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Dear Daniel

MARKET STABILISATION CHARGE ACTIVATION

We welcome the opportunity to respond to Ofgem's consultation on activating the Market Stabilisation Charge (MSC). Our answers to the consultation questions are in Annex 1.

We support activation of the MSC. Ofgem's analysis identifies a credible risk that high and volatile wholesale prices, larger winter hedge volumes and a growing population of customers on standard variable tariffs could expose responsibly hedged suppliers to material losses if wholesale prices fall sharply and customers switch in significant numbers. An active MSC would reduce that risk, support continued prudent hedging and protect consumers from the wider costs of market instability.

However, the proposed design does not adequately reflect the economic losses that can arise when customers leave the price cap. In particular, we continue to believe that:

- the trigger should be expressed as an absolute £/MWh threshold rather than a percentage of wholesale costs;
- the 10% trigger and 85% sharing factor should be reviewed against current evidence on customer responsiveness, supplier profitability and the scale of potential stranded hedge losses;
- activation and deactivation decisions should be supported by transparent criteria, consultation and sufficient notice to support suppliers' hedging and commercial decisions;
- the impact assessment should test a wider range of switching, price and timing scenarios, including switching before the proposed trigger is reached.

Our own high-level scenario analysis illustrates this concern. Under an illustrative scenario involving a 15% wholesale price fall and switching broadly aligned with Ofgem's central assumptions, the MSC would mitigate less than one third of the estimated gross

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stranded hedge loss. Although the results are, as ever, sensitive to the assumptions used, they demonstrate why prompt activation should be accompanied by early review of the trigger, sharing factor and scenario analysis.

We have supported the MSC since its introduction in 2022 because it corrects an asymmetry under which suppliers are expected to hedge responsibly for price-cap customers while those customers retain a cost-free option to leave if wholesale prices fall. We previously argued that the original parameters risked providing too little protection, too late, and failed to recognise relevant price-cap costs outside the wholesale-cost comparison. This remains the case.

We therefore support prompt activation, but ask Ofgem to commit to an early, evidence-led parameter review and to make the targeted improvements set out in this response. Prompt activation need not prevent Ofgem from correcting design weaknesses once the measure is in force.

Please do not hesitate to contact me if you would like to discuss this response.

Yours sincerely,



Richard Sweet
Director of Regulatory Policy

Annex 1

MARKET STABILISATION CHARGE ACTIVATION – SCOTTISHPOWER RESPONSE

Question 1: Do you have any comments on Ofgem's description of the current market context?

We broadly agree with Ofgem's description. High and volatile wholesale prices, the prospect of rapid movements in either direction, larger winter hedge volumes and the increased proportion of customers on SVTs together create a credible risk of significant stranded hedge losses. The analysis also correctly recognises that suppliers face other concurrent pressures, including deferred allowance cash-flow effects, bad debt and weather-related demand risk.

We particularly agree that the relevant risk cannot be assessed solely by reference to current prices. The critical scenario is a further increase in wholesale prices followed by a rapid fall while suppliers are holding substantial hedges and while a large group of recently engaged customers is on price capped SVT tariffs. Activation decisions must therefore be forward-looking. Waiting for the fall to begin would undermine the purpose of the mechanism.

However, Ofgem should place greater weight on the speed and non-linearity of customer response. In 2022 we argued that a large group of engaged customers on SVTs could switch quickly in response to savings below the existing percentage trigger. That concern remains relevant. Recent customer movement onto SVTs may increase the pool of customers able and willing to re-engage, while the sustained prominence of energy prices is likely to make customers more responsive to emerging savings.

Ofgem should also distinguish more clearly between capital resilience and the efficient allocation of regulatory risk. Requiring suppliers to hold capital does not make it efficient to expose that capital to an uncapped risk created by the interaction of mandatory/default-tariff hedging expectations and customers' ability to leave their supplier without bearing the costs caused by that decision. Capital requirements and the MSC are complementary, not substitutes.

Question 2: Do you agree that Ofgem should activate the MSC?

Yes, we support prompt activation. The MSC is a targeted response to a specific market asymmetry. A supplier serving price capped customers is expected to hedge in advance. If wholesale prices rise, that hedge protects customers and the supplier. If wholesale prices fall sharply, customers can move to cheaper tariffs while the supplier remains exposed to losses on energy bought for them. In ordinary markets, a firm might manage this risk through contractual cost-reflective exit charges, repricing or restrictions on accepting customers. Those options are constrained in domestic energy supply, notably by suppliers' inability to impose any exit charge on SVT customers.

An MSC partly aligns switching-related costs with the transactions that give rise to them, rather than leaving those costs with the losing supplier or socialising them through a later market intervention. It therefore supports both market efficiency and distributional fairness, while still preserving savings from switching because it mitigates only part of the relevant loss.

Activation also provides an *ex ante* benefit by supporting confidence to hedge. That benefit exists even if the charge is never triggered. Avoiding activation could encourage suppliers to hedge less in order to manage falling-price exposure, increasing risks if prices rise further.

The relevant comparison is therefore not between an MSC and a costless status quo; non-activation changes supplier incentives and creates its own consumer risks.

The current market environment presents materially higher levels of wholesale price risk than have existed for some time. Given the uncertainty surrounding future wholesale price movements, we consider it prudent that Ofgem is proposing to activate the mechanism before conditions deteriorate rather than waiting for substantial customer switching or supplier losses to materialise. The effectiveness of the MSC depends critically on timeliness. The mechanism is most valuable when it acts as a preventative safeguard rather than a reactive intervention after customer movements have already occurred.

Ofgem says (paragraph 4.36) that "*As part of considering a pessimistic scenario, the upper bound on losses would be in the situation where market backwardation was eliminated*." However, it is not obvious that elimination of backwardation represents the true upper bound of plausible supplier losses. Losses could be greater if wholesale prices decline materially below current spot prices and the market moves into contango. This raises the question as to whether Ofgem's analysis of the pessimistic scenario is intended to represent a maximum plausible loss under current market conditions or merely the loss associated with removal of the existing backwardation premium. Consistent with an agile and evidence-led approach, Ofgem should test a broader range of price paths rather than treating the removal of the current backwardation premium as the maximum plausible downside.

Finally, our support for prompt activation should not be treated as an endorsement of the existing parameters. Ofgem should activate now and undertake an expedited review of the trigger, sharing factor and treatment of deferred allowances (see our response to Question 4) to assess whether they provide sufficient protection in the adverse scenarios for which the MSC is intended.

Question 3: Do you have any comments on Ofgem's proposed MSC guidance?

The draft guidance is generally clear on the calculation and administration of the MSC. We support weekly publication of separate gas and electricity charge values and the commitment to consult before revising the methodology or key parameters.

The guidance should nevertheless be strengthened in three areas:

a) It should remove any ambiguity in the qualifying-loss formula and ensure all symbols used are defined consistently. In particular, the formula should be checked for legacy terms that may no longer be required under quarterly indexation.

b) It should state the evidence and tests Ofgem will use when considering parameter changes, including customer switching, supplier hedging positions, deferred allowances, profitability and market concentration.

c) It should include a clear correction process for data or calculation errors, including the treatment of payments already invoiced and a commitment to notify suppliers promptly.

Ofgem should also publish worked examples across different points in the cap cycle. The impact of the methodology depends on the timing of the price movement, hedge accumulation and switching. Worked examples would improve predictability and help suppliers validate implementation.

We would also encourage RECCO to engage with suppliers to ensure the implementation and administration of the scheme is effective. For example, our previous experience showed that there may be some benefits to having a consistent approach to identification of domestic properties.

Question 4: Do you agree with Ofgem's proposal to keep the MSC parameters unchanged?

No. We do not consider that previous consultation on the parameters is a sufficient reason to retain them unchanged in a materially different market context.

In our responses to Ofgem's 2022 consultations we argued that the 10% threshold and 85% factor could leave suppliers with only a relatively small proportion of their economic losses mitigated. Ofgem's illustrative scenarios now show that, even after an MSC payment, suppliers may retain substantial losses. Partial loss-sharing is appropriate, but the remaining exposure must be consistent with a resilient and investable market and with the normal-rate-of-return principle reflected in the price cap.

Ofgem should test alternative combinations of trigger and sharing factor against:

- the absolute £/MWh movement required before activation at current and plausible future wholesale price levels;
- customer switching before and after the trigger;
- losses at different points in the quarterly cap and hedge cycle;
- the interaction with backwardation and other deferred allowances; and
- the effect on an efficient supplier's EBIT and capital position.

Subject to that analysis, we continue to believe that the sharing factor should be reviewed with a view to increasing it above 85%. Retaining unchanged parameters may be appropriate as an interim measure to facilitate rapid activation. However, we urge Ofgem to undertake a subsequent review of the methodology and consult on improvements that would better align the MSC with suppliers' actual economic exposure. Ofgem should explain how it has weighed competing considerations and outline why the selected parameters represent an appropriate allocation of risk.

Question 5: Do you agree with maintaining the MSC trigger as a percentage value?

No. ScottishPower continues to favour an absolute £/MWh trigger.

A percentage trigger changes in absolute terms with the level of wholesale prices. When prices are high, a 10% trigger requires a much larger absolute fall before the MSC applies. Yet customer decisions are driven by expected bill savings, not by the percentage movement in an abstract wholesale index. A large absolute price reduction may prompt significant switching before the percentage threshold is reached, leaving losing suppliers exposed to losses that the mechanism was intended to mitigate.

This effect is particularly important where energy costs remain prominent in household budgets and customers have recently engaged with the tariff market. It is therefore not sufficient to argue that price cap risk allowances scale with wholesale prices. Those allowances and customer switching behaviour address different questions. The trigger should be calibrated to the likely savings that prompt material switching and to the resulting stranded-hedge loss.

An absolute trigger would be more predictable and aligned with customer switching behaviour. Ofgem should determine the appropriate £/MWh level using current evidence on switching

elasticity and should review it periodically rather than allowing its effective strength to vary automatically with wholesale prices.

If Ofgem retains a percentage trigger initially to avoid delaying activation, it should make clear that this is an interim implementation choice and commit to consulting promptly on an absolute trigger.

Question 6: Do you agree with not including deferred allowances in the MSC calculation?

No. The MSC should recognise material deferred allowances where the loss is directly caused by customers switching away before the relevant price-cap costs have been recovered.

In 2022 we identified backwardation, unexpected SVT and transition-related allowances as examples of costs that could be left unrecovered. The nature of the deferred allowances has changed, but the principle remains: if an efficient supplier incurs a cost in serving the relevant cohort, and the price cap deliberately recovers that cost later, customer departure can crystallise a loss that is economically inseparable from the switching event. Rather than excluding deferred allowances from the MSC calculation (which creates a precedent for future MSC interventions), Ofgem should include a parameter for deferred costs even if the size of that parameter is not hugely material.

Ofgem's concern that including such costs would turn the MSC into general compensation can be addressed through disciplined scope. Eligibility should be limited to allowances that:

- are objectively identifiable in the price-cap methodology;
- relate to costs that are already incurred or committed regardless of whether the customer remains with the supplier;
- are recovered on a deferred basis;
- would not be expected to be included in the cost stack for FTCs; and
- are rendered unrecoverable, or materially less recoverable, by the switch.

The most significant at the moment is backwardation costs, which are recovered on a lagged basis, where customers switch before those costs have been fully recovered through the price cap. This is approximately £37 per dual fuel customer in the October cap, but is likely to be very materially higher next quarter – our current estimate indicates that this could exceed £180 per dual fuel customer in the next cap period.

In the current context, allowances that may satisfy these criteria also include the nil consumption WHD allowance (£6.82 per dual fuel customer) which is intended to address under-recovery of costs from scheme year 2025/26.

If Ofgem is not prepared to include deferred allowances directly in the weekly charge, it should establish a targeted ex post true-up or price-cap mechanism for exceptional, demonstrable under-recovery caused by mass switching during an activated period. This would not protect suppliers from every commercial loss. It would ensure that the mechanism measures the relevant economic loss more accurately. Excluding all deferred allowances understates exposure and could leave the MSC too weak to support the hedging confidence on which Ofgem's activation case relies.

Question 7: Do you have any comments on the notice period required for activating the MSC?

One full working day should be treated as an emergency minimum, not the normal expectation. Suppliers need time to reflect activation in tariff pricing and commercial decisions, while intermediaries and industry bodies need time to implement changes accurately.

Ofgem should provide as much notice as practicable and should aim for at least two full working days between publication of the final decision and activation, unless urgent market developments make that impossible. The decision should state the exact effective date and time, the first applicable switching date, the publication timetable for charge values and any transitional treatment.

More broadly, prior consultation and transparent criteria are essential because suppliers rely on the MSC framework when making hedging decisions. Abrupt activation, deactivation or methodology changes can undermine the confidence the measure is intended to create.

Question 8: Do you agree with Ofgem's proposed approach to deactivating the MSC?

The MSC should ordinarily remain activated and available in reserve, with charges applying only where the published trigger is met. Repeated activation and deactivation would create avoidable uncertainty without providing a clear consumer benefit, particularly because activation does not itself impose a charge. If Ofgem nevertheless proposes deactivation, it should consult and demonstrate that maintaining the mechanism in reserve would create a material detriment.

Any deactivation decision should provide sufficient notice to avoid disrupting supplier hedging and pricing decisions already taken in reliance on the active framework. Ofgem should consult on the proposed timing and explain how it has considered already-hedged volumes for forthcoming cap periods.

Question 9: Do you have any comments on our draft impact assessment?

The draft impact assessment supports the case for activation but is not sufficiently robust to support the proposed parameter choices.

We welcome Ofgem's recognition that the relevant impacts extend beyond immediate MSC payments to market stability, investability, hedging incentives and the distribution of costs between engaged and less engaged consumers. We also agree that an ex post cap adjustment would place costs on customers remaining on the Cap and would be less targeted than the MSC.

However, the assessment could be strengthened in the following respects:

- Switching behaviour: test a wider range of elasticities and timing profiles, including a surge in switching before the 10% trigger is met, rather than assuming switching occurs in parallel with the price fall.
- Trigger design: compare the proposed percentage trigger with alternative absolute £/MWh thresholds at different wholesale price levels.
- Deferred allowances: quantify potential under-recovery of backwardation and other material deferred allowances and assess the combined economic loss.
- Supplier impacts: assess the effect on EBIT, liquidity and capital for efficient suppliers with different customer mixes, not solely an average notional supplier.

- Competition: assess entry advantages and the interaction with the BAT, including whether suppliers with small existing customer bases can acquire customers while established suppliers retain stranded costs.
- Timing: test price falls at different points in the quarterly cap cycle, including after suppliers have accumulated peak winter hedge volumes.
- Distribution: distinguish clearly between transfers, administrative costs, residual supplier losses and potential socialised costs from failure or later regulatory intervention.

The impact assessment should avoid treating the previous scheme's aggregate payments as evidence that future impacts will necessarily be modest. The scale of payments is contingent on market movements, switching and calibration. The relevant question is whether the framework performs effectively in the adverse scenarios for which it is designed.

Finally, monitoring should include the frequency and value of MSC charges, switching volumes, tariff spreads, supplier hedge confidence, unresolved deferred-cost exposure and the distribution of payments across suppliers. Ofgem should publish its evaluation after deactivation and use it to inform any future activation or parameter change.

ScottishPower
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