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## Introduction

On 14 March 2023, the European Commission published its proposals for reform of the electricity market design.<sup>1</sup> This followed a period of prolonged high electricity and gas prices, during which several stakeholders highlighted the challenges of the current market design, advocating for changes to the current arrangements.<sup>2</sup> More recently, the Commission reviewed emergency measures adopted at the EU level, sharing some lessons from the recent energy crisis.<sup>3</sup>

The Commission proposed revisions to various EU Regulations and Directives covering a wide range of issues relevant to wholesale and retail markets, as well as the renewable energy sector. In this note, we focus our attention on proposed reforms in the retail market.

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<sup>1</sup> European Commission (2023), '[Commission proposes reform of the EU electricity market design to boost renewables, better protect consumers and enhance industrial competitiveness](#)', 14 March.

<sup>2</sup> Examples include: (i) a proposal from the Greek government: Council of the European Union (2022), '[Information note 11398/22 ENER 366](#)', July; (ii) a non-paper from the Spanish government: Politico (2021), '[Non-paper on energy and electricity market](#)'; (iii) a more recent non-paper from the Spanish government: Spanish government, '[Proposal to reform the EU's wholesale power market](#)', Non-paper by Spain; (iv) a parliamentary resolution in Italy: Camera dei Deputati (2022) '[Allegato B, seduta di venerdì 11 febbraio 2022](#)'.

<sup>3</sup> European Commission (2023), '[Report from the Commission to the European Parliament and the Council on the review of emergency interventions to address high energy prices in accordance with Council Regulation \(EU\) 2022/1854](#)', 5 June.

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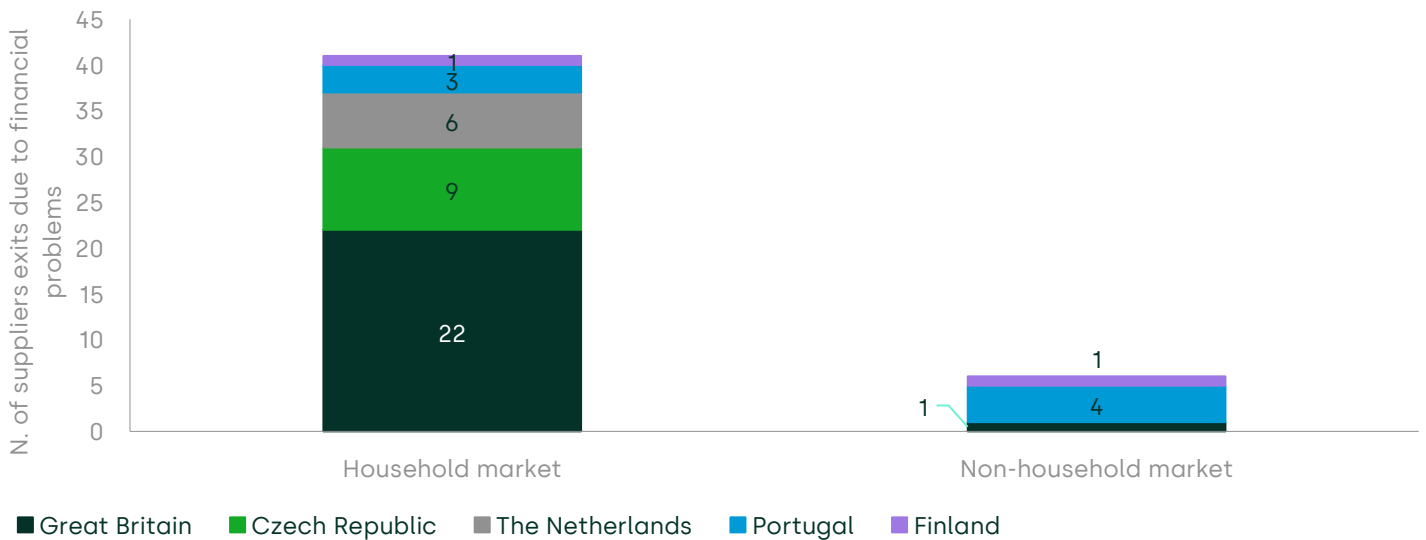
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# Risk management and hedging strategies

The Commission's assessment concluded that the current energy crisis has shown that some retailers have not adequately hedged the risks of wholesale energy price movements. Combined with the significant increases in wholesale prices, this resulted in several supplier failures (e.g. 16 suppliers collapsed in the Czech Republic between October 2021 and January 2022, as well as several suppliers in Germany in 2021),<sup>4</sup> which in turn implied higher costs for consumers. Further statistics on supplier failures in 2021 are summarised in Figure 1 below.

Figure 1 Number of suppliers exiting the market due to financial problems in 2021



Source: ACER (2022), 'Annual report on the results of monitoring the internal electricity and natural gas markets in 2021. Energy retail and consumer protection volume', October, p. 29.

For this reason, the Commission is proposing to introduce an obligation for all suppliers to have appropriate hedging strategies in place and implement them. No further details are provided at this stage, but most

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<sup>4</sup> European Commission (2023), '[Commission Staff Working Document Reform of Electricity Market Design. SWD\(2023\) 58 final](#)', 14 March, p. 79.

decisions seem to be left to member states. These will be responsible for assessing the appropriateness of retailers' hedging strategies, taking into account the size and business model of each supplier. A key question remains in relation to the precise form that any assessment of supplier resilience will take—for example, as to whether specific obligations will be imposed, or whether some stress testing of suppliers will be introduced.

Oxera has analysed proprietary data provided by the UK energy regulator, Ofgem, as part of a study on behalf of its Board. We found that low levels of hedging are one of several factors that have contributed to the large number of supplier failures in the UK since summer 2021 (29 suppliers, supplying around 4m customers, as at 31 October 2022).<sup>5</sup> Other factors associated with company insolvency included low levels of working capital and a reliance on customer credit balances to finance operating costs.<sup>6</sup>

Low levels of hedging have contributed to the large number of supplier failures in the UK since summer 2021.

One factor that contributed to low levels of hedging was that newer, less established entrants to the market were unable to access hedging markets of longer duration (in excess of six months) as they lacked the collateral required.<sup>7</sup>

The price cap methodology prevailing in autumn/winter 2021 (when the majority of supplier failures occurred) required suppliers to purchase energy up to 12–14 months in advance to ensure that they would be able to recover their full costs in future price cap periods. The price cap (introduced in 2018) therefore imposed an implicit hedging strategy on suppliers that much of the market was unable to meet. Had suppliers been required to follow this hedging strategy, it would have reduced the likelihood of supplier failure in response to high and volatile wholesale prices, but it would also likely have precipitated the exit of suppliers that were too small to access sufficient collateral when the regulatory requirement was imposed.

Ofgem has been monitoring suppliers' hedging strategies, as well as other financial resilience metrics, since 2020—initially in response to the COVID-19 pandemic.<sup>8</sup> Since January 2022, it has also been engaging with

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<sup>5</sup> House of Commons Committee of Public Accounts (2022), '[Regulation of energy suppliers](#)', 31 October.

<sup>6</sup> Oxera (2022), '[Review of Ofgem's regulation of the energy supply market](#)', 3 May, p. 57.

<sup>7</sup> Business, Energy and Industrial Strategy Committee (2022), 'Oral evidence: Energy pricing and the future of the energy market HC 1130', 19 April, [Q276](#); [Q250](#).

<sup>8</sup> Ofgem (2020), '[Impact of COVID-19 on retail energy supply companies – an enabling framework](#)

suppliers to carry out quarterly stress testing, including against adverse wholesale price movements.<sup>9</sup>

While Ofgem initially suggested that suppliers following 'insufficient hedging strategies' could be required to maintain higher capital buffers under its financial resilience proposals<sup>10</sup> or trigger additional scrutiny under its 'financial responsibility principle', both proposals seem to have been dropped.<sup>11</sup> Ofgem has not consulted on directly mandating that suppliers follow specific hedging strategies.

## Obligation for (big) suppliers to offer a fixed-price contract

Similarly, over 2021 and 2022 in particular, when wholesale prices reached unprecedented levels, fixed-price contracts became scarce in several European retail markets. When available, these contracts had higher prices, incorporating significant price premia. This somewhat limited the tariff options available to consumers.

While these (fixed-price) contracts involve some degree of risk for suppliers when prices are volatile, especially if the contracted supply is not hedged appropriately, they provide significant benefits for consumers. In particular, they can smooth price variations over time and reduce the direct impact of wholesale prices on retail prices.

In light of these benefits, the Commission is proposing that large suppliers, i.e. those with more than 200,000 customers, will be obliged to offer a fixed-price contract for at least one year. While suppliers will be able to freely set prices for these contracts, they will not be allowed to modify the terms and conditions before the pre-defined (contractual) expiry date.

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According to the Commission, the offers will need to be designed so as to incentivise electricity savings. Moreover, suppliers will be required to

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for regulatory flexibility', 8 April.

<sup>9</sup> Ofgem (2021), '[Action plan on retail financial resilience](#)', 15 December, p. 4.

<sup>10</sup> Ofgem (2022), '[Policy Consultation – Strengthening Retail Financial Resilience](#)', 20 June, para. 6.56.

<sup>11</sup> Ofgem (2023), '[Further Statutory Consultation: Strengthening Financial Resilience – introducing a Minimum Capital Requirement and Ringfencing CCBs by Direction](#)', 5 April; '[Decision on strengthening financial resilience](#)', 5 April.

provide clear and sufficient pre-contractual information in a simple and consumer-friendly format.

This new obligation is meant to expand the choices available to consumers, and its scope and design is similar to an existing obligation for large suppliers (also in this case defined as those serving more than 200,000 customers) to offer dynamic price contracts.<sup>12</sup>

It is worth noting that the Commission's proposals may have implications for the design of (early) termination fees that retailers often include in their contracts. To ensure the financial sustainability of fixed-term and fixed-price contracts, it is reasonable to anticipate that retailers would usually hedge contracted supply commitments. However, if consumers can switch providers at any time, this poses a risk that the hedged supplies may no longer be needed.

Early termination fees are allowed at the time of writing; however, they 'shall be proportionate and shall not exceed the direct economic loss' from a customer's termination of their contract.<sup>13</sup> The burden of proof lies with suppliers; this may therefore prove to be an area of further attention for suppliers in engaging with the European retail reform agenda.

## Suppliers of Last Resort (SOLR) mechanisms

Following several suppliers' bankruptcies in recent months and the increased risk of other suppliers exiting the market, the Commission is now proposing to introduce an obligation for member states to transparently (and indiscriminately) appoint suppliers of last resort at least for household customers. These suppliers will be responsible for serving consumers following a supplier's failure.

The key aim is to ensure continuity of supply for consumers, reducing uncertainty and making sure that the transition is managed in a smooth and transparent way, e.g. with customers being provided enough

The Commission has proposed that member states be obligated to appoint suppliers of last resort through transparent and non-discriminatory procedures.

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<sup>12</sup> Directive (EU) 2019/944 of the European Parliament and of the Council of 5 June 2019 on common rules for the internal market for electricity and amending Directive 2012/27/EU (recast), Article 11. This Directive defines a dynamic electricity price contract as an 'electricity supply contract between a supplier and a final customer that reflects the price variation in the spot markets, including in the day-ahead and intraday markets, at intervals at least equal to the market settlement frequency'.

<sup>13</sup> Ibid., Article 12.

information on the process, as well as being encouraged to switch to a market-based offer.

While most (if not all) member states have arrangements in place for an SOLR, there are usually large differences between countries in how the mechanisms have been implemented, such as with respect to precise scope, mechanisms to select the SOLR operator(s), or the price conditions that are applied. For this reason, the Commission is seeking to establish a more uniform and harmonised process in the EU.

In the UK, a form of SOLR process has been in place since 2003,<sup>14</sup> with revised guidance issued in 2016 to reflect new provisions to protect outstanding customer credit balances in the event of supplier failure.<sup>15</sup> Ofgem also has powers to seek an energy supply company administration order (SAR) under powers given to it by the Energy Act 2011.

Both mechanisms have been used to manage the large number of supplier failures since summer 2021, with 28 suppliers (supplying 2.4m customers) entering the SOLR process and one supplier being managed through the SAR regime.<sup>16</sup>

The recent application of the SOLR mechanisms in the UK may offer several lessons for those designing or modifying SOLR processes in other jurisdictions.

- The process has worked well in securing continuity of service for customers<sup>17</sup> and, in combination with Ofgem's price cap, has ensured that customers do not face immediate exposure to wholesale prices if their supplier exits the market.<sup>18</sup>
- Running the SOLR process has been costly (£2.7bn as at 31 October 2022),<sup>19</sup> as the appointed supplier of last resort needs to be compensated for the lost customer credit balances and the difference

The recent application of the SOLR mechanism in the UK showed that the process can work well. However, running the SOLR is usually costly, and the costs are mainly related to hedging.

<sup>14</sup> Ofgem (2003), '[Supplier of Last Resort Revised guidance](#)', November.

<sup>15</sup> Ofgem (2016), '[Guidance on supplier of last resort and energy supply company administration orders](#)', 21 October; '[Decision on our approach to dealing with supplier insolvency and its consequence for consumers](#)', 21 October.

<sup>16</sup> As of November 2022. See House of Commons Committee of Public Accounts (2022), '[Regulation of energy suppliers](#)'.

<sup>17</sup> House of Commons Business, Energy and Industrial Strategy Committee (2022), '[Energy pricing and the future of the energy market: Third Report of Session 2022–23](#)', 19 July, para. 69.

<sup>18</sup> Ofgem (2021), '[How you're protected when energy firms collapse](#)', 14 October.

<sup>19</sup> House of Commons Committee of Public Accounts (2022), '[Regulation of energy suppliers](#)', 31 October.

- between the underlying price of energy and the price cap, in addition to the administrative/IT costs associated with transferring customers.
- This has been exacerbated by suppliers failing in a high and rising wholesale price environment, as hedging arrangements are not transferred to the new supplier but are instead used to recoup costs for the creditors of failed companies. The cost of purchasing new hedging arrangements for customers comprised around 90% of the total costs of running the SOLR process.<sup>20</sup>

These findings from the UK could serve as a useful experience for European countries, as the Commission's proposals only provide overall principles and the detailed implementation seems to be left to member states. While they may wish to take into account some national specificities, the design features of the SOLR mechanism will need to be carefully considered as they will have an impact on the effectiveness of the scheme, as well as its overall costs.

## Retail price regulation in times of 'emergency'

In recent months, member states adopted several emergency measures to mitigate the impact of electricity and gas price increases on consumers.<sup>21</sup> Initially, there has been limited coordination at the European level, for this reason the Commission has issued several guidelines and proposals.

In particular, in October 2022 some emergency derogations from applicable rules on retail markets have been allowed, introducing the possibility for member states to temporarily:<sup>22</sup>

- extend regulated prices to small and medium enterprises (SMEs);
- set regulated retail prices below costs for domestic clients and/or SMEs.

The Commission recently highlighted that different member states acted upon this flexibility: 12 member states reported to have

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<sup>20</sup> House of Commons Business, Energy and Industrial Strategy Committee (2022), '[Energy pricing and the future of the energy market: Third Report of Session 2022–23](#)', 19 July.

<sup>21</sup> For example, see: Oxera (2022), '[REPowerEU: managing energy supply and prices in the EU](#)', May; and '[Stepping on the gas: European emergency measures to deal with high energy prices](#)', November.

<sup>22</sup> Council Regulation (EU) 2022/1854 of 6 October 2022 on an emergency intervention to address high energy prices, October, Articles 12–13.

implemented measures in line with these provisions.<sup>23</sup> For example, four countries reported the introduction of regulated prices for SMEs, while the Netherlands intervened by setting prices below costs for households and businesses through a scheme notified to the Commission for state aid clearance.<sup>24</sup>

In light of this experience, and to ensure more coordination in case of future price shocks, the Commission is now proposing a special derogation procedure, according to which member states can, at times of emergency (either regional or Union-wide), apply for price intervention for households and SMEs.<sup>25</sup>

The Commission is proposing a special derogation procedure, according to which member states can, at times of emergency, apply for price intervention for households and SMEs.

The Commission will be responsible for triggering the emergency situation based on the following pre-set criteria:

- high wholesale electricity prices, i.e. those at least two and a half times the average price during the previous five years, which are expected to continue for at least six months;
- an increase of at least 70% in electricity retail prices compared to the same period, which are also expected to continue for at least six months;
- the wider economy being negatively affected by higher electricity prices.

Prices may be set below cost for a limited volume of electricity consumption and for a limited period of time (no more than one year).

In order to ensure incentives for consumers to reduce their electricity consumption, regulated prices will be restricted to 80% of the average historical consumption for domestic clients, and to 70% of the average historical consumption for SMEs. This is similar to mechanisms already introduced in other member states, such as Germany.<sup>26</sup>

Learning lessons from the recent crisis, the introduction of such clarity around pre-defined conditions for the introduction of these measures by member states should ensure a smoother process for their timely adoption. It should also alleviate some of the concerns around

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<sup>23</sup> European Commission (2023), 'Report from the Commission to the European Parliament and the Council on the review of emergency interventions to address high energy prices in accordance with Council Regulation (EU) 2022/1854', 5 June, p. 15.

<sup>24</sup> Ibid.

<sup>25</sup> In its recent review of emergency measures, the Commission did not recommend to extend the provisions introduced in October 2022, as this derogation procedure has a very similar design and serves the same purpose.

<sup>26</sup> See Oxera (2022), '[Stepping on the gas: European emergency measures to deal with high energy prices](#)', November.



discrimination/distortions due to different national interventions. While the Commission more recently confirmed its proposals as part of its review of the emergency measures, these aspects have not been discussed.

Price regulation of domestic tariffs in the UK predated recent wholesale price changes, having been introduced through government legislation in 2019. While the original purpose of the price cap was to prevent companies overcharging inactive customers, it also delayed the pass-through of rising wholesale costs to customers. This was not an explicit objective of the price cap, but a consequence of its design, under which the maximum level of wholesale costs that suppliers could recover were capped based on an average of historical futures prices.

As wholesale prices eventually began to flow through to the price cap, the UK government intervened to subsidise standing charges and unit rates, such that the annual bill for a household on 'average consumption' would not exceed £2,500. This support was provided on a temporary basis, starting in October 2022 and until the end of June 2023,<sup>27</sup> as from July 2023 the price cap is below £2,500 without government support. However the scheme will remain in place until the end of March 2024 as a safety net, in case energy prices increase above £3,000 per year.<sup>28</sup>

Key considerations for how price caps (temporary or enduring) should be designed include:

- the role (if any) of government support to subsidise bills;
- the intended application of any price intervention, or coverage of any price cap—for example, is it only applied to vulnerable customers? Does it only extend to domestic consumers?
- how suppliers can recover any losses incurred by setting price below costs in future periods—for example, by over-recovering from customers in future periods;

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<sup>27</sup> However, it is worth noting that from July 2023, the Energy Price Guarantee will continue to provide a unit rate discount to households with a pre-payment meter to ensure that these clients do not pay more than those on direct debit. Department for Business, Energy & Industrial Strategy (2023), '[Policy paper: energy price guarantee](#)', 26 May.

<sup>28</sup> HM Treasury (2023), '[Energy Price Guarantee extended for an extra three months](#)', 15 March. Also see Department for Business, Energy & Industrial Strategy (2023), '[Policy paper: energy price guarantee](#)', 26 May.

- managing the transition from price regulation back to a competitive market in the event that temporary price interventions impede the functioning of competition in the market.

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