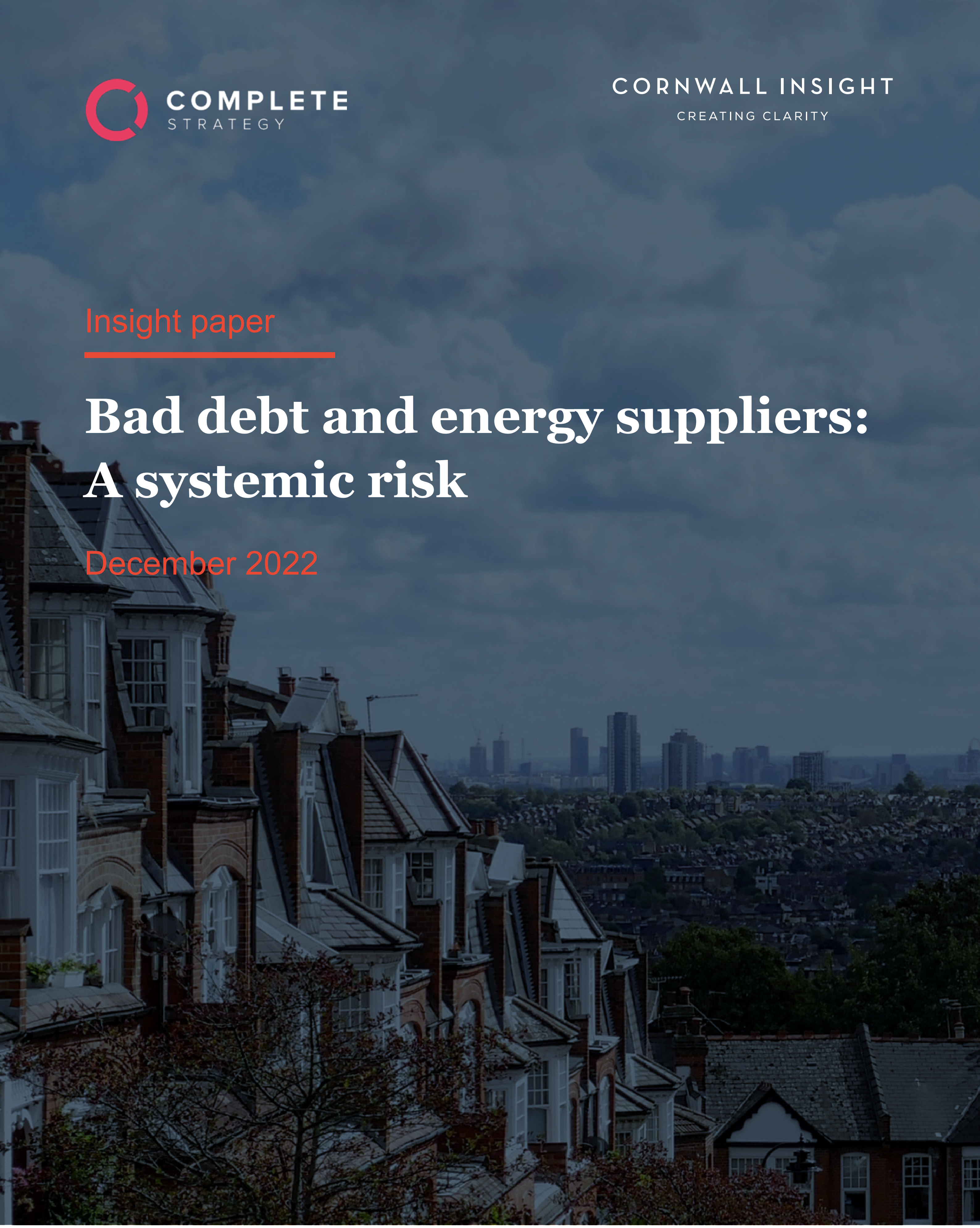

COMPLETE STRATEGY

CORNWALL INSIGHT
CREATING CLARITY

Insight paper

Bad debt and energy suppliers: A systemic risk

December 2022

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About Cornwall Insight

Getting to grips with the intricacies embedded in energy and water markets can be a daunting task.

There is a wealth of information to help you keep up-to-date with the latest developments, but finding what you are looking for and understanding the impact for your business can be tough. That's where Cornwall Insight comes in, providing independent and objective expertise.

You can ensure your business stays ahead of the game by taking advantage of our:

- Publications – Covering the full breadth of the GB energy industry, our reports and publications will help you keep pace with the fast moving, complex and multi-faceted markets by collating all the "must-know" developments and breaking-down complex topics
- Market research and insight – Providing you with comprehensive appraisals of the energy landscape helping you track, understand and respond to industry developments; effectively budget for fluctuating costs and charges; and understand the best route to market for your power
- Training, events and forums – From new starters to industry veterans, our training courses will ensure your team has the right knowledge and skills to support your business growth ambitions
- Consultancy – Energy market knowledge and expertise utilised to provide you with a deep insight to help you prove your business strategies are viable
- Research – Creating new knowledge and insight in markets that are rapidly evolving, leveraging our in-depth knowledge and expertise in the energy sector to design thought leadership campaigns to suit your needs.

For more information about us and our services contact us at 01603 604400 or enquiries@cornwall-insight.com

About Complete Strategy

- Complete Strategy help to develop executable strategies and provide actionable advice across the energy and water industries.
- First and foremost, we are energy and water experts. We have a deep understanding of the changing market conditions and policies that market participants, investors, regulators, and policymakers need to navigate.
- We have a diverse network of associates, and alliances with other professional advisory firms. The combined strength of our team, and our network provides our clients with access to a breadth of market intelligence and expertise.

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Executive summary

With the energy crisis squeezing the budgets of households and businesses, an increasing number of customers are struggling to meet their bills, despite the Energy Price Guarantee (EPG) and other forms of support provided by the Government. As millions more people fall into fuel poverty, energy suppliers' bad debt – debt for which most or all of it is considered unrecoverable – is set to rise. Escalating bad debt will put pressure on already razor-thin regulated margins for suppliers, with the potential for it to even exceed overall implied profit allowances for the sector as a whole.

From April 2023, the support provided by the EPG is set to be reduced for typical households and the Energy Bill Relief Scheme (EBRS) for businesses will likely turn into a much more tightly targeted support package for vulnerable businesses, with details set to be announced by 31 December 2022. These changes are only likely to further exacerbate the existing bad debt problems faced by suppliers.

Whilst there are a range of options available to both domestic and non-domestic consumers to help them manage high energy bills and rising debts, the scale of the crisis has the potential to overwhelm the capabilities of suppliers to administer cash flows and recover debts. As a result, suppliers are facing an increasingly challenging financial situation. In the worst case scenario, the elevated levels of bad debt could cause suppliers to exit the market, resulting in increased costs to consumers and thus further exacerbating the cost of living crisis. Suppliers carry the credit risk for the whole value chain, from generator to meter operator, and therefore supplier struggles, and potential exits have knock-on consequences for other areas of the energy market ecosystem.

This report – authored in partnership by Cornwall Insight and Complete Strategy – assesses the issues faced by consumers and suppliers as a result of energy prices that are elevated well above historical levels and discusses the options available for struggling consumers and suppliers in both the domestic and non-domestic sectors to help manage and alleviate the growing threat of bad debt.

Chapter 1: Households and businesses struggling

The steep rise in energy prices since 2021 has seen an increasing number of households pushed into fuel poverty, with National Energy Action[1] estimating 6.7mn UK households will be in fuel poverty this winter, an increase of 2.2mn compared to last winter. This is despite the introduction of the EPG on 8 September 2022[2], which capped unit prices for gas and electricity and resulted in the annual bill for a typical household equalling £2,500 until April 2023, a marked reduction when compared to the £3,549 and £4,279 levels that Ofgem's quarterly price cap would otherwise have been set at for Q422 and Q123, respectively[3]. In April 2023, Government support on energy bills through the EPG is being reduced, with the annual bill for a typical household rising to £3,000. Combined with the end of the Energy Bill Support Scheme (EBSS)[4], this is likely to cause even more households to face financial difficulties because of their energy bills. Whilst the Government has announced that additional financial support will be provided from April 2023 for households with people on benefits or the state pension, the Social Market Foundation calculates that there will be 4.5mn households in fuel poverty but not eligible for this additional support[5].

As discussed in Cornwall Insight's recent insight paper, *Weathering the storm: Mitigating the impact of energy price hikes for businesses*[6], businesses have also been facing the squeeze. Before the introduction of the EBRS, many businesses were unable to renew or access new energy supply contracts and were therefore ending up on higher out-of-contract rates. The EBRS has helped alleviate these concerns, with many suppliers offering short duration (6 month) contracts to businesses that were previously deemed 'uncontractable'. However, from April 2023 the EBRS is likely to turn into a much more tightly targeted support package for the most vulnerable business, with details due to be announced by 31 December 2022. As with the changes in domestic support it is feasible that the removal of widespread support for businesses from April 2023 will leave many without support but still facing high energy costs and difficulties securing long-term contracts.

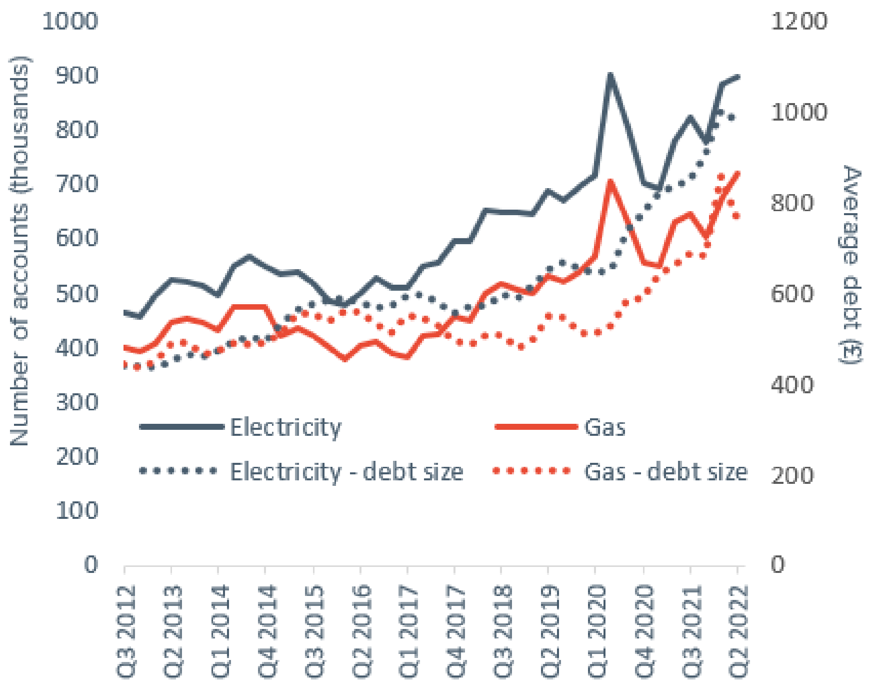
With both domestic and non-domestic consumers struggling with rising energy bills many are faced with difficult personal choices. Even back in January 2022, when the average household energy bill was ~£712 per annum cheaper than today, Citizens Advice identified that many vulnerable households were facing the dilemma between heating or eating[7]. A recent study by the Federation of Small Businesses indicated that a quarter of small firms will have to close, downsize, or radically change their business model when government support is removed in April 2023, with this figure rising to 42% of small firms in the accommodation and food sectors[8]. Energy supplier employees, particularly those running service and help desks, are also increasingly faced with managing very challenging and difficult situations with people who are struggling financially.

1 National Energy Action
2 GOV.UK
3 Ofgem
4 GOV.UK
5 Social Market Foundation
6 Weathering the storm: Mitigating the impact of energy price hikes for businesses
7 Citizens Advice
8 Federation of Small Businesses

Chapter 2: Debt is on the rise

Rising energy prices mean that an increasing number of domestic consumers are finding themselves unable to pay their energy bill and are, as a result, ending up in debt to energy suppliers. Both the number of consumers with no arrangement in place to repay their debt, and the average size of that debt have increased throughout the last decade (Figure 1), with over £1.4bn of domestic consumer debt in Q222 for which there is no arrangement to repay the supplier. Within this debt there will be a certain proportion for which most or all of it is considered unrecoverable, referred to as “bad debt”. In July 2022 eight major suppliers estimated that they would incur £1.3bn of bad debt across 2022-23[9]. This is compared with the much lower levels of £585mn and £522mn of bad debt in 2020-21 and 2021-22, respectively. Since then, energy prices have remained elevated at levels well above the historical average, and so, even with the implementation of the EPG, increased energy consumption and costs over the winter will only exacerbate the bad debt problem for suppliers. Whilst the EPG and EBSS have likely helped alleviate some of the bad debt problem, Cornwall Insight’s recent insight paper, *The Energy Price Guarantee – Counting the costs*[10], indicated that the high costs of these schemes to the Government means that they can’t continue in their current form indefinitely.

Figure 1: Number of domestic accounts with no arrangement in place to repay debt to suppliers and the average size of that debt.



Source: Ofgem Data

9 BEIS Committee Inquiry - Energy pricing and the future of the Energy Market
10 The Energy Price Guarantee - Counting the costs

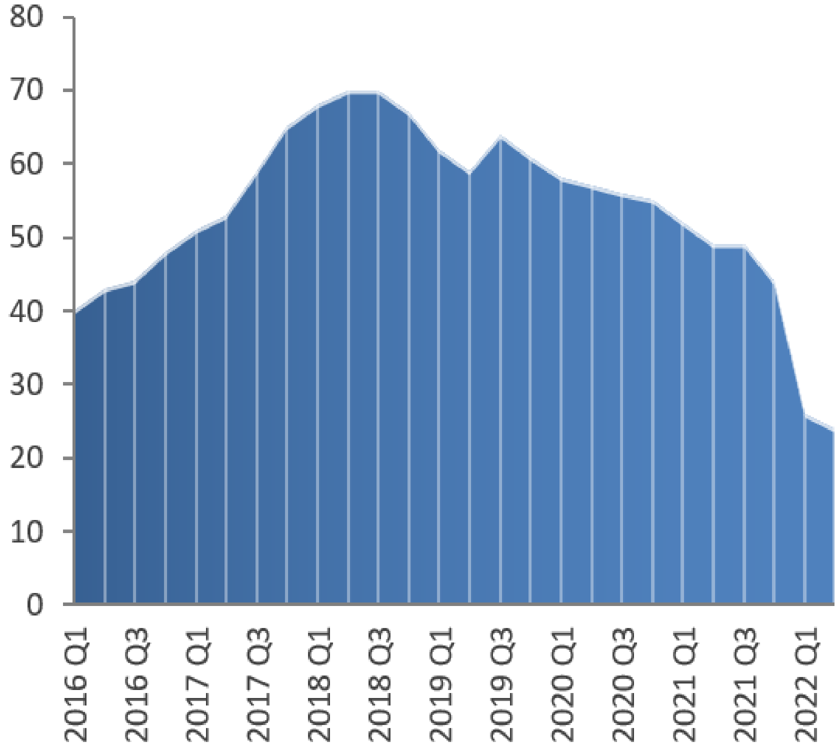
In Ofgem's written evidence to the BEIS Committee Inquiry on Energy Pricing and the future of the Energy Market, it indicated that, in Q122, ~1.9mn domestic consumers were in debt on their electricity bills and ~1.5mn were in debt on their gas bills[11]. Even assuming those two groups fully overlap, that is ~1.9mn households who have faced an average energy bill increase of ~£712 since March 2022, generating an additional ~£1.35bn of potential debt in that period. Adding to this, the End Fuel Poverty Coalition estimate that ~1.6mn customers have entered fuel poverty in the last six months[12]. If only 50% of those experienced equivalent challenges with rising prices, then the debt increase rises to ~£1.9bn. To put this figure into context, suppliers are allowed to make a margin of 1.9%[13] within the average £2,500 EPG supported bill, and so the total implied profit for the market is £1.4bn. Not all this debt will be bad debt but, even under our conservative assumptions, the debt increases expected by suppliers could outweigh the allowed profits they might be able to achieve within the EPG, highlighting the scale of the problem that could be building.

Without recovery of these debts, domestic energy suppliers are increasingly facing the prospect of very challenging financial circumstances, in particular on cashflow. Given the extraordinary costs incurred under special administration for the failure of larger domestic suppliers, such as Bulb, then the additional pressure created by debts should certainly be front and centre in the minds of the regulator as it considers its duties to the consumer. The costs associated with the Supplier of Last Resort (SoLR) process and special administration for exited suppliers will be passed onto consumers, only exacerbating the existing issues around paying for energy. Additionally, if in the worst case elevated levels of debt, and particularly bad debt, caused more suppliers to exit the market, the market runs the risk of no longer being truly competitive (Figure 2). As it stands suppliers are also currently carrying the credit risk for the whole value chain, and so potential supplier failure has knock-on consequences not just for the consumer but for the other market players as well.

On the business side, the more stringent contracting requirements put in place by suppliers, with many suppliers no longer offering new contracts or contract renewals to 'at risk' sectors and companies, reduce the chances of business energy suppliers exiting the market. The credit insurance market is crucial to non-domestic suppliers being able to manage credit risk and the stringent requirements being placed on businesses to access energy contracts are as a result of the need for suppliers to be able to access credit insurance for those customers. There are still suppliers for whom a greater proportion of their customer base are small and medium enterprises (SMEs) or companies in energy intensive sectors (e.g., heavy industry, shipping and aviation), which are potentially more vulnerable to the energy crisis. These suppliers face an increased risk of racking up substantial amounts of debt, especially come April 2023 when the government support for most businesses is due to end.

11 BEIS Committee Inquiry - Energy pricing and the future of the Energy Market
12 End Fuel Poverty Coalition
13 Ofgem

Figure 2: Number of domestic suppliers remaining active in the market



Source: Ofgem Data

Chapter 3: The paths ahead

Given the rate and scale of price increases, there is a clear need to protect customers and both the Government and industry need to do what they can to make sure the most vulnerable are suitably safeguarded. At the same time, suppliers will need to recover the increasing levels of debt they are incurring. In practice, this means that the costs of the bad debt will either need to be carried by the suppliers, by taxpayers or by customers who are in a better position to pay.

It is important that the industry finds a balance in which customer detriment is minimised. Suppliers will need to very carefully walk the tight rope to find the balance of securing their own financial resilience without causing additional harms to their consumers. This is especially true in the domestic sector, where we are already seeing increasing rates of pre-payment meter installation[14], and where disconnection, either voluntarily by the customer or forced by the supplier, can lead to bad outcomes for customers – many of whom will already be struggling in meeting other financial requirements. Concerns over the self-disconnection of vulnerable consumers, where customers stop topping up their pre-payment meter leaving the household without energy, has resulted in the End Fuel Poverty Coalition calling for an immediate ban on the imposition of pre-payment meters on struggling customers[15].

For domestic customers, Ofgem is considering a 'float and true-up approach'[16] as they did to adjust debt-related costs related to the COVID-19 pandemic, but this consultation is currently on hold. Instead, in August 2022 Ofgem stated that "*it is likely the allowance for bad debt in the existing cap methodology adequately covers suppliers' bad debt once the government support package is accounted for*". The same publication indicates that Ofgem will take their time to assess how bad debt is impacting suppliers and then look to act "*[I]f our supplier monitoring indicates that bad debt levels are likely to rise materially and systematically above the price cap allowances.*"[17]

On 25 November 2022, Ofgem announced a proposed package of reforms to both bolster consumer protection and to ensure suppliers are more resilient to market shocks[18]. These proposals include new requirements on levels of supplier capital and new regulations on how suppliers use customer credit balances, as well as a review of the 1.9% profit margin, with a potential move to a variable rate to take into account energy market price changes.

Ofgem's announcements indicate a direction of travel in which they will act to support suppliers, but suppliers need to act now without knowing exactly what Ofgem will do, as the proposed reforms are not due to finalised and published until Spring 2023. It may be assumed that Ofgem will only want to allow suppliers to recover the efficient costs of bad debt. As such, Ofgem could work out who is best at managing it, and

14 Uswitch
15 End Fuel Poverty Coalition
16 Ofgem
17 Ofgem
18 Ofgem

then only adjust the price cap (assuming there is one) to the level implied by the best performance in the market.

If this assumption is correct, suppliers will have to do everything they can now to manage bad debt. But this is not going to be received well by a public which may understandably struggle to see the difference between their supplier and other companies in the broader energy sector that could be making significant profits linked to the price rises.

For domestic consumers currently in debt to energy suppliers, Citizens Advice suggest a range of options to help manage and repay the debt[19]. These include working with suppliers to arrange a payment plan to spread the cost of the debt over a longer period or repaying the debt/paying for current energy usage directly from a consumer's benefits (e.g., Jobseeker's Allowance, Pension Credit, Universal Credit, etc.) through the Fuel Direct Scheme. Additionally, many energy suppliers are already offering a range of grants and schemes to support consumers struggling with debt. However, given the scale of the problem it is not clear whether these debt recovery options will materially impact on the difficulties being faced by both consumers and suppliers, as they do not address the underlying market issues.

In the longer-term, as part of the 2022 Autumn Statement[20], it was announced that the Government would be developing a new approach to protecting consumers from April 2024, including options such as social tariffs. A social tariff is a levy or subsidy-funded reduction in the cost of energy, targeted to give the most support to those least able to pay[21]. Social tariffs are already offered to consumers in the water and telecommunication sectors and help to reduce the number of consumers who are unable to pay and the bad debt that would subsequently be accumulated.

For non-domestic suppliers, there is likely to be less formal support in the long-term from Ofgem or the Government. Customers who are unable to pay are much more likely to be cut-off, with suppliers needing to minimise their exposure to unrecoverable losses. However, disconnecting a business consumer as a result on unpaid debts can still take a supplier over five months, and a business without gas or electricity is unlikely to be able to trade or repay any outstanding amounts owed. Therefore, non-domestic suppliers will not be immune from rising debt levels. An open letter published by Ofgem on 15 November 2022[22] also raised the prospect of a tougher regulatory stance from Ofgem in the future, providing more protections for business customers, and therefore potentially further impacting the ability of non-domestic suppliers to manage debt and bad debt risk.

For non-domestic customers, suppliers may act as a strategic energy advisor. Supporting customers to deploy energy efficiency measures and generation technologies – either through guidance, or financing, or both – presents an opportunity to create a new relationship with their customers, reducing customer propensity to fail to pay by reducing their demand from the grid. Offering such services with financing

19 Citizens Advice
20 GOV.UK
21 Cornwall Insight
22 Ofgem

gives the potential for the supplier to turn a bad-debt risk into a long-term revenue opportunity. However, these measures are unlikely to help businesses in the shorter-term, particularly those facing the cliff edge of extraordinary energy prices when the EBRS is replaced by a more targeted approach in April 2023.

In addition to the working with suppliers on long-term energy generation and efficiency measures, the Business Debtline suggests a series of options for businesses to help deal with high energy bills[23]. These include updating to a smart meter or providing manual meter readings to ensure that bills are based on actual energy usage rather than estimated usage.

While the non-domestic market issues may feel less troubling than those affecting households, we note that there is likely to be considerable knock-on impact if companies are unable to pay their bills. Approximately 550,000 UK companies employ between 5-50 employees[24], i.e. SMEs, which appear to be a group particularly at risk from high energy prices. Additionally, there is an uneven spatial distribution of the most at-risk sectors, with Yorkshire and the Humber, the West Midlands, and the North East identified as the regions of the UK with the greatest economic dependence on vulnerable sectors[25].

If there is a high level of bad debt and subsequent disconnections in vulnerable industry sectors, we could see significant redundancies, focused in areas that have historically been ‘falling behind’ in terms of economic development, forcing the issue of bad debt very much into the media limelight.

A potential option for non-domestic suppliers to reduce the credit risk from out-of-contract customers is to mutualise the risks by imposing a levy that socialises failure risk amongst the entire out-of-contract customer base. By helping suppliers minimise their credit risk, the levy could also be accompanied by a reduction in out-of-contract rates, lowering costs for business customers who have been unable to renew or sign onto a new contract.

Looking at the supplier exits from the market that have occurred in recent years, other than the early exits from suppliers with poor collateral and the hedging squeeze imposed by the Default Tariff Cap, there are no defining operational characteristics to which domestic suppliers have failed. Suppliers of a range of sizes and customer bases have exited the market and the building levels of debt and bad debt are therefore likely to have a destabilising impact across the entire retail market, with no single demographic of suppliers primarily at risk. Forced exits have been far fewer from specialised business energy suppliers, although there have been a number of voluntary moves made by companies to limit the markets in which they will trade.

If rising bad debts lead to business disconnections, or result in actions designed to beef up debt recovery from households being taken by domestic suppliers, then at that stage the temptation will be for commentators to turn their ire on the supplier community. Every case will need to be judged on its own merits. But, if we can already

23 Business Debtline
24 Office for National Statistics
25 Weathering the storm: Mitigating the impact of energy price hikes for businesses

see structurally a plausible scenario where we are heading into an environment of materially elevated bad debt levels, then the onus must be on the supplier community, the regulator, and the Government to develop orderly and proactive steps now, rather than react to a disorderly descent into foreseeable chaos.

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