

**To – all stakeholders**

Email: [Retailpolicyinterventions@ofgem.gov.uk](mailto:Retailpolicyinterventions@ofgem.gov.uk)

Date: 03 February 2023

Dear stakeholders,

**Consultation on technical changes to the Market Stabilisation Charge (“MSC”) model to reflect the decision to extend the MSC beyond 31 March 2023**

In this letter we are consulting on proposed technical changes to the MSC model to give effect to our February decision on extending the MSC and BAT beyond 31 March 2023<sup>1</sup> (the “**February Decision**”). It sets out the background to the issue and outlines the changes we propose to implement in the MSC model which will have effect from April 2023 – Mar 2024<sup>2</sup>. The scope of the proposed changes set out in this letter are limited to the technical changes required for the continued operation of the MSC beyond 31 March 2023 based on the current MSC design.

Additionally, with respect to our clarification letter to suppliers on the use of monthly contract prices in calculating the MSC published on 25 November 2022<sup>3</sup>, we also invite views on our treatment of prices in the calculation of the wholesale cost of energy during the current cap period (the term known as *Wn*).

We have also published alongside this consultation, a proposed worked example of the MSC model (Version 6) applicable for the period 1 April 2023 – 31 March 2024 that reflects the changes outlined in this letter. We intend to publish updated MSC guidance alongside our decision.

We would like views on the proposals set out in this letter from people with an interest in the domestic retail energy supply market. We particularly welcome responses from energy suppliers, consumer groups and charities. We would also welcome responses from other stakeholders and the public. We will consider any feedback and views received on the proposals set out in this letter by **27 February 2023**. These can be sent to [Retailpolicyinterventions@ofgem.gov.uk](mailto:Retailpolicyinterventions@ofgem.gov.uk).

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<sup>1</sup> Ofgem 2023, [Decision to extend the MSC and BAT beyond 31 March 2023](#)

<sup>2</sup> The proposed changes and any subsequent alterations arising from this consultation will be incorporated in the MSC guidance as set out in license condition 24A of the supply license

<sup>3</sup> Ofgem 2022, [Letter to suppliers on the use of monthly prices in calculating the market stabilisation charge](#)

## Summary

In April 2022<sup>4</sup> we introduced the MSC as a temporary measure aimed at managing the risk to market stability of efficiently run suppliers exiting the market in a falling price scenario. It ensures that energy companies who have taken a prudent approach to hedging, by purchasing energy for their customers in advance are not unduly penalised for doing so.

This charge, payable by suppliers gaining new customers to suppliers losing them, only takes effect if wholesale prices fall significantly below the level used to set the price cap. At the time we introduced the MSC we also published a worked example of the MSC calculation<sup>5</sup> and an associated guidance<sup>6</sup> document.

Following this, in May 2022, we made subsequent changes to the algebra underpinning the MSC calculation to implement 7-1-6<sup>7</sup> indexation and introduced an adjustment for unidentified gas (UIG) and electricity losses<sup>8</sup>. This was to reflect our decision to change the price cap indexation and to allow for a more robust and reflective view of the wholesale costs to which a supplier is exposed.

Further changes were undertaken in August 2022 to implement the 7-1-6 / 3-1.5-3 Transitional Indexation Approach ("**Transitional Indexation Approach**") into the MSC algebra<sup>9</sup>. This change was intended to facilitate the transition to quarterly price cap updates<sup>10</sup>.

Both of these changes ensured we maintained consistency with the price cap methodology. To maintain transparency, updated MSC worked examples and guidance accompanied both these decisions to allow industry to understand the underpinning methodology.

The February Decision, to extend the MSC beyond 31 March 2023 means that we are again required to update the MSC model for use during the extension period. This is because when cap period 10a begins, the Transitional Indexation Approach becomes obsolete, as all the assumed hedging volumes bought by a notional supplier under these arrangements have been unwound. In practice this means that all subsequent volumes should be treated according to a 3-1.5-3 indexation methodology to continue to maintain consistency with the price cap methodology.

We are therefore consulting on technical changes to the MSC model to replace the existing 7-1-6 / 3-1.5-3 Transitional Indexation Approach with a 3-1.5-3 indexation methodology. This reflects the completion of the transition to quarterly cap updates in the MSC model.

## Proposed technical changes

In this section we outline the proposed changes to the algebra as well as other minor consequential changes to ensure the MSC model continues to function appropriately.

We have sought to do this by developing an enduring set of formula terms for the entire period of 1 April 2023 to 31 Mar 2024. Notwithstanding any further potential changes to

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<sup>4</sup> Ofgem 2022, [Decision on short-term interventions to address the risks to consumers from market volatility](#)

<sup>5</sup> Ofgem 2022, [Market Stabilisation Charge - Worked Example](#)

<sup>6</sup> Ofgem 2022, [Market Stabilisation Charge - Guidance](#)

<sup>7</sup> We express the price cap formula in an index with the format X-Y-Z [A], where X is the price observation period, Y is the lag period between the end of the observation period and the start of the price cap period starting, Z is the length of forward contracts observed and A is the period for which the cap is in place, all in months. So a 3-1.5-12 [3] index for delivery starting 01 October 2023 means a 3 month observation period running from mid-May to mid-August where 12 month forward prices are observed. There is then a lag of 1.5 months from mid-August until the cap starts on the 01 October. And the cap runs for three months from 01 October to 31 December.

<sup>8</sup> Ofgem 2022, [Decision on changes to market stabilisation charge](#)

<sup>9</sup> Ofgem 2022, [Decision on extending Short-Term Interventions and adjusting the MSC calculation](#)

<sup>10</sup> Ofgem 2022, [Price cap - Decision on changes to the wholesale methodology](#)

the overarching MSC design or price cap indexation, we currently expect the algebra outlined within this consultation will apply for as long until the MSC remains in effect.

We have published a worked example of the model alongside this letter in the interests of transparency. This model reflects the changes we have proposed to allow industry to review and provide feedback on our proposed approach to calculating the MSC charge from April 2023.

The proposed MSC algebra set out below reflects a return to a linear indexation profile based on a 3-1.5-3 indexation approach, given that the Transitional Indexation Approach to facilitate a quarterly cap update cycle will be complete from 1 April 2023 onwards.

The formula used to calculate the MSC itself does not change, as has been the case in response to previous technical changes. However, to revert to a linear 3-1.5-3 indexation approach the calculations of the terms within the algebra do. Specifically, the calculations of the terms  $a, b, c$  and  $a', b', c'$  that describe the proportion associated with each hedging period with respect to the total volume of hedge held.

Furthermore, the volume factor ( $v$ ), that controls for the varying total volume of hedge held throughout the hedging period that was a result of the transitional indexation approach is no longer required. This is because it is now constant and has a value of 1.

Therefore, for clarity and brevity we only set out those aspects of the algebra that are proposed to change in this letter - all other aspects of the algebra will remain unchanged. Full details of the current MSC calculations and algebra can be found in the current MSC guidance<sup>11</sup>.

The updated terms are presented below.

Wholesale element of the price cap (Wpc) weighting factors

$$a = \frac{D_{rem}}{D_h}$$
$$b = \frac{D_{acc} + (D_{M1} - D_{sw})}{D_h}$$
$$c = \frac{D_{sw}}{D_h}$$

Where:

$D_{rem}$  = Number of delivery days remaining in the current cap period ( $n$ )  
(calendar days)

Commencing at a value equal to the number of delivery days in the current cap period ( $n$ ), subtracted by 1, thus ensuring it reduces to zero on the final day of the current cap period ( $n$ )

$D_h$  = Maximum cumulative number of days hedge held (calendar days)

A value equal to the number of days between the closure of the observation window for current cap period ( $n$ ) during the previous cap period ( $n-1$ ) and the end of the current cap period ( $n$ ) ~4.5 months, which corresponds to the sum of  $D_{rem} + D_{acc} + D_{m1}$

$D_{acc}$  = Number of delivery days of the current cap period ( $n$ ) hedged during the previous

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<sup>11</sup> Ofgem 2022, [MSC Guidance \(Version 3\)](#)

*cap period (n – 1) (calendar days)*

A value representing the volume of hedge already accumulated for the current cap period *n* during the previous cap period (*n-1*).

$D_{sw}$  = A term growing by 1 from the first day of the observation window for the following cap period (*n + 2*) during cap period (*n*) (calendar days)

This value facilitates the switch between the accumulation of hedges for the next cap period (*n+1*) and following cap period (*n+2*) at the point one observation window closes and the next opens.

$D_{M1}$  = Number of delivery days since the first delivery day of the current cap period (*n*) (calendar days)

### Wholesale cost (Wc) weighting factors

$$a' = \frac{T_{rem}}{T_h}$$
$$b' = \frac{T_{acc} + (T_{M1} - T_{sw})}{T_h}$$
$$c' = \frac{T_{sw}}{T_h}$$

Where:

$T_{rem}$  = Number of trading days remaining in the current cap period period (*n*) (working days)

Commencing at a value equal to the number of delivery days in the current cap period (*n*), subtracted by 1, thus ensuring it reduces to zero on the final day of the current cap period (*n*)

$T_h$  = Maximum cumulative number of days of hedge held ~4.5 months (working days)

A value equal to the number of days between the closure of the observation window for the current cap period (*n*) during the previous cap period (*n-1*) and the end of the current cap period (*n*) ~4.5 months, which corresponds to the sum of  $T_{rem} + T_{acc} + T_{m1}$

$T_{acc}$  = Number of trading days of the current cap period (*n*) hedged during the previous cap period (*n – 1*) (working days)

A value representing the volume of hedge already accumulated for the current cap period (*n*) during the previous cap period (*n-1*), this value is always 30 as it corresponds the price cap notice period

$T_{sw}$  = A term growing by 1 from the first day of the observation window for the following cap period (*n + 2*) during cap period (*n*) (working days)

This value facilitates the switch between the accumulation of hedges for the next cap period (*n+1*) and following cap period (*n+2*) at the point one observation window closes and the next opens.

$T_{M1}$  = Number of trading days since the first delivery day of the current cap period (*n*)

(working days)

### Volume factor (v)

The volume factor (v) was introduced to the MSC to control for the varying total volume held through the hedging period by ensuring that it correctly apportioned the total volume a nominal supplier held at any point in time. The need for the volume factor arose because the 7-1-6 and 7-1-6 / 3-1.5-3 indexation approaches are non-linear, meaning the volume of hedge held by a nominal supplier does not remain constant through the period. Given the proposed 3-1.5-3 indexation to be implemented from April 2023 is linear, the volume factor is a constant equal to 1 and therefore the requirement for it is no longer maintained.

We therefore propose to remove this from the model.

### **Continued alignment with the price cap methodology**

We will continue to ensure the MSC methodology remains aligned with the price cap methodology. For example where there are changes to demand shares, electricity losses, unidentified gas (UIG) or other relevant inputs from the price cap models, we will reflect this in the MSC model calculations during the relevant cap periods to ensure we maintain continued consistency with the price cap methodology. We do not intend to regularly consult on cyclic input changes to maintain alignment with the price cap, however, stakeholders will be able to find updated values for these MSC inputs from our price cap model publications.

However, in the event there are significant changes to the price cap methodology that may impact the MSC to the extent that changes to the guidance are necessary, we will consult with wider industry and stakeholders on any proposed changes in accordance with license condition 24A.

### **Treatment of prices**

On 25 November 2022 we published a letter clarifying on our treatment of prices in calculating the MSC<sup>12</sup>, specifically the use of monthly prices towards the end of any given cap period. We expect to maintain the same approach from April 2023. However, we would be interested in views from stakeholders on our approach and welcome any feedback on this as part of this consultation.

### **Timing considerations**

The proposed dates reflecting the transition to, and implementation of the new model are set out below. We also include a proposed update to the *effective to* date of the current (cap period 9b) model to ensure that the MSC remains in continual effect beyond 31 March 2023.

<b>MSC Model</b>	<b>Model Run</b>	<b>Effective from</b>	<b>Effective to</b>
<b>P9b   7-1-6 / 3-1.5-3 transitional indexation</b>	27 March 2023	29 March 2023	4 April 2023
<b>P10a-&gt;   3-1.5-3 indexation</b>	3 April 2023	5 April 2023	11 April 2023

<sup>12</sup> Ofgem 2022, [Letter to suppliers on the use of monthly prices in calculating the market stabilisation charge](#)

## **Next steps**

We welcome views on the approach set out in this letter and ask stakeholders to send any feedback to [Retailpolicyinterventions@ofgem.gov.uk](mailto:Retailpolicyinterventions@ofgem.gov.uk) by close of business on **27 February 2023**.

We expect to publish our final decision on the updated MSC model for use beyond 31 March 2023 prior to the first proposed model run date as set out above, this will be accompanied by a version of the worked example and MSC guidance document.

Yours Sincerely,

**Dan Norton**

Deputy Director, Retail Price Protection