven by regulatory failure and should be discounted for the purpose of a competition impact assessment.

24. Ofgem’s focus on switching as the key measure of competition suggests that it may not have learned from the last few years, when aggressive discounting by suppliers led to switches, but ultimately proved unsustainable and led to losses which customers are having to bear. As noted in our recent submission to BEIS, the focus on switching to the detriment of all other measures of competition has led to the market being in the fragile state it is currently in. Given recent events, this must change: Ofgem’s objective must be the orderly function of the market, with sustainable competition between suppliers. This also links to the prudential reforms which are needed: if suppliers were to resume heavy discounting of FTCs later this year, then Ofgem’s new supervisory regime should assess whether such pricing is sustainable and should be allowed to continue untrammelled.

25. By contrast, Ofgem has understated the potential long-run detrimental effects to competition of doing nothing. The CMA’s guidance specifically calls out the danger of policies which “*significantly raise the costs of current suppliers, causing them to leave the market*”. Ofgem’s modelling shows how, without further mitigation, the flaws in the price cap mean that suppliers may be driven out of the market under any of its price scenarios. The suppliers which are forced to exit will not do so because they are “uncompetitive” in any sense (e.g. having higher costs to serve customers). Instead, they will be firms which happened to forecast SVT demand (which is highly uncertain given it is driven by volatile wholesale prices, and is a risk that the price cap provides no way of managing) in a way that turned out to be incorrect,³ or do not have access to significant sources of finance. The exit of such otherwise sustainable businesses from the market would undoubtedly lessen competition, and send an adverse signal to investors.

26. Furthermore, a significant impact on competition will still occur even if suppliers’ losses are insufficient to force them out of the market. The CMA’s guidance refers to measures which “*significantly raise the costs of some current suppliers relative to other current suppliers*”. As

¹ Ofgem (2020), [Impact Assessment Guidance](#) para 56

² CMA (2015) [Competition Impact Assessment – Part 1: Overview](#)

³ As described in our response to Ofgem’s November Wholesale Consultation, in an environment of volatile prices, many different estimates of SVT churn may be reasonable ex-ante, even if ex-post the impact on supplier finances may be very different.

described above, the flaws in the current price cap, together with current market volatility, will lead to some suppliers (those which happened to make forecasts of SVT demand which differed most from the outcome) incurring additional costs. The distribution of these costs among firms is therefore arbitrary, and independent of the extent to which the firms have acted in a prudent or efficient manner. The imposition of such costs is anti-competitive compared to the options available to Ofgem which mitigate this risk. In addition, even if suppliers' losses do not cause them to become bankrupt, their exposure to such economic losses will damage confidence in the market, reducing the willingness and ability of investors to finance the investments needed for the transition to net zero.

27. While it is difficult to quantify these effects, it is clear that any measure which reduces the losses faced by suppliers (which are directly caused by the design of the price cap) will be pro-competitive.
- 28. Finally, while there are a number of deficiencies in Ofgem's modelling, these will - if anything - cause the case for intervention to be understated.**
29. Ofgem's "rising" price scenario applies an increase in gas costs for delivery in Summer 2022 up to 250p/th. However, as shown in the figure above, prices were already well above that level towards the end of December, and it is reasonable to suppose that they might reach at least that level in future. Applying a higher wholesale price under the "rising" scenario would increase the losses experienced by suppliers, and therefore the costs to consumers. Although we have not been able to fully replicate Ofgem's model, in a simplified version we found that increasing the "rising" gas price from 250p/th to the 336p/th observed in late December (and applying an equivalent increase to the "rising" electricity price assumption) resulted in an increase in supplier losses of around 60%, which feeds through to additional consumer detriment.
30. All of Ofgem's scenarios include only a single point of uncertainty: prices can take one of three paths from the start of April, but are known with certainty from that time onwards. This is not true of volatility: even if prices were to remain steady on average through Summer 2022, they could continue to move in a volatile fashion during this period. Without the certainty offered by a Market Stabilisation Charge, a prudent supplier would ✕. Ofgem's modelling does not account for this type of scenario.
31. Ofgem has indicated that the switching rates under a "do nothing" option in a falling price scenario are bound by the constraints on the current switching systems of around 2m switches per month. Ofgem has not explained the costs that would manifest if this limit were hit in practice, which might include a further reduction in consumer confidence in the market if customers attempting to switch face lengthy delays, or reductions in competition if more efficient suppliers with lower costs and prices are unable to attract switchers due to bottlenecks in the system. While these costs may be difficult to quantify, they would nonetheless add to the need for intervention.

Ofgem's analysis shows that Option 3 from its consultation - the MSC - is the appropriate intervention

32. Ofgem has set out three options for interventions which could mitigate the risks faced by consumers:
 - a. Option 1: A requirement that suppliers make all new tariffs available to existing customers;
 - b. Option 2: Exit fees on SVTs; and
 - c. Option 3: A Market Stabilisation Charge.

33. Ofgem states that “...we are not attracted at this time to the more interventionist options of exit fees or a Market Stabilisation Charge”, implying that it is currently minded to consider Option 1 only.
34. However, as we describe below, the analysis presented by Ofgem shows that Option 1 is unlikely to reduce the losses experienced by suppliers in a falling price scenario, and will do nothing to reduce these losses in a rising price world. It will therefore do little to reduce the costs to consumers, whether in terms of the overall cost to consumers (driven by mutualised costs of supplier failure, as well as any losses that must be passed through under the price cap), the adverse distributional outcomes of such costs, or the impact on long-run competition.
35. In principle Options 2 and 3 would both directly address these costs to some extent. However, Option 3 is the least likely to be associated with unforeseen adverse consequences. Ofgem must consult with an open mind and not unreasonably close its mind to all viable options before the consultation process has completed and all responses have been duly considered.

Option 1 is poorly targeted and will not avoid the costs to consumers that Ofgem has identified

36. As shown in the tables above, Ofgem’s own figures indicate that Option 1 has the lowest average consumer benefits across all options, including do-nothing, whether or not supplier losses are accounted for. Option 1 does nothing to reduce costs to consumers and suppliers under the steady and rising cost scenarios since Σ . It only partially mitigates costs in the falling cost scenario. It also does nothing to avoid the potential outcome with greatest consumer detriment (unhedged SVT customers in a rising market).
37. While Option 1 leads to no benefits in a steady or rising price scenario, it will lead to an adverse impact upon competition in *all* scenarios. As noted by Ofgem, the CMA originally argued that such restrictions could limit competitive pressure: The CMA “...consider[ed] that the requirement on suppliers to make all tariffs available to both new and existing customers reduces their incentives to respond, by offering cheaper tariffs, to competition for either the acquisition or retention of customers (which, in turn, reduces the competitive pressure each supplier exerts on their rivals).”⁴ Option 1 would dampen the incentive of suppliers to offer lower priced FTC tariffs, even if the wholesale market conditions meant that there was no loss to suppliers from customers leaving SVTs (under which conditions a MSC would have no impact). It would also potentially distort the market, by favouring suppliers with fewer customers on the cap (because of the smaller cannibalisation risk).
38. It is also highly uncertain whether, even under a falling prices scenario, Option 1 will be effective in moderating FTC prices in the way that Ofgem describes. The rationale behind Option 1 is that a supplier will be less likely to offer a lower priced FTC if doing so is at the expense of revenue on its SVT base. This incentive is entirely independent of the costs of hedged SVT customers. There is no reason to expect that any increase in FTC prices brought about by Option 1 will be in line with the costs incurred when SVT customers switch away.⁵
39. Ofgem has not carried out any modelling which could quantify the incentive not to offer low priced FTCs because of the cannibalisation risk. The modelled impact of Option 1 on FTC prices (and therefore switching), compared to the other options, is instead driven by two seemingly arbitrary modelling choices:
 - a. Under all other options, suppliers are assumed to set their fixed term tariffs “based on the prevailing wholesale market prices”. We understand this relates to the price required for a “back-to-back” hedged FTC to break even.

⁴ CMA (2016) [Energy Market Investigation Final Report](#) para 9.503

⁵ From an economic perspective, the hedges that suppliers have built up for their SVT customers reflect a sunk cost that does not affect the forward-looking costs to serve new customers. There is no reason to believe that, in a competitive market, the level of this sunk cost would affect market prices.

- b. Under Option 1, Ofgem has used the historic differential between larger suppliers' FTCs and the Default Tariff Cap as a proxy for suppliers' pricing behaviour. However, the historical differentials relate to a very different market, with lower levels of price volatility, a greater number of competitors, and no rule requiring suppliers to offer all tariffs to all customers.
- 40. There is no rationale given for why the introduction of Option 1 would cause FTC prices to rise from the level implied in point (a) to the level implied in point (b) – or why this would result in minimum consumer detriment.
- 41. There is therefore a substantial uncertainty regarding whether any increase in FTC prices caused by this policy will be too little or too much, relative to the level that reflects the cost to suppliers of customers leaving SVTs. For example, some suppliers will have a greater incentive to lower their prices – this may include suppliers which currently have a low number of SVT customers relative to their total capacity to serve customers, or which believe that they are able to target the marketing of their tariffs in a way which attracts a higher proportion of external rather than internal switches. In a world of falling prices, it would only take a single supplier to offer a low-priced FTC to produce an exodus away from SVTs, in a “race to the bottom” reminiscent of the behaviour of unhedged suppliers prior to the price rises.
- 42. In general, Option 1 is more susceptible to uncertainties in the modelling than the others. One important such uncertainty is the extent to which customers will switch if FTC prices fall. For example, Ofgem has assumed that large suppliers' SVT customer base are all “long-term disengaged” with lower switching rates, even though many of these customers will have: (a) actively opted-in to an FTC deal in the past; (b) now chosen to take an SVT due to the impact of rising prices; and (c) would likely choose to move back on to an FTC if a cheaper deal became available. If these customers were to switch more than modelled by Ofgem, the resulting losses experienced by suppliers would be greater. However, under Options 2 and 3 (but not Option 1), the underestimated engagement levels of SVT customers would be mitigated by suppliers receiving greater MSC payments or exit fees.
- 43. Finally, while Ofgem has described this option as potentially complementary to the others, if exit fees or an MSC are set correctly, they would compensate suppliers for the losses incurred in a falling price scenario, and therefore no additional short-term measure would be required. An exit fee or MSC that is correctly set at the loss incurred by a supplier would not risk suppliers being unable to finance their efficiently incurred costs, and so no additional intervention would be required in the short-term.⁶

While Options 2 and 3 will both reduce the costs for consumers, Option 3 is less likely to lead to unintended consequences

- 44. Ofgem's modelling shows how both Options 2 and 3 could reduce consumer detriment under all price scenarios. However the imposition of any exit fee at this point is likely to be impractical in the short term and inferior to an appropriate MSC.
- 45. Ofgem's modelling assumes that the exit fee could be set at the same level as the MSC, which would be re-calculated every week to reflect the cost of unwinding hedges. However, this would be challenging in reality, since suppliers need to communicate exit fees to customers in advance, and in a transparent way that is capable of being understood by the consumer. A supplier seeking to set an exit fee on a fully cost-reflective basis would need to either:
 - a. announce updated exit fees to consumers from time to time, which given the lag would not reflect the costs of unwinding their hedges (but would still likely be frequent enough to confuse customers); or
 - b. set a formula for the exit fee (similar to the MSC) which would be difficult for consumers to understand.
- 46. The changes that Ofgem is considering will be introduced at relatively short notice, and will be temporary (our response to Ofgem's Call for Input describes our initial thoughts on the options

⁶ Please refer to our response to Ofgem's Call for Input regarding potential longer-term interventions.

for wider market reform). The imposition of an exit fee would be highly visible to customers, and potentially cause much confusion – particularly if further changes are made later in the year. As Ofgem acknowledges, there are also substantial questions regarding how the exit fee could be enforced. Given that there is effectively no time available to test these issues, we consider that the MSC (which does not directly impact customers) has a much lower risk of unintended consequences than the exit fees.

47. This is not to say that exit fees may not be part of the longer-term solution. As described in our response to Ofgem’s Call for Input⁷, altering the cap so the default tariff is a fixed-term contract (with an exit fee) may enable the market to be put onto a sustainable footing. Some of the other issues associated with exit fees might then be addressable (for example, in a world where exit fees are common, suppliers may in some instances find it profitable to provide one-off joining bonuses, negating the way in which an exit fee may act as a barrier for some customers to switch). However, further research with consumers and suppliers would be required to fully understand the impact of such a change.

Responses to specific consultation questions

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

48. No. As described above, there are a number of issues regarding Ofgem’s assessment of these risks.
49. First, Ofgem’s IA does not appear to consider all price scenarios (rising, falling and steady) simultaneously, for example through the expected consumer value or least worst regrets approaches described above. Given costs to consumers ultimately arise from this uncertainty, it is important for the IA to consider all scenarios simultaneously and to do otherwise would be a serious mistake of fact. Contrary to this, in its conclusion in paragraph 2.16 it states that “*On the basis of the falling price scenario alone, the case for intervention is relatively weak.*” However, it is meaningless and irrational to focus on a single scenario in this way.
50. Second, Ofgem’s current IA is inconsistent with the statutory framework more broadly and in particular with the requirement that Ofgem take proper regard of the need for suppliers to finance their activities. Under a “do-nothing” scenario, the resultant losses (made by efficient suppliers, due to the failure of the price cap to account for these risks) would need to be passed through to consumers in order to maintain compliance with the Act. This is a material omission – although as noted above even without correcting for this, Ofgem’s results suggest the need for intervention.
51. Third, what we have seen of Ofgem’s distributional analysis understates the distributional cost of doing nothing. This is due to not accounting for the distributional impact of the recent rise in prices (the customers who will benefit under a “do nothing” scenario will tend to be the same ones that benefited from the unsustainable tariffs previously offered), and not applying distributional weights to its IA.
52. Fourth, Ofgem’s competition assessment incorrectly considers the artificial increase in switching under a “do nothing” scenario with falling prices to be a sign of competition, while simultaneously understating the anti-competitive effect if the price cap means that otherwise efficient and prudent firms are allowed to make losses and fail.
53. Fifth, Ofgem’s analysis includes a number of errors, including:
- a. a “rising” price scenario that understates the risks⁸;

⁷ <https://www.ofgem.gov.uk/publications/adapting-price-cap-methodology-resilience-volatile-markets>

⁸ Wholesale prices during some periods of December, for delivery in April, were above Ofgem’s “rising” scenario, which shows it is plausible that prices could rise even higher than Ofgem has suggested, with under-hedged suppliers making even greater losses

- b. an understatement of volatility beyond April 2022 (including the possibility that prices could remain steady on average, yet volatile), which would increase suppliers' hedging costs; and
 - c. not quantifying the costs incurred if switching limits are exceeded.
54. If these areas of the modelling were amended, they would show the cost to consumers of doing nothing to be greater than in the current IA.
55. We also note that the consultation does not cover the costs associated with backwardation, and the inability of suppliers to match the 6-2-12 hedging strategy specified in the cap. These costs will also increase with wholesale volatility. In our response to Ofgem's November Wholesale Consultation, we estimated that the shortfall in the cap for backwardation costs alone in cap periods 8 and 9 would be around £ per dual fuel customer at current TDCV. The £ estimate was based on a snapshot taken as of 29 November 2021. As of 17 December, the market was showing that for winter 2022 there would be a loss to efficient suppliers arising from backwardation of around £ per dual fuel customer, which was a move of £ per dual fuel customer in 14 days. The impact of the backwardation problem is likely to be particularly severe for suppliers who took on customers from failed suppliers via the SoLR process.

Question 2: Do you believe that intervention is warranted in the interests of consumers

56. Yes. As described above (and quantified by Ofgem's IA), doing nothing would leave consumers open to significant detriment, whether prices rise or fall.

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

57. As described above, Ofgem's analysis shows that an effective Option 3 – i.e. a well-designed MSC - is likely to be most effective, and will minimise unintended consequences.
58. Restricting suppliers to offer FTCs to their existing SVT customer base – i.e. Option 1 - would do nothing to mitigate the customer losses under a rising price scenario (where Ofgem's modelling shows some of the worst outcomes), and is unlikely to be effective in a falling price scenario. The poorly targeted nature of Option 1 would nonetheless reduce competition in the market. Option 1 is also subject to greater uncertainties in Ofgem's assumptions, as described above.
59. As described above it will not be practical to set exit fees in a way which is effective. Fairness will be key to enforceability of exit fees - an exit fee must fairly and reasonably reflect the cost to the supplier, and it must also be transparent and capable of being understood by the consumer. A variable exit fee would be particularly difficult to explain, but a fixed exit fee may not fully reflect costs at any given time. It would also be risky to make an adjustment which will have such a direct impact on consumers without conducting further research and preparation (which is not possible at this time), particularly when the measure may in any event be temporary.

Question 4: For each option, are there particular benefits or risks for consumers, including those in vulnerable circumstances, that we have not identified?

60. Yes. Please refer to our responses to Questions 1 and 3 above and the rest of the document preceding.

Question 5: For each option, do you agree that we have identified the full range of expected impacts on suppliers, consumers and competition?

61. No. Please refer to our responses to Questions 1 and 3 above and the rest of the document preceding.

Question 6: Where applicable, do you agree that the draft Licence Condition text accurately implements the intervention as described?

62. As described above, we do not consider that Option 1 (and the associated Licence Condition) will address the issues that Ofgem has identified with the market.
63. Much of the detail regarding Option 3 (for example the formula used to calculate the MSC) is not embedded within the licence condition itself and instead refers to guidance issued by the Authority and the requirements of the Retail Energy Code. We expect that Ofgem will take full account of the points made in this response regarding how the policy should be specified, and we reserve the right to make further comments as updated guidance and codes are drafted.

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

64. No. As we have described above, the MSC should cover the full loss incurred by a supplier when a hedged SVT customer switches away.
- a. A key benefit of the MSC arises from the way in which \propto . Ofgem's own analysis appears to show that the biggest risks to consumers occur in the event of a price rise scenario. \propto
 - b. The Act requires that Ofgem take proper regard of the need for efficient holders of supply licences to finance their activities. As described in our response to Ofgem's November Wholesale Consultation, the Default Tariff Cap contains no provision for the losses that a supplier experiences when a hedged SVT customer switches to a cheaper FTC (and provides no allowance that would allow this risk to be managed). As a result, any losses that are not covered by the MSC would need to be recovered through an amendment to the Default Tariff Cap. It is desirable to recover these charges as far as possible through the MSC, as recovering them through the cap would lead to adverse distributional consequences, which may be exacerbated if rising SVT prices cause further customers to switch to FTCs (meaning that these costs must be recovered from a shrinking base of SVT customers).
 - c. We understand that Ofgem has proposed the parameters of the MSC by using supplier financial data to understand the point at which consumer detriment is likely to occur as a result of unsustainable supplier losses (although we have not seen the results of the modelling exercise used to assess where this point occurs). The starting point of this assessment runs counter to Ofgem's principal objective to protect consumers and its underlying duties. As we have described above, supplier losses, and therefore customer losses, will occur even if suppliers do not fail. Moreover, Ofgem's own analysis suggests that supplier failure may still occur under its proposal (given the potential cost to customers who do not switch shown in table 7).
65. Ofgem notes in paragraph A2.7 that 2 million customers are on FTCs due to expire between April and October 2022, and that this is a reason for the MSC to only correspond to a portion of the full economic loss to suppliers. However this logic is incorrect, as it ignores the unmanageable risks that suppliers face associated with the decisions of FTC customers under volatile prices. This is the same risk that suppliers were exposed to last year and led to high unexpected SVT demand costs which will need to be recovered from consumers through the price cap. This risk is not quantified by Ofgem's modelling.
66. When hedging for customers' consumption after FTCs expires, a supplier needs to make an estimate of the proportion of the customers which will revert to an SVT (as opposed to taking up a new FTC). At present, with rising wholesale prices, most customers would choose to revert to an SVT. However, as indicated by Ofgem, there is a risk that prices may fall.

67. In the event that wholesale prices will remain steady or rise, then customers currently on FTCs would move to SVTs, and so a supplier which had not already hedged this volume would suffer unrecoverable losses under the price cap. However if a supplier *did* fully hedge for these customers and prices fell and the customers moved to different FTCs, then it would be unable to recover the cost of unwinding the hedge.
68. The MSC would cover fully hedged suppliers' losses under a falling price scenario. Crucially, ✂. The application of the MSC to these customers minimises the losses that may be incurred under both falling and rising price scenarios, and therefore minimises the potential detriment to consumers. As we have noted above, it is important that Ofgem takes account of the risks of both falling and rising prices at any given time: the key issue (both for customers currently on SVTs, and those due to roll off FTCs) is volatility, which remains extremely high.
69. In addition, we expect (based both on our portfolio, and the way in which fewer customers will have switched to FTCs once prices rose last summer) that many of these FTCs are likely to expire during the earlier part of the summer period. If the MSC was reduced for all periods, ✂. This would undermine the benefits of the policy.
70. We suggest that Ofgem amends the calculation of the MSC to better reflect how suppliers hedge SVT customers under the cap. The calculation of the MSC implicitly assumes that the cost of building up a hedge for a customer is equal to a year's worth of energy, valued at the prevailing price cap wholesale price. As we have explained in previous submissions to Ofgem⁹ it is not possible for a supplier to match such a hedging strategy. For example, in order to match the price cap set for Summer 2022, suppliers would need to have fully hedged their customers through Winter 2022/23, exposing them to a risk if wholesale prices (and therefore the allowance) moves before the Winter 2022/23 allowance is set.
71. With or without the MSC, ✂.

72. ✂

73. ✂

⁹ For example, Centrica's response to Ofgem's statutory consultation on the Default Tariff Cap Appendix 2 p8; Centrica's response to Ofgem's policy consultation on the Default Tariff Cap p28; and our response to Ofgem's November Wholesale Consultation.

74. Relative to Ofgem's current approach, this would more accurately correspond to suppliers' losses and (once the sharing factor and trigger are removed) avoid any compensation due to an excessive assumed forward hedge.
75. Under this approach, the consumption weighting would also be amended each week, to correspond to the amount of current and forward cap period indexation of expected consumption as described above.
76. Under both the approach suggested above and that described in Appendix 2, more clarity is also required on how the consumption weighting term (c) will be calculated.
 - a. The consumption weighting will need to include an allowance for losses (i.e. it should relate to the amount of energy suppliers purchase for customers after losses, rather than the amount consumed before losses).
 - b. The document is unclear whether the consumption weighting is the same for every customer (it describes "*applying the typical domestic consumption values*") or is specific to a customer's expected fuel usage (it is described as the "*Estimated consumption in MWh of the fuel by the SVT customer for one year*"). It should relate to the latter, as suppliers' costs are driven by the volume of energy used by a customer. However if this is not practical, a MSC based on average consumption will still on aggregate provide the appropriate incentives and levels of compensation for suppliers.

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

77. Yes. It is necessary to publish the charge on an ex-ante basis in order that suppliers can factor it into their FTC pricing decisions.

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

78. Yes. A weekly publication appears to strike a reasonable balance between a schedule that allows the charge to follow changes in wholesale price relatively quickly, while not being so rapid as to impose an unreasonable administrative burden.

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

79. The payment mechanism will need to be set up in such a way which:
 - a. enables suppliers' obligations, based on industry switching data and Ofgem's determination of the MSC, to be calculated in a way which is timely, transparent, efficient, and robust; and
 - b. ensures that suppliers' timely payment is enforceable.
80. The detail of the payment mechanism will be worked up by a Retail Energy Code Working Group, and we reserve the right to comment on it as further information becomes available
81. However, we have no objection in principle to the use of a central body such as RECCo, providing it can meet the criteria described above. Care will need to be taken to ensure that these payments are enforceable, as the policy requires suppliers to have certainty in the receipt of these payments in order to have the necessary incentives to adjust their hedging strategy.

This may include applying an interest rate to suppliers which make payments late, and after a certain point imposing a ban on customer acquisition.