National Energy Action (NEA) response to Ofgem's Call for Evidence on Levelising Payment Method Cost Differentials

About National Energy Action (NEA)

NEA[1] works across England, Wales, and Northern Ireland to ensure that everyone in the UK[2] can afford to live in a warm, dry home. To achieve this, we aim to improve access to energy and debt advice, provide training, support energy efficiency policies, local projects and co-ordinate other related services which can help change lives.

Background to this response

Since the creation of the price cap, and the integration of the safeguard tariff into the default tariff price cap, NEA consistently advocated for the different payment types to be levelized within the cap methodology. Historically, our focus has been on the premium faced by prepayment users, which before the pandemic, was the larger differential. While NEA has welcomed efforts to reduce this differential through modifications to the price cap methodology (most notably on the allocation of debt costs), this has come at the cost of a widening differential for households that pay by standard credit.

These differentials are important to address. Prepayment users are more likely to be fuel poor, more likely to have a very low income, and more likely to be disabled, be a single parent, and have multiple vulnerabilities when compared to the average customer. When compared to direct debit users, households using standard credit are more likely to be fuel poor, more likely to be a single parent, more likely to have a lower income and much more likely to be elderly.[3]

We were pleased that in the Spring Budget of 2023[4], the UK Government made a commitment to "removing the premium paid by over 4 million households using prepayment meters (PPM),52 bringing their charges into line with comparable direct debit customers until the EPG ends and saving them an average of £45 a year", and to "ensure the PPM premium is ended on a permanent basis". NEA supports this work and understands that while the UK Government will take action itself to end the premium in the short term, there is an expectation that Ofgem will end the premium from April 2024. This must be a priority for the package of work described in this Call for Evidence, alongside reducing, or eliminating, the differential that exists for standard credit users.

We are overall pleased that Ofgem is undertaking this work, and that a range of options are being considered that eliminate the prepayment premium, and reduce, or eliminate entirely, the standard credit premium. We hope that it will result in reducing a significant unfairness in the energy market.

Summary of Our Response

NEA is pleased that Ofgem is considering ways through which the payment differentials can be reduced in the energy market. We believe that within this work there are three areas that require significant consideration from the point of view of fuel poor and vulnerable households:

- Price differentials create unfairness in the market that have a significant impact on vulnerable customers.
- Ofgem should look to be ambitious in its work to reduce the premiums, but pragmatic options exist to make significant improvements to the current market.
- Application of price differential reduction should be universal in nature to avoid vulnerable households from missing out.

Each of these issues is addressed in turn below.

Price differentials create unfairness in the market that have a significant impact on vulnerable customers.

In the current price cap period (April – July 2023), there are significant price differentials between payment types in the energy market. Prepayment customers pay on average ~£40 more than direct debit customers on an annual basis for their energy. The figure for those who pay by standard credit is ~£200.

Both prepayment customers and those that pay by standard credit are more likely to be vulnerable across a number of metrics[5], including:

- Having a lower income
- Being more likely to be fuel poor
- Being more likely to be a single parent.

The reason for this is because, for the most part, households often use these methods because they have some level of financial vulnerability. For example, a household may have been forcibly moved onto a prepayment meter because they cannot afford their bills. Or a household may have moved onto standard credit, because their monthly direct debit is simply unachievable. A household may also be using standard credit because they do not feel comfortable giving control of their bank account to a third party through the direct debit system. Penalising these households, which are financially vulnerable, through price differentials, essentially amounts to adding to their costs as a direct result of their vulnerability. This is unfair. Ofgem has a statutory duty to consider the needs of vulnerable households. It is imperative that it uses its power to protect these households from unfairness in the market, not to extend unfair outcomes towards them.

Additional to this overall unfairness, there is a specific level of unfairness that comes from the allocation of debt related costs in the price cap. Currently, these costs are allocated based on which payment types are most likely to incur them. This is counter-productive – putting more costs on those households that are least able to afford their energy in the first place. Placing an additional burden on the most financially vulnerable households leads to increasing their financial vulnerability and increasing their debt risk.

Using this technique is also particularly unfair for those households that use standard credit, but do not cause a debt related cost for suppliers. Many standard credit customers use this payment method out because of a lack of confidence with online banking and direct debit, not because they have payment difficulties. The current system penalises them for little reason.

Lastly, one stated reason for differentials is to provide a price signal to move households towards direct debit. Since 2020, the payment differential between standard credit and direct debit has grown substantially, from £85[6] to more than £200. However, the number of households using standard credit has simultaneously grown in that period[7]. This shows that price is not a factor in payment method. NEA also contends that smart prepay is currently the most economic payment method for suppliers, and ~50% of prepay customers use smart meters. The best ways to improve the efficiency of the market are to:

- Increase the proportion of households that use direct debit through ensure that financially vulnerable households can afford energy. The current system makes energy more expensive if you are having difficulties with regular payments and move/are moved to standard credit.
- Accelerate the smart rollout for prepayment customers.

In order to address these issues, the differentials for prepayment users must be eliminated and standard credit users must see a significant reduction in their differential.

Ofgem should look to be ambitious in its work to reduce the premiums, but pragmatic options exist to make significant improvements to the current market.

NEA is pleased that there is a diverse array of options set out in the paper, and that there is a significant amount of distributional analysis presented. This helps NEA and other stakeholders to make informed decisions about our option preference.

Our preference order has been determined through three metrics to judge options on:

- Maintaining (or improving) the cost advantage of PPM aver UNC 0840 has been implemented.
- Reducing the differential for standard credit customers as far as possible
- Reducing standing charges for prepayment customers (where standing charges have the most negative impact due to the prevalence of rationing and self-disconnection). A rationale for reducing standing charges for prepayment users has been set out by Ideal Economics[8]

Overall, NEA believes that Ofgem should take an ambitious approach to levelisation. As discussed above, differentials create a significant unfairness in the market, and this opportunity should be taken to address this as far as possible. Therefore, **NEA's primary recommendation is that option 4 would provide the best outcomes, in terms of fairness, for vulnerable energy consumers.**

We do realise, however, that a balance must be struck, and there will be concerns about any impacts for fuel poor and vulnerable direct debit customers. While NEA does prefer the more ambitious options, these are valid concerns. **We therefore have a secondary recommendation, that option 2 would have significantly positive outcomes for prepay users, through a reduction in the standing charge and overall improvement for the group.** It would also reduce the burden of debt costs placed on standard credit users, reducing a significant unfairness in the market.

Application of price differential reduction should be universal in nature to avoid vulnerable households from missing out

The options set out by Ofgem in the call for evidence look to resolve unfairness in the market in terms of how costs are allocated. In other areas where market fairness is the primary goal, a universal approach is taken to ensure that all households receive fair treatment in the market – for example through the default tariff price cap.

Additionally, there are significant numbers of customers that face detriment from price determinants that may not found by data matching, if a targeted route were opted for. In particular, older people, who are more likely use standard credit, many of whom qualify for pension credit but do not receive it, are at risk of missing out on this vital protection, regardless of its benefit to them. **NEA therefore recommends that the application of a price differential reduction should be universal in nature.**

Answers to the Call for Evidence

Question 1: What do you think the objectives of levelisation should be (eg, full levelisation across payment methods, partial levelisation, anything else)?

NEA believes that there should be several objectives for this work.

Primarily, there is a need to improve fairness in the market.

In the current price cap period (April – July 2023), there are significant price differentials between payment types in the energy market. Prepayment customers pay on average ~£40 more than direct debit customers on an annual basis for their energy. The figure for those who pay by standard credit is ~£200.

Both prepayment customers and those that pay by standard credit are more likely to be vulnerable across a number of metrics, including:

- Having a lower income
- Being more likely to be fuel poor
- Being more likely to be a single parent.

The reason for this is because, for the most part, households often use these methods because they have some level of financial vulnerability. For example, a household may have been forcibly moved onto a prepayment meter because they cannot afford their bills. Or a household may have moved onto standard credit, because their monthly direct debit is simply unachievable. A household may also be using standard credit because they do not feel comfortable giving control of their bank account to a third party through the direct debit system. Penalising these households, who are financially vulnerable, through price differentials, essentially amounts to adding to their costs as a direct result of their vulnerability. This is unfair. Ofgem has a statutory duty to consider the needs of vulnerable households. It is imperative that it uses its power to protect these households from unfairness in the market, not to extend unfair outcomes towards them.

Additional to this overall unfairness, there is a specific level of unfairness that comes from the allocation of debt related costs in the price cap. Currently, these costs are allocated based on which payment types are most likely to incur them. This is counter-productive – putting more costs on those households that are least able to afford their energy in the first place. Placing an additional burden on the most financially vulnerable households leads to increasing their financial vulnerability and increasing their debt risk.

Using this technique is also particularly unfair for those households that use standard credit, but do not cause a debt related cost for suppliers. Many standard credit customers use this payment method out because of a lack of confidence with online banking and direct debt, not because they have payment difficulties. The current system penalises them for little reason.

Lastly, one stated reason for differentials is to provide a price signal to move households towards direct debit. Since 2020, the payment differential between standard credit and direct debit has grown substantially, from £85[9] to more than £200. However, the number of households using standard credit has simultaneously grown in that period[10]. This shows that price is not a factor in payment method. The best way to improve the proportion of households that use direct debit is to ensure that financially vulnerable households can afford energy. The current system makes energy more expensive if you are having difficulties with regular payments and move/are moved to standard credit.

Additionally, there is a need to follow through with the commitments that the UK Government made in the recent Spring Budget to "removing the premium paid by over 4 million households using prepayment meters (PPM),52 bringing their charges into line with comparable direct debit customers until the EPG ends and saving them an average of £45 a year", and to "ensure the PPM premium is ended on a permanent basis"

Based on these two elements, overall, this piece of work should look to reduce the differentials for prepayment users and for those who pay by standard credit as far as is possible. Reducing the SC/DD differential as far as practicable.

Question 2: Should we only focus on PPM levelisation or should we also consider SC?

No.

As stated in our answer to question 1, there are considerable fairness issues that arise from the differential for standard credit users. This must be resolved in this piece of work, as well as achieving PPM levelisation.

Question 3: If SC is included in levelisation, should some degree of price difference remain, whereby SC is higher than DD to maintain an incentive for customers to go on DD?

No.

While NEA understands that some degree of difference may remain for standard credit users after implementation, the purpose of this differential should not be to provide an incentive to move to direct debit.

Since 2020, the payment differential between standard credit and direct debit has grown substantially, from x to y. However, the number of households using standard credit has grown in that period two. This shows that price is not a factor in payment method. The best way to improve the proportion of households that use direct debit is to ensure that financially vulnerable households can afford energy. The current system makes energy more expensive if you are having difficulties with regular payments and move/are moved to standard credit.

Question 4: After considering the different levelisation options presented (charge type, individual elements of the price cap, extent to which levelisation should occur), are there any further levelisation options that you think should be considered?

Yes, NEA believes that all reasonable options have been covered.

Question 5: Can you provide any evidence on why one levelisation option should be preferred over another?

NEA is pleased that there is a diverse array of options set out in the paper, and that there is a significant amount of distributional analysis presented. This helps NEA and other stakeholders to make informed decisions about our option preference.

Our preference order has been determined through three metrics to judge options on:

- Maintaining (or improving) the cost advantage of PPM aver UNC 0840 has been implemented.
- Reducing the differential for standard credit customers as far as possible.
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Overall, NEA believes that Ofgem should take an ambitious approach to levelisation. As discussed above, differentials create a significant unfairness in the market, and this opportunity should be taken to address this as far as possible. Therefore, NEA's primary recommendation is that option 4 would provide the best outcomes, in terms of fairness, for vulnerable energy consumers.

We do realise, however, that a balance must be struck, and there will be concerns about any impacts for fuel poor and vulnerable direct debit customers. While NEA does prefer the more ambitious options, these are valid concerns. We therefore have a secondary recommendation, that option 2 would have significantly positive outcomes for prepay users, through a reduction in the standing charge and overall improvement for the group. It would also reduce the burden of debt costs placed on standard credit users, reducing a significant unfairness in the market.

Question 6: Can you provide any evidence of levelisation effects that should be avoided that have not been shown within our analysis?

No

Question 7: What are your views on targeting levelisation to particular groups of customers within payment methods (eg customers under the price cap or in vulnerable situations)? Do you have evidence to support your views?

The options set out by Ofgem in the call for evidence look to resolve unfairness in the market in terms of how costs are allocated. In other areas where market fairness is the primary goal, a universal approach is taken to ensure that all households receive fair treatment in the market – for example through the default tariff price cap.

Additionally, there are significant numbers of customers that face detriment from price determinants that may not found by data matching, if a targeted route were opted for. In particular, older people, who are more likely use standard credit, many of whom qualify for pension credit but do not receive it, are at risk of missing out on this vital protection, regardless of its benefit to them. NEA therefore recommends that the application of a price differential reduction should be universal in nature.

Question 9: Do you agree with our characterisation of the effects on competition? Can you explain why or why not?

NA

Question 10: Are there any additional impacts on competition or other areas that we should consider? Can you provide evidence of these?

NA

Question 11: Do you agree with our assessment on market competition and incentives? Can you explain why or why not?

No. There are several parts of the assessment that we do not agree with:

- NEA's own experience is that households that area able, and confident to use direct debit as a payment method are more likely to use that route if it works best for them, regardless of the price. The market should be designed to all households to use the payment type that suits them best, not what is most efficient for the market. Consumer choice is prioritised in other parts of the market, and it should be prioritised in this aspect too.

- While it can be contended that legacy prepayment is a more expensive payment type, Smart PPM is more cost efficient than direct debit, and this is a growing group (half of PPM customers have a smart meter). Therefore, reducing costs for PPM customers is not necessary a bad thing for market efficiency.
- For legacy prepayment, the CMA concluded in their Energy Market Investigation[11] that there was minimal competition, and that competition would require the smart rollout as a pre-requisite. This, coupled with the fact that smart prepay is the most efficient payment method, shows there is little negative impact on market competition/incentives on the PPM side.

We do however, with the positive impact that is posited around 'anchoring', and this should be considered a benefit of levelisation.

NEA would value levelisation across fixed deals in order to ensure universality as per our response to question 7 above.

Question 12: Are there any other impacts on your organisation or the market that we have not considered?

NA

Question 13: If costs are not reconciled, what would the impact of payment method levelisation be on your organisation, where relevant?

NA

Question 14: Do you consider that the costs of levelisation should be reconciled between suppliers? What are your views on the reconciliation mechanisms presented?

NA

Question 15: Are there any other reconciliation mechanisms that you think we should consider that we have not discussed?

NA

Question 16: Is there anything else Ofgem should consider with regards to levelising costs across payment methods?

NA

References and Notes

[1] For more information visit: www.nea.org.uk.

[2] NEA also work alongside our sister charity Energy Action Scotland (EAS) to ensure we collectively have a UK wider reach.

[3] CMA Energy Market Investigation Appendix 9.9 – Prepayment, CMA, 2016

[4] Spring Budget 2023, HMT, 2023

[5] CMA Energy Market Investigation Appendix 9.9 – Prepayment, CMA, 2016

[6] Default Tariff Cap Level Model April 2020, Ofgem, 2020

[7] English Fuel Poverty Statistics, DESNZ, 2023

[8] Reforming Standing Charges for Prepayment Customers, Ideal Economics, 2023

[9] Default Tariff Cap Level Model April 2020, Ofgem, 2020

[10] English Fuel Poverty Statistics, DESNZ, 2023

[11] CMA Energy Market Investigation Appendix 9.9 – Prepayment, CMA, 2016