

To all interested stakeholders

18 August 2022

Follow up on our review into the arrangements for recovering the costs of supplier failure

On 7 July 2022 we published an [open letter](#)¹ launching a review of how the costs of supplier failure² are recovered from electricity consumers. We specifically asked whether the existing fixed charge continued to be appropriate, or if a usage-based (volumetric) alternative would be a more suitable way to recover these costs. This year, Supplier of Last Resort (SoLR) costs to be recovered from electricity consumers exceeded £1bn, equating to a fixed charge of around £34 per household.³

Through this review we have engaged extensively with charities, consumer representatives, and other industry stakeholders. We have also carried out assessments of the options available, including an assessment of the cost implications of different charging approaches on a range of consumers, including vulnerable consumers. Our review has concluded that we should not change the current arrangements to a volumetric alternative in light of the evidence gathered, which shows:

- A relatively small benefit for some consumers at the cost of higher charges for some vulnerable consumers: while some low consuming customers, some of whom may be vulnerable, would likely benefit from a usage-based charge (typically by less than £10 per household per year) there are large numbers of higher consuming customers, including other vulnerable customers, that would pay more (around £5-£30) compared to the current fixed charge approach.
- A volumetric charge may negatively impact prepayment meter customers given their typical electricity consumption is higher than average.
- Stakeholder feedback from a wide range of charities, consumer groups and industry representatives overall supported the status quo.

Overall, the review showed that recovering supplier failure costs through unit rates may lead to small reductions in bills for some low-income consumers, however, these savings are relatively small in the context of overall bills and would be at the cost of increasing charges for some high consuming customers many of whom are vulnerable. On this basis we took the view that retaining the current methodology would better protect higher consuming customers who have greater energy needs such as disabled consumers, and consumers with electric heating in areas off the gas grid. As a result, we have concluded that this change is not supported by sufficient evidence of consumer benefit and could bring potential detriment to a large number of consumers. As such, it is unlikely to be proportionate. We have therefore decided not to direct industry parties to make changes to the method used to recover these costs.

¹ [Open letter: Review of how the costs of supplier failure are recovered \(ofgem.gov.uk\)](#)

² The Supplier of Last Resort process exists to protect domestic consumers when their suppliers exit the market. The costs of these events are currently recovered from all domestic consumers, as a charge per meter, which commonly built into the standing charges of supplier tariffs. More information is available in the open letter.

³ A further £800m is recovered via gas customers, equating to around £33/year but was not the subject of this review.

We recognise that standing charges remain an issue of significant concern to customers. We will be looking specifically at this area as we pursue other policy changes to address current affordability challenges and longer-term market reform. We will provide more detail on any relevant work in due course. We continue to look to support vulnerable customers, as well as working with BEIS to prioritise policy development in areas that support such customers. We will collaborate with key stakeholders to ensure we focus our efforts on initiatives that add the most value both for this winter and for the longer term.

The remainder of this decision sets out the background to our review and summarises our considerations.

1. Views from our stakeholders

Overall, most stakeholders who responded to the consultation were **not in favour** of a move to volumetric recovery of SoLR costs. Some consumer groups were in favour. In particular, these stakeholders felt the potential benefits to the lowest consuming customers justified changes, while recognising that some vulnerable customers consume more electricity.

Other consumer groups were not supportive of volumetric charges for the recovery of SoLR costs. These groups cautioned against changes that might increase costs for customers who are already facing high energy costs driven by greater energy needs. Some stakeholders also raised concerns that volumetric charges might be less effective in recovering costs overall, potentially allowing more affluent consumers to reduce their contributions.

Industry parties including energy suppliers and Distribution Network Operators (DNOs) also warned of impacts on vulnerable customers with higher consumption, and on impacts on customers who are not connected to the gas network in areas with typically higher heating requirements. Industry stakeholders also set out a number of concerns around the impacts of changes at short notice on industry processes and on the potential for charges to raise less revenue from volumetric charges, leading to a need to recover money in later years. In addition, we received other feedback from customers on their views on the SoLR process generally, as well as calls for further work on standing charges.

2. Our review

Our review covered a number of elements, including the history of the SoLR arrangements and the methodology behind them, how the options performed against our Principal Objective, other duties and the industry code objectives, and the likely impacts on a range of customers.

Our decision framework

We assessed this potential change in accordance with our Principal Objective and our other statutory duties⁴. For completeness, and noting that any change would ordinarily be progressed through the code modification process, we assessed against the Distribution Connection and Use of System Agreement (DCUSA) objectives. Our statutory duties and our assessment against the code objectives led us to the same conclusion that change is not in customers' interests.

Statutory duties including duties to vulnerable customers

Our statutory duties cover a range of obligations, including our Principal Objective to protect the interests of existing and future consumers and the various specific matters identified in section 3A of the Electricity Act 1989. We set out below some specific analysis of key aspects of our statutory duties, with focus on those to consider the impacts of policy changes on those consumers with vulnerable characteristics.

Vulnerable consumers

⁴ Our statutory duties, which includes our Principal Objective to protect the interests of existing and future consumers as well as various other specific matters are identified in section 3A of the Electricity Act 1989.

Ofgem has a statutory duty to have regard to the interests of persons who: have a disability or are chronically sick, have a low income, are of pensionable age, or reside in rural areas. These customers sit across the usage spectrum. Certain demographics are more likely to be low users, and previous Ofgem work established that while there is a broad link between affluence and consumption, there are significant variations in consumption within groups.⁵

For this reason, under a volumetric charge some low-income customers may pay slightly less compared to a fixed charge, but some other low-income customers may pay significantly more. Our distributional analysis highlighted that the disadvantage to some vulnerable customers is significant enough to outweigh the comparatively smaller benefits to others. This is particularly the case where customers have characteristics associated with greater need for energy. For example, disabled customers may have greater heating requirements or make use of medical or assistive equipment powered by electricity. Customers living in a rural situation or who are unemployed may also have higher consumption. We therefore consider that a move to volumetric SoLR recovery has the potential to disadvantage a range of higher consuming customers who may be vulnerable.

We also consider there to be the potential for much higher costs to fall on customers who have electric heating. We understand that customers of two-rate meters in some parts of GB have much greater typical electricity consumption, and that these heating types are strongly associated with fuel poverty in some areas. Stakeholders have also noted that electric heating is very common in the social housing sectors in some parts of GB, and that differences in the provision of support schemes across GB mean that in some regions, customers do not get additional help with these costs.

Feedback from some consumer groups was that volumetric charges would provide benefits to some low-income customers, though overall, we think such benefits need to be considered against impacts on the customers that would be disadvantaged by a move to volumetric charges.⁶

Prepayment meter customers

Around 1 in 7 meters in GB are prepayment meters (PPM). PPM customers are not a uniform customer group, but we do consider prepayment meters to be more prevalent in low-income households, and we generally consider them more likely to be vulnerable. Work carried out by Citizen's Advice in 2018⁷ found over 40% of prepayment meter customers to have health issues, with 15% reporting mental health issues, and close to 60% being in receipt of some kind of social benefit.

Prepayment meter customers may be more likely than direct debit customers to ration or "self-disconnect" to manage energy costs. This is due to links to low incomes and other vulnerabilities, and the direct link between available cashflow and energy use. These customers are therefore more likely to find themselves unable to use electricity when needed in a way that other meter customers do not.

We received some support for change from consumer groups as a possible way to reduce the amount of non-energy costs falling on prepayment meter customers. Other stakeholders felt that a change to the SoLR recovery method was poorly targeted as a means to help prepayment meter customers and vulnerable customers in general. Our analysis highlighted this complexity, showing that a typical customer with a PPM would likely be slightly worse off from a volumetric charge as compared to the current fixed charge.

⁵ Ofgem's Targeted Charging Review Minded to Decision set out analysis on the links between consumption and vulnerability

https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/targeted_charging_review_minded_to_decision_and_draft_impact_assessment.pdf

⁶ We have considered this decision in light of the Public Sector Equality Duty contained in S.149 of the Equality Act 2010 and consider that impacts on relevant protected characteristics are within the scope of our vulnerability assessment.

⁷ https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/PPM_self-disconnection_short_report.pdf

Data shows that prepayment customers have historically used, on average, very similar levels of electricity to other customers. Some of this may be explained by greater heating requirements due to vulnerabilities, and we understand households with a greater number of occupants may also be more likely to have prepayment meters.

Distributional analysis

We considered a range of evidence on this issue. Using Ofgem's vulnerability demographic assessment framework, we have found that volumetric charging is likely to deliver marginally lower costs for households in the lowest income decile, with the exception of households with unemployed members, who will pay more. Changes may lead to marginally increased costs for disabled customers and lone parents.

In summary, we have found the potential benefits to be relatively low, with potential for significant negative impacts on some vulnerable customers. While the correlation between energy consumption and vulnerability is complex, we would expect to see additional costs falling on customers in receipt of disability benefits and with health conditions, rural pensioners, and electric heating users. Electric heating is particularly prevalent in Scotland, creating a particular locational impact. We also expect that for the mean prepayment meter customers, change is unlikely to bring benefits, as average consumption for these customers is slightly above the population in general and prepayment meter use is correlated to a number of circumstances that are associated with higher use.

Typically, the differences are relatively low in annualised absolute values. Benefits are higher when weighted to reflect the level of disposable income of customers, but so are the impacts on customers who pay more. Given half of the SoLR costs for this year have already been collected using fixed charges, benefits were considered to be relatively low for this winter and savings relatively small compared to the expected price cap level for this winter for a typical customers.

Our distributional analysis suggests volumetric charging would bring significant downsides for some customers. Earlier Ofgem work⁸ suggests 13% of Scottish homes rely on electric heating, compared to 8% of English homes and 5% of Welsh homes, and that almost 50% of Scottish storage heater users are considered to be in fuel poverty. A typical storage heater user in Scotland could expect to pay, on average, between £9 and £31 more using volumetric charges, and with differences in the support schemes between Scotland and the rest of GB, these increases are not mitigated.

There is a complex relationship between consumption and affluence. Whilst there is a moderate correlation between consumption and affluence, there is considerable variation within affluence bands, such that some of the least affluent have very high consumption. Our distributional analysis suggests that:

- The average prepayment meter customer would be worse off from a volumetric charge;
- Electric heating users are likely to be worse off, which is important given the correlation between heating system and fuel poverty; and
- Typical storage heater / Economy 7/10 users could be worse off, with these meters more commonly associated with fuel poverty.

A move to volumetric would benefit some low consuming customers, including identified groups of single pensioners (Archetype C5) and lower income renters (E8s), but would also benefit a number of affluent groups. It would potentially disadvantage the lower income deciles of customers with higher levels of disability and fuel debt (D6s), other customers in receipt of disability benefits (D7s) and a number of other groups, including a several rural customer categories. In particular, it impacts the poorest pensioners as well as the rural disabled with electric heating (archetypes H12 & H13).

⁸ [Insights paper on households with electric and other non-gas heating | Ofgem](#)

Average annual savings by consumer archetype group and number of households represented by the consumer archetype from Ofgem’s distributional analysis tool⁹

Archetype	Selected attributes (vulnerabilities in bold)	Savings (£)	Households (m)
A1	Affluent, efficient homes on mains gas	6.96	2.76
A2	Affluent, mains gas	-8.94	2.92
B3	Retirees , own homes outright, engaged	2.96	3.67
B4	High incomes, owner occupied, high consumers	-1.04	2.32
C5	Single pensioners, low income , mains gas, health problems	13.43	1.92
D6	Low income, some with disability , social housing	0.58	1.55
D7	Disability benefits , mains gas	-1.51	1.21
E8	Low income renters, out of work or part-time.	3.44	2.36
E9	Educated early career renters	7.44	3.09
F10	Affluent rural users , many pensioners , no mains gas	-16.84	1.91
G11	Renters, many BME, lower salaries and electric heating	-12.08	1.51
H12	Older pensioners , very low income , half in poverty and half with health problems , no internet	-5.47 to -26.72	0.64
H13	Disabled, rural , out of work or pension, low income	-13.12	0.53

Due to the relatively modest benefits to lower income customers and the potential for higher costs for a range of other vulnerable customers, we have taken the view that, overall, volumetric charges are unlikely to be in consumers’ interests. We recognise there will be a section of customers, likely those on low-incomes, who would pay less, and where these users are on prepayment meters, this may provide some marginal assistance in reducing self-disconnection. However, we do not think change is proportionate when the potential impacts on other vulnerable users are considered.

Industry code objectives

We found that volumetric charges are likely to perform slightly worse against the relevant objectives of the DCUSA than the existing arrangements¹⁰. The objectives¹¹, in summary, are that compliance by each DNO Party with the Charging Methodologies:

1. facilitates the discharge by the DNO Party of the obligations imposed on it under the Act and by its Distribution Licence;
2. facilitates competition in the generation and supply of electricity and will not restrict, distort, or prevent competition in the transmission or distribution of electricity or in participation in the operation of an Interconnector (as defined in the Distribution Licences);
3. results in charges which, so far as is reasonably practicable after taking account of implementation costs, reflect the costs incurred, or reasonably expected to be incurred, by the DNO Party in its Distribution Business;
4. so far as is reasonably practicable, properly takes account of developments in each DNO Party’s Distribution Business
5. facilitates compliance with the Regulation on Cross-Border Exchanges in Electricity and any relevant legally binding decisions of the European Commission and/or the Agency for the Co-operation of Energy Regulator; and

⁹ Available at https://www.ofgem.gov.uk/sites/default/files/docs/2020/05/ofgem_energy_consumer_archetypes_-_final_report_0.pdf

¹⁰ DCUSA is the code that sets out how charges for the distribution network are set and how change proposals are assessed.

¹¹ DCUSA Objectives are set out in Standard Licence Condition 22A of the Electricity Distribution Licence [Electricity Distribution Consolidated Standard Licence Conditions \(ofgem.gov.uk\)](https://www.ofgem.gov.uk) and are set out in DCUSA

6. promotes efficiency in its own implementation and administration.

We consider there to be the potential for some small adverse competition impacts associated with a change to a volumetric charge, due to the need to change tariffs mid-year. Such changes are potentially troublesome for suppliers. In addition, due to different numbers of fixed tariff contracts between suppliers, there will be potentially different impacts on supplier portfolios. The extent to which changes to charges would be passed through to consumers on fixed tariffs may vary by supplier, meaning customers may be affected differently. These factors mean the status quo charges are likely to better facilitate the competition objective. There were also likely to be a range of impacts on suppliers and DNOs if costs were moved from stable fixed charges to less predictable volumetric charges, such as increased volume and forecasting risk and additional cashflow requirements, meaning fixed charges are likely to better facilitate the efficiency objective.

We also consider that volumetric charges would less directly reflect the nature of the costs being recovered and are therefore of the view that a change would perform worse against the objective associated with charges reflecting costs incurred. The recovery of SoLR costs exists to recover a sum of money that has already been paid out to suppliers by DNOs and does not increase or decrease with changes to customer consumption. We therefore consider fixed charges to better facilitate the objective, and to minimise the potential for recovering more or less money from customers than is needed.

We received feedback from a number of stakeholders that they considered a key requirement to be efficient collection of this revenue. We recognise that under- or over-recovery of revenues would require reconciliation in later years. This may lead to additional costs on customers or industry parties. For example, DNOs would need to cover these cashflow positions. Because under- and over-recovery are socialised in subsequent years, there may be a transfer between customers, including the possibility of costs associated with domestic protections falling on non-domestic customers who do not have the same protections.

Practical and implementation discussions

Changes to charging arrangements typically involve standard change processes and several rounds of consultation. In this case, the standard process would have taken too long to allow for change for the coming October price cap period. To facilitate potential changes, industry parties proposed a process of derogations from existing DNO obligations, alongside an alternative charging model.

This abbreviated process would represent a significant change from the standard approach and was not universally welcomed by industry parties. Those stakeholders that supported the process generally did so as a short-term option only. Had changes gone ahead, we would expect a number of impacts, including the need for Independent DNOs (IDNOs) to set their tariffs in short timescales, and also for suppliers to incorporate different tariffs at short notice. Additionally, change would have potentially significant cashflow implications for suppliers and DNOs.

3. Our decision

Having considered the range of evidence, in particular the potential distributional impacts, it is our view that the benefits of change to the arrangements are relatively limited, and do not represent an effective way of dealing with particular concerns raised surrounding low-income customers, or prepayment customer self-disconnection. We also consider that the impacts on high-consuming customers, particularly where users have greater energy use as a result of vulnerabilities such as disability or health conditions, are not desirable. Given the short period of time before the next price cap period, we do not consider it would be feasible to produce effective mitigation for the expected impacts.

In addition, we recognise that change would increase uncertainty and potentially increase risks for suppliers, as well as introducing additional risks and administrative requirements for other

areas of industry. Taken together, we do not think change is well justified, with the potential detriment to customers unlikely to be proportionate when considered against the expected benefits.

As a result, we have decided not to direct industry changes to the method of SoLR cost recovery at this time. We would like to thank consumer representatives and other stakeholders across industry that provided feedback for this work.

Yours faithfully

Jonathan Brearley

CEO, Ofgem