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Sent by email to: Neil.Kenward@ofgem.gov.uk; Neil.Lawrence@ofgem.gov.uk; retailpolicyinterventions@ofgem.gov.uk

Non-confidential version

Dear Neil

Consultation on changes to Market Stabilisation Charge (MSC)

We welcome Ofgem's proposal to lower the threshold to trigger the MSC and increase the derating factor. Recalibrating the MSC is a logical and necessary response to the significant increase in wholesale gas and electricity prices since Russia's invasion of Ukraine. However, Ofgem's framework for setting the MSC remains flawed because it tolerates significant financial losses for suppliers who have fully hedged for SVT customers in line with the price cap methodology and Guidance, thereby ✂.

Ofgem states that it sets the MSC at a level to avoid "[e]xcessive financial stress for well-managed firms that have hedged properly"[1] and "significant supplier exits from the market"[2]. Because the increase in wholesale prices increases potential losses for suppliers, Ofgem has responded by proposing to lower the MSC threshold and increase the derating factor, but only sufficiently to avoid "excessive" financial stress and "significant" supplier exits.

It is vitally important that Ofgem changes its framework for setting the MSC. Ofgem has recognised that it is in consumers' interests for suppliers to hedge to protect against rising prices[3] and for "efficient suppliers to be able to finance their businesses"[4]. Ofgem should therefore set the MSC at a level commensurate with full hedging and full efficient cost recovery: a threshold of 0% and a derating factor of 100%.

[1] Consultation paragraph 2.12, page 15
[2] Consultation paragraph 2.6, page 14
[3] "Indeed, if the MSC is not adequately effective in the event of falling prices, it could create an incentive for suppliers to hedge insufficiently, which could lead to them being unable to manage an outcome where prices rose further." Consultation paragraph 2.4, page 13
[4] Consultation paragraph 2.6, page 14

The need to set the MSC at a threshold of 0% and a derating factor of 100% would be further demonstrated if Ofgem looked at a stress test scenario that recognises the potential for prices to fall substantially at or near the end of the price cap setting period. The financial stress test RFI does not enable Ofgem to quantify the balance sheet requirements associated with enacting a hedging policy. In a falling market, suppliers who have hedged may be required to margin (through cash or balance sheet security) their hedged position and they would be exposed to the churn consequences described below. These risks ✂.

The objectives of the MSC

The objectives that Ofgem are seeking to achieve when calibrating the MSC[5] are incompatible. Ofgem should disregard as a real benefit any gains that active consumers may make in a falling market that are an artificial product of the lag between spot wholesale prices and the hedge used to set the cap. The key parameters of competition in the energy retail market should be customer service, cost control and product innovation and delivery. These parameters are maintained when the MSC is set with a threshold of 0% and derating factor of 100%.

The effect of a 0%/100% calibrated MSC should be the same as if wholesale prices remained constant. Engagement and switching do not stop in such a scenario – 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.

There will be adverse distributional consequences if Ofgem seeks to ensure the "availability of significant savings for active consumers in a falling market" by setting the MSC threshold above 0% and the derating factor below 100%. To the extent that well managed suppliers who have appropriately hedged to protect against rising prices incur losses in a falling market, the losses will need to be recovered through the price cap. The cost per customer on the price cap would also likely be higher because of customers switching away from the cap.

Illustrative financial implications of Ofgem's proposed thresholds and derating factors

We strongly agree with Ofgem that:

1. A sufficiently effective MSC "will provide confidence for suppliers that the market is viable"[6] and "will lead to stronger investment, competition and innovation"[7].
2. "Investors are unlikely to put money into, or remain in, a sector where prices are set according to an indexation structure that assumes a certain approach to hedging, but where those hedges are stranded without sufficient mitigation in the event that prices fall from extreme high levels"[8].
3. A "stronger MSC provides suppliers with more confidence to continue to hedge in accordance with the price cap methodology and the Guidance, to protect consumers against the risk of further wholesale price rises in the current difficult environment"[9].

[5] "We consider that revised parameters in this range will better balance the availability of significant savings for active consumers in a falling market with the requirement to avoid an undue level of financial stress for well managed suppliers." Consultation page 5, penultimate paragraph.
[6] Consultation page 15, paragraph 2.15
[7] Consultation page 15, paragraph 2.15
[8] Consultation page 16, paragraph 2.17
[9] Consultation page 16, paragraph 2.18

Ofgem should calibrate the MSC at a level that is consistent with these objectives. The current calibration of the MSC is plainly inconsistent with these objectives, particularly in the context of an already loss-making energy supply sector being exposed to a series of wholesale price shocks. As our response to Ofgem's RFI on financial stress tests shows, the current 30% threshold and 75% derating factor provides minimal protection in the scenarios modelled, and the sums at stake could easily ✂.

Ofgem's proposed threshold of 10-20% and derating factor of 80-90% are however also not consistent with objectives 1-3 because they tolerate significant financial losses for suppliers who have fully hedged for SVT customers in line with the price cap methodology and Guidance, ✂. The risk of such significant financial losses is unacceptable when the supply sector is already under such severe strain. To illustrate the scale of financial losses that Ofgem tolerates using a simplistic calculation:

- If the threshold was set at 10% and wholesale prices fell to just above the trigger and a hypothetical supplier lost a million customers, that supplier would incur losses of around ✂.
- If the threshold was set at 20% and wholesale prices fell to just above the trigger on 1 May and a hypothetical supplier lost a million customers, that supplier would incur losses of around ✂.

In these scenarios – which assume that the hypothetical supplier has fully hedged for its SVT customers in line with the price cap methodology and Guidance – these efficient costs would need to be recovered through the price cap. However, a future price cap adjustment would still not ✂. Therefore, unless Ofgem is willing to provide a legally binding commitment that suppliers who have fully hedged and then incur losses will be fully compensated through the price cap, then Ofgem is compelled to set the MSC at a threshold of 0% and a derating factor of 100%.

The real risk to suppliers is more severe than the simplistic calculation above illustrates, and is only in part revealed in our response to the RFI on financial stress tests. Concerningly, Ofgem's RFI does not capture the scenario where a sudden low-priced environment well below the forecast cap couples with warm weather. The absence of this scenario – to which the customer churn risk would be additional - further suggests that Ofgem should set the MSC at a level which is fully effective (i.e. with a 0% threshold and 100% derating factor).

The scenarios in the stress test RFI also look further ahead than the MSC is currently due to be in force, and also consider the impact of basis risk. In light of responses to the RFI and developments in the wholesale market, Ofgem should urgently consider the case for extending the period when the MSC is in force.

To avoid unnecessary price cap increases and otherwise protect consumers by ensuring that a fully hedged supplier can recover their costs – which is all the more important when the sector is under such financial strain - Ofgem should set the threshold for the MSC at 0% and the derating factor at 100%. Of the specific values discussed in the consultation, clearly the 10% threshold and 90% derating factor would be more effective than the 20% and 80%. But there would be no reasonable justification under current circumstances for retaining the current parameters or moving only to the 20%/80% calibration. As discussed, Ofgem should disregard as a real benefit any gains that active consumers may make in a falling market that are an artificial product of the lag between spot wholesale prices and the hedge used to set the cap. And given that there are currently no enforceable capital and liquidity requirements or credit balance protections to ensure that supplier prices are sustainable, the case for a fully effective MSC – i.e. with 0% threshold and 100% derating factor - is all the more compelling.

We respond to the specific consultation questions in the Appendix below.

Yours sincerely

Tim Dewhurst
Director of Regulatory Affairs and Policy

Appendix – responses to consultation questions

1. **Do you agree that, in the light of the considerations above, the MSC parameters should be adjusted to increase the effectiveness of the mechanism?**

Yes. Please see cover letter.

2. **Would parameters of a trigger point in the range 10-20% and a derating factor of between 80-90%:**
    a. **achieve a reasonable balance between active customers benefitting as quickly as possible from falling prices on the one hand, and protecting all customers from the consequences of suppliers facing significant losses and/or financial distress because of the accumulated hedging positions?**

No. Ofgem should disregard as a real benefit any gains that active consumers may make in a falling market that are an artificial product of the lag between spot wholesale prices and the hedge used to set the cap. The key parameters of competition in the energy retail market should be customer service, cost control and product innovation and delivery. These parameters are maintained when the MSC is set with a threshold of 0% and derating factor of 100%.

The effect of a 0%/100% calibrated MSC should be the same as if wholesale prices remained constant. Engagement and switching do not stop in such a scenario – 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.

There will be adverse distributional consequences if Ofgem seeks to ensure the "availability of significant savings for active consumers in a falling market" by setting the MSC threshold above 0% and the derating factor below 100%. To the extent that well managed suppliers who have appropriately hedged to protect against rising prices incur losses in a falling market, the losses will need to be recovered through the price cap.

For further views, please see cover letter.

    b. **provide greater confidence to energy suppliers in appropriately hedging to mitigate risks should prices rise further?**

The 10-20% threshold and 80-90% derating factor will provide *greater* confidence for suppliers to hedge for their SVT customers in line with the price cap methodology and Guidance *than the current 30% threshold and 75% derating factor*.

However, the proposed threshold of 10-20% and derating factor of 80-90% tolerates significant financial losses for suppliers who have fully hedged for SVT customers in line with the price cap methodology and Guidance, ✂.

3. **Do you have any views as to where in the above ranges the parameters should be set?**

For the reasons explained in the cover letter, the threshold for the MSC should be set at 0% and the derating factor at 100%. Clearly if Ofgem is only contemplating the values in the ranges being consulted on, then we would favour the 10% threshold and 90% derating factor.

4. **Do you agree with our proposal to incorporate the 7-1-12 hedging price indexation profile within the MSC calculation?**

Yes.

5. **If yes, do you agree with how we propose to amend the algebra / terms of the MSC to reflect the 7-1-12 indexation approach?**

The proposal seems to make sense but it is very difficult to tell whether it is accurate because Ofgem has not provided the model.

More generally, we find Ofgem's methodology and formulas to be extremely complicated and therefore difficult to follow and replicate. For example, we reach a slightly different result when calculating the cost of selling back hedges. Ofgem may also use some approximations but it is difficult to say for sure.

6. **Do you agree with our proposal to incorporate electricity losses and UIG within the MSC calculation?**

Yes.

7. **If yes, do you agree with how we propose to amend the MSc calculation MSC to account for electricity losses and UIG?**

Yes.