



Response to Ofgem

About Fair By Design

Fair By Design is dedicated to reshaping essential services such as energy, credit, insurance and payments so that they don't cost more if you're living in poverty – also known as the poverty premium. Fair By Design collaborates with regulators, government and industry to design out the poverty premium. Our Venture Fund provides capital/funding to grow new scalable ventures to innovate the market and design out the poverty premium. Ascension manages the Fair By Design Fund. Fair By Design is managed by the Barrow Cadbury Trust on behalf of a group of foundations.

In the context of the energy market, we believe that households on low incomes/living in poverty should not incur a poverty premium based on not being an “active” consumer or due to the way they pay for their energy.

Please note that we consent to public disclosure of this response.

For more information about this response please contact Maria Booker:

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Background


Ofgem is reviewing operating cost allowances for the first time since the energy price cap was introduced in 2019. Operating costs are an energy supplier's own costs for retailing energy and include the costs of running call centres, IT costs and costs associated with customer debt. They do not include the costs of buying energy, policy costs i.e. the costs of government social and environmental schemes or costs to fix and repair cables.

Ofgem is proposing to update the current operating cost allowance structure and to offer four allowances:

- Core operating cost allowance
- Debt-related cost allowance
- Smart metering net cost Change (SMNCC) allowance
- Industry charge allowance

Fair By Design's response

Approach to benchmarking

 We have no comments on Ofgem's approach to benchmarking. We support an approach that balances the need to ensure consumers pay a fair price for their energy, with the need to ensure stability in the market and the ability for suppliers to invest in things such as better customer service and the transition to net zero, which will ultimately benefit all consumers.

Approach to allocating costs across payment methods (p21)

We disagree with Ofgem's position on retaining the standard credit premium in line with today's levels and would like to see this premium eliminated. Fair By Design would like to see the link broken between the debt-related costs suppliers can recover and what they are allowed to charge consumers for using different payment methods.

There are two main reasons why Ofgem's approach to debt related costs does not work.

1) Payment method premiums are not cost reflective

Firstly, Ofgem acknowledges that while it aims for cost reflectivity, in practice, there is only a very loose relationship between the cost to serve an individual customer and the costs allocated to the payment method they use. On page 21 of the consultation document, Ofgem acknowledges that "while certain costs are inherently linked to the specific nature of the payment method, the majority are not, and many costs have considerable variation within the payment method". Ofgem goes on to note that "within Standard Credit customers, customers who pay their bills promptly present a vastly different cost profile compared to customers who fall into arrears or do not pay at all." Indeed, in its consultation document issued in May last year Ofgem acknowledged that differences in the way data is collected by suppliers and customer movement between payment methods makes it difficult to accurately allocate costs between payment methods.

In addition, the current consultation acknowledges that PPM customers are the most costly to serve (based on Ofgem's assumption of a mix of traditional and smart meters in 2023, the baseline year) yet they are largely protected from these costs due to Ofgem's levelisation intervention. We welcome this protection, but it does represent a move away from cost reflectivity.

Ofgem itself recognises that "we do not consider it to be the case that the average amount of debt-related costs suppliers report on each payment method is "cost reflective" of the cost to serve a typical (e.g. median or mode) customer on that payment method." Ofgem sets out the

perverse incentives that might result from increasing the standard credit premium further and therefore proposes keeping the standard credit premium as it is.

Again, we welcome Ofgem's decision not to increase the standard credit premium further, but the middle ground Ofgem seems to have settled upon seems to lack any claim to be cost reflective or to follow any other economic rationale.

Finally, the introduction of variable recurring payments this year (which is not mentioned at all in this document), will take Ofgem even further away from cost reflectivity. We believe it is time for Ofgem to acknowledge that it is not possible to accurately allocate costs in a fair, cost reflective way, and that costs of different payment methods should be socialised to ensure that consumers can access a wide variety of payment method that meet their needs. Fair By Design's recent report into flexibility in payments¹ recommended that Ofgem "should encourage suppliers to offer flexible payment methods and investigate and remove any regulatory barriers (if any) to this happening." Ofwat's "Paying Fair" guidance² sets a helpful precedent.

2) There is little evidence that maintaining a standard credit premium encourages switching to direct debit

Ofgem seeks to argue once again in this consultation document that a reason to maintain a standard credit premium is that it "will continue to incentivise both customers and suppliers to opt for lower cost-to-serve options, reducing overall costs". However, we do not see much evidence that this theory of change works in practice.

Ofgem's own consumer research³ shows that less than half (43%) of people on standard credit are even aware that it is more expensive than direct debit. Furthermore, our own focus groups have shown that even when people are aware of a premium, they often think it will be a small premium to cover printing and posting a paper bill, not a significant additional cost (£112 in total for the period Oct-Dec 2024 under the price cap). And if consumers aren't aware of the premium, or the size of the premium, they can't make an informed choice to choose a different payment method.

Fair By Design is organising a workshop with energy suppliers via Energy UK to establish what more could be done to make the standard credit premium transparent. But as things stand it is

¹ Fair By Design (2024), Flexible payments: understanding payment needs in low-income households. Available at: [Payments - Fair By Design](#)

² Ofwat (2022), Paying Fair – guidelines for water companies in supporting residential customers pay their bill, access help and repay debts. Available at: [Paying-fair---guidelines-for-water-companies-in-supporting-residential-customers-pay-their-bill-access-help-and-repay-debts.pdf](#)

³ Ofgem (2024), Consumer Impacts of Market Conditions survey - Wave 5: [Consumer impacts of market conditions survey: wave 5 \(January to February 2024\) | Ofgem](#)

not in consumers' interests to have a premium imposed on them that they don't expect and that most people affected aren't even aware of.

Whether due to lack of awareness or for other reasons, there is little evidence that the size of the standard credit premium drives choice of payment method. The University of Bristol calculated the standard credit premium to be £76 in 2016⁴, increasing to £206 in 2022⁵. Yet this rapid and dramatic increase of the premium has not been reflected the trend of payment method choice. The use of standard credit has been steadily declining since the 1990s, matched by a corresponding steady increase in the use of direct debit (aside from a 1% upturn in use of standard credit in 2021 which was not sustained, and went in the opposite direction to the one Ofgem's "incentivisation" theory predicts)⁶.

Use of data (p22)

We support Ofgem's approach of only using supplier's data where the supplier has over 100,000 customers on each payment method relevant to a differential. We note that this results in a significantly lower standard credit premium for core operating costs (£38 as opposed to £54).

Levelisation of debt costs (p24)

We are disappointed by Ofgem's decision not to proceed with levelisation of debt allowances between standard credit and direct debit. There is a good theoretical case for levelising debt allowances i.e. that all consumers who are capable of generating debt should contribute equally to debt-related costs. We do not think it is fair that individual customers who pay on time should not have to bear the additional costs created by people who pay in the same way as them, rather than by all people capable of creating debt, particularly as this group contains a significant proportion of fuel poor households (21.3% of fuel poor households pay by standard credit compared to 25.3% who pay by pre-payment meter and 10.8% who pay by direct debit)⁷.

Our preference is for Ofgem to proceed with levelisation of debt allowances in parallel to implementing the Debt Strategy. We would be keen to see more detail on the feasibility

⁴ Sara Davies, Andrea Finney and Yvette Hartfree, University of Bristol, (2016), Paying to be poor: Costing Methodology Appendix . Available at: [Paying to be poor](#)

⁵ Sara Davies, Jamie Evans, University of Bristol, (2022), The poverty premium in 2022. Available at: [The poverty premium in 2022 - Progress and problems](#)

⁶ Department for Energy Security and Net Zero (2024), Average annual domestic energy bills by payment type. Available at: [Annual domestic energy bills - GOV.UK](#)

⁷ Department for Energy Security and Net Zero (2024), Annual fuel poverty statistics report: 2024, Available at: [Annual fuel poverty statistics report: 2024 - GOV.UK](#)

barriers that Ofgem refers to in the consultation document, particularly given the precedent set by levelling standard charges between pre-payment and direct debit customers.

Standing Charges review (p31)

Ofgem's position is that it believes that on balance it should not make any changes to operating costs given the potential adverse impacts on some consumers.

In our focus groups on energy Fair By Design has heard how people on low incomes feel strongly that it is unfair that the standing charge people pay bears no relation to how much energy they use, or their income/size of their property:

"The standing charge is horrendous. My tariff has gone up which is understandable but the charge just for the meter has doubled"

"It's absurd that standing charges are such a large part of bill. The whole way that energy is purchased and passed to customers is absurd"

(Quotes from focus groups held by Fair By Design and Poverty Alliance with people with lived experience of poverty in April 2023)

The latest national statistics show that for the lowest income decile a typical energy bill is £972.40⁸. The average household's standing charges equate to around 30% of that total bill. Because people on low incomes pay a higher proportion of their bill as a standing charge, because they typically use less energy, they pay the highest cost per unit, a "poverty premium", for their energy. As Ofgem has recognised, high standing charges combined with low usage means that there is very little that people can do to reduce their energy bill further.

However, Fair By Design agrees that the Government and Ofgem need to work together to address energy affordability holistically. We would like to see standing charges reduced and the fixed costs of the energy system recovered in a more progressive way but recognise that some low-income groups would be adversely affected if £20-£100 of operating costs were moved from standing charges to unit rates, without other mitigating measures.

We will continue to urge the Government to introduce a social tariff that includes addressing the unfairness of standing charges. We also look forward to the publication of Ofgem's consultation on a zero standing charge option within the price cap.

In addition, we are pleased that the proposals in this consultation will not lead to further increases in standing charges even if they will not reduce them significantly.

⁸ [Family spending workbook 1: detailed expenditure and trends - Office for National Statistics \(ons.gov.uk\)](#) (Table A6 – elec and gas x 52)

