Decision

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Decision on changes to market stabilisation charge

Subject	Details
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From 31 March 2022 to 14 April 2022, we consulted on changes to the Market Stabilisation Charge ("**MSC**") parameters to make the charge more robust in the light of continued high and volatile wholesale prices. We also consulted 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 (the "**Indexation Guidance Letter**") and (b) electricity losses and unidentified gas.

Taking into consideration the responses to the consultation, this document describes our decision to revise the MSC, so that it better protects consumers' interests. The revisions are to:

- Alter the parameters so that the threshold (the percentage the wholesale price must fall below the price cap assumptions before the MSC applies) is reduced from 30% to 10% and the derating factor (the percentage of incremental hedging losses covered by the MSC) is increased from 75% to 85%
- Adjust the MSC calculation to take account of the Indexation Guidance Letter
- Adjust the MSC calculation to take account of electricity losses and unidentified gas ("**UIG**").

The revisions, set out in the updated MSC guidance document[1] that accompanies this Decision (the "**May Guidance**"), come into force on 25 May 2022. Also published today is a Statutory Consultation on changes to the wholesale methodology in the price cap that proposes quarterly updates among other changes (the "**Quarterly Update Consultation**") and an additional letter relating to price indexation (**the "Second Indexation Guidance Letter**"). These will in due course have further impacts on the MSC calculation.

This document therefore also provides future visibility of our intentions for the MSC, including our plan to consult in June 2022 on (a) Changes to the MSC calculation to reflect the Second Indexation Guidance Letter and (b) the extension of the MSC to 31 March 2023.

[1]Updated MSC guidance can be found in Version 2 both in final version and a marked up version with amendments on our decision page: https://www.ofgem.gov.uk/publications/decision-changes-market-stabilisation-charge

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Executive summary

The unprecedented rise in global energy prices, exacerbated by recent geo-political events surrounding the invasion of Ukraine, continues to put severe strain on energy markets. As the regulator of gas and electricity markets in Great Britain, Ofgem continues to develop and implement policies to manage this situation in the interests of energy consumers now and in the future.

The MSC, coupled with the ban on acquisition-only tariffs, form part of Ofgem's package of interventions to stabilise the domestic retail market in the current exceptional circumstances. These two measures recognise that the price cap effectively rules out some options suppliers might otherwise use to manage wholesale volatility, and they are necessary to mitigate the risks to suppliers if wholesale energy prices fall back towards historic levels. They enable suppliers to continue to work within the boundaries of the price cap to manage the procurement of energy on behalf of consumers. Following the invasion of Ukraine, hedging risks in the market increased and we consulted on changing the parameters of the MSC to make it more effective.

The MSC works alongside the price cap and today we are launching a statutory consultation on changes to the price cap which would help mitigate these risks (the "**Quarterly Update Consultation**[2]"). We are also publishing new guidance on indexation (the "**Second Indexation Guidance Letter**[3]"). However, these changes, if made, will take some months to fully flow through to suppliers' hedging positions. In the meantime, it is necessary in consumers' interests that the short-term measures, including the MSC, are effective. Markets remain volatile and there is significant uncertainty about wholesale price movements in the coming months. Under these conditions, domestic suppliers, even if well-hedged, are carrying significant risk, which could affect their ability to deliver for consumers.

Update to the MSC parameters

The effectiveness of the MSC is governed largely by two parameters. The first is the threshold which is the percentage by which the wholesale electricity and/or gas cost[4] must

[2] https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

[3] https://www.ofgem.gov.uk/publications/price-cap-may-2022-updated-guidance-treatment-price-indexation-future-default-tariff-cap

[4] As defined in the Guidance

fall below the wholesale element of the price cap to trigger the MSC[5]. The second is the de-rating factor, which is the percentage of the incremental hedging losses incurred by a nominal supplier, beyond the threshold, that is covered by the MSC. The parameters were initially set at 30% and 75% respectively.

We consulted on 31 March 2022 on changing these parameters (the "**March Consultation[6]**"). In response, a majority of stakeholders agreed that the parameters should be adjusted to make the charge more effective. Almost all who supported a change indicated a preference (within the range suggested) of a 10 per cent threshold and a 90 per cent derating factor. Five stakeholders advocated going beyond the consulted range with a threshold of less than 10 per cent and/or a derating factor above 90 per cent.

Our approach is to set the parameters at the minimum intervention that we judge would allow an efficient and well-managed supplier to finance its business and make prudent hedging decisions. We have assessed this through considering the profitability of a notional supplier with 5 million customers that has hedged prudently at 100% of its projected sales covered by the price cap. This is not a precise science, not least because we cannot know what future prices will do, and so we have sought a balanced outcome across our scenarios.

Our modelling suggests that with a threshold of 10% and a derating factor of 85% such a supplier would remain financeable (with low, but positive, underlying earnings before interest and tax ("**Underlying EBIT**")) if wholesale prices fall. Because our notional supplier is 100% hedged, it is also protected if prices rise. We have therefore decided to set the parameters at this level, which is the minimum intervention needed to secure the stability of the supply business and enable suppliers to better perform their function of procuring energy on behalf of customers in these unprecedented conditions.

This will help to avoid the risk that consumers end up paying more in the long run. If suppliers are unable to source energy for their customers and finance their businesses, consequences could include:

- Unplanned or disorderly market exits, with possible large mutualised costs for consumers:
- Consolidation, leading to insufficient competition;

[5] The threshold percentage is used in the MSC Guidance to calculate the "Losing Supplier Loss Trigger" as part of the MSC calculation
[6] Consultation on changes to market stabilisation charge | Ofgem

- Weak or no investment, and lack of innovation;
- Poor customer service.

Technical changes

After considering stakeholder responses, we have decided to implement the technical changes proposed in our consultation – to amend the MSC calculation to reflect the 7-1-12 price cap indexation profile and to uplift for UIG and losses. Stakeholders who provided views on our proposed technical changes were in general agreement with the inclusion of these changes.

Next steps

The Quarterly Update Consultation launched today and the Second Indexation Guidance Letter will require future changes to be made to the MSC calculation. We intend to cover our proposals to deal with these matters in a consultation which we expect to hold in June 2022 (the "**June Consultation**").

When we introduced the MSC in April 2022, the new licence condition gave the Authority the option to extend the measure until 31 March 2023 by publishing a statement in writing to that effect. Although we did not explicitly ask stakeholders about extending the MSC in the March Consultation, most chose to comment on this issue and the great majority of them urged us to extend it as soon as possible.

We currently consider that there is a strong basis for those requests as the risks that the MSC is designed to cover extend beyond September 2022. We therefore anticipate that we will extend the MSC until 31 March 2023, subject to consultation, which we will include as part of the June Consultation. That consultation document will set out our evidence and rationale. The responses to that consultation, alongside the market conditions at the time, will inform the Authority's decision.

Naturally, suppliers' procurement and hedging strategies remain their commercial decisions to take. Whilst we are endeavouring to provide as much information and clarity in advance of our decisions as possible, stakeholders must continue to assess and manage their own commercial risks.

1. Introduction

Context and related publications

1.1. The rise and volatility in global energy prices that started in 2021 intensified following Russia's invasion of Ukraine on 24 February 2022. This has continued to put energy markets under severe strain globally and prices remain high. Continued geopolitical events such as restrictions on Russian gas exports to some countries and embargoes by others mean that energy suppliers face an increased challenge of managing risks in buying energy for their domestic customers.

1.2. To help enable suppliers to manage those risks in the price cap environment while being able to finance their businesses, Ofgem decided on 16 February 2022 to introduce the MSC along with a ban on acquisition-only tariffs. On 31 March 2022, following the invasion of Ukraine and taking account of further internal analysis, Ofgem consulted on changes to the MSC (the "**March Consultation**"). This proposed changing the MSC parameters within a specified range. It also proposed certain technical changes to reflect Ofgem's guidance to suppliers dated 15 March 2022 on indexation of wholesale costs in the price cap (the "**Indexation Guidance Letter**"), and in relation to electricity losses and unidentified gas ("**UIG**").

1.3. The remainder of this document summarises the responses we received to consultation and sets out our decisions on how to proceed along with our planned next steps:

- Section 2 sets out our decision on the new MSC parameters.
- Section 3 sets out our conclusions on updating the MSC calculation to reflect guidance in price cap indexation.
- Section 4 sets out our conclusions on updating the MSC calculation to reflect electricity losses and UIG.
- Section 5 sets out planned next steps including issues we plan to cover in the June Consultation
- Section 6 provides information on our approach to considering consumer impacts and the use of a notional company to model the MSC.

1.4. The changes outlined in Sections 2 to 4 will come into effect on 25 May 2022.

1.5. The changes outlined in this decision document require updates to the MSC Guidance. Alongside this decision document we have published updated MSC Guidance which reflects the changes made as part of this consultation process (the "**May Guidance**") and some minor consequential changes to improve clarity. In the interests of transparency, we are also publishing a marked-up version of the MSC Guidance alongside this decision document.

Related Publications

1.6. The **MSC** is part of a wider package of measures to stabilise the retail energy market and protect consumers. These were published on 4 February 2022 and are described at:

https://www.ofgem.gov.uk/publications/overview-4-february-2022-price-cap-decisions

1.7. Of particular relevance to this decision is the **Volatility Decision** of 4 February 2022 to uplift the price cap in the periods commencing 1 April 2022 and 1 October 2022. This was to take account of the costs incurred in the period 1 October 2021 to 31 March 2022 arising from wholesale price volatility:

https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

1.8. The decision to implement the MSC and the ban on acquisition-only tariffs, published on 16 February 2022:

https://www.ofgem.gov.uk/publications/decision-short-term-interventions-address-risks-consumers-market-volatility

1.9. The **Guidance** that accompanied the MSC Decision, published on 16 February 2022:

https://www.ofgem.gov.uk/sites/default/files/2022-02/MSC%20guidance.pdf

1.10. **The Indexation Guidance Letter** of 15 March 2022, setting out proposed changes in the indexation of wholesale costs in the default tariff price cap:

https://www.ofgem.gov.uk/publications/updated-guidance-treatment-price-indexation-future-default-tariff-cap-proposals

1.11. The **March Consultation**, published on 31 March 2022, on changes to the MSC:

https://www.ofgem.gov.uk/publications/consultation-changes-market-stabilisation-charge

1.12. The **May Guidance,** which is an updated version of the Guidance that gives effect to this Decision, published on 16 May 2022:

https://www.ofgem.gov.uk/publications/decision-changes-market-stabilisation-charge

1.13. The **Second Indexation Guidance Letter** of 16 May 2022, setting out proposed changes in the indexation of wholesale costs in the default tariff price cap:

https://www.ofgem.gov.uk/publications/price-cap-may-2022-updated-guidance-treatment-price-indexation-future-default-tariff-cap

1.14. **The Quarterly Update Consultation**, published on 16 May 2022, comprising a statutory consultation on changes to the default tariff price cap, including changes to help manage volatility risks:

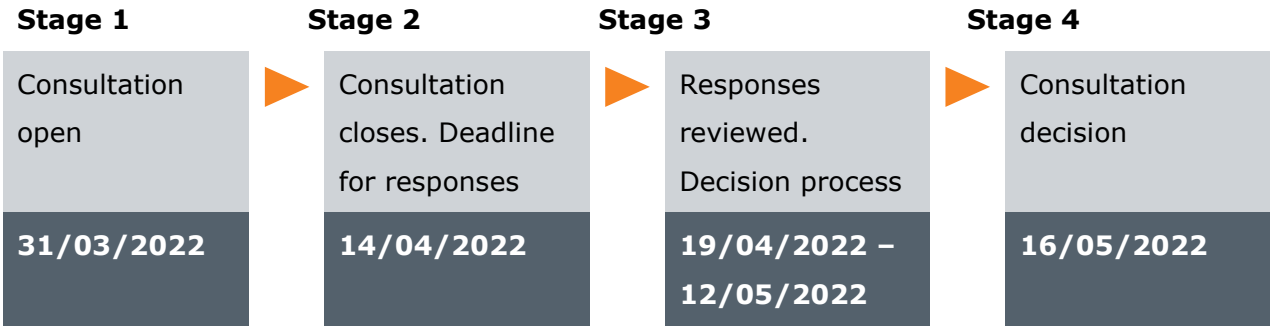
https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology

Our decision-making process

1.15. As described above, we launched a consultation (the "**March Consultation**") on 31 March 2022. The consultation closed on 14 April 2022 and we received a total of 12 responses, a small number of which were received very shortly after the closing date and have been considered.

1.16. Of the 12 responses, 7 were non-confidential (or the stakeholder provided a non-confidential redacted version of an otherwise confidential response) and 5 were confidential.

Figure 1: Decision-making stages



Your feedback

Consultation feedback

1.17. We have published non-confidential responses to this consultation on our website at https://www.ofgem.gov.uk/energy-policy-and-regulation/engagement/consultations.

General feedback

1.18. We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
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. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments?

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

2. Changes to the market stabilisation charge parameters

Section summary

Our March Consultation explained how, following Russia's invasion of Ukraine on 24 February 2022, global energy markets have experienced levels of price and volatility that have been significantly higher than those faced in January 2022. This increased risks for energy suppliers both as prices rise and as they fall. We therefore proposed strengthening the parameters of the MSC to ensure that it is effective in achieving its purpose in preventing the detriments to consumers from the risk of supplier exits and a less competitive market.

A majority of stakeholders agreed that the MSC should be strengthened, and argued for the strongest parameters in our range, with some saying Ofgem should go beyond the range indicated. Other stakeholders questioned the need for change.

It is in the interests of consumers that the retail energy market is stable, which means that well-managed energy suppliers should be able source energy for their customers and finance their businesses, so they can properly carry out the function of supplying energy. To this end, we set out below our decision on the required changes to the parameters of the MSC to ensure that it is effective.

Decision summary

2.1. In the light of the responses to the consultation and the analysis undertaken we have set the new MSC parameters to be a threshold of 10% and a derating factor of 85%. These new parameters will come into force on 25 May 2022.

Stakeholder responses

2.2. Stakeholders generally agreed with our assessment that the MSC parameters needed to be strengthened (nine of the twelve responses took this view, while two opposed our proposals and one was neutral). Those that were supportive of change generally noted that geopolitical changes had increased the need to ensure that the MSC was effective, but several felt that the current parameters of a 30% threshold and a 75% derating factor were insufficiently effective in any event, regardless of the invasion of Ukraine.

2.3. Two stakeholders proposed parameters of 0% and 100%, arguing (a) that this would put suppliers in the position that they would have been absent market volatility and (b) that the current arrangements give all customers an option to pick the lower of the hedged price and the forward price, and this creates a huge volume risk for suppliers. Three others

also argued for stronger parameters beyond the range put forward by Ofgem but not as far as 0% and 100%.

2.4. Several stakeholders urged Ofgem to take an immediate decision to extend the MSC, pointing out that the price cap indexation methodology implies that they would have large hedge positions postdating September 2022 which could be at risk from switching in the autumn.

2.5. Other stakeholders were sceptical of the need to alter the parameters and argued that the cost-of-living crisis necessitated the lowest possible prices for engaged consumers. Others sought more evidence from Ofgem. Concerns were also raised that the strengthened MSC might create an oligopoly and that the incentive to switch would be lost. Some stakeholders suggested that Ofgem should give more weight to the interests of present consumers compared to the longer-term benefits of a supply sector that can finance its activities. It was suggested that many of the remaining suppliers are (parts of) large financially stable companies and that it was unnecessary to protect them.

2.6. Some stakeholders who are cautious about the changes also suggested that Ofgem should exclude switches that were from non-capped contracts from the scope of the MSC, as they considered such customers would not have hedge risks attached to them.

Ofgem response

2.7. Consistent with our principal objective, it is in existing and future consumers' interests that efficient and well-managed firms in the energy supply segment remain able to source energy for their customers and finance their activities. It is also in the interests of consumers to have a stable market. Our approach is consistent with our duties to have regard to the need to secure that licence holders are able to finance their activities and the need to secure that all reasonable demands for energy are met. These duties sit alongside the need to contribute to the achievement of sustainable development, as well to carry out our statutory functions wherever appropriate by promoting effective competition in the market.

2.8. The segment performs many vital functions including collecting the monies that the entire sector needs to deliver for consumers, managing customer accounts and ensuring that customer needs are met; and administering a number of important social and environmental programmes.

2.9. Given the evidence, we are not persuaded by the arguments to strengthen the parameters to a threshold of 0% and a derating factor of 100%. This would wholly insulate suppliers from the impacts of wholesale market volatility at a time when consumers are facing significant hardship. We think suppliers have the capacity to play a part in helping manage those risks.

2.10. We do not consider that we should prioritise the lowest possible prices for consumers at the present time over the need to enable efficient suppliers to finance their businesses. Doing so would mean that pricing would not cover efficient costs, which would risk severe detriments, as discussed below. Similarly, we are not persuaded that we should prioritise present consumers over future ones beyond, where appropriate, using a discount rate to reflect the time value of money.

2.11. Significant detriment would be likely to arise for consumers if the regulatory framework does not allow the efficient costs of providing energy to be recovered. These detriments could include disorderly or unplanned exits (with potentially significant mutualisation costs), consolidation and lack of competition, low or no investment and poor service, lack of innovation and ultimately failure to properly carry out the activity.

2.12. In this context, it should be noted that, given the current very high level of prices, a threshold of 10% would still enable active customers to access significant gains based on falls in the wholesale market, even with a derating factor of 85%. For example, if the price cap cost is assessed at £2,000, a 10% threshold would allow consumers to access the first £200 of savings if wholesale prices fall, before the MSC has any impact. In addition, consumers who switch will also be able to make gains from the normal competitive opportunities – for example from better systems and lower cost bases, regardless of the MSC.

2.13. In order to get the best outcome for consumers, it is necessary to set a balance; the parameters need to be effective in preventing excessive financial stress for a nominal supplier while leaving room for suppliers to manage some of the expected risks themselves. We have therefore sought to assess this through a modelling exercise for which the principal metric is the Underlying EBIT of a notional supplier ("**NoCo**") with 5 million customers that has hedged prudently. We have looked at NoCo's Underlying EBIT across a number of scenarios. Our approach to this is set out in detail in section 6 and summarised in the following paragraphs.

2.14. In calculating the Underlying EBIT, we have disregarded the income arising from the **Wholesale Risk Allowance**. This is a £59 uplift to the price cap for a typical consumer,

which applies from April 2022 to March 2023, that was set out in the Volatility Decision. We exclude this uplift as it relates to compensating suppliers for prior period losses incurred between October 2021 and March 2022 (but not covered by the price cap at the time) and are not relevant to financeability going forward. We also deduct from Underlying EBIT the portion of the Wholesale Risk Allowance that, because of switching in our price fall scenarios, is not recovered.

2.15. Finally, we add to Underlying EBIT a sum to reflect the amount that NoCo is likely to make from customer acquisitions. This involves a certain degree of judgement but it is clearly a mitigation that is in the power of suppliers to influence by their own skills and abilities. We think it likely that suppliers will be able to achieve relatively high margins transitionally for acquired customers in a falling wholesale price environment (despite the MSC), and have estimated this mitigation as worth 0.9% EBIT, based on the switching levels in our scenarios.

2.16. The results in section 6 show that across our scenarios, NoCo achieves a positive Underlying EBIT that is below the 1.94% benchmark in the price cap with the MSC threshold at 10% and the derating factor at 85%. Cross-checking against confidential individual company data gives similar results (with some dispersion as companies differ) and a review of cash positions also indicates that these parameters will be effective in sufficiently mitigating financial stress in the scenarios we have explored.

2.17. We note the comments by stakeholders on extension of the MSC, the use of a fixed rather than percentage threshold and removing switches from non-capped contracts from the scope of the MSC. These are not issues we consulted on in the March Consultation so we have not taken decisions on them at this time. We discuss some of these issues in section 5 on next steps below.

Consumer interest

2.18. As noted above, it is in consumers' interests to have a viable and secure supply segment. This means that suppliers must be able to recover the efficient costs of the services they provide in order to properly serve customers.

2.19. We have estimated the impact of the change in MSC parameters on pricing for engaged customers and set this out in Section 6. At a distributional level, it remains the case that the savings from switching before the hedges are unwound accrue to engaged consumers only, while the costs from suppliers being unable to finance their operations – whether manifested through disorderly exits and mutualisation costs, lack of investment or

degradation of service and capability, accrue to all consumers. To the extent that vulnerability is disproportionately represented among disengaged consumers, the costs of failing to have an effective MSC could disproportionately affect vulnerable people.

3. Amending MSC calculation to reflect guidance on price indexation

Section summary

On 15 March 2022, Ofgem published the Indexation Guidance Letter on how the price cap indexation will change for the current observation window with regards to price cap period nine. This section describes our decision to allow for the updated price cap indexation in the MSC calculation.

Context

Guidance on price indexation

3.1. On 15 March 2022, Ofgem issued a letter with updated guidance on the treatment of the price indexation for cap period nine (the "**Indexation Guidance Letter**"). This letter set out updated guidance for domestic energy suppliers on the treatment of wholesale prices observed during the transitional period to a new cap mechanism due to start in October 2022. This is in readiness for shortening the period between price observation and delivery. We set out in this letter an indexation profile which extended 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.

3.2. This change in indexation approach impacts the MSC calculation. The previous version of the MSC Guidance document[7] sets out the calculations used to calculate the MSC. In this section, we set out our decision on the required changes to the MSC Guidance to allow for the new temporary indexation approach.

3.3. This decision document only relates to the intention to amend the MSC calculation to appropriately reflect the 7-1-12 indexation profile. We note that today we have also set out

[7] Ofgem, 2022 Market Stabilisation Charge Guidance: https://www.ofgem.gov.uk/sites/default/files/2022-02/MSC%20guidance.pdf

further guidance on price cap indexation going forward, ahead of the move to a quarterly price cap from Oct 2022.[8] We will consult in the June Consultation on relevant further changes to the MSC calculation to reflect the Second Indexation Guidance Letter.

Decision summary

3.4. We consider that the 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. We have taken into account feedback from all stakeholders, which was broadly supportive of our proposals in this area. As the price cap indexation is an important element of the MSC calculation, we consider it necessary to make this decision to align the MSC calculation with the updated guidance on indexation to ensure the MSC can continue to function as intended. The rest of this section describes this feedback and sets out our response.

3.5. We will apply the new temporary 7-1-12 indexation approach as set out in the March Consultation. It is worth noting that although the 7-1-12 indexation approach will be applied to the calculation of the price cap index, the MSC is based on a 7-1-6 notional hedging strategy, as that is the expected notional hedging strategy of suppliers (consistent with the previous published MSC Guidance. We have provided further detail on how the updated indexation approach impacts the MSC calculations in the updated MSC Guidance that has been published alongside this decision. In the interests of transparency, we have also published alongside this decision, an updated worked example which has been amended to reflect the 7-1-6 notional hedging strategy that corresponds to the 7-1-12 indexation profile (and uplifts for UIG / losses).

Stakeholder feedback and Ofgem responses

3.6. Stakeholders were supportive of the proposals to incorporate the 7-1-12 price indexation guidance within the MSC calculation. Of the twelve stakeholders in total that responded, eight stated their agreement with our proposed approach. No stakeholders disagreed with our overarching proposal.

3.7. For example, one stakeholder communicated that it was important the MSC reflects the actual losses incurred by a supplier that has hedged price cap volumes in line with the

[8] https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology

observation window. Another stakeholder commented that failing to update the hedging indexation approach would result in the MSC not functioning as intended.

3.8. We agree that updating the hedging indexation approach would allow the MSC to function as intended. Using a different indexation approach from the one used as part of the price cap methodology would limit the robustness and effectiveness of the MSC. This would also potentially lead to the over-compensation of the losing supplier, impacting adversely the competitivity of the fixed tariff contracts offered on the market.

3.9. One stakeholder, while in agreement at a high level with the proposed approach, was concerned with the complexity of the calculation. To help reduce complexity they suggested we adopt the usage of calendar days for the W_c part of the calculation, rather than trading days. It was also suggested that a model should be provided so suppliers can see how the calculations will work.

3.10. We are cognisant of the balance between having a temporary mechanism that is not unduly complicated (in the interests of transparency), versus one that aims for greater accuracy. While a more detailed approach may increase complexity, a more simplistic approach can risk increasing the degree of uncertainty. We have based the current approach in line with industry views and consider that reflecting trading days as part of the W_c calculation is an appropriate distinction.

3.11. The stakeholder also commented on the values of D_n and T_n, suggesting alternative values they believe should be used. D_n and T_n are set at 51 and 37 days respectively because of the non-linearity of the temporary 7-1-12 indexation profile. Between 16 March and 19 May we are applying a 50% weighting to price observation. They also raised other points of clarification on the MSC methodology. The worked example published alongside this document should provide the relevant detail required to address these comments.

3.12. A stakeholder raised a concern around the effectiveness of the MSC design under different circumstances. Specifically, to do with the market being in backwardation or contango. As stated in the MSC guidance, we will continue to assess whether further changes to the MSC are needed under various wholesale market scenarios. We have not considered as part of this consultation amending the MSC as a mechanism to reflect the cost implications associated with backwardation or contango. However, in our Statutory consultation on changes to the Price Cap Methodology published today, we set out our proposals to include an ex-ante allowance for costs related to backwardation. We will continue to review whether further changes to the MSC calculation are needed (within its expected lifetime) to account for changes made as part of our wider changes to the price

cap changes methodology, including the introduction of an ex-ante backwardation allowance.

4. Adjustment to reflect losses in the MSC

Section summary

The MSC Guidance, and the worked example published on 16 February 2022 (the "Worked Example") did not include an adjustment for electricity losses or unidentified gas. Here we set out our decision to include electricity losses and unidentified gas within the MSC calculation and therefore to update the MSC Guidance to include these factors. This section also sets out a minor clarification made to the Guidance to make clear when the charge takes effect.

Context

4.1. During the development of the MSC methodology as part of Ofgem's short term interventions consultation process, we did not explicitly consult on the inclusion of electricity losses and unidentified gas ("**UIG**") in the MSC calculation. After receiving further feedback on our approach to losses and UIG in the MSC, we considered it appropriate to consult industry on their inclusion in the MSC calculation. The March Consultation proposed their inclusion in the MSC calculation.

Decision Summary

4.2. We have decided to update the MSC calculation to allow for electricity losses and UIG. After considering stakeholder feedback, we consider it appropriate to 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, and to bring into alignment with the price cap methodology (by accounting for electricity losses and UIG in a consistent way). The rest of this section describes stakeholder feedback and sets out or response.

4.3. We will apply a percentage uplift of 9.88% for electricity losses and an uplift of 1.82% for UIG. These figures are consistent with Annex 2 on the wholesale cost allowance methodology, published on 3 February 2022.[9] They represent the GB average losses for electricity and our estimate of UIG uplift for non-PPM, both used in the current price cap allowance.

[9] Ofgem, 2022: https://www.ofgem.gov.uk/publications/default-tariff-cap-level-1-april-2022-30-september-2022

4.4. We will update the definition of the wholesale cost of energy (W_c) and the wholesale element of the price cap (W_{pc}) to include electricity losses and UIG, as set out in section 4.12 of the March Consultation. We will use the same set of uplifts for these losses across the full observation period for W_t, therefore, we have also defined W_t to include electricity losses and UIG after the application of the trigger point to W_{pc}.

Stakeholder feedback and Ofgem responses

4.5. Stakeholders were supportive of the proposals to allow for the inclusion of electricity losses and UIG within the MSC calculation. Of the twelve stakeholders in total that responded, seven stated their agreement with our proposed approach with none stating their disagreement.

4.6. Several stakeholders remarked that allowing for electricity losses is a necessary adjustment and ensures the MSC more accurately reflects the actual volumes that would be hedged by suppliers. It was also stated that our proposal reflects the way losses and UIG are already captured within the price cap methodology.

4.7. Another stakeholder said that it is not appropriate to provide an MSC payment based on consumer energy usage, but rather should be based on the energy purchased by a supplier.

4.8. We agree that allowing for electricity losses and UIG in the MSC calculation more accurately reflects the volume of hedges held by suppliers. Energy suppliers take account of losses when purchasing energy, so it is appropriate the MSC calculation reflects this. This will allow for a more robust view of the 'Qualifying losses'[10] incurred by a nominal supplier.

4.9. Two stakeholders said that they felt the allowances were too low. The uplifts we proposed are based on those being used in the price cap. We consider this point to be related to the allowances within the price cap methodology, therefore not directly in scope of this consultation process. We do not consider it appropriate to have an uplift for electricity losses and UIG that deviates from those used in the price cap. Further discussion

[10] The 'qualifying losses' to which the derating factor applies are the difference between the wholesale price (wc) and the Losing Supplier Loss Trigger (wt). This means that the losses that the MSC covers are the incremental losses below the trigger point.

of the UIG allowance in the price cap methodology can be found in section 3 of our decision on 'reflecting prepayment end user categories in the default tariff cap'.[11]

4.10. A stakeholder raised the concern that fluctuating volumes of UIG may result in the potential of a gaming scenario, whereby different MSC payments would occur given the same drop in wholesale prices. We engaged with this stakeholder to clarify the point made and the concern has been alleviated. Given that we will apply a fixed UIG uplift over time rather than a dynamic uplift reflecting changes in volumes, we do not consider there to be a risk of gaming. The UIG uplift used will reflect that used in the price cap methodology for the current charge restriction period. We may review the electricity and gas uplifts used in the MSC as part of any future wider review of the MSC.

4.11. A stakeholder also raised an issue around the lack of clarity on the timing of when the MSC charge is in effect. Taking this into consideration and also after discussions with Retail Energy Code Company (RECCo) who administer the MSC, we have decided to remove the ambiguity around the timing of what day and time the regular weekly MSC will come into effect. The original MSC guidance document stated that the weekly MSC charge comes into effect at 00:01 each Wednesday (for a week with no bank holiday). We consider it appropriate to change this timing to 00:00 rather than 00:01. The charge will then remain in place until the next weekly charge takes effect, whilst the MSC is still in effect. Further detail is set out in the latest MSC Guidance document published alongside this decision.

[11] Ofgem, 2022: Price Cap - Decision on reflecting prepayment End User Categories in the default tariff cap | Ofgem

5. Next steps

Section summary

This section sets out our intended next steps in relation to the MSC and, in particular, the matters we intend to consult on in June.

Background on price indexation

5.1. We are today launching a statutory consultation on medium term changes to the price cap which will help mitigate the stresses for suppliers relating to volume risk going forward, together with new guidance on price cap indexation (the "**Second Indexation Guidance Letter**").

5.2. Under these proposals, we propose to transition to a three-month 'index observation window' (as opposed to the current six-month index observation window) and to update the level of the price cap on a quarterly basis. We also propose to reduce the period between the end of the observation window and when the cap level takes effect, from 2 months to 30 working days (~6 weeks). Assuming that suppliers hedge in accordance with the index, this will reduce the hedge values at risk by about 50% and also reduce the time over which these hedges are held. This will make the price cap inherently more robust against future price volatility.

5.3. However, if suppliers have been hedging in accordance with the price cap indexation profile, half of the hedges needed for the period October 2022 to March 2023 will already be in place by 1 June 2022. While the transitional arrangements mean a short pause (from 1 June 2022 to 18 August 2022) in indexation for the period January 2023 to March 2023, indexation for the period October to December 2022 will continue.

5.4. Taking account of (a) the significantly higher consumption in winter than summer (broadly two thirds winter, one third summer in cost terms); (b) the high proportion of hedges already in place or shortly to be bought if suppliers follow the indexation, and (c) the high prices in recent months, the hedge values at risk in price cap period 9 (October 2022 to March 2023) are likely to be higher than during the current period.

MSC extension

5.5. When we introduced the MSC in April 2022, the new licence condition gave the Authority the option to extend the measure until 31 March 2023 by publishing a statement in writing to that effect. Although we did not explicitly ask stakeholders about extending the

MSC in the March Consultation, most chose to comment on this issue and the great majority of them urged us to extend it as soon as possible.

5.6. We currently consider that there is a strong basis for those requests as the risks that the MSC is designed to cover extend beyond September 2022. We therefore anticipate that we will extend the MSC until 31 March 2023, subject to consultation, which we will include as part of the June Consultation. The consultation document will set out our evidence and rationale. The responses to that consultation, alongside the market conditions at the time, will inform the Authority's decision. Naturally, suppliers' procurement and hedging strategies remain their commercial decisions to take. Whilst we are endeavouring to provide as much information and clarity in advance of our decisions as possible, stakeholders must continue to assess and manage their own commercial risks.

Further indexation changes to MSC calculation

5.7. The Second Indexation Guidance Letter, published today, sets out interim and enduring changes to the indexation of the price cap wholesale cost calculation as part of the intended move to 3-month indexation. This will have consequences for the MSC algebra, especially as the cumulative weight of hedges bought in accordance with the indexation begins to diverge from the current indexation position.

5.8. We will therefore also use the June Consultation to consult on changes to the MSC algebra to take account of changes in the indexation approach.

Further change to parameters

5.9. If the MSC is extended, there may be a case for the threshold to be increased and/or the derating factor reduced at some future point once the hedge values at risk begin to decline through the shorter indexation period. We think it is too early to assess this in the June Consultation, but may return to the issue in the autumn when we will have had time to consider the matter more fully and will know more about market developments in the interim.

Excluding switches from non-capped contracts from the scope of the MSC

5.10. Two stakeholders suggested that the MSC should exclude switches from contracts that were not subject to the price cap, otherwise losing suppliers would be over-compensated by being paid MSC payments where there was no hedging liability.

5.11. This is a known issue, but the existing industry data flows do not facilitate implementing this refinement. There would therefore be significant cost in doing so. For the moment, the issue is relatively small and is effectively accommodated for by the derating factor.

5.12. In addition, where suppliers have customers on fixed price contracts that pre-date the crisis, they may reasonably assume that a significant proportion of the customers will migrate to the SVT as the cheapest option when the contracts expire. They may take account of these expiries in their hedging planning and therefore could have a hedging liability on them.

5.13. We will continue to analyse this issue, recognising that its significance could grow over time as and when wholesale prices fall. If appropriate, we may propose changes, either directly or via the derating factor, if they appear necessary at a later date.

6. Modelling and Consumer Impacts

Section summary

This section describes how we have modelled the impact of MSC parameters and identified the consumer interest. It sets out the results of that work and how it supports the chosen parameter set.

Background on our approach

6.1. The MSC acts as an adjunct to the default tariff price cap. To protect consumers, the cap makes an allowance for wholesale costs, which are calculated according to an indexation algorithm. This constrains suppliers in how to manage wholesale market risk as they are unable to use price increases to do so, except as allowed by the cap. In practice, wholesale risk can only be managed by hedging energy purchases in close alignment with the indexation methodology in the cap.

6.2. This opens up a risk that the hedges taken out by suppliers (as the only practicable way to deal with wholesale risk in the price cap framework) can, in extreme circumstances, become stranded if wholesale prices fall and consumers switch to cheaper deals that reflect lower current wholesale prices. This would lead to significant costs for unwinding hedges meaning that suppliers would be unable to achieve sufficient income to finance their businesses.

6.3. We consider that the consumer interest is best served by energy being priced at the efficient level, which is broadly the cheapest price consistent with efficient and well-managed suppliers being able to finance their businesses. In a well-functioning market, this figure will be determined by competition (which also drives innovation and increased efficiency).

6.4. A market which is effectively constrained to not recover efficient costs is likely to lead to adverse consumer impacts. These could include disorderly or unplanned exits, with possibly large mutualisation costs; consolidation and the potential loss of competition; lack of investment or lower service quality; and ultimately failure to properly carry out the activity. In summary, a market which does not cover efficient costs is not sustainable and will leave consumers worse-off over time.

6.5. Of course, if the efficient level of costs is high, for example due to geopolitical events, that level may cause hardship for some consumers, especially vulnerable ones. In

such circumstances, it may be appropriate to take special measures to protect such consumers, but these issues are outside the scope of the present decision.

6.6. Our thinking in this area was recently set out in Ofgem's decision of 4 February 2022 on the potential impact of increased wholesale volatility on the default tariff cap (the "**Volatility Decision**").[12] This said "Our view is that a competitive market where suppliers can recover their efficient costs is in the long-term interests of all consumers. A competitive market ensures suppliers have adequate incentives to become more efficient and provide a better quality of service to their customers. It will also promote innovation and deliver a greater range of products and choices for consumers. It should also ensure consumers do not have to pay for the mutualised cost of supplier failures where efficient suppliers are unable to recover their costs."

6.7. Against this background, the Volatility Decision identified some important costs, arising from the extreme volatile market conditions, that were incurred during the period October 2021 to March 2022 and were not covered in the price cap. That decision uplifted the allowance for wholesale costs in the price cap for the period April 2022 to March 2023 by an amount (the "**Wholesale Risk Allowance**") to enable those costs to be recovered retrospectively.

6.8. Following this line of thinking, the core of our approach to the calibration of the new MSC parameters has been broadly to follow price cap principles. We have aimed to set the parameters at the levels which provide the least intervention consistent with a reasonable assurance that an efficient supplier would at least be able to cover its costs through a price fall scenario. This assessment inevitably involves an element of judgement as there are many behavioural and market related assumptions that need to be made to assess the position, and different scenarios give different results.

Modelling approach and assumptions

6.9. Our primary tool has been to explore the characteristics of a notional company ("**NoCo**") which is a substantial energy supplier affected by these issues. The impacts on NoCo have been calibrated against confidential real company data which we have obtained

[12] Decision on the potential impact of increased wholesale volatility on the default tariff cap (04 Feb 2022). https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

through Information Requests and there is a good degree of alignment, recognising that every real company is different, so the real company results are scattered around NoCo's.

6.10. We have used **Underlying EBIT** as our primary metric. This is the EBIT net of:

- The Wholesale Risk Allowance that is collected by NoCo, as this is income designed to correct for a too low wholesale cost allowance in the prior period price cap; and

- An estimate of the amount of the Wholesale Risk Allowance that is not recovered as a result of the loss of customers that occurs under the particular price scenario and parameter set (the "**Under-Recovery Estimate**"). This is because this sum is "owed" to the prior period but can only be so allocated by deducting it from current earnings.

6.11. We have chosen Underlying EBIT for two principal reasons:

- It is a good measure of general ability to finance a business and there is a clear benchmark from the price cap: 1.94%, though we consider that in the exceptional and time limited circumstances of responding to a price fall, Underlying EBIT can fall below this figure without creating excessive financial stress

- While businesses ultimately fail through running out of cash, Underlying EBIT is a good indicator of the viability of a business which will be looked at by an owner or backer in deciding whether to advance more funds.

6.12. NoCo's characteristics are as follows:

- 5 million customers, average (mean) consumption 3,650 kWh[13] per year electricity.

- For simplicity, all customers are assumed to be dual fuel, but the average gas consumption scaled to reflect the proportion of electricity only customers. This

[13] "Review of the average annual domestic gas and electricity consumption levels", BEIS, May 2020.

gives an adjusted mean gas consumption of 13,600 kWh x 23.9 million / 29 million = 11,208 kWh.

- All customers on standard variable tariff, priced at the price cap.
- 100% hedged in accordance with the wholesale allowance indexation in the price cap, as described in the Indexation Guidance Letter[14].
- NoCo's cost structure is as per the allowances in the price cap.

6.13. We have chosen 100% hedged as our assumption for NoCo because it is the neutral position for a company to follow the Indexation Guidance Letter. If a company believed that prices will fall faster than the market consensus revealed in the forward curve, they might take a slightly shorter position (say 95% hedged); this would indeed be profitable if they were right, but if prices exceeded market expectations, it could prove to be an expensive mistake. We do not consider that we should build the MSC around possible proprietary trading positions. So long as a company is not taking risks that could lead to significant mutualisation payments or other consumer detriments, such position taking is a commercial matter for them.

6.14. The model operates on a monthly cycle. It assumes monthly switching rates and applies a weighted average monthly MSC to the monthly losses incurred as a result of the price fall. It takes account of earnings from retained customers on SVT at 1.94% Underlying EBIT as well as profits from any unhedged customers who switch (where there is an MSC payment but no corresponding cost) or who are retained (where profits may be higher). It does not take account of acquired customers because of the considerable uncertainty as to which companies might gain customers.

6.15. However, to avoid setting parameters which might overcompensate suppliers, it is important to recognise that most switchers will in the short term probably end up with one or another of the existing firms. We expect that firms will take advantage of such competitive opportunities and are likely to be able to capture a proportion of the benefit of

[14] "Updated guidance on treatment of price indexation in future default tariff cap proposals", Ofgem, March 2022.

the falling prices transitionally as competition adjusts. We have made a post-model adjustment of +0.9% to Underlying EBIT to allow for this (the "**Acquisitions Benefit**").

6.16. In reality, some suppliers may be better than others at gaining customers and in maximising returns from gains. It is appropriate that we take account of the options that are in suppliers' hands to mitigate this issue. We have estimated the Acquisitions Benefit for NoCo based on the assumption that it gains roughly the same number of customers that it loses and that the margin after the effect of the MSC, taking account of the effect of the ban on acquisition only tariffs and the transitional opportunity for capturing a proportion of the benefit from falling wholesale prices, will be in the range £80-£100 per year for an average customer.

Scenarios and parameter sets

6.17. We have refreshed the scenarios that we are using to test the parameters since the March Consultation, to reflect the passage of time and to test some more stretching cases. We continue to look at cases where the gas price falls to the historic norm of around 50p/therm on the grounds that we have seen no evidence that the long run marginal cost of production has changed. This is a scenario not a prediction and if prices do fall back to this extent, it is unclear how quickly, from months to years, this might happen.

6.18. For the purposes of testing the MSC parameters, we have adopted two scenarios

- "**Flat Fall**", where gas prices fall gradually and linearly from current levels to 50p/therm, starting on 1 May 2022 and finishing on 31 August 2022;

- "**Sharp Fall**", where gas prices fall by 10% of the gap between current levels and 50p/therm on 1 July 2022; by 80% of that gap on 1 August 2022, then gradually to 50p in September 2022. This scenario is designed to test the process in adverse circumstances for well-hedged suppliers.

6.19. We have used these to test three parameter sets:

- "**30/75**" – A threshold of 30% and a derating factor of 75%. This is the "Do nothing" option, reflecting current parameters.

- "**10/85**" – a threshold of 10% and a derating factor of 85%.

- "**10/90**" – a threshold of 10% and a derating factor of 90% - this was at the top of the range in the March Consultation.

6.20. We also explored other parameter sets including 20/80 (the bottom of the range in the March consultation) and 15/85, but discarded them as insufficiently powerful to meet our objectives.

6.21. We assessed switching levels for NoCo based on estimated customer elasticities. The total switching levels are the same for both price scenarios, because we have the same final price. They differ between the MSC parameter sets because higher MSC payments will result in reduced switching gains, and therefore for a given elasticity, less switching. We have estimated NoCo's switching levels as:

Parameter set	**30/75**	**10/85**	**10/90**
% of customers switching	23.9%	19.22%	18.55%
Number of customers switching	1.2 million	0.96 million	0.92 million

Results and discussion

6.22. The modelling results are as follows:

UNDERLYING EBIT

Parameters	**10/90**	**10/90**	**10/85**	**10/85**	**30/75**	**30/75**
Scenarios	**Flat Fall**	**Sharp Fall**	**Flat Fall**	**Sharp Fall**	**Flat Fall**	**Sharp Fall**
NoCo model outputs	-0.2%	-0.4%	-0.5%	-0.8%	-3.5%	-3.5%
Acquisitions Benefit	+0.9%	+0.9%	+0.9%	+0.9%	+0.9%	+0.9%
Adjusted results	0.7%	0.5%	0.4%	0.1%	-2.6%	-2.6%

6.23. We do not consider that it is necessary for the MSC to guarantee the benchmark of 1.94% Underlying EBIT. In these exceptional and transitional circumstances and with a high degree of pressure on consumers, we consider that it is sufficient that Underlying EBIT is positive. And this intervention is by its nature fairly broad brush as, at this stage, we have no visibility of what pricing behaviour by suppliers, or switching behaviour by

customers, will actually be. We also consider that, so long as efficient costs are covered, it should be possible to attract finance despite a one-off period of potentially reduced returns.

6.24. The 10/85 parameter set is the one that best achieves our objectives. Taking account of the Acquisitions Benefit, it achieves positive Underlying EBIT for NoCo in both scenarios, including the highly adverse Sharp Fall scenario. We consider that these results indicate that the 10/85 parameter set constitutes the minimum intervention needed to avoid excessive financial stress.

6.25. We have cross-checked this conclusion against our modelling of EBIT and cash for the real suppliers based on confidential information submitted by them and can confirm that, according to our modelling, the 10/85 parameter set effectively mitigates the concerns we can see if the 30/75 parameter set were maintained.

Cost to consumers

6.26. As explained above, we consider that the interests of consumers are best served by pricing at the efficient level, given the adverse consequences for consumers of a regulatory framework that does not allow efficient costs to be recovered if prices were to fall suddenly and customers switched away from well-hedged suppliers. (As noted above, where efficient costs are high, it may be appropriate to take separate steps to protect vulnerable consumers.)

6.27. However, the necessary consequence of changing the MSC parameters in the manner we have decided is that active consumers will receive reduced savings for a period after a fall in wholesale prices, while the existing hedge positions work through (pricing for inactive consumers on the price cap is unaffected). This is in effect a transfer of resources from active customers to suppliers to enable efficient costs of energy supply to be covered. We have therefore estimated the amount that would be transferred (across the whole market, rather than for NoCo) as a differential with the 30/75 parameter set. The sums transferred arise in two areas: (a) the cost of MSC payments themselves (which are assumed to be reflected in contract prices); and (b) the fact that switches are lower with the higher contract prices. The results are as follows:

MARKET-WIDE CONSUMER COST COMPARED TO 30/75, £m

Parameters	10/90	10/90	10/85	10/85
Scenarios	**Flat Fall**	**Sharp Fall**	**Flat Fall**	**Sharp Fall**
Cost of MSC payments	568	251	540	238
Cost of missed switches	175	324	167	294
Total	743	575	707	532

6.28. To the extent that these cost figures are associated with pricing at efficient levels, they can be seen as necessary for the maintenance of a supply function upon which consumers depend. But in any event, they are low by comparison with recent experience of mutualised insolvency costs for larger suppliers (the Bulb insolvency was estimated late last year as likely to cost £2.1 billion to the end of April 2022[15]), so if the effect of the new parameter set were to prevent a single large supplier failure that led to similar costs, then the gains would outweigh the losses.

6.29. It is also worth noting the distributional impacts. The benefits of the new MSC parameters, whether in terms of avoiding potential mutualised costs of failure, or more widely in having a viable energy supply sector, accrue to consumers generally. The costs accrue only to active consumers. It was found by the CMA in its Energy Market Investigation that a number of indicators of vulnerability were associated with being inactive in the energy market[16]. Accordingly, vulnerable consumers are disproportionately in the inactive group, which will see benefits and no downsides from a more effective MSC.

[15] https://www.bbc.co.uk/news/business-59409595

[16] "We find that the groups of respondents who are less likely to have switched supplier in the last three years are those with any of the following characteristics: household incomes under £18,000 a year; living in rented social housing; without qualifications; aged 65+; with a disability or registered on the PSR." CMA Final Report, June 2016, Page 448 https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf