Household energy: a long-term funding proposal

BRIEFING PAPER

September 2022

SMF Social Market Foundation

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This briefing presents a long-term solution for keeping consumer energy companies afloat through the current crisis while limiting the financial burden on taxpayers, drawing upon the structure of the Brady Plan which helped to successfully resolve the 1980s sovereign debt crisis.

KEY POINTS

- The energy price cap will increase to £3,549 in October, and is set to average £5,519 over the subsequent 12 months – equivalent to a doubling of income tax for the median household.
- With millions of families potentially unable to pay their energy bills, energy providers risk bankruptcy.
- Energy providers' proposal of a price cap freeze and a multi-billion-pound funding facility to keep them afloat is good in principle but requires taxpayers to take on too much of the risk, and asks too little of energy company shareholders.

RECOMMENDATIONS

- A 30-year funding facility for energy companies should be created, secured by collateral assets to encourage bank lending.
- The cost of purchasing the collateral assets should be shared between taxpayers and shareholders in energy providers, on a basis to be negotiated.
- The facility should make loans that could be in place for up to 30 years, reflecting the fact it may take decades for providers to recoup (through household bills) the subsidy implicit in an artificially low cap.

BACKGROUND

Over the last year, the wholesale price of gas has increased by 260% (and elevenfold since 2019) and electricity prices have doubled (over 40% of the UK's electricity comes from burning gas). Consequently, the recently announced 80% rise in the energy price cap[i], to £3,549, effective for three months from October, is no surprise.

The causes of rising prices are well-reported, and like almost all crises their origins lie in multiple independent events materialising in close succession. The two big shocks are the post-lockdown rebound in demand, and the restrictions on Russian gas exports to Europe following its invasion of Ukraine.

That the UK imports minimal gas from Russia does not shield us from rising prices because we compete against other nations in a supply-restricted global gas market. Other contributing causes include a situation particular to France, ordinarily the world's largest net exporter of electricity (including to the UK). However, this winter France's electricity output is expected to be 25% below normal because more than half of its 56 nuclear reactors are shut for maintenance; as a result, France will be having to buy electricity on wholesale markets.

Some 24 million British households on default energy tariffs are exposed to the price cap (including around 4.5 million pre-payment meter customers); about 85% of the population. However, they are rapidly being joined by the few million currently on fixed-rate tariffs which are expiring and are unlikely to be replaced.

Meanwhile, the cap is widely misunderstood, hindering clear communication. Total bills are not capped because the cap only applies to daily standing charges and the energy price per kWh. It does not take into account the amount of energy consumed which is, of course, a variable controlled by the user.

This briefing is only focused on the highly politically sensitive retail (household) energy consumers. It does not consider the plight of Britain's energy-consuming industries, which account for roughly half of national energy spending. That said, industry faces similar issues, and a similar solution to the one outlined here could be extended to businesses.

[i] The energy price cap is based on Ofgem's estimate of the average dual-fuel consumption of households on a default energy tariff, and includes VAT. Ofgem's Typical Domestic Consumption Values (TDCV) are 2,900kWh of electricity, 12,000kWh of gas, and 4,200kWh of electricity for Economy 7. For those paying by direct debit (i.e. most households), the unit rates of the two components of the cap are, from October, as follows:

	Electricity	Gas
Standing charge per day	46p	28p
Energy price per kWh	52p	15p

Almost all the recent increase in the cap related to the energy price component (previously 28p per kWh for electricity, 7p per kWh for gas). The cap is set slightly higher for prepayment meter customers (who are often the most vulnerable, and already in fuel poverty).

CASHFLOW CRISES: IMMINENT

For the year to October 2022 the price cap averaged £1,624.[ii] Last month, it was announced that it will rise to £3,549 in October 2022, and it is now expected to average £5,519 over the subsequent 12 months to October 2023.[iii] This £3,895 leap will deliver an extremely brutal shock to household budgets; it is equivalent, in cash terms, to a more than doubling of the basic rate of income tax, to 41%, for a household with median disposable income (£31,400). The impact will be widespread and devastating because millions lack adequate savings to see them through the winter.

The cashflow problem confronting households will rapidly become the energy providers' problem, because without cash from customers, they will not be able to pay for the gas and electricity they buy from the wholesale markets. Indeed, without huge financial assistance, many – perhaps all – providers will quickly go bankrupt, sunk by millions of defaulting customers (including misguided adherents of the "Don't Pay UK" campaign).

The Government is under growing political pressure, and the energy providers are fast becoming credit-lending institutions. They could, of course, cut off energy supplies, but that would only invite further public opprobrium, and further politicisation.

STATE SUPPORT: WOEFULLY INADEQUATE

In May 2022, the Government announced that almost all of the eight million most vulnerable households across the UK will receive support of up to £1,200 this year, including a new one-off £650 cost of living payment.[iv] This pales into insignificance when compared to the aforementioned average £3,895 increase in the price cap expected over the next year. Indeed, the scale of the total additional funding requirement is staggering; the nation's households are likely to have to find in excess of an extra £90 billion *just for the next year* (and this is after deducting the former Chancellor's commitment to cut £400 from every bill).

[ii] As £1,277 from October 2021, then £1,971 from April 2022.

[iii] The £5,519 figure for the year from October 2022 is calculated using £3,549 for the final quarter of 2022, and then the average of two recent price cap forecasts for the first three quarters of 2023: Cornwall Insight's £5,387, £6,616, and £5,897, and Auxilione's £5,405, £7,263, and £6,485. Both forecasters suggest that the cap will then start to reduce, from October 2023, to £5,887 (Cornwall) and £6,006 (Auxilione).

[iv] As at end-August 2022, the government's support package comprises:

- an Energy Bills Support Scheme applying to all households, as a £400 non-repayable discount on energy bills, from October;
- a £150 Warm Homes Discount will begin to be paid to 3 million low-income households, from October; and
- further support for households most in need, to include:
  - £650 one-off Cost of Living Payment for around 8 million households on means tested benefits;
  - a one-off £300 Pensioner Cost of Living Payment for over 8 million pensioner households to be paid alongside the Winter Fuel Payment;
  - a payment of £150 for around six million people across the UK who receive certain disability benefits; and
  - a £500 million increase and extension of the Household Support Fund.

Admittedly, this is a guesstimate incorporating underlying assumptions for average household energy consumption and standing charges over the next year, but the figure still commands attention. And what will happen beyond Q4 of 2023? The Government has acknowledged that more support is required, but it has yet to produce a plan.

THE ENERGY PROVIDERS' PROPOSAL

Given the energy providers' perilous position, some of them have proposed that a state-backed funding facility be made available to them, with customer bills frozen at the previous price cap (£1,971) for two years. Less clear is who will provide the cash (the providers blithely suggest banks); how and when it will be repaid (the providers say, with self-serving vagueness, that it would be repaid over ten to 15 years via a surcharge on bills, or taxation); and where the credit risk ultimately resides.

That said, combining a price cap freeze with a new funding facility has merit because it limits the number of stakeholders needing to communicate with one another. It only requires a deal to be agreed between the Government, a few banks and the energy providers. Any alternative "retail" approach, such as providing additional funding to many millions of individual households through the benefits system, risks communications mayhem as well as confrontation between providers and millions of customers threatening to default on their bills.

One weakness in the proposal is that the banks are unlikely to provide cash to a vast funding facility when the source of repayment is so unclear. The facility would be fraught with unquantifiable energy market price risk, credit risk on the borrowing energy providers and, perhaps worst of all, political risk. Potential lenders could seek to offset risk by charging very high interest rates on any facility drawings, but this would invite a PR disaster.

Forecasters suggest that the price cap will slowly start to fall after October 2023, but this seems to be wishful thinking rather than evidence-based judgement. And even if energy prices "normalise" within five years, say, it may take decades for some energy providers to fully repay their facility drawings, reflecting the likely timeframe required for them to recoup (through household bills) the subsidy implicit in any artificially low price cap.

So, to be clear, this would not be a short-term facility, and any lenders would likely be exposed to the whims of several different governments. One (or more) of them may, for example, retrospectively seek to change the terms of repayment, perhaps in response to pressure from vocal consumer groups. Like energy, trust in government is in short supply.

In its current form, the providers' proposal is a financial bridge to nowhere. So what to do?

GUIDING PRINCIPLES

Whatever the final structure, it needs to:

(i) shield households from the reality of energy market prices (thereby removing the providers' exposure to consumer default risk). Note that this can only ever be a temporary arrangement;
(ii) be commensurate in scale with the cashflow required by providers to continue buying energy from the wholesale markets;
(iii) be very long term, to provide sufficient time to thinly spread, within household bills, repayment of the cost of the nearer-term shielding from market prices;
(iv) be operationally simple enough to facilitate rapid implementation; and
(v) not invite moral hazard, i.e. households should remain under pressure to cut energy consumption.

One structural challenge is that it will have to be flexible enough to accommodate the uncertainty of future energy prices without introducing risks that would prove unacceptable to potential private sector lenders.

THE PROVIDERS SHOULD SHARE THE PAIN

An entirely public sector-funded solution which ignores market conditions would highlight the ambiguity inherent in private sector delivery of what many consider to be a public (utility) service. This could invite renationalisation of the providers, although a change of ownership would achieve nothing in the short term. Indeed, the providers' share prices suggest there is an expectation that the government will step in and assume some risk, but another guiding principle should be "shared pain, shared gain" amongst shareholders and taxpayers. A public-private sector solution is required.

AN HISTORICAL PRECEDENT: THE BRADY PLAN

The Brady Plan helped to successfully resolve the sovereign debt crisis that accumulated during the 1980s.[v] Under the Plan, the banks provided long-term repayment rescheduling and debt relief in exchange for $160 billion of marketable securities with 30-year maturities (over $370 billion in today's money). Principal repayment was secured on pledges of zero-coupon US, UK and Japanese government bonds, held in escrow. This collateral was purchased by the creditor countries using cash given to them by the International Monetary Fund and World Bank, plus some of their own foreign currency reserves.

Given the high credit quality of the collateral assets, the banks were as certain of repayment as they could ever be (albeit 30 years hence). Consequently, the capital they required to support their assets was minimal, and the tradable nature of the bonds offered them the option of removing the debt from their balance sheets. In addition, the issuing countries benefited from flexibility provided by the incorporation of call features in the bonds, so that as their economies recovered they could redeem them

[v] The principles of the Brady Plan, designed to address the so-called Lesser Developed Countries (LDC) debt crisis of the 1980s, were first articulated in 1989 by U.S. Treasury Secretary Nicholas F. Brady.

early (and almost all of them did this). This enabled them to take back possession of the collateral assets, which could then be sold for cash.

AN ENHANCED PROPOSAL

Notwithstanding the recent announcement to increase the price cap, it is not too late to change tack and freeze it – as an integral part of a new funding arrangement for the energy providers. However, as the beneficiaries of the facility, they should be required to provide the lending banks with some form of high quality security, perhaps in the style of the Brady Plan. A collateral portfolio of 30-year zero-coupon gilts bought directly from the Treasury could be accumulated over the next few years in step with rising drawings from the facility.

The interest rate payable on facility drawings would have to be negotiated, but a sub-market rate would represent a subsidy to the energy providers, to the detriment of the lending banks. That said, with principal repayments assured, the rate should be low, and it could be even lower if some additional security were provided. The securities that emerged from the Brady Plan provided interest cover on a 12-24 month rolling basis, secured by a pledge of high-grade investment securities purchased by the debtor countries.

The Government could simply decide to fund the energy providers directly, but this would have a deleterious impact on the national accounts and the debt/GDP ratio. Given that the Treasury budget is already under pulverising pressure, and the banks are currently awash with cheap deposits that need deploying, a facility as described makes sense.

WHO WOULD PAY FOR THE COLLATERAL ASSETS?

The cost of purchasing the collateral assets should be shared between the energy providers (acting on behalf of shareholders) and the Treasury (taxpayers), on a basis to be negotiated. 30-year zero coupon gilts would cost approximately 42% of face value based on the current 30-year gilts yield of 2.95%.

This should be seen as the providers' contribution to taxpayers, in return for access to the funding facility that is essential for them to avoid bankruptcy. Consideration could include the Treasury receiving equity stakes in the providers, which subsequently could be sold off.

Alternatively, the Treasury may prefer to offer an unfunded Crown guarantee on facility drawings, rather than to issue gilts, in return for a fee from the energy providers. Guarantees could then be embedded in marketable securities if the banks insisted on holding readily saleable "liquid" assets rather than facility drawings, potentially an important consideration to ease banks' future lending capacity constraints.

CONCLUSION

The purpose of the proposed price cap freeze and funding facility is to buy time for households over which to spread their energy bills, but uncertainty abounds. Consequently, any facility structure needs to be flexible; a two-year price cap freeze, for example, may prove to be too short, so it would be prudent to incorporate an annual review process. And while a 30-year funding facility may seem too long, it would be better to secure too much time rather than not enough, and to retain the structural flexibility to terminate the facility early.

The Brady Plan dealt with existing debt, whereas today we are faced with two future (albeit imminent) debt crises, in respect of millions of households and the energy providers. There are some commonalities – in terms of financial scale, the timeframe required for resolution, and the need to collateralise risk – to encourage banks' participation.

Whatever the eventual funding structure adopted, it must incentivise less energy consumption, not only to save money but to also help ensure that there is sufficient energy available for those who need it most. Bold and imaginative leadership is required but, failing that, debt-inspired misery beckons for millions, probably accompanied by power blackouts. Meanwhile, we are engaged in a war with Russia through the proxy of energy prices.

In periods of crises, like those we find in wartime, it is critical that risks and burdens are shared equitably. The plans on the table for funding energy providers through the current price spike do not achieve such fairness. Policymakers are capable of doing better, as they demonstrated with the Brady Plan. The incoming government should take its inspiration from that example, and pull together a funding facility that requires providers to put up their own capital to crowd in bank lending, and lasts the full three decades it may take to unwind this crisis.