Making a positive difference
for energy consumers

To all interested stakeholders

07 July 2022

**Open letter: Review of how the costs of supplier failure are recovered**

Today we are launching a consultation to review part of the Standing Charge that consumers pay - the Supplier of Last Resort (SoLR) levy. We are requesting stakeholder views on whether the existing fixed charge continues to be appropriate, or if a usage-based (volumetric) alternative would be a more suitable way to recover the significant recent costs of supplier failure. We are also requesting views on the potential process for implementing a change, should the review conclude that is necessary. Given the scale of SoLR levy costs being recovered this year (April-March 2022/23) we note that if a change was required, it is our initial view that this should be implemented in time for the next price cap period (beginning October 2022). For this reason, we are running an expedited consultation process to ensure any change (if appropriate) is implementable within these timescales and are requesting responses by 22 July.

## 1. Context

The past year has brought unprecedented increases in energy wholesale market prices and volatility. The root causes of these price rises are global ones, with a number of contributing factors[1]. Collectively these developments have driven up gas prices, with electricity wholesale prices following suit. This has affected the GB energy market at every level, from impacts on our energy networks and markets to price increases felt by consumers when they receive their bills.

Market conditions have led to a number of suppliers exiting the market. The SoLR process ensures that when suppliers do fail, their domestic customers are protected. Domestic consumers' credit balances are kept safe and their supply continues uninterrupted while they are moved to another provider. The process also protects the new supplier by providing a mechanism by which the wholesale costs they face bringing on these new customers can be recovered.

This important process comes with a cost faced by energy consumers and given the significant number of supplier failures last winter, SoLR levy costs are currently at unprecedented levels. The need for the SoLR process and the charges to recover the costs of protecting customers was foreseen, but the amount of money these arrangements would need to recover from households was not. This year, the SoLR costs to be recovered from electricity consumers exceeded £1bn, with around £800m being recovered from gas consumers. These costs are currently recovered under domestic customer daily standing charges, using an approach Ofgem approved in 2020.[2]

[1] Including but not limited to: global energy demand increases linked to the economic recovery from the global coronavirus pandemic, European supply disruption and production outages, and the consequences of Russia's invasion of Ukraine

[2] DCP332 – *Appropriate treatment and allocation of Last Resort Supply Payment claim costs, approved October 2019 and implemented in April 2020.*

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We have listened to concerns from consumers and consumer groups on recent increases in standing charge levels allowed under the default tariff cap. We feel it is right to respond to this feedback with a review into how the current extraordinary costs of supplier failure should be recovered. We are also working with industry to understand how any changes that might be needed, can be put into action as soon as possible.

## 2. Background and existing arrangements

The SoLR process provides protection for the credit balances of failed suppliers' domestic consumers. Suppliers taking on customers through the SoLR process can claim a Last Resort Supply Payment (LRSP), following approval from Ofgem, to cover reasonable additional, otherwise unrecoverable, costs incurred in taking on the new customers. This is paid out to relevant suppliers by distribution network operators (DNOs) and the costs of the payments are recovered from DNO-connected customers.

In 2019, Ofgem approved a code modification '*DCP332 – Appropriate treatment and allocation of Last Resort Supply Payment claim costs'* which established charges for SoLR cost recovery as fixed charges for domestic customers.[2] This means all electricity consumers pay the same contribution towards SoLR costs (i.e. there is no link between electricity consumption and contribution to SoLR costs).

At the time of the DCP332 decision, relatively few customers had been affected by supplier failure and market conditions were much more benign. The magnitude of SoLR costs that might be recovered through the charges (and the cumulative standing charge impacts from this and other policies[3]) were not foreseen, particularly in the context of the wholesale price rises. The current level of SoLR costs (in excess of £1.5bn) equates to just over £34 per domestic consumer this year (April-March 22/23), versus typical levels of pence per year previously.

We have noted feedback from consumers and consumer groups that the existing arrangements are perceived by some to be unfair, with a "volumetric" or consumption basis seen as more fair. In particular, we understand that the use of fixed charges to recover SoLR costs can contribute to higher standing charges, and to users seeing energy costs, and sometimes debts, building up, despite their actions to reduce consumption. We recognise in these current times this adds to anxieties over energy affordability.

## 3. Consumption and vulnerability

Ofgem have a statutory duty to consider consumer vulnerability in our decisions.[4] As part of Ofgem's previous work on the Targeted Charging Review (TCR), we sought to understand the link between vulnerability and energy consumption. We considered income-based demographic data and found that consumption within demographics varies dramatically[5]. While there is a broad link between higher consumption and higher affluence, many demographics with known vulnerability are higher users.[6] We expect greater consumption by those with greater electricity requirements, such as those that are not on mains gas, or who need warmer homes or run medical equipment. As such, having considered the data, we are

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[3]The changes we have implemented as a result of the TCR have increased standing charges. These changes are expected to save consumers approximately £300m per year, with anticipated £4bn-£5bn consumer savings in total over the period to 2040 as we move to net zero. These benefits directly arise from the unavoidable nature of fixed charges and the corresponding removal of distortions to network charging revenue recovery.

[4] Ofgem have a statutory duty to consider persons who: have a disability or are chronically sick, have a low income, are of pensionable age or reside in rural areas. These consumers sit across the usage spectrum.

[5] Our analysis of Acorn Group data from the Energy Demand Research Project (EDRP) and Low Carbon London (LCL) trials data and BEIS fuel poverty data suggests that the groups where most vulnerability would be expected have a wide range of consumption levels, so it should not be considered that low usage equates to vulnerability or vulnerability to low usage. For example, Upper quartile consumption for "Difficult Circumstances" is similar to that for types within "Lavish Lifestyles" and "Executive Wealth". The LCL trial data showed significantly lower consumptions for those groups that were likely to be affluent flat-dwellers than the most-deprived groups. Low users also include second homes and those who have invested to reduce consumption.

[6] Off-gas grid housing may use resistive heating or heat pumps and rural users are more likely to be off gas grid with higher consumption. Acorn data shows larger families in rural areas have median consumptions well above the upper quartile consumptions of the wider user base.

of the opinion that there is a relatively weak link between consumption and vulnerability, and large variations of consumption within vulnerable groups.

It is therefore important to recognise that a usage-based charge would have the practical effect of reducing costs faced by low-usage consumers, and increasing them for higher-usage consumers. Given our current understanding of the link between vulnerability and consumption, we recognise that such a change may have different impacts for different consumers depending on their personal circumstances. We also recognise that there is a broadly held opinion that consumption may feel a fairer way to recover these costs for some users, particularly given the exceptional nature of these costs currently and the ongoing high wholesale prices. We are interested to understand stakeholder views on which recovery method is more appropriate given this difficult trade-off.

## 4. Our proposed review

We are proposing to review the current framework for SoLR cost recovery against the current context of high wholesale prices. Alongside the current arrangements, we will assess whether a usage-based (volumetric) charge would be more appropriate, either as a time-limited[7] or an enduring option. This will include consideration of different customer groups, with different consumption levels, as well as consideration of the recently expanded government Energy Bills Support Scheme[8] support measures.

In our view, SoLR levy costs are generally considered a type of "residual"[9] network cost. The recovery of these types of network costs was the focus of Ofgem's Targeted Charging Review. As such, we propose to carry out an assessment of fixed vs. volumetric charge using Ofgem's existing Targeted Charging Review (TCR) fairness[10] framework. However, we note that for the TCR, avoiding distortions was a particular priority given the enduring and predictable nature of the network costs concerned, and the existence of known distortions. However, this may be seen to contrast with the unexpected nature of the SoLR costs we are currently faced with and take this into account in our assessment. Ofgem also has a defined methodology for distributional analysis and this will also be presented if it provides additional insight. We welcome views from stakeholders as to whether there are other relevant considerations we should take into account as part of our assessment.

We expect the review to cover:

i. Current context and arrangements, and impacts on typical groups of consumers;
ii. Options for change and their impacts;
iii. Fairness;
iv. Interactions with government support package;
v. Vulnerability assessments including users covered by statutory duties and users with Prepayment Meters;
vi. Policy and implementation recommendations;
vii. Scope for unintended consequences.

We would like to request feedback on the questions set out within this consultation from any interested stakeholders and propose to supplement the insight we receive with direct engagement with suppliers, DNOs and consumer groups. We invite requests for engagement from relevant groups.

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[7] As set out above, for many costs, fixed charges are a suitable way to recover these. However, given the time limited and unexpected level of SoLR costs, it may be appropriate to retain the existing arrangements for future SoLR recovery while addressing the extraordinary level of costs in a different way.

[8] Energy Bills Support Scheme explainer - GOV.UK (www.gov.uk)

[9] Residual costs are those intended to recover the remaining parts of the network companies allowed revenues (established via their price controls) once cost-reflective charges have been levied. Charges for residual costs should not send signals to users about how these use the system. Residual charges are required because forward-looking, cost reflective charges do not usually fully recover the costs of the whole network.

[10] We think given the relatively exceptional and unexpected nature of these costs, an assessment against the TCR distortions criteria is less necessary, given the lower potential for distortions.

## 5. Further Engagement

We understand that many users will want changes (if required) to be delivered swiftly. We continue to discuss with the DNOs in particular, how changes could be delivered, including options that would deliver changes for the next price cap period beginning October 2022. We recognise these are challenging timescales and would appreciate stakeholder input on how these might be achieved if necessary. We propose to host, with the Energy Networks Association (ENA), an implementation-focussed workshop to understand from industry stakeholders their views on these issues and the options for implementation if the review and consultation suggested a change was required. Where necessary, we would expect to consult on necessary regulatory framework changes at a later date.

We would like responses from interested stakeholders to **retailpolicyinterventions@ofgem.gov.uk** by 22 July 2022. We will announce dates for the ENA delivery event shortly. We expect to share initial views with industry later this month with a final view in August.

## 6. Request for stakeholder views

As mentioned above, we would encourage interested stakeholders to provide concise, specific feedback and evidence relating to SoLR cost recovery. In particular, we would like views on the following questions in relation to the SoLR cost recovery:

a) Do you agree with the rationale for our review into SoLR cost recovery?
b) How do you consider we should manage trade-offs between charging on a fixed-charge basis vs. volumetric?
c) Should SoLR costs be recovered by fixed charges, unit rate charges (i.e. volumetric), or some other method?
d) Do you consider that vulnerable consumers' interests are best served through the use of fixed charges, unit rate (volumetric) charges, or some other method? Please share evidence where possible.
e) If changes were deemed to be necessary, should that take place:
    i. On an enduring basis; or
    ii. On a time-limited basis?
    iii. And if so, why?
f) If changes were deemed to be necessary, would you rather that they:
    i. were implemented using standard industry processes, even if this takes longer; or
    ii. were implemented as soon as possible, even if this meant using non-standard processes?
    iii. And if so, why?
g) Do you consider there to be any interactions between the method of SoLR cost recovery and the support provided from the recently expanded government Energy Bills Support Scheme?
h) Do you consider there to be any further impacts that need to be considered, for example on supplier, DNO or IDNO businesses, on the risks held by industry, investors or external parties, or on wider industry arrangements?
i) Do you consider there are any unintended consequences associated with the potential recovery through fixed or volumetric charges or any alternative method you are proposing?

Any responses to this letter are requested by 22 July 2022. Unless clearly marked confidential, all responses will be incorporated into the consultation response summaries that will be published on our website.

Yours faithfully

Neil Lawrence

**Director, Retail**