

Maureen Paul
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Ofgem
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Dear Maureen,

CONSULTATION ON CHANGES TO MARKET STABILISATION CHARGE

We are pleased to respond to your consultation on changes to the Market Stabilisation Charge (MSC).

The consultation sets out proposals to:

- Change the parameters that dictate the conditions under which the MSC is triggered and the level of lost revenue that the losing supplier will recover via the MSC; and
- Technical changes to the MSC calculation to reflect the 15 March 2022 announcement relating to the wholesale price indexation in the Default Tariff Cap and to take account of electricity losses and unidentified gas (UIG).

We continue to believe that an MSC offers the best overall prospects of mitigating the risks of sharp falls in wholesale market prices and delivering consumer benefit. The MSC must represent a meaningful proportion of the losing supplier's economic losses - which the current version does not. Based on the current methodology of the MSC, and the proposals being consulted on, parameters at the top end of Ofgem's proposal (10% decrease in wholesale costs for the trigger of the MSC, and a 90% derating factor) should give additional confidence to suppliers and their investors in both a rising and falling market given the high level of uncertainty and risk for suppliers. This additional confidence also has longer term implications for the energy market and consumers.

Notwithstanding the urgency of implementing reform, it is vital that Ofgem's proposals are subjected to meaningful scrutiny and challenge from suppliers and the process is fully transparent; we do not believe that the process to date has met this test. It is important that Ofgem commits to a clear set of milestones in relation to this proposed reform, and builds sufficient time into the process for fully engaged and informed consultation, and gives consideration to sharing relevant data with stakeholders.

In this regard, we note that without further action from Ofgem, the current licence conditions would only retain the MSC until the end of September 2022. Since the decision was made to implement the MSC, market conditions have changed significantly from what might have been expected when Ofgem was consulting on the MSC. Notably, we consider this could likely mean that the need for the protection of the MSC would extend past the end of September 2022 into Winter 2022/23 and (depending on the option chosen for medium term reform) Summer 2023. We therefore think that Ofgem should be taking action now to extend the MSC for a further six months.

Ofgem should also engage with stakeholders to consider whether it should consult on any other changes to the MSC, including technical changes to set the threshold that triggers the MSC from a percentage decrease in wholesale costs to an absolute threshold. Our experience of customer behaviour suggests that switching decisions are triggered by an absolute saving rather than a percentage, with anecdotal evidence suggesting customers will generally switch for a saving of greater than £50 in annual bill value. If the MSC is to apply for longer than one price cap period, which we strongly suggest is the case, then we think it is important that the trigger point is set in a manner that allows the MSC to do the job it has been designed to do. In using a percentage decrease trigger, depending on the level of the wholesale cost, we could see a situation where most consumer switching has taken place before the MSC is triggered, and therefore where losing suppliers are unprotected from the losses.

If you would like to discuss any aspect of our response, please do not hesitate to contact me.

Yours sincerely,



Richard Sweet
Head of Regulatory Policy

**CONSULTATION ON CHANGES TO MARKET STABILISATION CHARGE –
SCOTTISHPOWER RESPONSE**

Introduction

We welcome Ofgem reviewing the MSC and proposing changes to ensure it delivers the protections to suppliers it is intended to, should wholesale energy costs fall sharply from their current highs. We set out in this annex our answers to the questions posed in Ofgem's consultation document.

We consider that Ofgem's review has not gone far enough and it must also consider whether it should extend the MSC past the September 2022 end date currently set within the licence conditions. With the potential for market prices to remain higher for longer and with the crisis in Ukraine ongoing, we think it likely that the MSC will be needed for the winter period and potentially beyond.

We also consider that Ofgem must consult on further changes to the MSC to ensure it is robust to wholesale volatility and does not fail to deliver the expected benefits by creating risk that it is triggered too late to protect suppliers from losses as a result of significant customer switching from SVT to fixed term tariffs. We consider there is a real risk that this could happen if the trigger threshold remains as a percentage rather than an absolute decrease. Industry experience suggests that a saving of c. £50 in annual bill value should generally be sufficient to trigger a customer to switch. Depending on the level of wholesale costs, maintaining a percentage decrease as the trigger for the MSC could result in a situation where the majority of customer switches take place prior to the MSC being triggered, resulting in significant losses to suppliers with no recovery via the MSC.

We therefore think it important that in its continued monitoring of the MSC, alongside the assessment of the current trigger points, Ofgem assesses the need to extend the MSC and review the methodology to ensure the measure delivers the policy intent it was designed to achieve.

We recognise that Ofgem is consulting on changes to the MSC to reflect other policy developments that impact on the calculation of the MSC, notably the changes to the wholesale cost allowance within the Default Tariff Cap. We would highlight that there are a number of other changes that Ofgem is considering at the moment that could potentially impact on the MSC calculation if it is extended past the end of September 2022. It is important that Ofgem continues to consider the potential for amendments to be needed to the MSC methodology and consults on any necessary changes.

Chapter 2: Changes to market stabilisation charge parameters

Q1: 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. We highlighted in our response to Ofgem's January 2022 statutory consultation the need for the parameters proposed by Ofgem to be adjusted to ensure that the MSC provided a meaningful protection to suppliers if wholesale prices fall significantly. The parameters proposed by Ofgem were too low to be effective in any circumstances and

this ineffectiveness is now even more of an issue due to the challenges presented by the crisis in Ukraine. We therefore welcome Ofgem addressing this.

If Ofgem takes no action, we consider there is a real risk that suppliers will experience significant losses in the event that wholesale markets fall. This will continue to place significant financial risk on suppliers who remain in the market and, as Ofgem suggests, may lead to further exits from the market. In addition, as mentioned above, we believe the MSC should be extended beyond September 2022.

We consider that Ofgem must set the parameters at the top end of each range, ie 10% decrease in wholesale costs for the trigger of the MSC, and a 90% derating factor. This is essential to ensure that the regulatory framework can provide suppliers and investors with confidence that losses that are efficiently incurred can be recovered.

Q2: 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? And**
- b) **provide greater confidence to energy suppliers in appropriately hedging to mitigate risks should prices rise further?**

This question is answered in our response to Question 3 below.

Q3: Do you have any views as to where in the above ranges the parameters should be set?

We consider the current parameters are insufficient and would provide little to no protection to suppliers if wholesale prices were to fall significantly. We held this view prior to the impact on prices of the crisis in Ukraine, and consider that the crisis serves to emphasise the need for Ofgem to make significant amendments to the parameters to ensure that suppliers are protected from significant losses.

We believe that in setting the current parameters, Ofgem gave undue weight to enabling active customers to benefit as quickly as possible from falling prices. Active consumers have benefitted before this recent crisis from product prices below the default tariff cap, indeed some of which were set unsustainably low. The costs that resulted from this are spread across all customers. Ofgem's priorities only appear to be to reduce supplier market exits rather than responding to the need to ensure that suppliers can finance their licensed activities.¹ Indeed, an MSC set with a 10% trigger and a 90% derating factor would still maintain incentives to switch² albeit somewhat reduced.

We consider that there may be an argument for Ofgem to set the parameters above the range currently proposed. However, as a minimum, we consider Ofgem must set the value to recover a meaningful proportion of a losing suppliers economic losses, and therefore it should set the values at the top end of Ofgem's proposal (10% decrease in wholesale costs for the trigger of the MSC, and a 90% derating factor). This should give some additional comfort to suppliers and their investors in respect of the high level

¹ Domestic Gas and Electricity (Tariff Cap) Act 2018 Section 1(6) (b) and (d).

² cf s1(6)(c) of the Act

of risk they currently face in both a rising and falling market. This additional confidence has longer term benefits for the energy market and consumers.

Chapter 3: Amending MSC calculation to reflect guidance on price indexation

Q1. Do you agree with our proposal to incorporate the 7-1-12 hedging price indexation profile within the MSC calculation?

Yes, we agree that Ofgem should amend the calculation of the MSC to ensure it aligns with the hedging indexation profile of the Default Tariff Cap wholesale allowance.

Q2. 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?

Without a worked example showing Ofgem's proposed approach to amending the methodology, it has been difficult for us to review the proposal in the short timescales provided by Ofgem's two week consultation period (which coincides with a particularly busy period for the relevant teams). So, while our initial review suggests that Ofgem's proposed amendments seem sensible, we may have further comments once we have been able to fully review the proposals. As noted above, it would be helpful if Ofgem could provide a worked example of all the proposed technical changes to support suppliers in reviewing the proposed changes.

Chapter 4: Adjustment to reflect losses in the MSC

Q1. Do you agree with our proposal to incorporate electricity losses and UIG within the MSC calculation?

Yes, we agree with the proposal to incorporate electricity losses and UIG into the MSC calculation. We agree with Ofgem that the alternative to "do nothing" is not appropriate as the methodology for the MSC would provide suppliers with a payment based on consumer energy usage, not taking into account that the energy purchased and therefore the cost, is greater to account for lost energy.

Q2. If yes, do you agree with how we propose to amend the MSC to account for electricity losses and UIG?

We think Ofgem's approach to amending the MSC calculation is appropriate for the current MSC calculation noting the benefits of a more simplistic approach where losses do not vary much across different customer types and locations. We note Ofgem's statement (paragraph 4.9) that it may review the electricity and gas uplift values as part of any wider review of the MSC. We agree that this will be needed, particularly if, as we strongly suggest, Ofgem extend the MSC past the end of September 2022.

ScottishPower
April 2022