Decision

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Making a positive difference for energy consumers

Decision on extending short-term interventions and adjusting MSC calculation

Subject	Details
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Contact	Maureen Paul, Deputy Director, Retail Market Policy
Team:	Retail
Email:	retailpolicyinterventions@ofgem.gov.uk

We consulted from 28 June 2022 to 18 July 2022 on extending the Market Stabilisation Charge ("**MSC**") to 31 March 2023 and invited comments on extending the ban on acquisition-only tariffs ("**BAT**") to the same date. We also consulted on changes to the MSC calculation methodology to reflect our announcement of 16 May 2022 relating to price indexation in the default tariff cap (the "**Second Indexation Guidance Letter"**). These indexation changes have been confirmed by Ofgem, with minor modifications, in a Decision published on 4 August 2022.

This document describes our decision to proceed with all the above changes. We have taken into account the responses received to the consultation and have considered them in the light of how to best protect consumers' interests.

For the avoidance of doubt, this document, insofar as it sets out the decision to extend each of the MSC and the BAT, is the statement in writing as referred to in Standard Licence Conditions (SLC) 24A and 22B respectively of the electricity and gas supply licences. Accordingly:

- The MSC is extended until 31 March 2023.
- The BAT is extended to the same date
- New MSC Guidance (the "**Version 3 Guidance**") is published today to reflect the indexation changes and will come into force on 7 September 2022.

This document also invites comments from stakeholders on what action, if any, Ofgem should take in relation to the period after 31 March 2023, when the current licence conditions for the MSC and BAT end.

Contents

Executive summary

The short-term interventions to stabilise the market

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 and more recently by restrictions on the availability of Russian gas to Europe. Future wholesale prices could rise further – for example if shortfalls intensify – or they could fall if forward supply levels once again exceeded demand.

This requires domestic energy suppliers to manage significant risks 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 support the UK supply industry in managing this risk, by providing an element of protection against the downside risk, so assisting companies in being able to continue hedging for consumers in accordance with the price cap. The MSC may have already significantly benefitted consumers, even though it has never been triggered, by providing suppliers with the confidence to hedge appropriately. Without it, suppliers would have had an incentive to reduce hedging cover and, with the current very high price background, consumers could be facing further costly and disruptive market exits. In section 6 we present an estimate that these benefits could be in excess of £1 billion.

The MSC also benefits consumers should prices fall. This is because it enables efficient suppliers to broadly cover the costs of supplying energy in such situations. 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 ban on acquisition-only tariffs ("**BAT**") was introduced alongside the MSC in the decision of 16 February 2022 (the "**February Decision**"). It augments the MSC by reducing the incentive for suppliers to offer very aggressive acquisition prices in a time of market turmoil because they would have to make the same offers available to their existing customers. This reduces the likelihood that deals would be offered that might increase the risks of financial stress and supplier exit and the resulting costs and disruption for consumers. It also ensures that any discounted deals are available to existing customers, which improves fairness in the market

The MSC and BAT are intended to be temporary interventions. They were due to expire at the end of September 2022, but the Authority has power under SLC 24A and SLC 22B respectively to extend them until no later than 31 March 2023.

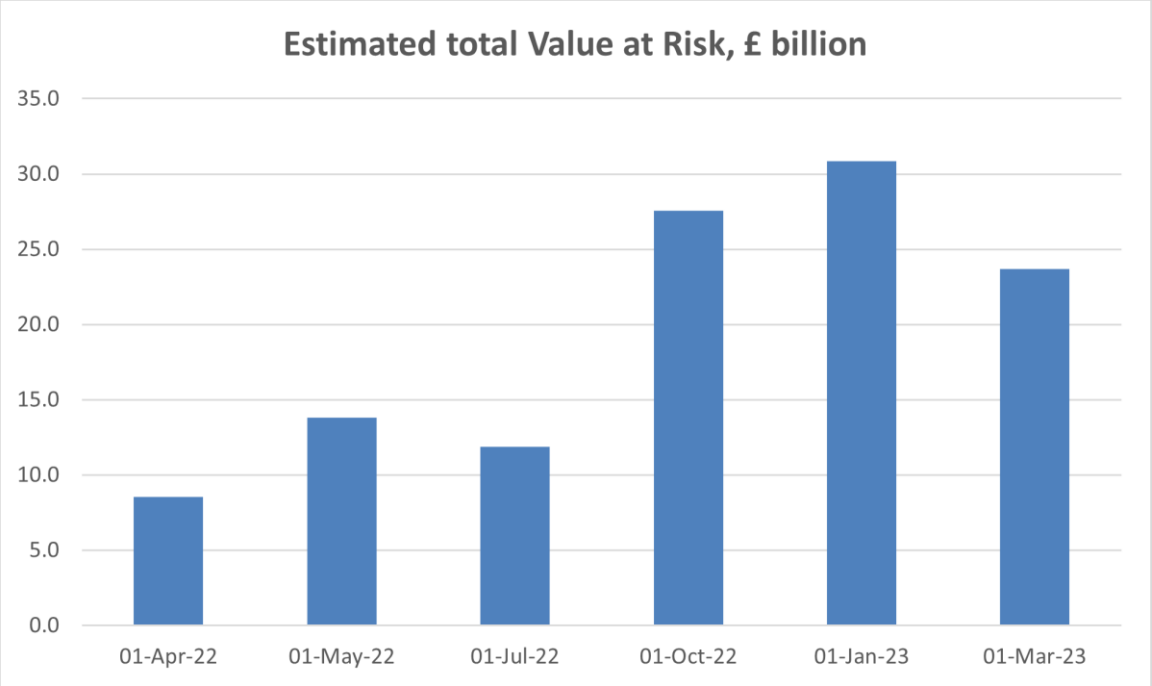
In order to reduce risks generally from the default tariff price cap, Ofgem proposed in a consultation of 16 May 2022 to move to quarterly updates to the price cap. This was accompanied by the Second Indexation Guidance Letter, published the same day, which set out the planned changes to indexation over the proposed transition. These proposals were confirmed by Ofgem in a Decision dated 4 August 2022. These changes have implications for the algebra used by the MSC calculation.

Summary of Decisions

In our consultation of 28 June 2022 (the "**June Consultation**"), we set out our proposals to extend the MSC. We used the measure of Value at Risk ("**VaR**") as a broad indicator of the scale of the problem that exists by virtue of the need to hedge in these market conditions. We consider it to be a helpful indicator because it boils down many interacting issues into a single number for which the evolution over time can be easily seen (see section 2 for a further discussion of the methodology and the comments made by stakeholders).

In the June Consultation, we estimated the total VaR for the period October 2022 to Match 2023 ("the **Extension Period**"). That analysis suggested that, throughout the Extension Period, the total VaR would be similar to, or significantly higher than, the level when the decision to implement the MSC was made in February 2022. On this basis, the consultation concluded that the VaR metric made a strong case that the MSC was needed throughout the Extension Period, at least as much as it was needed when the decision to introduce it was originally taken. The great majority of stakeholders in the consultation, including suppliers and some consumer groups, supported this conclusion.

The VaR figures in the consultation were based on the assumption that forward prices would remain at 25 May 2022 levels. However, forward wholesale energy prices have risen very considerably since 25 May 2022, following restrictions on Russian gas exports to Europe. We have also made improvements to the methodology for estimating VaR so that it more closely tracks the calculations used in the MSC. The combined effect of these changes is to increase most of our VaR estimates such that it is now likely to be more than double the original level throughout the Extension Period, as illustrated in the chart below.



On this basis, and taking into account the current market position as well as the views of stakeholders that are more fully set out in section 2, Ofgem considers that the benefits of the MSC for consumers are likely to be greater throughout the Extension Period than they were when the original decision to implement it was made. Accordingly, Ofgem has decided to extend the MSC to 31 March 2023.

The arguments concerning VaR set out above (and more fully in section 2) in relation to the MSC can also be applied to the BAT as this obligation acts to augment the MSC by reducing the incentive to offer deals that could disrupt market stability. Again, the great majority of stakeholders agreed that the BAT should be extended to 31 March 2023. Those agreeing included both suppliers and consumer groups. The fact that VaR is estimated to be significantly higher throughout the Extension Period indicates that the contribution of the BAT to market stability is more valuable during the Extension Period than when the BAT was first introduced. Accordingly, Ofgem has decided to extend the BAT to 31 March 2023.

As regards the technical changes needed to update the MSC calculation to take account of the Second Indexation Guidance Letter, stakeholders generally agreed that these were appropriate though some expressed dissatisfaction with the complexity of the algebra. Ofgem considers that, as the MSC is based on the indexation value from the price cap formula, it is necessary for the MSC to reflect the indexation. The higher complexity in the latest Guidance is unfortunately necessary because of the transition from six-monthly to quarterly indexation.

Having considered the responses from Stakeholders, Ofgem has decided to implement the technical changes in methodology as set out in the new MSC Guidance Document published today.

Next steps

Although we did not ask about extending the MSC beyond March 2023, almost all the supplier responses also indicated a view that the MSC should be extended beyond that date and most said it was imperative to decide this by November 2022, when suppliers who hedge according to the price cap will start buying energy for April 2023.

The existing MSC comes to an end on 31 March 2023 and Ofgem has no power to extend it other than through a licence modification. This raises the following questions:

(a) is some kind of regulatory response likely to still be needed to this issue after March 2023; and
(b) if so, what measure (or suite of measures) could be appropriate?

In section 5, we present some preliminary analysis that suggests that the VaR will remain very high, subject to some seasonal variation, throughout the remainder of 2023 after the current licence condition ends. We are therefore inviting stakeholders to provide us with their views on what steps, if any, Ofgem should take to support market stability beyond March 2023.

It would be helpful to receive initial responses, together with any evidence where possible, by Monday 19 September 2022, with any follow-up information in the following two weeks. This input will help inform our considerations; our intention is to make proposals (if any) in late 2022. Any responses or other input should be sent to: retailpolicyinterventions@ofgem.gov.uk.

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. Subsequent events, including restrictions in Russian exports of gas to Europe, have continued to drive international wholesale prices to extremely high levels. These circumstances mean that energy suppliers in Great Britain face a substantially increased challenge of managing risks in buying energy for their domestic customers.

1.2. To help enable suppliers to better manage wholesale energy purchase risks on behalf of consumers in the price cap environment, 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**") aimed at strengthening the MSC mechanism to ensure that it remained effective in achieving its intended purpose.

1.3. As well as commenting on the proposed changes to the MSC, many responses to the March Consultation suggested that Ofgem consider extending the MSC beyond September 2022, because the issues and concerns the MSC was intended to address remained in place and suppliers were already buying energy for October 2022 and beyond. Our own analysis came to a similar conclusion. Accordingly, in our decision of 16 May 2022 on the parameter review (the "**May Decision**"), we acknowledged these concerns and commented that, subject to consultation, Ofgem anticipated that the MSC would be extended until March 2023. We stated that we would consult on this in June 2022 and the consultation document would set out our evidence and rationale.

1.4. Accordingly, on 28 June 2022 we published a consultation on extension of the MSC to 31 March 2022 (the "**June Consultation**") which also covered an extension of the BAT to the same date and the necessary technical updates to the operation of the MSC to take account of the latest proposed changes in price cap indexation (as set out in the Second Indexation Guidance letter also published on 16 May 2022).

1.5. The remainder of this document summarises the responses we received to that consultation and sets out our decisions, along with our planned next steps:

- Section 2 sets out our decision on extending the MSC to 31 March 2023.

- Section 3 sets out our conclusions on updating the MSC calculation to reflect the Second Indexation Guidance Letter.

- Section 4 sets out our conclusions on extending the BAT to 31 March 2023.

- Section 5 sets out planned next steps including responding to questions raised by many stakeholders on possible further extension of the MSC.

- Section 6 provides information on our approach to considering consumer impacts in relation to this decision including updated modelling of the impact of the MSC on a notional energy supply company.

Related publications

1.6. The decision (the "**February Decision**") to implement the MSC and the ban on acquisition only tariffs, published 16 February 2022:

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

1.7. 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

1.8. 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

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

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

1.10. The **May Decision**, changing the MSC parameters to make the mechanism more effective, published on 16 May 2022:

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

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

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

1.12. 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

1.13. 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

1.14. The **June Consultation**, published on 28 June 2022, on extending the short-term interventions (MSC and BAT) to 31 March 2022 and adjusting the MSC publication:

https://www.ofgem.gov.uk/publications/consultation-extending-short-term-interventions-and-adjusting-msc-calculation

1.15. The **Quarterly Update Decision**, published on 4 August 2022:

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

1.16. **The Final Indexation Guidance Letter**, published on 4 August 2022:

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

1.17. The **Version 3 MSC Guidance** published alongside this decision:

https://www.ofgem.gov.uk/publications/decision-extending-short-term-interventions-and-adjusting-msc-calculation

Our decision-making process

1.18. 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**").

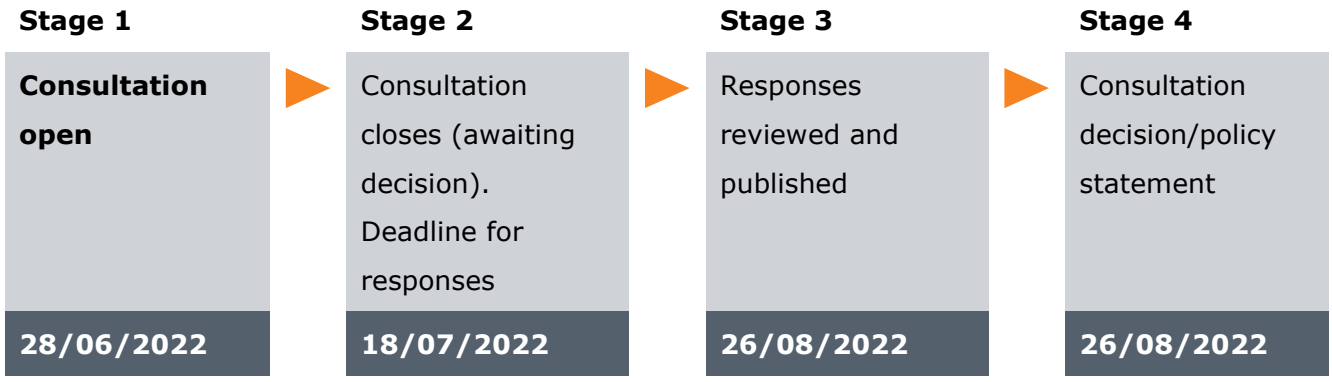
1.19. The new licence condition implementing the MSC (SLC 24A) gave the Authority the option to extend the measure until no later than 31 March 2023 by publishing a statement in writing to that effect. We stated that we would consult before exercising that power. The condition implementing the BAT (SLC 22B - Requirements to make all tariffs available to new and existing customers) contained a similar extension power, though we did not commit to consulting before utilising that option.

1.20. On 28 June 2022 we consulted on extending the MSC and on proposed technical changes to the MSC. We also sought views on extending the BAT.

1.21. The consultation closed on 18 July 2022. We received 14 responses including 3 given orally in a discussion session with consumer groups. One response was received very shortly after the closing date and has been considered as has a follow-up letter received from one of the consultees.

1.22. Of the 14 responses, 10 were non-confidential (or the stakeholder provided a non-confidential redacted version of an otherwise confidential response) and 4 were confidential.

Figure 1: Decision-making stages



Your feedback

General feedback

1.23. 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 stakeholders@ofgem.gov.uk.

2. Extension of Market Stabilisation Charge

Section summary

Our June Consultation analysed the case for the MSC during the period October 2022 to March 2023 (the "**Extension Period**") using a Value at Risk ("**VaR**") metric. This indicated that the need for an effective MSC was similar, and at most times significantly greater, during the Extension Period than it was when the policy was first decided. This was the case despite the impact of the proposed phasing in during the Extension Period of quarterly indexation of wholesale costs in the price cap.

Following consultation, we have decided to maintain the use of the VaR metric as the principal indicator of whether the MSC should be kept in place during the Extension Period. Forward wholesale prices have risen significantly since the June Consultation data was gathered on 25 May 2022 as a result of restrictions on Russian gas exports. We now estimate that, throughout the extension period, it is likely that VaR will significantly exceed – by a factor of more than 2 – the level it was when the decision to implement the MSC was made. We have therefore decided to extend the MSC until 31 March 2023.

Decision Summary

2.1. In the light of responses to the consultation and the analysis we have undertaken, we have concluded that there is a strong case that the MSC should be kept in place during the Extension Period, and accordingly we have decided to extend the MSC to 31 March 2023.

2.2. Insofar as this decision document sets out the decision to extend the MSC to 31 March 2023, it is the Authority's statement in writing referred to in SLC 24A of the gas and electricity supply licences, that the MSC is so extended.

Context

2.3. 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 by the gaining supplier to the losing supplier when a customer switches.

2.4. 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. We consulted from 28 June 2022 until 18 July 2022 (the "**June Consultation**") on a proposal to exercise this power to extend the MSC to 31 March 2023.

Stakeholder responses

2.5. Of the 14 responses received, nine were in favour of extending the MSC (including two consumer groups and almost all supplier responses), two opposed it and three offered no opinion. Consumer groups that were in favour generally thought the proposals were fair and logical in the current circumstances and were reassured that they would not cause the price cap to rise – whilst also recognising it would be important to enourage people to engage with the market when the time was right. Suppliers that were supportive of the proposals generally agreed with Ofgem's reasoning, highlighting the role of the MSC in enabling appropriate hedging and the fact that the adverse market circumstances that necessitated the MSC remain in place and indeed have intensified.

2.6. Those against extending the MSC comprised one consumer group and a business aiming to offer switching services. They questioned whether Ofgem had provided sufficient evidence that the benefits in maintaining the viability of well managed suppliers outweighed the harms to customers (reduced savings available from switching when the MSC is active). They stressed the significant pressure on consumers arising from high and rising energy bills and suggested that maximising competition should outweigh ensuring market stability. One commented that the weaker suppliers had already failed and viability was no longer a risk. One stakeholder, broadly neutral on the extension of the MSC to March 2023, commented that Ofgem was under-estimating the value of competition and that much could be lost by consumers in the longer term if the market stagnated for too long.

Methodology responses

2.7. A few stakeholders commented on the use of the VaR methodology. One commented that VaR provided a clear, quantifiable indicator of the extent of ongoing market risk and requested that Ofgem continue to update this measure. Others sought clarity on the relationship between VaR and the approach of modelling the underlying EBIT for a notional

supplier company ("**NoCo**"). Some said that they did not consider the level of VaR seen when the MSC was decided upon as necessarily the appropriate benchmark. (The implication of these remarks was that they considered that the appropriate benchmark was a lower figure.)

2.8. A stakeholder asked if Ofgem could publish its VaR and NoCo models in order that suppliers could make more informed judgements about when the MSC would be in place and with what parameters. They suggested that this visibility could reduce risks and therefore costs to consumers.

2.9. Some responses indicated that the VaR assessment should be validated by modelling the expected EBIT for a notional supplier company ("NoCo") as Ofgem undertook in the May Decision. One stakeholder said that VaR over-estimated actual supplier losses in a price fall scenario, because not all customers would switch and they considered that a fall of wholesale prices to historic levels was not feasible.

2.10. One stakeholder questioned elements of the NoCo EBIT methodology used in the May Decision on the Parameter Review, in particular suggesting that the estimate of NoCo's gains from acquired customers in a price fall scenario (the "**Acquisitions Benefit**") was too high.

Other issues

2.11. A number of stakeholders raised issues about the design of the MSC. Some suggested that it could be triggered too late and that suppliers could suffer very large losses before it was activated; a related point that was made was that the parameters remained too weak with suggestions both that the threshold should be reduced and that the derating factor should be increased. Two consultees suggested that the threshold should be a fixed cash sum below the price cap indexed value, rather than a percentage and two others proposed that the MSC could have a role in relation to backwardation allowances in the price cap.

2.12. Two stakeholders pointed out that the arrangements in the price cap for recovery of exceptional costs are also subject to stranding risk – that even if there are no wholesale price movements, customers can avoid paying for exceptional cost recovery by switching to a fixed tariff from a competitor. They suggested that the energy cost protected by the MSC should include the exceptional cost recovery element.

2.13. One stakeholder picked up on our comments in the June Consultation about tapering the MSC being premature before January 2023 and commented that in their view tapering would be extremely premature even at January 2023.

2.14. Although the June Consultation did not raise the issue of extension of the MSC beyond March 2023, the great majority of stakeholders chose to comment on this. Almost all suppliers considered that such an extension would be needed because the issues in the market that the MSC is designed to address would be likely to still be present after March 2023. Several of these consultees also indicated that Ofgem should set out a clear direction of travel on this by November 2022, because that is when (if they hedge according to the price cap) they would start buying energy for April 2023. However, some other stakeholders argued against further extension. One did not state when they considered that the MSC would no longer be needed, but stressed the need to remove the measure at the earliest possible opportunity and asked that Ofgem explains its exit strategy from the MSC.

Ofgem response

Methodology and analysis

2.15. In order to measure the scale of the issue which the MSC seeks to treat, the June Consultation introduced 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 which is proportional to the level of financial risk which hedging in line with price cap methodology may require suppliers to take on.

2.16. We are grateful for the comments on our analytical framework. We introduced the VaR measure because it condenses into a single number the question of how big the issue that the MSC aims to treat is. This enables an easy comparison of the scale of the issue over time without the need to create multiple scenarios of differing price movements at different dates.

2.17. The VaR measure takes account of estimates of price movements, seasonal demand, numbers of SVT customers and effects of changes in indexation to give an indication of the size of the potential problem. It is of course correct that only a portion of the VaR would ever in a real situation translate into actual losses, but that does not prevent it from being a helpful indicator of whether the overall situation is getting more or less problematic.

2.18. In the June Consultation we said that the VaR was estimated to be similar or higher during the Extension Period than it was when the MSC was decided upon. We deduced that this made a strong case that the MSC was needed throughout the Extension Period at least as much as it was needed when the decision was originally taken. This is not equivalent to saying that we considered that VaR close to the original £7.9 billion VaR figure (now revised to £8.5 billion) was consistent with a risk of market instability that is acceptable for consumers ("**Tolerable VaR**") and the June Consultation was not intended to give that implication. We might wish to estimate the maximum Tolerable VaR in the context of deciding next steps (see section 5); this would require further analysis, which might well involve looking at NoCo EBIT estimates in various scenarios. However, this is not necessary for the current decision.

2.19. We have therefore decided to retain use of the VaR figure as the principal indicator to assist us with the extension decision. In addition, we present in section 6 impact assessment and NoCo EBIT estimates. Those estimates use the methodology we used in the May Decision, appropriately updated for factors including price movements and changes in price cap indexation. We comment in section 6 on the stakeholder comments on the Acquisitions Benefit.

2.20. We have updated our VaR assessment to take account of energy price data as of 18 August 2022 and to improve the way we do the calculation to more closely track the calculations done in the MSC itself[1].

2.21. Our updated view of VaR per customer is 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 (updated for our methodology improvements), and that for 1 May 2022 reflects the position when we announced the decision on revising the MSC parameters.

[1] In particular, we have updated the methodology for estimating prices to more closely reflect the calculation of the W_{pc} term in the MSC Guidance, adapted for monthly estimates so that we can apply monthly demand weightings to derive total sums at risk.

Estimated 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	£210	£282	£241	£531	£604	£535
Gas	£250	£413	£337	£795	£863	£578
Total	**£460**	**£695**	**£578**	**£1,326**	**£1,467**	**£1,113**

2.22. The VaR per customer captures the forward-looking value of the assumed hedge positions (based on the MSC methodology) compared with the historic norm for market pricing. The high level in October 2022 reflects the combination of recent higher wholesale prices, a seasonal increase in forward looking demand and the incomplete phasing in of quarterly indexation. By January 2023, the projected VaR per customer has risen further, mainly because the increased weight of very high recent prices outweighs the further phasing in of quarterly indexation. By March 2023, seasonal demand factors reduce the number a little, though the effect of much higher wholesale prices leaves the projected VaR per customer over twice the original level.

2.23. As before, we then assess the total VaR by multiplying by the number of electricity and gas SVT customers respectively. We fine tuned our view of the SVT customer numbers using updated data to August 2022 from supplier Information Requests and a new source for overall customer numbers.[2] One supplier suggested that we were over-estimating SVT customer numbers (based on the price data used in the June Consultation) because the exceptional cost recovery allowances would mean that the SVT was uncompetitive against fixed price contracts if wholesale prices were flat. However, the supplier then conceded that recent increases in wholesale prices have nullified their concern in the short term.

2.24. Because SVT has generally been the cheapest tariff in the market, these numbers have grown during the year as fixed deals expire and we assume that they will continue to grow, albeit relatively slowly at 0.5% per month, until December 2022. For the SVT

[2] In order to calculate VaR, we need separate gas and electricity SVT customer numbers. The relevant information requests seek a combined figure and we therefore use that number to estimate the percentage of domestic supplies that are on SVT. We then multiply that percentage by the numbers of gas and electricity customers respectively, taken from "Subnational Electricity and Gas Consumption Statistics", BEIS, 22 December 2020. This source is also used for mean electricity and gas consumption figures.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/946968/sub-national-electricity-and-gas-consumption-summary-report-2019.pdf

customer numbers at the time of the decision to implement the MSC, we have taken the numbers in early February 2022. This gives the following results:

Estimated 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	20.31	21.97	22.68	22.95	23.18	23.18
Electricity VaR, £ billion	4.3	6.2	5.5	12.2	14.0	12.4
Gas SVT customers, Million	17.04	18.43	19.03	19.36	19.55	19.55
Gas VaR, £ billion	4.2	7.6	6.4	15.4	16.9	11.3
Total VaR, £ billion	**8.5**	**13.8**	**11.9**	**27.6**	**30.9**	**23.7**

2.25. The VaR is now estimated to be over twice the initial value of £8.5 billion throughout the Extension Period. In essence, this is because in the period to March 2023, very much higher wholesale prices and a modest increase in SVT customer numbers, together with seasonal demand factors in part of the period, will on current estimates more than compensate for the risk reduction caused by the phasing in of quarterly indexation.

2.26. Impact analysis is provided in section 6. It covers both the impacts in the period before the MSC is triggered (when it is likely to have benefitted consumers significantly by leading to more appropriate hedging and therefore avoiding failures caused by the recent wholesale price rises) and the impacts once it comes into effect.

Extension decision and other issues

2.27. As we said in the May Decision on the parameter review, 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.

2.28. We therefore continue to believe that Ofgem should act to address the threat to recovery of efficient costs that arises from the risk of market instability if prices fall. In our opinion, the benefits of well managed suppliers being able to cover the costs of supply outweigh the temporary reduction in savings when switching as and when the MSC is activated.

2.29. Moreover, it is likely that the MSC may have already significantly benefitted consumers, even though it has never been triggered, by providing suppliers with the confidence to hedge appropriately. Without it, suppliers would have had a strong incentive to provide a lower level of hedging cover and, with the current very high price background, suppliers could be facing financial stress and consumers could be facing further costly and disruptive market exits.

2.30. It is therefore too narrow to look at the benefits of the MSC solely on the basis of the benefits once it is triggered by a substantial fall in prices. As we describe in section 6 below, it could have benefitted customers by at least £1 billion already.

2.31. The necessity to cover efficient costs also addresses the suggestion that the companies that remain are generally more robust than those that have already failed. The MSC is designed to address the problem that in the current extreme market situation, a supplier is able to adopt a risk management stance that protects sufficiently against wholesale prices rising, or falling, but not both. Robustness of a supply company (or its owners) may not of itself make it attractive to stay in the market if this dilemma remains unresolved.

2.32. As we cannot know at this stage whether future developments during the Extension Period will cause wholesale energy prices to rise or fall, or when, it is critical that the framework provides suppliers with the necessary confidence to maintain appropriate hedging.

2.33. We note the concern raised that Ofgem may be under-estimating the value of competition and that much could be lost by consumers in the longer term if the market stagnated for too long. Competition is extremely valuable to consumers. However, the current hiatus is due to the state of wholesale energy markets and the MSC is unlikely to prevent competition so much as reduce savings for switchers over a few months while hedge positions unwind. We judge that the importance of having a viable supply sector to do the competing outweighs the transitional reduction in competition that the MSC entails. In the event that circumstances were to arise where the MSC was diminishing competition for longer than is necessary to achieve the objective of market stabilisation, Ofgem is able to adjust the parameters to deal with the issue.

2.34. We note the various observations about the design of the MSC and its parameters. This consultation and decision are focussed on the narrow question of whether the MSC should be extended for the Extension Period. We continue to monitor the position closely for evidence of the need to change MSC parameters – either to tighten or loosen the

mechanism – and will launch a parameter review or propose other changes if, on the basis of the evidence, we consider it would be appropriate in consumers' interests to do so.

2.35. We note the request to publish more details of our modelling. There are issues of commercial confidentiality which we would need to consider and anything published would need to be in a form that would be helpful and clear to stakeholders. We will continue to consider what we can proportionately and appropriately do in this area to assist stakeholders and improve transparency.

Conclusion

2.36. Ofgem therefore considers that the issues the MSC is intended to address are likely to be greater in terms of potential supplier and consumer impacts, throughout the Extension Period, than they were when the original decision was taken. Accordingly, the rationale of the February decision to implement the MSC continues to apply in relation to the Extension Period and a decision to extend it until March 2023 is appropriate in the current circumstances.

3. Technical Changes Section

Section summary

On 16 May 2022, we published updated guidance on how price cap indexation would change in response to the proposed move to quarterly cap updates. As the MSC calculation is based on price cap indexation, in the June Consultation we proposed to update the MSC calculation to reflect this guidance and sought views on this approach.

On 4 August we published our decision to move to a quarterly price cap and reduced notice period. This means the changes to the MSC calculation that we consulted on (with respect to price indexation) appropriately reflect how wholesale costs are accounted for in setting the price cap. This section sets out our decision to amend the MSC calculation to reflect the proposed change to price cap indexation.

Context

Guidance on price indexation

3.1. On 16 May 2022, Ofgem issued a letter with updated guidance on the treatment of the price indexation on the basis of a move to quarterly price cap updates (the "**Second Indexation Guidance Letter**"[3]). This letter set out updated guidance for domestic energy suppliers on the treatment of wholesale prices observed during the transitional period to quarterly cap updates which are due to commence in October 2022. In this letter we set out an indexation profile which incorporated the 7-1-12 transitional arrangements as well as further adjustments to bring about a move to quarterly cap updates. This was comprised of the original 50% weighting to prices observed over a two-month period (from 16 March to 19 May, inclusive), further weightings during what will become price cap periods 9a and

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

9b to ensure a 50:50 split between the periods when 7-1-12 and 3-1.5-12 indexation approaches are respectively applied to the Annex 2 price cap methodology and a further adjustment to ensure a fair transition from seasonal to quarterly hedging for electricity. This is the 7-1-12 / 3-1.5-12 transitional indexation approach (the "**Transitional Indexation Approach**") set out in our May consultation and subsequently revised in our decision on changes to the wholesale methodology[4].

3.2. This change in indexation approach impacts the MSC calculation. The previous version of the MSC Guidance document[5] sets out the methodology used to calculate the MSC. In this section, we set out our decision on the required changes to the MSC and accompanying guidance to implement the Transitional Indexation Approach in the MSC model.

Decision Summary

3.3. We consider that the guidance contained in the Second Indexation Guidance Letter necessitates an amendment to the MSC calculation and we have decided to implement the Transitional Indexation approach in the MSC model. This is to ensure the calculation takes into account the updated price cap indexation approach. We have considered 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.

3.4. We will apply the new Transitional Indexation Approach as set out in our consultation and updated in our 4 August decision to move to a quarterly price cap and reduced notice period. Therefore, the proposed changes to the MSC calculation we consulted on (with respect to price indexation) appropriately reflect how wholesale costs are accounted for in setting the price cap.

[4] Ofgem (2022), Price cap – Decision on changes to the wholesale methodology, https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology
[5] Ofgem (2022), Market Stabilisation Charge Guidance: https://www.ofgem.gov.uk/sites/default/files/2022-05/MSC%20guidance%20v2.0.pdf

3.5. We have provided further detail on how the Transitional Indexation Approach impacts the MSC calculations in Version 3 of the MSC Guidance, published with this decision.

3.6. Based on stakeholder feedback and in the interests of transparency, we have also published an updated MSC worked example (v3.1) for the remainder of cap period 8. The v3.1 of the worked example published alongside this decision includes some minor changes to the v3.0 published as part of this consultation.[6] We also expect to publish updated worked examples applicable to cap periods 9a and 9b ahead of when these cap periods take effect.

3.7. The changes to the MSC calculation set out in this section will take effect from 7 September 2022 with the first charge for P8 published 5 September 2022 using the P8 model. The first charge for P9a will be published on 3 October 2022 using the P9a model and the first charge for P9b will be published on 3 January 2023 using the P9b model.

Stakeholder feedback and Ofgem response

3.8. Stakeholders were broadly supportive of the proposals to incorporate the 7-1-12 / 3-1.5-12 price indexation guidance within the MSC calculation. Of the fourteen stakeholders in total that responded to our consultation, six responded to our question on the technical adjustments. Four agreed that the Transitional Indexation Approach should be incorporated into the MSC calculation. No stakeholders disagreed with our overarching proposal.

3.9. We agree that updating the hedging indexation approach would continue to 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 incorrectly compensating the losing supplier, impacting the competitivity of the fixed tariff contracts offered on the market.

3.10. However, several of those stakeholders who responded to our questions on the technical adjustments expressed concerns that the calculation was becoming overly complex and urged us to consider whether it could be simplified. For example, one stakeholder suggested we adopt the usage of calendar days for the *Wc* part of the

[6] v3.1 of the worked example reflects update Sn, Sn+1 and Sn+2 values based on the latest demand weights published in Annex 2. Additionally, the daily consumption weighting factor *t* has been implemented, with detailed calculations provided at the end of the workbook

calculation, rather than trading days given the subjective nature of the trigger points. Another suggested we could have replicated the reasoning we used for calculating the backwardation deadband in the wholesale cost model in the MSC model.

3.11. 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 simplified approach can risk increasing the degree of uncertainty.

3.12. As we set out in our previous decision on changes to the market stabilisation charge in May[7], we consider that reflecting the distinction between trading days and calendar days with respect to the calculation of *Wc* is appropriate.

3.13. With respect to the calculation of the backwardation deadband, we proposed a simplified transitional approach moving directly from seasonal to quarterly because it did not have a material impact on the output. Given this is a static value we consider that this approach was appropriate. However, the MSC is a dynamic calculation, based on daily prices which are updated weekly. It is therefore sensitive to movements in the wholesale price of energy. To formulate the calculation on a simplification that did not take into account the transitional arrangements would raise questions of consistency in our approach to the calculation of the MSC. This would potentially lead to over or under compensation of suppliers depending on when the MSC was triggered. We therefore do not think it is appropriate to apply the same rationale as we used for the backwardation deadband and simply move from seasonal to quarterly calculations without using the transitional arrangements.

3.14. Several stakeholders requested we publish worked examples of the MSC model to increase transparency or highlighted minor issues with our proposed algebra or models[8]. We are committed to transparency and ensuring the models we publish have been subject to rigorous quality assurance. On this basis we published a conceptual model alongside the consultation to facilitate stakeholders' understanding of how the terms evolve through the price cap periods during which the MSC will be effective. We continue to develop the

[7] Ofgem (2022), Decision on changes to the market stabilisation charge, https://www.ofgem.gov.uk/sites/default/files/2022-05/Decision%20document%20-%20Changes%20to%20MSC.pdf

[8] We also note there was a typographical error in appendix I, page 43 of the consultation document which should have read *"Discount prices from 19 August to 16 November to reflect the fact that there are **63** trading days between these dates"* for cap period p9b

models required for each cap period and have published the P8 model worked example in advance of this decision to aid transparency and facilitate stakeholder understanding. The updated guidance applicable to all cap periods has also been published alongside this decision and we will publish the P9a and P9b models at the earliest opportunity, not less than two weeks prior to the beginning of the relevant cap period.

Technical aspects

3.15. For clarity, we also set out a number of technical aspects relevant to the decision to implement the Transitional Indexation Approach in the MSC model based on stakeholder feedback and our own further internal review.

Modelling feedback

3.16. One stakeholder noted issues in the example of the model outlining the proposed algebra with respect to use of the transitional weightings and another in the demand weighting references in the worked example published on 16 May 2022. We have reviewed each of these and rectified accordingly.

Consumption weighting factor (t)

3.17. Our own internal quality assurance identified an issue with the calculation of *t* for period 8 - because each term in the numerator was weighted by the volumes each period there was no need for the denominator as proposed in the algebra as set out in the consultation. Therefore the revised *t* is now:

$$t = (Ave\ 8\ fwd\ months * (\ a/v\ ) + Ave\ of\ 4.5\ fwd\ months * (\ (b + c)/v\ )\ )$$

3.18. As we also noted in our consultation, *t* varies on a daily basis, this is because it is based on the dynamic values *a, b* and *c.* Therefore, the consumption weighting factor is calculated on the relevant day of each publication for the remainder of cap period 8.

3.19. For P9a and P9b *t* remains as set out in the consultation:

$$t = Ave\ of\ 4.5\ fwd\ months$$

3.20. In this instance, as *t* it not driven by *a, b* and *c*, it does not vary on a daily basis and there is no need for a daily calculation of this term.

Use of quarterly prices

3.21. The move to quarterly indexation has a consequential impact on the terms *Wn*, *Wn+1* and *Wn+2*. *Wn* is calculated using a combination of quarterly and monthly price contracts.*Wn+1* and *Wn+2* are based on season + 1 and season +2 prices respectively from 1 February 2022 to 1 June 2022, and quarter +1 and quarter +2 prices respectively from 6 June 2022 onwards. It is then adjusted to account for the relevant seasonal/quarterly weightings in a similar manner to *Wpc.* This methodology is analogous to that used to set the price cap. Where appropriate we have updated the terms and definitions to refer to 'periods' rather than 'seasons'.

Practical implementation of the transitional arrangements

3.22. Finally, when we set out the approach to transitioning to a quarterly price cap[9] we set out transitional weights to ensure a 50:50 split between 7-1-12 and 3-1.5-12 blocks and a further demand weighting adjustment (that applied only to electricity) to account for the move from the use of seasonal to quarterly prices (quarterly prices are already used for gas).

3.23. Like the calculation of PCn+1, PCn+2 mirrors the methodology set out in Annex 2 and we use the combination of both the 50:50 split between 7-1-12 and 3-1.5-12 blocks and the demand weighting adjustment for electricity.

3.24. However, for the terms *a,b,c* of *Wpc* and *a'b'c'* of *Wc* we only use transitional arrangements weights to ensure a 50:50 split between 7-1-12 and 3-1.5-12 blocks. This is because the volume components calculations of *Wpc* and *Wc* are not expected to factor in the demand weights, and therefore the transition from hedging seasonally to quarterly does not impact the calculation of the volume components of *Wpc* and *Wc.*

[9] Ofgem (2022), Price cap - Decision on changes to the wholesale methodology, https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology

4. Ban on acquisition-only tariffs

Section summary

The BAT works alongside the MSC by reducing the incentive for suppliers to offer very aggressive acquisition pricing in times of sharply falling wholesale prices. The reduced incentive to offer prices that could threaten market stability augments the stabilisation achieved by the MSC.

The VaR analysis set out in section 2 above in relation to the MSC captures movements in the overall scale of the market stability risk. It is therefore also relevant to the BAT intervention and indicates that the market stability benefits of the BAT are also likely to be greater throughout the Extension Period than they were when the policy was decided upon in February 2022.

This is the case despite the impact of the phasing in during the Extension Period of quarterly indexation of wholesale costs in the price cap. We have therefore decided to extend the BAT until 31 March 2023.

Decision Summary

4.1. In the light of responses to the consultation and the analysis we have undertaken, we have concluded that there is a strong case that the BAT should be kept in place during the Extension Period, and accordingly we have decided to extend the BAT to 31 March 2023.

4.2. Insofar as this decision document sets out the decision to extend the BAT to 31 March 2023, it is the Authority's statement in writing (as referred to in SLC 22B of the gas and electricity supply licences) that the requirement that all domestic tariffs are offered to both new and existing customers is so extended[10].

[10]this is subject to the Retention Tariffs Derogation and any other derogations

Context

4.3. 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**") 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.

4.4. 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 fall sharply. The BAT acts to augment the MSC by reducing the incentive on suppliers to offer very aggressively priced deals to prospective customers in a time of market turmoil because the BAT requires these deals to also be made available to existing customers. 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. It also means that any better deals that are on offer are available to existing customers as well, which will help improve perceptions of fairness in the market.

Stakeholder Comments

4.5. Eleven of the fourteen responses we received mentioned the BAT and nine of those favoured extending this measure until 31 March 2023. Many of them agreed that in the event of a sharp fall in wholesale energy prices, the BAT would support the MSC in helping to prevent unsustainable conditions in the market which could risk further supplier exits. A significant proportion of those supporting extension added that extending BAT would also benefit customers who do not switch by making all their suppliers' tariffs available to them, addressing perceived loyalty penalties and making the market fairer. Two stakeholders did not support the extension of the BAT. One said that Ofgem had not properly assessed the impact the BAT has on different suppliers. It argued that the BAT would incentivise new suppliers with fewer customers to offer lower tariffs as they have a much lower risk than larger suppliers of cannibalisation from internal switching. It added that if the BAT was extended, it was even more important that Ofgem ensures suitable customer protections are in place and new tests for entrants are robust.

4.6. Another stakeholder who did not support the extension said that the BAT will prevent deals which are priced below the level of the price cap coming onto the market. It argued that it will not benefit those customers who remain on SVTs as the BAT will not bring down the price they pay. It added that the BAT is unnecessary as Ofgem's new financial responsibility and licensing reforms prevent suppliers pursuing high risk aggressive customer acquisitions while the price cap already protects customers who roll off a supplier's acquisition tariff.

4.7. Not all stakeholders who supported the extension of the BAT until 31 March 2023 expressed views on whether it should become an enduring measure. The views of those who did were split. Several stakeholders said that Ofgem needed to carry out further impact assessment on the question of BAT as an enduring consumer protection intervention, rather than a temporary market stability measure, before a decision is made.

4.8. Other stakeholders said that Ofgem should continue to extend the BAT as long as it still benefited customers and market conditions warranted it but one of them added that now was not the right time to consider whether it should be made enduring. One stakeholder said it may support an enduring BAT depending on the future direction of the retail market. Two stakeholders supported making the measure enduring.

Ofgem response

Methodology and analysis

4.9. As the BAT acts to augment the MSC, we are adopting a common framework to assess both interventions in their context as short-term interventions to promote market stability. As discussed above in section 2, this continues to be based on use of the VaR metric which provides a simple picture over time of the scale of the market stability challenge.

4.10. Similarly, we have modelled the combined effect of the MSC and BAT on our "NoCo" notional company and the results are described in section 6 (Impact Assessment) below.

4.11. Our response to the comments we received on our methodology and analysis in the MSC context is set out in section 2. We did not receive comments specifically relating to the use of this methodology in a BAT context.

Other issues

4.12. Ofgem notes the concern that the BAT could have different impacts on a new entrant and an existing supplier. However, it is important not to overstate this. In the short term, the market participants likely to have the reach and scale to grow significantly are those with significant customer bases who will all have to weigh the impact of the BAT in their decision making. They will also need to do this against the background of the MSC.

4.13. While larger companies could be said to have more to lose from adopting an acquisitive stance, they would also have more reach and scale which could mean that they could target larger gains. In any event, with the MSC also in place we doubt that differences would be material, or that they would outweigh the additional contribution that the BAT can make to market stability.

4.14. We also note the concern that the BAT could reduce the incentive to offer cheaper deals. In the context of a discussion about whether the BAT should be permanent, this would be an issue to weigh against other consumer benefits such as addressing the perceived loyalty penalty. However, in the context of the role of BAT as a temporary market stability measure, a reduced incentive for aggressive discounting based on a fall in wholesale prices is actually the desired effect. The need to promote market stability outweighs the reduced incentive for discounting.

4.15. In response to the various comments about the benefit or otherwise of making the BAT a permanent feature of the market, this is something we will assess in due course. We have said that any consideration of this would require a fuller discussion and more analysis – please see section 5.

4.16. We agree with the view of the majority of stakeholders that the BAT would act to augment the MSC during the Extension Period and that it would help to prevent unsustainable conditions in the market which could risk further supplier exits, which would ultimately be a cost to the consumer.

Conclusion

4.17. Following on from our analysis described in section 2, and taking account of the discussion above and stakeholder views, Ofgem has assessed the benefits of the BAT in augmenting the MSC during the Extension Period. We have concluded that those benefits are likely to be greater, throughout the Extension Period, than they were when the original decision was taken to implement the short-term interventions. Accordingly, the rationale of

the February decision to implement the BAT continues to apply in relation to the Extension Period and a decision to extend it until 31 March 2023 is appropriate in the current circumstances.

5. Next steps

Section summary

We will continue to review the market and the suitability of the MSC parameters and technical design. If appropriate, parameter reviews or other changes will be initiated.

Projections indicate that VaR will continue to be very high after March 2023 and therefore that the market may continue to be at risk of instability. Ofgem is therefore inviting stakeholders to provide views and/or evidence as to what it should do in relation to this issue, with a view to us bringing forward any proposals in late 2022. This section outlines some of the factors that stakeholders may wish to consider.

As well as the possibility of market stability measures being required beyond March 2023, there is the separate question of whether the BAT should be implemented on an enduring basis. We explain below some of the considerations and reiterate that full consultation and impact assessment would accompany any such proposal.

Monitoring the MSC parameters and other characteristics

5.1. The significantly higher level of wholesale prices experienced since June, together with the continued move to quarterly price caps, have had impacts on our analysis of the profitability of a notional company, NoCo. These are set out in section 6. They indicate that, in the scenario we have investigated and under the current MSC parameters, the Underlying EBIT of NoCo including the Acquisitions Benefit is estimated at around -1.4%. This is below the target range of 0 to 1.94% of turnover that we described in the May decision. We are continuing to analyse this result but note that it is slightly closer to the position before the parameter review outlined in the May Decision than after, as shown in the table below:

	May Decision: "Flat Fall" Scenario 30/75 original parameters	**May Decision:** "Flat Fall" scenario 10/85 new parameters	**This decision:** Gradual fall scenario 10/85 current parameters
NoCo EBIT before Acquisitions Benefit	-3.5%	-0.5%	-2.18%
NoCo EBIT after Acquisitions Benefit	-2.6%	+0.4%	-1.4%

5.2. We are therefore considering whether it would be in consumers' interests to undertake a further review of the MSC parameters at this stage in the light of market developments. If we conclude that this is necessary, we would aim to issue the consultation in September 2022.

5.3. We will continue to keep the market under review throughout the Extension Period. If that review process suggests that any changes to the MSC, whether a parameter review and/or any other changes, would be likely to be in consumers' interests, we will consider whether to initiate consultation accordingly.

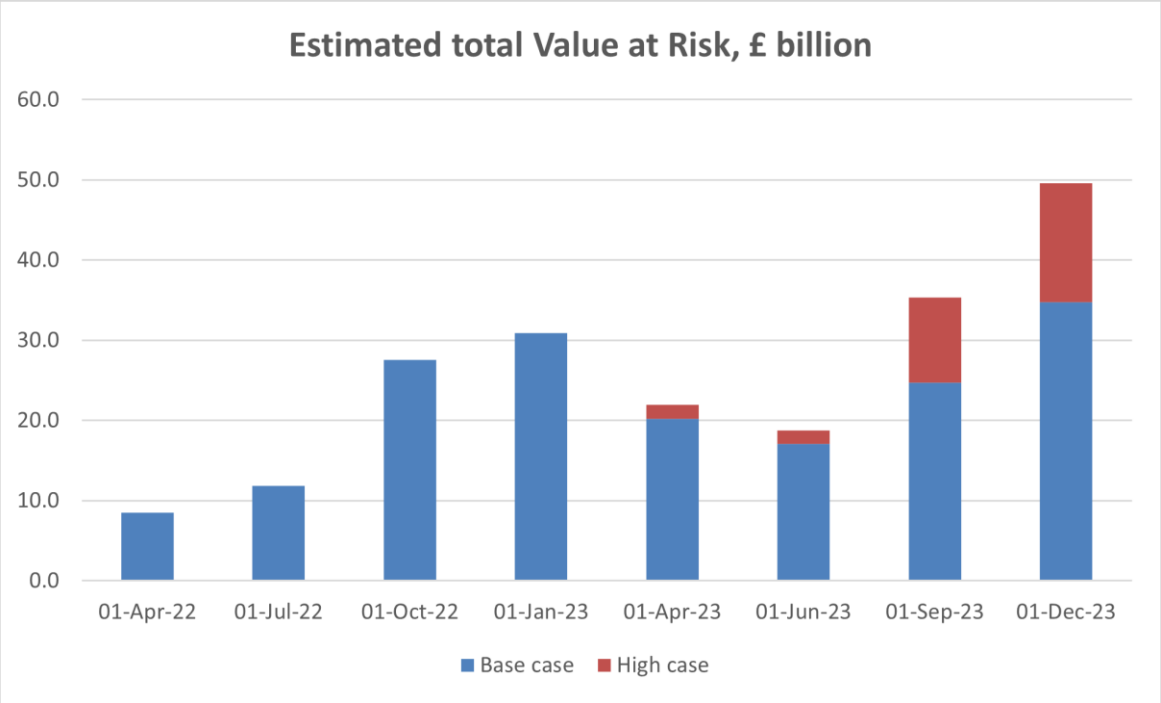
5.4. We note the suggestion of one stakeholder that four months' notice be given of changes to the MSC parameters, and understand that this may reflect a concern that Ofgem might make a change which reduced the protection to existing hedge positions. We understand the concern that any changes to the MSC should not strand existing hedges but consider that paying due attention to this risk does not necessarily imply a four month notice period. For example, quicker action might be appropriate were the MSC to appear insufficiently effective, or if the risk entailed in holding the hedges could be shown to be significantly lower than previously thought.

5.5. We note the suggestion by some stakeholders that the MSC should also protect the various wholesale related allowances in the price cap, rather than being focussed on the hedge positions alone, as these sums are also at risk of being undercut if prices fall. We will reflect on the merits and demerits of this suggestion in the context of considering or carrying out any future parameter review.

Short term interventions post March 2023

5.6. The MSC and BAT are intended to be temporary measures. The existing licence conditions for them expire on 31 March 2023 and it is not possible for Ofgem to extend them without a licence condition modification.

5.7. VaR analysis shows that on current projections, significant risks may remain in the market post March 2023. We have made a preliminary estimate of VaR for this period, recognising that there are much greater uncertainties further into the future. However, if the current high prices are maintained through 2023, VaR levels will be very high. Accordingly, for periods beyond 31 March 2023, we have estimated high and base cases to give a range for the balance of 2023, as set out in the chart below.



5.8. The high estimated levels of VaR in late 2023 reflect assumed high wholesale prices and seasonal demand. The relationship with the values in autumn/winter 2022 is affected by the fact that late 2022 VaR is reduced by some hedges that were taken out when wholesale prices were much below current levels. Together, these factors cancel out or exceed the reduction in VaR from the move to a quarterly price cap. These preliminary projections indicate that there may continue to be significant threats to market stability beyond March 2023.

5.9. When the decision to implement the MSC and BAT was taken in February 2022, we were looking at what appeared to be a short term supply/demand imbalance caused largely by the worldwide economic disruption and recovery related to Covid-19, as well as other market factors. The duration and intensity of the crisis has however significantly increased as a result of Russia's invasion of Ukraine on 24 February 2022 and the way that that conflict has developed.

5.10. Our initial judgements about how long the threat to market stability was likely to last have accordingly been overtaken by the change in circumstances, and it is appropriate to consider:

- Are any stabilisation measures needed beyond March 2023 to best protect the interests of consumers while the current abnormal market conditions persist?

Previous experience suggests that more normal market conditions are likely to return at some point in the future, but the timescale is uncertain;

- Whether, if stabilisation measures are in consumers' interests, it is better to seek new policies that might be more appropriate to the longer timescale than we originally expected, or to retain and extend the existing ones (MSC and BAT)?

5.11. We intend to consult in late 2022 so that suppliers have sight of our thinking when, according to Ofgem's price cap indexation formula, they would be buying energy to supply domestic customers from April 2023.

5.12. In order to assist us in preparing that consultation, we therefore invite stakeholders to provide their initial opinions on these issues, and where possible evidence, by Monday 19 September. Any follow-up information can be added in the following two weeks. Possible points for consideration might include:

- Is there any evidence that, following the move to quarterly updates to the price cap, a higher level of VaR could be accepted by Ofgem before the best interests of consumers would require intervention? For example, is the fact that the price cap will catch up more quickly with any change in the wholesale pricing background likely to reduce the proportion of the VaR that converts to unsustainable losses?

- Will supplier resilience have increased by April 2023 and if so, how might this affect the position?

- What, if any, alternatives to MSC and/or BAT should we consider if intervention is required?

- If your view is that MSC and/or BAT should be retained, what if any changes should be made to these measures?

- What criteria could be used to determine when to end any protection measures put in place beyond March 2023?

- We would be grateful for suppliers' perceptions on how collateral and credit requirements are likely to play out should wholesale prices for a future period fall significantly below the price of hedges already bought for that time.

5.13. It may also be useful at this stage to set out some provisional criteria that could be applied in deciding whether to have an intervention for April 2023 onwards and if so, what it might be. These might include:

- Does the policy effectively minimise the costs to consumers and maximise the benefits?
- How effective would any intervention be in dealing with the risk of stranded hedges?
- How certain is the policy in effect – to what extent would the proposal give suppliers the confidence to continue to take out appropriate hedges?
- Are there any distributional effects that should be considered?
- Does the policy require any consumer action or are all the mechanics handled by the industry?

5.14. Please send your initial views and any evidence by Monday 19 September 2022 to retailpolicyinterventions@ofgem.gov.uk, with any follow-up information in the following two weeks.

Possible enduring application of BAT

5.15. 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 customer benefits of extending the BAT beyond 31 March 2023 and potentially making it an enduring feature of domestic retail regulation. These include the ability to limit price discrimination by suppliers (where such discrimination is contrary to consumer interests) and addressing the perceived loyalty penalty. 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 customers.

5.16. 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.

5.17. 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.

5.18. However, the effect of the BAT that enables it to contribute to market stability is its effect in discouraging aggressive acquisition tariffs. If this effect occurred in more normal times, it could be thought to be adverse to consumer interests, unless it also resulted in better deals being offered to existing customers and/or improved trust in the market. We will consider how these various impacts could be evaluated and weighed up.

5.19. Taking account of all these factors and, if possible, evidence of the practical impact of the BAT, we intend in due course to undertake a full 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.

6. Impact Assessment

Section summary

This section sets out how we have modelled the effects of the MSC during the Extension Period against various scenarios, looking both at the impact on a notional domestic supply company ("**NoCo**") and at the effect on consumers. Although the MSC, when triggered, has the effect that active consumers can only access reduced savings for a period following a price fall, there are benefits in terms of maintaining the viability of the supply function and avoiding costly market exits, that arise both before the MSC is triggered and once it is active. We also set out below an outline view of the likely benefits of the MSC prior to it being triggered.

Assessment framework and methodology

Background to our approach

6.1. The impacts of the MSC on consumers arise in two phases:

- Before the MSC is triggered, when the impacts arise from the existence rather than the operation of the MSC ("**Initial Impacts**"). These impacts can also continue to arise when the MSC has been triggered by particular short term wholesale price movements and is therefore having only minor additional impacts from its operation;

- During the period where the MSC is operating in full and protecting significant hedge positions as they unwind following a major price fall ("**Operating Impacts**")

6.2. While it is possible in principle for there to be more than one significant period of Operating Impacts, we consider that the most likely evolution of the MSC is that there will be a relatively long period where the Initial Impacts are observed, followed by a relatively short period of the Operating Impacts, after which the market may have achieved more normal conditions and the MSC may no longer be required.

6.3. As respects the Initial Impacts, we have analysed the effects broadly qualitatively. This is made easier because the benefits are essentially the avoidance of under-hedging by

suppliers, while there are no material direct costs because the charge is not triggered or not triggered to a material extent.

6.4. In considering the Operating Impacts, we have decided to follow substantially the same approach as we did in the decision of 16 May 2022 on changes to the MSC (the "**May Decision**"). In particular, we are continuing to apply price cap principles, 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 price will be determined by competition – where a price cap is needed, it should deliver that result.

6.5. 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.

6.6. Of course, if the efficient level of costs is very high, for example due to geopolitical events, that level may cause hardship for consumers, especially vulnerable ones. This is not a problem that can be solved by creating a framework that does not allow the recovery of efficient costs as this would make for an unsustainable energy market which is itself contrary to consumers' interests. Instead, the social and economic impacts of exceptionally high energy costs driven by global gas prices must be a matter for wider Government policy.

Modelling approach and assumptions

Initial Impacts

6.7. In the case of the Initial Impacts, the MSC is likely to have increased the confidence of suppliers to hedge appropriately. This is because, in the absence of the MSC, suppliers would need to balance the risks of being under-hedged (and therefore risk selling energy at a loss if wholesale prices rise) with the risk that prices would fall and their hedge positions would be stranded by competition (and therefore have to be sold at a loss). In such a case, a supplier would be likely to minimise the overall risk by hedging only a proportion of the expected requirements.

6.8. Such a strategy would, however, have led to difficulties as wholesale energy prices have risen unexpectedly twice since the MSC was decided upon – once in late February

following the Russian invasion of Ukraine, and again from late June as Russia started progressively restricting gas exports to Europe. Winter 2022 natural gas, for example, was priced at around 190p/therm in February 2022 when we decided to introduce the MSC, around 250p/therm from March to early June 2022 and around 700p/therm now.

6.9. The Bulb Special Administration was estimated in March 2022 by the OBR to be likely to cost £2.2 billion[11] and this figure is likely to have risen substantially as wholesale prices have increased. Many of the remaining companies in the market are significantly larger than Bulb and, had they under-hedged, could be facing energy losses which could exceed the value of the business. This would put them at risk of their owners or financial backers declining to provide support leading to an insolvent or disorderly exit and a cost in excess of £1 billion. A similar figure could be estimated based on previous experience of mutualised costs from supplier exits, taking account of the size of the remaining companies.

6.10. It is therefore reasonable to assume that the benefits that could have accrued already to consumers from having the MSC and BAT in place to avoid an incentive to under-hedge may be in excess of £1 billion.

6.11. The costs to consumers of the MSC during this period are very limited. There has been some administrative cost in Ofgem and suppliers considering and operating the policy and implementing the payment mechanics; however, these are likely to be insignificant compared to the possible benefits mentioned above. It is possible that the MSC's existence may have deterred some companies from attempting to enter the market, but it is unclear if this is a real effect (since the MSC does not prevent efficient suppliers from profitably gaining customers). In any event, any impact is likely to be small.

6.12. The BAT has similar costs during the period of the Initial Impacts. In current market circumstances its main costs are administrative since fixed price contracts are generally not competitive with the capped SVT price. Meanwhile it contributes, to some extent, to the confidence of suppliers in hedging appropriately by reducing the incentive for very aggressive acquisition tariffs.

[11] Economic and Fiscal Outlook (Office of Budget Responsibility), 15 March 2022 Annex A3 https://obr.uk/docs/dlm_uploads/Annex-A-3.pdf

6.13. Looking forward to the Extension Period, we can expect the Initial Impacts to follow a similar pattern. Although wholesale forward energy prices are very high at present, we do not know what policy Russia will follow in relation to gas exports over the coming winter, and we cannot exclude the possibility of significant rises, or falls, in price. In the absence of the MSC (augmented to some extent by the BAT), suppliers would face the same dilemma on hedging. Accordingly, the Initial Impacts during the Extension Period could be similar to those in the recent past.

Operating Impacts

6.14. Our primary tool for looking at the Operating Impacts of our policy has been to explore the characteristics of a notional company ("**NoCo**") which is a substantial energy supplier affected by these issues. We have continued to develop the modelling of this notional entity following its use in the May Decision.

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

- The income that is collected by NoCo under the price cap in order to correct for a too low wholesale cost allowance in prior period(s) (the "**Wholesale Risk Allowance"**); 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.

6.16. 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.

6.17. NoCo's characteristics are as follows:

- 5 million customers, average (mean) consumption 3,578 kWh[12] per year electricity.
- For simplicity, all customers are assumed to be dual fuel, but the mean gas consumption is scaled to reflect the proportion of electricity only customers. This gives an adjusted mean gas consumption of 13,495 kWh x 24.1 million / 28.7 million = 11,332 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 version of the Indexation Guidance Letter in force at the relevant time
- NoCo's cost structure is as per the allowances in the price cap.

6.18. We have chosen 100% hedged as our assumption for NoCo because it is the neutral position for a company to follow the relevant edition of 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.

6.19. The model operates on a monthly cycle. It assumes a switching price elasticity, which is used to derive monthly switching rates based on an assumed price trajectory 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 during the Extension Period

[12] "Subnational Electricity and Gas Consumption Statistics", BEIS, 22 December 2020. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/946968/sub-national-electricity-and-gas-consumption-summary-report-2019.pdf

on SVT at 1.94% Underlying EBIT. It does not directly take account of acquired customers (but see the discussion of Acquisitions Benefit below).

Acquisitions benefit

6.20. However, to avoid under-estimating supplier earnings, 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 the falling prices transitionally as competition adjusts. We have made a post-model adjustment to Underlying EBIT to allow for this (the "**Acquisitions Benefit**") and re-estimated this to take account of changes in the market since the May Decision.

6.21. 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, because it is open to any supplier to take a more, or less, aggressive stance in its pricing.

6.22. One stakeholder asked us to present more detailed thinking on our assessment of the Acquisitions Benefit. The gain from taking on a customer as estimated by the Acquisitions Benefit can be estimated as the sum of:

- A gain of 1.94% of the final price. (It is assumed that the final price is set so as to enable the MSC to be paid first.) Assume final price is £2,600, taking account of the MSC of say £500 (average of MSC estimation in Extension Period under the assumed price trajectory), non-energy costs and a possible wholesale cost plus the two points below. Multiply by 1.94% = £50 at TDCV dual fuel

- The effect of BAT in reducing the incentive to price aggressively. We estimate this at £50 at TDCV dual fuel

- A further £100 on the same basis, arising from transitional retention of margin against falling wholesale input costs.

6.23. This comes to £200 for TDCV dual fuel or a 7.7% EBIT margin on the acquired customers. On the assumption that the acquired customers are around 20% of the total

customers and that their price is around 75% of SVT pricing, after the effect of the MSC, this provides an uplift of the order of 7.7% x 20% x 75% = 1.15% of Underlying EBIT.

6.24. However this is an annual figure and for comparability with the principal model, which calculates EBIT during the six month Extension Period, it is necessary to scale back the benefit to the six winter months, which amounts to an uplift of c. 0.75% of EBIT.

Scenario

6.25. Since the primary basis for this decision is the VaR analysis, we present a single price fall scenario, where the wholesale gas price falls gradually from current levels to around £100p/therm (about double historic levels) in the months of October to December 2022 and remains at that level until March 2022. Corresponding movements are assumed for wholesale electricity.

Results

6.26. We compare the estimated results for NoCo in the scenario with and without the MSC for the 6 month Extension Period in the following table:

	No MSC	MSC in Place
NoCo customers switching during Extension Period following price fall	2.34 million	1.87 million
Financial impact on NoCo of trading through Extension Period	-£2,038 million	-£312 million
Modelled NoCo EBIT on turnover during Extension Period	-29.82%	- 2.18%
Acquisitions Benefit	+0.75%	+0.75%
Net EBIT in Extension Period	-29.1%	-1.4%

6.27. A rough estimate of NoCo's ongoing value as a business can be obtained as follows. Take the normal times price cap (we use the price cap for the period October 2021 to March 2022 to represent that) at mean consumption, scaling back the gas consumption for the reduced number of customers = £1,295. Multiply by 1.94% EBIT on turnover and by 5

million customers. This gives an annual EBIT of about £126m. Multiplying by a p/e ratio of ~8 indicates a possible value for NoCo of £1 billion.

6.28. In the absence of the MSC, the losses incurred by NoCo would be around double the value of the business. In such circumstances, it is unlikely that NoCo's owners or investors would support the business and it would be likely to fall into insolvency.

6.29. With the MSC in place, the EBIT after adding the Acquisitions Benefit is of the order of -1.4%. This is below the target range of 0% to 1.94% identified in the May Decision on the parameter review and arises from the various impacts of the much higher wholesale prices. We comment in section 5 on how we might respond to this shortfall.

6.30. The BAT is in place in both cases above. It can be seen that it is insufficient on its own (ie without the MSC) to make NoCo viable in the scenario examined. With BAT working alongside the MSC at current parameters, NoCo's EBIT is still below the target range identified in the May Decision, so it can be seen that having both measures in place is not excessive, and indeed there may be a case for further strengthening (see section 5).

Consumer Impacts

6.31. As we have explained in previous documents and above, the consumer interest is best served over time by having a framework in which efficient costs can be covered by a notional supplier. To the extent that those efficient costs are likely to cause hardship for consumers (or any group of consumers), the most appropriate approach in the current exceptional circumstances is for Government to take special measures to mitigate the impacts.

6.32. We have quantified the Initial Impacts of the MSC and BAT as being likely to be a gain in excess of £1 billion for consumers (also with large gains for suppliers) by avoiding incentives for companies to under-hedge.

6.33. As regards the Operational Impacts, the effect of the MSC and BAT is to transfer resource to suppliers from consumers who switch (or who would have switched) during the period the MSC and BAT are active.

6.34. In the case of NoCo's customers, that transfer could be estimated as the difference between the £2,038 million and £312 million figures in the table above. That is a figure of £1,726 million. However, this is illusory as it is unlikely that NoCo could survive a loss on this scale. Moreover, in the absence of the MSC, NoCo would in all probability not have

been able to take out the hedges projected and therefore would have been at risk of insolvency if wholesale prices rose (as they have several times this year already).

6.35. At an industry wide basis, we can work out the same numbers under our scenario. Without the MSC, the total industry losses can be estimated as £9.311 billion. With the MSC, the figure comes down to £1.497 billion (prior to the Acquisitions Benefit and net of the Wholesale Risk Allowance). The difference is £7.8 billion, but the same comments above apply – in reality the £7.8 billion is not available to consumers as it exceeds the means and value of the supply industry and the hedges would in all probability not have been taken out without the MSC.

6.36. In any event, if these losses and transfers did occur on this scale, they could be accompanied by insolvency of many or possibly all the remaining companies in the supply industry as supply companies with losses exceeding their value might be abandoned by their parents or investors.

6.37. There would also be huge costs of any insolvencies. Bulb, with 1.6 million customers, accounted for approximately 6% of the industry and was estimated by OBR in March 2022 to cost £2.2 billion through its special administration. That figure is likely to have risen substantially with rising wholesale prices. Leaving that likely increase aside, scaling up the OBR's £2.2 billion Bulb cost for the whole industry would reach a total of around £38 billion.

6.38. We remain of the view that the appropriate focus for impact assessment in this area is to look to policies ensuring that efficient costs for energy supply can be covered, so ensuring that a sustainable market exists to the benefit of consumers. It is less useful to seek to weigh up costs and benefits in relation to scenarios which are not sustainable.

Distributional impacts

6.39. It is also appropriate to note the distributional impacts. In relation to the Initial Impacts, these create savings for all consumers by avoiding the costs of supplier exit or failure from under-hedging. However, such savings are more valuable to people with lower incomes than those who are more affluent. This is discussed in Ofgem's distributional impacts framework document,[13] which indicates that a particular cash saving is worth

[13] Ofgem, "Assessing the distributional impacts of economic regulation" (2020) https://www.ofgem.gov.uk/sites/default/files/docs/2020/05/assessing_the_distributional_impacts_of_economic_regulation_1.pdf

around 10 times more, on an equity weighted basis, for somebody in the lowest income decile than the highest. To the extent that low incomes are associated with groups such as pensioners and disabled people, the benefit of the Initial Impacts will have a greater positive impact on their standard of living.

6.40. A similar effect occurs in relation to the Operating Impacts, which are more complex but overall involve benefits to consumers from maintaining a sustainable energy supply market and avoiding additional market exit costs. However, there are additional distributional effects, set out below, which relate to differing propensity to switch.

6.41. The benefits of maintaining the MSC and BAT, 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 of delayed savings through switching accrue only to active consumers.

6.42. 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. Accordingly, vulnerable consumers are disproportionately in the inactive group, which will see benefits and no downsides from continuation of the MSC and BAT during the Extension Period.[14] Therefore, since we are aware that people with some of the characteristics protected by the Equalities Act 2010 (such as age and disability) can be more likely to be inactive with the supply market, they should, overall, be relatively advantaged by this decision. People with the remaining protected characteristics are unlikely to be more, or less, active in the supply market than consumers generally and so this group is likely to be relatively neither advantaged nor disadvantaged by this decision.

[14] "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