Consultation

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Consultation on changes to market stabilisation charge

Subject	Details
Publication date:	31 March 2022
Response deadline:	14 April 2022
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In our decision of 16 February 2022, we announced that we would be implementing a Market Stabilisation Charge ("**MSC**") as a temporary measure. This would protect the interests of future and existing customers by helping domestic suppliers to better manage, on behalf of consumers, the risks posed by severe energy price volatility. We set out the initial parameters of the charge and published guidance on how it would be calculated. We confirmed that we would consult for at least two weeks if we proposed changes to the guidance.

We are consulting on changes to the MSC parameters to make the charge more robust to ongoing and sustained levels of volatility observed in the recent months. We are also consulting on two technical changes to the MSC calculation methodology to reflect (a) our announcement of 15 March 2022 relating to price indexation in the default tariff cap and (b) electricity losses and unidentified gas.

We welcome views from all stakeholders with an interest in the domestic retail energy supply market. We particularly welcome responses from energy suppliers, consumer groups and charities.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at Ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

Executive summary

Recent geo-political events have exacerbated the high and volatile electricity and gas wholesale prices seen since Autumn 2021, resulting in ongoing and unprecedented tariff levels for consumers and financial instability for suppliers. In particular, these conditions are making the management of price and volume risks significantly harder for energy suppliers.

Considering the potential impact of recent events on the functioning of the market, we think it appropriate to review whether the parameters of the Market Stabilisation Charge ("**MSC**") that were set out in our decision of 16 February 2022[1] (the "**Decision**") are sufficient to enable suppliers to mitigate the risks they face from sustained and ongoing wholesale market volatility.

We are also using the opportunity to propose two additional technical amendments to the guidance in respect of the calculation of the MSC published the same day (the "**Guidance**")[2] to take account of:

1. The consequences of our letter of 15 March 2022[3] (the "**Indexation Guidance Letter**") giving updated guidance on the treatment of price indexation in future default tariff cap proposals; and

2. Making the proper allowance for electricity line losses and unidentified gas.

In our Decision, we set out the parameters for the MSC which would take effect from 14 April 2022. These parameters included (a) a threshold (described in the Guidance as the *losing supplier loss trigger*), which is the percentage by which wholesale gas and/or electricity prices must fall below the amount implied in the price cap for the relevant period for the MSC to be activated and (b) a derating factor, which is the percentage of the incremental hedging losses

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[1] Ofgem (2022), Decision on short-term interventions to address risks to consumers from market volatility: https://www.ofgem.gov.uk/sites/default/files/2022-02/Short%20Term%20Interventions%20-%20Decision%20Document.pdf
[2] Ofgem (2022), Market stabilisation charge calculation methodology: https://www.ofgem.gov.uk/sites/default/files/2022-02/MSC%20guidance.pdf
[3] Ofgem (2022), Updated guidance on treatment of price indexation in future default tariff cap proposals: https://www.ofgem.gov.uk/sites/default/files/2022-03/Updated%20guidance%20on%20treatment%20of%20price%20indexation%20in%20future%20cap%20proposals1647277779834.pdf

incurred by a nominal supplier that is covered by the MSC. We set a threshold of 30% and a derating factor of 75%.

The higher and more volatile wholesale energy prices currently being observed mean that a well-managed and prudent supplier is exposed to potentially large losses if prices fall, despite the MSC. In this environment, the MSC, with its current parameters, does not appear likely to have the effect that we intended, of allowing a nominal supplier to recover a sufficient proportion of its hedging losses. In accordance with the Authority's principal objective to protect the interests of existing and future consumers, it is necessary for Ofgem to have regard to the need to ensure that licence holders are able to finance their licensed activities – in this case, to be able to manage energy procurement risks on behalf of consumers.

We have therefore re-assessed the parameters, taking account of the consequential impact on the nominal supplier's hedging strategy of the Indexation Guidance Letter, and propose that they should be altered to a threshold of 10-20% and a derating factor of 80-90%. We will continue to keep the parameters under review and stand ready to make further changes, where appropriate, in the interests of consumers. Any future changes to parameters will be subject to separate consultation in line with the Guidance.

We consider that revised parameters in this range will better balance the availability of significant savings for active consumers in a falling market with the requirement to avoid an undue level of financial stress for well managed suppliers.

The MSC will take effect on 14 April 2022. The charge will be updated and published on a weekly basis. This consultation period closes on 14 April 2022, with the decision document following in due course. We expect any changes arising from this consultation to take effect from 27 April 2022.

1. Introduction

What are we consulting on?

1.1. On 16 February 2022, we published our Decision setting out our short term interventions to address risks to consumers from market volatility, one of which was the MSC.

1.2. The first element of this consultation is to seek comments on proposed revisions to the MSC parameters (particularly the threshold at which the charge takes effect, and the derating factor) to ensure that the MSC remains robust to the increased levels of wholesale prices and volatility observed in recent months. We are also proposing to make two technical amendments to how the MSC is calculated, to reflect a change in the price cap indexation profile and to ensure the calculation appropriately reflects electricity losses and unidentified gas.

1.3. This document is split into four chapters:

- Chapter 1 sets out the scope, purpose and context for this consultation, and outlines the key stages the consultation will progress through to get to a final decision.
- Chapter 2 sets out the nature of the changes proposed to be made to the MSC parameters along with a review of the impact and timings of these changes.
- Chapter 3 sets out the changes to the MSC guidance needed to take account of the updated guidance on the price cap indexation methodology.
- Chapter 4 sets out the changes to the MSC Guidance to take account of electricity losses and Unidentified gas ("**UIG**").

Background and Context

1.4. The rise and volatility in global energy prices that started in 2021 has intensified following recent geopolitical events. This has continued to put energy markets under severe strain globally, and the effects have been reflected in UK wholesale markets. As the regulator of gas and electricity markets in Great Britain, Ofgem continues to work at pace to protect consumers in this difficult environment.

1.5. On 16 February 2022, we announced our Decision to implement the MSC along with a ban on acquisition-only tariffs as temporary interventions designed to bolster market stability. Our MSC Guidance was published the same day.

1.6. This consultation sets out our views and proposals on whether further changes are required to the MSC parameters and calculation to ensure it remains robust to market volatility in the interests of future and existing customers.

1.7. The responses to this consultation will be taken into consideration and used to inform our decision-making. The MSC guidance document will be updated to reflect the changes set out in our decision and a new version will be published together with our decision on this consultation. The current published version of the Guidance document should be referred to until the changes are confirmed in our decision.

Consultation stages

1.8. We invite stakeholders to submit comments on any aspect of this consultation on or before 14 April 2022. This will give Ofgem, if persuaded of the need to act in consumer interests, the ability to make changes to the MSC parameters and guidance that could come into effect from 27 April 2022

1.9. Industry stakeholders are invited to provide any relevant supporting material evidencing the nature, scale and timing of risks posed by current market volatility and how this has changed since early February.

Figure 1: Consultation stages

Stage 1	Stage 2	Stage 3	Stage 4
Consultation open	Consultation closes (awaiting decision). Deadline for responses	Responses reviewed and published	Consultation decision/policy statement
31 April 2022	**14 April 2022il 2022**		**In time for changes to take effect on 27 April 2022**

How to respond

1.10. We want to hear from anyone interested in this consultation. Please send your response to retailpolicyinterventions@ofgem.gov.uk.

1.11. We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

1.12. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

1.13. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.14. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.15. If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("**UK GDPR**"), the Gas and Electricity Markets Authority will be the data controller for the purposes of UK GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

1.16. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

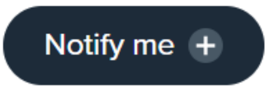
1.17. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

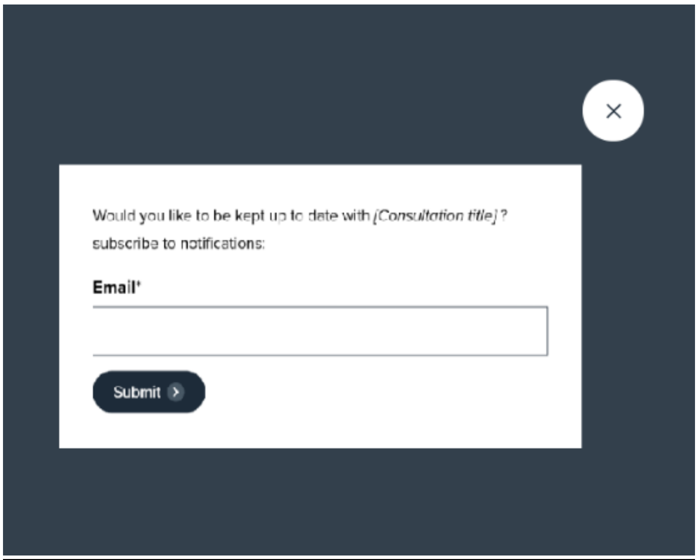
1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. [Ofgem.gov.uk/consultations.](https://www.ofgem.gov.uk/consultations)





Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

Upcoming	▶	Open	▶	Closed (awaiting decision)	▶	Closed (with decision)

2. Changes to market stabilisation charge parameters

Section summary

Following Russia's invasion of Ukraine on 24 February 2022, global energy markets have experienced levels of price and volatility significantly higher than those faced in January. This has increased risks for energy suppliers both as prices rise and as they fall. It is in the interests of consumers that well managed energy suppliers are able to finance their businesses under unstable and uncertain market conditions and to this end we have reviewed the parameters of the MSC to ensure that it is effective.

Our assessment of these risks indicates that it would be prudent to change the MSC parameters to a threshold of between 10-20% (the amount by which market prices must fall below the wholesale cost allowance in the default tariff cap before the MSC comes into operation)[4] and a derating factor of between 80-90% (the percentage of supplier hedging losses, beyond the threshold, that are to be covered by the MSC).[5] We would welcome views on where in those ranges would be the optimum outcome.

Context

Wholesale prices have become significantly higher and more volatile

2.1. The Russian invasion of Ukraine (24 February 2022) has been followed by significant increases in the level and volatility of wholesale prices. The chart below shows how the benchmark gas price used to set the Default Tariff Cap has moved since the beginning of the year.

[4] The Losing Supplier Loss Trigger as defined in page & of the Guidance

[5] The calculation is set out in pages 6-9 of the Guidance.

2.2. Although the political situation around the war in Ukraine could change quite rapidly, there is obviously a risk that prices could remain high and volatile for some time, for example if a wish to diversify away from Russian hydrocarbons puts pressure on supplies from other sources. There is also considerable risk about how Middle Eastern countries and other sources of international oil and gas will adapt their production policies.

2.3. As a result, suppliers are exposed to risk and cost managing the current volatility and high prices. This is exacerbated by the higher volumes of energy consumption over the autumn and winter. A nominal supplier that is hedging in accordance with the algorithm used to set the default tariff cap will be holding significant and increasing volumes of high-priced energy for autumn 2022. Accordingly, the hedge values at risk have risen substantially and the MSC may need to act more powerfully in the event that prices fall.

2.4. Indeed, if the MSC is not adequately effective in the event of falling prices, it could create an incentive for suppliers to hedge insufficiently, which could lead to them being unable to manage an outcome where prices rose further. It is therefore appropriate to review the parameters to ascertain that the MSC remains fit for purpose.

The current MSC parameters do not strike the right balance in the current environment

2.5. The parameters for the MSC involve achieving a balance between enabling active consumers to gain as quickly as possible from the falls in energy prices, if and when wholesale markets fall closer to historic levels, and avoiding financial stress for well-managed and prudent energy suppliers who serve them.

2.6. The exposure of well-managed and prudent suppliers is significantly higher, following the invasion of Ukraine, than we expected when the parameters were first set. In particular, the cost of unwinding hedges no longer required following loss of SVT customers has, under the current parameters, increased significantly. This is likely to lead to high levels of financial stress if and when prices fall, with the risk of further planned or unplanned exits. It is in the interests of existing and future consumers that efficient suppliers are able to finance their businesses. Our modelling shows that on the current MSC parameters there would be significant supplier exits from the market.

2.7. The work underlying the updated impact assessment described below indicates that significant cash and earnings losses are likely for hedged suppliers under the current MSC parameters if prices fall to historic levels over the coming months. A threshold of 30% is likely to allow excessive losses on hedge positions before the MSC is activated. We are therefore consulting on a change in the threshold to a figure in the range 10-20%, as we consider that this would better mitigate the risk

2.8. The greater exposure of suppliers in these more adverse circumstances means that it is also appropriate to review the derating factor. As the scale of the potential losses rises, the 25% share that companies were expected to absorb (above the substantial losses incurred before the threshold is crossed) becomes more onerous compared to the ability of companies to meet them. This could lead to increased financial stress in the sector, and the harm to consumers described above. We therefore propose increasing the derating factor to a level in the range 80-90%.

2.9. Confidence in the effectiveness of the MSC will also assist energy suppliers in appropriate hedging to mitigate risks should prices rise further.

The consumer interest remains protected

2.10. All consumers will benefit in time from lower prices, if wholesale prices fall, as the default tariff cap will fall once the hedges implied by the cap indexation unwind. As this happens, the MSC threshold will cease to be met. However, active consumers are likely to find that the MSC limits the scale of the savings they can achieve early on.

2.11. On the assumption that default tariffs are priced at the cap, the MSC does not affect the pricing for consumers who are inactive or for other reasons choose to remain on Standard Variable Tariffs. This is because it does not affect the trajectory of the default price cap – except in so far as the MSC causes the cap to be lower than it otherwise would have been (by preventing socialised costs of default).

2.12. In return for delaying part of the benefits of falling wholesale prices for active consumers, the MSC, especially with the proposed new parameters, is expected to reduce the risk of financial stress for well-managed firms. We judge this to be in the interest of consumers, so that the firms who serve them are able to fund their businesses. Excessive financial stress for well-managed firms that have hedged properly is not in the interests of consumers. It would deter investment in the market and could lead to significant costs from further supplier exits. These costs and other disbenefits could fall disproportionately on inactive consumers who would not gain from the lower short-term prices achieved by active customers.

Updated impact assessment

2.13. We have updated our assessment to take account of the Indexation Guidance Letter, the decision to implement the ban on acquisition-only tariffs and movements in the market in the light of international events since the Decision. We have also updated our price fall scenarios to reflect events and the passage of time as follows:

- A "flat fall" scenario, where prices fall gradually from 1 June 2022 and reach historic norms on 1 September 2022; and
- A "sharp fall" scenario, where prices fall to historic norms on 1 May 2022 and remain at that level.

2.14. These scenarios are used to create approximate ranges for the cost to engaged customers of the MSC in delaying their access to the cheapest possible deals. That cost has to be weighed against the benefits of the MSC.

2.15. In the short term, the MSC benefits will include the avoided cost of any disorderly supplier exits and the likely levy calls from the special administration or supplier of last resort mechanisms. In the longer term, and perhaps more significantly, a sufficiently effective MSC will provide confidence for suppliers that the market is viable. This will lead to stronger investment, competition and innovation.

2.16. Ofgem estimates £1.2 bn of mutualisation cost of supplier exit (based on our existing parameters) as the possible short term costs to consumers. We estimate the gains foregone by engaged consumers who switch tariff or supplier to be of a broadly similar magnitude. We estimate a range from £1.1bn to £1.5bn, depending on when and how the wholesale price falls and the changed MSC parameters (from the current threshold of 30% and derating factor of 75%, up to a threshold of 10% and a derating factor of 90%). Despite this, consumers would still stand to make significant gains by moving early in a falling price scenario.

2.17. There are significant net benefits from strengthening the MSC because of the less quantifiable but very significant factor of maintaining the viability and investibility of the domestic energy supply sector. Investors are unlikely to put money into, or remain in, a sector where prices are set according to an indexation structure that assumes a certain approach to hedging, but where those hedges are stranded without sufficient mitigation in the event that prices fall from extreme high levels.

2.18. The stronger MSC provides suppliers with more confidence to continue to hedge in accordance with the price cap methodology and the Guidance, to protect consumers against the risk of further wholesale price rises in the current difficult environment.

Distributional considerations

2.19. As noted in the Decision, the MSC does not require any action by consumers, so does not present an additional barrier to switching by low income or otherwise vulnerable consumers. While the strengthened MSC is likely to be fed into fixed term contract prices, which would reduce the savings for engaged consumers, disengaged consumers (who are more likely to be low income or vulnerable) would not be affected. They would, however, benefit from the savings from socialised costs of any disorderly supplier exits. In addition, all consumers will benefit from a supply sector that is viable so that suppliers are able to compete, innovate and invest.

Questions

1. Do you agree that, in the light of the considerations above, the MSC parameters should be adjusted to increase the effectiveness of the mechanism?

2. 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?

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

3. Amending MSC calculation to reflect guidance on price indexation

Section summary

On 15 March 2022, Ofgem published updated guidance on how the price cap indexation will change for the current observation window with regards to price cap period nine. As the indexation is used as a term in the MSC, we intend to reflect this change in the calculations.

Context

New guidance on price indexation

3.1. On 4 February 2022, Ofgem consulted on medium term changes to the price cap methodology[6] for implementation in cap period nine (October 2022 – March 2023). This consultation closed on 4 March 2022. Ofgem is in the process of analysing responses to determine the most effective way to systemically reduce the risks that suppliers bear on unexpected SVT demand and backwardation costs in highly volatile market conditions.

3.2. After reviewing suppliers' and other stakeholders' responses to our policy consultation, it was clear that there is support for a reduction in the price cap implementation period.[7] To facilitate a reduction in notice period, should we deem it appropriate to do so, Ofgem issued a letter on 15 March 2022 with updated guidance on the treatment of the price indexation for cap period nine (the "**Indexation Guidance Letter**"). [8]

[6] Ofgem (2022), Consultation on medium term changes to the price cap methodology: https://www.ofgem.gov.uk/publications/consultation-medium-term-changes-price-cap-methodology
[7] The implementation period is the time between announcement of the new cap level and this level applying to suppliers' prices. Under the existing cap mechanism, it would be from 5th August to 30th September 2022 for cap period nine.
[8] Ofgem (2022), Updated guidance on treatment of price indexation in future default tariff cap proposals: https://www.ofgem.gov.uk/publications/updated-guidance-treatment-price-indexation-future-default-tariff-cap-proposals

3.3. The Indexation Guidance Letter sets out updated guidance for domestic energy suppliers on the treatment of wholesale prices observed during the transitional period to a new cap mechanism, following consultation, due to start in October 2022. This is in readiness for shortening the period between price observation and delivery. In the Indexation Guidance Letter, in effect, we extend the observation window by one month (from six months to seven months), by applying a 50% weighting to prices observed over a two-month period (from 16 March to 19 May, inclusive, the earliest period we could accommodate). This new temporary indexation approach is referred to in this document as the '7-1-12' indexation approach.

3.4. On 16 February, Ofgem published its MSC Guidance[9] setting out the workings of the MSC, alongside our short-term interventions decision document. In the MSC Guidance, we stated, "*any future adjustment to the price cap that materially affects hedging strategies may require us to make an adjustment to this guidance to take account of this change in circumstance*" and "*Before making changes to the guidance, we commit to consult stakeholders on our proposed changes for 14 days*."

3.5. We consider that the new guidance contained in the Indexation Guidance Letter necessitates an amendment to the MSC calculation, to ensure the calculation takes into account the updated price cap indexation approach. The rest of this chapter sets out the changes that we propose to make to ensure the MSC calculation and Guidance appropriately reflect the new 7-1-12 indexation approach.

Proposed changes to MSC calculation

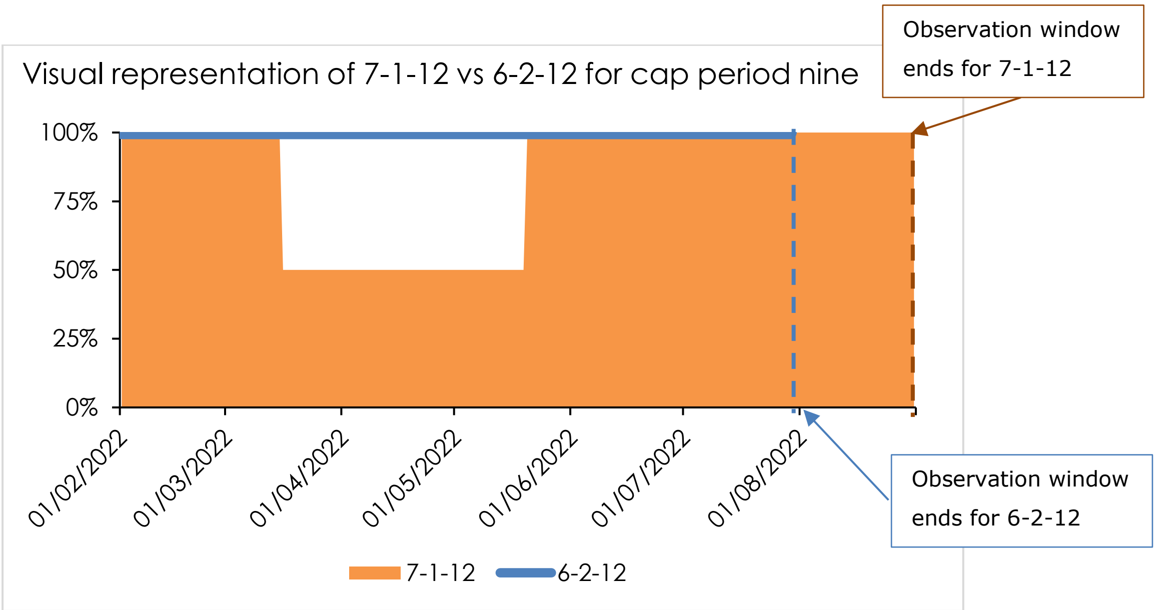
7-1-12 price indexation profile

3.6. The 7-1-12 profile is a non-linear indexation approach, described and illustrated below:

- Observing prices at 100% from 01 February to 15 March inclusive (31 trading days);

[9] Ofgem (2022), Market stabilisation charge calculation methodology: https://www.ofgem.gov.uk/sites/default/files/2022-02/MSC%20guidance.pdf

- Observing prices at 50% from 16 March to 19 May inclusive (44 trading days);
- Observing prices at 100% from 20 May to 31 August inclusive (71 trading days).



3.7. This price indexation profile change serves two purposes:

- It facilitates the transition to a one-month notice period for the price cap should we deem it appropriate to do so, and
- By bringing price observation closer to delivery, it allows the price cap to better reflect the market at the time, so reducing volume risk for suppliers.

3.8. It is important to highlight that this 7-1-12 indexation approach is expected to be in place for cap period nine only. Further changes to the MSC calculation may be required to reflect any further changes to the price cap indexation approach going forward. We expect to consult on any future changes to the price cap indexation approach which may impact the MSC for as long as the MSC remains in place.

3.9. The outcome of the Medium Term Changes to the Price Cap Methodology statutory consultation process (decision expected in summer 2022) will set definitive expectations on the most appropriate hedging profile for a nominal supplier for summer 2023. However, the MSC formula must include the volume of hedges held for the n+2 season (summer 2023 in this case) as a nominally hedged supplier is expected to be buying n+2 season towards the end of the current season. Therefore, for the time being, we have chosen to reflect what the reduction in notice period implies for summer 2023, which is a start in price observation on 1 September 2022 (instead of 1 August 2022). The formula of the c and c' terms may be amended to reflect a potential changed profile for summer 2023 and if this changes the effective MSC payments change as a result, we will take it into account.

Proposal – amend the algebra of the MSC calculation to reflect the 7-1-12 approach

3.10. Through the 'Qualifying losses' term of the MSC formula, the MSC captures the cost at which a supplier will buy energy (price cap level) and the price at which a losing supplier will unwind their hedge (market price). These values are respectively incorporated into W_{pc} and W_c.

3.11. The MSC algebra factors in the wholesale allowance of the price cap, which has so far itself been based on a linear 6-2-12 price indexation profile. The non-linear 7-1-12 profile therefore impacts the terms that control the volume of hedges held by a nominal supplier for the forward seasons in W_{pc} (b and c).

3.12. Additionally, W_c is defined as the weighted average of the forward contracts for the remainder of the periods a nominal supplier is hedged for. The non-linear 7-1-12 profile therefore impacts the terms that control the volume of hedges held by a nominal supplier for the forward seasons in W_c (b' and c').

3.13. A clarification is made to the definition of D_h and T_h to ensure that it is the fixed number of delivery days held. (which we assume to be the number of calendar/trading days in the next 8 months from the 1st day of the observation period).

3.14. The non-linear 7-1-12 profile results in a breakdown of b and b' so that it captures the rate of hedged volumes for Winter '22/23 at any point in time. In order to reflects this, we propose to build the formula at daily granularity.

3.15. The terms c and c' (ie, the volume hedged for Summer '23) will only be reduced as the guidance to reduce the notice period from two months to one month implies that the observation window for the price cap period 10 starts on the 1 September 2022 instead of the 1 August 2022.

3.16. Below, the changed terms in light of the 7-1-12 indexation profile. The terms reflect the new 7-1-12 price indexation profile that was itself based on trading days, and we therefore built b' and extrapolated it to reach b.

$$b = \frac{D_n + 0.5(D_{d1} - D_{d50}) + (D_{d50} - D_{d154})}{D_H}$$

$$c = \frac{D_{d154}}{D_H}$$

$D_n = Delivery\ days\ of\ season\ n+1\ held\ on\ day\ 1\ of\ season\ n\ (51\ days\ fixed\ throughout\ the\ period)$

$D_{d1} = Term\ growing\ by\ 1\ unit\ per\ calendar\ day\ from\ calendar\ day\ 1\ of\ season\ n\ (1^{st}\ April\ for\ Summer\ '22)$

$D_{d50} = Term\ growing\ by\ 1\ unit\ per\ calendar\ day\ from\ calendar\ day\ 50\ of\ season\ n\ (20^{th}\ May\ for\ Summer\ '22)$

$D_{d154} = Term\ growing\ by\ 1\ unit\ per\ calendar\ day\ from\ calendar\ day\ 154\ of\ season\ n\ (1^{st}\ September\ for\ Summer\ '22)$

$D_H = Total\ number\ of\ delivery\ days\ in\ conventional\ 8\ month\ hedge\ (242\ calendar\ days)$

$$b' = \frac{T_n + 0.5(T_{t1} - T_{t33}) + (T_{t33} - T_{t104})}{T_H}$$

$$c' = \frac{T_{t104}}{T_H}$$

$T_n = Trading\ days\ of\ season\ n+1\ held\ on\ 1st\ day\ of\ season\ n\ (37\ trading\ days\ fixed\ throughout\ the\ period)$

$T_{t1} = Term\ growing\ by\ 1\ unit\ per\ trading\ day\ from\ trading\ day\ 1\ of\ season\ n\ (1^{st}\ April\ for\ Summer\ '22)$

$T_{t33} = Term\ growing\ by\ 1\ unit\ per\ trading\ day\ from\ trading\ day\ 33\ of\ season\ n\ (20^{th}\ May\ for\ Summer\ '22)$

$T_{t104} = Term\ growing\ by\ 1\ unit\ per\ trading\ day\ from\ trading\ day\ 104\ of\ season\ n\ (1^{st}\ September\ for\ Summer\ '22)$

$T_H = Total\ number\ of\ trading\ days\ in\ conventional\ 8\ month\ hedge\ (168\ trading\ days)$

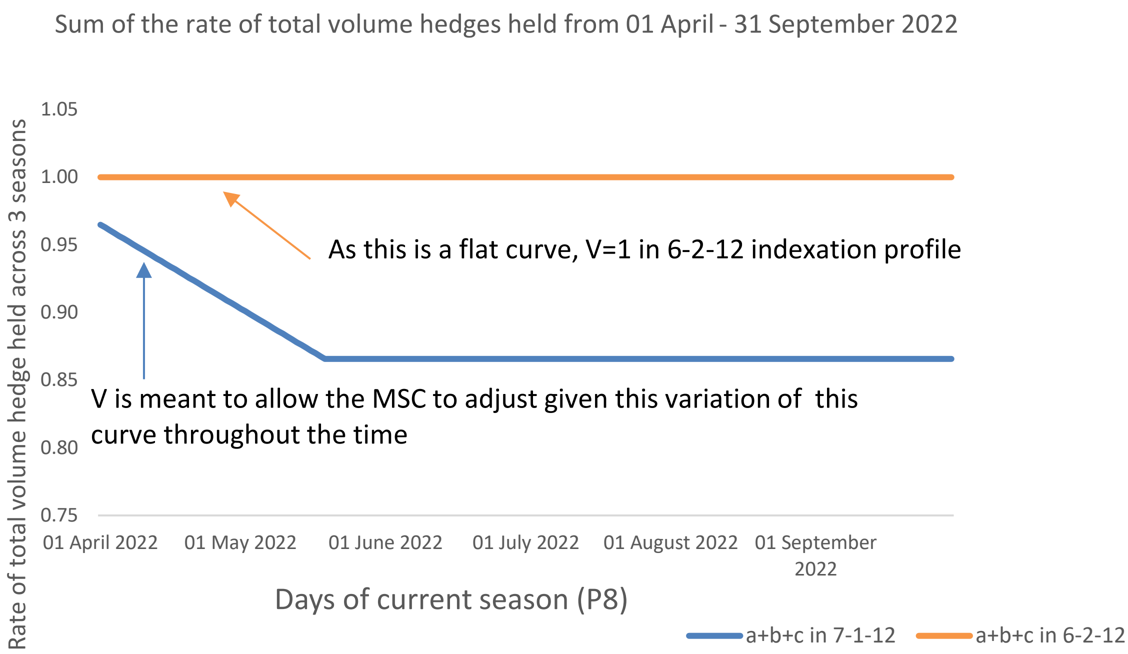
3.17. For information, Table 1 gives the relevant number of pivotal dates in terms of calendar and trading days throughout Summer '22.

Date	31st March	1st April	19th May	20th May	31st August	1stSeptember
Calendar day number	0	1	49	50	153	154
Trading day number	0	1	32	33	103	104

Table 1 - calendar/trading day number for pivotal dates

3.18. Conversely to the previous (linear) 6-2-12 price indexation profile, the non-linear 7-1-12 profile assumes that a nominal supplier will not be holding the same volume of hedges at any point in time during the observation period. Therefore, we introduce a volume factor to the MSC formula to ensure that it is correctly apportioned to the total volume a nominal supplier holds at any point in time. The volume factor should allow to control for a varying total volume held throughout the hedging period. We propose to introduce a volume factor such as:

$$V = (a + b + c)$$



Therefore, Qualifying losses under 7-1-12 non-linear would be changed to:

$$l = v \cdot (W_t - W_c)$$

Alternative option considered – do nothing

3.19. The impact of doing nothing, ie leave the algebra built on a 6-2-12 price indexation profile rather than the 7-1-12 that is being implemented, would be to over-compensate the losing supplier by up to 12%,[10] potentially impacting adversely the competitivity of fixed tariff contracts offered on the market.

3.20. We do not think it appropriate to continue with a "do-nothing" option. We consider that proceeding with an indexation approach for the MSC calculation that differs from the

[10] On the 19th May, when the hedging reverts to 100% as described in para 3.8, a losing supplier would have to unwind its hedge for 37.5 weeks (26 weeks for P8 + 11.5 weeks for P9, including the 9 weeks at 50% between 16th March and 19th May). Under a 6-2-12 profile, a losing supplier would have to unwind 42 weeks' worth of hedges, ie 12% more.

one used as part of the price cap methodology would limit the robustness and effectiveness of the MSC.

Questions

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

2. 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?

4. Adjustment to reflect losses in the MSC

Section summary

The Guidance, and the worked example published on 16 February 2022[11] (the "**Worked Example**") do not include an adjustment for electricity losses or unidentified gas. Here we set out our proposal to include electricity losses and unidentified gas within the MSC calculation.

Context

4.1. During the development of the MSC methodology as part of Ofgem's short term interventions consultation process,[12] we did not explicitly consult on the inclusion of electricity losses and unidentified gas ("**UIG**") in the MSC calculation. This was not raised by stakeholders as part of the statutory consultation responses.

4.2. We consider it appropriate to consult specifically on the inclusion of electricity losses and UIG as part of the MSC calculation. This chapter sets out our proposed approach to amending the MSC calculation for this purpose.

Proposed changes to MSC calculation

4.3. We propose to update the MSC calculation to allow for electricity losses and UIG. When purchasing energy, suppliers will be likely to include provision for losses and UIG in their hedging strategy. We consider it appropriate to also reflect these losses in the MSC calculation to allow for a more robust and reflective view of the wholesale costs to which a supplier is exposed.

[11] Ofgem (2022), MSC guidance worked example: https://www.ofgem.gov.uk/sites/default/files/2022-02/MSC%20Guidance%20Worked%20Example%20.xlsx
[12] Ofgem (2022), Statutory consultation on potential short-term interventions to address risks to consumers from market volatility: https://www.ofgem.gov.uk/sites/default/files/2021-12/StatCon%20Interventions%20to%20manage%20risks%20from%20current%20market%20volatility%20Final%20version_0.pdf

4.4. For electricity losses we propose to apply a percentage uplift of 9.88% and for UIG we propose to apply a percentage uplift of 1.82%. These values are broadly consistent with how the price cap methodology accounts for electricity losses and UIG, at the GB average level. These figures are derived from annex 2 on the wholesale cost allowance methodology to our price cap decision, published on 3 February 2022.[13] The direct fuel cost allowance in the cap takes into account both electricity and gas network losses.

4.5. The 'Supplementary workbook to Annex 2, 3 and 4 – demand and losses v1.8' that we published alongside our 3 February price cap decision develops the distribution and transmission losses in the energy network, using the latest publicly available industry data at the time of determining the cap levels. These losses are broken down into the 14 electricity distribution regions in GB and then applied to the direct fuel allowance on a "per region" basis. For the purposes of the MSC calculation, we are proposing to use the GB average electricity losses for single rate metering arrangement, which is 9.88%.

4.6. For UIG we propose to use the latest estimate of UIG uplift for non-PPM gas which is 1.82%, as set out in annex 2 to our February 2022 price cap decision. This is our most recent estimate of UIG using the most up-to-date industry data. More details can be found in our recent decision published on 4 February 2022.[14]

4.7. We consider that using the electricity losses and UIG uplifts from the above source allows ease of access and transparency. These figures have been developed as part of our wider price cap methodology and have been consulted on transparently through this process already.

4.8. The vast majority of electricity consumers are single rate. Similarly, the majority of gas consumers are non-PPM. We consider that both these user types are a fair representation of the typical consumer. We do not have a separate MSC for different consumer types and we consider it appropriate to avoid complexity where possible.

[13] Ofgem, 2022: https://www.ofgem.gov.uk/publications/default-tariff-cap-level-1-april-2022-30-september-2022
[14] Ofgem, 2022: https://www.ofgem.gov.uk/publications/price-cap-decision-reflecting-prepayment-end-user-categories-default-tariff-cap

Using a weighted average approach may cause further complexity while not providing much in terms of benefit.

4.9. We consider it appropriate to use the same set of uplifts for losses across the full observation period for the 7-1-12 price indexation profile. Doing so helps to avoid any additional complexity. We may review the electricity and gas uplift values as part of any future wider review of the MSC.

Implementation

4.10. As set out in the current MSC Guidance, the MSC (A, £/MWh) is calculated using the formula below:

$$A = x \cdot l \cdot t \cdot c$$

where:

x	**The derating factor (%)**
l	Qualifying losses (£/MWh)
t	Consumption weighting factor (%)
c	Conversion factor (unitless)

4.11. The 'Qualifying losses' are the financial losses incurred by a nominal supplier, beyond a trigger point, derated by a factor and accounting for the fact that suppliers hold different volumes of gas/electricity at different times of the year. We propose to update the 'Qualifying losses' component of the equation to also allow for electricity losses and UIG.

4.12. The 'Qualifying losses' are dependent on both the wholesale cost of energy (W_c) and the wholesale element of the price cap (W_{pc}). Section 2.3 of the current MSC guidance sets out the definition of these factors. We propose to update the definition of these two factors as set out below (new text double underlined):

$\mathbf{W_c}$	**The wholesale cost of energy, <u>including elec losses/UIG</u> (£/WMh)**
$\mathbf{W_{pc}}$	The wholesale element of the price cap, <u>including elec losses/UIG</u> (£/MWh)

4.13. Each fuel type will have its own uplift applied as described earlier in this chapter, to allow calculation of a separate MSC for both electricity and gas.

Alternative option considered – do nothing.

4.14. We do not think it appropriate to continue with a "do nothing" option. Energy suppliers take account of losses when purchasing energy, so it is appropriate that the MSC reflects this. We consider that proceeding with the "minded to" position to explicitly account for electricity losses and UIG makes the MSC calculation more robust and reflective of the costs facing suppliers.

Questions

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

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

Appendix 1 - Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the retained General Data Protection Regulation (the "**UK GDPR**").

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "**Ofgem**"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the UK GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

4. With whom we will be sharing your personal data

We may share consultation responses with BEIS and HMT, where appropriate.

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for six months after the project, including subsequent projects or legal proceedings regarding a decision based on this consultation, is closed.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete

- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas

8. Your personal data will not be used for any automated decision making.

9. Your personal data will be stored in a secure government IT system.

10. More information For more information on how Ofgem processes your data, click on the link to our "Ofgem privacy promise".