

Consultation on extending short-term interventions and adjusting MSC calculation

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We are consulting on extending the Market Stabilisation Charge (“**MSC**”) to 31 March 2023 and on technical changes to the algebra of the MSC to reflect the proposed revised priced cap methodology. In addition, we are seeking views on extending SLC 22B (Requirements to make all tariffs available to new and existing customers), which implements a ban on acquisition-only tariffs (“**BAT**”), to the same date.

In our decision of 16 February 2022 (the “**February Decision**”), we announced that we would be implementing the MSC as a temporary measure alongside the BAT. These measures were introduced to address the impacts of the unprecedented and unexpected rise in gas and electricity prices since Autumn 2021, which has put energy markets under severe strain. They came into effect on 14 April 2022 and 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.

The MSC is intended to be a temporary measure, with the licence condition (SLC 24A) due to expire on 30 September 2022. However, the condition gives the Authority the option to extend the measure until no later than 31 March 2023 by publishing a statement in writing to that effect. In the February Decision, we undertook that we would consult before exercising that power. This document consults on our proposal to extend the MSC until 31 March 2023.

This consultation also covers changes to the MSC algebra. On 16 May 2022, Ofgem published updated guidance on how the Price Cap indexation will change in light of the proposed move to quarterly updates. As that indexation features in the calculation used in deriving the MSC, this consultation sets out our intention to reflect this change in the MSC calculations.

The BAT was also introduced in April 2022. The relevant licence condition (SLC 22B) specified that this would be in force until the end of September 2022, unless the Authority decided to extend it by up to a further six months. Whilst we did not commit to consulting before exercising our powers to extend this measure, we have chosen to seek the views of stakeholders and this document requests input accordingly on a proposal to extend the measure to 31 March 2023.

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](https://www.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.

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Executive summary

Wholesale energy markets have, over the past year, experienced a level of disruption not seen since the oil crisis of the 1970's, leading to record high wholesale prices and significant and continuing impacts on consumers. The disruption initially arose in Autumn 2021, in part due to worldwide demand recovering faster from the Covid crisis than supply, and has been significantly exacerbated following the Russian invasion of Ukraine. Future wholesale prices could rise further – for example if there were further restrictions in the sale or purchase of Russian gas – or they could fall if forward supply levels once again exceeded demand.

This puts domestic energy suppliers in a very difficult position when they purchase energy on behalf of customers in order to supply it within the constraints of the price cap. To protect themselves and their price-capped customers against the risk of further upward movements, they are likely to choose to buy energy ahead (“hedge”) in accordance with the indexation provisions of the price cap. But in doing so, they would be holding significant stocks of energy bought at prices higher than historical norms. This exposes them to the risk of having to sell that energy at a loss if wholesale prices fall back and customers switch before consuming the energy that had been bought for them.

We introduced the MSC in April 2022 to enable the UK supply industry to manage this risk, by providing an element of protection against the downside risk, so assisting companies in being able to continue hedging appropriately. Without this protection, consumers could face significant detriment which could include disorderly or unplanned exits from the market (with potentially significant mutualisation costs), consolidation and continuing lack of competition, low or no investment, poor service, lack of innovation and ultimately failure to properly carry out the activity.

The MSC is intended to be a temporary intervention. It is due to expire at the end of September 2022, but the Authority has power under SLC 24A to extend it until no later than 31 March 2023. In order to inform the decision on whether to extend, Ofgem has developed a value at risk (“**VaR**”) methodology which estimates the difference between the value of energy held by domestic suppliers for standard variable tariff (“**SVT**”) customers (assumed to be fully hedged in accordance with the indexation provisions of the price cap) and the value that that energy would have under normal market conditions.

There is no direct relationship between VaR and any particular outcome in terms of the MSC value, supplier losses or consumer prices – as these things will depend on the actual price

evolution, the MSC parameters and consumer behaviour. However, VaR is a simple indicator of how big the problem that the MSC is designed to address is, at any point in time.

In Section 2, we estimate the VaR level during the period until March 2023¹ and compare it with the level when we first decided to implement the MSC. The estimation of VaR takes into account the proposed phasing in of quarterly updates to the price cap. While this change reduces VaR, other factors such as prices, growing SVT numbers and seasonality of demand increase it.

Throughout the period October 2022 to March 2023 (the “**Extension Period**”), we estimate total VaR to be similar to, or significantly higher than, the level when the decision to implement the MSC was made in February 2022. This is illustrated in the chart:

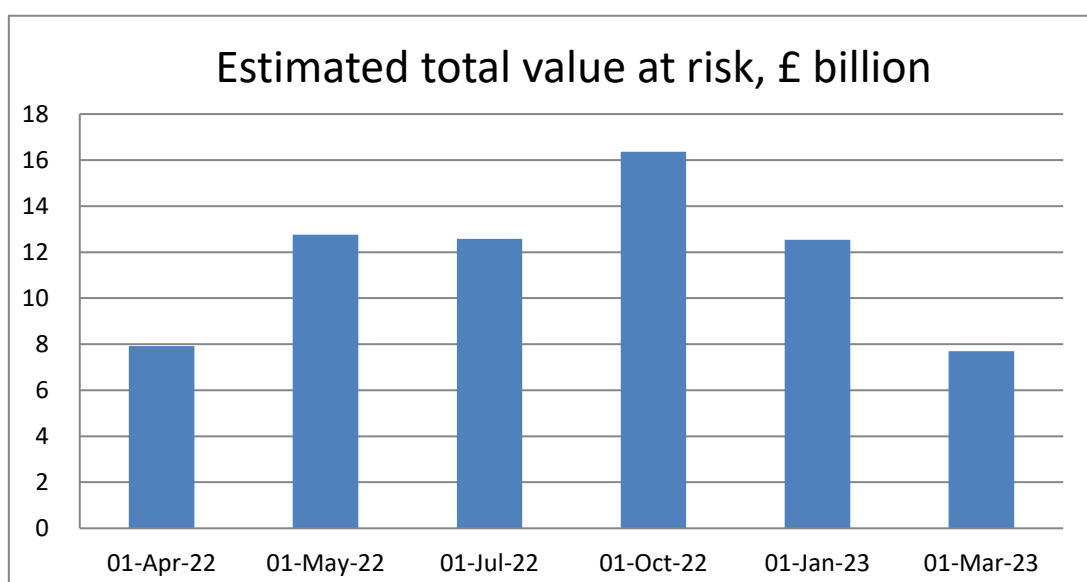


Chart 1: Estimated total value at risk £ billion

We believe that this indicates that the need for an effective MSC to be in place until March 2023 is as high as, or higher than, the need for the MSC when the mechanism was first introduced. Accordingly, this consultation proposes extension of the MSC until 31 March 2023 when, under the current licence condition SLC 24A, it will expire.

¹ Assuming future forward prices are at 25 May 2022 levels

The proposed transition to quarterly updates to the price cap has an effect on indexation, as set out in our letter of 16 May 2022 (the "**Second Indexation Guidance Letter**"²), and this in turn affects the operational calculation of the MSC. We are using this opportunity to consult on the necessary technical amendments to how the MSC is calculated to reflect that guidance.

The final element of this document concerns the ban on acquisition-only tariffs ("**BAT**"). This was introduced alongside the MSC in the decision of 16 February 2022 (the "**February Decision**"³). It augments the MSC by reducing the incentive for suppliers to cut prices very aggressively in a time of market turmoil.

When we introduced the BAT, we noted that this intervention could be extended beyond its expiry date of 30 September 2022 by up to six months, should the Authority decide to do so. Whilst we did not commit to consulting on the question of extending this provision, we are also seeking views at this time on whether the obligation should remain in force for the Extension Period.

The arguments concerning VaR set out in Chapter 2 in relation to the MSC can also be applied to the BAT. The higher VaR during the Extension Period can be seen as an indicator that the contribution of the BAT to market stability will be needed more during the extension period than when the BAT was first introduced. We therefore intend, subject to the Authority's decision taking account of any views expressed, to extend the BAT to 31 March 2023.

² Ofgem (16 May 2022), Updated guidance on treatment of price indexation in future default tariff cap proposals: <https://www.ofgem.gov.uk/publications/price-cap-may-2022-updated-guidance-treatment-price-indexation-future-default-tariff-cap>

³ Ofgem (16 February 2022), Decision on short-term interventions to address risks to consumers from market volatility <https://www.ofgem.gov.uk/publications/decision-short-term-interventions-address-risks-consumers-market-volatility>

1. Introduction

What are we consulting on?

- 1.1. On 16 February 2022, we published the February Decision, setting out our short-term interventions to address risks to consumers from market volatility. These were the Market Stabilisation Charge (“**MSC**”) and a ban on acquisition-only tariffs (“**BAT**”).
- 1.2. The new licence condition implementing the MSC gave the Authority the option to extend the measure until no later 31 March 2023 by publishing a statement in writing to that effect. We said that we would consult before using this power. The condition implementing the BAT contained a similar extension power, though we did not say we would consult before utilising that option.
- 1.3. There are three elements to this consultation. The first element of this consultation is to seek comments on our proposal to extend the MSC until March 2023. In response to the consultation on changes to the MSC published on 31 March 2022 (the “**March Consultation**”)⁴, a number of stakeholders urged us to exercise the power to extend the MSC and in the subsequent decision published on 16 May 2022 (the “**May Decision**”)⁵, we set out our intention to consult on such an extension.
- 1.4. The second element of the consultation is to seek views on our proposed technical amendments to how the MSC is calculated to reflect the indexation approach set out in the Second Indexation Guidance Letter, which reflects the proposed transition to updating the price cap on a quarterly basis.
- 1.5. The third element of this consultation is to seek comments on the proposed extension of the BAT until March 2023. Whilst we did not commit in the February Decision that we would consult before any use of that power under the existing licence condition, we are seeking stakeholder views to help inform the Authority’s decision.
- 1.6. This document is split into four sections:

⁴ Ofgem (31 March 2022), Consultation on changes to market stabilisation charge <https://www.ofgem.gov.uk/publications/consultation-changes-market-stabilisation-charge>

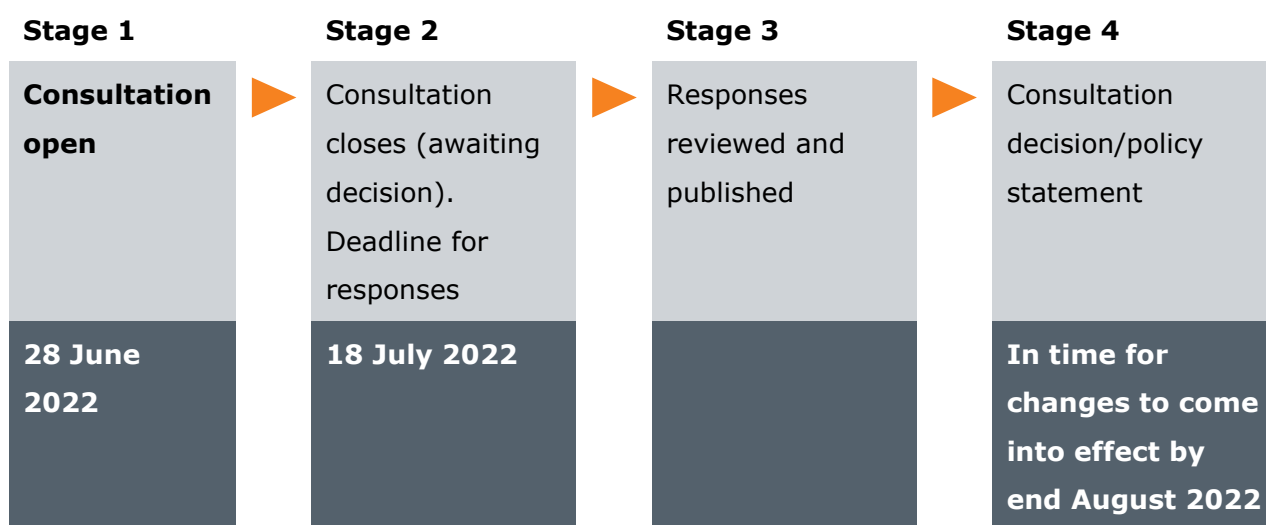
⁵ Ofgem (16 May 2022), Decision on changes to market stabilisation charge <https://www.ofgem.gov.uk/publications/decision-changes-market-stabilisation-charge>

- Background and Context
- MSC Extension
- Technical changes to the MSC
- BAT Extension

1.7. We invite stakeholders to submit comments on any aspect of this consultation on or before 18 July 2022. This timetable is intended to allow Ofgem to make decisions, in accordance with the interests of consumers, which would come into effect by the end of August 2022.

1.8. 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 they see this evolving from 1 October 2022 onwards.

Figure 1: Consultation stages



How to respond

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

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

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

Your response, data and confidentiality

- 1.12. 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.
- 1.13. 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.
- 1.14. 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.
- 1.15. 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

1.16. 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?

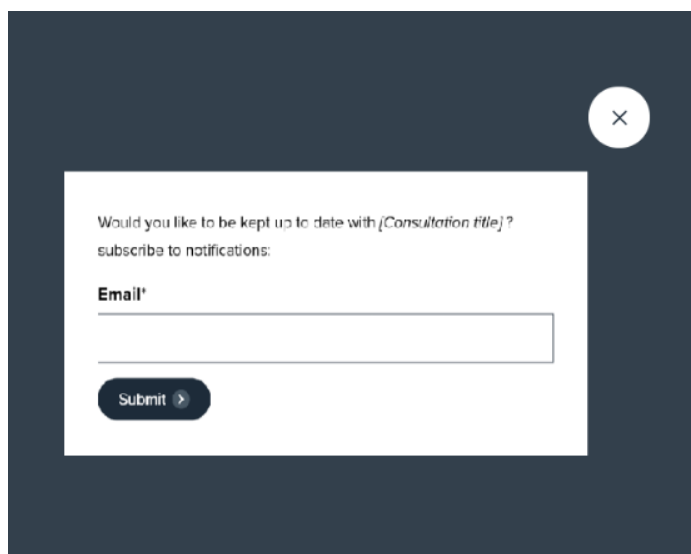
Please send any general feedback comments to stakeholders@ofgem.gov.uk

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.

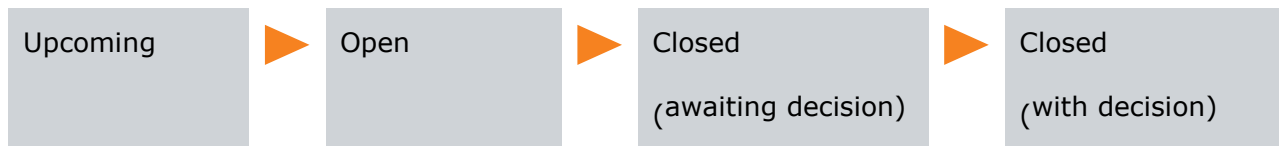
[Ofgem.gov.uk/consultations.](https://www.ofgem.gov.uk/consultations)

Notify me +



The image shows a dark-themed modal window with a white background for the form. At the top right of the modal is a close button (X). The form text reads: "Would you like to be kept up to date with [Consultation title]?" followed by "subscribe to notifications:". Below this is an "Email" label and a text input field. At the bottom left of the form is a "Submit" button with a right-pointing arrow.

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:



2. Extension of Market Stabilisation Charge

Section summary

We have analysed the need for the MSC during the period October 2022 to March 2023 (the “**Extension Period**”) using a Value at Risk (“**VaR**”) metric. This indicates that the need for an effective MSC is similar, and at most times significantly greater, during the Extension Period than it was when the policy was first decided. This is the case despite the impact of the proposed phasing in during the Extension Period of quarterly indexation of wholesale costs in the price cap. We consider, in the light of this analysis and subject to views expressed in consultation, that the case for using the power to extend the MSC to March 2023 appears to be very strong.

Context

Background to and purpose of the MSC

- 2.1. Starting from August 2021, prices in international wholesale energy markets have risen to unprecedented levels, initially as a result of supply and demand imbalances generally thought to reflect recovery in demand from the impacts of the Covid pandemic combined with low storage levels. These imbalances have been exacerbated following the invasion of Ukraine and concerns about possible restrictions on the sale or purchase of Russian gas. The result is a shock in energy markets comparable to the oil crisis of the 1970s and extremely high forward wholesale prices for gas and electricity.
- 2.2. Future prices could rise further, or they could fall. For example, further restrictions in the purchase or sale of Russian gas or technical issues with production or processing facilities could reduce effective supply, and demand for gas could be increased by cold weather or low output from wind or nuclear generation. Conversely, resolution of the geo-political issues and/or increases in output from other gas facilities could increase supply, and demand could fall. Managing the impacts of these issues on behalf of customers is a key role for energy suppliers.
- 2.3. The default tariff cap administered by Ofgem includes an allowance for the cost of wholesale energy which is indexed to observations of wholesale market prices. Prudent

suppliers are likely to choose to protect themselves, and their price capped customers, against the risk that price rises in wholesale markets could get out of step with the price cap by buying energy forward in accordance with the indexation in the price cap. This is called “hedging”. In autumn 2021, many suppliers that had failed to hedge appropriately went out of business, creating costs for consumers measured in the billions of pounds.

- 2.4. However, this prudent approach itself carries a risk, should wholesale prices fall back sharply. This is because, in the current market environment, hedging to protect consumers against further price rises involves buying forward significant amounts of energy at high prices. If the forward price falls, there is a risk that consumers switch to take advantage of these lower prices before the energy that had been bought for them has been supplied.
- 2.5. If this happens, the suppliers concerned would need to sell the surplus energy at a significant loss and this could leave the suppliers facing financial stress. In turn, this could lead to significant consumer detriments arising including 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.
- 2.6. The MSC was introduced by Ofgem, together with the BAT, so that suppliers were better able to manage wholesale market risk, in the context of continuing to hedge for standard variable tariff (“**SVT**”) customers in accordance with the price cap indexation. The effect of the MSC is that if the forward market price over the price cap indexation period is more than 10% (the threshold parameter) below the value indexed under the price cap, 85% (the de-rating parameter) of the difference has to be paid when a customer switches by the gaining supplier to the losing supplier.
- 2.7. This is likely to mean that customers who switch are likely to see smaller benefits for a period while the market re-orientates itself if wholesale prices crash, though gains in the hundreds of pounds are still likely to be possible. However, all consumers gain from avoiding the detriments described above and Ofgem has previously concluded that this trade-off is in consumers’ interests.

Duration of the MSC

- 2.8. When the MSC was introduced, Ofgem made clear it was intended to be a temporary measure. The licence condition, SLC 24A, provided that the MSC would cease to operate at the end of September 2022, unless the Authority decided to extend it to a date no later than 31 March 2023.
- 2.9. This consultation seeks views on our proposal to extend the MSC to 31 March 2023 (the "**Extension Period**") under this power.
- 2.10. The reasoning, as set out below under the heading "Analysis", is that the issues that the MSC is intended to address are likely to remain throughout the Extension Period. Indeed, our analysis suggests that throughout the Extension Period, the potential risks are comparable to, or greater than, they were when the February Decision was issued. For these reasons, we believe, subject to views we receive in the consultation, that it would be appropriate to extend the MSC to 31 March 2023.
- 2.11. In the February Decision, Ofgem indicated that reforms to the price cap methodology and other initiatives would reduce the need for the MSC. Although that is the case, the necessary phasing in means that much of the effect would not be evident before January 2023 and there are other factors that may delay the impact, such that an extension to 31 March 2023 appears to be necessary, proportionate and in consumers' interests.
- 2.12. The February Decision also indicated that Ofgem will publish analysis on whether there is a case to taper down the parameters of the MSC in order to smooth the way to removing it altogether. The analysis below indicates that the potential risks that the MSC is designed to address remain significantly above the level at the time of the February Decision until at least January 2023. Accordingly, we think that any such tapering appears premature prior to January 2023 and that more work is needed to assess whether there is a case for tapering beyond that point. Accordingly, we intend to return to that issue at a later date.

Analysis and methodology

- 2.13. In order to measure the scale of the issue which the MSC seeks to treat, we use a Value at Risk ("**VaR**") measure. The VaR at any time is an estimate of the value of energy bought forward to serve all domestic customers on SVTs, assuming that

suppliers have hedged in accordance with the price cap indexation, less the value that that energy would have if prices fell back to typical historic levels. This gives an indication of the level of financial risk which hedging in line with price cap methodology may require suppliers to take on.

2.14. In order to estimate VaR historically and project it into the future, we have used the following methodology:

- We have assumed for this document that forward prices remain unchanged from 25 May 2022 values⁶. The assumption of continued high prices is of course subject to the risk that the MSC is designed to cover – that a reversion of wholesale prices toward historic levels could happen at any time;
- We have used a model for estimating the wholesale allowance under the Price Cap to derive the VaR per electricity and gas customer at mean consumption⁷;
- We have estimated the numbers of gas and electricity customers on SVT by deriving the proportion of customers on SVT from suppliers' fortnightly "Financial Responsibility" questionnaire responses and multiplying by the total numbers of gas and electricity customers⁸;
- We have assumed that the proportion of SVT customers will continue to grow in line with recent trends until August 2022 and then remain constant. This reflects the fact that fixed price contracts have generally not been attractive to consumers since wholesale prices rose in August 2021 so expiry of one year deals will be likely to diminish in around August 2022. Furthermore, (under the assumptions above) the price cap would be likely to be broadly similar to fixed contract prices by October 2022.

⁶ This is the date upon which we gathered data for the analysis

⁷ Mean consumption based on data in "Review of the average annual domestic gas and electricity consumption levels", BEIS, 2020. For electricity, a weighted average of standard and economy 7 consumption is used.

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/886473/annual-domestic-gas-electricity-consumption-levels-review-methodology-note.pdf

⁸ Number of customers taken from the same source as consumption. Although there will have been some growth in total customer numbers since that publication, this is largely compensated for by those suppliers that are not hedged but remain in operation.

2.15. The VaR per customer does not align with the expected loss to suppliers in the event of falling prices, the expected value of the MSC nor any expected reduction in potential customer savings. This is because the actual value of the MSC will be affected by the parameters in force at the time as well as the out-turn level of wholesale prices. The total level of losses for suppliers will also be affected by supplier pricing decisions and consumer switching behaviour.

Results

2.16. Our per customer VaR estimates are as set out in the following table. The entry for 1 April 2022 reflects the view we had of forward looking risks at the point in February when the decision to implement the MSC was made, and that for 1 May 2022 reflects the position when we announced the decision on revising the MSC parameters.

Value At Risk (£ per domestic customer)	01 April 2022 (Decision)	01 May 2022 (Review)	01 July 2022	01 October 2022	01 January 2023	01 March 2023
Electricity	£208	£277	£259	£289	£235	£169
Gas	£230	£380	£377	£523	£385	£208
Total	£438	£657	£636	£812	£620	£377

2.17. The VaR per customer captures the forward looking value of the assumed hedge positions compared with market pricing over the same period. Until October 2022, we observe an increasing VaR driven mainly by a seasonal increase in forward looking demand. After October 2022, we observe a decreasing VaR mainly because of the impact of the Transitional Indexation Approach (see section 3), as part of the proposed move to quarterly indexation. This decline accelerates in the first quarter of 2023, due mainly to the interaction of forward-looking seasonal demand and further progress in the phasing in of quarterly indexation. However, even in March 2023, the estimated VaR remains substantial.

2.18. We then assess the total VaR by multiplying by the number of electricity and gas SVT customers respectively. As described above, these numbers have grown during the year and we project that they will continue to grow until August 2022. For the SVT customer numbers at the time of the decision to implement the MSC, we have taken the numbers in early February 2022.

Value At Risk (total, £ billion)	01 April 2022 (Decision)	01 May 2022 (Review)	01 July 2022	01 October 2022	01 January 2023	01 March 2023
Electricity SVT customers, million	19.38	19.62	21.65	22.09	22.09	22.09
Electricity VaR, £ billion	4.0	5.8	5.6	6.4	5.2	3.7
Gas SVT customers, million	16.90	17.11	18.52	19.08	19.08	19.08
Gas VaR, £ Billion	3.9	7.0	7.0	10.0	7.3	4.0
Total VaR, £ billion	7.9	12.8	12.6	16.4	12.5	7.7

2.19. These figures indicate that throughout the Extension Period the estimated total VaR is similar to, and at most points significantly higher than, the VaR when the decision to implement the MSC was taken.

Conclusions

2.20. The hedging decisions of suppliers are entirely their own commercial choices (subject to compliance with the financial responsibility principle, whether by hedging or otherwise). However, we have recognised that in the current market environment, appropriate hedging carries significant risks should wholesale prices fall, and the role Ofgem can play in helping address that. In the current circumstances, the MSC is the main regulatory mechanism which (working alongside the BAT) fulfils this role.

2.21. Other things being equal, the higher the value of the VaR, the greater the need for an effective MSC. As shown above, on 1 October 2022 the total VaR indicator will be more than double the value it had for April 2022 when we decided to introduce the MSC. Even with the initial effects of the proposed transition to quarterly indexation, the value at 1 March 2023 is similar to that when the policy was decided. This result arises from the interplay of the phasing in of quarterly indexation, wholesale prices being higher than when April 2022 was hedged, demand seasonality and growing numbers of SVT customers.

2.22. We therefore believe that the value at risk metric makes a strong case that the MSC is needed throughout the period October 2022 to March 2023, at least as much as it was needed when the decision was originally taken.

2.23. We have previously provided quantification of costs and benefits for a notional company (“NoCo”) and estimated impacts on consumers in various scenarios. Our

approach to this work remains appropriate and we will update our estimates when necessary.

- 2.24. However, quantifiable costs and benefits for consumers will depend on the specific parameters of the MSC as well as the pricing scenario considered. Our proposal to extend the MSC to 31 March 2023 does not assume any specific parameter levels. As we have set out in the February Decision, we will keep the MSC parameter levels under regular review and publish updated information when appropriate.

Questions

- 1. Do you agree that MSC should be extended to 31/3/2023?**
- 2. Do you have any further comments on the analysis and reasoning presented?**

3. Technical Adjustments

Section summary

On 16 May 2022, Ofgem published updated guidance on how the Price Cap indexation would change in response to a proposed move to quarterly updates. As the indexation features in the calculation used to derive the MSC, this section sets out our intention to amend the MSC calculation to reflect this proposed change to price cap indexation.

Context

Requirement for transitional indexation profile

- 3.1. On 16 May 2022, Ofgem issued a statutory consultation on medium term reforms to the Price Cap⁹ which included proposals to move to quarterly updates with a reduced notice period, the index proposed being 3-1.5-12 [3]¹⁰. We expect to publish a decision on this in August 2022. However, recognising the decisions suppliers need to make in the meantime, we issued the Second Indexation Guidance Letter in which we set out the proposed transitional indexation arrangements to support our minded-to position to move to a quarterly price cap index.
- 3.2. The Second 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, which subject to the Authority's decision following consultation, may start in October 2022. The proposals set out in this section are therefore in readiness for the potential implementation of a quarterly Price Cap, in line

⁹ Ofgem (2022), Price Cap – Statutory Consultation on changes to the wholesale methodology <https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology>

¹⁰ We express the price cap formula in an index with the format X-Y-Z [A], where X is the price observation period, Y is the lag period between the end of the observation period and the start of the price cap period starting, Z is the length of forward contracts observed and A is the period for which the cap is in place, all in months. So a 3-1.5-12 [3] index for delivery starting 01 October 2023 means a 3 month observation period running from mid-May to mid-August where 12 month forward prices are observed. There is then a lag of 1.5 months from mid-August until the cap starts on the 01 October. And the cap runs for three months from 01 October to 31 December.

with our minded to position. The letter set out the methodology for the 7-1-12 / 3-1.5-12 transitional indexation approach (the “**Transitional Indexation Approach**”).

Rationale for consulting on changes to the MSC calculation

- 3.3. On 16 May, we also published updated guidance (the “**May Guidance**”¹¹) setting out the workings of the MSC. In the May Guidance, we note that, “*any future adjustment to the price cap that materially affects the price cap indexation profile may require us to make an adjustment to this guidance to take account of this change in circumstance*”.
- 3.4. We consider that the update contained in the Second Indexation Guidance Letter necessitates an amendment to the MSC calculation to reflect the Transitional Indexation Approach.
- 3.5. The MSC is based on the hedging losses incurred by a nominal supplier hedging the relevant delivery period, in line with the relevant indexation approach assumed in the Price Cap methodology. This means that the hedging strategy of a nominal supplier for the original 6-2-12 indexation profile was reflected on a 6-2-6 basis. Similarly, we expect the 7-1-12 / 3-1.5-12 transitional indexation to be reflected in the MSC based on a 7-1-6 / 3-1.5-3 hedging strategy.

*Dependency between proposed MSC technical amendments and consultation on changes to the wholesale methodology*¹²

- 3.6. The recent consultation on changes to the wholesale methodology set out a minded-to position with regard to the move to a quarterly Price Cap and we issued the Second Indexation Guidance Letter, intended to help inform suppliers in formulating their prudent risk management strategies pending publication of our decision on a new mechanism. Recognising this, we consider it appropriate to consult on the proposed

¹¹ Ofgem (2022), Price Cap – MSC Guidance (version 2)

<https://www.ofgem.gov.uk/sites/default/files/2022-05/MSc%20guidance%20v2.0.pdf>

¹² Ofgem (2022), Statutory consultation on changes to the wholesale methodology

<https://www.ofgem.gov.uk/sites/default/files/2022-05/Price%20cap%20-%20Statutory%20consultation%20on%20changes%20to%20the%20wholesale%20methodology.pdf>

changes to the calculation of the MSC set out in this section. This reflects an intention set out in the May Decision¹³ on changes to the MSC.

- 3.7. However, given the fact that we have not yet made a decision on the changes to the wholesale methodology, we shall keep the situation under review. Should the outcome of that consultation deviate from the minded-to position we have set out, then we will consider whether further changes to the indexation guidance, and subsequently to the MSC calculation are required, consulting upon such changes where appropriate.
- 3.8. We propose to make changes to the MSC calculation to reflect the Transitional Indexation Approach for the remainder of Cap period 8, irrespective of whether the MSC is extended. We also propose changes to the MSC that would apply during Cap periods 9a and 9b, so as to provide clarity on how the algebra would look in the event we decide to extend the MSC beyond 30 September 2022. Again, recognising that this decision is yet to be taken, we will keep the situation under review and reflect the outcome of any decision on MSC extension in our decision on the technical adjustments to the MSC that follow this consultation.
- 3.9. In recognition of the complexity of the algebra, we have also published alongside this consultation, an algebra demonstration model to improve transparency of our proposals and how the proposed algebra would work in practice. This model is specifically to demonstrate the workings of the algebra, it is not intended as a full worked example and we still intend to publish worked examples following this consultation process as has been done previously.

Proposed changes to the MSC calculation

7-1-12 / 3-1.5-12 Transitional Indexation Approach

- 3.10. In this section we set out our proposed changes to the MSC calculation to reflect the Transitional Indexation Approach. We do not set out the detail of the Transitional Indexation Approach itself in this consultation. However, in the interests of

¹³ Ofgem 2022, Decision on changes to the market stabilisation charge <https://www.ofgem.gov.uk/publications/decision-changes-market-stabilisation-charge#:~:text=On%2031%20March%202022%2C%20we,and%20volatile%20wholesale%20price%20levels.>

transparency we have provided a summary annexed to this consultation. Further detail can also be found in the Second Indexation Guidance Letter and the statutory consultation on changes to the wholesale methodology.

- 3.11. The remainder of this chapter sets out the options and proposed algebra that would be implemented should we decide to reflect the Transitional Indexation Approach in the MSC model.

Proposal – amend the algebra of the MSC calculation to reflect Transitional Indexation Approach

Overview of changes

- 3.12. The MSC captures the cost at which a supplier will buy energy (under an assumed nominal supplier's hedging strategy) and the price at which a losing supplier will unwind their hedge (market price) through the 'Qualifying losses' term of the MSC formula. These values are respectively incorporated into W_{pc} and W_c .
- 3.13. The Transitional Indexation Approach impacts the MSC formula differently for P8, P9a and P9b. One major implication is reflected through our position on how P9 seasonal hedges accumulated prior to 01 June are split into two quarters. This is on the basis that one proportion will be delivered in Q4 (P9a) and the other in Q1 (P9b) to avoid an overcomplication of the MSC formula. Therefore, if MSC is triggered and a customer switches in P9a, the compensation will reflect the loss associated to all accumulated hedges in P9 but P9a proportion and P9b proportion will be weighted differently. Also, transitional weights to ensure a 50:50 split between the volume hedged prior to 01 June and post 01 June for each of the periods are incorporated into the terms of the formula. To accurately reflect these changes, a number of new terms are required. Due to the dynamic nature of the model, the requirements of these terms vary according to the Price Cap period during which the MSC is calculated.
- 3.14. Consequently, we present three sets of algebra; one for use during the remainder of Cap period 8 and one each for Cap periods 9a & 9b, to be effective in the event of MSC extension for the Winter. We therefore expect to develop and publish three worked examples following this consultation process, as the Transitional Indexation Approach requires specific amendments to the algebra and therefore, each Cap period requires its own unique set of algebra. The weekly published model will be based on the

relevant algebra for the Cap period and we set out the proposed dates from which each set of algebra will be effective in paragraph 3.47 - Implementation of updated algebra.

Transitional Indexation Approach – changes to algebra

3.15. The formula used to calculate the MSC itself does not change in response to the Transitional Indexation Approach. However, the calculation of the terms within this algebra do. Specifically:

- the calculation of the terms a, b and c that describe the proportion associated with each hedging period with respect to the total volume of hedges held.
- the calculation of the consumption weighting factor (t) is updated to reflect the transitional arrangements in P8 and the shorter forward hedges in P9a and P9b.
- seasonal demand weights transition from 6 monthly to quarterly weightings, which require the addition of the term S_{n+2} to the existing S_n and S_{n+1} .

3.16. The changes to the calculation of these terms are described in the following sections for each Cap period.

3.17. The term v , the volume factor, was introduced to the MSC formula to ensure that it is correctly apportioned to the total volume a nominal supplier holds at any point in time and controls for a varying total volume held throughout the hedging period. The transition to quarterly cap updates reinforces the need for the volume factor (v) as the Transitional Indexation Arrangements interact with the MSC calculation.

3.18. Furthermore, the price cap indexation terms (PC_n , PC_{n+1} and PC_{n+2}) used in the MSC model, would be derived according to the Transitional Indexation Approach and this is in line with our proposals set out in the consultation on changes to the wholesale methodology.

3.19. We also propose to introduce the terms TWQ4 and TWQ1 to replicate the 50:50 split between 7-1-6 and 3-1.5-3 blocks followed by the price cap methodology. They are applied to the post 01 June 2022 period. The transitional weights in trading days as set out in the Second Indexation Guidance Letter and the transitional weights in delivery days (which have been calculated using the same methodology) are shown below.

Term	Transitional weight (trading days)	Transitional weight (delivery days) ¹⁴
TWQ4	1.148	1.134
TWQ1	0.984	0.983

3.20. The move to a quarterly Price Cap also requires that we also transition to using the quarterly seasonal demand weights. This transition will occur throughout P8 be fully implemented in P9a and P9b. These weights (consistent with Annex 2) are set out below.

Quarter	Electricity ¹⁵	Gas ¹⁶
Jan – Mar	28.8%	42.3%
Apr – Jun	21.9%	16.7%
Jul – Sep	21.0%	7.6%
Oct – Dec	28.3%	33.4%

3.21. Finally, we propose to apportion the seasonal hedges associated with P9 delivery period, accumulated prior to 01 June using the terms below. This implies that there is a different proportion of P9 hedges allocated to P9a and P9b respectively by the introduction of the terms Q4 and Q1¹⁷. This is explained by a longer P9a delivery period than P9b delivery period.

Term	adjustment
Q4	0.506
Q1	0.494

¹⁴ There are 88.5 weighted delivery days 1 Feb - 1 June, 78 between 2 June – 18 Aug and 90 between 19 Aug – 16 Nov. Therefore TWQ4 = 88.5/78 and TWQ1 = 88.5/90.

¹⁵ Profile class 1

¹⁶ Non-PPM share of demand

¹⁷ Consistent with the calculation in Annex 2 v1.11 tab 3b (as calculated in cells E49-F50 and explained in cell E48) https://www.ofgem.gov.uk/sites/default/files/2022-05/DRAFT%20-%20Annex_2_-_wholesale_cost_allowance_methodology_v110%20%28data_removed%291652444679865.xlsx

3.22. The specific algebra changes proposed for each Price Cap period are outlined in the following sections.

Proposed MSC Algebra for Cap period 8

3.23. The weighting terms (a/a' , b/b' and c/c') used for the calculation of Wc and Wpc are proposed to be updated as follows:

3.24. Terms a and a' , the volumes associated with the current Cap period:

- remain unchanged

3.25. Terms b and b' , the volumes associated with the next Cap period (P9a) are:

- multiplied by $Q4$, the proportion of P9 allocated to P9a
- multiplied by $TWQ4$ from 06 June to 18 August to reflect the transitional weight adjustment in order to allow for a 50:50 split between 7-1-6 and 3-1.5-3.
- discounted by 50% from 16 March to 19 May inclusive to reflect the original transitional arrangements moving to a 7-1-6 indexation approach

3.26. Terms c and c' , the volumes associated with the following Cap period (P9b) are:

- multiplied by $Q1$, the proportion of P9 allocated to P9b
- multiplied by $TWQ4$ from 19 August to 16 November to reflect the transitional weight adjustment in order to allow for a 50:50 split between 7-1-6 and 3-1.5-3
- discounted by 50% from 16 March to 19 May inclusive to reflect the original transitional arrangements moving to a 7-1-6 indexation approach
- multiplied by a 'dummy' term to demonstrate the pause in increasing the hedging level for $n+2$ to facilitate algebra understanding.

3.27. The value for Th (the total volume of hedges held for the relevant cap periods before Cap period n starts, expressed in terms of trading days) remains at 168 and Dh (the

total volume of hedges held for the relevant cap periods before Cap period n starts, expressed in terms of calendar days) remains at 242.

3.28. The updated terms are presented below, which reflect the 7-1-6 / 3-1.5-3 transitional indexation approach for the remainder of P8. The profile was built based on trading days and a, b, c (in calendar days) for the calculation of Wpc , was extrapolated from $a'b'c'$ (in trading days) for the calculation of Wc .

Wholesale element of the price cap (Wpc) weighting factors

$$a = \frac{D_{rem}}{D_h}$$

$$b = \frac{Q4 * ((D_n + 0.5(D_{d1} - D_{d50}) + (D_{d50} - D_{d63})) + TWQ4 * (D_{d63} - D_{d141}))}{D_h}$$

$$c = \frac{Q1 * ((D_n + 0.5(D_{d1} - D_{d50}) + (D_{d50} - D_{d63})) + 0 * (D_{d63} - D_{d141}) + TWQ1 * (D_{d141} - D_{d1P9b}))}{D_h}$$

Where:

D_{rem} = Calendar days remaining in period n (P8)

D_n = Weighted calendar days of next period (P9A) hedged during the n – 1 period (P7) = 51

D_h = Total number of calendar days in 8 months of hedges

D_{d1} = Term growing by 1 unit per calendar day from calendar day 1 of period n (1st April '22)

D_{d50} = Term growing by 1 unit per calendar day from calendar day 50 of period n (20th May '22)

D_{d63} = Term growing by 1 unit per calendar day from calendar day 63 of period n (2nd June '22)

D_{d141} = Term growing by 1 unit per calendar day from calendar day 141 of period n (19th August '22)

D_{d1P9b} = Term growing by 1 unit per calendar day from calendar day 1 of period n + 1 (1st October '22)
= always 0 during P8

$Q4$ = The proportion of P9 allocated to P9a

$Q1$ = The proportion of P9 allocated to P9b

$TWQ4$ = Transitional weight to allow 50:50 split between 7 – 1 – 6 and 3 – 1.5 – 3 blocks

$TWQ1$ = Transitional weight to allow 50:50 split between 7 – 1 – 6 and 3 – 1.5 – 3 blocks

Wholesale cost (Wc) weighting factors

$$a' = \frac{T_{rem}}{T_h}$$

$$b' = \frac{Q4 * ((T_n + 0.5(T_{d1} - T_{d33}) + (T_{d33} - T_{d42})) + TWQ4 * (T_{d42} - T_{d96}))}{T_h}$$

$$c' = \frac{Q1 * ((T_n + 0.5(T_{d1} - T_{d33}) + (T_{d33} - T_{d42})) + 0 * (T_{d42} - T_{d96}) + TWQ1 * (T_{d96} - T_{d1P9b}))}{T_h}$$

Where:

T_{rem} = Trading days remaining in period n (P8)

T_n = Weighted trading days of next period (P9A) hedged during the n – 1 Season (P7) = 37

T_h = Total number of trading days in 8 months worth of hedges

T_{d1} = Term growing by 1 unit per trading day from trading day 1 of period n (1st April '22)

T_{d33} = Term growing by 1 unit per trading day from trading day 33 of period n (20th May '22)

T_{d42} = Term growing by 1 unit per trading day from trading day 42 of period n (6th June '22)

T_{d96} = Term growing by 1 unit per trading day from trading day 96 of period n (19th August '22)

T_{d1P9b} = Term growing by 1 unit per trading day from trading day 1 of period n + 1 (3rd October '22)
= always 0 during P8

$Q4$ = The proportion of P9 allocated to P9a

$Q1$ = The proportion of P9 allocated to P9b

$TWQ4$ = Transitional weight to allow 50:50 split between 7 – 1 – 6 and 3 – 1.5 – 3 blocks

$TWQ1$ = Transitional weight to allow 50:50 split between 7 – 1 – 6 and 3 – 1.5 – 3 blocks

Consumption weighting factor (t)

3.29. The term t , tracks the seasonality and should reflect the value of the hedge held. The qualifying losses are multiplied by the average demand weight of the forward 8 months and therefore, t is now:

$$t = \frac{\text{Ave 8 fwd months} * \left(\frac{a}{v}\right) + \text{Ave of 4.5 fwd months} * \left(\frac{b+c}{v}\right)}{3}$$

3.30. This is because P8 hedges are valued over an 8 month forward looking period and P9a and P9b hedges are valued at the forward 4.5 months, so we propose to take a weighted average. This terms varies on a daily basis, the table below shows these values for the 1st day of each month.

Month	t (electricity)	t (gas)
April	29%	47%
May	28%	47%

June	31%	46%
July	36%	45%
August	42%	44%
September	59%	58%

Seasonal demand weightings

3.31. The fuel type seasonal demand weightings (S_n, S_{n+1}, S_{n+2}) capture the relative importance of the hedge held for each season. For the P8 MSC model we propose to use the summer 6 monthly demand weightings for S_n (P8) as this was based on 6 monthly contracts. For S_{n+1} and S_{n+2} , given that they are based on quarterly contracts, we propose to use the 3 monthly demand weights. These weights applicable to each season are shown below where n is current Price Cap period.

	S_n	S_{n+1}	S_{n+2}
Electricity	42.9%	28.3%	28.8%
Gas	24.3%	33.4%	42.3%

MSC Algebra for Cap period 9a

3.32. The weighting terms ($a/a', b/b'$ and c/c') are proposed to be updated as follows:

3.33. Terms a and a' , the volumes associated with the current Cap period are:

- updated to reflect difference between the cumulative weight purchased up to the 18th August (93) and the daily growing sum of the daily delivered weight in season n (P9a)¹⁸

3.34. Terms b and b' , the volumes associated with the next Cap period (P9b)

¹⁸ For W_c , the cumulative weight purchased up to 18 August / total number of trading days in Cap period n (P9a) = $93/63 = 1.476$ (1.59% of total volume to be delivered for 63 days) and for W_{pc} , the cumulative weight purchased up to 18 August / total number of calendar days in Cap period n (P9a) = $132.75/92 = 1.443$ (1.10% of total volume to be delivered for 92 days)

- multiplied by $Q1$, the proportion of P9 allocated to P9b
- multiplied by $TWQ1$ from 19th August 2022 to 16th November 2022 to reflect the overall uplift in order to allow for a 50:50 split between 7-1-6 and 3-1.5-3.

3.35. Terms c and c' , the volumes associated with the following Cap period (P10a)

- are updated to reflect the start of the observation period (17th November 2022) for Cap period 10a.

3.36. The value for Th (the sum of maximum cumulative hedge weight held for each Cap period expressed in trading days before Cap period n starts) is ~ 154 (this is the sum of cumulative hedge weight held for P9a = 93 and P9b = ~ 61). The value for Dh (the sum of maximum cumulative hedge weight held for each Cap period expressed in delivery days before Cap period n starts) is ~ 220 (this is the sum of cumulative hedge weight held for P9a = ~ 133 and P9b = ~ 87). Th and Dh here represent the maximum of the cumulative purchased hedges for each Cap period before P9a starts.

Wholesale element of the price cap (Wpc) weighting factors

$$a = \frac{D_c - D_{pass}}{D_h}$$

$$b = \frac{Q1 * D_n + TWQ1 * D_{n2} + TWQ1 * (D_{d1} - D_{d48})}{D_h}$$

$$c = \frac{D_{d48}}{D_h}$$

Where:

D_c = Cumulative weight purchased up to 18 August '22 = 132.75

D_{pass} = Sum of daily delivered weight in period n (P9a) = 1.443 * calendar day of period

$Q1 * D_n$

= Weighted purchase weight of next period (P9b) hedged up to the 62nd calendar day of period n – 1 (P8) (1st June '22) = $Q1 * 88.5$

D_{n2} = Calendar days of next period (P9b) hedged after the 1st June and before P9a starts = 43

D_h = Max of the cumulative hedge weight purchased before P9a starts = ~ 220 (133 for P9a, 87 for P9b)

D_{d1} = Term growing by 1 unit per calendar day from calendar day 1 of period n (1st October '22)

D_{d48} = Term growing by 1 unit per calendar day from calendar day 48 of period n (17th November '22)

$Q1$ = The proportion of P9 allocated to P9b

$TWQ1$ = Transitional weight to allow 50:50 split between 7 – 1 – 6 and 3 – 1.5 – 3 blocks

Wholesale cost (Wc) weighting factors

$$a' = \frac{T_c - T_{pass}}{T_h}$$

$$b' = \frac{Q1 * T_n + TWQ1 * T_{n2} + TWQ1 * (T_{d1} - T_{d34})}{T_h}$$

$$c' = \frac{T_{d34}}{T_h}$$

Where:

T_c = Cumulative weight purchased up to 18 August = 93

T_{pass} = Sum of daily delivered weight in season n (P9a) = 1.476 * trading day of period

$Q1 * T_n$

= Weighted purchase weight of next season (P9b) hedged up to the 41st trading day of period n – 1 (P8) (1st June '22) = $Q1 * 62$

T_{n2} = Trading days of next period (P9b) hedged after the 1st June and before P9a starts = 30

T_h = Max of the cumulative hedge weight purchased before P9a starts ~93 + ~61 = ~154

T_{d1} = Term growing by 1 unit per trading day from trading day 1 of period n (3rd October '22)

T_{d34} = Term growing by 1 unit per trading day from trading day 34 of period n (17th November '22)

$Q1$ = The proportion of P9 allocated to P9b

$TWQ1$ = Transitional weight to allow 50:50 split between 7 – 1 – 6 and 3 – 1.5 – 3 blocks

Consumption weighting factor (t)

3.37. The term t , tracks the seasonality and should reflect the value of the hedge held ahead. The qualifying losses are multiplied by the average demand weight of the forward 8 months and therefore for P8 t is now

$$t = \text{Ave of 4.5 fwd months}$$

3.38. This is because all hedges (P9a, P9b and P10a) are valued at the forward 4.5 months.

Seasonal demand weightings

3.39. The fuel type seasonal demand weightings (S_n, S_{n+1}, S_{n+2}) capture the relative importance of the hedge held for each season. For the P9a MSC model we propose to use the 3 monthly demand weights for each of the terms S_n, S_{n+1} and S_{n+2} , given that they are based on quarterly contracts. These are shown below.

	S_n	S_{n+1}	S_{n+2}
Electricity	28.3%	28.8%	21.9%
Gas	33.4%	42.3%	16.7%

MSC Algebra for Cap period 9b

3.40. The weighting terms ($a/a', b/b'$ and c/c') are proposed to be updated as follows:

3.41. Terms a and a' , the volumes associated with the current season,

- are updated to reflect difference between the cumulative weight purchase up to the 16th November and the daily growing sum of the daily delivered weight in season n (P9b)¹⁹

3.42. Terms b and b' , the volumes associated with the next price cap season (P10a),

- updated to reflect the start of the observation period (20th February 2023) for Cap period 10b.

3.43. Terms c and c' , the volumes associated with the following price cap season (P10b) are

- updated to reflect the start of the observation period (20th February 2023) for Cap period 10b.

¹⁹ For W_c , the cumulative weight purchased up to 16 November / total number of trading days in Cap period n (P9b) is $93/64 = 1.453$ (1.56% of total volume) and for W_{pc} , the cumulative weight purchased up to 18 August / total number of calendar days in Cap period n (P9b) is $132.75/92 = 1.475$ (1.11% of total volume)

3.44. The value for Th (the sum of maximum of cumulative hedge weight held, expressed in trading days before Cap period n starts) is ~ 123 (this is the sum of cumulative hedge weight held for P9b = 93 and P10a = 30). The value for Dh (the sum of maximum of cumulative hedge weight held, expressed in delivery days before Cap period n starts) is ~ 178 (this is the sum of cumulative hedge weight for P9b = ~ 133 and P10a = 45). Th and Dh here represent the maximum of the cumulative purchased hedges for each Cap period before P9b starts.

Wholesale element of the price cap (Wpc) weighting factors

$$a = \frac{D_c - D_{pass}}{D_h}$$

$$b = \frac{D_n + (D_{d1} - D_{d51})}{D_h}$$

$$c = \frac{D_{d51}}{D_h}$$

D_c = Cumulative weight purchased up to 16th November '22 = 132.75

D_{pass} = Sum of daily delivered weight in period n (P9b) = 1.475 * calendar day of period

D_n = Calendar days of next period (P10a) hedged during the $n - 1$ period (P9b) = 45

D_h = Max of the cumulative hedge weight purchased as long as you dont deliver for period n
 = ~ 178 (133 for P9b, 45 for P10a)

D_{d1} = Term growing by 1 unit per calendar day from calendar day 1 of period n (2nd January 2023)

D_{d51} = Term growing by 1 unit per calendar day from calendar day 50 of period n (20th February '23)

Wholesale cost (Wc) weighting factors

$$a = \frac{T_c - T_{pass}}{T_h}$$

$$b = \frac{T_n + (T_{d1} - T_{d35})}{T_h}$$

$$c = \frac{T_{d35}}{T_h}$$

T_c = Cumulative weight purchased up to 16th November '22 = 93

T_{pass} = Sum of daily delivered weight in period n (P9b) = 1.453 * trading day of period

T_n = Trading days of next period (P10a) hedged during the $n - 1$ period (P9b) = 30

T_h = Max of the cumulative hedge weight purchased before P9b starts = ~ 123

T_{d1} = Term growing by 1 unit per trading day from trading day 1 of period n (3rd January 2023)

T_{d35} = Term growing by 1 unit per trading day from trading day 35 of period n (20th February '23)

Consumption weighting factor (t)

3.45. The term t , tracks the seasonality and should reflect the value of the hedge held ahead. The qualifying losses are multiplied by the average demand weight of the forward 8 months and therefore for P9b t is:

$$t = \text{Ave of 4.5 fwd months}$$

This is because all hedges (P9b, P10a and P10b) are valued at the forward 4.5 months.

Seasonal demand weightings

3.46. The fuel type seasonal demand weightings (S_n, S_{n+1}, S_{n+2}) capture the relative importance of the hedge held for each season. For the P9a MSC model we propose to use the 3 monthly demand weights for each of the terms S_n, S_{n+1} and S_{n+2} , given that they are based on quarterly contracts. These are shown below.

	S_n	S_{n+1}	S_{n+2}
Electricity	28.8%	21.9%	21.0%
Gas	42.3%	16.7%	7.6%

Implementation of updated algebra

3.47. Given the differing sets of algebra which will apply for the remainder of Cap period eight and period 9a and 9b, the table below sets out the proposed dates that each version of the MSC model will be in place for, until end March 2023 (should we decide to proceed with the proposal to move to quarterly updates and extend the MSC). This aligns with the first scheduled update when we move from one Cap period to another, however, the effective from date will not necessarily begin on the same day as the subsequent charge restriction period.

MSC model	Published	Effective from	Effective to
P8²⁰	Mon 22 August 2022	Wed 24 August 2022	Tue 04 October 2022
P9a	Mon 03 October 2022	Wed 05 October 2023	Tue 03 January 2023
P9b	Mon 02 January 2023	Wed 04 January 2023	Tue 04 April 2023

3.48. Should we decide to proceed with the proposals as outlined above, we will also publish a worked example of each of the three models (for P8, P9a and P9b) and an updated version of the MSC Guidance alongside our decision document.

3.49. In the event that, following this consultation, we issue further guidance to industry with respect to price cap indexation, we will consult on any further changes to the MSC calculation as necessary, while it remains in effect.

Alternative option considered – do nothing

3.50. We do not think it would be appropriate to continue with a “do-nothing” option. Our analysis indicates that on balance, maintaining the 7-1-6 indexation profile would ultimately overcompensate the losing energy supplier in the event that the MSC is triggered²¹. On this basis, we consider that proceeding with an indexation approach for the MSC calculation that differs from the 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 Transitional Indexation Approach within the MSC calculation?

²⁰ P8 dates are illustrative only, subject to when the decision to this consultation is published. The P8 timings as set out in this table are indicative of an assumed decision publication date of the week commencing 15th August 2022, which is subject to change. We will provide an updated implementation timeline alongside our decision.

²¹ Whilst a marginal undercompensation may occur in P9a this becomes a large overcompensation in P9b

2. If yes, do you agree with how we propose to amend the algebra / terms of the MSC to reflect the Transitional Indexation Approach?

4. Ban on acquisition-only tariffs

Section summary

The BAT works alongside the MSC to help provide market stability in times of falling wholesale prices, by reducing the incentive to offer very aggressive acquisition pricing. The VaR analysis set out in section 2 above in relation to the MSC is also relevant to the BAT intervention and we consider that the case for extending this measure is also strong. The section also notes the possibility that this measure could become an enduring feature of domestic retail regulation, for example because of its impact on price discrimination and perceived loyalty penalties. It sets out Ofgem’s current thinking on how that question might be addressed in the future.

Context

4.1. Standard Licence Condition SLC 22B, which requires that all domestic tariffs are offered to both new and existing customers, came into force on 14 April 2022. The effect of this condition was significantly modified by a derogation issued on 7 April 2022 (the “**Retention Tariffs Derogation**”)²² which came into force simultaneously with SLC 22B. The Retention Tariffs Derogation disapplies SLC 22B to fixed-term offers made to existing customers, subject to certain conditions. As a result, the principal effect of SLC 22B is to act as a ban on acquisition-only tariffs (“**BAT**”) and its effect as a short term market stabilisation measure arises from this characteristic. Under the terms of SLC 22B, the BAT will cease to have effect on 30 September 2022 unless the Authority uses the powers under SLC 22B to extend the measure up to a date no later than 31 March 2023.

4.2. The BAT was introduced as a temporary measure to work alongside the MSC to promote stability in domestic retail energy markets in the event that wholesale prices fell sharply. The nature of the risks which this would cause for a notional efficient and well-managed suppliers, who had hedged their positions to enable compliance with the price cap,

²² Ofgem (7 April 2022) Derogations from SLC 22B – requirement to make all tariffs available to new and existing customers
<https://www.ofgem.gov.uk/publications/decision-derogations-slc-22b-requirement-make-all-tariffs-available-new-and-existing-customers>

is described in paragraphs 2.1-2.7 above. In the February Decision, Ofgem considered that the BAT would reduce the incentive on suppliers to cut prices very aggressively in a time of market turmoil and that this in turn would help mitigate to some extent against major supplier financial losses leading to significant costs for consumers from disorderly supplier exits and longer-term negative impacts on investment, innovation and competition.

Extension considerations

4.3. Although the MSC is likely to be a more powerful mechanism than the BAT in mitigating the risks in a falling wholesale market, the arguments concerning value at risk set out in Chapter 2 can be applied in relation to BAT. The higher VaR during the Extension Period can be seen as an indicator that the contribution of BAT to market stability will be needed more during the extension period than when the BAT was first introduced.

4.4. We are therefore considering, subject to the Authority's decision, extending the BAT to 31 March 2023. Whilst the practical impacts of SLC 22B are yet to be seen, owing to current market prices, we are aware that there may be other theoretical benefits of introducing the ability to limit price discrimination by suppliers and addressing the perceived loyalty penalty, which is in line with recent CMA proposals across multiple markets.²³

4.5. In the February Decision, we noted for example that the FCA has recently introduced rules to ensure that renewal quotes for existing insurance customers are not more expensive than they would be for new customers²⁴. Some of these benefits are currently delivered by the default tariff price cap and it would be instructive to see how the two approaches interact, once market conditions make that possible.

4.6. The measure also has the potential to increase consumer trust in the market by enabling customers to access their own suppliers' cheapest tariffs at a time when perceptions of switching risks are likely to be high, particularly among consumers who are vulnerable or disengaged.

²³ ['Loyalty penalty' super-complaint - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/news/loyalty-penalty-super-complaint)

²⁴ [FCA confirms measures to protect customers from the loyalty penalty in home and motor insurance markets | FCA](https://www.fca.org.uk/news/press-releases/fca-confirms-measures-to-protect-customers-from-the-loyalty-penalty-in-home-and-motor-insurance-markets)

4.7. Taking account of all these factors and, if possible, evidence of the practical impact of the BAT, we intend in due course to undertake an evaluation of the impact of this measure on consumers and competition. This will help inform future consideration of whether to implement the measure on an enduring basis. We would consult on any such proposal.

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](#)".

Appendix 2 – Background to MSC technical proposals

We set out our approach to manage the transition to quarterly updates in the Second Indexation Guidance Letter and Appendix 2 of the consultation on changes to the wholesale methodology. This is a non-linear indexation approach which is described and illustrated below and has been designed to maintain 30 full trading days between the end of the observation period and the beginning of the associated Price Cap period:

For Cap period 9a

- Observe prices at full weight from the beginning of the observation period, 01 February, for P9a and P9b until the 15th March
- Observe prices at 50% weight from 16 March to 19 May inclusive (44 days) in accordance with the decision to move to a 7-1-12 indexation approach
- Observe prices at full weight again from 20 May to 01 June then cease to hedge using 7-1-12 on 01 June, when a nominal supplier will have bought 50% of its volumes (62/124 weighted trading days) under this indexation approach
- Adjust prices from 06 June to 18 August to reflect the fact that there are only 54 trading days between these dates

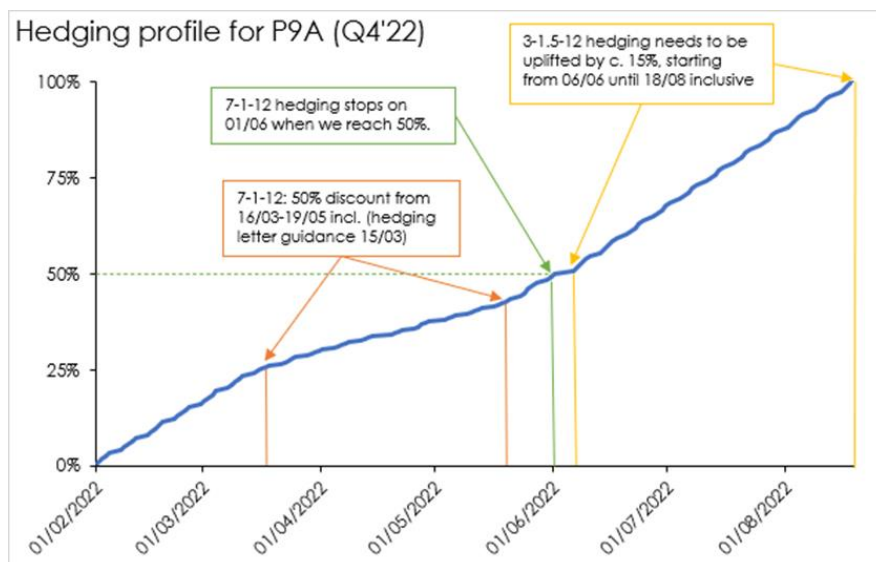


Figure 1 - Graphical representation of hedging profile for Cap period 9a

For Cap period 9b

- Observe prices at full weight from the beginning of the observation period, 01 February, for P9a and P9b until the 15th March
- Observe prices at 50% from 16 March to 19 May inclusive (44 days) in accordance with decision to move to a 7-1-12 approach
- Observe prices at full weight again from 20 May to 01 June then cease to hedge using 7-1-12 on 01 June, when a nominal supplier will have bought 50% of its volumes (62/124 weighted trading days) under this indexation approach
- Pause observing prices from 01 June to 18 August
- Discount prices from 19 August to 16 November to reflect the fact that there are only 54 trading days between these dates

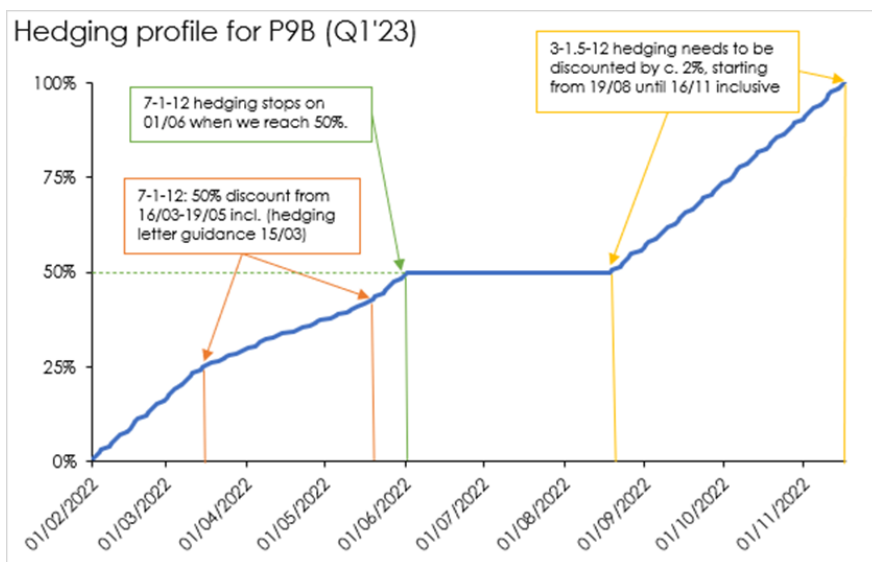


Figure 2 - Graphical representation of hedging profile for Cap period 9b

The final day of the observed prices under the existing 7-1-12 [6] indexation approach would be 01 June 2022. This represents the mid-point of the 124 weighted trading day observation window of the 7-1-12 [6] approach (01 February to 31 August inclusive) and we would expect a nominal supplier will have purchased 50% of its volumes for delivery over the winter season

(October 2022 – March 2023). From 06 June 2022,²⁵ we would expect a nominal supplier to be following the 3-1.5-12 indexation approach for quarterly cap updates.

²⁵ The gap between 01 June 2022 and 06 June 2022 is due to the extended Jubilee bank holiday weekend