

Maureen Paul
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Ofgem
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18 July 2022

Dear Maureen,

CONSULTATION ON EXTENDING SHORT-TERM INTERVENTIONS AND ADJUSTING MSC CALCULATION

We are pleased to respond to your consultation on extending the short term interventions and adjusting the Market Stabilisation Charge (MSC) calculation.

The consultation sets out proposals to:

- Extend the MSC to 31 March 2023 including the potential to taper the parameters from January 2023; and
- Amend the MSC calculation to account for the changes to indexation as a result of the possible move to a quarterly cap.

Ofgem has also set out its intention to extend the Ban on Acquisition only Tariffs (BAT) to March 2023 including seeking views on whether this should be an enduring feature.

Extending the MSC

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. Market conditions mean that there is a continued need for the protection of the MSC. Even if we move to a quarterly cap, the market prices in the observation window can be significantly out of step with the present day market prices, resulting in volume risk. We therefore agree with Ofgem's proposal to extend the MSC past the end of September 2022 into 31 March 2023 and believe this mechanism should be enduring. Even with the MSC there remains an incentive to switch, since the current MSC is set with a 10% trigger and an 85% derating factor. The MSC gives 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 positive longer term implications for the energy market and consumers. Ofgem should monitor the effectiveness of the MSC when it is triggered in the future to make further decisions about its enduring suitability.

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. 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. We also consider that there remains a strong case to increase the de-rating factor higher than 85%.

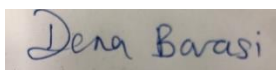
We agree that Ofgem should amend the calculation of the MSC to ensure it aligns with the hedging indexation profile of the Default Tariff Cap wholesale allowance

Extending the ban on acquisition tariffs

Ofgem should be mindful of the lessons from its decision in 2009 to introduce SLC 25A prohibiting regional price discrimination. This intervention was made in response to political pressure, was widely criticised by economists, and was found by the CMA to have likely had the effect of softening competition.¹ Although the ban on acquisition tariffs targets a different form of discrimination, similar difficult economic trade-offs arise. We supported its introduction as a temporary measure in response to a crisis within the industry, and would support its extension to March 2023. In principle, depending on the strategic direction of the retail market including the price cap, we may be supportive of an enduring BAT, but we believe that proper deliberation, including a full policy consultation and a robust impact assessment are required before such a decision is made. In any event, if the BAT is to be extended, whether temporarily or permanently, Ofgem should draft a new licence condition that appropriately ringfences retention only tariffs offered to existing customers only, as well as being fit for purpose in a future retail market with time of use tariffs.

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

Yours sincerely,

A handwritten signature in blue ink that reads "Dena Barasi". The signature is written in a cursive, slightly slanted style.

Pp Richard Sweet
Director of Regulatory Policy

¹ CMA Energy Market Investigation, Final Report, 24 June 2016, para 11.139

**CONSULTATION ON EXTENDING SHORT-TERM INTERVENTIONS AND
ADJUSTING MSC CALCULATION – SCOTTISHPOWER RESPONSE**

Introduction

We welcome Ofgem’s consultation on extending the MSC and BAT past the September 2022 end date currently set within the licence conditions. There is potential for market prices to remain higher for longer and with the crisis in Ukraine ongoing, we think it likely that these measures will be needed for the winter period. We also think that beyond the winter, these interventions remain appropriate to reduce the still very high volume risks for suppliers in the market even if the quarterly cap is introduced.

We welcome consideration of the BAT and MSC together. A BAT arguably should go hand-in-hand with an enduring MSC. In the absence of this, new entrants could still take advantage of periods of lower wholesale prices to launch land grabs for customers (since they do not have an existing customer base to concern themselves about), at the expense of existing suppliers who would be stuck with higher cost energy.

In principle, depending on the strategic direction of the retail market including the price cap, we may be supportive of an enduring BAT, but we believe that proper deliberation, including a full policy consultation and a robust impact assessment are required before such a decision is made. Further, an enduring BAT would need a redrafted licence condition to ensure it is fit for purpose and does not require widespread derogations. We discuss our views on this in more detail below.

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 possible move to a quarterly cap. 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: Extension of Market Stabilisation Charge

Q1: Do you agree that MSC should be extended to 31/3/2023?

Yes. We highlighted in our response to Ofgem’s April 2022 consultation “Changes to the market stabilisation charge” the need for an extension beyond September 2022.

We continue to consider this is the case and believe Ofgem should keep the situation under review including the need for a new licence condition that would be required to extend the MSC further or introduce an MSC on an enduring basis.

Ofgem has recognised that *“in the current market environment, appropriate hedging carries significant risks should wholesale prices fall”*. We contend that this is the case in all market environments. Whilst the quarterly cap (if introduced) reduces the volume risk relative to a 6 monthly cap, we believe that when market prices fall, supplier losses could still be considerable, including from customers switching to new market entrants. These risks are real and, in the absence of measures to mitigate the risks, suppliers will have reduced confidence to hedge for their customers. The MSC deadband ensures that the MSC does not come into effect during normal market conditions and only kicks in when needed. We therefore urge Ofgem to make the MSC an enduring

solution. This would help to ensure that the price cap works in varied market conditions, and does not, as the current price cap has, break down when there is volatility. It would address some of the remaining volume risk² associated with any quarterly cap introduced, and would, we believe maintain incentives to switch.

In addition, we believe the MSC should be based on an *absolute decrease* in the wholesale price. 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. 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. 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.

Q2: Do you have any further comments on the analysis and reasoning presented?

We note that Ofgem has considered the value at risk to measure the scale of the issue. At a high level, the value at risk increases when market prices increase as well as when SVT customer numbers increase. Ofgem has used the value at risk from the 1 April decision as a benchmark and considered the forecast levels relative to this. As noted above, the type of hedging considered appropriate by Ofgem carries significant risks should wholesale prices fall in any market environment. We do not know the extent to which Ofgem will use the same value at risk methodology in the future and how it will use a benchmark to consider what is “too high”, but we do not think it is appropriate to include this to decide on MSC since:

- the value at risk measure is crude and requires a benchmark to be selected to be able to judge the severity against;
- the 1 April is not a well-considered benchmark to measure the severity of the issue against; and
- this approach does not take into account that different companies have different percentages of SVT customers.

The NoCo approach, if used, must take into account all relevant costs and benefits.

Chapter 3: Technical Adjustments

Q1. Do you agree with our proposal to incorporate the Transitional Indexation Approach 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.

² A ban on acquisition only tariffs does not help in this area since new entrants could still take advantage of periods of lower wholesale prices to launch land grabs for customers (since they do not have an existing customer base to concern themselves about)

Q2. If yes, do you agree with how we propose to amend the algebra / terms of the MSC to reflect the Transitional Indexation Approach?

We welcome the attachment provided but would have appreciated a fully worked example showing Ofgem's proposed approach to amending the methodology. Without a worked example it has been difficult for us to review the proposal. Whilst 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. We would welcome Ofgem's commitment to provide worked examples.

Chapter 4: Ban on acquisition-only tariffs (BAT)

No questions were asked in this chapter but we set out our views below.

In the February Decision, Ofgem considered that the BAT would reduce the incentive on suppliers to cut prices very aggressively in a time of market turmoil and that this in turn would help mitigate to some extent against major supplier financial losses leading to significant costs for consumers from disorderly supplier exits and longer-term negative impacts on investment, innovation and competition. This is the case when there is limited market entry, but a BAT does not protect existing suppliers from a new supplier entering the market and pricing very low to win customers (land grab). It is for this reason that we consider that the MSC is necessary as an enduring solution, with sufficient protection triggered during periods of market turmoil.

In this consultation, Ofgem considers that there may be benefits of introducing the BAT on an enduring basis, not just restricting it to times of market turmoil. Ofgem includes:

- the ability to limit price discrimination by suppliers; and
- addressing the perceived loyalty penalty.

In our cover letter we note that the BAT was found by the CMA to have likely had the effect of softening competition. Whilst Ofgem may consider, at a later date for example when there is no price cap, that the potential impacts on competition are justified (for example, that some form of ban on acquisition tariffs could address risks of a loyalty penalty), we would expect this to be the result of a well-considered holistic strategic strategy and would be subsequent to a full policy consultation and a robust impact assessment. In any event, if the BAT is to be extended, whether temporarily or permanently, Ofgem should consult on a new licence condition which addresses the policy intent with no unintended consequences as is currently the case under SLC 22B which currently requires a current market wide derogation for tariffs targeted at existing customers only. Any new enduring licence condition should appropriately ringfence tariffs for existing customers only, including tariffs for the purpose of customer retention or those innovative time of use tariffs so there is no need for a derogation process.

ScottishPower
July 2022