Making a positive difference
for energy consumers

To all interesting stakeholders

Email: retailpolicyinterventions@ofgem.gov.uk

Date: 12 October 2023

Dear all,

Future of Market Stabilisation Charge post-March 2024

The Market Stabilisation Charge (MSC) and the Ban on Acquisition-only Tariffs (BAT) are set to expire on 31 March 2024. This follows an extension of both provisions in February 2023[1] ("**February Decision**") to maintain the resilience of the GB energy sector and continued consumer protection against the risk of further, sustained price shocks and resulting consumer detriment[2].

Following a review of current market conditions, the MSC's evolving impact on the market and the effect of other policy measures on improving supplier resilience, **we will allow the MSC to expire at the end of its current extension in March 2024.** We are notifying stakeholders now in response to concerns raised from industry during our November 2022 statutory consultation[3] around giving stakeholders enough notice prior to making any changes to the MSC. We also intend to conduct further analysis on the BAT's role, as below.

We have consistently said that the MSC is a temporary measure that would only be retained for as long as it was in the interests of consumers. In our February Decision we said that the future of MSC was contingent on three factors: market conditions including supplier resilience, alternative or supplementary policies promoting supplier stability and the effects of MSC on competition.

Our view is that market risks that the MSC is designed to mitigate, around instability and volatility, are now markedly less. As a result, the likelihood of supplier failure as a whole, and estimated costs to the rest of the market and consumers as a result of any failure, are also significantly lower, relative to that at the time of our February Decision. The MSC's negative impact on competition is also greater than at the height of the crisis in 2022, when suppliers were focused more on stability and survival than on competing against each other. As we are slowly seeing competition re-emerge in the markets, the MSC is reducing incentives for existing suppliers to compete and potentially acting as a deterrent

[1] Decision to extend the MSC and the BAT beyond 31 March 2023 | Ofgem
[2] The MSC, like the BAT, was extended for a year until 31 March 2024 with the licence condition amended to contain a mechanism enabling renewal on an annual basis.
[3] Statutory Consultation on extending the MSC and BAT beyond 31 March 2023 | Ofgem

for new suppliers to enter the market, both of which have negative repercussions on the ability of consumers to benefit from switching.

In reaching this conclusion we have considered a range of relevant factors which are, in general terms, set out below:

Reduced market-wide stability risk

While prices remain high by historical standards, the risks of market instability and supplier failure are reducing. This is exemplified via Value-at-Risk (VaR) - our estimated total value of hedges held by all domestic suppliers (assumed to hedge 100% of standard variable tariff customers according to the price cap indexation strategy), less those hedges' value if prices reverted to historic norms. We have used VaR as a helpful tool to inform our MSC decisions, including our decision to extend the MSC earlier this year, albeit it is not the only factor.

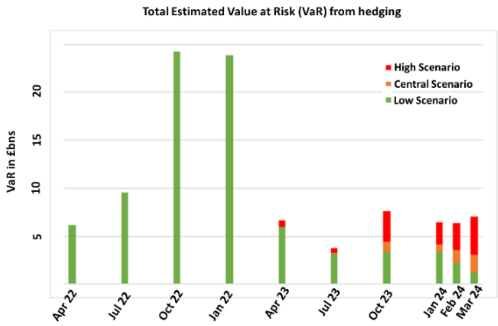

Figure 1 - Estimated VaR, April 22 - Mar 24

VaR projections have fallen markedly in the latter half of 2023 as prices have continued to fall and stabilise. Our central VaR modelling scenario, where future prices materialise largely as expected, is well below the levels when the MSC was introduced. This indicates that risks have declined from their peak last year. Our high prices scenario, with future prices at the upper limit of Ofgem's projections, would leave VaR at around the same level as when the MSC was first introduced.

Supplier resilience and supplementary policies

Remaining suppliers are more resilient and better capitalised than many others who have exited the market in recent years. We also expect to see suppliers increasing their capital positions in 2024 in line with the minimum capital requirement, effective from 31 March 2025[4], introduced to, amongst other things, strengthen supplier resilience such that they can better absorb losses in light of severe but plausible financial shocks and thereby minimising the risk of future supplier failures. Revised EBIT allowances, in place since 1 October, should also bolster suppliers' future ability to absorb future price shocks.

Alongside the enhanced Financial Responsibility Principle which came into effect on 31 May 2023, we consider that these measures should make suppliers more resilient to market instability, enabling them to tolerate higher VaR levels and further reducing the need for the MSC.

Negative Impact on Competition

We have always known and stated publicly that the MSC could have a negative impact on competition. This was considered a reasonable trade-off to manage the risks caused by

4 [Decision on introducing a minimum capital requirement and ringfencing customer credit balances by direction | Ofgem]

unprecedentedly high and volatile prices. However now that the supply market is more stable, the interests of consumers are best served by a return of competition to the market. The MSC is having a significant dampening effect by reducing incentives for established market participants to compete. While we are seeing evidence of new suppliers seeking to enter the market, the MSC is also likely to be acting as a deterrent to entry as a result of high costs whenever new suppliers acquire customers. In addition, now that prices are less volatile there are some circumstances where the MSC may effectively penalise suppliers who are hedging efficiently, compared against suppliers who have under-hedged.

While fixed term contracts (FTCs) have been returning to the market slowly, the MSC is likely to make it more difficult for suppliers to price them competitively against the price cap; this, in turn, has likely contributed to the slower-than-expected return to regular market competition in recent months. This is illustrated by the chart below, showing tariff offerings in recent years. There was a marked fall in Q2 2022, when MSC/BAT were introduced, suggesting a significant direct impact (noting that other factors will also have had an effect). Our analysis also indicates that there has been poor innovation amongst suppliers and weak customer service during the competitive conditions accompanying the MSC. Stronger competitive conditions without the MSC in place could improve incentives to compete in these non-tariff areas, too.

We expect suppliers to offer more competitive FTCs if wholesale prices continue to fall, but additional MSC costs mean consumers may not immediately see the full benefit of significantly cheaper tariffs from wholesale price falls. When introducing the MSC (and extending it in March 2023), we considered that short-term costs to consumers as a result of delayed savings through switching were outweighed by the benefit of lower risk of expensive, disorderly, unplanned exits from the market. As the wholesale price crisis continues to abate and suppliers become more financially resilient, we no longer consider this is the case.

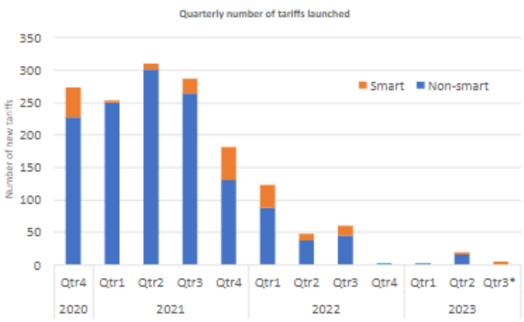

Figure 2 - New tariff offerings, Q4 2020 - Q3 2023

MSC - Next steps

The MSC licence condition SLC 24A ceases to have effect at 23.59 on 31 March 2024.

For the reasons set out above we do not intend to extend the MSC past this date.

Ban on Acquisition-only Tariffs

Alongside its primary role complementing the MSC as a market stability measure, we have also said that the BAT might promote fairness in the market by ensuring that any discounted deals are also available to existing customers and as such, there may be merit in retaining the BAT as a standalone measure.

The BAT gives rise to different considerations than MSC and we have therefore considered its potential continuation separately. We believe that the BAT may have played a role in dampening competition by reducing switching for existing and new customers. On the other hand, BAT may incentivise new market entrants, on the basis that existing suppliers are unable to offer aggressive, loss-leading deals to dissuade customers from joining new competitors.

At present the BAT is also due to expire on 31 March 2024. We intend to conduct further analysis of its impact on the market, to assess the consumer benefit of retaining it beyond that date. Any extension of the BAT would take full account of this potential consumer protection role, as well as the residual stability benefits that the BAT may provide as a standalone measure.

In our February 2023 Decision, we noted that any decision to extend the BAT beyond March 2024 would be the product of a thorough review which would include a consultation. Given that we are considering whether or not to extend BAT, we will publish a separate letter shortly, inviting comments from interested parties on this issue. This will inform our further analysis on the BAT's impact on the market. We will set out our position once this work is concluded.

Yours faithfully,

Dan Norton

Deputy Director, Price Protection

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