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for energy consumers

Resetting the energy debt landscape: supplier funding route working paper

1. Introduction

1.1. This working paper is an addendum to our policy consultation published on 12 December.

1.2. Following several stakeholder workshops and bilateral discussions, we are publishing our updated thinking on the necessary conditions for the supplier funding route, as outlined in Chapter 5 of our policy consultation. We welcome any comments or views on the below.

Background

1.3. In December 2024, we published our policy consultation document, '[Resetting the energy debt landscape: the case for a debt relief scheme]' setting out our proposal to introduce a debt relief scheme. We proposed options for how the debt scheme could be financed and recovery of these costs. We also set out design features to reduce the overall level of funding, including netting off previous funding suppliers have recovered through historical price cap debt related cost allowances and supplier contributions.

1.4. The two options for financing of the balance of the debt scheme were:

- Funding provided by network companies and recovered through network charges
- Funding provided through suppliers, supported by a price cap allowance.

1.5. Under these options, we would ultimately be socialising the cost of debt to fund the debt support. However, we expect the scheme to be 'cost-neutral' in the medium term as without intervention we could reasonably expect a portion of debt yet to be provisioned to become bad debt which would likely result in higher bad debt charges within future price caps.

1.6. This working paper focuses on the options for suppliers funding a debt relief scheme. Following our engagement with stakeholders, we see three options for how a supplier funding route could be implemented:

1.7. **Option 1:** New allowance without reconciliation. This approach would calculate an appropriate level for the allowance that compensates a notional supplier's scheme costs and add this to the price cap level without a reconciliation mechanism to recover and redistribute the costs of the scheme between suppliers. The cost to customers would be recovered by a lower debt allowance through future price caps.

1.8. **Option 2:** New allowance with reconciliation. This approach would require a reconciliation mechanism to recover costs across different suppliers due to having different customer bases with different levels of debt, and to redistribute the costs of the scheme between suppliers. The cost to customers would be recovered by lower debt allowances through the cap in the future.

1.9. **Option 3:** No allowance and no reconciliation. This approach would require suppliers to fund write off of customer debt accrued during the eligible period (April 2022-March 2024) based on provisioning for a portion of debt from this period and future debt allowances in the price cap. There would be no reconciliation.

2. Supplier Funding Options

2.1. The sections below describe each of the three supplier funding options we are considering at present.

Option 1: New allowance without reconciliation

2.2. Under this option, Ofgem would assess the extra costs of the scheme and determine whether they are material and systematic. If they are then we would calculate an appropriate level for the allowance that allows suppliers to recover the costs of a notional supplier for scheme costs, and this could be set using an average weighted benchmark or set at an alternative level. This allowance would then be added to the price cap level that suppliers would then recover.

2.3. This approach would not include an additional reconciliation mechanism, which could mean that some suppliers may over-recover and others may under-recover. As the cap is one level, we would have to carefully consider an allowance that is suitable market wide. Suppliers would bear responsibility for managing their own debt costs (from the eligible period) within the new allowance. If this option is pursued, we would need to consider the allocation of costs across each of the cap components as set out in Chapter 3.

2.4. Under this option we could set the length of the recovery period to be one-year or over two-three years. We would have to undertake further analysis to understand which option would best minimise the impact on consumers' bills, however we would expect the cost of the allowance to be offset against future debt allowances.

Option 2: New allowance with reconciliation

2.5. Similar to Option 1, Ofgem would assess the total extra funding required to write-off eligible customers' debt based on suppliers' submissions. Then Ofgem would calculate an appropriate level for the allowance, setting the allowance once actual data is available (ex post) that compensates suppliers for scheme costs. This would then be added to the price cap level which would ultimately be paid through customer bills.

2.6. An accompanying reconciliation mechanism would be run by a third party to calculate and oversee payments required between parties. Suppliers would submit portfolio data to the reconciliation operator, which would allow the operator to calculate the aggregate allowance and therefore any repayments to/from each supplier. Then suppliers would pay invoices as they receive the allowance and those that get a net benefit will recover in addition to the allowance recovered from their customers.

2.7. As set out in our policy consultation, the justification for a reconciliation mechanism must be based on analysis demonstrating that, among other relevant factors, without it, there would be an impact on supplier stability, market diversity, and competition and that it would be in the interest of customers as a whole. Additionally, reconciliation provides greater certainty that specialist suppliers can recover efficient costs. The aim of the mechanism would be to manage reconciliation of costs between suppliers who may have a greater or lesser claim on a scheme than they receive from customers through the cap allowance.

2.8. The purpose of the reconciliation mechanism for the debt relief scheme is that it should share scheme costs equitably between suppliers to largely mitigate the impact between suppliers where some may have a larger proportion of eligible customer debt write-offs, however it would take a proportionate approach to the accuracy of this mitigation.

2.9. The need for a reconciliation mechanism would derive from the differing ability of a supplier's customer base to repay its debt and therefore its debt levels. Suppliers which have many similar characteristics (customer numbers, split of payment types) may still have very different levels of debt due to their customer's differing ability to pay. To target debt forgiveness to customers who are least able to afford repayment, suppliers with higher levels of eligible debt will need to write off more debt than suppliers with relatively lower levels of debt. As such, high debt suppliers may need more funding under a debt relief scheme than those with lower levels of debt in order to be able to fund their activities.

2.10. A zero-sum reconciliation ensures that the total amount collected from all suppliers matches the total amount reimbursed. This means that once all invoices are settled, there is no surplus or deficit in the reconciliation 'pot'. Each supplier should end up in a position that reflects what they should have spent, ensuring fairness and accuracy in cost recovery.

2.11. In order to operate the reconciliation mechanism, a third-party would need to collect data on supplier costs, total value of the scheme and calculate the differences for each supplier. They would then calculate and process the reconciliation payments to be made or received by suppliers.

2.12. This option could include capped and uncapped tariffs, so the costs of the scheme do not fall solely on SVT tariffs and customers. Uncapped tariffs are all domestic contracts not covered by the cap including fixed term contracts and tariffs that have a derogation from the price cap. However, it is likely that we would have to exclude uncapped contracts agreed prior to the publication of our decision as suppliers cannot add the costs to these customers for the term of their contracts.

2.13. This option provides greater flexibility to allocate costs to different payment methods as one of our policy objectives includes 'reducing the differential between standard credit and direct debt rates in the price cap as compared to the baseline of not intervening'. However, we consider any allowance could be recovered over a one-year period or over two to three years. We would need to consider further analysis to understand the impacts on supplier financeability and impacts to consumers' bills. We do not propose to include any adjustments for interest or working capital financing costs when determining reconciliation amounts. Ofgem considers that this has already been covered in the debt related costs allowance.

2.14. The cap periods in which the costs would be recovered over will be dependent on the timings of the scheme, which we have left open to stakeholder feedback in the policy consultation.

2.15. The reconciliation process has disadvantages including the costs and complexities associated with this route, which would likely extend the timescales for delivery of the scheme. Additionally, there could be collateral risks if a supplier cannot pay into the reconciliation mechanism which could lead to underfunding of the debt relief scheme. Given the inherent weaknesses in a reconciliation process, it is crucial that we are satisfied the benefits to customers, such as enhanced supplier resilience and increased competition, are substantial enough to justify this process.

2.16. Based on cost allocation, we would also consider whether costs would be allocated to the unit rate or standing charge and are actively exploring methods for allocating costs in the price cap.

2.17. Levelling the debt related costs across payment methods was an Ofgem initiative paused last year aimed to address differences in payment type. In the absence of additional mechanisms, setting the level of the bad debt allowance could become increasingly complex. By implementing a reconciliation mechanism that reconciles the variances in supplier debt portfolios, to apportion the funding accordingly, this could provide an option to address debt as an alternative to Levelisation of debt-related costs. Additionally, we expect that the cost of the allowance will be offset against future debt allowances.

Option 3: No allowance and no reconciliation

2.18. If the conditions for Options 1 and 2 are not met (material and systematic increase in costs and a difference in supplier-specific costs that may impair their ability to fund their activities and create risks to market stability and competition), then we could implement the policy without an allowance or reconciliation mechanism. Under this approach, there would be no allowance given and suppliers would be required to write off eligible customer debt accrued during the period (April 2022-March 2024).

2.19. In addition, there would be no reconciliation mechanism as a proportion of eligible debt write-off would been provisioned for.

2.20. Suppliers have an allowance in the price cap to manage their bad debt costs. Therefore, we would expect that a proportion of the debt and arrears captured by the debt relief scheme eligible accrual period would have been written off or provisioned as "bad debt" by suppliers as they do not expect to ever recover it from a customer.

2.21. In addition, suppliers will have provisioned for a portion of the debt from this period. Therefore, we would expect that some of the costs of this debt would have been recognised in suppliers' income statements so some of this could be written off on customer accounts.

2.22. The scheme is expected to reduce future bad debt provisioning and be reflected in lower future debt allowances; therefore we would expect the overall impact of a debt relief scheme on suppliers to be cost-neutral.

3. Considerations

3.1. Should option 1 or 2 be progressed, we would need to consider how to apportion the costs between the different caps and cap components.

Recovery over fuel type

3.2. We are considering several options for how to allocate costs across fuels, including.

- Equally apportioned between gas and electricity
- Split 55:45 electricity:gas as per SOLR cost recovery
- Weight according to the relative allocation of debt across the two fuels
- Weight the cost per consumer proportionately to the split between fuel costs in the cap.

3.3. Given that most customers are dual fuel, cost allocation between fuel types could be equally apportioned between gas and electricity. We consider that equal allocation between fuel types to be the simplest approach as it does not require complex calculations or assumptions about the relative costs of each fuel type. When making assumptions about relative costs there is a risk of inaccuracy and therefore this method avoids introducing uncertain assumptions.

3.4. The alternative is to allocate the costs in a way that reflects actual usage. This means identifying the actual costs associated with each fuel type and allocating these costs to consumers based on their usage. For example, if electricity accounts for a larger share of the total debt compared to gas, a greater portion of the costs would be allocated to electricity, and vice versa. Allocation in this way could have an immaterial impact on each allowance as the difference between each fuel's cap level is minimal.

Recovery over the unit rate and/or standing charge

3.5. The cap is defined at two levels: nil consumption and typical consumption. These values are used to calculate the standing charge (the fixed element of the cap) and the unit rate (the variable element of the cap). We need to determine how the adjustment is distributed across these consumption levels. We have considered three options:

- Recover all costs through the standing charge.
- Recover all costs through the unit rate.
- Recover costs through both the unit rate and the standing charge

3.6. The option we choose would impact the design of the reconciliation mechanism. Each option presents itself with pros and cons. For example, recovery through the standing charge/imposing a cost on the cap at nil consumption means that all customers would share the adjustment equally, irrespective of their energy usage. Consequently, this would cause a significant increase in prices for customers with low energy consumption. Alternatively, recovering through the unit rate may be beneficial to those with low energy consumption, particularly in light of Ofgem's work on lowering/removing the standing charge element in the price cap.

3.7. Recovering over the unit rate could be beneficial as this is more progressive than standing charge on average however, we recognise that this approach has drawbacks including consumers who are on a lower income with higher consumption would be negatively impacted. Therefore, there is a need to balance recovery and consumer impacts.

Recovery over payment types

3.8. When allocating costs across different types, we need to consider and balance our duty objective to protect all consumers and have regard to the ability of efficient suppliers to finance their licensed activities. There are several options to recover costs over the different payment types including:

3.9. Equal allocation of debt relief scheme costs across payment types. This approach would be simplest and easiest to implement ensuring fairness across all consumers, however, may not reflect the actual cost differences associated with each payment type and could create distortions as suppliers have differing proportions of customers who pay for each payment type.

3.10. Allocating the debt relief charge in different proportions between payment types such as allocating a percentage of standard credit additional costs to direct debit customers. This approach could ensure that the cost of the debt relief scheme is shared more equitably among consumers. Reducing the differential costs and spreading them across payment types may reduce the incentives for consumers to switch to more efficient payment methods like direct debit. Additionally, it is likely that this approach could lead to higher overall costs for direct debt customers creating potential unfairness for those consumers who typically pay on time and manage their accounts well.

Recovery over single-rate and multi-register electricity meter

3.11. Currently, the cap has two levels for electricity, one for single-rate meters and another for multi-register meters. Multi-register meter customers tend to use more energy on average, so the typical consumption benchmark for the multi-register cap level is set at a higher level of consumption.

3.12. We could apply a percentage allowance to single-rate and multi-register meter benchmarks separately. This could then give a higher percentage allowance for multi-register meter consumption than for single-rate meter typical consumption benchmark.

3.13. Alternatively, we could equally allocate costs across single-rate and multi-register electricity meter types. This would mean using the weighted average figure through our benchmarking exercise for each cap component allowance.

4. Other considerations

Reconciliation mechanism

4.1. Introduction of a reconciliation mechanism to recover costs across suppliers would allow the redistribution of costs of the scheme between suppliers mitigating the risk that no supplier makes excessive gains or losses.

4.2. Whilst the reconciliation would reduce the risk of over- and under- recovery of costs, the mechanism could be complex to design and implement within the debt relief scheme timeframes. It would likely require data collection from suppliers and analysis, therefore increasing the administrative costs.

5. Emerging Thinking

5.1. We are open to views on what the best option could be to deliver the debt relief scheme via a supplier funding route. Below we outline our thinking and weigh up the pros and cons of each option.

5.2. Option 1 would provide a more straightforward approach and could be implemented within the necessary timeframe to roll out the debt relief scheme. This simplicity could be a significant advantage as it allows for quicker implementation compared to more complex mechanisms.

5.3. To the extent that the difference in scheme costs between suppliers is driven by non-efficiency factors, such as customer base differences, Option 2 is likely to provide a fair approach to apportioning the debt costs between suppliers. Designing such a mechanism would involve several challenges:

- Creating a fair and effective reconciliation mechanism requires careful consideration of the diverse customer profiles across different suppliers. This complexity can lead to significant administrative and operational challenges.
- The process of developing and implementing this mechanism would incur additional costs which would ultimately be passed onto consumers.
- The time required to design, test and roll out the reconciliation mechanism would likely delay the provision of support to customers impacting our timelines to deliver a debt relief scheme.
- It is critical that we ensure the mechanism meets the principles and its objective to apportioning the debt relief costs between suppliers in accordance with their debt portfolios. However, if it is unable to do so, there could be collateral risks leading to reduced financial resilience for certain suppliers and therefore reduced competition.

5.4. Without a reconciliation mechanism there is a risk that the scheme could create imbalances in the market (e.g. this could lead to an inability for suppliers to fund their operations to the extent that this might cause market instability or impact competition and customer outcomes). While Option 1 offers the benefit of simplicity and timely implementation, it also carries the risk of uneven cost distribution among suppliers.

5.5. Option 3, which involves no new allowance, and no reconciliation mechanism. This option is straightforward and avoids the complexities associated with designing and implementing a new allowance and reconciliation mechanism. Additionally, by maintaining the current price cap without additional allowances, we are ensuring stability and predictability in pricing for consumers who could then avoid spikes in their bills. However, we do understand that this option comes with drawbacks as this option lacks the flexibility to address the varying financial situations among suppliers and does not account for the differences in debt portfolios. Our rationale would be that suppliers have already received a bad debt allowance in the price cap, and this option could be preferred if evidence shows there is a large enough overlap between this and those eligible for debt relief to deal with the supplier differences. There is still a risk that this option/scheme could lead to an inability for suppliers to fund their operations to the extent that this might cause market instability or impact competition and customer outcomes.

6. Next Steps

6.1. We have been working collaboratively with interested parties on this, and in the interest of open consultation, if anyone else wishes to share their views with us, we would be happy to invite you to working group sessions or bilaterals.

6.2. Following the close of the policy consultation, we will carefully consider and review the responses. If we go ahead with a debt relief scheme, then we aim to publish a statutory consultation in Spring 2025 with a view to making a final decision by Summer 2025.

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