Utility Warehouse

Thursday 14 April 2022

Response to Ofgem's consultation on changes to the Market Stabilisation Charge

---

Summary

Our response emphasises six key issues Ofgem must consider before it goes ahead and implements the changes proposed in the consultation:

- There is a risk that the Market Stabilisation Charge ('the charge') could evolve and end up moving a long way from its stated aim of being a short-term market intervention
- The charge creates a fundamental risk to consumer choice and therefore competition, as it could inadvertently kill-off healthy levels of switching
- In the absence of an impact assessment with this consultation, Ofgem should stick to the cautious side of the suggested ranges: a threshold of 20% and a compensation parameter ('derating factor') of 80%
- There is no case for the charge to apply for customers switching from one price-capped Standard Variable Tariff to another, for example for better service or following a home move, meaning a further amendment is required
- Ofgem's pause on new entrants does a better job of protecting the market from the consequences of high wholesale prices
- The significant transfer of market risk from suppliers to consumers is an important issue which has been disregarded

Translating these issues into priority actions means that:

- First, if Ofgem goes ahead with changing the threshold and compensation parameters now, it should (i) stick to the cautious side of the ranges, and (ii) resist changing them again before the charge expires at the end of September
- Secondly, whilst Ofgem is considering these parameter changes, it should also tighten the eligibility criteria to ensure that the charge is targeted at the volume risk associated with cheaper **fixed price tariffs** ('fixed tariffs') returning to the market
- Thirdly, Ofgem should hold the line on the original decision that the charge will expire at the end of September

---

The key issues

<u>It must not be forgotten that the charge is a short-term intervention in a crisis</u>
The charge was designed to be a short-term market protection intervention in response to the energy crisis. It's also an intervention particularly susceptible to 'mission creep', meaning Ofgem should be alert to the risks of the charge becoming too generous to losing suppliers and/or being left in place too long.

Thankfully, it remains the case formally that the charge is to fall away at the end of September. However, the consultation is concerning because the recommendations would make implementation of the charge more likely, by lowering the threshold, and more generous to suppliers who lose customers to switching.

If Ofgem is to implement these parameter changes, based on its own modelling and considering the impact of the war in Ukraine, any further changes between now and September should be resisted.

If the charge were to be tinkered with too frequently, or if it were to endure beyond this summer, it could undermine the functioning of the retail energy market. Indeed, this consultation demonstrates that the scope of the charge could start to evolve in response to events.

It could accidentally end up, step by step, becoming a major market-changing intervention, akin the price cap. Ofgem needs to be wary of finding itself trapped in a position where the charge becomes difficult to unwind.

The fundamental risk to consumer choice

The most obvious risk to emphasise is that the charge could impair competition, or even inadvertently kill-off healthy levels of retail energy switching.

Ofgem's model assumes that the charge can still allow room for a sufficient switching incentive in fixed tariffs. At this point it's important to call out that a deliberate effect of the charge will be to dampen the switching incentive that the market would otherwise deliver. This means that in practice a lot of market power is being placed on Ofgem's model. If triggered, the charge will create substantial supplier-to-supplier cost transfers, whilst the extent to which switching is reduced is in fact unknown.

What if the 'right' level of switching incentive isn't achieved? For example, there is a credible scenario whereby the price of fixed tariffs could become stuck within a fairly narrow range below the price cap after the impact of the charge. This scenario is an example of the risk of unintended consequences and highlights why the charge cannot evolve to become more than the short-term intervention it was designed to be.

Determining the actual parameter changes from the recommended ranges

The absence of an impact assessment to accompany the consultation can be understood to a degree, given Ofgem having to work to an urgent timeframe in the crisis. However, it also emphasises the need for Ofgem to manage what is a profound market intervention carefully.

The parameter changes should be restrained to the cautious end of Ofgem's indicative range: a threshold of 20% and a compensation parameter of 80%. An adjustment more radical than this would require a higher burden of proof. In contrast, this consultation is exceptional as it runs counter to Ofgem's own best practice standard: whereby changes of significant impact should be laid out with transparent analysis.

The fixed tariffs issue: targeting the intervention to mitigate the identified risk

The charge is evidently intended to target fixed tariffs. The volume risk to suppliers' hedging positions for defaulted Standard Variable Tariff customers would be realised when wholesale prices fall to the extent that fixed tariffs become cheaper again.

The consultation confirms Ofgem's clear expectation that the charge will mitigate this risk from two sides: by compensating suppliers for a percentage of incremental hedging losses (consultation document: executive summary) and by feeding into fixed term contract prices (consultation document: distributional considerations).

It's therefore a serious oversight that the charge isn't actually designed to target *only* switches to lower-priced fixed tariffs. There is no plausible rationale for why it should also apply to customers who switch from one price-capped Standard Variable Tariff to another, which could be for any number of reasons, including a home move or in response to a supplier service failing.

In this response we are sounding the alarm about Ofgem's exposure to mission creep, as it's easy to see that the charge could evolve to become a major and enduring market intervention by accident. Whilst the parameters of the charge are open for review, Ofgem should take the opportunity to also tighten the eligibility criteria, so that it applies only to switches from Standard Variable Tariffs to fixed tariffs. A workaround could achieve this extra adjustment. The effect would be crucial, as it would limit Ofgem's market intervention to tackling only the identified risk, and lessen the potential for unintended consequences.

Revisiting the pause on new market entrants

Since the run of supplier failures witnessed at the start of the energy crisis, those remaining in the market have to an extent proved their resilience by continuing to manage the effects of high wholesale prices. The charge is designed to protect the remaining suppliers from unfair competition in an environment of falling wholesale prices. By definition this means protection from any new entrant suppliers who will not themselves be having to manage the costly legacy of the crisis.

Ofgem has previously recognised the new entrant risk to the market in its present state. In its important letter at the start of the crisis ('Rising wholesale energy prices and implications for the regulatory framework', 29 October 2021), Ofgem covered this risk with a pause on granting new supply licences, and then went on to extend that protection by a further three months ('Action plan on retail financial resilience', 15 December 2021).

Given that it is in effect providing the same market protection as the charge, it has never been properly explained why Ofgem feels it could not extend the pause on new entrants further. The charge already looks over-engineered, requiring a new and complex supplier cost transfer process to be implemented via the Retail Energy Code, and risks being subject to continuous technical adjustments.

In contrast, a longer pause on new entrants could not be more simple, requires no technical process, and could remain in place until Ofgem was confident (via the same modelling it is using for the charge) that the risk to remaining suppliers from the transition to lower wholesale prices had sufficiently passed. In its impact assessment, when available, Ofgem should make a comparison of the relative simplicity and effectiveness of the two solutions. It may show that an intervention as complex as the charge was not required after all.

The charge transfers risk from suppliers to consumers

The consultation refers to Ofgem's principal objective 'to protect the interests of existing and future consumers'. However, Ofgem seems only to be thinking about a definition of this obligation that protects consumers from further supplier failure costs. It's stark that the more immediate and literal threat to consumers' interests is disregarded. Namely, that in the absence of further supplier failures the charge is demonstrably not protecting consumers. It is instead protecting suppliers from their wholesale volume risk to a much greater extent than ever before.

There will be a risk transfer from suppliers to consumers. Consumers will in effect become responsible for 80-90% of the value of the hedges taken out on their behalf. Suppliers will enjoy the benefit of insurance against the falling value of their wholesale hedges, paid for by consumers being charged more for fixed tariffs than would otherwise be the case.

The charge will also be payable, at a level likely much greater than a normal exit fee, by consumers already on a fixed tariff, such as those wanting to switch out of an expensive fixed tariff taken out during the crisis. These fixed-to-fixed switchers will be over-compensating their suppliers by also paying the traditional exit fee on top of the charge. Analysis of the total value that consumers will end up paying, and whether that value is fair, is the most significant omission from the consultation.