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30 December 2022

Dear Maureen

STATUTORY CONSULTATION ON EXTENDING THE MSC AND BAT BEYOND 31 MARCH 2023

We welcome the opportunity to respond to Ofgem's statutory consultation on extending the Market Stabilisation Charge (MSC) and Ban on Acquisition Tariffs (BAT) beyond 31 March 2023. Our answers to the consultation questions are in Annex 1 attached.

We welcome the proposal to extend the BAT and MSC until 31 March 2024, with powers given to Ofgem to renew either or both measures beyond that date on an annual basis, where required, by publishing a statement to that effect. This will be essential to maintain market stability, give suppliers the confidence to hedge efficiently and protect consumers from the risks of supplier insolvencies. However, we have the following concerns:

- Ofgem says it intends to retain the existing power to terminate the MSC early by publishing a statement to that effect. Given the reliance that suppliers place on the MSC for their hedging decisions, it is essential that Ofgem gives sufficient notice of any such termination, and we believe it would be good regulatory practice for Ofgem to consult ahead of the termination decision.

- Ofgem states (paragraph 2.4) that the MSC ensures that suppliers are compensated for a large portion of their losses from stranded hedges. In fact, with current parameters the compensation may often be a relatively small proportion of economic losses. For example, the MSC does not compensate suppliers for non-recovery of allowances. We welcome Ofgem's confirmation that it intends to bring forward a review of MSC parameters and methodology early next year (to include consideration of an absolute (£/MWh) rather than a percentage trigger, and inclusion of relevant price cap allowances), and that it is targeting Tuesday 4 April for any new MSC parameters or methodology to come into effect.

- Ofgem says (paragraph 2.27) that it does not consider the MSC to be a suitable mechanism to be an enduring part of the regulatory framework, and that the MSC will only be retained for so long as it is necessary in the interests of consumers. We think the adverse impacts of the MSC on competition have been overstated and Ofgem should not rule out retaining the MSC for the longer term, so that it is there in reserve should market instability return. If, as Ofgem suggests, alternative lighter touch measures can achieve the same effect, we agree that that they may be preferable.

- We would suggest that Ofgem's powers to extend the BAT annually beyond 2024 should be made contingent on Ofgem having carried out (and consulted on) a more thorough review of the BAT.

Yours sincerely,

Richard Sweet
Director of Regulatory Policy

Annex 1

STATUTORY CONSULTATION ON EXTENDING THE MSC AND BAT BEYOND 31 MARCH 2023 – SCOTTISHPOWER RESPONSE

Question 1: Do you agree that Ofgem should modify supply licence standard conditions SLC 24A and 22B so as to maintain powers to operate the MSC and the BAT until 31 March 2024, with powers given to the Authority to renew this annually?

We welcome Ofgem's proposal to modify the licence conditions SLC 24A and 22B to extend the MSC and BAT until March 2024, with powers given to the Authority to renew this annually. The market continues to be volatile and suppliers remain at significant risk should prices either rise or fall. Our thoughts on the MSC and BAT extensions are explained below:

MSC

In our response to the August decision on extending the MSC and BAT to March 2023, we argued that the parameters and thresholds of the MSC require urgent reconsideration. Ofgem states (paragraph 2.4) that the MSC ensures that suppliers are compensated for a large portion of their losses from stranded hedges. In fact, with current parameters and methodology, the compensation may often be a relatively small proportion of economic losses and may fail to provide the stability and hedging confidence that is intended. We believe the parameters should be further strengthened, the percentage threshold should be replaced by an absolute £/MWh threshold, and the methodology should be extended to included economic losses relating to non-recovery of deferred price cap allowances (backwardation, unexpected SVT, BSUoS transition).

We welcome Ofgem's confirmation[1] that it intends to bring forward a review of MSC parameters and methodology early next year (to include consideration of an absolute (£) rather than a percentage trigger, and inclusion of relevant price cap allowances), and that it is targeting Tuesday 4 April for any new MSC parameters or methodology to come into effect. It is essential that Ofgem proceeds promptly with this review and achieves this implementation date.

BAT

The BAT targets price discrimination between potential and existing customers, preventing suppliers from offering acquisition-only tariffs. We believe the BAT can augment the MSC in the near term, but we would note that the CMA identified significant consumer detriment from other interventions (such as SLC 25A) which were intended to constrain discrimination. We believe Ofgem should be cautious about extending the BAT indefinitely and should not do so without careful assessment of the impact on competition. In the current context for example, we believe the BAT could have a negative effect on market stability if prices fall and new suppliers enter the market who do not face the same backwardation or other costs as incumbents do.

Further, we suggest Ofgem draft a new licence condition that appropriately ringfences retention-only tariffs offered to existing customers only. In future consultations, Ofgem should also consider the BAT's impact on innovative time of use tariffs, which we believe will be a feature of the future retail market.

[1] At the Regulatory Directors Forum on 30 November 2022

We would suggest that Ofgem's powers to extend the BAT annually beyond 2024 should be made contingent on Ofgem having carried out (and consulted on) a more thorough review of the BAT.

Question 2: Do you agree that this should continue to include, in the case of the MSC, the existing power for the Authority to terminate it early?

Market events may lead Ofgem to believe that the MSC should be terminated early - we are aware that the MSC can have a limiting effect on switching, as the charge will constrain suppliers' ability to offer aggressively priced products. However, we believe the MSC's adverse effect on competition has been overstated; we agree with Ofgem that the introduction of the Energy Price Guarantee (EPG) has its own limiting effect on competition that dampens that produced by the MSC. In future, we can see a revised MSC being retained in the long term, either as an active policy or as one kept in reserve if market instability should return.

We believe that the power to terminate the MSC early should be subject to consultation or at least be subject to guidance as to what would constitute appropriate circumstances, and, if invoked, should be done so with enough notice so as not to impact on already hedged volumes for the following cap periods. Ofgem's recent meetings with energy suppliers have highlighted how it no longer views switching levels as an end in and of itself or as proof of competition. We hope Ofgem will use a more sophisticated approach to analyse market competition and the impact of terminating the MSC early on supplier finances, which could result in market exit and ultimately consumer costs. This approach, and the grounds for possible MSC termination, should be communicated formally with suppliers.

Ofgem has also suggested that it need only publish a statement to the effect of terminating the MSC before it ends the measure earlier than anticipated. We ask how Ofgem expects this level of notice to impact suppliers, especially as regards their confidence in hedging appropriately. Ofgem is under significant political and societal pressure to reduce bills and we therefore fear that if Ofgem has the ability to terminate the MSC without adequate notice and consultation, suppliers' confidence to hedge will be impacted with consequent potential for increased consumer cost.

Question 3: Do you have any comments on the proposed drafting of the changes to the supplier licence standard conditions?

We have no comments on the drafting of the changes beyond our suggestion that Ofgem redraft the BAT licence condition to avoid the need for the derogation process (see our response to Question 4 below).

Question 4: Do you agree that we should extend the market-wide derogation from SLC 22B for fixed retention tariffs?

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 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.

Question 5: Do you have any comments on the analysis presented in section 2?

We agree with Ofgem's analysis regarding the need for market stabilisation measures. Suppliers continue to face significant risks if energy prices rise, where they will experience a time lag between price cap periods before costs are recovered, or if prices fall, where they face the downside risk of stranded hedges if customers choose to switch. The MSC and BAT help reassure suppliers to continue hedging appropriately, even before they are triggered, as they reduce suppliers' exposure to falling prices.

Ofgem continues to use the Value at Risk (VaR) metric as a primary indicator of market stability. The market VaR has risen from £8.5 billion in the April 2022 decision to a worst case projection of £49.6 billion in December 2023. This suggests that the MSC and BAT should be extended for the same reasons that they were implemented in April. However, we would encourage Ofgem to explore other tools for assessing market stability and to clarify how it intends to conduct market assessments in future extension decisions. For example, it would be useful to understand Ofgem's thinking around other indicators such as the Tolerable VaR indicator suggested in the August decision.

As noted above, we believe the adverse impacts of the MSC on competition have been overstated and Ofgem should not rush any decision to remove the MSC, not least because in stable market conditions its only impact is to increase suppliers' confidence in hedging. We think Ofgem is right to make any decision to remove the MSC contingent on implementing alternative less intrusive measures that can achieve the same effect. In this context, we agree that exit fees on SVTs would raise difficult distributional issues at present, as the exit fees could prevent poorer customers making switches that would be beneficial to them in the long run. However, recent Government interest in the idea of a social tariff could potentially provide a way forward here, depending on what form it takes. If exit fees were charged on normal SVT but not on the social tariff version of SVT, this could substantially mitigate the distributional issues.

Question 6: Do you have any comments on the draft impact assessment presented in section 3?

Ofgem has repeated the exercise of its August 2022 decision and uses the example of a notional supplier (NoCo) to illustrate the effects of the MSC. As such, many of the points we raised in our response to the August decision still stand. Although we agree with the assessment that the large VaR figures demonstrate a *prima facie* case for extending the MSC, the NoCo modelling is likely to overstate the beneficial impact of the policy because consumers are likely to switch before the percentage trigger is activated. This follows from the large group of engaged customers on the SVT and the potential for a rebound effect of any price decrease due to the greater awareness of energy price coverage in the media. As noted above, we believe the increased likelihood of consumer switching merits a reassessment of the MSC's parameters and thresholds through Ofgem's upcoming consultation.

We are concerned about how Ofgem will assess the NoCo modelling in future. Ofgem has used the VaR metric as its primary indicator, often referring to the £8.5 billion figure estimated in April 2022, yet it has not clarified the relationship between its MSC decisions and the total level of VaR. We ask whether Ofgem plans to use the April figure as a baseline for future decisions or if it plans to consult with suppliers on ideas for a minimum acceptable VaR level. Further, we wish to understand how Ofgem will consult on the MSC's parameters to leave the NoCo within its EBIT range. We are aware this is subject to the ongoing EBIT consultations, but we highlight that market investors will expect policy to reflect a reasonable rate of return. The MSC's parameters should be designed to leave NoCo at the top of its EBIT range, since that is what would be expected of an efficient suppler.

ScottishPower
December 2022